Connecting investors with ideas

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## This Week's Top Articles



## Investing against the herd, Part 3, Testing the theory

## Ashley Owen

Part 1 of 'Investing against the herd' focussed on resisting the emotional responses which are natural instincts for most investors. In part 2, we confirmed consumer sentiment is indeed at its maximum after a period of strong share market performance – and just before the fall.

In Part 3, we test the theory that if we invested *against* the herd by *selling* some of our shares when sentiment is bullish, and *buying* more shares when sentiment is bearish, then we ought to be able to avoid some of the buy-high, sell-low mistakes and be better off in the long run. You may be surprised to find out just how much money you could be losing or making by following the herd.

We look at three theoretical portfolios from September 1974 when the Westpac Consumer Sentiment Surveys were first published.

The first portfolio is a 'passive benchmark' portfolio that consists of 50% shares and 50% cash, and is re-balanced back to this 50/50 asset mix at the end of each month. All dividends and interest are re-invested.

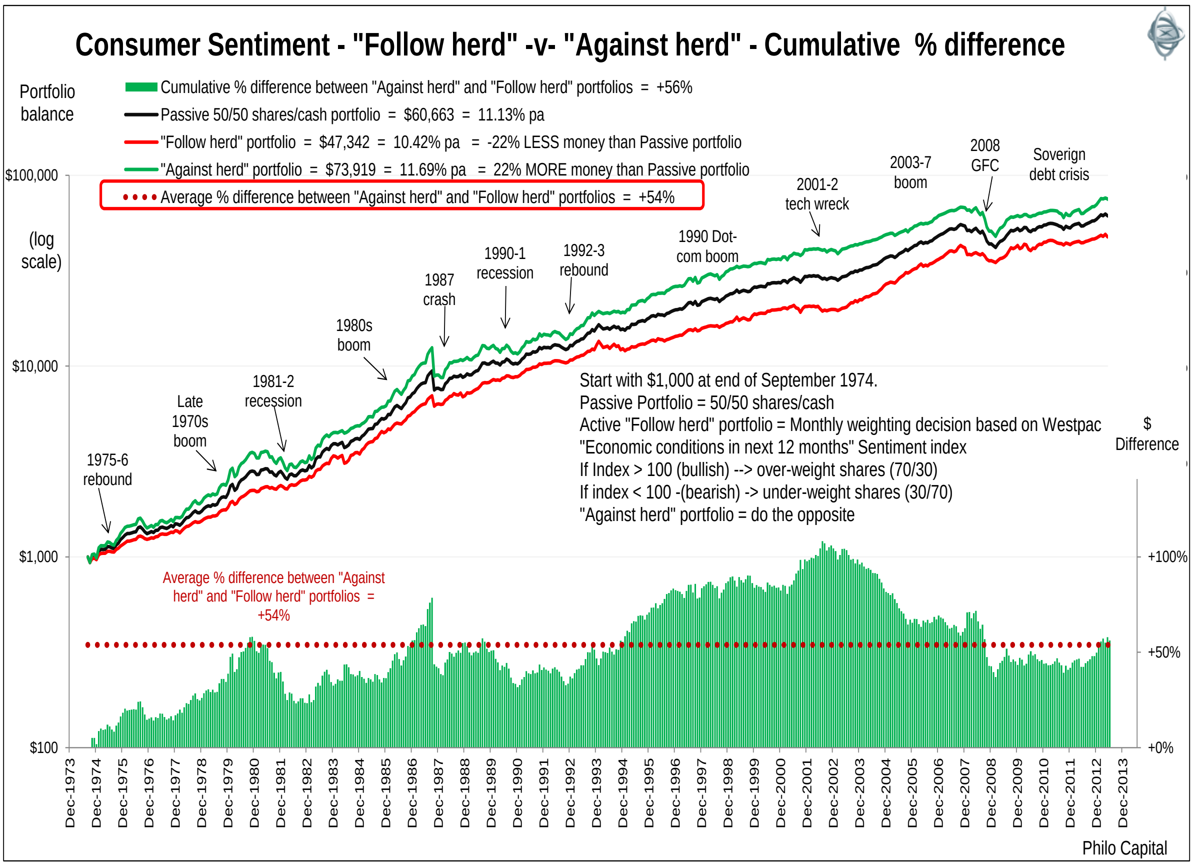
In addition, we also run two active portfolios: a 'follow the herd' portfolio and an 'against the herd' portfolio.

