Cuffelinks
Connecting investors with ideas

Edition 169, 19 August 2016

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10 reasons not to have a bank royal commission

Graham Hand

Last week, a Liberal Party insider told me a bank royal commission was "one major stuff-up away". While this does not fit with the denials by both the Prime Minister and the Treasurer (who said the call for a royal commission was a "populist whinge"), there is no doubt the major banks' refusal to pass on the recent 0.25% reduction in the cash rate to borrowers was fuel on the fire. The issue has become even more politically charged since the election. Regardless of the merits of CBA's $9.45 billion profit and Chief Executive Ian Narev's $12.3 million take-home pay last year, the headlines did not help the banking industry's case.

My view is that a royal commission would be counterproductive. This might come as a surprise to anyone who has read my original bank 'whistle-blower' book, Naked Among Cannibals. The sub-title was, '*What Really Happens Inside Australian Banks*.' It gave a blow-by-blow description of how banks price products and set fees, and many of the practices continue 15 years after the book was published. Notwithstanding, I set out 10 reasons why a royal commission is a bad idea.

We have included a survey at the end of this article for you to provide your opinion.

Public support for royal commission grows

Between 12 and 15 August 2016, Essential Media conducted a survey which included the question in the table below. The results suggest 64% support a royal commission, up from 59% in April 2016, and only 4% strongly oppose. Other data collected shows those most likely to support the royal commission were aged 65+ (70%) and those earning over $2,000 per week (70%).

Research on public opinion on royal commission

Question: Would you support or oppose holding a royal commission into the banking and financial services industry?

	Total	Vote Labor	Vote Lib/Nat	Vote Greens	Vote other	April 2016
Total support	**64%**	**76%**	**59%**	**71%**	**72%**	**59%**
Total oppose	**13%**	**6%**	**22%**	**8%**	**10%**	**15%**
Strongly support	28%	38%	17%	34%	33%	27%
Support	36%	38%	42%	37%	39%	32%
Oppose	9%	5%	15%	8%	7%	11%
Strongly oppose	4%	1%	7%	-	3%	4%
Don't know	23%	18%	19%	21%	18%	25%

Source: Essential Media. For details on methodology, see full report.

The politics is worsening for the banks

When Malcolm Turnbull recently called for banks to pass on the full cash rate reduction, he again reminded the banks of their social responsibility:

"They operate with a very substantial social licence and they owe it to the Australian people and their customers to explain fully and comprehensively why they have not passed on the full rate cut and they must do so."

Labor's Bill Shorten clearly thinks he's on a winner with the demand for a royal commission, hitting all the right political notes when he said:

"There is a culture in banking which puts the profits of banks, big profits, billions of dollars of profits, ahead of the national interest and interests of mum and dad mortgagees, small businesses and people with large credit card interest rate debts."

Of course, the royal commission issue is not primarily about failure to pass on the rate cut. That simply shows how every headline affecting the banks triggers the debate. The original calls were driven by the Senate Inquiry two years ago which recommended a royal commission to investigate "forgery and dishonest concealment of material facts" in the financial planning arm of CBA. That was followed by the delay or denial by CommInsure in paying out insurance claims due to tight medical definitions that played out badly on ABC television's *Four Corners.* A bank can never win an argument in the media about the definition of a heart attack while the victim lies in a sick-bed.

The election result made the likelihood of a royal commission even greater. Fairfax Media has done a headcount in the Senate and estimates that 43 of the 76 senators favour a royal commission, while the Government would control the numbers in the Lower House. However, a royal commission is an executive (cabinet) inquiry, not a parliamentary inquiry, and the government can ignore motions from either house.

Reasons a royal commission is inappropriate

While a royal commission may not even have the rate cut issue in its terms of reference, the two issues have become joined due to the community expectations and bank culture issues which have resurfaced since the election. I have previously discussed these points in this article.

Here are some arguments against a royal commission:

1. There are already enough regulators, inquiries and committees

Banking is already the most regulated industry. Global and domestic regulators set rules for most facets of the sector including liquidity, capital, maturity mismatch, loan growth and dozens of other obligations. Banks are subject to monitoring and oversight by the Australian Securities & Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA), and, to a lesser extent, the Australian Competition and Consumer Commission (ACCC) and the Reserve Bank of Australia (RBA). There are many other interested government bodies such as the Banking Ombudsman, the Credit and Investment Ombudsman and the Superannuation Complaints Tribunal. The Financial Ombudsman Service Australia (FOS) is currently under a

review with detailed Terms of Reference on the dispute resolution and complaint framework for the financial system.

The Financial System Inquiry reported on 7 December 2014 and the Government released its response on 20 October 2015. A Senate Inquiry into the performance of ASIC spent considerable resources investigating financial advice, and especially Commonwealth Financial Planning. The Future of Financial Advice (FoFA) legislation has been argued and changed and debated for at least the past five years. Allegations of misconduct by CommInsure led to intense public scrutiny. The Productivity Commission is studying the costs and benefits of vertically integrated financial advice, and bank CEOs are now required to appear before the House of Representatives Economic Committee each year to answer questions over a wide range of topics.

No doubt there are others, but the fact is that many senior executives spend their careers bouncing from one crisis, public review, regulator meeting or enquiry to another. Policy or regulatory changes can be imposed on the banks without a royal commission.

