Cuffelinks
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Are public super funds tax efficient?

Professor Margaret McKerchar and Gordon D Mackenzie

The tax paid by a super fund can be one of its biggest expenses so you would expect that it would be managed as efficiently as possible.

In small superannuation funds, such as SMSFs, that is relatively easy as the fund is usually directly invested and, in most cases, the investments are attributed to a member's account. But is that the case for large super funds? Do they manage the tax on their investments and, if so, how do they do it? These were the questions that we set out to answer.

Our research was triggered by the personal experience of one of the authors when working as a tax manager in a large superannuation business. The Deputy Managing Director asked an actuary (as actuaries are better at numbers than tax people!) to review the returns on one of the funds of the company. It was found that the returns could have been increased by 2% per annum had the investment managers taken tax into account when they made their investment decisions.

That was a long time ago, so the question now was whether that was still the case: do investment managers of large super funds still ignore tax when investing, to the detriment of the fund members' returns?

Our starting point was the thinking that the performance bonuses of the Investment Managers of large super funds are based on whether their returns beat certain investment indices, such as the All Ordinaries index. Those indices do not account for tax so, arguably, Investment Managers can ignore tax because they are not rewarded for recognising it.

There are other reasons why Investment Managers might ignore tax, such as the fund structures, tax complexity, costly administration and so on.

In preparation for our research we identified from the academic literature 21 ways that a super fund could efficiently manage its tax. These ranged from 'good housekeeping' tax practices, such as holding investments for at least 12 months to receive the 33.3% Capital Gains Tax (CGT) discount and effectively managing imputation credits, to the other end of the spectrum, such as quite exotic and expensive tax management practices.

What we wanted to know was the attitude of the Chief Investment Officers to managing the fund for tax. But instead of asking them about the 21 tax management methods, we focussed on their attitude to eight of those: were they positive or negative towards taking tax into account by reference to each of those eight?

The second thing that we were interested in was whether they actually did manage the tax of the fund and, if they did, how exactly it was done.

Finally, after the Cooper Review, the regulation of superannuation funds changed from 1 July 2013 so that Investment Managers are now legally obliged to take tax into account when investing. We wanted to know if Chief Investment Officers had changed the way they did their job.

What we found

Again, our starting point was the generally accepted view that because investment managers do not get paid to be tax efficient, they ignore it. We spoke to about 30% of the large fund market, and we found that the Investment Managers are now pretty 'tax savvy'. In fact, they invested the funds by considering the tax effect even though the members of their fund are not directly told about the tax savings. Of course, the members' returns are after-tax, but even though the hard work of managing the tax efficiently was not clearly visible to the members, the managers still considered it a worthwhile exercise.

Managing tax in a big super fund is more complicated than in a SMSF. Take investment in Australian shares. SMSF trustees can invest in Australian shares directly and manage the tax effects. In a large super fund, the investment manager usually appoints a number of sub-managers, some who actively trade Australian shares and others who just invest and hold in accordance with an index. The two sub-managers might hold shares in the same company, with one manager holding theirs for more than 12 months but the other manager holding the shares for less. The latter wants to sell the shares but the other doesn't. The best tax result for the fund, which is a reduction of 33.3% tax on the profit, is to sell the ones that have been held for over 12 months but those are being managed by the manager who does not want to sell. The fund's Investment Manager has to adjust the performance of each of the sub-managers accordingly. This would not be a problem in a SMSF.

Next we wanted to know what methods these large funds used to manage their tax on investments.

There were no major surprises here. Most funds reported managing the 12 month CGT discount rule and investing for imputation credits. But that was about it. As mentioned, we identified at least 21 different ways to manage tax efficiently but broadly, only two of these are widely used in practice.

Finally, we wanted to know if things changed for Investment Managers after 1 July 2013 when the law told them to take tax into account when investing. Again, there were no surprises, as the majority expected not much change.