These active portfolios also have a neutral 50/50 shares/cash asset allocation, but the weights of shares can range between +/- 20% from neutral (ie can range from 70% weight of shares to 30% weight for shares), depending on whether the general population is relatively bullish or bearish according to the national consumer sentiment surveys.

- In the active 'follow the herd' portfolio, the asset allocation for the following month is:
  - 70%/30% shares/cash (ie over-weights shares) if the 'Economic conditions for next 12 months' index level is *above* 100 (ie consumers are relatively *bullish* about the next 12 months); and
  - 30%/70% shares/cash (ie under-weights shares) if the 'Economic conditions for next 12 months' index level is *below* 100 (ie consumers are relatively *bearish* about the next 12 months).
- In the active '*against* the herd' portfolio, the asset allocation for the following month is the opposite:
  - 30%/70% shares/cash (ie *under*-weights shares) if the "Economic conditions for next 12 months" index level is *above* 100 (ie consumers are relatively *bullish* about the next 12 months); and
  - 70%/30% shares/cash (ie *over*-weights shares) if the "Economic conditions for next 12 months" index level is *below* 100 (ie consumers are relatively *bearish* about the next 12 months).

Therefore, the active portfolios are making moderate (20%) tilts toward or away from shares based on the **weight of consumer sentiment each month.**

The next chart shows the results. Three portfolios were started with $1,000 and re-balanced each month using the above rules using the Consumer Sentiment Survey results for the prior month.



**What are the findings?**

The passive benchmark (50/50) portfolio (black line) is re-balanced back to 50/50 shares/cash each month, and would have grown from $1,000 in September 1974 to $60,663 by June 2013, which is 11.1% pa compound total return over the period. (All returns are before taxes and transaction costs but before franking credits. The impacts of these factors would be similar in all portfolios since all three portfolios would need to be rebalanced each month due to market movements alone).

The active '*follow* the herd' portfolio (red line) is overweight shares in months in which consumers were bullish in the prior month and underweight shares in months in which consumers were bearish in the prior month. The 'follow the herd' portfolio would have grown from $1,000 at the start to $47,342 over the same period (10.4% per year). So, by following the herd by buying more shares when the market sentiment is bullish and reducing the weight of shares when sentiment is bearish, the end balance is 22% *lower* than with the passive 50/50 portfolio.

The active '*against* the herd' portfolio (green line) is underweight shares when consumers were bullish and overweight shares when consumers were bearish. It would have grown from $1,000 to $73,919 over the same period (11.7% per year). This total return of 11.7% per year over the whole period is 0.56% per year higher than the passive benchmark static portfolio, and 1.27% per year higher than the 'follow the herd' portfolio. By going against the herd, the end balance of the 'against the herd' portfolio is 22% *higher* than with the passive 50/50 portfolio.

The bottom section of the above chart shows the extent to which the 'against the herd' portfolio would have been higher than the 'follow the herd' portfolio over time. At all times the 'against the herd' portfolio is ahead of the 'follow the herd' portfolio.

On average over the whole period, the 'against the herd' portfolio is some 54% higher than the 'follow the herd' portfolio and is still around 50% higher after nearly 40 years. 50% higher balances from going against the herd compared to following the herd is a big difference. It means 50% more wealth, 50% more income, and 50% better lifestyle - from just going against the herd and moderately tilting the balanced portfolio against the weight of public opinion at each stage over the 40 year period.

**Some conclusions from these findings**

Following the herd is a basic human instinct but it destroys wealth. Going against the heard and doing the opposite of what the herd is doing can generate excess returns over and above doing nothing. But it is very difficult to go against the tide and ignore all the hype - especially at the tops of booms and in the depths of the busts.

However, doing the opposite of what the herd is doing - ie selling in booms and buying in busts - is not actually necessary to be a successful investor. If all you do is ignore the herd and avoid buying in booms and avoid selling in busts, then you are avoiding the two most dangerous wealth destruction zones, and you are still going to be better off than probably 90% of investors and fund managers in the market.

