Cuffelinks
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Is Magellan's listed fund a game changer?

Graham Hand

The Magellan Global Equities Fund listed on the ASX on 5 March 2015 and is a new structure for the listed market, a Trading Managed Fund or TMF. Magellan launched its first fund in 2007 and is now managing over $35 billion, including $10 billion of retail money. Previously, its funds were standard unlisted managed funds and a single Listed Investment Company, MFF. But its latest structure (ASX code MGE) is breaking new ground, and the question must be asked whether it is a significant breakthrough which will both generate a strong following and be copied by others.

[Upfront disclaimer: Magellan is a sponsor of Cuffelinks but our content is independent and we do not publish product promotions. This article is about a genuine market innovation that should interest our readers. While we discussed the structure with Magellan to clarify our understanding, they did not request or approve this article.]

What perceived problems does it seek to address?

Over recent years, SMSF trustees and other direct investors have become increasingly comfortable using the ASX platform, especially through online brokers such as CommSec and nabtrade. Investments in the listed space compete with the unlisted funds available on platforms administered by major wealth management businesses. On the ASX, each of the alternative ways to invest in a listed portfolio of shares has its strengths and weaknesses, as described here and here in previous articles. In every case, there is a feature which detracts for some investors:

- Listed Investment Companies (LICs) – closed-ended funds which rely on buyers and sellers in the market for liquidity because there is no capacity to create or redeem units regularly according to demand. There is no market maker ensuring LICs trade at their Net Asset Value (NAV), which means they may trade at discounts to NAV at times of market stress when there are few buyers. On the other hand, they may trade at premiums (although it's difficult to understand why anyone would buy at a premium) and they are actively managed, and there are advantages in the company structure.

- Exchange Traded Funds (ETFs) – open-ended with a market-making mechanism which usually ensures they trade at close to NAV across a spread. Most are passive funds based on some type of index or smart beta. They have cost advantages but do not access the skills of an active manager.

- mFunds - ASX's service for issuing and redeeming unlisted managed funds via the ASX operating rules and settlement service, but with no real time unit pricing, and only available through brokers who have joined the mFund service, which excludes the major bank-aligned brokers. Many mainstream fund managers have also not joined. As mFund does not quote live prices, an investor must wait until after the end of trading to know the price of the units bought and sold.

Magellan's TMF seeks to address each of these weaknesses: it is open-ended, permitting the creation and redemption of new units each day via a market-making function with the intention of preserving the price close to NAV; it is actively-managed, for investors who believe a good investment manager is worth paying for; and the price quoted is live, removing the uncertainty of waiting until the end of the day.

How does the TMF solve the perceived shortcomings, and what problems of its own are created?

Why is the structure different?

The reason ETFs are able to maintain prices close to NAV is that, as index funds, their portfolios are continuously available to external market makers. This allows a third party to arbitrage between the prices of units in the fund and the underlying securities in the portfolio which pushes prices towards the NAV. For example, if the NAV of a fund is $5 and a buyer wants 100,000 shares at this price, a market maker may go into the market and buy the underlying shares for $4.95 or $495,000, and make $5,000 matching the ETF order.

The problem for active managers using this structure is that they do not want to reveal their portfolios to the market. That is the proprietary knowledge their clients pay for (Magellan's listed and unlisted global equity funds hold the same assets). Magellan has a base fee of 1.35% plus a performance fee, far higher than the cost of an ETF. Magellan could not allow a third party to replicate this portfolio each day and offer a cheaper alternative. The breakthrough achieved in the structure is that the TMF is only required to report its portfolio quarterly, and then with a lag of up to two months, denying the opportunity to replicate in a timely manner.

This creates a problem many managers have been trying to solve. If the portfolio is not available to a third party, who does the market-making to ensure to fund trades close to NAV? In the case of this new fund, Magellan is the market maker, and any gains or losses from the activity accrue to the fund. Magellan argues it has an incentive to perform this role well to ensure confidence is retained in the fund.

