

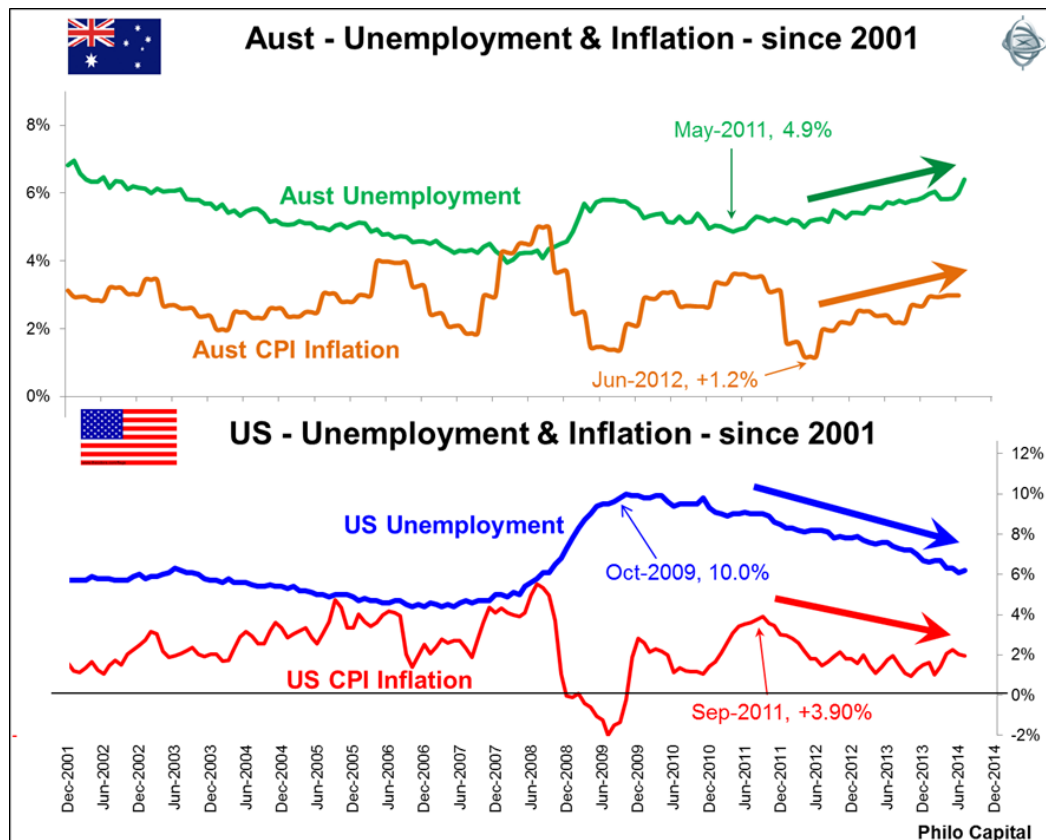
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Policy pincers in Australia and the United States

Ashley Owen



In the US, the two big policy imperatives – unemployment and inflation – have been going in the right direction (down) since 2011. Ultra-loose fiscal policy (four years of trillion dollar budget deficits) and ultra-loose monetary policy (near- zero interest rates and unprecedented money printing) have borne fruit, albeit slowly:- the economy is growing, the unemployment rate is falling, the budget deficit is contracting, deflation has been avoided, inflation has been low, and asset prices are rising (including shares, bonds, housing and commercial property). The 'QE' money printing program is coming to an end without rattling asset markets or investor confidence.

Falling unemployment plus very low inflation, despite the strong dollar and tightening budget, mean the Fed can start tightening monetary policy by raising interest rates. The big risk is that the Fed continues to dismiss rising inflation as 'noise', and keeps interest rates too low for too long. The likely outcome is that the Fed will wait too long and have to hit hard with unexpected interest rate hikes, rattling investment markets, as in 1994.

Standing behind Fed Chair Janet Yellen now is the new Fed Vice Chairman Stan Fischer who, as head of Israel's central bank from 2005 to 2013, used aggressive money printing to over-stimulate the Israeli economy, resulting in high inflation and a roaring housing bubble.