Successful investing is mostly about avoiding risks and not blowing up your money. Whether you are rich or poor in 20 or 30 years' time when you are going to really need the money, is mostly a function of whether or not you make 'buy-high, sell-low' mistakes in the critical wealth destruction zones along the way.

Although the relationship between these sentiment measures and subsequent returns from shares has been statistically significant and, when used as a contrary indicator in portfolio decisions, would have led to superior portfolio outcomes (as illustrated above), I am certainly *not* suggesting that people should follow this plan. It is included here merely to demonstrate that following the herd would have led to a significant destruction of wealth over the past 40 years, relative to doing nothing, and especially relative to going against the herd and doing the opposite.

In the proprietary portfolio models used in our investment process, we do not include the Consumer Sentiment Surveys because the historical data series is not long enough (we require a minimum of 50 years history), and we believe our measures are more robust.

However they are interesting to look at as additional evidence of the general market sentiment and what the herd is thinking and doing. In other words, we use it as evidence of warning signs and not confirmations. For example, if we are bullish on shares when the general market is also bullish, that is more of a warning sign for us than a comfort.

Surveys like these are regular reminders of the need to ignore the market hype and general sentiment and focus instead on the facts.

*Ashley Owen is Joint Chief Executive Officer of Philo Capital Advisers.*

# Tax-effective charitable bequests

## David Bell and Ben Kurtz

Many people plan their bequests well in advance and these are stated clearly in their wills. Bequests form a major part of the revenue of many charities. With some extra thought in determining their estate planning strategy, a bequest to a charity could be made in a more tax effective way, creating the potential for larger charitable bequests or a greater amount leftover for other beneficiaries.

Consider this simple example. There are circumstances in which assets such as shares can be directly bequested to a charity. These assets may have significant capital gains attached to them. If the charity has zero tax status then these assets can be transferred without tax being incurred on the capital gains. Compare this to the situation where all the assets of the estate are sold down: capital gains will be incurred, and the amount of money that can be distributed amongst beneficiaries, including the charity, is smaller.

The Australian Tax Office (ATO) website explains the rules around estates, bequests and taxation. In summary:

- Generally, capital gains tax (CGT) applies to any change of ownership of a CGT asset (unless it was acquired pre-CGT (20 September, 1985)).

- However any capital gain or capital loss made on a post-CGT asset is disregarded if, when a person dies, an asset they owned passes directly through to a beneficiary. The beneficiary receives the asset and assumes the capital gains or loss position. Similarly, the capital gain on a testamentary gift of property is disregarded in the estate if the gift is made to a deductible gift recipient (DGR) and the gift would have been income tax deductible if it had been made before the taxpayer's death. In this case 'property' is not specifically defined by the ATO and thus takes on its dictionary meaning (broadly, possessions) which we interpret as including shareholdings.

- A DGR does not have to pay taxes on income earned, thus the collective outcome (that of the DGR and the estate combined) is improved compared to converting all estate assets to cash or if a CGT event is deemed to have occurred and included in the 'date of death (tax) return'.

- It appears that the ATO and the government are aware of this technique. A 2004 case confirms this (reference: ATO ID 2004/641) and was withdrawn because it was a straight application of the law and no interpretation was required. The 2004 Federal Budget removed the requirement that testamentary gifts of property to a DGR must be valued at greater than $5,000.

To make the most of this opportunity, charities need to:

- Ensure they are registered as a DGR.

- Consider whether they know their potential testators (people making the bequest) well enough to suggest that there may be a more effective way (for all parties involved) to design their estate planning. This may at first appear to be an awkward conversation but this may not always be the case. For instance some people may indicate to a charity beforehand that they intend to make a bequest to them out of their estate. Many charities develop deep personal connections with potential testators through the provision of assistance to people or associated family members, in some cases lifelong. It is quite common for the beneficiaries of charitable assistance to seek to allocate some of their estate to the charity. These situations may present opportunities to have such a discussion around how this bequest could be structured.

- Ensure that the contacts within charities handling bequests are also aware of these rules so that when they discuss the transfer of these assets with the solicitors tasked with winding up estates, the actual shares are transferred, as opposed to liquidating the shares and transferring the cash, as is often, by default, the action taken.

