Cuffelinks
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This Week's Top Articles

Avoid the sugar hit of a fast buck from fast food

Jack Nelson

We sit in the office of the Chief Executive of one of South East Asia's leading business families, high above the bustling streets below. The group's sprawling interests range from property development to a leading airline. But the jewel in the crown is an emerging, pan-regional snacks business. We are invited to try some samples and we spend the next five minutes examining the various cake bars, potato chips and cookies on offer. None look especially appetising or close to healthy. As we turn over the packets in our hands, doing our best to discern ingredients, we recognise and find some nutritional information. Several 'chocolate' products do not appear to contain any cocoa. Slightly bemused, we raise this point with our host. He explains that the company finds it cheaper and easier to simply use vegetable fats as a substitute, and add more sugar to preserve a taste of sweetness.

Consequences of Asian incomes rising

As the disposable incomes of tens of millions of Asians rises, so does the demand for more variety and convenience in food. The sales by domestic companies serving local tastes as well as those of multinationals producing western fares have grown very quickly over the last 20 years. One consequence has been an increasingly rich universe of consumer staples companies available to investors in Asia.

However, it is clear that rising per capita income does not necessarily imply better nutrition. Much of Asia seems mid-way through a period of rapid growth in consumption of highly processed ingredients with high levels of salt, sugar and fat. Globalisation has ensured that the speed with which nutritionally poor quality food has become both available and affordable to large swathes of the urban population in emerging Asia has completely outstripped any education around sensible consumption.

The result is that large portions of the population in Asia are beginning to experience the types of non-communicable lifestyle diseases that are more often associated with older, richer and more developed western societies.

The prevalence of diabetes is now higher in Vietnam than in Japan and higher in Indonesia than Italy. Malaysia's incidence of the disease ranks amongst the highest globally. Startlingly, rates in China and India are twice as high as in Australia, the UK or France. In countries with such large, in some cases ageing, populations and inadequate public health systems, it is no exaggeration to say that poor nutrition and the associated illnesses represents a potential health time bomb for the continent in the 21st century.

It is a tragic dichotomy that in the same Asia-Pacific region, far away from the bright lights of Hong Kong and Mumbai, live two-thirds of the world's population of 800 million people who do not have enough food to simply live healthily. Malnutrition and stunting remains, despite the rapid economic progress of Asia over the last two decades, the norm for hundreds of millions of people in the region, primarily in rural areas in northern India, southwest China and the more remote parts of the Indonesian archipelago.

How sustainable is this?

It is within this extremely challenging and bewildering context that the team attempts to identify potential investee companies. As we meet companies around the region, we are constantly asking ourselves to consider the sustainability positioning of the businesses we meet. We set out to find those which are best positioned to contribute to and benefit from sustainable human development in the region over the next ten years.

In the area of food and beverages, that means trying to find companies that we think can continue to increase sales in a profitable way over the next ten years, governed by sensible management teams who will deliver reliable and steadily growing cash flows to shareholders. Often, this means seeking out those companies focused on increasing rural, bottom of the pyramid consumption and those products which are truly needed by the end-user.

We are trying to find companies whose products, by their nature, are well-positioned for future health and wellness trends. In countries around the world, the manufacturers of excessively unhealthy products are facing headwinds to earnings growth. This is coming on one hand from changing consumer preferences, reflecting a growing underlying awareness of health issues around sugar and salt consumption. At the same time, governments are throwing up barriers in the form of heavier regulation and special taxes in the knowledge that such products can create significant costs for society which will be borne through the public purse via future health spending.

These headwinds are extremely relevant long-term investment points in Asia not 20 or 30 years from now, but today. Just as Asia has experienced an increase in these problems earlier and faster than the west did, it may also be the case that the region's populations begin to address them at a pace that few currently expect. Consequently, we consider a rupee or baht of earnings from selling milk or oatmeal to be far lower risk than earnings from selling snacks made from vegetable fats and sugar. Investing in the former seems a far more sober and responsible way of preserving and growing clients' capital over time in a low-risk manner.

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Differences between a direct bond and a bond fund

Warren Bird

In my previous article, "A journey through the life of a fixed rate bond" , I provided an overview of the price and performance history of the Commonwealth Government Security that matured this month, April 2015. This article responds to a reader question about the similarities and differences between investing directly in bonds and buying units in a bond fund or Exchange Traded Fund (ETF).

