Firstlinks
Connecting investors with ideas

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Why good investing is like a healthy diet

Graham Hand

Every investor should think in advance how they are likely to react to a shock impact on their portfolio. For example, it's often the investors who sell after a market fall who suffer the worst performance. Part of the assessment is understanding the 'factors' which adversely certain types of assets.

Here's a useful way to think about factors and portfolio risks, and it comes from a text book that has become a standard in many investment courses.

Think of assets like foods

Over the recent holidays, I skimmed through Andrew Ang's seminal book, *Asset Management.* I say 'skimmed' because it's 700 pages of technical analysis, subtitled, *'A systemic approach to factor investing'.* I've met Ang a couple of times, and he's a friendly and highly approachable business school professor and consultant to a range of sovereign wealth and pension funds.

It was in the skimming that I found a fascinating idea which will help anyone better understand investing and their portfolio risks.

It's simple: assets are just like foods.

Invest for the bad times

Ang says the two most important words in investing are *bad times*. Optimal portfolio allocation requires investors to take account of how their portfolio and themselves will react in bad times. The long-term returns on assets are compensation for taking the risks that will occur in these bad times.

Ang believes we should focus not on the assets in our portfolios, but on their exposure to underlying risk factors. It is the factors which drive returns.

Factors include interest rates, economic conditions, macro trends, inflation and exposure to different investment styles such as value, growth or momentum. Each asset has a different risk due to exposure to these factors.

For example, a fund manager might hold a portfolio of 1,000 carefully selected stocks, but if they are highly-correlated individual bets in a value-oriented investment style, they become one large bet on a single factor. As Ang says:

"An equity manager going long 1,000 value-oriented stocks and underweighting 1,000 growth stocks does not have 1,000 separate bets; he has one big bet on the value-growth factor."

He has an analogy in farming:

"A farmer, for example, may certainly be able to select a farm with the best soil and conditions for planting (farm security selection). But if there's a severe drought, having chosen the best farm is not going to help (rain is the factor)."

And so starts the fascinating food comparison.

Factors are to assets what nutrients are to food

The table below from the US Food and Nutrition Board recommends intakes of five macronutrients – water, carbohydrates, protein, fibre and fat – for the average male, female and child. Certain foods deliver the nutrients we need, such as protein from meat and fibre from wheat and rice. Some foods contain more than one nutrient.

Depending on our health and lifestyle, we have different nutrient requirements, and the underlying nutrients deliver the sustenance we need.

In the same way, while we invest in assets, it is the underlying risk factors which determine the returns. The factors are like nutrients. For example, in the table below, our bodies benefit from protein in the same way our returns might benefit from a rising stockmarket or falling inflation.

Nutrients and food

Macronutrients				
	Male	*Female*	*Child*	*Examples of Food*
Water	3.7 L/day	2.7 L/day	1.7 L/day	
Carbohydrates	130 g/day	130 g/day	130 g/day	Bread, Beans, Potato Rice
Protein	56 g/day	46 g/day	19 g/day	Cheese, Milk, Fish, Soya bean
Fiber	38 g/day	25 g/day	25 g/day	Peas, Wheat, Rice
Fat	20 – 35% of calories		25 – 35% of calories	Oily fish, Peanuts, Animal fat

Source: Food and Nutritrion Board, National Academies, 2004.

The comparison between food and assets

Andrew Ang draws out three similarities:

1. Factors matter, not assets (nutrients matter, not food)

People could lead a healthy life gaining all their nutrients from boring, tasteless products grown in a laboratory. Similarly, it's the factors affecting the assets that are important for returns, and investors should look beyond the assets to the factors.

2. Assets are bundles of factors (foods are made up of bundles of nutrients)

Some foods contain only one type of nutrient, such as rice and carbohydrate, but most contain many nutrients. Water is considered both a food and a nutrient. Similarly, some factors such as equities or government bonds are factors in themselves, while others such as corporate bonds or hedge funds might contain different types of factor risks, such as volatility, credit and interest rate risk.

Volatility is a factor which can be damaging in bad times, but for those prepared to embrace it in good times, it can deliver exceptional returns.

3. Different investors need different risk factors

We eat differently and invest differently. Some long-term investors can expose their portfolios to leveraged equity risks as they can tolerate fluctuations in their portfolio values that most find unacceptable. Similarly, some athletes eat large amounts of protein and carbs to feed their energy requirements. No one diet of nutrients or factors suits everyone.

And I'll add a fourth:

4. Factors and nutrients can be good and bad

Ang says nutrients are inherently good, but too much of almost anything can be unhealthy. A certain level of fat is beneficial but too much can be bad.

Factor risks are bad, and enduring the poor consequences is rewarded by better returns. Bad times for factors and investments include low economic growth, high inflation and falling stock markets.

And much like the sum of all the nutrients we absorb determines our level of health, so the assets we own deliver factors which behave not in isolation but in relation to all the other factors we own.

A balanced portfolio as defined for most investors

While it is possible for a government department to make recommendations on diet, the same level of scientific integrity does not apply to investing universally. The appropriate portfolio differs for everyone, based on many factors such as goals, risk appetite, age and financial resources. There is no one meal fits all.

However, there are some principles common to all good investment plans, such as diversifying risk, starting early and saving consistently. Employees who do not make an explicit investment choice for their superannuation are usually placed into a MySuper fund, which has a default asset allocation selected by an experienced fund manager supported by an investment committee.

Like a recommended diet, the asset allocation for all MySuper funds is shown in the table below. While this allocation may not suit a retiree who values capital preservation before earnings maximisation, it is a recommended diet of factors to suit most people who are saving at an earlier stage of their lives.

