Cuffelinks

Connecting investors with ideas

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This week's top articles

- **The state of play in the funds management industry** *Chris Cuffe*
- **Know who's managing your business** *Roger Montgomery*
- **Watch the performance of your performance fee** *Graham Hand*
- **Equities deliver high returns and low volatility – again** *Ashley Owen*
- **What do fund managers mean by Quality Investing?** *Raelene De Souza*
- **See Caveat Emptor on inflation linked bonds, the Nine IPO, and SMSFs**

The state of play in the funds management industry

Chris Cuffe

Chris Cuffe spoke recently at the Finsia Leadership Connect dinner, and this is an edited transcript.

The funds management industry is undergoing consolidation and evolving rapidly, under pressure to provide better service and high returns while cutting costs.

Total Australian superannuation system assets are around $1.7 trillion - spread between self-managed super funds, industry funds and retail funds - that's around 100% of our GDP. Treasury forecasts suggest that super assets will grow to $8.6 trillion by 2040, which would represent around 200% of GDP. To reach this level, taking inflation into account, it would require a compound growth rate of about 6 to 7% per annum.

In a recent speech, Paul Keating suggested that the superannuation system returns that we've achieved to date are not going to be repeated in the future. If you have a system that's reached 200% of GDP, it's probably mathematically impossible to have returns of 4–6% above GDP growth. We are likely to see significantly lower returns from our super investments into the future. As Keating points out, perhaps we should be quite satisfied with receiving a long-term return equal to nominal GDP plus 1%.

Fees

Assuming investment returns become materially lower than over the past few decades, the level of fees charged to manage assets will come under increasing focus.

I think we will see a material downward trend in fees which are based on a percentage of funds under management (FUM). This is partly because industry funds are moving towards managing funds in-house due to their obvious economies of scale and consequent cost savings. Most big industry funds in Australia are non-profit (or perhaps better termed 'profit for members'), and they only need to cover the cost of managing money, without trying to incorporate a profit margin. If these funds are growing bigger and need proportionately fewer staff for a given level of FUM, then the fees that a member pays for the management of their money will come down, and I see that as creating downward pressure on the whole industry. Put another way, we see one large segment of the industry that have a fee based on 'cost recovery' rather than a set 'per cent of FUM'.

It is important to also appreciate that most industry funds are now 'public offer', open to anyone to invest in, providing head-on competition to for-profit retail funds.

Similarly, SMSFs don't need a profit margin as they're managing for themselves. While many trustees of SMSFs may continue to use managed funds, many trustees are happy to directly invest. So there's downward pressure from this area as well. The SMSFs will continue to proliferate in my view, but possibly at a slower rate if the costs of having their money managed via external superannuation funds continues to come down.

Scale benefits

There has been a lot of talk about lower costs arising from mergers and scale benefits with the introduction of MySuper but I'm not completely convinced about that. I've always thought that if you took commissions out of products (e.g. with the FoFA reforms) you would see more competition, and you might not need the MySuper reforms in order to get lower cost products as well. Certainly though, one good aspect of MySuper is making the insurance offering compulsory given the apathetic nature of many people.

But in investment management and superannuation generally, there are both economies of scale and diseconomies of scale. For example, in my view it's very hard to manage an Australian equity portfolio that is larger than $5–6 billion and can still generate alpha, whereas if you're managing a fixed-interest portfolio, scale is your friend. On the administration side of superannuation, people talk about 'unlimited scale benefits'. I question that. I think you reach a point where you've probably got it to the lowest cost per unit, and from there you plateau or you have diseconomies.

The demise of defined benefits schemes

The demise of defined benefits schemes has been absolutely profound both here and globally, and I contend it has not been a great thing. In the Western World, the accountants forced market movements through the financial statements of the corporates underwriting the schemes. This was untenable for corporates, so DB schemes have been closed and most of the population is now in defined contribution schemes. But the defined contribution system around the world has focused 'the system' way too much on short-term investing, which has led to a lot of problems.

UniSuper has the largest open defined benefits scheme in Australia. The scheme used to share the same pool of assets as their accumulation balanced fund. Some years ago, they separated it and invested it differently, investing on the defined benefits side by matching the liabilities to get the right return, without regard to the rest of the market. Interestingly, each year now, the defined benefits scheme significantly outperforms the defined contributions side.