What happens to the cash on maturity of the bond?

The first difference is that the maturity of a single bond doesn't bring the life of a bond fund to a close. Other bonds with different maturity dates continue to generate investment returns.

Furthermore, within funds the cash that's generated when an individual bond matures is reinvested into the market. Although unit trusts are required to pay all interest earnings and realised capital gains to the unit holders as distributions, the proceeds of bond maturities don't have to be returned to the investors. Instead, they are used to buy new bonds in accordance with the investment policy of the fund.

This isn't as big a difference as it might first seem, because it's what direct bond holders often do in practice. Just as people who have a maturing term deposit then roll the proceeds into a new term deposit, so bond investors typically aren't in the bond market for the limited period of the life of the first bond they invest in. They reinvest into the market and keep their bond portfolio going.

If an investor in a bond fund wants to get some capital back they need to redeem units. Otherwise the manager of the fund will automatically reinvest.

Behaviour of other unitholders

Another difference between owning bonds directly and investing in a fund is that the behaviour of other unitholders can impact some aspects of your investment.

When you own your own portfolio of bonds, you earn interest and only generate any capital gains or losses if you decide to sell some bonds before maturity. If someone else decides to redeem units in a trust in which you are invested, then that may force the manager to sell a bond before it matures. This could generate a capital gain or loss on that security.

This impacts the distributable income that all unit holders in the fund are paid. The main impact is that in addition to interest earnings there will be net realised gains included in all distributions. In turn, this can have tax implications, depending on the tax rate you pay on different sources of income.

There is also the possibility that the bond that has to be sold to fund the other unit holder's redemption will be sold at a price that is different to the price used in valuing the fund. This could dilute the value of the fund for all unit holders, who have effectively had a small portion of their investment sold at a low price. However, this is usually managed by the fund having a buy-sell spread for transactions in units, based upon the market level of buy-sell spreads for the assets held in the fund. Therefore, it's only the unit holder who redeems from the fund who experiences losses from this source.

Price movements of bond funds and ETFs

In the article about the April 2015 bond, its price history was summarised. There were times when bonds were in great demand and the price rose compared with times when bonds were unpopular and the price fell. Bond funds will similarly experience rising and falling prices through time, as the price of all securities held within the fund will change as market yields change.

However, a bond fund can be thought of as a family, made up of old bonds, middle aged securities and young 'uns. That is, it holds a range of securities with a range of different maturity dates. Some will behave like the April 2015 did in its early days – highly sensitive to market yield changes and thus volatile in price. Others will be closer to maturity and behave like the April 2015 has done in the last couple of years – less volatile, with the amortisation towards par value being the dominant feature. A bond fund's price fluctuations will reflect the average of all the individual bonds that are held within it.

In Australia, most funds have an average term to maturity of around 3 – 5 years. So they'll fluctuate like an individual bond with 3 – 5 years to maturity. They will do this all the time, though, rather than eventually shortening towards zero. The reinvestment of maturing bonds across the market keeps the average maturity reasonably steady.

Government bond funds tend to be longer than the average – and thus more volatile in the short term - while corporate bond funds typically have a shorter average term and are less volatile.

Some of these features of bond funds also apply to ETFs, particularly the reinvestment of maturity proceeds and the way they tend to have similar maturity profile over time. One key difference is that the behaviour of other investors in the ETF doesn't have the same impact because they don't always force sales or purchases – another investor buys or sells units and the portfolio isn't affected. Only when

investor demand and supply for the ETF are out of balance will bonds have to be traded. This ensures that the value of the ETF reflects the market value of the bonds it holds, rather than the unique demand-supply conditions for the ETF itself.

Investing in a bond fund isn't exactly the same as investing in individual bonds. However, the most important difference isn't unique to bond funds. Unit trusts in all asset classes create the same exposure for an investor to the behaviour of other unit holders. For example, an equity fund investor can have the dividend and capital gain mix of their income influenced by other unit holder behaviour in the same way.