It mainly includes growth assets - perhaps the meat and other protein in a diet - but with some defensive protection - perhaps like a good helping of vegetables.

In the same way that nutrients determine the benefits in a diet, so a better appreciation of risk comes from knowing the factor exposure of an investment portfolio. What would be the impact of a rise in rates, a fall in equities, a swing from value to growth or a widening of credit spreads? Look through to the factor exposures that matter.

MySuper funds

Characteristics	Amount ($billion)	%
Cash	29	4
Australian fixed interest	98	13
International fixed interest	70	9
Australian listed shares	157	20
Listed property	17	2
Unlisted property	56	7
International shares	219	28
Infrastructure	59	8
Hedge funds	0	0
Unlisted equity	41	5
Other	26	3
	778	**100**

Source: APRA September quarter 2019.
*Number of MySuper products: 97, 35 lifecycle.

Food for thought

In the same way you might balance your diet with an intake of the different nutrients you need, so you should select assets based on the underlying factors.

And while you might enjoy the beer and chips and pizza in the good times, in the same way a surging equity market is fun while it lasts, it's the consequences in the 'bad times' which determine the long-term health of investment returns. Is your portfolio fit for a healthy lifestyle?

Graham Hand is Managing Editor of Firstlinks. Andrew Ang's 'Asset Management' is published by Oxford University Press.

How do your financial priorities stack up with our pyramid?

Christine Benz

The U.S. Department of Agriculture's food pyramid, designed to help set healthy dietary priorities, debuted in 1992, urged us to indulge sparingly in fats. Meanwhile, bring on the carbs: pasta, rice, bread, and cereal made up the bottom of the pyramid graphic, with a recommended six to 11 servings per day.

Oopsie. Dietary scientists eventually determined that eating a lot of refined carbs isn't that good for us after all, so the original pyramid was replaced with another, more confusing-looking pyramid in 2005. The revised pyramid showed fruits and vegetables on a near-equal scale alongside grains.

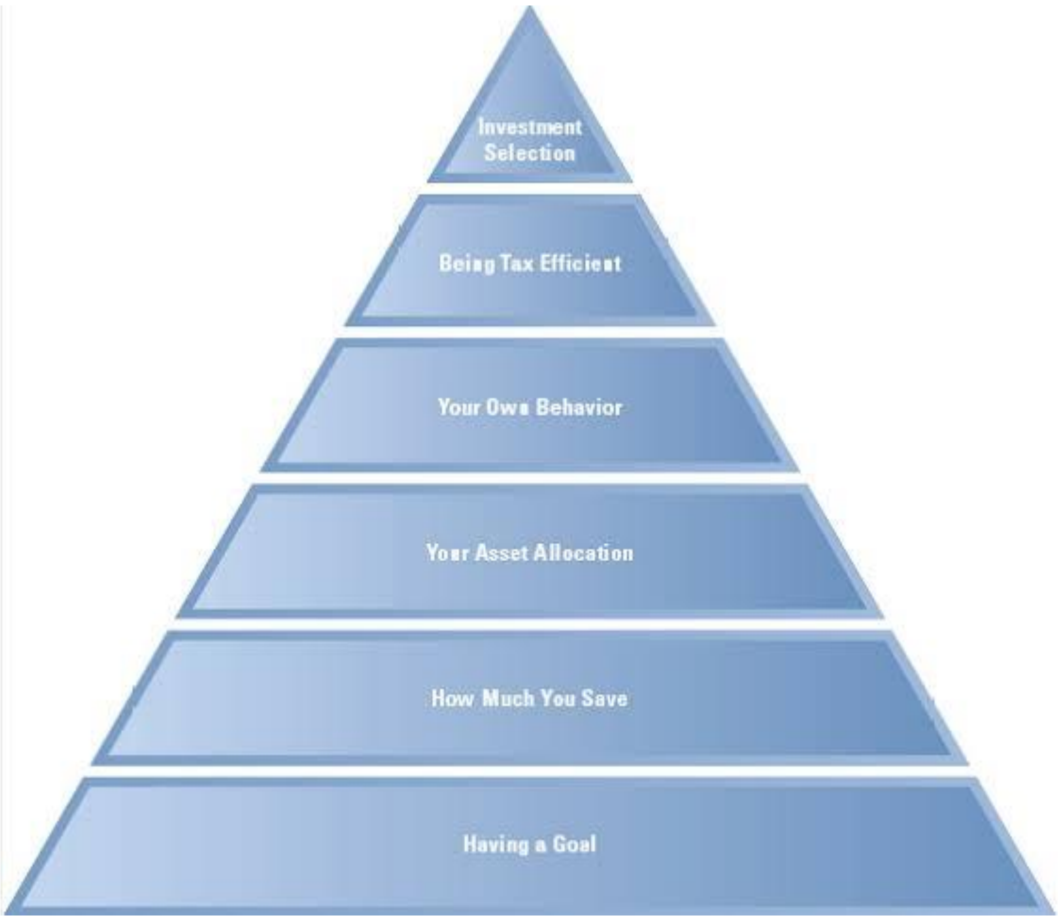
Alas, in 2011 the pyramid was scrapped altogether in favor of a square food plate called MyPlate. Vegetables take up more than one fourth of the MyPlate plate, followed by smaller portions of grains, protein, fruit, and dairy.

A guide to allocating time and resources

Yet even though the USDA abandoned the pyramid as an image to help set dietary priorities, it's still a useful shape to convey how to allocate your time and resources, including when you're investing. At the bottom of the pyramid are the activities that you should spend the most time and energy on because they have the biggest impact on your results. They're the equivalent of broccoli and brown rice. Meanwhile, at the top are tasks that, though worthwhile, will have a smaller impact on your bottom line.