This week, Moody's Investors Services reaffirmed Australia's Aaa sovereign issuer rating, stating: "Australia's monetary policy and banking regulation and supervision are vigilant and responsive to economic and financial conditions."

2. Banks have many stakeholders and can't keep everyone happy

Much of the discussion about bank 'stakeholders' revolves around the trade-offs between depositors, borrowers and shareholders. Other stakeholders include the government, the community and even staff. It's a fine balancing act every time a bank makes a major decision.

The most vocal defence of banks in face of recent criticisms came from CBA's Narev at his profit announcement. One of his slides was headed, "Depositors and shareholders fund our lending to borrowers", and he noted that CBA has over 11 million deposit customers and only 1.9 million home loan borrowers. CBA has 800,000 shareholders, and almost every adult with any form of superannuation would have exposure to the major banks. The banks comprise about 30% of all shares listed on the ASX. The one million SMSF trustees have a particularly heavy weighting to Australian equities and banks. Millions of Australians depend on the dividends from the banks, with over $4 billion paid annually to households by CBA alone. It is the country's largest taxpayer and employs around 45,000 staff, while it contracts services from over 6000 small- and medium-sized businesses.

There is also an argument that, with far more depositors than borrowers, there is a stimulatory impact on the economy from higher deposit rates, whereas low mortgage rates receive all the media attention. Mike Hirst, the Chief Executive of second-tier Bendigo and Adelaide Bank, emphasised the need for his bank to remain competitive on deposits as they rely far more on domestic funding sources, with less ability to issue in global bond markets.

3. An exercise in bank bashing

Daily news stories of banks mistreating people does not help confidence and stability in our financial system, where the banks hold prime position. In an industry managing the money of 20 million customers, there will inevitably be those that should have been treated better, and victims are always eager to tell their stories. The GFC showed how fragile the banking system can be, and a regular news feed undermines trust in the banks even more.

4. The majority of customers are satisfied with their bank

While banks cop a lot of public criticism (I've voiced more than my share), Roy Morgan Research reports consumer banking satisfaction is close to an all-time high, and certainly far higher than levels a decade ago. While banks cop a lot of public criticism (and I've voiced more than my share), Roy Morgan Research reports consumer banking satisfaction is close to an all-time high, and certainly far higher than levels a decade ago. While there will always be performance issues such as delays reaching call centres, the customer interaction experience in branches, internet, mobile, and telephone services is better than it has ever been.

5. Bank profits may have already peaked

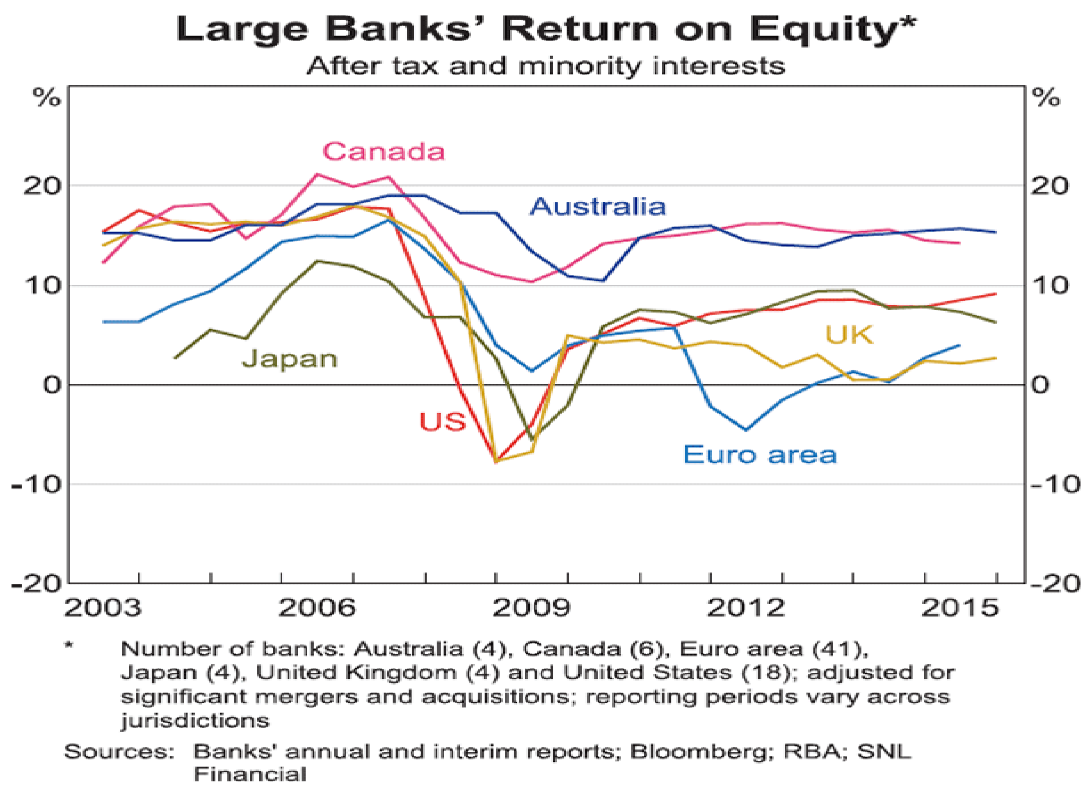
Most bank share prices have fallen in the past 12 months as the market realises the golden days for bank profits are probably over. The regulatory requirement to hold more capital and liquidity, the passing of the low

point in the cycle of bad and doubtful debts, the increasing competition for loans and deposits, and the gradually rising threat of fintech, especially in payments systems, all weigh on the sector's outlook.