It is hard to unscramble the egg and create defined benefit schemes again, because no employer or government will want to be the underwriter. But I think the right scheme going forward is a hybrid scheme, where you have something that looks like a defined benefit scheme, but without an underwriter. That is, you have a pooling of risk rather than an underwriter of risk. I think Australia would be much better served by something like that. But ironically, that would mean turning the clock right back to the first funds that we had in Australia and many other parts of the world, which came out of life companies; they had reserves and would manage the highs and lows of the markets by smoothing investor returns.

Accumulation phase versus the retirement income phase

Although the baby boomers are now moving into the retirement stage, annuities are not very popular (and never really have been in Australia or overseas). I think the reasons are pretty obvious: the returns offered are unattractive because of the need for a profit margin, the need to price uncertainty and also to hold sufficient regulatory capital. There is also the risk that the commercial organisation isn't going to exist in 20–30 years. There's a problem with matching assets with liabilities in long-term funds where people need a retirement income for 30 years. You can't easily buy a 30-year bond in Australia.

I think the Australian Government is extremely well placed to offer an annuity scheme, whether as principal or as guarantor, and could do so offering far superior rates to commercial operators. This is something that Paul Keating also believes in. In an article he wrote in *Cuffelinks* earlier this year, he said:

"A government-administered, universal, compulsory deferred annuity scheme would be a fully-funded scheme, with the capital provided by the annuitant from a portion of their lump sum superannuation benefit. This would mean that if there was any shortfall in the actual assets set aside and the liability due to the annuitant, the government would fund the gap. However, careful asset management with a long-term horizon should ensure that any such shortfall should, over time, be insignificant."

To me, this has a lot of appeal and would be a strong encouragement for people to better fund their retirement.

A quick reflection on regulation and risk

Particularly post-GFC, I think the burden of regulation has been excessive and in the super industry we have completely bastardised the term 'risk'. People use it in so many different ways, and it means different things to different people. What's happened is that people have looked at the downturn in investment markets and called that 'risk', and regulators have wanted to put new rules around it. But you can never find the rules to solve investment risk; it's just part of the game. After 30 years in investment markets, as I've learned more and more, I realise I actually know less and less. As time goes on, you figure out that you can't get from A to B any quicker in terms of returns or the time it takes to generate these, but you just learn where the landmines are. The learning in investment management is really about doing things the right way.

This transcript originally appeared in Finsia's INFINANCE magazine, December 2013 edition.

Know who's managing your business

Roger Montgomery

Like many investors, we try to gauge the quality of management of the companies we invest in. We believe that the prevailing investment concern should generally be the quality of the business rather than the people running it, but poor management can quickly erode value, even in a good business, so it's important to have confidence in the people pulling the levers.

This is not always easy to do. As investors, you tend to see only a carefully curated slice of the senior executives, and it's easy to be impressed by charismatic leaders or confident presenters, but confidence and charisma may not be what's required for ultimate success. To make a reliable assessment of management may take years of carefully following commentary and promises, and comparing these against subsequent achievements.

(As an aside, it is interesting to note that CEOs the world over tend to conform to certain stereotypes. For example the average CEO is much taller than the population average. Not many boards would explicitly set height as a CEO requirement, but it clearly finds its way into the selection process).

Where a detailed multi-year track record of success in the role is not readily available, there are some things you can focus on as an investor to get a read on management. The key is in having a clear idea of what skills or traits really matter, and which you can sensibly assess from outside the company.

Here are some things on our management shopping list, together with the reasons why we think they are important, and some indicators you can look at to help judge whether they are present.

At the top of the list is integrity and character. Ultimately, management is in control, and a CEO who puts their own interests ahead of shareholders is unlikely to do a good job for investors. This problem is sometimes referred to as agency risk, and there are many ways your 'agent' can act contrary to your best interests. These include using investor funds to build an empire through unsound acquisitions, and managing the business or the share price (such as through buy backs and unsustainable dividend policies) to achieve their personal remuneration goals rather than to maximise the value of the business.

Also look at the standard of disclosure. Is the business and its performance explained by management in a clear and transparent way, or is it largely PR spin and obfuscation that makes it difficult to understand what is really happening (recall Enron)? Good management will demonstrate respect for the owners by telling the market what is happening, and letting investors set the share price accordingly. Management that is more concerned with managing the share price than the business is unlikely to do well at either in the long run.

The remuneration report can also tell you something about agency risk. Modest rates of remuneration and a focus on long-term performance goals can be taken as a very good sign, especially if profitability measures such as return on equity are considered.

