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This Week's Top Articles

Rising US bond rates should be good for shares

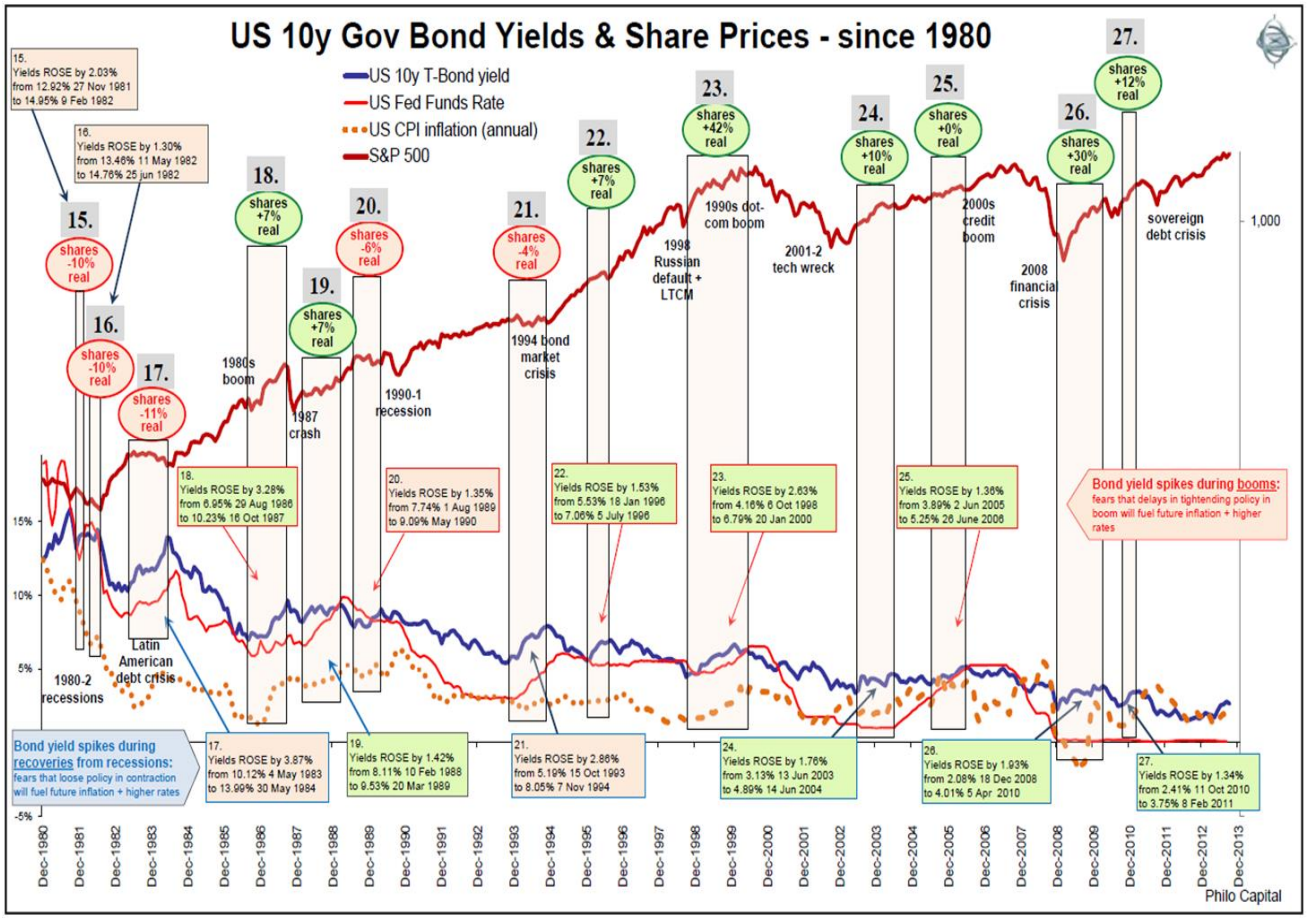
Ashley Owen

There is a widely held belief, supported by theory, that rising bond yields should be bad for share prices. But is this true in real life? Just about every stockbroker and security analyst in the world today uses valuation models driven by discount rates based on long term government bond yields. The implication is that, all else being equal, a rise in government bond yields (which drives discount rates) should result in a fall in asset values.