However, there was one unexpected result. When we asked if they were concerned about tax risk, such as reputational damage from being seen as tax avoiders, the responses astounded us. Yes, indeed that was a concern of the majority of the Chief Investment Officers. It was surprising to us as we are tax people and the 21 or so tax practices and, indeed, the eight we had specifically asked about, were not 'offensive' in tax terms. But they saw them as a risk. We put that down to the fact that the people who we were talking to were not tax people and, perhaps were overly cautious about the complexities of tax and penalties if you get it wrong.

What was the overall message?

It is much harder to manage the tax in a large superannuation fund than in a SMSF but the Chief Investment Officers of these large funds are tax-aware when investing. They use CGT and imputation credit management methods to reduce tax but they are concerned about crossing the line between tax efficient management and tax avoidance.

One issue that did come up was a comparison between the way that these large funds look after their tax and how SMSFs do it. We hope to do a similar exercise in the SMSF market.

Professor Margaret McKerchar and Mr Gordon D Mackenzie, Australian School of Business, Tax and Business Law, UNSW. Research funded by the Institute of Chartered Accountants of Australia. The full report is called, 'Tax-Aware Investment Management by Public Offer Superannuation Funds in Australia: Attitudes, Practices and Expectations'.

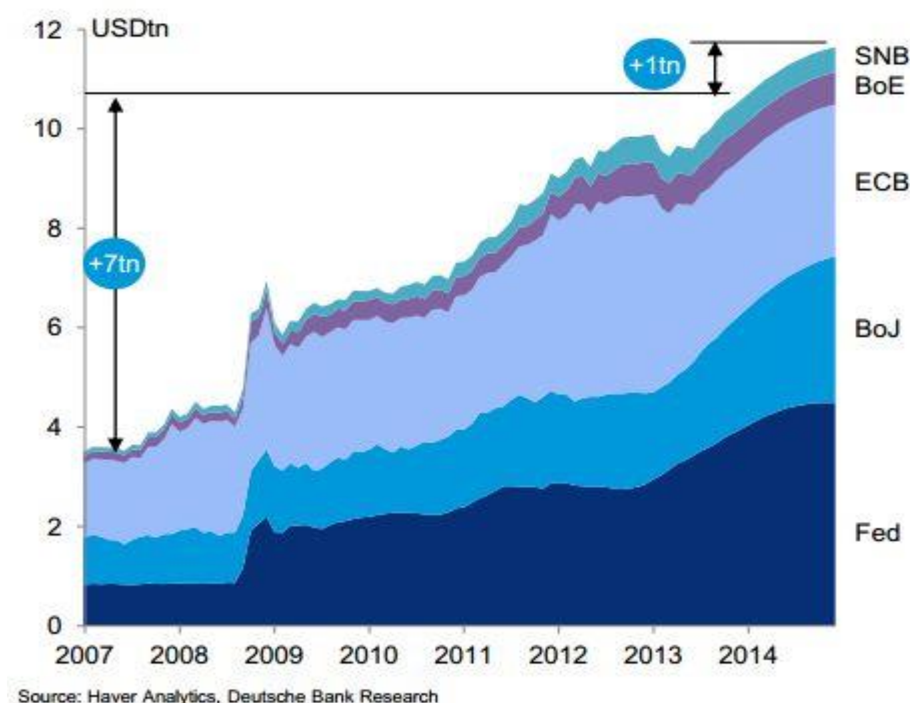
Liquidity is abundant despite QE wind down

Don Stammer

In 1974, the Whitlam Government was making its ill-fated moves to borrow USD4,000,000,000 from the surpluses of oil-exporting countries, and Australians quickly adopted the concept of billions to measure really big numbers. These days, we're used to hearing things measured in trillions. A thousand billion. Last year's US GDP was USD17 trillion and Australian superannuation assets have reached AUD1.75 trillion.

A recent report from Deutsche Bank caught my eye for its use of trillions to quantify the huge expansion in the balance sheets of central banks in the US, the Euro zone, Japan, UK and Switzerland. The five central banks "*have delivered unprecedented monetary stimulus since the [global financial] crisis … Interest rates [have been] slashed to all-time lows [and] USD7 trillion in liquidity added since 2007 … These central banks will remain ultra-supportive, adding a further USD1 trillion of liquidity [in 2014]".*

Figure 1: USD8 trillion of additional liquidity, 2007-2014



I should remind readers that the word 'liquidity', when used in discussions of financial markets, has several different meanings. It's most often used to describe the 'depth' of a financial market: liquidity means that the buying or selling of a particular security doesn't much affect the price at which it trades. Liquidity can also refer to the speed and ease with which a bank or insurance company can convert various assets into cash.