Another useful management attribute is passion for the business. A good leader need not be perpetually cheerful, but one who genuinely enjoys the work they do will achieve far more than one who doesn't. When you hear a passionate manager speaking about their business, their enthusiasm is usually apparent. Paul Zahra at DJs may be well-regarded by some of the larger shareholders, but from reading recent reports it might be reasonable to assume that he's not tap-dancing to work. A manager who doesn't enjoy what they are doing may find it challenging to give their best efforts for the company, or to inspire others to do so.

On a related note, we believe that a detailed understanding of the business by the executive is valuable. A manager that has a complete grasp of every aspect of their business and its industry can be far more effective than one who relies heavily on others to fill in the gaps. Every negotiation or interaction with suppliers, customers and staff presents an opportunity for a poorly-

informed manager to put a foot wrong by failing to properly understand the flow-on effects of the choices they make.

There is no substitute for industry experience, so it's good to look at senior management CVs. A CEO who can confidently answer questions on the business without needing to delegate them, take them on notice or issue subsequent 'clarifications' is usually a good sign.

This is a far from exhaustive list, and other skills including intellect, vision and strong leadership will be more or less important depending on the business and the circumstances. However, as a general observation, if you can feel comfortable that management is honest, enthusiastic and knowledgeable (in that order), you have a reasonable basis to expect that they will be able to steer the ship around some of the larger icebergs that inevitably lie in the path of every business venture.

Roger Montgomery is the founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'.

Watch the performance of your performance fee

Graham Hand

Many investors take a cursory look at the performance fee when investing in managed funds or Listed Investment Companies (LICs), perhaps figuring that a high fee is a good problem to have. It must mean the fund manager has delivered outstanding performance. It's a reward for excellence, and we share the spoils together, right?

Not always. There is no market standard for performance fees, and it pays to know how a fund will reward its manager. The most common performance fee is 15 to 20% of the excess return above the benchmark plus the base management fee. Therefore, with an average base management fee for Australian equities of about 0.9% (which is paid regardless of performance), a performance fee often starts to accrue if the fund outperforms the benchmark plus 0.9%.

But it doesn't always work like that. For example, there are Australian equity funds with performance fees calculated over the cash rates. In the last 12 months, the ASX200 is up 22%, while the cash rate is 2.5%. Even if the fund manager only achieves the index, a 20% performance fee will generate a payment of 20% X (22%-2.5%) which equals an eye-popping 3.9%, usually on top of a base management fee.

This reduces the index return from 22% to 18.1% less the management fee and expenses. That's probably more than the investor is earning on the cash allocation elsewhere in the portfolio.

MySuper rules on performance fees

There have previously been no rules or guidelines issued by regulators on performance fees, so it was good to see some clarity from the Stronger Super Review. It's a useful guide to what to look for, and many current fees breach this model. MySuper products are allowed to charge performance fees on the following terms:

- a reduced base fee that reflects the potential gains the investment manager receives from performance based fees, taking into account any fee cap
- measurement of performance on an after-tax (where possible) and after-costs basis
- an appropriate benchmark and hurdle for the asset class reflecting the risks of the actual investments

- an appropriate testing period
- provisions for the adjustment of the performance based fee to recoup any prior or subsequent underperformance (for example, high water marks, clawbacks, vesting arrangements and rolling testing periods).

Key findings from Morningstar study

In 2011, Morningstar studied 82 investment strategies in large cap Australian share funds, and found 18 employed some form of additional performance charge, as reported in this White Paper. They also learnt that even the fund managers themselves often misunderstood their own fee calculations.

Their key findings have a significant overlap with the MySuper rules, plus:

• The headline performance fee is just one aspect which should be considered. The management fee has the potential to be much more costly.

• Absolute fee structures – those not linked to an appropriate equities-related benchmark – would have proven extremely costly to investors over the previous 10 years.

• Any performance hurdle employed should at least cover the base management fee, to avoid investors paying additional fees for potentially sub-par (net of management fees) returns.

• Fund managers which have the ability to reset their high watermarks have the potential to act against investors' best interests.

• Fund managers typically crystallise their performance fees over too short a period, creating the potential for a shorter-term mindset which is inconsistent with their stated longer-term goals.