The problem of course is that all else is never equal. Rising bond yields are usually the result of rising expectations of future interest rates and/or rising expectations of future inflation. The factors that drive these expectations are often also driving expectations of increased economic activity which, to varying degrees, may be expected to flow through to higher company revenues, profits and dividends. As a result, the relationship between government bond yields and share prices is more complex than it first seems.

This article studies all 27 bond yield spikes in the US market since World War II and their impacts on share prices. A subsequent paper will look at the Australian market.

Figure 1: US 10 year Treasuries and S&P500 share price index since 1980



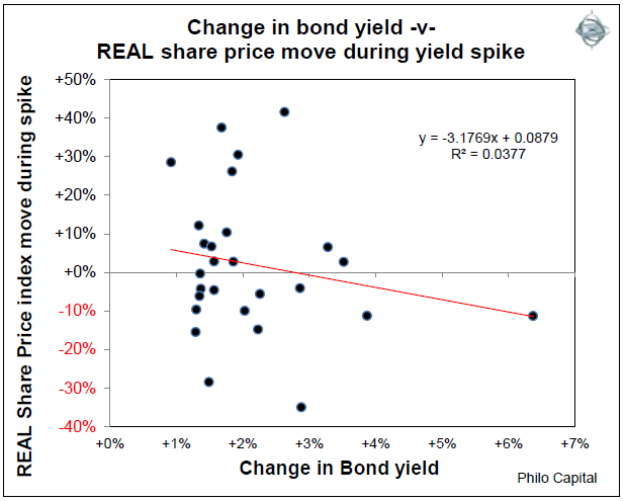
(Figure is easier to read in its full detail in an enlarged version on our website).

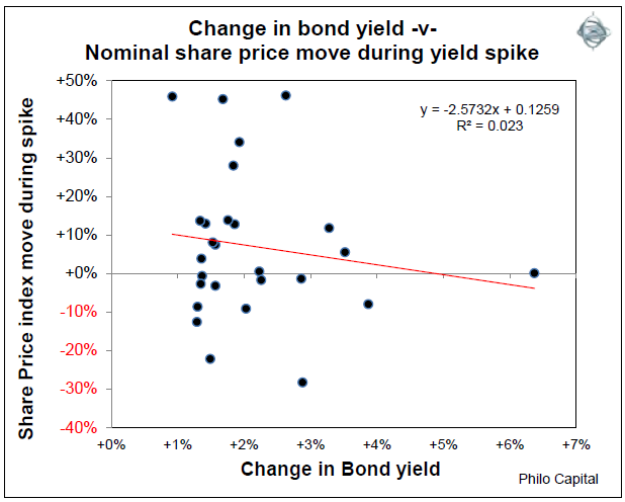
Statistical relationship bonds and shares

Bond yield spikes on the whole have had *no consistent impact* on, or statistical relationship with, share prices in the US market, either in the rising inflation phase (1946-1981) or in the disinflation phase (post-1981). It is notable that:

- Around half of the US bond yield spikes since 1946 were accompanied by *rising nominal* share prices during the yield spike. (57% during the 1946-1981 rising inflation phase, 62% during the post 1981 disinflation phase, and 59% overall)
- Around half of the bond yield spikes since 1946 were accompanied by *rising real* share prices during the yield spike. (43% during the 1946-1981 rising inflation phase, 54% during the post 1981 disinflation phase, and 48% overall).