This article has been broad and general in nature, because specific bond funds have their own features – actively managed or indexed, for instance. It doesn't cover all the similarities and differences, but hopefully does provide some helpful information about investing via funds compared with direct bond ownership. Some additional information can be found in another earlier article, "The Idiot's Guide to Bond Funds".

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Bond price volatility matters for credit investing

Jonathan Rochford

Analysis of corporate credit comprises three key areas of assessment: volatility of bond prices, financial ratios and structure. Everyone knows and uses financial ratios, or at least the rating agency shorthand of them which is summarised in labels such as 'AAA' or 'BB'. The most common financial ratios are leverage, interest cover and gearing. (Property transactions substitute loan to value ratio for balance sheet gearing and infrastructure often uses debt to regulated asset base.)

Structure is less well understood, but most observers at least know that secured is better than unsecured and that covenants are a good thing.

Volatility is the simplest of the three key areas to test, but it is often the most ignored. As credit can suffer losses when a business underperforms but doesn't usually share in the upside of business outperformance, volatility of earnings and cashflows is undesirable. Convertible bonds and debt structures that come with warrants or options seek to address the perceived imbalance of risk sharing. However, these bells and whistles are used to allow lenders to obtain a share of the upside in more volatile companies rather than protecting against downside. Vanilla loans and bonds are therefore best suited for companies with relatively stable cashflows.

Recent examples of bond price volatility

The recent months have given us fresh examples of what can happen when potentially volatile companies take on meaningful levels of debt. American Eagle Energy Corporation raised US$175 million in secured bonds in August 2014. The first interest payment was due in March 2015. The company skipped the payment and is now negotiating with creditors in order to salvage some value for shareholders. The drop in oil prices means that it isn't generating enough cashflow to service its debts. Its cost of doing business is simply too high with oil prices at nearly half the level when the debt was issued.

Fortescue Metals spent a good part of March 2015 trying to extend its debt profile and then reassuring investors that its failure to do so wasn't a big deal. The bond markets clearly disagreed with the 2019 bonds dropping from 98.5% after the proposed debt restructuring was first announced to 78% at the time of writing. Comments from the CFO that the business is "bulletproof" and from the Chairman that the four largest iron ore producers should jointly restrict supply didn't help perceptions.

Based on iron ore prices at month end, Fortescue is thought to be cashflow negative after interest and maintenance capital is taken into account. With substantial principal repayments due in 2017 and 2019 Fortescue is now looking for other ways to raise capital, which are thought to include sales of mines or rail infrastructure. The missed opportunities to sell infrastructure, raise cheap long term debt or to raise additional equity in the years since the 2012 debt scare may well come back to bite Fortescue. Chart 1 shows how the bond market has reacted to changes in the iron ore price.

Chart 1: Price of Fortescue's 2022 bonds versus iron ore price

Commodity producers are amongst the most volatile companies, with the long term graphs of commodity prices showing enormous fluctuations. When times are good, new capacity enters the system but it has long lead times and before production ramps up prices can rise sharply. When demand falls or oversupply occurs it again takes time (typically years) for the supply of the commodities to drop back to balanced levels and prices can drop sharply. Agricultural commodities can also suffer from a high level of price volatility. Unexpected weather that knocks out a season of production in one part of the world quickly boosts prices for those elsewhere who are still able to supply. Companies that service industries dependent upon volatile commodity prices also get caught up in the cycle, as the focus on costs and amount of new capital invested varies substantially as the profit margins in the industry wax and wane.

Managing volatility is often overlooked

Old-fashioned mechanisms for mitigating volatility such as hedging and weather insurance have been discarded by many. Had either American Eagle or Fortescue wanted to, they could have locked in their selling prices for several years at healthy levels back in 2014 using futures or long term supply contracts. The trend in the last ten years has been for shareholders to discourage commodity producers from hedging, preferring to keep the revenues of the businesses variable and subject to market forces in what was expected to be a seller's market. The balance of power has now changed and the lack of long term hedging looks set to render many higher cost producers insolvent.

Volatility goes beyond commodity producers and their related industries. Other volatile industries are often referred to by equity investors as 'cyclicals'. These include airlines, hotels, construction and some retailers with spending on these items seen as discretionary and subject to being cut in a time of recession. These too can be an inappropriate match for traditional debt funding.