In practice, Magellan estimates the NAV based on the closing prices in global markets where the shares trade, and publishes the so-called iNAV on its website before the Australian market opens each morning. Buyers and sellers can trade live around this iNAV on the ASX. The iNAV may change but normally only due to FX movements. At the end of the day, Magellan works out the net position of buyers and sellers and creates or redeems units with the fund, and then buys or sells the underlying shares when liquid markets for those stocks open overseas. Magellan's global fund has a concentrated portfolio of major stocks in highly liquid markets and its activities have negligible impact on the market price.

What are the potential shortcomings?

We have listed at least one Achilles' heel for every competing structure, so what is TMF's?

The main issue is the ability of the fund and Magellan to accurately reflect the NAV at all times, including in stressed markets, without significantly widening the spread. What can potentially go wrong?

Magellan is acutely aware of the risks, as described in its offer PDS. MGE is a global fund which invests in stock markets which are closed during the ASX trading day. It is not possible for Magellan (as the market maker) to hedge the fund's market-making activities or always know the exact NAV. It states:

"The iNAV published by the Fund is indicative only and might not be up to date or might not accurately reflect the underlying value of the Fund."

For example, consider this (unlikely) circumstance:

- An investor sells 200,000 MGE shares at midday in Australia at $2.50 for $500,000. This price is the iNAV based on New York's close the previous day, and there has been no change in FX rates.
- A bomb explodes at the NYSE. In Asia, the S&P500 falls 10% on futures markets (Magellan believes hedging their portfolio in this time zone using futures is expensive and inefficient).
- Offshore stockmarkets open and prices are still down 10%. To match the sale done in Australia, the underlying shares are sold for an equivalent of $2.25 and the fund loses 10% or $50,000 on this trade. This cost is borne by all investors in the fund.

This is an extreme event for illustration purposes, but risk management is about covering extreme events. Magellan says it has in place strategies based on back-testing of the same underlying fund since inception, but it is not explicit about these techniques. Magellan has the ability to widen spreads in uncertain conditions, and it's entirely possible that the fund will make money from this trading activity.

Is it a game changer?

Magellan's fund is well-suited to the structure because it holds highly liquid companies that can be bought and sold offshore without moving the price. The shares are less likely to respond significantly to announcements in the Australian trading day, as the major holdings are companies like eBay, Microsoft, Oracle, Visa and Nestle. This improves the accuracy of the NAV estimate.

In addition, Magellan has massive brand recognition among advisers, brokers and direct investors like SMSFs. As a global fund, Magellan's TMF will be supported by Australian brokers who would not promote an Australian equities fund, because the latter would be too much of a competitor to their core business in local equities. The value of broker support for a listed security should not be underestimated.

The types of funds less suited to the structure are those with less liquidity in the underlying shares, where it is difficult to estimate the NAV during the Australian day, such as a global small companies fund where the price may depend on volume traded. Some Australian funds may be open to arbitrage activity, such as the recent 60% fall in the price of Sirtex and its impact on Hunter Hall funds. Would the market react quicker than the market maker and sell at a NAV set too high?

My conclusion is that Magellan has introduced an important development with most attraction to large cap portfolios with major managers in global equities who have the resources and capital to make markets and respond quickly to changes. The ASX is known to be fielding many enquiries from other fund managers and the Magellan structure will be replicated. It will encourage the move away from retail platforms and onto the ASX. It will take business away from mFunds, where the dependency on specific broker participation and lack of live pricing are drawbacks.

It's not likely to be a major competitor to ETFs, which will continue to have cost advantages and appeal to those who do not believe in paying for active management. It's likely to complement ETFs by allowing a total ASX-based solution, where an investor may have a 'core' ETF and a 'satellite' TMF with fees for a different type of exposure. LICs will continue to have a following, aided by their company structures and use by several high profile managers such as Wilson Investment Management. Boutique LICs, such as the recent Future Generations and Global Value Fund offers, would not have the resources to manage a TMF.

As new active funds are listed in this format, the ASX's suite permits a diverse portfolio without paying higher fees for the traditional choice and administration strengths of retail platforms. The ASX itself becomes more of a competing platform.

In the short time between launch on 5 March 2015 and 24 March 2015, about 26 million units in MGE traded at around $2.50 with narrow spreads, usually only 1 cent. Net amount issued to 1,500 investors was about $60 million, equivalent to the launch of a new mid-sized LIC. It's not quite game changer territory, but that sort of success will invite many competitors.