This is shown in the following pair of charts that plot changes in bond yields during bond yield spikes versus nominal share price moves during the yield spike (left chart), and versus real share price moves during the yield spike (right chart). They show no clear relationship between the magnitude of the yield spike and share price returns during the spike:





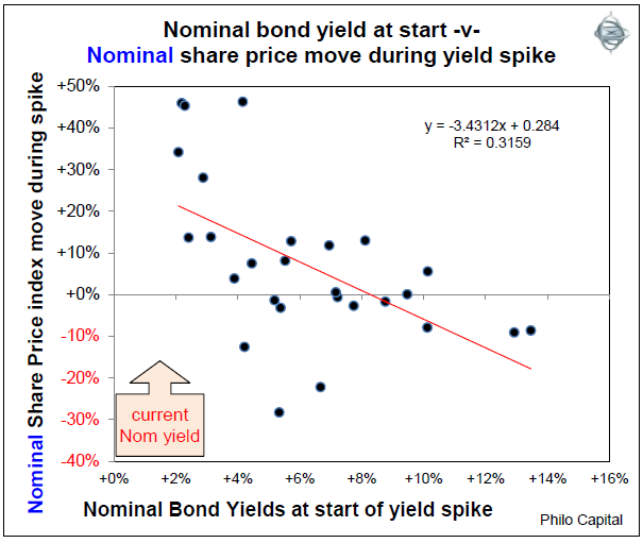
Level of nominal bond yields at start of rate rise

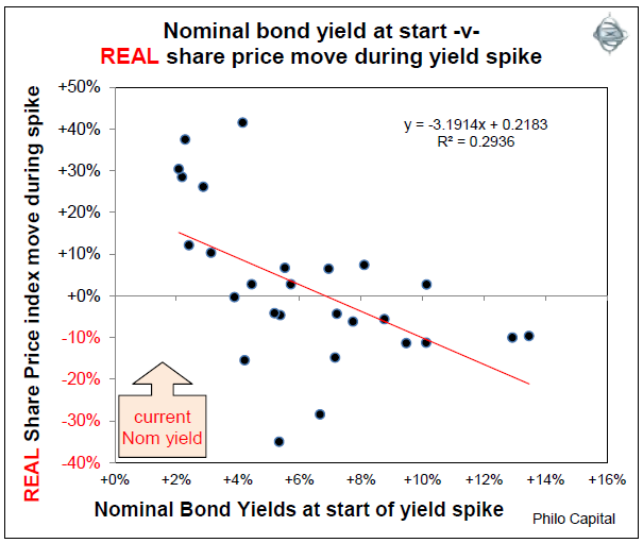
What does make a difference to share price returns during bond yield spikes is the level of *nominal bond yields at the start* of the yield spike:

- *all* of the bond yield spikes that started when nominal bond yields were *low* were accompanied by *high* nominal and real returns from shares during the spike; and
- *all* of the bond yield spikes that started when nominal bond yields were *high* were accompanied by *low* nominal and real returns from shares during the spike.

This pattern has been consistent in both the rising inflation phase and also in the disinflation phase.

The next pair of charts shows this moderately strong negative relationship between the nominal bond yield at the start of the yield spike versus *nominal* share price moves during the yield spike (left chart), and versus *real* share price moves during the yield spike (right chart):





Current yield spike: When the last bond yield spike started in July 2012, the nominal bond yield at the start was an extremely low 1.43%. In *all* prior yield spikes since 1946 that started with nominal yields at very *low* levels, share prices have *risen* strongly in both nominal and real terms during the bond yield spike. This is the case once again during the current yield spike, as we are still bullish on US equities. (*Editor's note: this paper was written in March 2015*).

Potential for favourable share returns

There are some reasonable indications that share returns are likely to be favourable during the current bond yield spike. Specifically:

- Rising bond yields that start when nominal bond yields are low (which was the case at the start of the last bond yield spike and also the case now) have consistently been accompanied by *high* nominal and real returns from shares during past bond yield spikes. This has been the case through all types of market conditions and inflationary environments during the post-World War II era.

