Cuffelinks
Connecting investors with ideas

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Cuffelinks Reader Survey results

Our thanks to the 972 readers who filled in our Reader Survey. This is a great response rate and the feedback provides valuable guidance for the future of Cuffelinks.

Cuffelinks is a community of investors sharing ideas, and in the spirit of openness, we are taking the unprecedented step of attaching all 447 answers to the final question – 20 pages of comments, warts and all. We have edited out only names and email addresses in the interests of privacy and confidentiality, and we have not touched the spelling or grammar.

The bar charts on responses to every question are linked here.

The verbatim comments are linked here.

In brief, some of the findings are:

- 38% of our readers identify themselves as 'SMSF trustees' while 32% are investors without an SMSF. Most of the rest are industry professionals, many of which would also manage an SMSF.
- 73% say the length of our articles is about right, while 15% say it depends on the subject. Overall, we think we are writing appropriately for our audience.
- 82% like to receive the newsletter once a week, with little support for more frequent.
- a large majority consider our articles easy to understand, credible and professional, so we hope we are pitching our content at the right level.
- there is not much support for more political commentary or lifestyle stories, and only a little more for stock picking. Long term forecasting is more popular.
- while almost 60% report using Cuffelinks to investigate particular subjects and to reference useful articles, over 40% do not use the search function or use Cuffelinks as a general information source.

- 82% have already recommended Cuffelinks to a friend or colleague and a further 5% want to do so. Thank you very much, the word-of-mouth support is crucial for our growth.

There were also hundreds of responses attached to specific questions which we take on board.

The 447 responses to the last question are a treasure trove of useful insights. Most value our independence and variety of expert opinions, and want us to avoid overt product promotions or advertising. There is recognition of our focus on quality of analysis, sharing expert opinions and information rather than grabbing the headlines. While some say we are too technical, others say we should write more in depth, so hopefully each edition has something for everyone. We have attached every comment to allow everyone to see what our community thinks.

We know you all have many priorities in your life and we appreciate the time you took to complete the survey.

From the team at Cuffelinks
Chris, Graham, David, Ashley and Leisa
July 2014

Different risks and benefits in SMSF gearing

Tony Rumble

The Murray Financial System Inquiry Interim Report has called for scrutiny of SMSF gearing. Certainly any form of dodgy spruiking must be eradicated from all forms of consumer activity. But misunderstanding the variety of true risks and benefits involved with SMSF gearing is what led to the inept banning recommendation in the Cooper Report into superannuation. Sensible analysis of SMSF gearing must delineate between the benefits of 'protected' SMSF loan products, compared to newer, riskier SMSF lending technology which certainly should be under the microscope.

Analysis needs to understand the portfolio construction drivers of SMSF gearing. SMSF investors are often reacting to the failure of the actively-managed funds industry to adequately protect retirement savings from market crashes. Ken Henry has called this 'sequencing risk'. Even the peak super regulator (APRA) stated in its 2009 review of superannuation that it doubted "the value of the active approach to risk management" because of fund under-performance which they saw as "more pronounced in down markets."

Investment control is the main reason people set up SMSFs. Many buy and hold assets for the long term – the opposite of the high turnover trading of actively managed 'benchmark aware' managed funds. Increasingly they are turning to the apparent security of bricks and mortar and direct share investing, and use SMSF gearing to help. The buy and hold approach accesses a growing income stream from rent or dividends, insulating the capital value of the portfolio from the risk of loss that comes with high frequency trading.

All SMSF borrowing is limited recourse

SMSF gearing is required by law to be 'limited recourse' - it must not allow the lender to recover any losses from the general assets of the borrower. Think 'jingle mail' lending in the US housing market, where apart from selling the secured asset to cover any loan default, the lender can't chase the borrower to top up any remaining losses. That can lead to systematic risks to the banking sector and that is why – at least in the case of SMSF lending against shares – loan providers typically embed additional protection mechanisms when they lend to SMSFs.