Graham Hand has worked in wealth management and banking for 38 years and is the Editor of Cuffelinks.

Who can make tax-deductible super contributions?

Trish Power

Generally speaking, you can make two types of super contributions: non-concessional (after-tax) contributions and concessional (before-tax) contributions. Concessional contributions can include tax-deductible super contributions, where an individual claims a deduction.

For the 2014/2015 year, from 1 July 2014 to 30 June 2015, an eligible individual can make concessional contributions of up to $30,000 a year if aged 48 years or under on 30 June 2014, and up to $35,000 for the year if aged 49 years or over on 30 June 2014.

Am I eligible to make tax-deductible contributions?

If you're self-employed (or substantially self-employed) or you're not employed, you can claim a tax deduction for your super contributions, which means these super contributions are treated as concessional contributions. However, an individual under the age of 18 can only claim a tax deduction for super contributions when his or her income comes from gainful employment, such as carrying on a business.

If you're an employee, in nearly all circumstances you cannot claim a tax deduction for making a super contribution, although you can get a similar tax benefit by making salary sacrifice contributions. Salary sacrificing refers to including before-tax superannuation contributions as part of a salary package, which then reduces a person's taxable salary and the amount of income tax payable.

If you're an employee and you can satisfy the 10% income test rule (more on this later), then you may be able to claim a tax deduction for a super contribution, even as an employee.

The rules for claiming tax deductions on super contributions can be complex depending on the type of work that you do, and whether you hold down other jobs.

I suggest you confirm your ability to claim a tax deduction with the Australian Taxation Office or check the ATO website, but you can usually claim a tax deduction for super contributions if you fall into one of the following three categories:

- You are self-employed and you're not working under a contract principally for your labour
- You are not employed, for example, you're a full-time investor or looking after children.
- You meet the 10% income test rule.

Am I eligible for the 10% income test rule?

The 10% income test rule is where you receive part of your income as an employee but less than 10% of your assessable income plus salary sacrifice contributions plus reportable fringe benefits are attributable to employment as an employee. The 10% test sounds fairly complicated but if you're employed, and also self-employed, then you can work out step-by-step if you're eligible to claim a tax deduction for your super contributions.

Note that employment income includes reportable employer super contributions, such as salary sacrifice contributions, but doesn't include Superannuation Guarantee contributions. Assessable income is gross income before any deductions are allowed, and includes salary and wages, dividends, interest distributions from partnerships or trusts, business income (including personal services income), rent, foreign source income, net capital gains and a few other items. Reportable employer super contributions (such as salary sacrifice contributions) are also added back to assessable income when working out whether an individual satisfies the 10% test – the employment income divided by total income must be less than 10% for an individual to claim a tax deduction for his or her own super contributions.

Watch the tax on concessional contributions

Tax-deductible super contributions and other concessional contributions are subject to 15% tax within a super fund, which means that claiming a tax deduction for super contributions may not be tax effective if you pay less than 15 cents in the dollar tax on your income. Note that some self-employed individuals may be eligible for a refund of the 15% contributions tax paid on super contributions for the 2012/2013 year through to the 2016/2017 year. If you earn less than $37,000 a year, and your employer (or you) makes concessional (before-tax) contributions on your behalf, then you can expect a refund of the contributions tax deducted from your super account, paid directly to your superannuation account by the federal government. The federal government calls this refund of super tax, the Low Income Super Contribution (LISC).

If you're a high-income earner and your adjusted taxable income is more than $300,000 a year, your concessional contributions will be subject to an additional 15% tax, known as Division 293 tax.

Ensure you complete the paperwork

If you plan to claim a tax deduction for a super contribution, you must notify your super fund in writing before you lodge your tax return for the financial year, or by the end of the financial year following the year the contribution was made, whichever is earlier.

If you belong to a SMSF, then as both a trustee and member of a SMSF, you have to formally notify yourself of the intention to claim a deduction. In theory, the trustee (you) isn't aware of your intention to claim a tax deduction for your contributions until you inform the trustee.