However, in discussions on monetary policy, liquidity refers to what a central bank is doing to the level of the money base. That is, the total of currency (notes and coin) on issue plus the level of deposits the commercial banks have with central bank (which can readily be converted into notes and coin). In turn, 'liquidity creation' (or 'liquidity generation') describes the expansion of the money base, or how much money is being printed.

A central bank creates liquidity when it buys bonds or other financial instruments, intervenes to keep the exchange rate down, or lends to banks or other financial institutions. In those circumstances, the central bank simultaneously acquires an asset (the bond, foreign exchange or loan) and increases its liabilities (the deposits that commercial banks hold with the central bank or the volume of currency on issue).

Central banks in developed economies have been doing 'whatever it takes' to increase spending and jobs and to avoid deflation; in the Euro zone, they've been keen also 'to preserve the euro'.

To date, however, central banks haven't succeeded in boosting business activity as much as they, and their governments, would like. That's because, with many companies and households wanting to cut back on debt and with commercial banks taking a cautious view on lending, much of the additional liquidity isn't circulating or giving rise to an expansion in credit; instead, it's sitting around in idle balances. In the US, for example, commercial banks have USD2 trillion of excess reserves held on deposit with the Fed.

However, the massive creation of liquidity in recent years has greatly reduced the risks of another global recession and deflation. And in most developed economies it's helped drive share prices and house prices higher.

The US Central Bank is expected to end its 'quantitative easing' (QE) by late 2014. Until recently, that programme was running at USD85 billion a month, but has since reduced. But that move – the 'taper' - will simply reduce the rate of build-up in liquidity. It will not result in the withdrawing of some of the massive increase in liquidity that's already been generated. With the central banks of Europe and Japan apparently on course to move further along the paths of unconventional monetary policy, global liquidity is likely to rise strongly over the coming year. A recent move by the German constitutional court could complicate, and for a while delay, asset purchases by the European Central Bank, but the ECB will have no alternative to generating more liquidity if it is to preserve the euro.

Share markets in developed economies seem likely to benefit from the continuation of an ultra-easy setting in monetary policy by the major central banks. However, as average valuations of shares are so much higher than a year ago, the pace of liquidity-led gains is likely to be modest.

Anyone who misspent their youth studying economics would recall the concept of the velocity of circulation of money. Alas, there's not much velocity at present. As and when confidence returns and money starts circulating again, central banks will find it hard to sufficiently reduce the volume of liquidity they've recently created.

Investors preparing for retirement need many years ahead to allow for the mounting risk of a powerful return of global inflation. Not yet, but in the medium term.

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APRA still resisting 'retail' deposits in public super funds

Graham Hand

In the last month, the Australian Prudential Regulation Authority (APRA) has issued two papers on Basel III bank liquidity which continue to take a hard line on deposits offered by public super funds qualifying as 'retail'. APRA views the super fund trustee responsibility as a crucial 'non retail' characteristic. It makes it more difficult for public super funds to compete with retail deposits offered directly by banks themselves, and gives another advantage to SMSFs.

However, while there's certainly no welcome mat, the door is not slammed firmly shut. There are a few snippets in the announcements which give hope to trustees of public super funds. The special exemption which categorised SMSFs as retail has been confirmed.

Previous debate in Cuffelinks

This discussion can become rather technical, but there was a lively debate when the subject was posted in Cuffelinks on 17 April 2013. Here's the previous article. Although we at Cuffelinks thought this was a seriously geeky subject (we even issued a health warning), it received thousands of pageviews. Lots of geeks out there!