Properly used these protection mechanisms can actually reduce risk to investors. Take the case of ASX listed instalment warrants, which have been popular with SMSFs since their inception in 1997 (and disproving the urban myth that SMSF gearing has only been legal since 2007). In this multi-billion dollar market, the instalment warrant issuer charges a slightly higher loan interest rate and uses the excess to buy put options to cover its risk of loss in the event that the instalment loan is not repaid.

In the case of these instalment warrants, because the loan subsidises the cost of investment, the investor actually enjoys lower risk than if they purchased the share outright. Further, as long as annual interest payments are made on the instalment loan, the investor retains total control over the loan and hence controls when and if the underlying share is sold. SMSF property loans work similarly. As long as the loan interest is paid, the lender can never force the sale of the property against the wishes of the SMSF.

This avoids the problem with margin loans where the investor can be forced to sell shares into a falling market, even if loan interest is being paid, when the share prices falls sharply. Being forced to sell in down markets is termed being 'short gamma', and this is the problem which bedevils margin loans, many structured products, and traditional actively-managed funds.

Structural issues which need addressing

There are four structural concerns with SMSF gearing:

1. An investor protection issue does arise with newer forms of SMSF gearing, such as the 'stop loss' style of instalment warrant, and the 'equity lever' forms of synthetic SMSF gearing. Both products are 'short gamma' and behave like margin loans. The product issuer doesn't use put options to protect their loan, instead selling down shares when the market falls, in order to repay the loan prior to the share price falling below the loan amount.

2. SMSF gearing is a form of derivative because repayment of the loan is optional. It should be regulated by requiring advisers to have competency to advise on derivatives, and the financial skills to assess the risk of higher break-even costs (because of interest payments) overwhelming the geared investment.

   This highlights two other aspects of concern: the need for better professional education for financial advisers (critically noted by the Murray FSI); and the need for effective policing of the 'investment strategy' provisions of the SMSF rules (as yet ignored by the FSI).

3. Under current rules for Registered Training Organisations (which can deliver vocational training to financial advisers, as well as to builders, nurses, etc), far more emphasis is placed on educational mapping than on the calibre of the teachers or course content. Registration of financial adviser education should be singled out for far better quality control than the current system allows.

4. All SMSFs must have a comprehensive investment strategy, but this key financial statement isn't properly regulated by the ATO which under current staffing arrangements isn't equipped to do so. Expert investment analysis of the sort routinely conducted by APRA is needed to evaluate investment strategies.

SMSF gearing can reduce risk and is part of a DIY trend which seeks to avoid the problems that characterise the traditional funds management industry. Improved financial literacy and exposing the variety of SMSF gearing products and risks - coupled with better regulation of the financial advice industry - is a better way to move forward, compared with throwing the baby out with the bathwater by banning this important form of investment.

Tony Rumble was a consultant to the Ralph Review of Business Taxation and is Chief Executive of LPAC Online and Founder of SMSF Advice Solutions.

SMSF Professionals' Association of Australia (SPAA) has published its Lending Guidelines for limited recourse borrowing arrangements (LRBAs) with SMSFs.

Learn your knowns and unknowns

Roger Montgomery

Investing is a 'risky' business. Whenever you part with capital, you're doing so in the hope that the return will adequately compensate you for the likelihood of loss. As such, one of the keys to long run success with any investment is an intimate understanding of both risk and reward.

Unfortunately, it seems that people are more familiar with the expected returns of an investment, and less aware of the risks required to generate those returns. This is akin to investing with a blindfold on. For instance, many investors will be familiar with a company's dividend yield as distributions are a primary source of their income. But they may fail to consider that their income can be adversely affected by a drop in the share price if they sell.

This imbalance may be explained by the inherent difficulty of quantifying risk in the share market. To accurately assess risk, you need to understand the payoffs from all possible outcomes. For instance, when you enter a casino and walk up to a roulette table, there are three possible outcomes from putting your chips on black. If the ball lands on red or zero, then you lose all your capital. If the ball lands on black, then the payout is twice the initial wager.

Defining the risks and rewards in the share market is far more intensive. It's vital to understand intimate details of a company's operations and all external forces that may impact earnings.