Recent bank profit results were mediocre. CBA's full year rise disguised second half weaknesses, while ANZ's cash profit fell in the last quarter. As banks struggle in coming years to hold their dividends and profits, it's likely that claims of greed will become less vociferous. Having said that, it would clearly help if CEOs were not paid 153 times average weekly earnings. But the claims of 'greedy banks' may be more difficult to sustain as profits steady or fall.

6. A strong economy needs strong banks

As the table below shows, Australian banks are among the world's most profitable, especially since the GFC of 2008. This is a double-edged sword: during times of economic stress it's important to have strong banks that earn good profits to maintain their capital, but at what point has it gone too far? I believed when I wrote my book that in recovering from the recession of 1991, the bank culture went too far in promoting profit and shareholders at the expense of other stakeholders. I still see many examples of bank activities that should embarrass its executives, but a royal commission would do little to change that.



Source: Reserve Bank Bulletin, March 2016.

7. Vague notions of what a royal commission is trying to achieve

We know banks can be bastards, but we don't need a royal commission to tell us that.

There is nothing resembling a terms of reference to let the public know what questions will be addressed. Bill Shorten has talked about vertical integration, whistle blower protection and remuneration structures, but these are issues already being addressed. Do we really want the satisfaction of a bruised and battered industry disliked by even more people and a range of recommendations about changing corporate culture? Do we want arrogant CEOs humiliated in public, like the George Pells of business? Do we seriously think most of the public will understand the complexities of banking and how decisions are made? The vast majority of people do not have a clue what bank capital adequacy is and the implications of tighter rules.

Inside the banks, they would steadfastly go about considering the needs of all their stakeholders, and would be just as likely not to pass on a full rate cut as they are now. As bank profits struggle, there may even be more of a community desire for banks to remain strong and well-capitalised, and maintain their dividends, as pass on a rate cut.

8. It would be expensive and last for years

Initial estimates for the cost of a royal commission are $50 million over at least two years. While that is not a large number in the scheme of things, little more than four times Ian Narev's remuneration last year, the far higher cost would be within the banks themselves. Consider the inquiry into Commonwealth Financial Planning: the project management and investigation has required a team of over 600 people and tens of millions of dollars in expenses. Of course, CBA and CFP have a case to answer and brought many of these issues on themselves, but a royal commission would absorb incredible resources and management time when there is a major business to manage.

9. The recommendations may be bad for economic growth

Following two years of sad customer stories and revelations of bad culture, the only way a royal commission could create change is by introducing a new set of rules and regulations.

What might they look like? New taxes on banks, limits on credit growth, government bureaucrats involved in decision-making, formal controls over deposit and lending rates, directions to lend to certain industries, instructions on how to allocate resources? It could go anywhere.

And when these decisions are placed in the hands of the government rather than competitive forces (even in a strong oligopoly), unregulated industries prosper outside the banks. Taxpayers take the losses on inappropriate loans done for political purposes. Interest rates are set so that banks cannot attract deposits and loans are not priced properly. Bank money is used to prop up failing industries. When access to credit is compromised, business is stifled and good projects lost.

Many of these measures would limit economic growth. The banks already claim that ongoing political and public criticism reduces foreign investors' appetite to invest here. The banking system is the plumbing through which the economy functions. Block the plumbing and we're all in a mess.

10. Like democracy, what's a better alternative?

The banking system and the banks are far from perfect, but it's like the Westminster System and democracy. As Winston Churchill said: "Democracy is the worst form of government, except all those others that have been tried." Be careful what we wish for.

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How good a guide is guidance?

Roger Montgomery

How often have we read or heard that a listed company has missed guidance? Ahead of the upcoming 2016 reporting season, I have been thinking about whether guidance is helpful or not and have been encouraged by recent developments.

Putting aside the persistent presence of selective briefings, 'inadvertent' disclosures and other avenues through which company information is disseminated unequally, the idea of dispensing with guidance is one that more companies should consider, and not only when the economic or market outlook is particularly obscure.

Short-term trading is not investing

The shortening of time horizons among professional investors in the United States has been occurring for decades and is a function of the corruption of what investing actually is. Professional investors now destabilise markets, not through buying and selling based on changes of opinion about the outlook for a business or its value, but simply by attempting to anticipate its short-term price movements and reacting more quickly than others.

John Maynard Keynes observed this devolution in 1936:

"Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from 100 photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole ... It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be."

It seems little has changed, and if anything, the situation has become much worse. Sitting in our investment committee meetings I am constantly surprised by the obsession of others with short-term earnings. In the US, a company that misses quarterly guidance or expectations is savaged, as if the change in the rate of growth over the prior 12 weeks signals a permanent end to its fortunes. Conversely, a company that beats its quarterly guidance is heralded as the new growth stock and its shares priced as if the rate experienced over the last 90 days will continue indefinitely.

Little thought, it appears, is paid to the possibility that the company was always going to report the number it ultimately did, and that the guidance might have been set so it could be beaten.