We will not repeat the entire argument here. The conclusion was:

"Both the Basel rules and APRA's interpretations judge money from financial institutions to be 'hot' and an unstable source of funding, and the regulations will discourage banks from raising this type of money … It's not a good prospect for publicly-offered super funds as investors seek the security of bank deposits, and it will do nothing to reduce the reliance of our banks on wholesale and offshore funding. We should be designing the system to put super money and bank deposits together, not force them apart."

What are the new announcements, and why is there still any doubt?

There have been two important APRA updates:

1. **Implementing Basel III liquidity reforms in Australia – December 2013**

APRA released its final position on the implementation of the Basel III liquidity reforms for authorised deposit-taking institutions (ADIs) in Australia in December 2013, linked here.

The liquidity reforms involve a 30-day Liquidity Coverage Ratio (LCR) to address an acute stress scenario and a Net Stable Funding Ratio (NSFR) to encourage longer-term funding resilience. The LCR will become effective from 1 January 2015 and the NSFR from 1 January 2018.

In its response to previous drafts, APRA clarifies the position for deposits sourced through public super funds (underlinings are mine):

"Intermediated deposits

In draft APS 210, APRA provided for a treatment for deposits sourced via an intermediary that was different to that for retail deposits. In its May 2013 discussion paper, APRA clarified the reasons for that different treatment, noting that where the intermediary retains investment responsibility or has a fiduciary duty to the underlying customer, APRA considers it appropriate to assume the intermediary will observe that responsibility and duty in a time of liquidity stress.

APRA considers that, in cases where a fiduciary duty exists, the intermediary will consider the complete withdrawal of intermediated deposits at a time of ADI liquidity stress. APRA does not believe it appropriate to consider alternative and weaker interpretations of fiduciary duty."

That appears firm and clear. A super fund trustee has a strong fiduciary obligation to consider a complete withdrawal of funds, and so retail treatment is not appropriate.

But then it becomes slightly equivocal:

"Where an intermediary enters into an arrangement with the receiving ADI to restrict its own ability to withdraw intermediated funds at a time of liquidity stress, while the intermediary can choose to do this with its own funds, such a contract would not limit its fiduciary duty toward its client. APRA also observes that such an arrangement appears dubious on its face for intermediaries with a fiduciary duty to others."

The words "… *such an arrangement appears dubious on its face*" is hardly a definitive, blanket ruling.

Some in the industry believe APRA will not allow retail treatment of any managed investment scheme due to the trustee responsibility, and APRA does not accept that the trustee can put a notice period on its obligations. APRA is also not impressed by 'devices' which try to circumvent the intent of the regulations. Others argue this advice could be interpreted as only warning trustees that they must genuinely have the best interests of their members in mind.

What else supports the claim that the door to 'retail' is slightly ajar?

APRA has reworded the actual Prudential Standard APS210 on Liquidity, Appendix A, paragraph 34, linked here since the last draft by adding this:

"An ADI is required to notify APRA prior to applying a retail deposit treatment to a category of intermediated deposits in the LCR and must be able to demonstrate how this treatment satisfies the conditions outlined in this paragraph."

APRA is inviting trustees to make the case. No doubt it will be a high bar to jump, but publicly-offered super funds will start carefully crafting their responses.

2. Implementation of the Committed Liquidity Facility – January 2014

On 30 January 2014, APRA issued a letter on the operation of the Basel III Committed Liquidity Facility (CLF), linked here, on related-party transactions. This is especially important as banks want their own wealth management businesses (including public super funds) to direct deposits back to the bank.

In the letter, APRA says that some local banks seem to believe that funding from related-party entities has a potential to reduce cash outflows, highlighting two categories that raise prudential concern:

- firstly, where an ADI assumes the related-party entity would choose not to withdraw funds in a stress situation even though it had the right to do so; and
- secondly, where the related-party entity entered into a contractual arrangement that significantly impeded its ability to withdraw funds without any obvious compensating benefit to that entity.

Sounds clear. But here again, the door is left open. It says: *"without any obvious compensating benefit to that entity." But t*here may be a compensating benefit for retail treatment. It assists the banks to meet their liquidity requirements, and therefore they will be willing to pay a higher rate. The trustee can pass this on to the investor (depositor) and show they have assessed the risk/return trade off and decided the compensating benefit is worth it.