The following investment pyramid can help guide priorities for new investors. It can also assist in keeping more experienced investors on the right track. After all, the more you know, the more likely you are to geek out about small matters such as whether to own a high-yield exchange-traded fund or an actively managed fund. In so doing, it's possible you'll lose sight of game-changers such as your saving and spending rates and your total asset allocation.

Here's a look at the investment pyramid I would propose, ranging from what should be investors' top priorities - the base of the pyramid - to the least important ones.



The pyramid's base: setting your financial goals

You know how it is when you don't start a day with a to-do list? You get buffeted around by whatever comes up. Phone calls, answering emails, chatting with colleagues about favorite childhood candy bars, and whoops – how on earth did it get to be 11:20 already?

Managing your finances without first articulating your near- and long-term goals is similar. Rather than operating with the amorphous goal of 'wealth accumulation', take a step back and articulate the specifics of what you're trying to achieve, when you'll need the money, and how much.

Paying the full freight for college for each of your kids? Retirement while you're still young enough to enjoy it? A move to a bigger house within the next five years? By quantifying each of your financial goals, you may see that it's not going to be possible to achieve them all, but it's better to know that early on so you can prioritise. And each of those goals likely carries its own time horizon, which in turn will dictate what types of investments you hold and where.

The next band: managing your saving and spending

Budgeting is boring, which is why it's easy to give short shrift to it in favor of sexier pursuits such as trading stocks. But even if you select the very best investments, you'll be hard-pressed to make up for a shortfall if you haven't saved enough.

This is key to ensure that your savings rate puts you on track to achieve the above-mentioned goals. This concept matters long after you've stopped saving, too. Retirees are obsessed with the topic of spending rates and for good reason. The difference between a 4% and a 6% withdrawal rate can be enormous when it comes to the viability of a retirement plan. Being able to adjust one's spending rate – especially downward in times of market duress – has also emerged as a best practice in the realm of retirement portfolio management because it helps a retiree avoid turning paper losses into real ones.

The next band: choosing your asset allocation

There's near-universal consensus among market practitioners that the asset-allocation mix you choose matters. A lot. A portfolio that consists entirely of cash and short-term bonds will exhibit very few fluctuations, which can provide peace of mind and may be appropriate for very short-term goals. Over time, however, it will get eaten alive by a portfolio that includes a stock component.

Specific recommendations about asset allocation will vary by adviser and financial services company, but the basic rules of the road should hold you in good stead during your investing career. For your long-term goals, start heavy with stocks, then gradually shift more into safer securities as your need for the money draws near. And be careful not to gorge on niche investments such as gold and emerging-markets stocks, whose returns are sometimes explosive but so is their downside potential. Diversify reasonably among the core asset classes – high-quality stocks, high-quality bonds, and cash – and you'll be OK. Setting an asset allocation in retirement is a bit more complicated than asset allocation in the years leading up to retirement.

The next band: managing your own behavior

Even if you've gone to the trouble of creating a well-allocated portfolio, none of it is going to matter if you freak out and retreat to cash in times of turmoil. Many financial advisers say one of their most important contributions to their clients' financial well-being is to help them manage their emotions and stick with their plans through good and bad market environments. It's important to identify and manage your own potential behavioral hang-ups, such as a tendency to be too risk-averse for your life stage or to have more confidence in your investing abilities than is warranted.

The next band: managing for tax efficiency

Paying attention to tax efficiency encompasses a very broad and important set of issues, including taking advantage of tax-advantaged superannuation accounts, using low turnover stock funds, proper asset location, and employing tax-efficient withdrawal strategies during retirement. In fact, tax-efficient decision-making is one of the key factors that add value in the financial planning process.

The top: making investment selections

Ta-da! We're finally at the top of the pyramid and on to the fun stuff - investment selection. Its placement here shouldn't indicate that picking securities is not important. Needless to say, we at Morningstar think there's a big difference between investing with a high-quality fund than a C-list fund, and that investors will be better off buying a wide-moat stock that has a Morningstar Rating of 5 stars than one with no moat and a high valuation.

Rather, investment selection appears at the top because it needs to be informed by the factors beneath it in the pyramid. It's not always the case that tax considerations will trump your investment selection, but taxes should be an input in what securities you choose, as should your allocation needs, your expectations for the investment (having the right expectations should ameliorate bad behavior), and the rest of your financial plan.

Once those factors point the way toward a certain category of investments, you can then look at fees, management, and other investment-specific hallmarks of quality. And if you have little time left once you've made it to the top of the pyramid, you can reasonably skimp on investment selection by opting for a portfolio that consists of inexpensive index funds.

Christine Benz is Morningstar's director of personal finance and author of 30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances and the Morningstar Guide to Mutual Funds: 5-Star Strategies for Success. This article does not consider the circumstances of any investor, and minor editing has been made to the original US version for an Australian audience.

Authorities reveal disquiet over LIC fees

Graham Hand

The ethical and business dilemmas about whether financial advisers should accept 'selling fees' from fund managers took a dramatic twist last week with the release of documents under a Freedom of Information (FOI) request. Although the internal memos from the regulator, ASIC, are not released publicly on their website, they are available on request following the FOI inquiry by *The Australian Financial Review*.

We have written extensively on this subject, such as here, as it is crucial for the future success of Listed Investment Company (LIC) and Listed Investment Trust (LIT) issuance. Investors have pumped $4 billion a year into the sector in the last two years, and so settling the debate has major implications for thousands of investors, especially those whose investments are guided by a financial adviser.