- Finally, be able to handle the assets that have been bequeathed. Can they easily take custody of these assets? Can they dispose of these assets if they do not fit the investment strategy of the charitable funds? Do they have the ability to understand how a particular asset will affect the overall risk profile and liquidity of their charitable funds. I am aware of some charities which are quite comfortable receiving bequests in the form of Australian equities as they have arrangements in place with fund managers to accept shares as in-specie application funds (indeed there are some interesting funds which target charitable groups and zero tax entities in general, seeking to maximise the benefit of franking credit refunds). This removes the need for the charity to perform its own transactions.

Note that this article is focused on assets held outside of superannuation. There will be different outcomes for assets held in superannuation which will depend on a number of issues including the type of super fund (whether it is a SMSF or not). For an individual planning a bequest strategy for their assets in super, it is recommended they seek specific advice on this issue.

Overall, funding remains a constant ongoing challenge for charities. This strategy results in more efficient estate planning amongst those intending to make a bequest, which in turn can lead to better outcomes for charities. Of course we recommend you seek professional advice if you intend to formalise such a strategy.

*David Bell's independent advisory business is St Davids Rd Advisory. Ben Kurtz is a Senior Accountant at Nortons Business Advisors.*

# The C words: an irregular, irritating series of dictionary narratives

## Jack Gray

**C stands for ….***

**Comfort,** a state of mind as inappropriate in superannuation as it is endemic. One visitor to our fatal shores described the superannuation industry as a "giant love-in whose core competency is preserving its comfort, privilege and power." When threatened, reviling antipathy between groups dissipates like the Cheshire cat's grin. Hint at changing the tax rate on large retirement benefits or merely mention 'independent trustees' and hear the industry scream in unison, "don't touch super" perennially justified, with nary a hint of irony, as being "in members' best interests."

**Certainty,** an unattainable state that offers eternal comfort. Long ago Friedrich Hegel foresaw the danger, *"(we) are so hungry for certainty that (we) will readily subordinate consciousness and conscience to it"*, a hunger that drove many to buy Bernie Madoff's promised certain returns.

**Confidence**, a strange characteristic to claim in our world of profound ambiguity and intrinsic uncertainty. Yet managers and advisors feel compelled to project unjustified levels of confidence lest clients lose confidence (*sic*) in them.

**Capital guaranteed**, an offer that given our abiding aversion to loss and re-enforced by Hegel *should* have great appeal. That it doesn't is probably due to the complexity and opacity of underlying derivative structures or of hidden balance sheet manoeuvres that rightly warn investors off.

**Capitalism**, a system desperately in need of profound renewal to escape from Minsky's Sixth State of Capitalism - Money Market Capitalism – in which power, status, people and rents flow not to the production of goods and services nor even to the matching of risk-capital with economically meaningful investments, but flow mightily to Wall St vampire squids.

**Competition**, the core of capitalism that *should* act for the common good by pushing prices down toward the marginal cost of production, which it does in the whitegoods industry but not in investments or superannuation where quality cannot be assessed. In *haute* fashion and investment banking vendors put prices *up* when demand falls lest buyers sense a decline in quality. In investments and superannuation competition serves to increase the number of agents and aggregate costs for no material net benefit to members.

**Commitment fees**, the second most egregious of fees. All businesses are 'front-end loaded' but only private equity managers raise capital from future clients and charge them for the privilege. Other businesses raise capital by going to markets, by borrowing from banks or from mothers-in-law, or by stealing. At least the latter has a slight modicum of integrity.

**Co-operation,** more of which is sorely needed by superannuation funds in their battle against Wall St squids, while by design competition has led to a decline in co-operation and collaboration.

**Complexity,** the *pursuit* of which (like money) is a sin yet so appealing to some. (*Mea maxima culpa*.) Heed the words of Alfred North Whitehead (yes philosophers *can* 'add value'), *"seek simplicity … but distrust it"* and of Al Einstein *"Everything should be made as simple as possible, but no simpler."* (Note to the Young: Enhance your credibility today by quoting Einstein and Buffett.)

**Copulas, $CLO^3$s, Correlation Swaps, …,** and other complex constructs of dubious provenance. They *can* be of *some* value but are best kept in bestiaries, allowed out only if brutally constrained.