A current example of the outcome of a volatility assessment is to avoid buying Qantas unsecured bonds but to invest instead in Sydney Airport debt. Qantas has shown over the last seven years that it is good at making excuses but not good at making profits. Airlines are known to be notoriously volatile with a long history of insolvencies and government bailouts. Conversely, mainline airports have shown a much lower level of volatility and financial issues. When downturns occur, airlines typically bear the brunt with airports, aircraft manufacturers and aircraft leasing companies typically remaining profitable. Savvier

debt investors have also been lending to airlines via lease structures. In the event of an airline's insolvency the planes often remain under contract with all payments made. The fall-back position is having a hard asset to seize (ideally a late model plane) that can be redeployed elsewhere.

Footnote: Post the writing of this article, Fortescue announced its March 2015 quarterly production report and the bonds and shares rallied in response to expectations of lower iron ore production costs.

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Shorting and pair trading using ETFs

David Bassanese

Imagine you have found a stock you think is likely to rise relative to the overall market, possibly because it is either technically oversold or fundamentally cheap. To trade this view, you could simply buy the stock outright, though that opens you up to the risk that its price could still decline during a market sell-off. To hedge against this risk, the alternative would be to enter a 'pair trade' whereby you buy the stock outright while also simultaneously taking a short position against the overall market. While usually the domain of sophisticated and institutional investors, exchange traded products allow individual investors to implement such trading techniques.

Stock versus market pair trade using the 'Bear' hedge fund

Assume you expect the overall equity market to enter into a period of sluggish price growth or even price declines. In this environment, you might also expect relatively 'defensive' stocks such as Telstra to outperform. For example, in the two months from 13 October 2014 to 15 December 2014, the S&P/ASX200 traded largely sideways, rising by only 0.6%. During this same period, shares in Telstra rose by 9.5%. If you felt Telstra's price was likely to continue to outperform, you could implement a pairs trade by shorting the S&P/ASX200 and buying Telstra shares.

But how do you short the S&P/ASX 200 in a simple way? To obtain short exposure to the S&P/ASX 200, an investor could use the ASX-traded 'BEAR' fund, which is an Exchange Traded Fund (ETF) which sells the S&P/ASX 200 SPI futures contract (the Fund invests nearly all its assets in cash and cash equivalents and obtains its 'bearish' exposure by selling SPI200 futures contracts). This means the price of the BEAR fund is expected to move up when the S&P/ASX 200 falls and vice versa. Importantly, compared to short selling the physical shares or futures contract directly, the BEAR fund does not impose any margin call requirements on investors. All margin call requirements are met within the fund.

Figure 1: Returns of the BEAR fund after fees to 31 March 2015

Fund Returns After Fees (%)

	1 month	3 month	6 month	1 year	3 year p.a	5 year p.a	Since Inception (p.a.)	Inception Date
Fund	0.47 %	-8.73 %	-11.77 %	-10.34 %	-	-	-13.37 %	6-Jul-12
S&P/ASX 200 Accum. Index	-0.06 %	10.33 %	13.76 %	14.13 %	-	-	18.90 %	-

(Returns are calculated in Australian dollars after fund management costs, do not include brokerage or the bid ask spread, assume reinvestment of any distributions and do not take into account tax paid by investors. Returns for periods longer than one year are annualised).

The BEAR fund should not be expected to provide the exact opposite of the market return over any time period. In the 12 months ending 31 March 2015, for example, the BEAR fund fell 10.3% even though the S&P/ASX 200 accumulation index rose by 14.1%. The reason is that, although the fund follows a rules-based strategy, these rules allow the Fund's market exposure to vary between 90% to 110% short on a given day. Therefore a 1% fall in the Australian share market on a given day can be expected to deliver a 0.9% to 1.1% increase in the value of the fund (before fees and expenses). The Fund's approximate exposure to movements in the S&P/ASX 200 Index, as measured by the futures contracts held in the Fund, is quoted on the BetaShares website. For example, if the Fund's portfolio exposure is -105%, and the S&P/ASX 200 index goes down 1% that day, the Fund would be expected to go up approximately 1.05% that day, before fees and expenses. Note that the futures contract does not always align perfectly with the ASX 200, and the Fund is actively managed on a daily basis, affecting returns over time.