It's a fact that it is impossible to raise a billion dollars in a month for a relatively unknown fund manager without paying selling fees (officially, 'stamping fees') to financial advisers and brokers. In the wake of the Royal Commission and the industry's new Code of Ethics, the advice industry must answer the question:

Why would an adviser put clients into a new LIC or LIT when there are hundreds of similar choices readily available if not for the incentive of earning the selling fee?

The 'made things and provided services' exemption

The FOI release (a zip file of emails and documents) shows the regulator feels the scope for conflicted advice is amplified by section 7.7A 12B of the Corporations Act, which allows financial advisers to collect a stamping fee. The most telling section comes from Anna Dawson, Senior Specialist, Financial Advisers at ASIC, who says:

*"The initial carve-out was given because of an argument that companies would not be able to raise capital. The carve-out was restricted to companies that '**made things and provided services**' – hence investment companies were excluded unless they were investing in infrastructure, so, **the initial carve-out for stamping fees did not apply to LICs and REITs**."* (my emphasis)

This is a fascinating revelation. The carve-out from FoFA which has encouraged billions of dollars of LICs and LITs to be issued was not initially available.

And here's the sting in the tale, as ASIC continues:

"ASIC was consulted on the 'streamlining' package which extended the stamping fee carve-out by including investment companies. In December 2013, ASIC wrote to Treasury again opposing the expansion of the carve-out for the following reasons …

*Broadening the exemption will **expand the scope for conflicted advice and corresponding consumer detriment**. It will also cause an undesirable market distortion by preventing conflicted advice in the secondary* *market (transfer acquisitions) but **permitting conflicted advice** for the whole primary market (issue acquisitions). From a consumer protection perspective, we do not see any policy rational for this distinction.*

*We are also concerned that any broadening of the exemption will lead to arguments by other industry sectors that they have been put at a competitive disadvantage by the uneven playing field that the exemption creates. **Subsequent relaxing of the FoFA reforms will inevitably lead to consumer detriment**." (*my emphasis*)*

So what happened? ASIC's advice was ignored under intense lobbying from sections of the financial services industry which benefit from allowing advisers to receive selling fees.

Why do the businesses that rely more on unlisted funds, including many of the major platforms, not object to this special treatment which allows a competitor product (in the listed market) a special ability to pay a fee to an adviser?

In Item 20 from the ASIC file, this time written by David Dworjanyn, Senior Specialist (Legal & Policy), Markets, ASIC, he says:

"The poor performance of the majority of these funds don't justify the fee structure generally and it makes me question any advice to go into these products, particularly at the issuance stage."

Meetings between ASIC and Treasury

It's also fascinating to see how many resources Treasury and ASIC have devoted to this problem. The emails include detailed analysis of the LIC and LIT market. The email below shows David Dworjanyn copying 10 people into the analysis on stamping fees in August 2019.

From:	David Dworjanyn
Sent:	Monday, 5 August 2019 3:04 PM
To:	Hallyburton, Stephen; Pai, Neena; Moore, Ruth; Storer, Aidan; kate.o'rourke@treasury.gov.au; Quinlivan, Ciaron
Cc:	Calissa Aldridge; William He; Kate Metz; Anna Dawson
Subject:	RE: ASIC/Treasury meeting re LICs [DLM=Sensitive]
Attachments:	Review of LICs and LITs and Stamping Fees Aug 2019.pptx

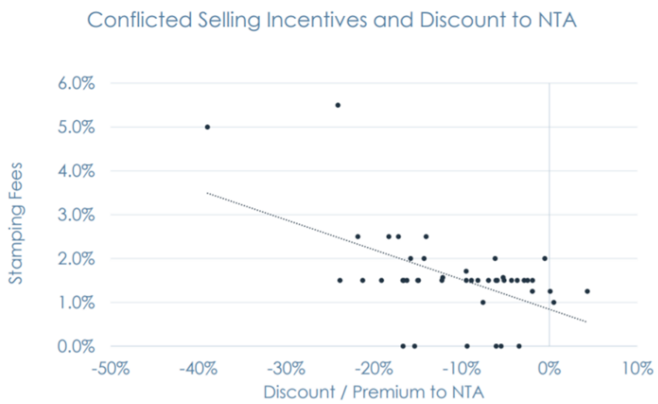
Dear all

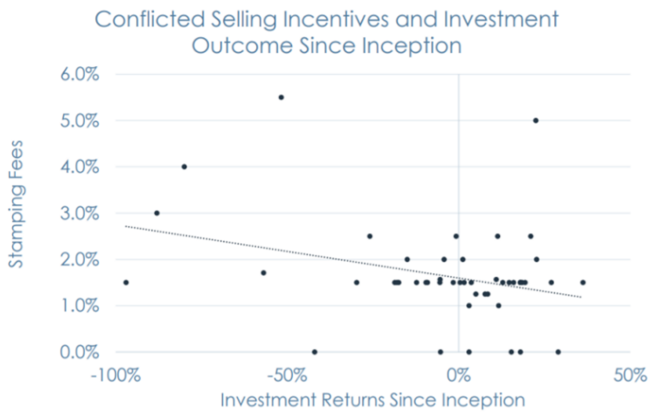
Please find attached a slide presentation of the analysis of LIC and LIT issuances since the beginning of 2015. There is no particular sensitivity in the document as we have compiled information that is generally available. The key findings are:

- **Poor performance** of LICs and LITs: a significant proportion had negative returns (including two delisted due to fraud). Overall -6.1% cumulative since inception, -6.3% for recent year.
- **Large discounts to NTA**, averaging -10.7%. 42 out of 48 LICs and LITs issuances since 2015 trade at discount to NTA.
- **Higher management fees** charged by LICs and LITs than ETFs and ETMFs, while significantly underperforming on average.
- **Conflicted selling incentive,** 42 out of 48 LICs and LITs issuances since 2015 involved stamping fees (selling fees paid to the broker or advisor that are directly proportional to the volume sold)
- Higher stamping (selling) fees for LICs and LITs are **correlated with worse investment returns and bigger discount to NTA**
- LICs and LITs with **stamping (selling) fees underperform** LICs and LITs without stamping (selling) fees on average

However, these results are not as clear cut as ASIC suggests. For example, some of the LICs that did not pay fees were not new issues, but rather, LICs involved in some internal restructuring that did not involve funding. Furthermore, analysis of LIC prices is fraught as discounts and premiums change almost daily, and prices are affected by modest amounts of supply and demand.

Nevertheless, regulator opinion of the market is shown by the following charts included in the presentation referred to above. They indicate the higher the stamping fee, i) the greater the discount to NTA and ii) the worse the investment outcome.





With the dispute on adviser selling fees growing in the media, Treasurer Josh Frydenberg recently wrote to ASIC saying:

"I am sure you share my concern that ASIC's analysis revealed some correlation between higher stamping fees and underperforming LICs. Can you please provide me with details as to how ASIC is monitoring LICs and other investments to which the stamping fees exemption applies to ensure that the interests of consumers are not being compromised."

Advisers don't know how much will be issued

The float of a company that 'made things and provided services' differs from an investment company. When a company such as Afterpay or Xero is floated, there is a set amount of stock available, valuing the floated company at a specific price. There is often a scramble for the limited supply.

With a LIC or LIT, the fund manager can accept every dollar offered and then simply buy more assets. There is an enormous incentive to 'back up the truck', as L1 Capital did with its $1.3 billion raise and KKR did with its $925 million issue. Both then struggled in the secondary market under the weight of supply and traded at discounts to NTA.

Yet financial advisers and brokers put $2 billion into these two issues, readily accepting the selling fees, even after the originally-advised minimum transaction amounts were massively exceeded, with the inevitable oversupply issues

How can an advice licensee assessing whether an adviser's action was motivated by the selling fee argue that a LIC or LIT that trades at a discount is in the best interests of the client?

What is the relevance for investors?

Many SMSFs and more sophisticated retail investors assemble their portfolios using ASX-listed investments, and Exchange-Traded Funds (ETFs) have now reached $60 billion, while LICs and LITs are about $50 billion.

But there's a difference between the two. Demand for ETFs is primarily driven by cheap and easy access to index exposure, with many funds available for less than 10 basis points (0.1%). ETF providers devote considerable resources to investor education rather than paying promotional fees to financial advisers and brokers (there are no stamping fees paid on ETFs).

How can LICs and LITs compete with such low fees? Some such as Magellan rely on the long-term reputation of the manager, with a direct client base built over a decade of success, engagement and marketing effort. But new managers have none of this, so they pay selling fees to advisers to promote their products. From the manager's perspective, this is fair enough as it pays the adviser for their distribution.

Without the selling fees, many of these transactions simply will not come to market. Advisers will have no more incentive to promote them to clients than the hundreds of unlisted funds they could sell any day of the week.

If the latest review by ASIC and Treasury, and the ethical questions raised by FASEA's Code of Ethics, lead to a change in treatment of selling fees, then ETFs will receive a boost, and investors and advisers may need to focus more on unlisted funds.

Graham Hand is Managing Editor of Firstlinks. This article does not consider the circumstances of any investor.

1 January is a moment of truth for the wealth industry

Paul Heath

For investors who poured $925 million into the listed KKR Credit Income Fund (ASX:KKC) during October 2019, the opening weeks of trading would have provided a sobering insight into the pitfalls of a Listed Investment Trust (LIT) structure.

The experience also highlighted an important ethical question for the wealth advice industry to answer.

KKC upsized the deal to $925 million following a flood of demand, but since listing, the shares have consistently traded below the $2.50 issue price. And when the shares sank to $2.43, the decline in capital value had eaten into nearly half of the expected total annual income return.

Problem of trading at a discount

One of the major challenges of a LIT structure is that the underlying shares can trade away from the value of the units in the trust. Occasionally, the shares trade at a premium to the underlying value, but of the 114 Listed Investment Company (LICs) and LITs trading on the ASX at the time of writing, 72% trade at a discount to Net Tangible Asset (NTA) value. The average discount is 12.6%.

While there is always a risk of capital loss when investing, the possibility of a discount to NTA amplifies that risk significantly.

The risk of variance to NTA is just one of the pitfalls of investing via a LIC/LIT structure. Another major risk for investors is the lack of liquidity. In the first three weeks of listing, only around 3% of KKC changed hands. The total value of KKC bid for in the market at time of writing is a mere $270,000. The harsh reality of a LIT such as KKC is that even if an investor decided to exit their investment, it will be difficult to sell volume without driving the price down further.

The toxic pairing of a discount to NTA and a lack of liquidity is a value-destroying combination that is unique to LIC and LIT structures.

Why do so many investors line up to participate?

Depending on the specific LIC/LIT, there can be a variety of reasons for the massive demand. However, our view is that a loophole in FoFA regulations that allows fund managers to pay incentives to advisers who sell LICs and LITs to their clients is a major contributor.