But it's certainly not a welcome mat, and APRA also says:

"APRA cannot accept assumptions relating to the potential behaviour of directors and trustees of related-party entities that are not consistent with their duties and fiduciary obligations, in particular where they are imposed through legislation such as the Corporations Act 2001 or the Superannuation Industry (Supervision) Act 1993. Nor can APRA accept directors or trustees of related-party entities signing legal agreements that are not in the best interests of their own entity, its customers or members. APRA expects that ADIs will give careful and detailed consideration to such matters as they assign related-party deposits to particular outflow categories."

Again, "*careful and detailed consideration to such matters*" does not sound like a deal breaker. That's what investment committees and compliance committees are for. Some public super fund trustees will be comfortable that their fiduciary obligation is met in return for a higher rate.

Where to from here?

Qualification as a retail deposit is the Holy Grail for deposit margins, and APRA has been discussing the Liquidity Prudential Standard for years. There remains a divide between those who believe there is little or no room for super funds to claim 'retail', versus others who are convinced that trustees will be able to designate the deposits as outside the LCR (due to a notice period beyond 30 days, for example) and be satisfied they are fulfilling their fiduciary obligations.

The Prudential Standard came into effect on 1 January 2014, although the LCR compliance is not until 1 January 2015. You can guarantee that a few more thousand hours of meeting time will be consumed this year by trustees (and their grateful lawyers) debating whether APRA has left an opening. Ultimately, APRA has the supervisory authority to impose its will, so it's a brave trustee who designs a deposit product that relies on retail pricing before justifying its position with APRA. With the confirmation of genuine retail treatment for SMSFs, it will make it difficult for public funds to offer competitive rates on their deposits.

Four big fat myths of superannuation

Andrew Gale

Welcome to 2014, yet another year of policy debate and wealth industry developments. We have a lot on the slate, including:

- the Financial System (Murray) Inquiry
- FOFA amendments and associated draft regulations and legislation (released on January 29, 2014)
- The Assistant Treasurer's November 2013 discussion and consultation paper, '*Better regulation and governance, enhanced transparency and improved competition in superannuation*'.

… and much, much more.

With such debate, scrutiny and, no doubt, change, it's important we start with firm foundations, and dispel some myths. I hope readers can use my observations to influence opinions in the community.

Today we consider four broad myths or sources of misinformation relevant to public policy. Next week I will address other interesting developments in 2014.

Myth #1: $32 billion of superannuation concessions

Our retirement incomes system gives concessions now to encourage us to save for later, mainly retirement, and relieves the Government of paying for social security in future.

The $32 billion per annum Treasury estimate is, at best, an incomplete measure of the cost of superannuation concessions and the impact on the Federal budget. It's only a snapshot at a point in time, and makes no allowance for offsetting current and future social security savings, the so-called longitudinal effects. Nor is there an allowance for alternative tax-effective investment strategies that people would use if not investing via super, such as family trusts, negatively- geared residential investment, and income from shares with high imputation credits.

Regardless of the estimated cost, Treasury can't escape the fact that Australia's population is ageing, with the proportion of working age people to those aged 65 and over reducing from around 5:1 currently to around 2.7:1 by 2050. Any policy changes which undermine self provision in retirement are not helpful for this future dependency.

Myth #2: Superannuation doesn't fulfil its purpose because retirees just spend their money

A common criticism of our system is that super doesn't fulfil its purpose because people just spend their money in their immediate post-retirement years, then 'double-dip' by claiming social security benefits. This claim is sometimes used to argue for compulsory annuitisation of retirement benefits, rather than allowing lump sum withdrawals.

For example, in October 2012, CPA Australia/KELLYresearch released a report entitled, "*Household savings and retirement – where has all my super gone?*" It calls into question whether superannuation, especially mandated superannuation, and the fiscal support for superannuation is fulfilling its purpose, and it was widely reported in the media.