- Rising bond yields that start when the CPI inflation rate is low (which was the case at the start of the last bond yield spike, and is still true now) have consistently been accompanied by *high* nominal and real returns from shares during past bond yield spikes. This has also been the case through all types of market conditions and inflationary environments during the post-World War II era.

At least we can say that historical precedents provide no warnings of poor returns, as poor returns have occurred when nominal bond yields and/or CPI inflation rates are high during the yield spikes, and neither is the case at present.

We wrote an original paper on this subject warning of the last yield spike in 2012, and the S&P500 index of US stocks indeed rose by 40% between when yields bottomed at the start of that spike to the last day in December 2013 (bond yields rose by 1.61% to 3.04%).

This is consistent with the patterns over the past seven decades through a wide variety of inflationary conditions, and this provides support for our relative bullish stance on US shares over the period, in the face of rising bond yields.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general educational purposes only. It is not personal financial advice and does not consider the circumstances of any individual.

Why China's property market matters

Sam Churchill

A credit-fuelled property bubble enabled China to maintain its incredible run of growth through the global financial crisis (GFC). However, now China has to deal with a massive excess supply of property that is causing construction activity to contract along with a range of other linked sectors in the Chinese economy, as millions of homes lie vacant.

Background to China's property bubble

In 2007, China was constructing around 1.5 billion square metres of gross residential floor space per year (or approximately 15 million housing units) to support urbanisation, to replace old housing stock and to meet the investment needs of Chinese households. By 2013, despite a fall in the rate of urbanisation, the construction rate had reached 2 billion square metres, resulting in several million more housing units being constructed each year than new households being formed.

A serious geographic mismatch also developed between housing supply and demand. Although urbanisation generated strong housing demand in Tier 1 and 2 cities, a disproportionate share of property development was concentrated in smaller cities. Subsequently, Tier 1 cities such as Beijing and Shanghai generally suffer from housing shortages, while Tier 3 and 4 cities hold most of the excess supply.

The excess supply problem is compounded by a lack of affordable housing for domestic migrant workers who account for the majority of new urban households. Almost 60% of migrant workers live in company dormitories or on work sites, most of whom cannot afford to buy homes, even if the 'hukou system'

allowed it. China's government has directly contributed to the property glut, having built an estimated 46 million low-cost subsidised housing units from 2010-2015.

Moreover, unfavourable demographics are putting downward pressure on property demand. China's working age population (aged 15-59) peaked in 2012 and is currently declining by several million people each year, while the main property buying demographic, the population aged 25-49, is expected to peak in 2015 and decline thereafter.

Most of China's excess housing supply is vacant stock held by private investors, with the remainder sitting on the books of real estate developers, many of whom are highly-indebted. According to the China Household Finance Survey, 22% of urban housing in China is vacant.

What does this mean for China?

A build-up of unoccupied properties will ultimately lead to a major contraction of construction and linked sectors in the Chinese economy. Indeed this process is already underway. National house prices have fallen 6% in the past year and urban housing completions are down 13% so far in 2015. Electricity consumption increased by 1% over the year to April 2015, compared to 8% growth per annum in 2012 and 2013. Steel production, cement production and rail freight traffic are slowing significantly while imports are contracting, which may reflect domestic macro weakness.

A property fire sale by investors or developers could lead to large falls in prices and capital losses, rendering many developers insolvent. China's property industry is highly leveraged, and closely linked to the shadow banking system, creating potential financial system risks. Local governments are increasingly buying land from themselves, via local government financing vehicles (LGFVs), using money borrowed from banks and shadow lenders. Many Chinese households have effectively lent to LGFVs via trusts and wealth management products (WMPs).