Under the 2012 Future of Financial Advice (FoFA) regulatory reforms, fund managers are banned from paying sales commissions to advisers who sell their products. But in 2014, listed funds were exempted from this rule, and the extent to which that exemption has been exploited is eye-popping. Nearly $45 billion of capital is now invested in LICs and LITs, mostly on behalf of mum and dad investors.

And advisers are being paid lucrative incentives, called 'stamping fees' by fund managers, to sell their clients these funds. Initially these structures were used to buy portfolios of listed shares, similar to a managed fund. However more recently, as in the case of KKC, the structures have been used to acquire portfolios of unlisted, high yield, fixed income securities that are more difficult to value. We can now add another risk into the mix: opaqueness.

There are several more similar strategies queued up to come to market in 2020.

Can an adviser be impartial when paid to sell a product?

Good advice is always important, and that importance is only increasing as the risks keep rising. The key question to consider is how can an adviser who is receiving a significant fee for selling a product be in a position to offer good, impartial advice to their client? The truth is, they can't.

As Kenneth Hayne noted in his final report of the recent Royal Commission,

"Experience shows that conflicts between duty and interest can seldom be managed; self-interest will almost always trump duty."

The advice industry in Australia has evolved around the idea that it is acceptable for an adviser to have an interest that is in conflict with the interests of their client. There has been a view that the conflicts could be adequately managed, or adequately disclosed. The case studies of the Royal Commission graphically revealed why the current situation cannot be allowed to continue.

We have taken a public position against the exploitation of the stamping fee loophole. You can read the article we published (*There Are Still Dangerous Loopholes In Financial Advice Rules*) on the topic earlier this year here.

Good advice means conflict-free advice. We took a stand that we would only accept fees that were paid by our clients to ensure our advice would never be compromised.

A shift in what is acceptable

Importantly, conventional wisdom is slowly shifting for the better. The Financial Adviser Standards and Ethical Authority (FASEA) Code of Ethics came into force on 1 January 2020, and Standard 3 states:

"You must not advise, refer or act in any other manner where you have a conflict of interest or duty."

The guidance notes attached to the Code specifically call out stamping fees on Initial Public Offerings. However the disciplinary body charged with monitoring and enforcing adviser's adherence to the code has not yet been established. Whilst ASIC has provided relief for the requirement that advisers are registered with a compliance scheme, they have also stated that:

"AFS licensees will still be required to take reasonable steps to ensure that their financial advisers comply with the code from 1 January 2020, and advisers will still be obliged to comply with the code from that date onwards. ASIC may take enforcement action where it receives breach reports."

So it is at this point that we reach the fundamental ethical question for the industry.

We know where the regulator stands on this issue. Will fund managers follow the lead of Magellan and voluntarily call time on the practice of paying lucrative incentives to advisers to place private investors into risky structures? Will advisers voluntarily call time on accepting fees that compromise the advice they give to the clients who trust them?

Or will the industry continue to exploit the loophole before it finally closes?

1 January 2020 is a moment of truth for the wealth advice industry. How the industry responds will say a great deal about integrity and intent.

Paul Heath is a Founding Partner and Chief Executive Officer at Koda Capital. This article is general information and does not consider the circumstances of any individual.

A crisis of underinsurance threatens to scar rural Australia

Chloe Lucas, Christine Eriksen and David Bowman

Australia is in the midst of a bushfire crisis that will affect local communities for years, if not permanently, due to a national crisis of underinsurance.

Already more than 1,500 homes have been destroyed – with months still to go in the bushfire season. Compare this to 2009, when Victoria's "Black Saturday" fires claimed more than 2,000 homes in February, or 1983, when the "Ash Wednesday" fires destroyed about 2,400 homes in Victoria and South Australia, also in February.

The 2020 fire season could end up surpassing these tragedies, despite the lessons learned and improvements in preparedness.

One lesson not really learned, though, is that home insurance is rarely sufficient to enable recovery. The evidence is many people losing their homes will find themselves unable to rebuild, due to lack of insurance.

We know this from interviews with those affected by the October 2013 Blue Mountains bushfires (in which almost 200 homes were destroyed). Despite past disasters, more than 65% of households affected were underinsured.

Research published by the Victorian government in 2017, meanwhile, estimated just 46% of Victorian households have enough insurance to recover from a disaster, with 28% underinsured and 26% having no insurance.

The consequences aren't just personal. They potentially harm local communities permanently, as those unable to rebuild move away. Communities lose the vital knowledge and social networks that make them resilient to disaster.

Miscalculating rebuilding costs

All too often the disaster of having your home and possessions razed by fire is followed by the disaster of realising by how much you are underinsured.

As researchers into the impact of fires, we are interested why people find themselves underinsured. Our research, which includes interviewing those who have have lost their homes, shows it is complicated, and not necessarily due to negligence.

For example, a woman who lost her home in Kinglake, northeast of Melbourne, in the 2009 fires, told us how her insurance calculations turned out to bear no resemblance to the actual cost of rebuilding.

"You think okay, this is what I paid for the property," she said. "I think we had about $550,000 on the house, and the contents was maybe $120,000." It was on these estimates that she and her partner took out insurance. She told us:

"You think sure, yeah, I can rebuild my life with that much money. But nowhere near. Not even close. We wound up with a $700,000 mortgage at the end of rebuilding."

An extra mortgage

A common issue is that people insure based on their home's market value. But rebuilding is often more expensive.

For one thing there's the need to comply with new building codes, which have been improved to ensure buildings take into account their potential exposure to bushfire. This is likely to increase costs by 20% or more, but is rarely made clear to insurance customers.

Construction costs also often spike following disasters, due to extra demand for building services and materials.