Of course, there are natural constraints to the amount of time, effort and resources one can commit to research. What's more, if you attempt to understand every minor aspect of a company, you may become lost in the detail and fail to see the bigger picture.

Clearly there will be a point where you will have a sufficient, but incomplete amount of knowledge to justify your commitment to an investment. But how long should you spend researching a company?

Unfortunately, there is no clear answer this question. What may be helpful though is to consider Donald Rumsfeld's simple (yet rather ineloquent) approach to assessing risk. The former US Secretary of State divides risk into three categories – known knowns (things that we know that we know), known unknowns (things that we know that we do not know), and unknown unknowns (things that we don't know we don't know).

You may need to re-read that passage again before continuing. Although it's a complete tongue-twister, we can actually apply this into a research framework.

The easiest place to begin researching a business is to consider the known knowns. What is it that we know about long-term performance? Has the business been successful in the past, or is it just another promising story?

A deep pool of academic research has shown that companies that have generated meaningful returns over a long period have certain financial characteristics. For instance, companies with a track record of high returns on equity and strong balance sheets should offer more compelling long-term value than companies with highly volatile performance and excessive borrowings.

Understanding a company's financial statements will help shape your subsequent research, as it will allow you to become aware of certain unknowns that warrant investigation.

A critical known unknown is how the business operates, yet many investors would dismiss this as a known known. For instance, you may think you know how Woolworths operates, because you buy your groceries there. But can you clearly articulate how one dollar of revenue flows through the business? The more you understand how a business operates, the more unknowns you will become aware of, which further improves your understanding of the investment's risk.

Your analysis should continue until you're comfortable for the known unknowns to remain unknown. For instance, the customer base of a business is a critical known unknown. If your research reveals that a company is dependent on a single customer, this presents a material unknown that requires further

investigation. But if the customer base is highly fragmented, then it may not be worthwhile (or even possible) to identify the risks in every contract.

Invariably there will always be unknown unknowns when investing. The weather, global events, human behaviour and emotions can have a meaningful impact on a company's prospects, but these are more difficult to quantify.

It is because of this unquantifiable risk that we should require a sufficient margin of safety to warrant the investment. If we remain patient and wait for the share price to trade at a meaningful discount to what we think the business is worth, then this gives us an additional buffer against adverse events that we've yet to consider.

Of course, your analysis of a company won't stop once capital is committed. Over time, you will become aware of more unknowns, and these revelations may result in a completely different investment thesis. While your investment style may become more conservative with this approach, your portfolio is more likely to generate returns that better reflect the effort applied to understanding the risks.

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

Understanding the bring forward rule

Monica Rule

The maximum personal contribution (i.e. non-concessional contribution) into an SMSF (or any superannuation fund) increased on 1 July 2014 to $180,000 per year or $540,000 using the two year bring forward rule. Many SMSF members are confused as to how to use the bring forward rule. The questions that I am often asked are: when does the clock start, which financial years are counted, and can you only make three years worth of contributions while you are under the age of 65?

Let me explain.

Firstly, the two year bring forward rule will be triggered automatically as soon as you make personal contributions totalling more than $180,000 in one financial year. This will occur even if you only exceeded the annual amount by one dollar.

Secondly, under the superannuation law, you are entitled to use the bring forward rule as long as you were under 65 years of age in the first year of contribution. You just need to make sure that at **any time** in the first financial year (from 1 July to 30 June) you were under 65 years of age. If your birthday falls on 2 July and you turned 65 on that date, you qualify because you were under 65 years on 1 July. It doesn't matter that you are no longer under 65 years of age the rest of the first financial year or the following two financial years.

Thirdly, if you are aged 65 to 74, then you will need to be working at least 40 hours in a period of not more than 30 consecutive days in a financial year to be entitled to make a contribution into your SMSF. If you did trigger the bring forward rule in the first financial year when you were under the age of 65 and you have made some non-concessional contributions towards the $540,000 limit, and you are planning to contribute the remainder of your $540,000 after you turned 65, you will need to meet the part-time work test. The work test only has to be met once in a financial year. You can make contributions once you have met the work test. You do not need to be working every month to make further contributions.