High water marks

Performance fees should only be paid once the manager has recovered previous underperformance (either relative to an index or in absolute terms, depending on the incentive structure). This test in the performance fee calculation is called a 'high water mark' because the previous high level of the fund must be reached before the performance fee kicks in.

For example, assume the market index is up 10% in the first year, while a fund is up only 5%. Then in the second year, the index is up 10% again, and the fund rises a healthy 15%. Ideally, there should be no performance fee in the second year, because the manager has delivered index performance over two years (ignoring the impact of the base fee, which should make the hurdle for performance fees even higher). The high water mark established at the end of the first year needs to be recovered.

But here is an opportunity for a new investor which became highly attractive after many funds underperformed during the GFC. If an investor enters the fund in the second year in the above example, there will be no performance fee paid despite that investor experiencing an above-market 5% return. There is a negative accrual in the performance fee calculation from the year before. If the fund is one where the base fee is lower due to the performance fee, the investor can achieve active returns for modest fees if the timing is right. It should be possible to ask any fund manager for a list of funds with negative performance fee accruals.

However, this also demonstrates a weakness of pooled unit trust structures which Individually Managed Account-type products are designed to avoid. Performance fees in a unit trust must be calculated at the trust level as a whole, not by investor. The negative accrual from prior losses is shared with future investors in a pool, resulting in a return to paying performance fees earlier.

Vast variety of performance fees

Even within a single Product Disclosure Statement of a platform provider, the performance fee section shows amazing diversity, including non-compliance with the MySuper rules laid out above (and hence, these are not eligible to be My Super funds). Take as an example the PDS of Colonial First State's FirstChoice Wholesale platform, available here (fee section on page 9). The variations include performance fees that are calculated:

- before management fees*
- after management fees*
- over zero – commonly used for hedge funds or 'absolute return funds' which do not have a market index (or beta) exposure
- over the cash rate
- over the bank bill rate
- over an equity market index such as the S&P/ASX300 Accumulation Index or MSCI World
- inclusive of franking credits and overseas withholding tax
- with a variation from 10% to a mouth-watering 25% of the 'excess return'.

*An example of the difference is: assume a fund has a management fee of 1%, delivers 2% above its benchmark, and a performance fee of 20%. If the performance fee is calculated 'before management fees', it is 20% X 2% equals 0.40%. If it is 'after management fees', it is 20% X (2%-1%) or 0.20%. Easy to overlook, but costs an extra 0.20% in fees.

Performance fees make an extraordinary difference to the economics of running a funds management business. A rule of thumb is that a fund manager might expect the base management fees to cover the costs of opening the doors, while the performance fees deliver the profits, shared in large measure with staff. For example, the listed Australian company K2 Asset Management with around $750 million in funds under management had a good year in 2013, earning $24.3 million in performance fees compared with only $124,000 the year before.

Here are two examples of different approaches in the Listed Investment Company (LIC) space:

1. Flagship Investments Limited is an Australian equity fund which aims to be at least 90% invested. Its performance fee is 15% of the amount by which its net performance (after all costs) exceeds the bank bill rate. On first look, this seems unreasonable, as a long-only equity fund is measuring itself against a cash index. But the mitigating feature is there is no fixed management fee, and the manager provides administrative services without charge. This approach pays off handsomely for the manager in good equity market, then he relies on his own resources in flat or down years. An investor can decide if this is fair.

2. Sandon Capital is a new Australian equity LIC currently in the IPO stage. Its performance fee will be 20% above the one month bank bill rate, plus a base fee of 1.25% per annum. Again, on first blush, it looks expensive. However, this is not a normal long-only fund, it is an activist fund. It will invest in shares where the manager will advocate for change to unlock value, and may often be substantially in cash. Again, the investor can decide if this is fair.

These two funds illustrate the unique circumstances behind many performance fees.