You must lodge a 'Notice of intent to claim a tax deduction for super contributions or vary a previous notice' (section 290-170 notice) with your SMSF. You must receive acknowledgment of receipt of the notice from your SMSF (you), BEFORE you lodge your individual income tax return. The trustee (you) then uses the notice to determine the treatment of the contributions for benefit component purposes, and to report the nature of the contributions in the SMSF's annual return.

Trish Power is co-founder of [SuperGuide](), a free website for consumers on superannuation in Australia, and the author of Super Freedom, DIY Super For Dummies, Superannuation For Dummies *and many other books on super and investing. A version of this content was published in SuperGuide and is reproduced with permission. This article provides general information and does not address the personal circumstances of any individual.*

This is mean (-reverting that is)

Roger Montgomery

Mean reversion: A theory suggesting that prices and returns eventually move back towards the mean or average. This mean or average can be the historical average of the price or return or another relevant average such as the growth in the economy or the average return of an industry. (Source: Investopedia).

Investors are currently enjoying the fruits of an extreme event. Let's begin with a quote from an excellent interview given by Ken Henry to Fairfax media recently. When asked about investors' current preference for yield, and the consequences of this behaviour, Henry responded first by noting that the popularity of yield chasing is; "typical of periods of low inflation and high rates of savings." He added however, "… it is also worth recalling earlier episodes of investor herd behaviour."

Recalling the unfolding of the tech boom, Henry noted that the period was also one marked by high savings and low inflation but one where hoped-for productivity improvements turned out to be illusory. Furthermore, Henry noted that the years prior to the GFC were similarly characterized by low inflation

and high savings, triggering a pursuit for yield (in securities backed by subprime loans) that "turned out not to be there".

Weak domestic conditions

There is a risk that profits supporting the dividends of companies may turn out not to be there. Note the current suite of weak domestic economic indicators, which we have previously alerted investors to and which Ken Henry has also cited:

- the NAB Survey of Business Confidence has turned down
- half a decade of flat non-mining investment, which is also reflected in weak business credit growth
- unemployment higher than during the GFC, also reflected in the weak and still weakening Westpac and Melbourne Institute Index of Consumer Sentiment.

CLSA analyst Christopher Wood, who notably advised clients to sell mortgage-backed securities prior to the subprime crisis (we count ourselves among those who also warned investors at the time), said Australian economic conditions will warrant rates of less than 1% "within the next two years".

Ken Henry seems to concur noting, "other risks worth building into scenario planning include: volatility in energy prices; slower growth in our major trading partners, especially China; global deflation and prolonged economic stagnation …"

CommSec's recent review of the ASX Top 200 stocks revealed flat revenue growth and a 26% decline in profits over the six months to 31 December 2014.

Meanwhile, there exists ample evidence that these conditions - forcing yield-needy investors out of term deposits and into shares – have pushed valuations to extremes.

Market is on the expensive side

In the US, many note that P/E ratios of 18 times trailing earnings are far below post war records of 30 times, even though they are higher than 74% of observations since 1945. But while P/E ratios which stole the headlines prior to the GFC and the tech wreck are not currently at extremes, median valuations are climbing to post war records with stealth.

When the S&P 500's P/E multiple is only slightly above average, but the median US stock is at a record high, the implication is that the valuation extreme is broad-based and is similar to the circumstances in 1962 and 1969.

Between 2012 and 2014, the overall US stock market, according to US hedge fund manager Jim Paulsen, went from most stocks being priced only slightly above average to almost all stocks being priced near post-war records. As of June 2014, the median US stock was trading at a post war record of 20 times earnings. The median stock is also at a post war record price to cash flow of 15 times and the only time its price/book ratio has been exceeded was in 1969 and 1998 – periods that were both followed by substantial corrections. The implication is that US stocks are priced higher than is widely perceived.

While it can last for some time, and in the past has persisted for some years, when share prices disengage from their fundamentals, the situation is never permanent. There is no 'permanently high plateau' here.

Cash rates are low but cash is ammunition

What has complicated the outlook is that low interest rates might be with us for some time thanks to the same business conditions that are, ironically, causing people to rush into shares. A less-extreme event (a mean-reversion) will follow, and that less-extreme event includes share prices returning to levels that reflect the threat to their weakening earnings.