The fourth point is once you have triggered the bring forward rule, you cannot make further non-concessional contributions into your SMSF until after the third financial year. So if you triggered the bring forward rule in the 2014/2015 financial year and contributed the full amount of $540,000, you cannot

make any more personal contributions until 1 July 2017. This is because you have used up your annual limits for three financial years being 2014/2015, 2015/2016, and 2016/2017.

Finally, for those that have already triggered the two year bring forward rule in the last financial year (i.e. 2013/2014), you are stuck with the $450,000 limit (three times the old $150,000 cap) and cannot use the increased limit of $540,000 until your bring forward time period is over. Don't make the mistake of claiming a further $90,000 under the three year cap by making further contributions. Your three year limit is still $450,000 because you triggered it prior to the change in the limit taking effect. Making a contribution in excess of your limit will be considered an excess contribution and you will be penalised.

A lot of people have missed a good opportunity to make larger contributions into their SMSF simply because they have not stayed informed of changes to government policy. It pays to have a good understanding of how the limits apply to your personal circumstances.

Monica Rule worked for the Australian Taxation Office for 28 years and is the author of 'The Self Managed Super Handbook – Superannuation Law for Self Managed Superannuation Funds in plain English'.

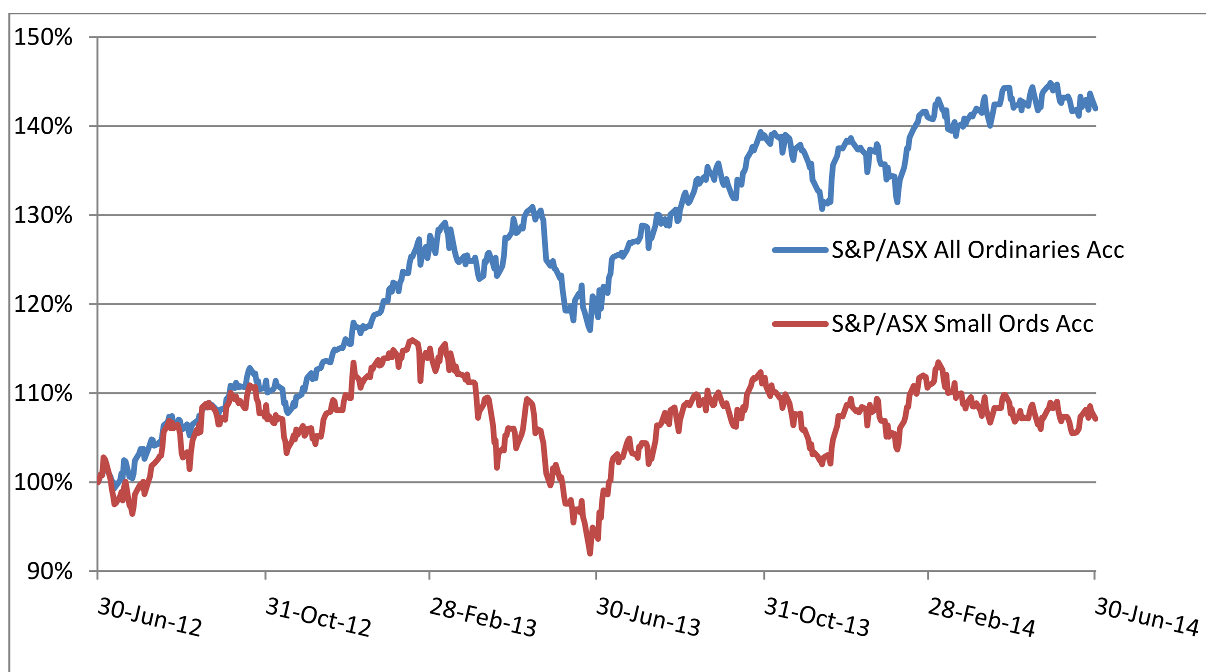
Why have small cap stocks underperformed?