Investors want to see the Fed keep interest rates low for longer, but not for so long that it will be forced to act suddenly and unexpectedly to tackle inflation. All eyes and ears are on Yellen and how she views inflation and unemployment. In July she indicated that the rising inflation was merely 'noise'; that monetary policy (rate hikes) should not be used to address asset bubbles; and that her main focus is now on 'under-employment', which is running at twice the rate of unemployment. In her Jackson Hole address at the end of August she hinted at possible rate rises early in 2015, rather than mid-year. But she also made it clear that she would be very careful and responsive to any adverse effects of rate rises on growth or employment.

It is the reverse in Australia. Here we have rising unemployment rates and rising inflation. In addition we still have very loose, and now politically chaotic, fiscal policy (big budget deficits and a hostile, volatile Senate). Inflation is already at the top end of the RBA's target range but the RBA cannot raise interest rates to kill inflation and cool the housing market for fear of causing the dollar and unemployment to rise even further.

August saw the unemployment rate rise to 6.4%, up from a pre-GFC boom-time low of 3.9% in February 2008 at the peak of the commodities boom. Inflation is now up to 3%, the top of the RBA's target range, and up from just 1.2% two years ago. Even 'core' inflation is now 2.9%. July also marked the start of the new Senate, with Palmer and other micro parties making fiscal policy and genuine economic reforms more challenging. This is dampening business confidence and investment and may necessitate the RBA providing monetary support for longer – ie keep interest rates low for longer.

As a result, the RBA, like the Fed in the US, will also probably act too late and too harshly with rate hikes. Indeed the RBA may even try another rate cut first to try to bring down the dollar. This would probably further inflame prices in the property and share markets, as well as accelerate consumer price inflation. That would mean it would need to come down even harder and harsher with rate hikes later on.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

Does insurance belong in super?

Christopher Sozou

The establishment of the compulsory Superannuation Guarantee was in recognition of the unaffordable nature of the pension system, given the demographic shift that the baby boomers would create in coming decades. It forms a major pillar in Australia's retirement savings framework whereby retirement income is funded by:

1. the safety net of the pension system
2. superannuation savings including voluntary and compulsory contributions
3. personal savings.

After only 20 years, Australia has created a savings pool that is the envy of the world.

Interestingly, there is nothing in the above which addresses insurance needs, yet life and TPD (total and permanent disability) insurance are playing an ever-increasing role in superannuation. There is little written about why insurance was included in the superannuation architecture, but one can envisage the logic went something like this:

- superannuation is a compulsory system and every working Australian should have at least one account
- there is an underinsurance problem in Australia
- we can solve the underinsurance problem if we default insurance in super
- if we try hard enough, we can make a link between life and TPD insurance and retirement income.

Insurance seems to be increasingly important in superannuation, whether it be the large increase in premiums in the last couple of years, or the entire section dedicated to insurance in the Super System Review recommendations (otherwise known as the Cooper Review). ASIC lists insurance as one of six key considerations in picking a super fund, while the acknowledgement of consideration of insurance is mandatory in accepting a super rollover form. For SMSF trustees, it is now mandatory to consider insurance as part of the SMSF's investment strategy. Insurance is well and truly imbedded into the superannuation system.

Yet the question that does not seem to be asked is, "does insurance belong in super?"

The main objective of the super system is to alleviate the pressure on the age pension system. This gives us the 'sole purpose test' which ensures a super fund is maintained to provide benefits to its members upon their retirement (benefits can be released prior to retirement age, but these are only under special circumstances).

Contrary to the sole purpose test, life and TPD insurance provides protection primarily for the current day, whether for a member's family in the event of death or the member themselves in the event of a permanent disability. The Cooper Review's justification for this was that:

"Superannuation funds are generally structured towards financing a period of retirement after a long engagement in the workforce. Fortunately, that is the experience of most members. However, for a significant number of members each year, total and permanent disability (TPD) or premature death mean that they or their dependants need to call on their superannuation savings much earlier and for a longer period than they would have expected. Insurance plays a crucial role in allowing those needs to be met."

This explanation is not a very convincing link but given the noble purpose outlined, it should not be an issue provided that it does not impact the functioning of the superannuation market.

And this is where things get interesting. Superannuation provides for a retirement outcome. The decision on which superannuation fund is the right fund for an individual is in itself a difficult one, considering fees, service quality, investment options, performance and trust in the institution. Insurance on the other hand provides protection for the current day. In selecting an insurance provider, an individual would consider the level of cover, premiums, service quality, policy exclusions and trust in the institution.