The Montgomery Fund's value model for a hypothetical portfolio of highly liquid, quality companies is suggesting the Australian market is slightly expensive compared to recent history. Our investment process is also producing a near-maximum cash weighting. After selling certain stocks recently, we aren't

able to find compelling alternatives to leaving money in cash. As a result we remain only about 75% invested. This puts us in an enviable position to take advantage of lower prices if and when they occur.

The spread between share prices and their underlying drivers will mean-revert but as to when, the only logical advice I can offer other investors is to enjoy the party but dance very close to the door.

If the herd rushes for the exits (and it may not for months or years) you will want to secure one of the few cabs waiting outside and join the revellers heading home to safety.

Roger Montgomery is the founder and Chief Investment Officer of Montgomery Investment Management. This article provides general information and does not address the personal circumstances of any individual.

What can investors expect from QE in Europe?

Sam Churchill

The European Central Bank (ECB) was the most reluctant of the major developed world central banks to embrace quantitative easing (QE) following the global financial crisis. Having belatedly reduced interest rates to zero, it finally adopted QE in late 2014 in an attempt to fight deflationary forces and boost growth. The question is: will it work?

The euro zone recently emerged from a sovereign debt crisis (although Greece is still problematic), and remains stuck in an economic and political muddle which is hindering growth and perpetuating instability. As ECB President Mario Draghi has suggested, structural reforms, coordinated fiscal policy and greater institutional integration are all key to transforming the region's prospects. Extraordinary monetary policy measures such as QE are necessary, but will not be sufficient to address the euro zone's malaise.

Euro zone QE involves the purchase of €1.1 trillion of public and private assets, predominantly government bonds, paid for with money 'created' by the ECB. The programme commenced in October 2014 with the purchase of asset-backed securities (ABS) and covered bonds. QE has since been expanded to include government bonds and will run for 19 months from March 2015, or until "*a sustained adjustment in the path of inflation"* is achieved towards the ECB's target of just below 2%.

The primary justification for QE is to avert the risk of deflation, such as that experienced by Japan in the 1990s and 2000s. In theory, QE can help restore growth and inflation pressures through a combination of asset price inflation, easier credit conditions and currency depreciation. QE also has the advantage of partially monetising the euro zone's large government debt burden, although heavily indebted countries are not specifically targeted. While the precise impact of QE is difficult to assess, it is likely to be beneficial at the margin. The policy is not without risks, though, and the deep structural vulnerabilities of the euro zone currency union will remain.

Helping to restore growth and inflation

Positive wealth effects

ECB asset purchases will crowd out other investors, push yields lower than they otherwise would have been, and generate capital gains for asset holders in the short to medium term. This is consistent with what has occurred since the announcement of QE. As yields fall, investors are encouraged to take on more risk in search of higher returns. This 'reach for yield' will flow through to other asset classes, causing asset prices to rise broadly and creating a positive wealth effect that could support economic growth and consumer price inflation at the margin. Investors should be cautious about adjusting their expectations of long term risk adjusted returns in the euro zone, however, as the effect may turn out to be transitory.

Lower borrowing costs

Falling yields and spreads should also reduce borrowing costs for businesses and governments. Although, the impact is likely to be more muted in the euro zone than in the US, as most corporate borrowing is channeled through the banking system rather than bond markets, and government bond yields are already very low.

A flood of excess liquidity in the banking system under QE may also support lower bank loan rates, potentially inducing households and corporates to borrow more. In this regard the impact of QE is difficult to disentangle from other measures such as the ECB's targeted long term funding obligations (TLTROs) which directly lowers funding costs for banks. Small businesses and households still face difficulties accessing finance at reasonable interest rates, especially in the euro zone periphery, a problem that QE is unlikely to address.

On the other hand, yields may rise if economic fundamentals or expectations improve, or if investor risk aversion shifts. There is some evidence that this occurred for 10 year US Treasury yields during QE by the Federal Reserve. Alternatively, an adverse macroeconomic shock could cause the yields of riskier assets, such as Portuguese government bonds, to spike.

Currency depreciation

Currency depreciation is another important transmission channel for QE. Lower yields reduce demand for euro denominated assets, while ECB money creation increases the supply of euros, putting pressure on the euro to depreciate. Since the announcement of QE the euro has depreciated materially against the US dollar. This will provide a boost to inflation and growth as the cost of imported goods rises and the externally exposed parts of the economy become more competitive.