Corruption of strategic visions

Hillary Clinton, in a speech a year ago at New York University, proclaimed, *"It's time to break free of the tyranny of quarterly capitalism."* She's onto something. Pressure from recently minted analysts, who have never run a business, to have their earnings models and estimates validated by corporate CEOs and CFOs is an obvious case of the tail wagging the dog. It also corrupts a company's strategic decision-making by prioritising the short-term needs of a bunch of disloyal gamblers over the long-term valuation creation requirements of investor-owners.

Investing has been corrupted by the focus on betting on rising share prices. A company that meets or beats guidance is likely to experience a huge bounce and academic studies showing stocks 'outperform' over the three, four or five subsequent days after a 'positive surprise' only fuels the fire of the addicts, reinforcing the gambling and speculative behaviour and reducing the stock market to a casino.

Lost along the way has been the understanding that the stock market is a venue through which investors can share in the wealth created by the compounding of profitably reinvested retained profits.

Turning point

It seems, however, that July 2016 might mark a turning point. In a carefully worded open letter, the chiefs of America's largest corporations and investment managers, including Warren Buffett, Jamie Dimon, Jeff Immelt, Larry Fink and others representing Blackrock, Vanguard, General Motors, T.Rowe Price and State Street Global Advisors, outlined a series of common-sense corporate governance principals such as:

"Our financial markets have become too obsessed with quarterly earnings forecasts. Companies should not feel obligated to provide earnings guidance – and should only do so if they believe that providing such guidance is beneficial to shareholders."

Expanding on the above summary, the full document recommends: *"Companies should frame their required quarterly reporting in the broader context of their articulated strategy and provide an outlook, as appropriate, for trends and metrics that reflect progress [or not] on long-term goals. Companies should determine whether providing earnings guidance for shareholders does more harm than good. If a company does provide earnings guidance, it should be realistic and avoid inflated projections. Making short-term decisions to beat guidance [or any performance benchmark] is likely to be value destructive in the long run."*

There is little doubt that when a company's management announces a forecast, and some weeks out it becomes obvious it won't meet the target, there is a very great temptation to find the difference, perhaps borrowing it from the future or even worse, borrowing it from thin air. Removing temptation is clearly superior.

There can be little doubt that the future of Australia, its employees and investors, depends on the effective management of business and companies for long-term prosperity.

The recent evidence that corporate payout ratios for Australia's top 200 companies have increased from 55% in 2010 to nearly 80% today (leaving just 20% of earnings retained and reinvested for growth), says a great deal

about our nation's growth prospects as well as the serious need to think beyond next quarter and the analyst community's desire for short-term earnings certainty.

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Re-contributions another victim of Budget proposals

Peter Hogan

Re-contribution strategies are widely-used to minimise the impact of the so-called 'death tax' on death benefit lump sums paid to adult children of deceased superannuation members. Unfortunately, it could be a casualty of the proposed new rules for non-concessional contributions contained in the Federal Budget.

Whether or not the Government intended to deliberately affect those who implemented this strategy by restricting their future access to non-concessional contributions, this would be the result if those proposed changes became law.

The proposal to limit the non-concessional contribution cap to a lifetime $500,000 can be seen for what it is – a need to shut down people contributing millions of after-tax dollars into the tax-effective superannuation environment.

So what is the context of this re-contribution strategy, how has it been used in the past and how do the proposed changes impact those who have adopted it?

The core purpose of superannuation

A core purpose of superannuation is to provide benefits to members in their retirement. These benefits when received are either not taxed at all if the recipient is 60 or over, or very concessionally taxed if under 60.

Notwithstanding this core purpose and while they are alive, members can also choose not to take any sort of benefit from their super arrangement and leave their account balance in accumulation phase indefinitely.

Payments on death of a member

Another core purpose is the payment of benefits on the death of a member to their legal personal representative or dependants. Unlike when a member is alive, however, regulations require the death benefit be paid as soon as possible after death.

The taxation of the benefit, which must be paid in these circumstances, will depend on who the death benefit is paid to, and the type of death benefit allowable depends on who the recipient is:

a) Payments to death benefit dependants

Lump-sum death benefits paid to a surviving spouse, child under 18, someone in an interdependent relationship or financially dependent on the deceased, are tax-free. Death benefit pensions are also payable to these dependants and are either tax free or concessionally taxed.

b) Death benefits paid to other dependants such as adult children

For adult children of the deceased, the options are more limited in terms of benefits payable and the taxation of those benefits. Only death benefit lump sums can be paid to these individuals under superannuation and tax rules. Pensions cannot be paid to adult children of the deceased member, except in limited circumstances and only for limited periods of time.

This is mainly to prevent successive generations passing on entitlements to pensions to the next generation, regardless of their age or retirement status. In this scenario, if allowed, adult children of the deceased would receive a tax effective or even tax-free pension prior to their normal retirement age, and the underlying investment income derived from the assets supporting the pension would be tax free within their fund.

The legislative response

By only allowing adult children to receive a lump sum death benefit, the deceased member's account balance is forced out of the superannuation system, short-circuiting the pension in perpetuity strategy. The only way for this money to find its way back into the super system is by way of a contribution by the adult children. These contributions are limited by caps and access to account balances is also limited until a later condition of release has been met. There are, however, consequences in limiting the benefits payable to adult children.