The problem with insurance in super as a default option is that it distorts the decision-making process.

For example, an individual may want to change super funds because they are not happy with the features and service levels of the incumbent fund; however their insurance offering is excellent. What decision does the individual make? Do they compromise their retirement outcome due to their present day insurance needs?

Conversely, a member's superannuation fund may experience a large increase in insurance premiums. Does the member change super funds as a result, even if they are happy with all other aspects of their fund?

Both scenarios create difficult decisions for members and more importantly distract from what a superannuation decision should be based on, engaging with members on their desired retirement outcome.

From a super fund's perspective, there is the time, effort and cost invested in managing insurance within the fund, whether negotiating a policy's premium rates, managing data to support the group underwriting process or managing the claims process. All this distracts from the sole purpose of maintaining a superannuation fund for the purpose of providing benefits to its members upon their retirement.

In trying to solve an under-insurance issue, we have added cost and complexity to superannuation for both product providers and members. The further question is, does the social benefit outweigh the additional cost and complexity?

Christopher Sozou is Head of Wealth at Virgin Money.

Is this time different for trend-following funds?

Professor Mark C. Hutchinson and John J. O'Brien

Following large positive returns in 2008, managed futures (or Commodity Trading Advisers (CTAs)) funds such as those offered by Aspect Capital, Man and Winton received increased allocations from institutional and retail investors. However, subsequent performance has been below its long-term average. From January 2009 to June 2013, the annualised return of the Newedge Trend Index was -0.8%, compared to 8.0% over the prior five-year period, while managed futures assets under management have grown from US\$206 billion to US\$331 billion, according to BarclayHedge estimates.

Understandably, investors in CTAs have begun to question performance. Have markets changed after the 2008 financial crisis? Will these types of strategies ever work again?

In a discussion paper using almost a century of data, we investigate what typically happens to the performance of the core trend-following strategy pursued by managed futures following major global financial crises, and ask is what has happened post-2008 typical of what happens after a financial crisis?

If yes, then what happens to price patterns in the futures markets traded by CTAs to cause this under performance during such turbulent periods?

Methodology

A global portfolio was simulated to analyse the performance of trend-following during six of the largest global crises in the last century: the Great Depression in 1929, the 1973 Oil Crisis, the Third World Debt crisis of 1981, the Crash of October 1987, the bursting of the Dotcom bubble in 2000, and the sub-prime/Euro crisis beginning in 2007.

The start date for each crisis was defined as the month following the equity market high preceding the crisis. Rather than try to define the end of the crisis, 'crisis periods' were considered over two fixed time periods, 24 months and 48 months. All data outside of these periods were considered 'non-crisis' periods.

The data set consisted of 21 commodities, 13 government bonds, 21 equity indices, and currency crosses derived from nine underlying exchange rates covering a sample period from January 1921 to June 2013. Transaction costs were included in the calculation of portfolio performance, based on asset classes traded and time periods. Management and incentive fees of 2% and 20% were applied.

The trend-following portfolio was constructed using momentum signals made up of multiple time periods, averaged to create a momentum signal for each instrument. Each asset class was given an equal risk weighting. Equal risk was also allocated to each instrument within each asset class.