Future inflation and interest rate risks

There is much debate about the potential inflation and interest rate risk associated with QE in the long run. While there is little evidence of inflation pressures in the US or UK at this stage, we cannot rule out this prospect when the global economy returns to full capacity given the massive growth in base money supply in recent years. Investors should also note the potential for yields and spreads to increase following the conclusion of QE, or under any future *sale* of assets. At present the ECB has not articulated a QE exit strategy. However, with euro zone unemployment currently at over 11%, inflation and interest rate pressures are likely to be some way off.

Macroeconomic shocks could be destabilising

The euro zone is not immune to macroeconomic shocks. For instance, there is a risk that rising US interest rates could be disruptive to euro zone bond markets. Currently the spread between 10 year US Treasury yields and German Bunds is at record highs. A tightening US labour market could prompt rate rises by the US Federal Reserve, placing upward pressure on euro zone yields.

Yield and spread compression has been a feature of financial markets in recent years. Should this rapidly unwind, it could disrupt euro zone stability. European periphery nations could face a potential 'triple whammy' scenario as they did in 1994 when the US Federal Reserve increased interest rates. This could happen through rising US Treasury yields, a normalisation of the spread between Treasuries and Bunds and a widening of the spread between Bunds and periphery government bonds.

Even if QE helps to restore inflation at the euro zone level, the sustainability of government debt may remain an issue in highly indebted, weak economies such as Greece, Portugal and Italy. Future debt restructuring, defaults or the election of eurosceptic parties could prompt a reassessment of euro zone sovereign risk premia.

The euro zone remains vulnerable to an escalation of the Russia/Ukraine crisis or a China hard landing. Either of these scenarios could cause a dramatic uplift in the yields of troubled euro zone government bonds and seriously test the ability of the ECB to intervene in bond markets in an unlimited way.

Conclusion

QE is important for global investors as it has implications for yields, growth, inflation and systemic risk. Although it will probably be beneficial at the margin, QE is unlikely to be a silver bullet for the euro zone's deep structural problems. Investors would be unwise to materially adjust their expectations of long run risk adjusted investment returns in the euro zone based on the implementation of QE alone.

Sam Churchill is the Head of Macro Research at Magellan Asset Management. This article provides general information and does not address the personal circumstances of any individual.

Asia: bull or bear in the Year of the Goat

Casey McLean

Since 1973, the Year of the Goat has generated the highest average returns among the 12 Chinese zodiac symbols, averaging an impressive 45.3% each year, according to JP Morgan. Leaving superstition aside, there are some strong fundamental reasons why Asian equity markets can make like a bull in the Year of the Goat, 2015.

The growth premium appears to be re-gaining ground

Asia's reputation as a high growth region came under pressure during the last few years as the growth premium narrowed. This is a key reason why the region has de-rated since 2010. However, it appears as though the growth premium has bottomed out and is now beginning to regain some ground. As global growth also improves, the high beta nature of Asian economies begins to work in their favour, not against them. This higher return potential suggests Asian equities are increasingly relevant in an investor's asset allocation even when considering the higher risk nature of the region.

The slowdown in China shouldn't be seen as a 'negative'

While China is experiencing a slowdown in growth, this in itself is not a negative for equity markets. The Chinese equity market tends to get excited when real Gross Domestic Product (GDP) growth is above 'potential growth' and sells off when real GDP slows below potential growth.

But 2015 could mark the year in which Chinese growth rebases after stimulus-led excesses and real GDP growth are expected to remain in line with potential growth. At the very least, this should not provide another reason for a de-rating. As risk sentiment normalises and volatility subsides, risk aversion should be a buying opportunity when coupled with attractive valuations.

Earnings expectations have improved

Earnings expectations for Asia excluding Japan in 2015 are the most realistic they have been in years. Consensus is forecasting earnings per share growth of 9.5%, which is below the usual starting point of around 15% and the five-year compound annual growth rate of 11.4%. This provides some comfort that the downside risk to earnings estimates is relatively low.

We believe the earnings upside will come from margin expansion. Asian net margins are at their lowest level since the financial crisis but appear to be bottoming out. Margin expansion in the coming period is expected to be driven by a combination of lower commodity prices, lower interest expenses, less wage pressure and faster revenue growth.