The death tax

Death benefit lump sums paid to adult children are subject to a flat tax rate of 15% plus the Medicare levy on the taxable component of the lump sum. All attempts to lobby successive governments to change this tax treatment, often dubbed the 'hidden superannuation death tax', have failed, to the point that it is not generally accepted as an item for discussion at all.

So if politicians and bureaucrats won't talk about it, how can advisers, whether they are accountants, financial planners, lawyers or administrators, help to mitigate the impact of this tax?

Strategy from advisers to increase the tax-free component

The most common response to date has been to reduce the taxable component of the death benefit lump sum (the amount subject to tax at 15% plus the Medicare levy).

For many years, both before and after the change in the calculation of the components of superannuation entitlements from 1 July 2007, common strategies have included:

a) re-contribution, which involves cashing out superannuation entitlements from unrestricted non-preserved components, paying any tax applicable, if at all, then using these proceeds to make a non-concessional contribution back into the super arrangement, or

b) simply making large non-concessional contributions from sources outside superannuation into the member's super account.

Both strategies have successfully increased the tax-free component of the contributing member's account balance and reduced the taxable part. Hence, the impact of the tax on death benefit lump sums paid to adult children has been minimised. The strategies were accepted by the ATO as legitimate for tax planning.

This was done in good faith by members of all types of super arrangements in an environment where non-concessional contribution caps were initially set at $150,000 per year with the ability to contribute up to three years' worth ($450,000) at any time in a three-year period. More recently, this was increased to $180,000 per year or $540,000 in a three-year period.

The new problem

The consequences of the Government's decision to count non-concessional contributions made as part of the re-contribution strategy described in example (a) above from 1 July 2007 against the new lifetime cap, appears to have not been considered.

These non-concessional contributions have not been funded from large non-superannuation resources, but from existing saved super entitlements, which have been recycled to improve the tax consequences of certain death benefits. They have not substantially increased the account balances of the members who have undertaken these strategies. In fact, the account balances in some instances have been reduced by the lump sum tax paid on the benefits withdrawn before being re-contributed.

Unintended or not?

It is not possible to know whether this was an intended consequence of the Budget announcements or not. Discussions have centred around large non-concessional contributions made prior to Budget night that have substantially increased member account balances.

If nothing else, it highlights the complexity of amending superannuation legislation in Australia, where a change in policy and subsequent amendment of relevant legislation can have a wider-than-expected impact on the actions of people acting appropriately and legally when saving for their retirement.

It also draws into question the ongoing use of the re-contribution strategy as a means of minimising the impact of the tax on death benefit lumps sums paid to adult children of deceased members. It may even provide an unexpected windfall in tax collected on death benefit payments made in these circumstances.

Peter Hogan is Head of Technical, SMSF Association. This article is general information and does not consider the specific needs of any individual.

Australia's mid-caps are fertile territory

Michelle Lopez

The ASX is one of the largest 15 stock markets in the world, with a market capitalisation of $1.5 trillion. What investors might not be aware of, however, is how top-heavy it is. The largest 20 stocks account for 60% of the S&P/ASX300 Index, while financial and mining companies comprise more than two-thirds of the top 20. Banks and miners dominate the local market.

These companies are facing challenging times. Banks are now required to retain more capital on their books, crimping credit growth and putting pressure on returns. At the same time, interest rates are on a downward trend, which has negative impact on their margins. Additionally, they will need to set aside more money in provisions for bad debts, which can only rise from historic lows. All this will cut into their profitability.

Meanwhile, mining companies are being hurt by the decline in commodity prices and a slowdown in the economic growth of China, Australia's largest trading partner.

Greater investment options

This makes a strong case for investing in the mid- and small-cap companies that comprise the remaining 40% of the ASX and that derives its earnings from more varied sources. This diversity is important, because you don't want all your stocks exposed to the same growth drivers, nor do you want your returns to be highly correlated.

Once you exclude the top 20 stocks, as the table below demonstrates, the weighting of financial companies falls from 59% to 24%, making it far more balanced and diversified.

Sector breakdown for ASX300 ex-20

Sector	Top 20	ASX300 ex-20
Financials	58.8%	24.2%
Materials	10.9%	19.2%
Consumer Staples	9.2%	4.3%
Telecommunication Services	8.0%	1.8%
Industrials	5.2%	13.2%
Healthcare	5.8%	8.4%
Energy	2.3%	6.7%
Information Technology	--	3.1%
Utilities	--	6.1%
Consumer Discretionary	--	13.1%

Source: Aberdeen Asset Management

If we consider mid-caps alone, they generally have more developed governance and risk frameworks than small companies, their cash flows are more stable and replicable, and their share prices less volatile.

Still, defining what constitutes a mid-cap company is not an exact science. A good starting point is the S&P/ASX Midcap 50 Index, which comprises all stocks listed on the S&P/ASX 100 excluding the top 50 – in other words, numbers 51 to 100. But this is a narrow definition, and fund managers tend to have their own interpretations. At Aberdeen, we think of mid-caps more broadly as future leaders in their sectors with the right foundations to become the next blue chips: it's more about potential than position in an index.

This potential is reflected in their returns. Over the past five years, the ASX Mid-Cap 50 Index has consistently outperformed the larger ASX100, 200 and 300 ex-20 indexes.