Real estate accounts for more than half of household wealth in China. If prices fall dramatically household consumption will follow, and some overleveraged households may be forced to sell. Household debt, around half of which is mortgage-related, has risen strongly from around 8% of GDP in 2000 to around 38% in 2014, but remains relatively low. Interest rate liberalisation, capital account opening, and the availability of alternative investments (e.g. WMPs) could also undermine property market fundamentals.

To work off the excess supply it is possible that China's residential property construction activity could fall by as much as 50%. Real estate and related industries account for 20-25% of GDP. The housing sector directly represents approximately 10% of GDP (approximately 50% more than the US pre-GFC). The bursting of the property bubble would cause fiscal balances to deteriorate, especially for local governments which rely on land sales for around 35% of revenues. A large contraction in China's property sector would cause a major slowdown in the economy and perhaps even a recession.

Implications for global markets

China is a key driver of global growth. Since 2010, the country is estimated to have directly contributed around a quarter of global economic growth, despite its economy only representing around 12% of global GDP. China accounts for around half of the world's consumption of iron ore, cement, coal and steel. Should China's economy continue to slow the global repercussions are likely to be significant, including:

- **Trade links**: countries such as Brazil, Russia, Australia and Canada are vulnerable to a China slowdown and have already experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. These economies may also be exposed to the unwinding of commodities-linked domestic credit booms. Other economies with major trade linkages to China, particularly in Asia and Japan, would also be adversely affected.

- **Financial links:** Although relatively nascent, links between Chinese banks and Hong Kong or Singapore could provide channels for the international transmission of a Chinese financial shock. Foreign lending to Chinese corporates has grown at a rapid pace and is focused on the property sector. Chinese property developers currently represent approximately one-third of Asian high yield non-financial corporate bond issuance and could trigger a reassessment of risk premia in the event of

large scale defaults. If China experiences a recession and defaults spread across borders, an emerging markets credit crunch is not out of the question.

- **Capital repatriation**: Property markets in Canada, Australia, the UK and Hong Kong could be hit if investors pull out of international assets. China also has massive foreign exchange reserves and is one of the world's largest holders of US Treasury securities.

Fortunately, the Chinese authorities appear to be taking steps to manage the housing market correction and slow credit growth. Furthermore, almost all of China's debt is held domestically, which makes it easier for the government to manage large-scale defaults as it did in the late 1990s. With government debt at 56% of GDP, China has room for additional fiscal stimulus and debt nationalisation. The country's huge foreign exchange reserves and current account surplus also make it highly resilient. However, if the returns on incremental spending and investment are sufficiently low the government may not be able to prevent a sharp slowdown or a recession.

While there are a number of reasons to be optimistic about China's long-term economic future, the short-to-medium term challenges are considerable. China's property bubble is set to burst and the economic ramifications will be widespread, warranting a cautious approach by investors.

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Putting sequence risk in its place

Paul Resnik and Peter Worcester

Discussions of sequence or series risk regularly appear in the specialist financial media, and are increasingly appearing in the general press. In simple terms, fear of sequence risk drives investors to take equity and risky asset exposures out of their retirement portfolios.

Sequence risk is the fear that a series of bad returns in the early stages of retirement drawdown will significantly diminish capital values such that the portfolio is incapable of recovery, can't support future drawdowns and will not meet its investor's longer term needs.

Analysis of Australian historical data suggests that sequence risk for retirees may not be the danger claimed. If this is true, then many of the standard approaches to investment within retirement plans are flawed. Specifically, this includes notions of decreasing growth asset exposure with age and deferring home equity release opportunities to later stages of retirement. History actually shows that there are good arguments for increasing growth asset exposure around retirement. We show that this is consistent with the data from three countries: Australia, the UK and the US.