The BEAR fund can be used to short sell the broad market, and provides a simple and convenient way to assist in the implementation of a pairs trading strategy.

Sector versus stock pair trade using a sector ETF

For investors with access to stockbrokers providing short selling services, another pairs strategy could be used to take a view on a stock's performance relative to that of its relevant sector. For example, if you believed BHP's share price was likely to underperform the overall Australian resources sector, you could short BHP through your stock broker and buy a fund which provides broad sector exposure, for example, a resources sector ETF.

While the premise of pairs trading is simple – simultaneously buy and short sell different shares or indices, there are more advanced pairs trading strategies which look at hedging or managing volatility. And, of course, investors in the Fund need to understand that, while the product is expected to rise when markets go down, it is also expected to fall in value when market rise.

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See this interview with Alex Vynokur, Managing Director of BetaShares, for an explanation of pricing and liquidity for ETFs.

A sombre reflection on financial literacy

David Bell

Cuffelinks was established as a forum to improve financial literacy and its readers come from diverse backgrounds. Financial literacy is a topic near to our hearts; unfortunately financial literacy levels in Australia and around the world are disturbingly low. A recent research paper by the global leaders in research into financial literacy, Annamaria Lusardi and Olivia Mitchell, both based in the US, provides the broadest review of the research undertaken on this topic (the full paper is available here). While the results are concerning, Lusardi and Mitchell take the positive view that there is a clear opportunity to improve financial literacy levels and benefit society as a whole.

How do you measure financial literacy?

Lusardi and Mitchell developed a three question financial literacy test known as the financial literacy instrument. The test is simple, brief and relevant, focusing on compound interest, inflation and diversification. This test and the poor results in Australia and around the world have been detailed previously in Cuffelinks (see *Do clients understand what advisers are saying?*). In short, only 40% of the population (in Australia and in the developed world) display basic financial literacy.

It would appear that individuals are unaware of their lack of financial knowledge: in the US a government study revealed that 70% of respondents self-assessed their level of financial knowledge as 4 or higher on a scale of 1 to 7, but only 30% of the respondents actually passed the basic test of financial literacy.

These results are concerning when we consider the structure of Australia's financial services industry. The broad philosophy of the Wallis Inquiry and the Coalition Government is that consumer choice and competition lead to a more efficient industry. But are those making the choice sufficiently literate to be able to make important financial decisions? In a country where more than one million people are SMSF trustees, financial literacy, when combined with one's potentially overstated view of their own level of literacy, is a potentially dangerous mix.

Who are the most vulnerable?

Lusardi and Mitchell review the existing research on which people have the lowest degree of financial literacy. Here we summarise the findings across multiple dimensions:

- Age: the life cycle profile of financial literacy is somewhat hump-shaped, meaning the lowest levels of literacy exist amongst the young and old. What makes this finding more worrying is other research cited by the authors finding that peoples' confidence in their own financial decision-making abilities actually increases with age. This potentially makes the aged the most obvious targets for fraudsters.

- Gender: regardless of age, the research finds a higher level of financial literacy among males than females. Although much research has been undertaken to try and understand why this difference exists it remains unclear.

- Education and cognitive ability: higher levels of education and higher levels of cognitive ability lead to greater levels of financial ability. Even once the research adjusts for cognitive ability (often highly correlated with the attainment of education levels) higher education levels still contribute to a greater likelihood of being financially literate.

There are a large range of other patterns exist regarding financial literacy, but we already know enough to target financial literacy programmes to the greatest need.

The consequences of financial illiteracy

Lusardi and Mitchell review a large range of research on the consequences of low levels of financial literacy. The picture is disturbing: those with low levels of financial literacy have a greater likelihood of making financial mistakes, including being misled or defrauded. On the other hand those with higher financial literacy undertake sensible actions such as creating diversified portfolios, maintaining a precautionary savings pool and planning for retirement. Those with lower financial literacy levels commonly experienced higher costs for financial transactions and higher rates for loan products.

Some studies have attempted to measure the financial cost of financial illiteracy. Generally it has proven difficult to estimate the lifetime financial impact between two otherwise similarly specified groups of people who only differ by their level of financial literacy.