Performance of large cap vs mid cap

	S&P/ ASX Mid Cap 50	**S&P/ ASX 100**	S&P ASX 200	S&P/ASX 300 ex20
1 Year	10.03	-2.95	-2.38	7.58
3 Years (p.a.)	15.51	7.73	7.71	11.33
5 Years (p.a.)	9.45	7.93	7.54	7.33

Source: Aberdeen Asset Management, 31 May 2016

Reasons mid-caps may outperform

There are a number of reasons for this.

Firstly, mid-caps have more capacity to grow than blue chips, which are constrained by their size in the sectors they already dominate. Average growth in earnings per share for companies in the S&P/ASX300 ex-20 is forecast to be 14.9% over the next 12 months and 9.4% for the following year, versus 7.05% and 8.9% for the S&P/ASX200 Index, according to Bloomberg data.

Secondly, mid-caps have greater flexibility to disrupt the industries they operate in. For example, NIB Holdings, which offers low-cost health insurance products, is competing against market leaders Bupa and Medibank Private. Its comparative nimbleness and lack of bureaucracy allows it to make quick decisions, enabling it to deliver above-average growth consistently. NIB is also diversifying into new markets.

Thirdly, compared to small companies, mid-caps have greater access to capital to drive their expansion. It means they can gain more exposure to larger and/or faster-growing economies, reducing their dependence on domestic earnings. A good example of this is in the health-care sector. Cochlear, Ramsay Healthcare, ResMed and Fisher & Paykel Healthcare are all mid-caps that derive a strong proportion of their earnings outside Australia.

Cochlear makes implants for the hearing impaired. Initially it focused on infants domestically but has since broken into the market for adults and now sells products in more than 100 countries, becoming a global leader in its field.

Similarly, Fisher & Paykel Healthcare, which designs and manufactures products to treat sleep-disordered breathing conditions, has innovated constantly to extend its range of equipment. In a world of rising obesity levels, it now sells its systems in more than 120 countries.

Be wary of sector titles

As an active manager, the sector a company operates in is not a factor in our investment decision-making. We want to understand if a business can generate returns in excess of its cost of capital. Having said that, we are mindful of avoiding overlapping exposures in our portfolio and we prefer to invest in industries with strong tailwinds.

While we take a company-by-company approach, generally we see industrials as asset-intensive and carrying significant amounts of debt, so we are underweight. Aurizon and Asciano, for example, are leveraged to trading volumes driven by mining and agriculture, creating cash-flow uncertainty.

At the same time, some sector titles are misleading. Consumer discretionary firms, which provide non-essential goods and services such as entertainment and leisure, make up 13% of the ex-20 index. Because they deal in discretionary goods, demand tends to fluctuate. However, Invocare is a mid-cap in this sector that provides funeral services, and we don't see them as discretionary at all. In a similar vein, wagering and lotteries operator Tatts Group has produced consistent cash flows across investment cycles.

It is this diversity that makes mid-caps such a fertile ground for active managers to find value. They have a wider dispersion of returns than blue chips and offer greater opportunities to uncover mispricing.

These companies don't have the inherent bias that comes with large index weightings, or the volatility of the smaller end of the market. There's a lot to like about them. They're not too big and not too small, just right, as Goldilocks might say.

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Banks take political heat to preserve margins and deposits

Stephen Mickenbecker

The Reserve Bank's decision this month to reduce Australia's official cash rate by 0.25% to an historic low of 1.50% is an unexpected boon to savers, unlike other rate cuts since 2011. Three of the Big 4 banks and some smaller institutions have increased one-, two- and three-year term deposit rates by up to 60 basis points (0.60%) to rates where savers are now ahead on their cash savings after tax and inflation.

To fund these increases, banks have passed on between only 10–14 basis points to mortgage-holders.

What's behind the move?

The decision by the Big 4 is not surprising in retrospect given the pressures of regulatory reform and global funding markets, both now and coming soon.

Regulatory reform is perhaps the most significant pressure. Under Basel 3, banks are required to hold highly liquid assets equal to or greater than net cash outflow over 30 days. The Australian Prudential Regulation Authority's (APRA's) Liquidity Coverage Ratio (LCR) framework was fully implemented in Australia on 1 January 2015, after APRA determined that Australia did not need the extended phase-in period that lasts until 2019 in some other countries. Those banks that are larger and more complex with respect to their liquidity risk are subject to the LCR in Australia.

Banks are required to hold low-yielding assets (e.g. government bonds) against deposits and wholesale funding that have a maturity of less than 30 days, making deposits with a maturity *greater* than 30 days more attractive. Hence the introduction (albeit slow) of notice accounts that require 31 days' notice to withdraw, and the toughening up by the banks of rules regarding early breaks of a term deposit. Term deposits are becoming more attractive to the banks, leading to an upwards re-pricing.