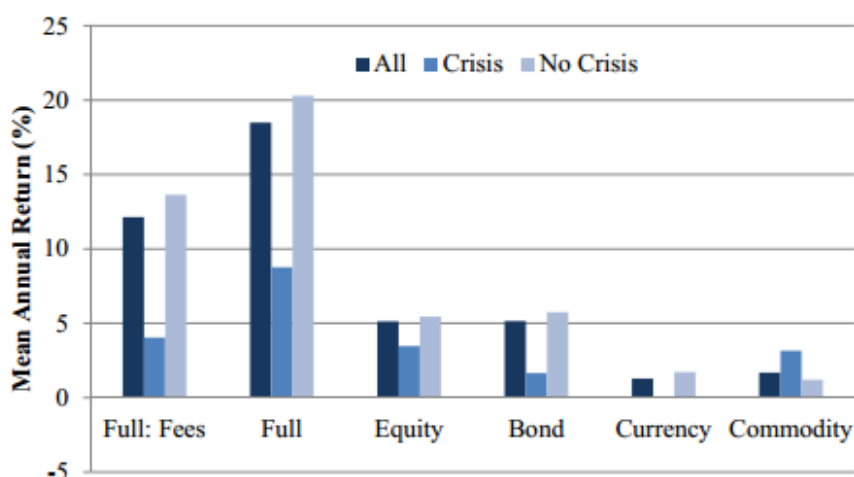
Results

Net of fees, the portfolio delivered an average annual excess return (i.e. excluding the cash return) between 1925 and 2013 of 12.1%, with an impressive Sharpe ratio of 1.1 and volatility of 11.0%. Between 2000 and 2013 the portfolio, net of fees and costs but including a cash return, had a 0.76 correlation to the Newedge Trend Index.

Looking at performance in crisis and non-crisis periods, across the full sample period from 1925 to 2013, the results are very consistent, as shown in Panel A.

The Performance of trend following during financial crises (January 1925 to June 2013)

Panel A: Crisis Period Twenty Four Months



At the full portfolio level the average annualised return in the first 24 months of a crisis is 4%, compared to 13.6% in the non-crisis months. The Sharpe ratio also falls by 0.88 to 0.36. The return in the four-year period from the start of a crisis averages 6%, compared to 14.9% in the non-crisis sample. Here the Sharpe ratio falls from 0.80 to 0.55.

Across asset classes, the results for equity indices, government bonds, and currencies over the four-year crisis periods are all consistent, with the drop in Sharpe ratio ranging from 0.19 to 0.71. Consistent with prior evidence on the lack of synchrony between the cycle of commodities and financial asset classes, commodities generate similar returns in both crisis and non-crisis periods.

For a two-year crisis period the full portfolio net of fees generates positive returns which are almost one third of those earned in non-crisis periods.

The only exception is currencies which performs worse in the two years following a crisis, but after four years performs in line with non-crisis returns.

A comparison of crises

The heterogeneous nature of global crises makes them difficult to compare. However a number of features can be highlighted.

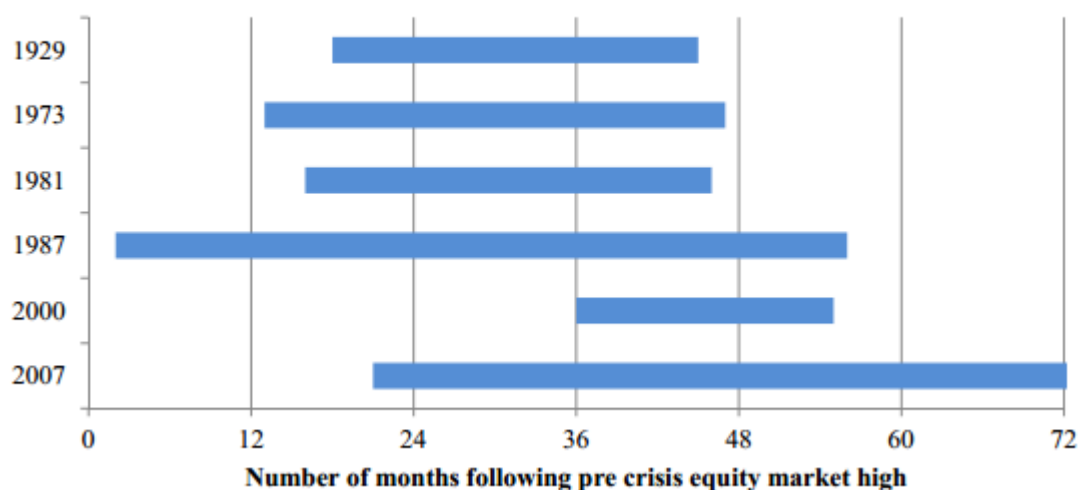
The crises can be loosely classified into two groups, those that develop quite rapidly, 1929, 1987 and 2000, and those that develop more gradually, 1973, 1981 and 2007.

Those in the first group tend to start with a period of very poor trend-following performance, generally due to losses in the equity index sub-portfolio, as the indices reverse quite sharply. Those crises which develop more slowly allow time for the trend-following signals to adjust to the new market direction before the crisis fully develops, resulting in short run profitability.