**Cash,** the simplest asset class whose malleability reached its apogee with a banker classifying his yacht as a 'cash equivalent'. Detracts from performance through cash drag and simultaneously enhances performance through its option value. At times beloved by investors; always despised by investment managers.

**Causality**, a notion with which we struggle mightily. One touted benefit of Australia's compulsory retirement system is that increased savings causes economic growth. Yet evidence from other countries suggests causality (if it exists) may flow in the other direction. The common assumption that high levels of government debt *cause* low growth is also in doubt. Causality (if it exists) may flow in the opposite direction: low growth causing government revenues to fall necessitating borrowing.

**Cynic,** one who, according to Oscar Wilde, *"knows the price of everything and the value of nothing."* Did Oscar also frequent the haunts of momentum investors?

**Committees,** strange groupings to which we all belong. Like families, each is dysfunctional in its own way. *Some* committee decisions are better than those of any individual member.

**Consumer,** a word that should be *verboten* in the industry as it encourages the mass- and mis-selling of 'products' to be consumed like breakfast cereal, for short-term excitement, rather than to be invested in for patient long-term gain. Worse still, categorising *people* (are we embarrassed to use that word?) by their consumption is de-humanising.

**Courage,** a notion that elicits images of confronting tanks in Tiananmen Square. Thankfully, for most of us, *all* that's required yet rarely seen is the courage to differ from the herd, the courage to invest in strategies before they have the comforting 3-year consultant stamp of approval, the courage to reject cant and self-serving bullshit, the courage to resist lawyers and regulators when to do so is in members' interests, and the courage to stand up to bullies on boards and elsewhere.

**Proposed Trade For Us All:** Swap a large dollop of the abundant and over-priced **comfort** for a tiny pinch of the scarce and under-priced **courage**.

* **C** also stands for **C**onservative, **C**onform, **C**omply, **C**autious and **C**onsultant.

*Dr Jack Gray is a Director at the Paul Woolley Centre for Capital Market Dysfunctionality, Faculty of Business, University of Technology, Sydney, and was recently voted one of the Top 10 most influential academics in the world for institutional investing.*

# Investing in commercial property

## Jack McCartney

Approximately ten years ago, I became involved in the small commercial property market as an investor. My research had shown this was an investment segment that provided steady income growth and capital gains when you take a longer-term investment approach (10 years+). I have since added more commercial properties to my portfolio and the experience to date has been favourable.

This article provides some insight into the investment opportunities and risks in the smaller end of the commercial market (valued at around $2 million) and why it is different from residential. These small commercial properties are sometimes purpose-built for tenants who are expanding or updating, and they can have a mixture of commercial and industrial uses.

Commercial property has a similarity to fixed interest investing in that valuations are based on yield expectations. The most common proxy for valuations of smaller properties is the capitalisation method ('cap rate'), where the annual net income is divided by the market value or purchase cost.

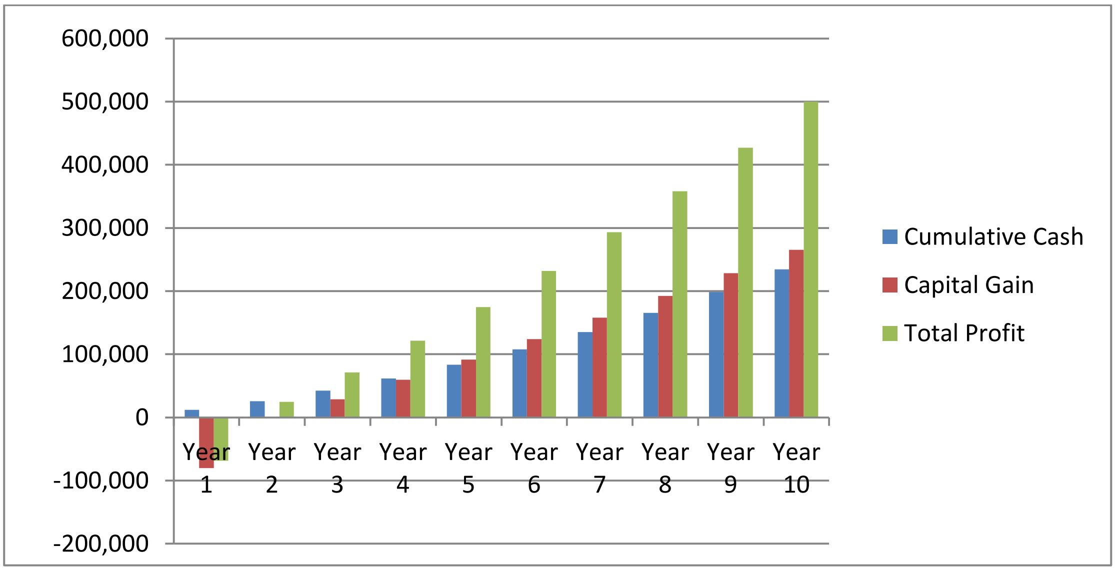
Cap rates for good quality, prime properties are around 7% – 8% currently, although each building is unique and returns vary significantly. Competition for the best locations can drive yields lower. Some examples of recently reported sales include:

- Commonwealth Bank Lilydale, sold for $2.88 million at 4.5% yield
- Bank of Queensland Varsity Lakes, sold for $620,000 at 7.5% yield
- Red Rooster Toowoomba, sold for $1.88 million at 7.2% yield
- VicRoads Regional Victoria, sold for $920,000 on 5.5% yield.

It is possible to obtain funding at around 5.25% – 5.5%. This means you can buy high quality-tenanted properties that are cash flow positive from day one i.e. positive gearing.

Consider the following example:

- the property is valued at $1 million
- acquisition costs are 5%
- 100% of the purchase price is borrowed at 6.5%
- rental is $80,000 pa and increases are 3% pa
- capital growth (increase in value of property) is 3% pa
- the capitalisation rate is 7.62% ($80,000/$1.05 million).




The graph shows that after 10 years the total 'profit', ignoring tax effects, is $500,000, made up of $235,000 surplus cash and $265,000 increase in property value. I don't recommend 100% gearing unless you have other equity you can risk. There is, of course, nothing profound in these numbers, since the example assumes the property is positively geared and increases in value each year. But this has been my past experience and many investors who only consider the residential market are missing the potential of commercial property.

As with all investments, commercial property has risks and you need to build some contingencies into your budgeting for when this will happen. The main one in my view is 'tenant risk', where the property may be vacant for 6-12 months. It is common to obtain a bank guarantee for the first 3-6 months rent as part of an acquisition.

My experience is that valuers don't tend to take into account to a significant extent the value of the tenant when determining the market value of a small commercial property. They will make reference to the tenant in their report but don't qualify the value based on the tenant bonafides. I would rather take a marginally lower rent and wait an extra 3-4 months to get the right tenant, than take on a potential tenant who may encounter cash flow problems in the future. Again, you need to do your research. I have seen market reports on commercial properties which state that the average yield on national tenants is about 1% less than non-national tenants, but this has not been my experience.

Leases are typically in the 3-5 year range and the tenant pays for most of the maintenance costs. e.g. strata levies, rates and water. Get the right lawyer to draw up the lease and the tenant can even pay your land tax.

I prefer better quality properties with excellent tenants (e.g. national brand names and subsidiaries of public companies) on longer leases (5 years) in the 500-700 square metres range, in growing areas with excellent transport links.

To get the best interest rate when borrowing, banks don't like the loan to valuation ratios (LVRs) to exceed 65% and will charge a higher interest rate for the higher risk. To be conservative I'd suggest a 50/50 gearing ratio as during the GFC, banks wound back their LVRs and clients that didn't have spare cash ended up selling at fire-sale prices.

As in the share market, investors have been chasing yields in the last year, and this has increased commercial property prices, notwithstanding that real estate agent Knight Frank recently reported a high commercial property vacancy rate of 10.1%. The increased borrowing appetite of SMSFs is another competitive factor.

Furthermore, there are signs of weakening fundamentals such as loss of manufacturing jobs, small business stress, other staff reductions and falling rents which add a further need for caution. The specific supply and demand characteristics of the location are affected by the local economy, industry mix, transport patterns, planning permissions, capital expenditure and potential secondary use on sale.

It emphasises you need to do your research, which means reading, inspecting premises, speaking to agents and bankers. That way you will start to develop an understanding of the issues involved when you see the right commercial property, and you will have a better chance of making an informed decision.