A close look at the KELLYresearch report highlights some concerns with the process for reaching their conclusions, including a lack of causal analysis in some cases and inconsistency with other sources including ASFA research. For example, it is stated in the Executive Summary that "*people approaching retirement age are using the equity in the family home as a source of funds to assist their children into homeownership, to fund an overseas trip, retire early or simply to live a lifestyle their income cannot support*". The report does not provide strong causal evidence supporting this assertion.

There is clear evidence, especially in SMSFs, that superannuation meets its purpose. On 16 December 2013, the Australian Taxation Office (ATO) released a publication '*Self-managed super funds: A statistical overview 2011–12'***.** Over five years to 30 June 2012, benefit payments from SMSFs averaged $18.9 billion per annum. This report found in 2012, 72% of all benefit payments were as pensions. This has steadily increased from 64% in 2008. There was a corresponding fall in the proportion of lump sum payments over the period. Further, at least a portion of the 28% in lump sum benefits is reinvested in income-producing investments.

Myth #3: SMSF property investments are driving a price bubble

Alarmist comments about investment in property in SMSFs cite property spruikers, Limited Recourse Borrowing Arrangements (LRBAs), and SMSFs favouring residential property as all contributing to a property bubble. These comments are not always well informed by the facts.

It's even more worrying when the comments come from the Reserve Bank (September 2013 Financial Stability Report warning: the SMSF sector represents a potential source for speculative demand) and ANZ (ANZ's January 2014 submission to the Senate's ASIC review highlighted the potential dangers of geared real estate investments by SMSFs).

The facts are:

1. SMSF borrowing growth is moderate. The ATO's Statistical Overview (sic) says,

   "At 30 June 2012, SMSFs held $6.3 billion in borrowings and $3.5 billion in other liabilities. The level of borrowings is equivalent to 1.4% of total SMSF assets. The proportion of SMSFs (by number) with borrowings increased progressively to 3.7% in 2012."

   This is hardly rampant expansion. LRBAs amounted to $2.3 billion as at June 2012, or 0.52% of SMSF assets, and only 1.04% of SMSFs were involved in such arrangements.

2. The total residential housing market is Australia's single largest asset class (total estimated value $4.89 trillion as at June 2013, per RP Data). Investment by SMSFs in residential real estate as at June 2012 was $15.9 billion or 3.6% of SMSF assets. SMSF investment in residential real estate is around 0.35% of the estimated value of the residential real estate market – not enough for SMSFs to drive a property price bubble.

Myth #4: Superannuation is massively skewed in favour of the very well off.

A sound superannuation and retirement incomes system should be grounded in adequacy, affordability, equity and simplicity. Ideally it would also be supported by stable medium-long term policy so confidence isn't eroded in the system.

It is acknowledged that there is a real vertical equity issue to be addressed, and super concessions are skewed to higher income earners, so it is a regressive system. However, the degree is often exaggerated. As mentioned above, if superannuation didn't have tax advantages, high net worth individuals would (and do) use other tax planning and efficiency structures, including geared property, investment in high yielding shares with imputation credits and management of affairs through family trusts.

Very high income earners benefit from super because in addition to getting a bigger tax concession for each dollar they put into superannuation, they also make on average bigger contributions. The Higher Contributions Tax (HCT) partly addresses vertical integration issues. The equity could be improved by the Government recommitting to the Low Income Superannuation Contribution for people on incomes up to $37,000 pa. In general, vertical equity is an issue requiring further policy consideration.

So, by all means, let's have healthy debate on superannuation public policy matters, but let's have such debate informed by the facts.

Andrew Gale is co-owner and Executive Director at Chase Corporate Advisory and a board director for the SMSF Professionals Association of Australia (SPAA). The views expressed in this article are personal views and are not made on behalf of either Chase Corporate Advisory or SPAA.

Don't go swimming naked for a short term thrill

Roger Montgomery

In the latter half of calendar 2013, investors (and I apply that definition loosely) rewarded those companies that were of lower quality, bidding up their prices to drive a stock market rally that made many look like geniuses.

As John F. Kennedy noted wryly, a rising tide lifts all boats. But it was Warren Buffett who later observed; it's only when the tide goes out that you see who was swimming naked.