A further contributing factor is that banks can claim insurance payments to pay off mortgages, meaning the only way to rebuild is by taking out another mortgage.

"People who owned houses, any money that was owing, everything was taken back to the bank before they could do anything else," said a former shop owner from Whittlesea, (about 30km west of Kinglake and also severely hit by the 2009 fires).

This meant, once banks were paid, people had nothing left to restart.

She told us:

"People came into the shop and cried on my shoulder, and I cried with them. I helped them all I could there. That's probably why we lost the business, because how can you ask people to pay when they've got nothing?"

Undermining social cohesion

In rural areas there is often a shortage of rental properties. Insurance companies generally only cover rent for 12 months, which is not enough time to rebuild. For families forced to relocate, moving back can feel disruptive to their recovery.

Underinsurance significantly increases the chances those who lose their homes will move away and never return – hampering social recovery and resilience. Residents that cannot afford to rebuild will sell their property, with "tree changers" the most likely buyers.

Communities not only lose residents with local knowledge and important skills but also social cohesion. Research in both Australia and the United States suggested this can leave those communities less prepared for future disasters.

This is because a sense of community is vital to individuals' willingness and ability to prepare for and act in a threat situation. A confidence that others will weigh in to help in turn increases people's confidence and ability to prepare and act.

In Whittlesea, for example, residents reported a change in their sense of community cohesion after the Black Saturday fires. "The newer people coming in," one interviewee told us, "aren't invested like the older people are in the community."

Australia is one of the few wealthy countries that heavily relies on insurance markets for recovery from disasters. But the evidence suggests this is an increasingly fraught strategy, particularly when rural communities also have to cope with the reality of more intense and frequent extreme weather events.

If communities are to recover from bushfires, the nation cannot put its trust in individual insurance policies. What's required is national policy reform to ensure effective disaster preparedness and recovery for all.

The Conversation

Chloe Lucas, Postdoctoral Research Fellow, Geography and Spatial Sciences, University of Tasmania; Christine Eriksen, Senior Lecturer in Geography and Sustainable Communities, University of Wollongong, and David Bowman, Professor of Pyrogeography and Fire Science, University of Tasmania

Headwinds and tailwinds, a decade in review

Hugh Dive

Investing in equities is a long game, with share prices in the short-term influenced by market emotions, forced selling and Trump tweets – factors that often have little to do with a company's profits and growth prospects. However over the longer term, companies that reward their patient shareholders with a higher share price are those that grow earnings and navigate their way through the issues that markets, regulators and customers throw at them.

The last decade has generally been kind to investors in Australian equities with the ASX200 up by 130%. This week, we check how the market has fared since 2009, along with the key themes that have influenced the share market during this period.

Setting the scene

December 2009 was a bleak time for investors. While the ASX200 had recovered from its low in February 2009, investor confidence remained fragile. The Babcock and Brown group of companies had just gone into administration and Centro was looking shaky. Over the course of 2009, ASX-listed companies had raised a record $70 billion in hurried rights issues and placements to shore up company balance sheets, placating the banking wolves howling at their doors. The 2009 financial reporting year was one to forget with companies delivering weaker profits and writing down the value of assets acquired in the heady days before the GFC.

Key factors and foundations

While management teams can grow earnings via expanding into new markets, taking market share from competitors and making acquisitions (or selling unprofitable businesses), external factors over which a company's management has no control such as exchange rates, commodity prices and interest rates often have the biggest impact on a company's profits and thus share prices.

Over the past decade, the Australian dollar declined to US$0.68 after peaking at US$1.10 in 2011. The decline steadily boosted the earnings of companies such as CSL (+885%), Amcor (+266%) and Sonic Healthcare (+154%), all of which derive most of their profits from operations outside Australia.

Similarly, the steady decline in interest rates over the past decade has reduced interest costs for all Australian companies, increasing profits after tax. In January 2010, the benchmark Australian Government 10-year bond rate was 5.7%, but it finished the decade at a low of 1.29%. Borrowers saw the standard variable mortgage rate decline from 6.9% to 3.3%. On a $700,000 loan, this reduced monthly payments from $4,900 to $3,430. While falling interest rates saw Australian credit growth increase from 0% to 12% by 2016, over the past four years, credit growth has fallen to 3-4%. High levels of household debt and tighter bank lending standards discourages additional borrowing, despite further rate cuts.

NAB's Chairman Phil Chronican Noted in November 2019 that the RBA's rate cuts were not achieving their goal of stimulating the Australian economy. He saw that when interest rates were cut, NAB's borrowers were not reducing their monthly payments to spend on consumer goods, but were maintaining their monthly repayment to pay down their loan faster.

Conversely, savers such as retirees living off term deposits – who are likely to spend all of their interest income – now faced reduced cash flows. Thus, the fall in interest rates over the past decade appears to have resulted in a wealth transfer between savers who would otherwise be spending their interest income, to reducing the debts outstanding for borrowers. This transfer has affected a minimal positive impact on the economy.

Factor	Total Return last 10 years	Notes
Australian Dollar vs United States Dollar Spot	-25%	Trending downwards
Iron Ore (USD/MT) - Daily	-9%	Very volatile
WTI Spot	-14%	Stable until 2014, then down
Gold	30%	Trending upwards
Aus 10 Yr Bond Rate	-78%	Trending downwards

The falling oil price over the past decade provided a consistent headwind for Woodside (+11%), Origin Energy (-12%) and Santos (-13%). However, decisions by Santos and Origin to spend tens of billions on competing LNG export plants at Gladstone in Queensland when the oil price was over US$100 per barrel (now US$60) weighed on their share prices. The development of US shale gas in the early part of the decade changed the USA – previously one of the largest oil importers – to a nation that is now exporting energy globally. This damaged OPEC's capacity to manipulate the global oil price and has revitalised US manufacturing, now powered by cheap US energy.