The poor performance following global crises is generally due to extended periods where **cumulative returns move sideways** rather than experiencing significant drawdowns. These periods are characteristic of all the crises examined. The maximum period in each crisis where a new investor would generate zero excess return (net of cash) ranges from 18 months (2000) to 54 months (1987) and averages three years.

It is notable that this extended period of weak performance begins at different intervals in the crises and is of varying duration.

Global Crises: Maximum Period with Zero Cumulative Excess Returns



Why returns vary so much

Our analysis of the long term performance of trend-following strategies using a diversified global multiple asset class portfolio from 1925 to 2013 suggests that the strategies have produced consistently high returns through time. These strategies typically underperform for an extended period, of varying magnitude and duration, following a crisis.

This should give investors employing these types of strategies some comfort. Despite the below average recent performance of trend-following managed futures, this performance is consistent with comparable historical periods. Each of these periods has ended and the strategy has gone on to generate returns closer to the long-term average.

We find significant differences in the time series dynamics of the underlying markets between crisis and non-crisis periods. In futures markets there are strong autocorrelations in time series returns of instruments at lags of one to twelve months, which drive trend-following returns. We find that during periods of financial crisis, this relationship is significantly diminished. This has the consequence of significantly reducing the returns of the trend-following strategy.

What happens to cause this break down in the time series behaviour of futures markets following a major financial crisis?

Existing behavioural finance theories provide some predictions which our results support. For example serial correlation in asset returns has been linked to increases in overconfidence and decreased risk aversion of investors. Precisely the opposite conditions occur following a financial crisis with investor

confidence falling and increasing risk aversion. Under both models, opportunities for generating trend-following returns should decrease in these periods.

Also, governments have an increased tendency to intervene in financial markets during crises, resulting in discontinuities in price patterns. The Federal Reserve's support of Bear Sterns in March 2008 and the intervention by the Hong Kong Monetary Authority in Hang Seng futures in 1998 both caused sharp reversals in their respective markets. The frequency, effect and consequences of these interventions for trend-following requires further research.

Finally, hedging pressure has long been recognised as having a role in the price setting mechanism of commodity markets. Changing dynamics in hedging pressure during crises may cause changes in market characteristics. More explicitly, the returns of trend-following have been linked with the cost of hedging, as speculators (trend-followers) capture a premium from hedgers. It is possible that, as hedgers benefit from positions in a crisis, the premia normally paid by hedgers to speculators is reversed.

To read the full discussion paper, featuring detailed methodology, results and analysis, including evidence from regional crises, visit <http://ssrn.com/abstract=2375733>

Professor Mark C. Hutchinson and John J. O'Brien are from the Department of Accounting, Finance & Information Systems and Centre for Investment Research at University College, Cork, Ireland. Aspect Capital provided financial support for the study. This article is general in nature and readers should seek their own professional advice before making any financial decisions.

Watch those unexercised options in LICs

Graham Hand

Any investor wanting a broad exposure to the market in a single investment has three main alternatives: managed funds, listed investment companies (LICs) and exchange traded funds (ETFs). There are hundreds of choices, and each structure comes with strengths and weaknesses. Supporters of each will tell you about the strengths, but this series of articles is about the shortcomings.

To show neither fear nor favour, we will focus on one significant weakness in each of these three product types, which could materially affect whether the investment is appropriate. This week, we look at LICs.

A brilliant solution to a problem

LICs have become the darlings of the funds management industry in the last couple of years, with well-established unlisted fund managers such as Investors Mutual and PM Capital turning to the listed space for the first time. But it was not always so, as the initial issuing process had a fundamental problem. A LIC would be issued at \$1 but after paying broker fees, legal costs, listing fees, marketing and printing, only 97 cents would be left to invest. So the opening Net Asset Value (NAV) was already 3% below the issue price, so why would anyone invest?

Then a brilliant solution was adopted. At issue, the LIC would offer a 'free' option to buy more shares in the LIC at \$1, with an expiry date on the option of say 18 months. As an 'at the money' option with decent time value, this was 'valued' by the lead broker using Black-Scholes methodology at about 7 cents. Problem solved. Cost \$1, NAV \$0.97, option \$0.07, immediate profit 4 cents. Where do I sign? Even if I don't care for the investment, I'll just flip it.