Despite their clear passion for raising financial literacy levels, Lusardi and Mitchell highlight that any financial literacy program should be considered from a cost-benefit perspective. They note that it could actually prove more effective from a net benefits perspective to simplify investment decision-making through regulation rather than focus on education programmes. While the first reaction might be that it is difficult to consider such an option in Australia with our heavy focus on choice, the majority of the

population remains in default-style funds and this has been one of the areas which recent regulation such as Stronger Super has sought to simplify.

Lusardi and Mitchell further consider the role of regulators in controlling for behavioural biases, such as the way information is framed to the public. One well known US case study is illustrative, based on an employer pension plan for new employees with a 3% default contribution rate (if they do not make a contribution rate decision). This default rate appeared to be misinterpreted as a suggested target rate resulting in some new members actually reducing their contribution levels back to this amount compared with the savings plan they had with their former employer.

Financial advice could be an alternative to financial literacy programs. The authors ponder the thought that a population-wide high degree of financial literacy may be unrealistic and that more people would benefit from financial advice. They recognise that it is unrealistic for the entire population to receive quality financial advice in the near term.

Ultimately Lusardi and Mitchell conclude that it would be beneficial for society if financial literacy levels were improved. This can be in conjunction with regulators and industry becoming more educative, user-friendly and aware of how information is framed. I believe all parts of the financial services industry have a contribution to make to financial literacy. In the words of the authors: "*While the costs of raising financial literacy are likely to be substantial, so too are the costs of being liquidity-constrained, overindebted, and poor.*"

Footnote: In Australia, ASIC has a National Financial Literacy Strategy and with Financial Literacy Australia, they have projects to improve financial literacy, but they announced in late 2014 that the MoneySmart Week initiative will be discontinued.

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Articles referenced by readers in response to 'wealth disruption'

Graham Hand

In response to the two articles in Cuffelinks on disruption in wealth management, readers provided some follow up articles on related subjects.

Why Paying for Financial Advice Makes Sense, New York Times, 3 April 2015

This article tells the story of LearnVest, a company established in the US in 2009 to bring financial planning to the masses. After spending US$75 million of venture capital money, it has less than 10,000 clients in its standard plan at $299 upfront and $19 a month. Sobering numbers for any fintech looking to engage with a large, untapped market. LearnVest has effectively capitulated by selling to a large insurance company, Northwestern Mutual.

Investing's Old Guard Gets Its Algorithm On, Bloomberg Business, 20 March 2015

This article quotes an investor from Houston who pulled all his money out of the market in 2008 only to miss all the gains as the market recovered to 2013. "I just need protection from myself" he says as a reason to let others make investment decisions for him. He did not like the high fees of traditional advisers, so turned to roboadvice. It then outlines the move by the US$3 trillion 'behemoth' Vanguard and the US$2.5 trillion Charles Schwab into this space.

Digging into Digital Advice White Paper, Fidelity Investments, 28 November 2014

This US White Paper focusses in particular on the propensity of Gen-X and Gen-Y to work with a 'digital adviser', and among affluent members of these groups, 29% are already familiar with digital advisors, and 7% use one. The potential benefits are lower fees for advice, ease of doing business, low asset

requirements and online access to do-it-yourself tools. 46% of those surveyed believe professional financial advice is too expensive, and so digital is probably tapping into an audience that would not otherwise see an adviser.

The Paper also includes details on pricing levels (as low as 15bp), size of 15 largest online advisers ($4.3 billion in September 2014) and total number of providers (estimated at about 50). But it's not only for new players. Fidelity offers views on how existing planners can evolve their practice. One message: "Be online, or risk being irrelevant".

Robo-Advisor White Paper, Equity Institutional, 2014

This paper provides financial advisors with six ways to benefit from "the coming boom in robo-advice assets". It distinguishes three categories of clients: delegators ("Do what you think is best with my money"), validators (who participate in decision-making) and self-directeds (who want to do it themselves). The writers say 72% of investors want some level of financial advice with their investment decisions. They reassure traditional advisers by arguing that the roboadvice experience is like a calculator with better graphics, often cold and generic and lacking the human element that is essential to good advice. It also has an impressive list of further reading.

Graham Hand is Editor of Cuffelinks and nothing in this article addresses the personal needs of any individual, nor is it responsible for the accuracy of the content in any referenced material.