Chris Stott

According to the renowned Elroy Dimson, Emeritus Professor of Finance at the London Business School, the share prices of small companies have consistently outperformed large companies over the longer term. The 'small-cap premium', as Dimson describes it, equates to an average of 0.54% per month across global equities over the long term. In the United States the premium is 0.72% per month and in Australia, it accounts for 0.52% of outperformance per month, one of the highest premiums of the markets compared. However, over the last two years small caps have underperformed their large cap rivals in Australia. So why have our small company share prices bucked the historical trend?

Measuring up

Since mid-2012, the S&P/ASX All Ordinaries Accumulation Index, which represents the 500 largest companies listed on the Australian Securities Exchange (ASX), has risen a remarkable 47.0% as the current bull market has charged ahead. Over the same period, the S&P/ASX Small Ordinaries Accumulation Index, which tracks the performance of the ASX's small-cap companies (outside the top 100), has increased just 11.7%. The contrast between the two indexes is stark and particularly incongruous when you compare the two indexes over the preceding three years. Between March 2009 and June 2012 the Small Ordinaries Index outperformed the All Ordinaries by 9.6%.



Is the 35.0% outperformance by large companies over small companies in the last couple of years reflective of a structural change or is it a mere short term variance? In our view, the last two years in the Australian equities market represents a short term anomaly to the longer term trend. We believe this is the case for two main reasons. Firstly, small mining and mining services companies which dominate the Small Ordinaries Index have significantly underperformed in recent years. Secondly, the All Ordinaries Index is dominated by the big four banks and Telstra and has relatively outperformed as investors have piled into these stocks in search of yield.