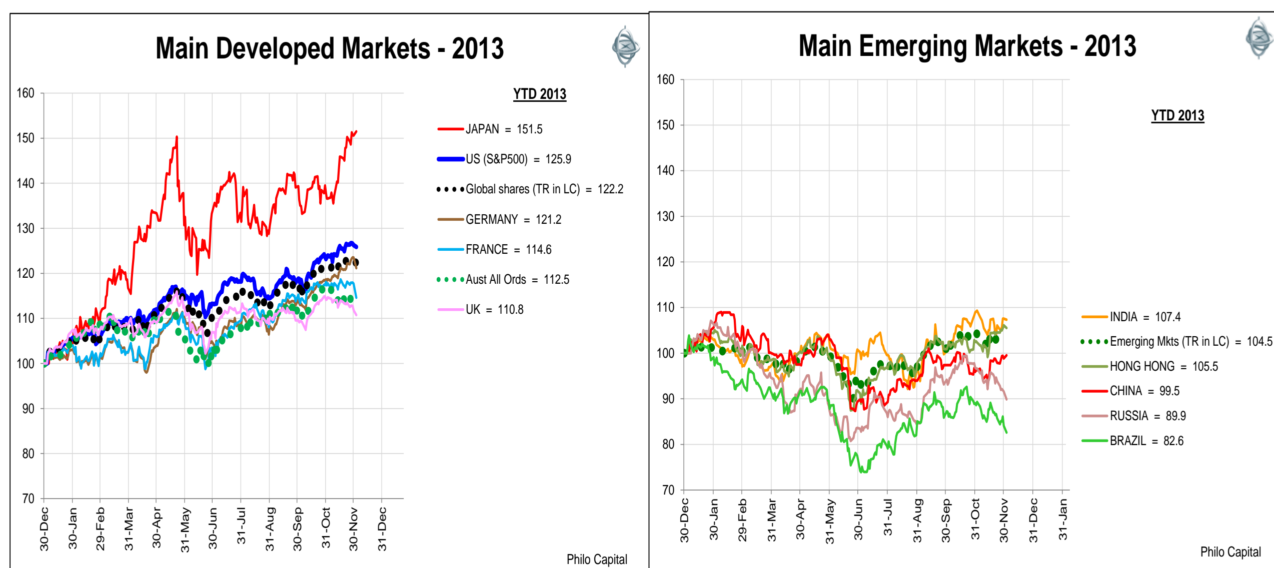
In summary, the ideal performance fees will be measured against an appropriate benchmark after allowing for the fixed management fee, be subject to a high water mark and have some trade off with a lower base fee. But there may be particular circumstances related to the way money is managed which justify a deviation from this formula.

Equities deliver high returns and low volatility - again

Ashley Owen

As we near the end of 2013, it looks like this year has been a repeat of 2012 for shares in the major developed world stock markets - high returns plus super-low volatility.

Stock markets in the US, Europe and Japan have done very well again this year despite their moribund economies being on life support in intensive care, their crippling government debt levels, high unemployment, aging populations, soaring pension costs, and debilitating political wrangles.



At the bottom of the pack once again for stock market returns were the BRIC markets, despite their much healthier fiscal, monetary, current account positions, more favourable demographics and lower unemployment levels.

The US stock market and deficit/debt crises

The US market in particular has had a remarkably smooth upward run this year, cruising right through the fiscal cliff, the sequester cuts, the QE taper scare, the government shut down, the debt-ceiling crisis, plus the worsening acrimony and dysfunction in Washington.