Strategy decided in advance

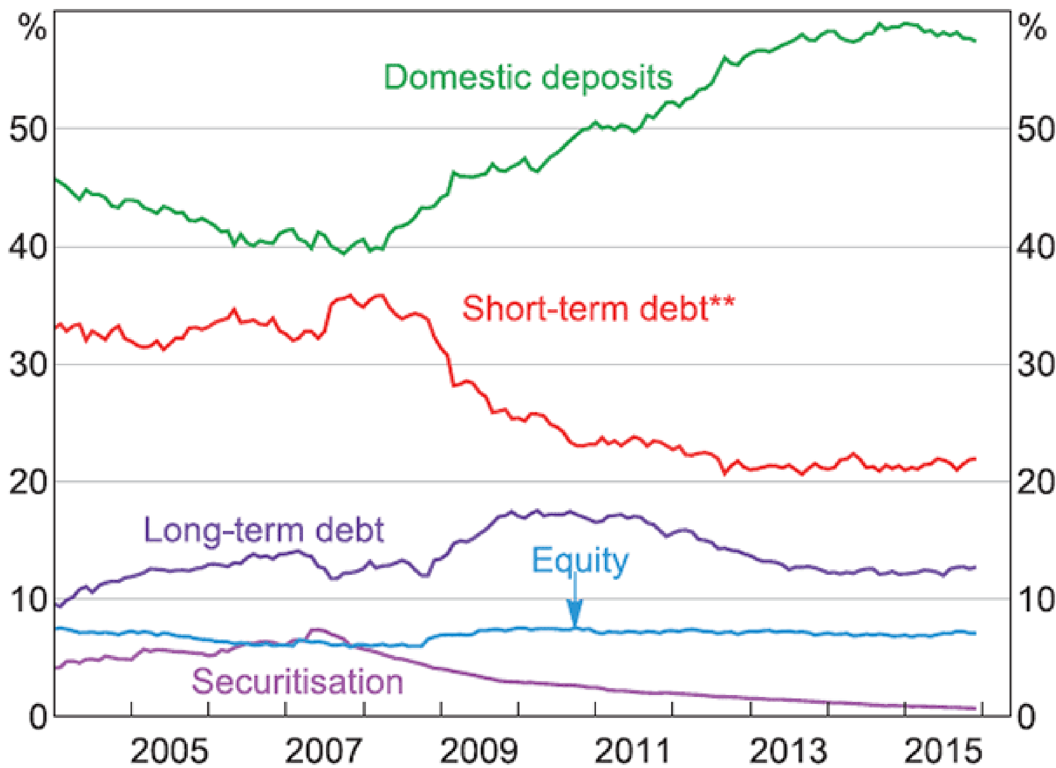
Judging by the speed with which the majors announced their rate decisions, ANZ, Commonwealth Bank and Westpac had planned and costed this strategy in advance. The banks are obviously protecting margins while establishing a funding mechanism for competitive two- and three-year fixed rate loans that are quarantined from the variable rate book. The same can be said on the funding side, but higher rates on term deposits are not passing through to their whole deposit base (for example existing term deposits until maturity, at-call bonus and online savers, and shorter-term term deposits). A significant majority of investors are looking for an investment term of 12 months or less, according to analysis of more than 100,000 visitors to the CANSTAR term deposit comparison tables so far this year. This latest move is likely to change that as investors chase the higher return, which is another good reason for consumers not to opt for the lazy rollover option.

Big 4 term deposit rate increases in longer-term rates

Maturity	ANZ		CBA		NAB		WPAC	
	Old	New	Old	New	Old	New	Old	New
3 month	2.25	1.75	2.35	1.90	2.25	1.75	2.35	2.00
6 month	2.30	1.75	1.90	1.90	2.35	2.00	2.40	2.00
12 month	2.40	3.00	2.35	3.00	2.40	2.40	2.45	3.00
2 year	2.45	3.20	2.50	3.10	2.65	2.65	2.65	3.10
3 year	2.50	2.50	2.60	3.20	2.70	2.70	2.65	3.20

Source: canstar.com.au. Interest rates at maturity, based on a $25,000 deposit. CommBank interest rates above are not effective until 19th August.

Term deposit rates are far less supercharged either politically or with media commentators, and banks can make moves without creating waves. Increasing domestic deposits also results in a reduced reliance on wholesale funding.



* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

Sourced from http://www.rba.gov.au/publications/bulletin/2016/mar/3.html

Competition will significantly increase

The actions of the large banks to increase their domestic deposit reserves puts significant pressure on the smaller banking players, who are more reliant on term deposits to fund their home loan bases.

Canstar market share analysis shows that the aggregate of top and second tier bank term deposit balances is less than 16% of their aggregate home loans. Smaller institutions' reliance on term deposits to fund their balance sheet is, in most cases, double that and more. The smaller institutions therefore have much to lose

and will be obliged to stay competitive in this space and raise their one to three-year term deposit rates accordingly. Indeed, this is already happening, with more than a dozen smaller players matching or exceeding the 12-month rates of the Big 4, while some have moved on 2 and 3-year rates.

Highest 12-month term deposit rates

Institution	% paid at maturity
Gateway Credit Union	3.11%
Bank of Qld	3.05%
ING DIRECT	3.05%
Big Sky	3.01%
ANZ	3.00%
Bank of Melbourne	3.00%
Bank SA	3.00%
Bankwest	3.00%
Commonwealth Bank	3.00%
Community First Credit Union	3.00%
MyState	3.00%
Newcastle Permanent	3.00%
St George	3.00%
The Mutual	3.00%
The Rock	3.00%
Westpac	3.00%

Source: CANSTAR. Based on a deposit amount of $50,000, as at 14 August 2016.

Tellingly, of the 54 financial institutions in our database that have reduced standard variable home loan rates so far this month, only six have passed the full 25 basis points through to borrowers. Protecting deposit market share appears to be the primary focus right now. Keep an eye out for possible out-of-cycle home loan increases by the smaller institutions over the next year as margin pressures bite. This will be aggravated by maturities in the existing book rolling into higher rates.