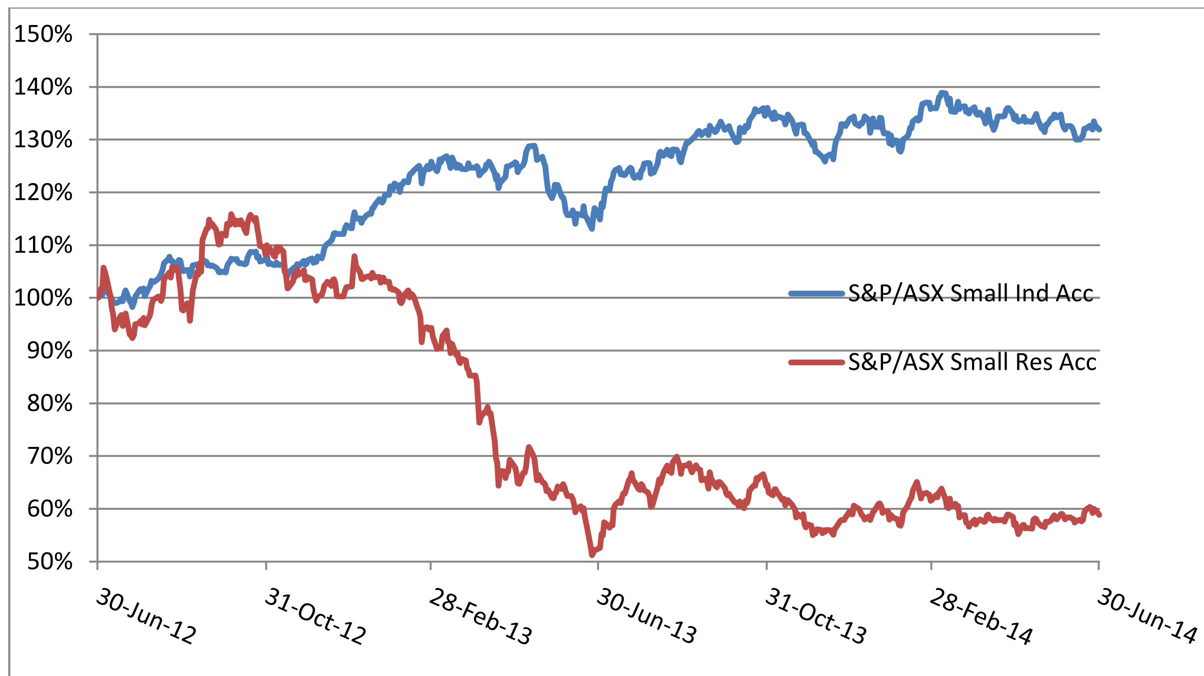
End of the mining boom

The well-documented end of Australia's recent resources investment boom has hit the mining and mining services sector hard. As China adapts to lower economic growth, the demand for resources has softened and spot commodity prices have fallen, in some cases, significantly. While Australia's miners were the major beneficiaries of numerous major mining projects announced, through the 2000s, many of these projects are now coming to an end. With Hancock Prospecting's Roy Hill mine the only major new domestic project currently slated to come on line, the contract pipeline for many of Australia's mining and mining services companies is now very weak. As a result the valuations and share prices of many of these companies have plummeted with some trading below their prices during the depths of the GFC. Tellingly, the five worst performers over the last two years are mining and mining services companies as shown in the following table.

ASX code	Company	2 year share price performance
BLY	Boart Longyear	-93.5%
SBM	St Barbara Limited	-93.5%
RFE	Red Fork Energy	-88.4%
BTU	Bathurst Res Ltd	-88.1%
LYC	Lynas Corporation	-84.6%

In 2012, a total of 36% of companies that made up the Small Ordinaries Index were mining or mining services companies. As at 30 June 2014, this figure had dropped to 26%. Over the last two years, the Small Resources Index which measures the performance of small mining companies alone, shows they

collectively fell 42%. Stripping out the mining companies from the Small Ordinaries Index, the Small Industrials Index reveals the remainder of the small caps performed strongly, rising 32% over the last two years. While mining companies have floundered, we have experienced a recovery in many cyclical industrial stocks such as those in the housing and finance sector.



The hunt for yield

A key market theme over the last couple of years has been investors' chase for yield as the Baby Boomer generation moves into retirement. While in the past a reasonable income stream could have been derived from term deposits, the current historically low interest rates have driven investors into higher-yielding blue chip stocks. Whereas term deposit yields are averaging around 3.3% per annum, Telstra, for example, is currently paying a grossed-up yield of 7%. With some maturing term deposits previously paying around 6%, the choice between rolling over at around half the yield or investing in Telstra is compelling. And as banks have benefitted from low interest rates and better economic conditions, they have performed strongly.

Australia's equity market is very narrow with the four major banks and Telstra currently accounting for 32% of the All Ordinaries Index. Their valuations have increased with a disproportionate impact on the equity market resulting in them being responsible for approximately two-thirds of the equity market's performance over the last two years.

Small cap performance to return to long term trend

The key to small caps turning around will be the improvement in mining stocks. If commodity prices rise and investor sentiment towards mining stocks improves, this will necessarily improve their valuations. Already there has been an improvement in sentiment which has led to a rise in the sector's share prices of approximately 15% off their recent lows.

We expect that current low interest rates could drive economic growth which would in turn lead to an uptick in small cap earnings. In our view, the small cap sector will again outperform the large caps reflecting Dimson's findings over the longer term, and the recent underperformance by the small cap sector is a cyclical, rather than a structural change.

Chris Stott is Chief Investment Officer at Wilson Asset Management. His views are not personal financial advice and readers should seek their own professional advice before making any financial decisions.

Piketty's best seller: Bleak House, not Balzac

William J. Bernstein and Rob Arnott

Few outside of a Trappist monastery will be unaware of the stir created by Thomas Piketty's *Capital in the Twenty-First Century*. The book distills the fruits of a career in the econometrics of inequality. Recently under attack for some errors in basic arithmetic, its theoretical and empirical insights, literary grounding, and agile prose improbably propelled this massive economic tome to number one on the Amazon list!

Distilled to its essence, *Capital* posits that the real return on investment, '*r',* is necessarily greater than the real growth of the economy, '*g'.* The gap between these two, estimated at 3% per year, drives wealth and income disparities around the developed world. With stagnating productivity and population growth, Piketty sees this gap widening, fueling ever-worsening inequality that threatens to recreate the hereditary wealth of Europe's ancient regimes.