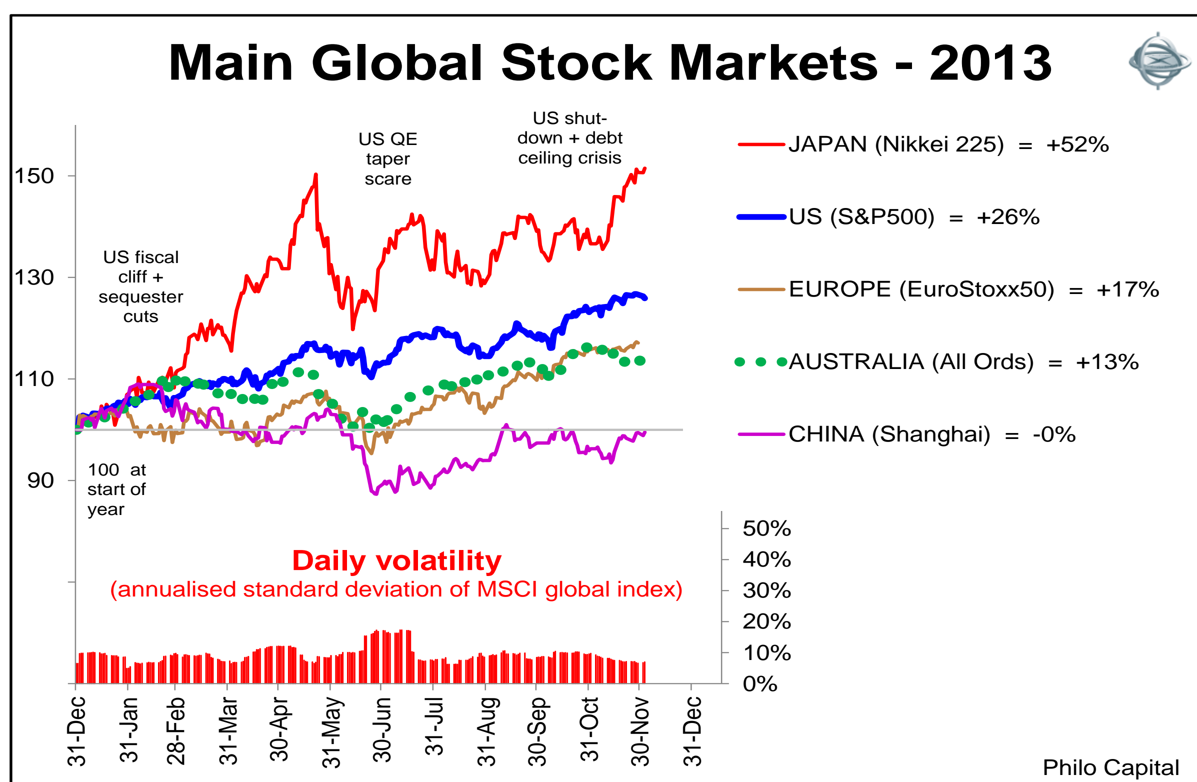
We have been over-weight global shares in portfolios (nearly half of which is US shares) since early 2012, and our confidence in the US was underpinned by a great deal of detailed fact-based research we did over the past 12 months into the US debt situation going right back to Abe Lincoln. This work was summarised in a number of Cuffelinks articles.

Far from being the end of the world, as predicted by many, our research showed that prior US Treasury defaults and government shutdowns actually provided catalysts for positive change and rising share prices.

Low volatility as well!

Volatility on global stock markets has also been incredibly low again this year, on any measure. The chart below shows the annualised standard deviation (the most common measure of price volatility) for the global index during the year. It has averaged an amazingly low 9% (compared to a long term average in the mid-teens), and has been below 10% for 74% of the year.

This has been even more calm than the super-calm 2012 (12% volatility) and 2011 (15%) which was more in line with long term average volatility levels.



In spite all of this we still see almost daily media headlines bemoaning these 'volatile times' in this low return world. All this scare-mongering helps sell newspapers, and it gives all those reporters on the 24/7 financial news channels something to babble to each other about.

As I said at the end of 2012, if this is the so-called new-new normal, high volatility, low return world, then let's have more of it.

The missing link has been the money printing on an unprecedented, global scale. The uninformed chatter in the media is that as QE is withdrawn, as it inevitably must be, rising bond yields will be bad for share prices. Last year we also undertook extensive research into every bond yield spike since the Second World War to show that rising bond yields in the current conditions should actually be good for share prices. This has indeed been the case since bond yields started to rise in July 2012. Future Cuffelinks articles will summarise this work.

In summary, 2013 has been yet another reminder for investors to ignore the media hype and focus instead on the facts.

Ashley Owen is Joint Chief Executive Officer of Philo Capital Advisers and a director and adviser to Third Link Growth Fund.

What do fund managers mean by Quality Investing?

Raelene De Souza

Since 2010 global markets have witnessed a flight to yield and quality. In Australia this has been more a flight from resources, but the result is the strong performance of financials, utilities and staples. Investors are looking to invest in companies that are of high quality, are stable, and have steady cash flows. They are looking for stocks that pay regular dividends, and particularly in low interest rate environments, even begin to look like bonds. But successful quality investing means looking at many different factors, and quality investing is definitely not new.

Value investing, on the other hand, is about buying stocks cheaply. An investor may select a group of stocks based on valuation metrics such as high dividend yield or low price-earnings ratio. These metrics will tell you if a stock is cheap but tell you nothing about how healthy the company is. For example, a stock that is in financial difficulty is cheap for a very good reason. This is when quality measures are useful. Quality looks at the health of a firm based on information in the financial statements thus allowing an investor to avoid poor quality firms that are cheap, also known as 'value traps'.

Quality investing extends back to the work of Benjamin Graham in his 1949 book The Intelligent Investor. Whilst Graham is considered the father of value investing the book also indicates he is also the founder of quality investing with the important claim that the greatest losses in share prices come not from buying quality at an excessively high price but, rather, from buying low quality at a price that seems like good value.