Background

For the last 10 years, FinaMetrica has provided advisers in nine countries with **40-plus years of performance** histories for a wide range of portfolio asset mixes for both lump sum investments and regular savings from an investor's perspective. In the UK, the rolling 10-year real return for a 40% growth portfolio over the last 40-plus years has been 5.5% p.a, in the US 5.5% and Australia 5.9%. What would have happened if a higher growth asset exposure had been selected? Not as much as might be expected. An 80% UK growth portfolio would have delivered 0.9% p.a. more at 6.4% p.a. In the US 6.9% p.a., a 1.4% increment; and in Australia 7.1% p.a., a 1.2% p.a. increment.

Our data set is based on mainstream accumulation indexes, rebalancing each year. So on face value there has been little additional return for the greater exposure to growth assets and the associated volatility.

Australian withdrawal history shows counter-intuitive outcomes

In our example for 40% growth portfolio using the returns described above, we drawdown $3,000 p.a., $5,000 p.a. and $7,000 p.a., adjusted for inflation each year from a $100,000 portfolio. There is no allowance for fees, taxes or other frictions which can amount to 200 bps (2.0%) or more each year. The real balances after ten years are shown in the main body of the table.

Table 1: Real end value of portfolio based on different drawdown rates (3%, 5% and 7%)

	After 10 years		
	Real End Value of $100,000		
Historical returns	3%	5%	7%
Best	227,696	195,809	163,922
Good	207,996	175,609	143,652
Average	141,818	114,098	83,378
Poor	67,300	42,524	17,747
Worst	47,030	26,972	5,867

The Good means a result that was higher than 95% of the results and, similarly, the term Poor means a result that was higher than only 5% of the results. The Average is the average return. We can discount the Best and the Good as we shouldn't be over-emphasising high returns to investors. It's the Average, Poor and Worst outcomes that need to be explored.

The account balances alone don't provide any easy insight into the future so we looked to reinterpret the data consistent with the number of future years the real income might continue to be withdrawn at the end of the tenth year. We can divide the closing 'real' balances for future annual payments by $3,000, $5,000 and $7,000 and see the future year payments.

We now have a framework for comparing retirement benefits based on future payments.

- After 10 years our $3,000 p.a. withdrawing investor had on average 47.3 more years' payments. In the Poor case (5%) she had 22.4 more years. And the very Worst 15.7 more years.
- After 10 years our $7,000 pa withdrawing investor had on average 12.3 more years' payments. In the poor case (5%) she had 2.8 years. And the very Worst 0.8 more years.

How does this compare to the client who took on the additional 40% risky asset exposure and ran with an 80% Growth asset portfolio? We already know that the additional return was 1.2% p.a. in Australia over the last 40-plus years. Averages can hide all sorts of unexpected insights.

- Best, Good and Average returns are generally consistent with what most would expect. The additional growth asset exposure delivers better returns, much better than might have been expected considering the annualised incremental return was only 1.2% p.a. greater.
- The Poor and Worst returns are another matter. They are counter-intuitive. Investors didn't necessarily have a lower return for lower growth asset exposure.
- Investors were not significantly worse off for taking the 40% higher exposure to growth assets.

Comparison of Australia with the UK and US

Is this an Australian aberration? How does this compare to similarly exposed portfolios in the UK and US?

- The patterns are similar in both the US and UK to Australia for a 40% growth portfolio across all five cases. There is no significant differences in future year payments for portfolios across countries in Poor and Worst cases.
- The patterns are similar for the 80% growth portfolio as the 40% growth asset portfolio in both US and UK.
- Specifically, there's no significant differences in future year payments for portfolios across countries in Poor and Worst cases.
- A 5% withdrawal rate leaves investors with potential additional payments after 10 years for a further 20.1 years in UK, 19.5 years in US and 26.2 years in Australia in Poor cases. The Worst cases are also consistent.

Is sequence risk an unnecessary anxiety?

So, at least historically, sequence risk looks to be an unnecessary anxiety. It seems to be a case of focusing on one particular part of the portfolio performance data rather than the full context. Reducing equity exposure hasn't changed the Poor and Worst returns in any meaningful way but will have likely impacted Average, Good and Best returns. In summary, the opportunity cost of being underexposed to growth assets was high.