At The Montgomery Fund, we carve up the universe of stocks around the world by rating every listed company from A1 down to C5. A C5 company has the highest risk of going broke. Gunns Timber, Hastie Group and Autodom were all C5s for some years before plunging into stock market folklore. Elders, whose woes have seen the company search for buyers and whose share price has collapsed from over $22 in 2008 to 13 cents today, has been annually rated sub-investment grade since 2008.

But the market doesn't always agree that investing in quality is the way to go. From 1 July 2013 to 22 January this year, what we consider high quality companies have done less well, in aggregate, than poorer quality companies.

By way of example, healthcare stocks that we rate investment-grade rose 28% from 1 July 2013 to 22 January 2014, but those we rate sub-investment grade rallied 51%. Similarly, in the consumer staples sector, those stocks rated investment-grade rose just 0.8%, while those rated sub investment-grade rallied 53.9% in aggregate. Finally, in the consumer discretionary sector, investment-grade stocks rallied 17.1%, but sub investment-grade rallied 43.1%.

Is something wrong with our rating system? No. In the long run, investing in quality at prices below our estimate of their value works, but it doesn't work all of the time.

Think for a moment about a rather oft-heard piece of commentary that investors are "switching out of defensives into cyclicals". This statement means it is time to expose more of your portfolio to those companies that are more acutely exposed to the vagaries of the economy.

BHP is a company regarded as cyclical. Its consensus normalised profit this year is expected to be no higher than it was seven years ago, back in 2007. Yet it has increased the amount of money it's

borrowed to help achieve this result from $14 billion to $38 billion. That's what we call cyclical. Similarly with airlines which I have written about before, where profits are lower than a decade ago despite massive capital and debt injections.

Unattractive economics are common amongst cyclical businesses or those that score poorly using our quality scoring approach.

Regardless, many will believe that the market is always right, and whatever price the everyday investor is willing to pay for shares – irrespective of whether it's based on poor or unqualified advice or not – is the true value of the company. Rubbish!

In my view, absolute value has had little to do with the recent trend of poor quality company outperformance. Much of it, however, can be attributed to the equally spurious investment strategy based on relative value.

Many analysts believe that if the best quality companies have already rallied hard and their aggregate price to earnings ratio (PE ratio) is, for argument's sake, 18, and a security in the same sector can be found with a PE ratio of 12, then the rationale goes that it's time for the stock with the PE ratio of 12 to catch up.

Our current thinking is that the market rally in the early part of 2013 eroded most of the value that was observable prior to that. There was still some relative value available among the lower quality companies, so much of the market gains more recently have been driven by a rally in the laggards.

The pattern is not without precedent. High quality companies rally first and then, desperate to generate activity, advisers encourage the latecomers to purchase those companies that haven't caught up. But the idea that company X should have a higher share price because its peers are now at 1.3X, is logic that's akin to suggesting a Volkswagen Kombi will beat a Ferrari in the next race because the Ferrari has won every race prior.

Unjustified by valuations and the economics of a business, the shares of some companies can indeed rally strongly and remain high for a time, but in the long run, share prices follow the economics of a business and its resultant valuation.

As Buffett also advised: "If you aren't happy to own the whole business for ten years, don't buy a little piece of it for ten minutes."

This sensible piece of advice is easily forgotten by those brokerages whose need to generate profits requires activity on the part of their clients. But sound advice, which is the preserve of many brokerages most of the time, can give way occasionally to some absurd examples. Witness, for example, this recent suggestion by one international broker:

"As we are proposing a move away from quality, which has performed well in recent years … it provides the opportunity for portfolio managers to consider the merits of some of the less fundamentally-favoured stocks … as they will likely provide the most alpha ..."

Just as the steam rises from dog dung in winter, so too can the price of rubbish companies in the short run. In the long run, they fall right back again and you'd have to be a very clever gambler to know precisely when the steam will stop rising.

While the rubbish is running, it's hard not to be tempted from one's own strategy, especially as there's a regret that emerges when prices for all stocks broadly rise. But don't regret the gains that were missed. The risks aren't worth it when the tide goes out and you're left swimming naked.

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

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