Almost every LIC uses this same issuing method. It seems like magic. Value has been created and everybody is happy, so what's the problem? Beware the implications of that 'free' option.

Impact of unexercised options

The problem is the future dilution in the value of the shares if the market rises and the options are exercised. Here is a simple example, assuming:

- Initial Public Offering (IPO) of 100 million shares at \$1 each
- includes 100 million options exercisable over next 18 months at \$1
- issue costs of \$3 million
- market then rises 30% over next 18 months
- all options are exercised just before expiry
- shares always trade at NAV and stock selection matches the market rise

Without the options, the NAV per share rises from \$0.97 to \$1.261 ($\$0.97 * 1.3$). With the market up 30%, the LIC investor is up 26.1%. Not bad but it never fully recovers from the impact of the costs.

With the options, the NAV per share rises from \$0.97 to \$1.13 (now 200 million shares on issue and NAV of \$126,100,000 + \$100,000,000 or \$226,100,000). That's only half the NAV because only half the money was invested at the start. The outcome is not too bad for the investors who held and exercised the option. They gain on exercise of the option what they lost on dilution of their shares.

Some investors are disadvantaged

There are two types of investors who miss out. First, those who sell their options early or forget to exercise. As the market rises, the LIC underperforms when the future impact of the dilution is factored into the share price. The investor does not have the \$1 option in his back pocket to compensate for the LIC underperformance.

The second type is the investor who buys the shares in the secondary market, unaware of the coming dilution. With few exceptions, LIC managers report their NAV excluding the impact of the options. The day before all the options are exercised, an investor on the ASX may have checked the NAV and seen it reported as \$1.26 when only 100 million shares were issued. A few days later, the NAV is down to \$1.13 and they lose 13 cents, or over 10% ($\$0.13/\1.26).

Those who have the time to watch or know the exercise pattern of option holders will understand that the stated NTA of \$1.26 is unrealistic, and will be willing sellers to those who don't know. If they bought during the IPO, they probably hold options which they can exercise to maintain their overall exposure.

The example makes the assumption of exercise just prior to expiry of the option, which is the most efficient time to do it, but in practice, some options are exercised earlier.

What do LIC managers tell investors?

There is a varying level of disclosure on this issue among the dozens of managers of LICs.

An example of the best type of disclosure is the Magellan Flagship Fund, ASX code MFF. A copy of the recent weekly report on NTA is [linked here](#). It states:

"Note that no adjustments are made for the future exercises of the MFF 2017 options (exercise price \$1.05 per option). The approximate pre-tax NTA would have been reduced by approximately 10.5 cents per share if all of the MFF 2017 options had been exercised on Friday, 22 August 2014."

This makes the investor aware of the heavy dilution impact. At time of writing, the undiluted NTA was \$1.51, shares were trading at \$1.51 while the options were at \$0.45.

An example of the second-best type of disclosure is [Wilson Asset Management's fund, WAX](#):

"The above figures are after 5,090 options exercised during the month and have not been adjusted for the remaining options on issue."

At least the issue is on the table, even if it is not quantified. However, many other LIC managers do not mention the dilution impact on the NTA in their regular reports to shareholders.

There's another wonderful side to all these options, for the manager if not the investor. The exercise of the options creates a massive uplift in the size of the fund, potentially doubling the total fees. It's a great way to build a business over time.

Check unexercised options before buying

What's the lesson? Before investing in any LIC, find out how many unexercised options exist, the strike price and the remaining term, and make a judgement on the possible dilution of NAV if the options are exercised. Note also that options are not only created in the IPO stage, as many LICs continue to fund raise with options attached.

(Over the next two weeks, we will examine product shortcomings in unlisted managed funds and ETFs).

Graham Hand was General Manager, Capital Markets at Commonwealth Bank; Deputy Treasurer at State Bank of NSW; Managing Director Treasury at NatWest Markets and General Manager, Funding & Alliances at Colonial First State. Nothing in this article constitutes personal financial advice. Graham holds investments in the companies mentioned above.