So what are the take-aways?

- There may be no investment need to reduce growth asset exposures in portfolios around retirement. In fact, there may be an argument to increase it.
- The best retirement portfolio may be the one that best matches the investors' financial risk tolerance with assets. On that basis they are less likely to be carried away by stock and property market movements.
- Our collection of 800,000 risk tolerance test reports shows that there's little likelihood of material change to an individual's risk tolerance as they age. What changes is their perception of risk as markets move and other factors change.
- The role of annuities in an individual's retirement portfolio needs to be carefully considered.
- Short-term cash flow needs may be best financed by low cost borrowings, through a reverse mortgage for instance. And repaid when equity markets recover.
- When markets are in disarray investors may choose to spend less.

Retirement planning has never been so challenging.

For more detail on the calculations, including relevant tables on the results and a comparison with the UK and US, see the full research paper. This article is for general education purposes and does not address the specific circumstances of any individual investor.

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Peter Worcester has spent 40 years working in the financial services industry. He is an actuary, has been a director of several financial planning firms, and has been an investment manager with several firms.

IPOs: Beware of investment bankers bearing gifts

Hugh Dive

Over the past two years investors have faced a barrage of glowing research from the investment banks trumpeting the blue sky potential of new companies seeking to be floated on the ASX. What is also clear is that the overall quality of these new initial public offerings (IPOs) has been declining and investors should be more critical of the bright forecasts contained in the prospectuses.

Earlier this week we received the IPO offer documents for a company exposed to the buoyant domestic housing sector, valued based on the assumption that the current demand for new homes and apartments remains unchanged. Indeed one of their competitors that listed just over six months ago has already fallen 20%.

When analysing IPOs, few have been more eloquent on this subject than Benjamin Graham, the Father of Value Investing

"Our recommendation is that all investors should be wary of new issues – which usually mean, simply, that these should be subjected to careful examination and unusually severe tests before they are purchased. There are two reasons for this double caveat. The first is that new issues have special salesmanship behind them, which calls therefore for a special degree of sales resistance. The second is that most new issues are sold under 'favorable market conditions' – which means favorable for the sellers and consequently less favorable for the buyer" (*The Intelligent Investor* 1949 edition, p.80)

The cycle

Typically during an IPO cycle, the higher quality businesses are listed first, generally at attractive multiples to overcome investor skepticism. When these floats perform well (and generate handsome fees for the investment banks), the more marginal businesses get listed. Then finally, towards the end of the cycle, investors will see companies that have been hastily cobbled together to take advantage of investor greed. Generally this window closes either due to a large negative macroeconomic event such as the GFC which reduces investors' appetite for risk, or a particularly poor large float that burns investors' fingers such as Myer in 2009.

Why is the vendor selling?

The motivation behind the IPO is one of the first things to look at. Historically investors tend to do well where the IPO is a spin-off from a large company exiting a line of business such as Orica and their paints division Dulux or the vendors are using the proceeds to expand their business. The probability of new investors doing well from an IPO is far lower when the seller is just looking to maximise their exit price and end their involvement with the company, a classic example of this was the Myer IPO. In situations like this the seller can be incentivised to make short term decisions to inflate current earnings such as economising on maintenance capex, if they are not long-term owners of the business.

Is the company profitable?

Any IPO is presented to the market in the most favourable light (albeit with a large number of disclaimers) and at a time of the seller's choosing. Over the last six months we have seen a number of businesses being listed that have been unprofitable for a number of years, yet are expected to switch into profitability in the years immediately after the IPO. We put little store in the notion that companies are being listed for the altruistic benefit of new investors. Thus we are doubtful of such dramatic improvements after listing, especially when the IPO vendors have significant incentives to show profits before listing.

Can the business be readily understood?