The leaders of today aren't always the leaders of the future

The below table looks at how the ASX Top 50 stocks in December 2009 have performed over the past decade. Particularly striking is the distribution of the table, with only 17 of the Top 50 stocks outperforming the ASX200, and the bulk of the Top 50 underperforming.

The index has been driven by companies that were either quite small in 2010 such as Magellan (+884%) or were still a twinkle in their founder's eyes, such as Afterpay. About 10% of the ASX Top 50 from December 2009 did not get a chance to shine over the full 10 years as they were taken over by mostly foreign buyers. Generally, this was good news for Australian shareholders as Japan Post and SAB Miller clearly overpaid for their acquisitions of Toll and Fosters respectively, with both companies subsequently writing down the value of the transport and beer assets by billions. Though overpaying for ASX-listed companies is not solely the province of foreigners, AMP's $4.15 billion bid for AXA Asia Pacific in 2011 was a poor move.

ASX Top 50 Companies December 2009

Company	Total Return last 10 years	Notes
CSL Limited	885%	Star perfomer of the decade
Spark New Zealand	298%	
Macquarie Group Ltd	269%	
Transurban Group	266%	
Amcor PLC	266%	
Fortescue Metals Grp	218%	
Qantas Airways	211%	
ASX Limited	204%	
GPT Group	185%	
Insurance Australia	178%	
Lendlease Group	169%	
Wesfarmers Limited	166%	
Brambles Limited	158%	
Sonic Healthcare	154%	
Crown Resorts Ltd	136%	
Suncorp Group Ltd	134%	
Commonwealth Bank.	130%	
S&P/ASX 200 Acc	**129%**	
Twenty-First FOX Inc	128%	Moved listing to US 2014
AGL Energy Limited.	124%	
TABCORP Holdings Ltd	101%	
ANZ Banking Grp Ltd	91%	
Computershare Ltd	89%	
Woolworths Group Ltd	86%	
Stockland	85%	
Telstra Corporation.	81%	
Rio Tinto Limited	81%	
Westpac Banking Corp	79%	
Novion Property Grp	69%	Now Vicinity Centres
National Aust. Bank	62%	
Oil Search Ltd	54%	
Foster's Group	50%	Taken over SAB Miller 2011
Coca-Cola Amatil	49%	
Westfield Group	47%	
BHP Group Limited	42%	
Intoll Group	42%	Taken over CPP 2010
Lihir Gold Limited	39%	Taken over Newcrest 2011
Incitec Pivot	36%	
Orica Limited	30%	
Toll Holdings Ltd	27%	Taken over Japan Post 2015
Cimic Group Ltd	25%	
AXA Asia Pacific	15%	Taken over by AMP 2011
BlueScope Steel Ltd	13%	
Woodside Petroleum	11%	
Origin Energy	-12%	
Santos Ltd	-13%	
Newcrest Mining	-14%	
QBE Insurance Group	-16%	
Worley Limited	-21%	
AMP Limited	-29%	
OneSteel/Arrium	-100%	Administration 2016

Source: IRESS

Top performers on the ASX

The key themes among the leaders are companies that have **grown earnings** (CSL, Fortescue, Sonic Healthcare), benefited from falling interest rates (Transurban, GPT), and have enjoyed a tailwind from a **falling Australian dollar** (Amcor, Macquarie). The fall in the oil price has dramatically improved Qantas' business model, transforming the company from one needing to raise capital to stay afloat to one that consistently conducts share buy-backs.

Bringing up the rear

Steelmaker Onesteel/Arrium is the worst performing stock in the Top 50 over the past decade with the company going into administration in 2016. The steel company's long steel manufacturing operations and significant investment in some small high-cost iron ore mines in South Australia resulted in climbing debts and mounting losses.

However, several household names have also had a decade to forget. AMP (-29%) suffered due to a poor acquisition in AXA, along with rough treatment in the 2018 Royal Commission that raises questions about its long-term viability. While QBE Insurance (-16%) has been a better performer over the past few years, for most of the 2010s, management has been dealing with the hangover of an acquisition spree that saw QBE grow via acquisition into one of the Top 10 global insurers. Unfamiliar areas of business resulted in large profit downgrades before foreign business units were sold.

Among the Big 4 major banks, Commonwealth Bank (+130%) is the pick, although this result matches the ASX200. The Bank avoided offshore adventures that caused pain for NAB and ANZ's shareholders. Against a background of falling credit growth, rising compliance costs and newly aggressive regulators levying heavy fines, ANZ (+91%) NAB (+62%) and Westpac (+79%) have all returned less than the ASX200 over the past decade.

Our final take

The 130% return over the 2010s equates to a compound growth rate of 8.7% per annum, around the average for Australian equities since 1900. One of the biggest issues that all investors face is the relentless noise and news flow that often obscures the long-term trends for company earnings.

What is clear from reflecting on the past decade is that companies that have successfully increased their share price over the long term require both astute management teams, but also some help from underlying economic trends outside of the company's control. While top-performing companies such as CSL, Macquarie Bank and Amcor have all made successful acquisitions and grown their existing operations, they have also all enjoyed support from the tailwinds of decade long decline in the Australian dollar and falling interest rates.

Hugh Dive is Chief Investment Officer of Atlas Funds Management. This article is for general information only and does not consider the circumstances of any investor.