*Jack McCartney has worked in a variety of senior management roles in financial services and most recently ran Commonwealth Bank's Business Bank Wealth division.*

# Superannuation emerges from a torrid period to more regulatory upheaval

## IBISWorld

The prominence of superannuation in Australia means superannuation funds administration is big business. Australia's funds management market is the fourth-largest in the world. Much of this is due to the nation's $1.5 trillion superannuation system, which ensures a steady flow of retirement savings. Both administrators and asset managers benefited from this steady flow of funds over the five years through 2012-13, a result of strong national employment and income. However, equity markets – and thus the total value of superannuation assets – were highly volatile.

A significant portion of superannuation assets is invested in Australian and international equities. After years of double-digit growth, the value of assets increased by just 4.9% in 2007-08 as the Global Financial Crisis began to hammer equity markets. A significant contraction occurred in 2008-09, and revenue earned by the superannuation industry followed, recording a double-digit decline. Although asset values have since recovered, it took two years to restore the lost ground. Ensuing market volatility was not helpful, with many funds reporting poor performance. However, strong stock market gains over 2012-13 resulted in healthy earnings for fund managers, which typically derive their revenue from management and performance fees, meaning income tracks in line asset values.

Superannuation industries are facing yet another wave of significant changes. The rollout of MySuper reform on 1 July 2013, coupled with an increase in the superannuation guarantee contributions, could set off several structural shifts in the related industries. MySuper is a standardised superannuation option similar to the traditional default option previously offered by superannuation funds. It is designed to be easily comparable across numerous funds and offer clients more transparency. As of 1 January 2014, employers will be required to nominate the MySuper option on behalf of their employees, unless the latter choose otherwise. Additionally, the superannuation guarantee contribution increased from 9.0% to 9.25% in July 2013. Although this is expected to come out of employers' pockets, some workers may see a slight decline in their wages.

The sheer amount of funds in superannuation means that any changes will affect both fund administrators and asset managers. They both benefit from the increasing amount of funds in superannuation accounts, and Australian managers charge the highest fees out of any developed country. However, this could change with MySuper regulation, as the Federal Government places increased restrictions on fees and charges. Additionally, managers will have to adjust to a larger number of self-managed super funds (SMSFs) bypassing them and investing directly in equity and debt markets.

The MySuper reform is a double-edged sword for the superannuation industry. On the one hand, it presents an opportunity to design new products that are suited to the distinctive features of the reform. On the other, super funds offering a MySuper option may select more passive investment strategies that do not require the high expertise of asset managers.

The reforms are coming at a time when national and regional banks are seeking new growth opportunities within Australia. For these institutions, mortgage lending is the largest source of revenue, followed by corporate and other retail lending. Corporate lending has been weak, as business sentiment remains subdued, while household deleveraging weighs down retail lending. Therefore, the domestic growth of banks is essentially limited to the housing market.

Moving into superannuation management presents a big opportunity for banks. Although this trend has been occurring since the late 2000s, the banks are now trying to penetrate the superannuation asset management business, with limited success thus far. Banks are trying to cross-sell their superannuation products to their existing client bases. As well as providing superannuation accounts, banks provide trading platforms for SMSFs. These are designed to provide a wide range of services and be a complete one-stop shop for SMSF management. Ultimately, this may allow the banks to further tap into the $1.5 trillion of assets that need to be managed. To put this in perspective, the total value of superannuation assets now exceeds the total market capitalisation of the All Ordinaries in Australia.

Overall, the outlook for the superannuation management industry remains bright, but all participants need to be aware of challenges that could prevent them from capitalising on current opportunities. Similarly, banks need to be smart about the way they target their customers and make sure that their acquired superannuation businesses, such as Westpac's BT Financial and the Commonwealth Bank's Colonial First State, are effectively utilised.

*IBISWorld is Australia's best-known business information corporation providing research, analysis and forecasts on over 500 industries, and has provided this summary of the current superannuation landscape exclusively for Cuffelinks.*

# Once in a lifetime returns from US shares

## Ashley Owen

Investors look for high returns as well as consistency. That is what the US stock market has delivered this year for Australian investors. The S&P500 index has generated positive total returns in Australian dollars for nine consecutive months from November last year to July 2013.