This year, the opportunities for creating alpha appear the best since the global financial crisis. The correlation among stocks in Asia has declined to five-year lows. This is true whether analysing the correlation between the largest ten stocks in the regional index, the largest stocks in each country or the largest stocks in each sector.

Asia is going through a process of reform, with many governments taking the window of opportunity to reduce subsidies, make State Owned Enterprises more efficient, improve tax systems, introduce foreign direct investment and private capital and enforce environmental standards. These reforms are critical to overcoming some structural weaknesses that have been brought to light by the cyclical slowdown. Most reforms are market friendly and should help drive a market re-rating.

Risks

Two recent events that were cause for concern – the quantitative easing decision by the European Central Bank and the Greek Election/Exit – barely registered. There is risk around when the US will raise interest rates. Our view is it may be delayed into late 2015 or even 2016 due to deflation and a lack of wage growth. With liquidity conditions from Europe, Japan and China remaining supportive, this is not the greatest risk to Asia.

The greatest risk is a Japanese-inspired currency war due to the Bank of Japan Governor Kuroda's steadfast refusal to budge from the 2% core inflation target. This is because the Japanese definition of core includes the price of oil. If the target is not revised lower or to a core ex-oil target, another round of quantitative easing will no doubt be needed. The resultant yen weakness could force competitive devaluations by other Asian countries, with Korea one of the biggest casualties.

The Chinese property market and debt build-up remain an ever-present risk. This has spawned a greater and more immediate risk of capital flight. In the fourth quarter of 2014 alone, the capital outflow amounted to Rmb600 million by some estimates. Luckily, this liquidity reduction was exactly offset by the Reserve Requirement Ratio (RRR) cut. China has more fire power to do so with RRRs at 17.5-19.5%. Even if the 'hot money' outflows are stemmed, there is a structural trend for more outward foreign direct investment. A prime example of this is the formerly unheard of Anbang Insurance's US$2 billion purchase of New York's Waldorf Astoria. This occurred after insurance companies were mandated to invest up to 15% of their capital offshore.

Portfolio positioning

We are overweight Asian equities from a dynamic asset allocation perspective. Within the region, our portfolios' positioning is overweight China, Indonesia, India and the Philippines. However, stock selection remains paramount in light of the alpha opportunities and the concurrent risk.

Notwithstanding the risk of war – currency, physical or in cyberspace – Asian equity fundamentals look attractive. Valuations are supportive with realistic earnings estimates. Earnings upside comes from margin expansion on the back of falling commodity prices, lower wage pressure, faster revenue growth and lower interest rate cuts. The latter will also help drive a re-rating as the cost of equity falls as will an improvement in return on equity. All in all, we support the case for being a bull in the Year of the Goat.

Casey McLean is a Portfolio Manager and Analyst with AMP Capital Asian Equities. This article provides general information and does not address the personal circumstances of any individual.

Chris Bowen, Kevin Davis and regulators at CIFR Conference

Graham Hand

The Centre for International Finance and Regulation (CIFR) hosted a conference on the Financial Systems Inquiry (FSI) on 11 March 2015. Subjects included superannuation, retirement incomes, product innovation, consumer outcomes and regulation. CIFR has just released videos of the sessions on this website, and highlights included:

The Hon Chris Bowen MP, Shadow Treasurer, with his insights on the FSI recommendations.

Professor Kevin Davis, a Committee Member of the FSI, on the approach taken by the FSI members.

Panel discussions included:

Wayne Byres, Chairman of the Australian Prudential Regulation Authority (APRA); Professor Davis; and **Peter Kell**, Deputy Chairman of the Australian Securities and Investments Commission (ASIC). The discussion revealed broad based support for the approach taken by the FSI in its review process.

Karen Chester, Commissioner of the Productivity Commission; **Professor Graeme Samuel AC**, Vice Chancellor's Professorial Fellow, Monash University, and former chairman of the ACCC; and **Dr Deen Sanders**, CEO of the Professional Standards Council. The discussion focussed on the merits of regulation imposed for the public good.

Graham Hand attended the Conference as a guest of CIFR.

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