Why the Financial System Inquiry should interest SMSF members

Duncan Fairweather

Everyone with an SMSF should be taking an interest in David Murray's Financial System Inquiry (FSI) because it asks some fundamental questions, like should there be any limitations on the establishment of SMSFs? And makes some interesting observations, such as: The majority of superannuation tax concessions go to the top 20% of income earners.

Tax breaks and tax payments

Let's start with this one.

It's true that the majority of super tax breaks go to the top income earners. The FSI's Interim Report has a chart showing the top 20% of earners receive 56% of the superannuation tax breaks. But that's only half the picture. The report should also include another chart, based on ATO data, that would show the top 20% of earners pay 63% of all income tax collected. So, in fact, the top earners are more than paying for the super tax breaks they receive.

It's important for policy makers, and those advising them, to look at the whole picture and not be swayed by the emotional arguments of people who see the world in simplistic terms like rich versus poor, terms which tend to be defined by individual perspective and ideology.

The Interim Report also notes that a small number of accounts (12%) hold a high proportion (60%) of superannuation assets. They are talking about SMSFs and the picture is hardly surprising. On average, SMSFs have much higher account balances than retail or industry funds. SMSF members tend to have higher incomes than members of managed funds and so are able to make larger compulsory and voluntary contributions. Many also make non-concessional contributions, while others have been able to transfer assets, such as business property, into their SMSFs.

Some commentators think that's unfair and that SMSFs with high balances should be heavily taxed. They believe everyone should have a standard pension and pay tax on their retirement income. That may be how it is done in some other countries, but it's not the way the retirement incomes system has been set up in Australia over the past two decades.

Superannuation drives many economic and social benefits

Superannuation helps Australians to save enough to support themselves financially throughout their years in retirement and into old age and to be independent of taxpayer-funded pensions. It is not a mechanism for the redistribution of wealth. That is achieved via the income tax and welfare payment systems.

The Government provides tax incentives to encourage people to save for retirement through the compulsory Superannuation Guarantee levy and via voluntary contributions up to set limits. The incentives are economically sensible, returning a dividend in the form of lower public pension costs in the future. Our [research](#) shows that the basic tax break given on the SG levy will be repaid three times over in reduced age pension costs.

Other economic and social benefits include creating a large pool of capital to be invested in the productive economy and giving people the security of knowing that they will be able to live decently in retirement and old age. As the Treasurer noted at the time of the last budget, only 20% of Australians are self-sufficient and 80% rely on some level of taxpayer support and this would still be the situation in 2050. Indeed many Australians don't pay any net tax.

Superannuation gives people an opportunity to lift themselves out of a state of dependency on other taxpayers and super tax incentives, particularly voluntary contributions above the SG rate, encourage and enable them to do that.

Of course, there is some immediate cost to the budget, but there are some offsets. If the super tax breaks are removed or reduced, less money will flow into super and more people will ultimately have to rely on the pension. If the flow of money into super is reduced, the tax collected from fund earnings will be reduced. And people will use other tax effective ways, such as negative gearing, to invest.

We are not saying the present superannuation system is perfect – far from it. It is falling short of the objective of enabling most Australians to be financially independent in retirement, though the gap will be reduced if people work longer before retiring.

More flexible contribution caps

One change that should be made is to move towards a more flexible regime on contributions with the overall limit averaged over a cycle or maybe over a whole working life so people can pump more money into superannuation when they are able to do so. Many people don't have the capacity to turbo charge their super savings until they have paid off their house and educated their children. A more flexible system would help people with broken work patterns, such as women taking time off to raise a family.

Another significant structural change may be to move, over time, from the current TTE system (tax on contributions and earnings but not on retirement pensions) to an EET system (no tax on contributions and earnings but pension income is taxed) as applies in other countries.

These are big policy questions that need to be tackled in a far-sighted and clear-headed way. When change is made, it must be implemented carefully, without haste and without disadvantage to people who have saved and planned their retirement under the existing rules. If there's one thing that damages confidence in the superannuation system, it's unexpected, arbitrary and piecemeal changes to the rules, particularly to taxation. This may be driven by governments' need for revenue because they haven't managed the budget well or in response to emotive arguments about fairness. These issues are no doubt near the top of the list for David Murray and his Inquiry.

Duncan Fairweather is Executive Director of the SMSF Owners' Alliance (SMSFOA), which was set up to provide a voice for the one million Australians who are trustees of their own super funds. SMSFOA is a member of the ATO's Consultation Hub and ASIC's Consumer Advisory Panel.