Nurtured in *les grandes écoles*, Piketty never descended into the grubby depths of practical finance; incredibly, he depends largely on Balzac and Austen to estimate *r*, which he sees as a near-gravitational constant of a real 5% per year. Would that he had studied actual market returns, readily available over a century-plus from Elroy Dimson and his colleagues, and the nature of historical dynastic wealth, as well as he had nineteenth century literature.

Better, we think, to read Dickens' *Bleak House*, which saw a patrimonial fortune disappear into estate litigation. He is wrong in his core premise and hence about the risk of dynastic wealth. How many of today's billionaire 'dynasties' descended from vast wealth? And how many fortunes of the Austen and Balzac eras survived? Piketty's dynasties are a myth, more implausible today than ever.

Let's examine why.

In theory, Piketty admits, '*r'* falls with increasing societal wealth, but he ignores that this is ancient history: while Austen's Regency Period characters thrived on 5% consols, by 1900 their yields had fallen to 2%. The encyclopedic data of Dimson, Marsh and Stanton show that while global equities indeed dealt out a real return of about 5% during the twentieth century, bonds returned only 2%, and bills 1%. Today, with real bond yields hovering near zero, even a 2% real return on a balanced financial portfolio seems wildly optimistic.

Much of the world's wealth today consists of residential real estate. Today's price/rent ratio of Paris flats allows Piketty to declare the same 5% current return on property enjoyed by Austen and Balzac's protagonists. This would certainly surprise the Parisian property owner who is liable for taxes, repairs, periodic renovation, and depreciation as the properties age. These easily consume half of that 5% gross yield.

The tip-off that he would rather not consider the role of this tumbling forward-looking '*r'* is his trumpeting of the more than tenfold increase in the fortunes of two billionaires, Bill Gates and heiress Liliane Bettencourt, between 1990 and 2010. It takes a peculiarly ideological blindness to ignore the fortuitously high '*r'* of those two decades, and also to suppose that business acumen played no role in their fortunes.

Piketty touchingly believes that hedge funds, alternative investments, and private equity enable the One Percent to outperform the huddled masses and their pitiful index funds. We're serious professionals, so we would appreciate it if Mr. Piketty refrained from trying to make us giggle.

In addition to expected real returns about half his presumptive 5% norm, Piketty ignores a laundry list of factors that further corrode family fortunes. Attentive observers might notice that even rich people breed, as did his beloved Austen and Balzac characters. Each generation saw a comfortable £1,000 annual income halved or worse unless, of course, they hijacked another family's fortune through marriage. Estate taxes, non-existent in Austen's England, can halve this yet again.

The rich also make performance-chasing investment blunders, give to charity, pursue costly estate battles, overpay for investment and tax advice, and suffer taxes on capital gains and interest/dividends.

By the way, do the rich and their heirs tend to *spend?* Yes, they do … sometimes a lot.

If each of these "wealth extinction factors" costs just 1% of annual return, personal real net worth tumbles more than ten-fold per generation. We think that a 2% average annual cost per factor is closer to the truth, in which case hereditary wealth evaporates within the proverbial two generations. Our eye settles on a family reunion held at Vanderbilt University in 1973 – less than a century after the death of Cornelius, then the wealthiest man in the world – with not a single millionaire among the 120 heirs in attendance.

Most of today's affluent – even in France – earned their success through entrepreneurial risk-bearing, innovation, hard work, and much luck. Not that income and wealth inequality don't concern us. Wherever social mobility is absent, they do. Dynastic wealth, which disappears faster than you can say "Vanderbilt" or "Bleak House"? Not so much.

William J. Bernstein is an American financial theorist whose bestselling books include The Birth of Plenty and A Splendid Exchange. Rob Arnott is the Chairman and CEO of Research Affiliates, a former Chairman of First Quadrant and has published over 100 financial articles in major journals, many of which have received awards.

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