Overall, the cash rate is simply a signalling mechanism that flows through to other rates in the economy. This time it has not flowed through fully on the housing front, which both the RBA and APRA may quietly welcome, and has instead, for the first time in many years, provided welcome relief for savers.

Stephen Mickenbecker is the Group Executive, Ratings and Financial Services, at CANSTAR.

Advice may be the silver bullet on the super battlefield

Jeremy Duffield

This is the fifth in a series of articles highlighting the leadership attributes that can help superannuation industry executives move from the industry's historical focus on accumulation to whole-of-life with an emphasis on retirement income provision.

In the battle to retain super fund members into retirement, advice is the key weapon. And First State Super's (FSS) acquisition of financial planning firm StatePlus for about $1 billion is a clarion call to this new super fund battlefield. By buying a well-respected financial planning provider, FSS signalled that advice is of paramount

importance for leading super funds. If leadership means 'taking a stand and acting on something you believe in', this move shows advice is critical to serving members and keeping them into retirement phase.

Higher satisfaction levels

Other funds have increasingly stated the importance of advice in their plans. Advised investors, on the whole, benefit from savings, investment and insurance advice through better outcomes, and generally report higher levels of satisfaction.

These efforts seem to be paying off as, anecdotally at least. Funds that make strong financial planning efforts appear to have much better member retention rates into retirement and more success particularly with higher-balance members.

But many funds have only a basic financial planning offer, provided more as an add-on service, not a core component. And the numbers from Comparator show just how modest the overall impact is: industry-wide, only 2% of members reportedly receive financial advice from their super fund each year.

Industry, and other profit-for-member funds, were once labelled the 'sleeping giant' of the advice business and it's long been suspected that industry and retail funds would converge through more similar advice offers. Surely, the giant is waking up.

Strategic imperative and strategic decisions

If there's a clear strategic imperative for fund executives to build advice capabilities, it's not quite as clear how to do it. Executives face a number of strategic questions and opportunities:

a. **Distribute through independent financial planners?** In the post FOFA fee-for-service world, the competitive pricing and performance of profit-for-member funds should place them in a strong position to compete with retail funds in distribution through independent financial planners. This is dependent on them being able to master the arcane requirements of third-party distribution, build a brand, and match the service proposition of retail funds.

b. **Introduce external planners to serve members?** A number of funds, such as AustralianSuper and Sunsuper, have headed down this path by developing panels of independent financial advisers to extend the services available to members. The challenge of course is to not lose the member in the process.

c. **Build internal planning capability?** Many funds such as Unisuper have ramped up internal capability by hiring a team of planners, with all the licensing, management and business process challenges that involves. Smaller funds may struggle to get the economies of scale and efficiency needed to offer a first-class effort, but larger funds may be able to do it with a significant investment.

d. **Reach the mass of members?** This requires adopting a much broader focus than traditional advice approaches. The economics of financial planning delivery means that only high balance members can be served through traditional telephone or face-to-face processes. The costs per statement of advice are too high to provide advice to the mass membership. Retail firms often talk about the costs of advice being $2000-$3000 per client. Even straightforward intra-fund telephone advice can cost hundreds of dollars to deliver. Those economics aren't supported by the typical balances of industry fund members.

The role of digital advice in reaching a larger audience

Leaders look at trends and what is happening in other industries for a competitive edge, and digital advice has the potential to be the 'game-changer'. Using the toolkit of digital disruption changes the economics of advice delivery and opens up access to advice for all members at low costs.

Digital advice enables personalised experiences, both financial and behavioural. Digital approaches can engage the client in an ongoing journey, which makes the experience personalised, on demand (24X7), 'in my living room' or anywhere else. Digital advice need not be transactional based only on one-time statements of advice. It can guide. It can educate. It can provide motivation and personalised communications as needed.

And it can coexist with traditional human forms of advice. Effective triage is an essential part of strong digital advice offers. At times, people need the validation provided by another human being; at times, advice requirements are just beyond today's digital solutions.

The US industry has been leading the way. While often referred to as robo advice, that catchy title doesn't capture the variety of digitally based solutions currently available. Often overlooked in articles about US robo advice is Financial Engines, the 'granddaddy' of online retirement advice services companies. This pioneer, founded by Nobel Laureate Bill Sharpe, has for 20 years offered online retirement forecasts, advice and managed accounts to members of US defined contribution (401(k)) plans. Financial Engines currently provides advice to millions of members, with assets under advice exceeding $A1,300 billion, and investments in managed discretionary accounts of more than $A160 billion. It is the largest independent investment adviser in the US.

Others in the US are focusing on hybrid solutions. A major trend is using technology to make human advisers more efficient and allowing the interaction between consumer and adviser to be more interactive and integrated, so the customer can decide when to obtain advice online and when to call a human adviser.

In conclusion, advice will become a key battlefield for funds serving their members into retirement. As most funds don't have a billion to spare to buy existing capability and need better ways to reach the mass membership with ongoing advice, digital advice is the most promising solution.

Jeremy Duffield is Co-Founder of SuperEd. See www.supered.com.au. He was the Managing Director and Founder of Vanguard Investments Australia, and he retired as Chairman in 2010.

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