The Editor of Cuffelinks, Graham Hand, will be presenting on SMSF Portfolio Construction at an SMSFOA Workshop on 9 October 2014. For details of the full agenda, see www.smsfoa.org.au.

There's growth, and then there's growth

Andrew Macken

If it looks like a duck and quacks like a duck, is it necessarily a duck? That's the mindset that is sometimes required to fully understand the numbers that are being reported by companies in Australia and around the world at this time of year.

One of the first numbers examined by investors and analysts when a company reports its results is revenue. And more specifically, most are interested in the growth in revenue from, say, one year prior. A company that is growing revenues strongly is more likely to be growing earnings strongly, and therefore more likely to be growing its dividends to shareholders strongly. Furthermore, revenue growth is considered to be a relatively clean metric in that it is independent of the company's cost structure and is typically untainted by management's accounting policies.

But not all revenue growth is created equal. And investors and analysts need to carefully dissect the nature of the revenue growth.

Consider a retailer that owns a number of stores. While revenue growth in each store might be weak, the company can boost its headline revenue growth number by opening new stores. We observed this at JB Hi-Fi (ASX: JBH) which reported full-year 2014 revenue growth of 5.3% per annum. Yet on a store like-for-like basis, revenue only grew by 2.0% per annum over the same period.

Similar to the idea of opening new stores is the idea of acquiring new businesses to boost headline revenue growth. This is the strategy of childcare and education provider G8 Education (ASX: GEM). The company recently reported revenue growth of a whopping 59% per annum for the half-year ending 30 June 2014. Most of this has stemmed from the acquisition of additional learning centers. This can be clearly observed in G8's cash flow statement: payments for the purchase of businesses were \$218 million in the six-month period to 30 June 2014. These are significant cash investments given reported revenues in the same period were \$187 million.

Sometimes companies can simply benefit from fortuitous macroeconomic tailwinds that serve to inflate revenue growth. A company that has operations offshore with revenues denominated in other currencies will typically go through periods of tailwind and headwind as the foreign currency strengthens or weakens relative to the currency in which the company's financial results are reported.

The Australian medical device manufacturer and distributor, ResMed (ASX: RMD), has benefited from exactly this dynamic over recent quarters. While the company reports in US dollars, it sells its devices in many countries around the world, in particular those in the Eurozone. Over the last five quarters, the strength in the Euro relative to the US dollar has added around 2-4% in additional revenue growth from ResMed's international businesses.

Finally, investors and analysts need to be cognisant of the accounting rules around consolidation when examining revenue growth. If company A owns 49% of company B, then company A will typically report no revenue for company B and instead report just its 49% share of company B's earnings on its income statement. Yet if company A were to increase its ownership to, say, 51%, then all of company B's revenues would be reported on company A's income statement under the rules of consolidation. The perceived growth in reported revenue can be substantial, simply by increasing ownership in an associate company to a level above the 50% threshold. This quirk in the accounting rules has certainly been a contributing factor to the very strong reported revenue growth of online employment advertiser, Seek (ASX: SEK). Seek owns a portfolio of interests in online employment portals around the world and has slowly increased its ownership in these associate companies over the years. As Seek's ownership level in each associate crossed the 50% threshold, it was required to consolidate 100% of the associate's revenues into its own income statement, providing a substantial tailwind to its reported revenue growth.

There is nothing inherently right or wrong with each of the examples described above. They simply reflect different versions of the same thing: reported revenue growth. Each has different implications, however, and investors and analysts need to consider these carefully. Perhaps the most important consideration is

around the sustainability of the revenue growth that is reported. Understanding the underlying drivers of revenue growth serves to inform this assessment of sustainability for the investor or analyst.

Finally, investors and analysts should be cautious of very high rates of reported revenue growth. It is not that high rates are inherently unsustainable, it is just that they cannot exist in aggregate across the corporate sector. Roughly speaking, the growth in aggregate corporate revenues should be roughly equal to the GDP growth of the economy. So if a company or a sector is growing at rates well above this level, one needs to believe that there are other companies or sectors growing at rates well below this level.

Andrew Macken is the Senior Analyst at Montgomery Investment Management.

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