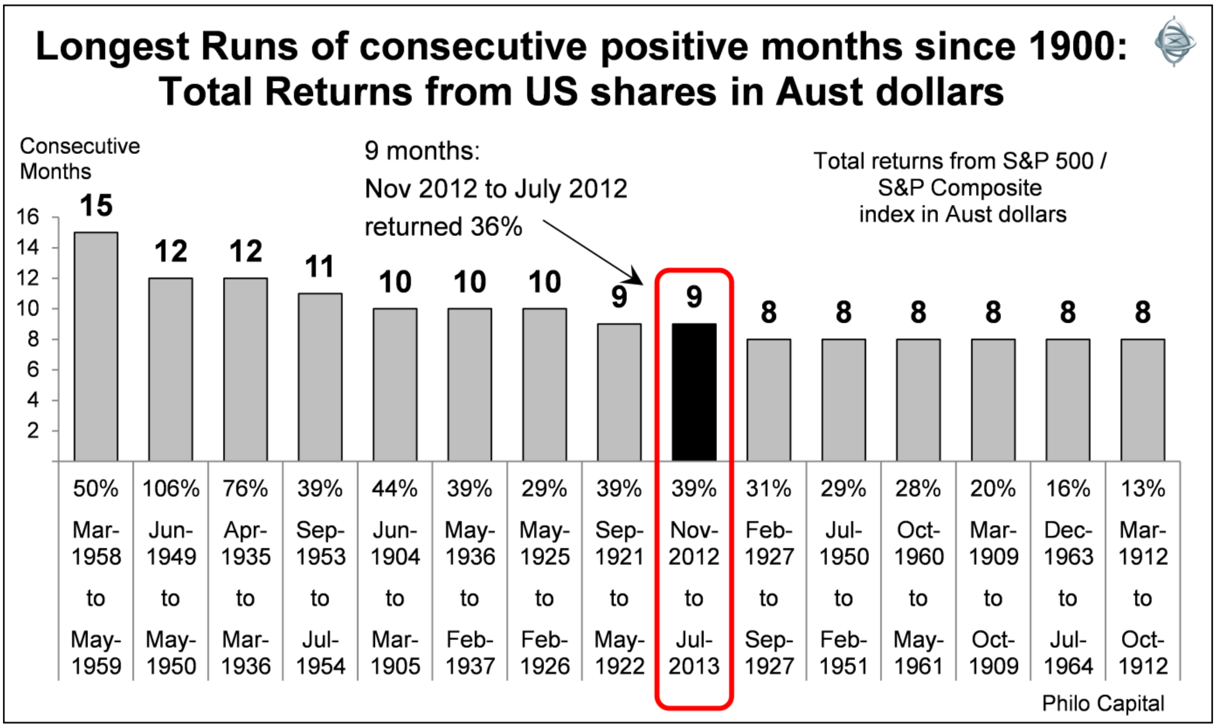
This run of 9 positive months makes it into the list of top 10 longest runs of positive returns from US shares in Australian dollars since 1900. It has been the longest positive run since 1958-59, which ran for a record 15 months. There have been only three positive runs longer than 8 months since WW2 but they were all before I was born (just!), so I never saw them.

Not only has the US market returned 39% in Australian dollars over the past 9 months, volatility has not been lower since the mid-2000s. So it has been the best run of consistent, high returns in my lifetime. So much for the so-called 'high volatility, low return, new normal!'

This does not imply that the run will continue of course, but it does show the value of ignoring the media hype and focusing on the facts.

The currency effect helped the performance. The Australian dollar fell by a total of 13% against the US dollar during the period, including declines in six of those nine months – in December, February, April, May, June and July. This currency effect greatly assisted in keeping the returns positive for Australian investors, especially when the US market fell in US dollar terms during the great Bernanke 'QE-taper' scare in May and June. Australian investors in US shares sailed through the crisis because the falls in US share prices were more than offset by falls in the Aussie dollar, leaving un-hedged Aussie investors ahead.

Contrary to popular myth, this foreign exchange component of investing in foreign shares actually lowers portfolio volatility and helps smooth returns for Australian investors in un-hedged foreign shares.

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