Quality measures gained popularity after the burst of the dot com bubble and the spectacular failures of companies such as Enron and WorldCom. More recently the global financial crisis and subsequent sovereign credit crisis has resulted in a resurgent interest in quality measures.

But how do we measure quality? There is no one specific measure; instead numerous studies have been published on the topic with different variations on how it should be measured. Most of these methods look to identify companies that have high predictability of earnings and if possible earnings growth. Some investors start with companies with strong branding, good governance, and well-defined customer base. Others look for staple products, large distribution, and input costs that are easily controlled and modelled.

One of the most popular measures is Piotroski's F-score developed by Joseph Piotroski and published in his 2000 paper, "The use of financial statement information to separate winners from losers". Starting with a portfolio of value stocks, Piotroski looked at whether it was possible to improve performance by eliminating those of the lowest quality. He did this by scoring a stock on nine metrics. For each metric that is met a stock is scored one point as a sign of strength, but if it is not met then zero is assigned as a sign of weakness. The scores are then aggregated to a score out of nine for each stock. The higher the score, the better quality the company.

The nine individual measures of the Piotroski score are:

1. Positive return on assets (ROA) in the current year

2. Positive operating cash flow (OCF) in the current year

3. Higher return on assets in the current year than in the previous year (ROAX)

4. Cash flow from operations greater than net income (ACCRUAL)

5. Lower ratio of long term debt to assets in the current year than previous year (LEVERAGE)

6. Higher current ratio this year compared to the previous year (LIQUIDITY)

7. No new shares were issued in the last year (EQUITY)

8. A higher gross margin compared to the previous year (MARGIN)

9. A higher asset turnover ratio compared to the previous year (TURNOVER)

Each of these measures captures different aspects of a firm's health.

The first three measures capture profitability or whether the firm can generate funds through operating activities.

The accrual measure is an earnings manipulation factor and is widely known in earnings quality research. Accruals are measured as the difference between profits and cash flow from operations. If a company is reporting positive accruals, its management could be manipulating earnings by 'borrowing' earnings from future cash flow.

Three of the signals measure changes in capital structure. Leverage looks at the firms long-term debt levels. A company that increases its long term debt perhaps cannot generate sufficient internal funds from its business. Similarly companies that raise external capital by issuing new shares could be signalling their inability to generate sufficient internal funds. Change in current assets to current liabilities is known as liquidity. A company which has improving liquidity is a good indicator about its ability to pay its debt obligations.

The remaining two signals measure changes in the efficiency of the firms operations. An improvement in margins could mean an improvement in managing costs and/or a rise in the price of the firm's product. An improvement in asset turnover signifies greater productivity from the assets. This can come either from more efficient operations or an increase in sales.

Individually, the nine measures have at times been labelled as weak and having limitations. But together they are a broad brush that can be applied to an index or a large portfolio, and successfully identify companies that are having financial difficulty. Most companies will score in the range five to seven, and they are likely to be safe. But a company that is only scoring one or two out of a possible nine really needs to be looked at very closely.

In the Australian market stocks with low f-scores (scores three or less) tend to demonstrate falling earnings, a reduction in dividends, lower share price performance and increased share price volatility. Companies scoring eight or nine tend to have the opposite characteristics, and portfolios made from high quality value stocks have outperformed over the long term.

Quality measures work best in down markets when investors are looking for certainty. It performs best during a recession (e.g. the tech wreck in the early 2000's and the GFC). It tends to only perform poorly during speculative periods of 'irrational exuberance' such as the dotcom bubble (late 1990's-2000) and the resources boom of 2004 to 2007. During these environments risk appetite increases and investors are willing to speculate on low quality companies. In the sideways market of 2010-2012, following the strong rebound in 2009, market and thematic certainty disappeared and investors moved towards stock level earnings certainty.

In conclusion whilst there is no single measure to define what a quality company is, there are a number of combined metrics which can indicate the overall financial health of a company and provide indications of quality. These measures can certainly help to provide some downside protection especially in more benign or tough market conditions.

Raelene De Souza is a Portfolio Manager at Realindex Investments.

Caveat Emptor

Four Caveat Emptor questions or criticisms on the Nine Entertainment float, inflation linked bonds, SMSFs and investing in bonds as rates rise are on the website.

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