Given the reduced level of historical financial data it is important that an investor can easily understand how the company makes money and its competitive advantage. We are wary of companies with complicated business models, as investors usually only have a few weeks (9 or less) to analyse whether

to buy an IPO, whereas the seller has generally owned the company for five years or more. When Medibank Private was listed in November 2014, it was clear how the company made money from collecting insurance premiums from the public to settle hospital bills.

How attractive is the price?

The sole reason behind any new investment is the view that it will generate a higher rate of return than the alternative options in your portfolio. Additionally as the audited financial history may be limited or the financial accounts complicated by bolt-on acquisitions made in the lead up to the IPO, investors should build in an additional margin of safety and price the new issue at a discount to existing listed companies in similar industries. The Mantra Group hotel IPO in June 2014 was priced at an attractive PE of 12.7 times forward earnings, a 30% discount to the original price sought by the vendors in a failed attempt to list the business in March 2014. This allowed new investors an attractive entry point with a margin of safety. Conversely the May 2015 IPO of MYOB was priced at almost 24 times and at this level we saw minimal scope for price appreciation for new shareholders.

Significant IPO Listings over the last 18 Months

Listing date	Company name	Industry	Current Price	Original IPO Size (A$m)	Performance since listing	Listing PE
Mar/2014	SG Fleet	Commercial Services	$ 2.49	189	34.6%	12.8x
Apr/2014	Japara Healthcare	Health Care	$ 2.60	450	30.0%	19.0x
Apr/2014	Burson Auto Parts	Distributors	$ 3.50	224	92.3%	13.6x
Apr/2014	Genesis Energy	Utilities	$ 1.69	570	16.2%	16.2x
May/2014	Genworth	Mortgage Finance	$ 3.20	583	20.8%	7.5x
May/2014	Intueri	Diversified Consumer Services	$ 1.62	162	(25.7%)	11.9x
May/2014	Spotless	Commercial Services	$ 2.14	995	33.8%	12.4x
Jun/2014	iSentia	Internet Software	$ 3.82	287	87.3%	15.0x
Jun/2014	Mantra	Hotels	$ 3.70	239	105.6%	12.7x
Jun/2014	PAS Group	Specialty Retail	$ 0.50	121	(56.5%)	8.9x
Jun/2014	Asaleo Care	Personal Products	$ 1.88	656	13.9%	14.1x
Jun/2014	Monash IVF	Biotechnology	$ 1.33	316	(28.1%)	16.4x
Jul/2014	3P Learning	Education	$ 2.38	283	(4.8%)	34.7x
Jul/2014	Smartgroup	Commercial Services	$ 2.06	113	28.8%	9.8x
Jul/2014	Healthscope	Health Care	$ 2.60	2,300	23.8%	21.9x
Jul/2014	Metro Performance	Materials	$ 1.50	229	(5.7%)	13.9x
Aug/2014	SpeedCast	Telecommunications	$ 2.91	236	48.5%	17.0x
Aug/2014	Ashley Services Group	Professional Services	$ 0.60	100	(63.9%)	12.1x
Oct/2014	Regis Healthcare	Health Care	$ 5.35	486	46.6%	22.8x
Nov/2014	GPT Metro Office	Real Estate Investment Trusts	$ 2.10	255	5.0%	18.6x
Nov/2014	Huon Aquaculture	Food Products	$ 3.25	133	(31.6%)	13.4x
Nov/2014	APN Outdoor	Media	$ 3.08	329	20.8%	15.0x
Nov/2014	Simonds	Homebuilders	$ 1.45	161	(18.5%)	13.2x
Nov/2014	IPH Limited	Professional Services	$ 4.62	166	120.0%	13.9x
Nov/2014	Medibank Private	Insurance	$ 2.08	5,679	(3.3%)	22.0x
Nov/2014	Orion Health Group	Health Care E	$ 3.80	115	(34.5%)	11.0x
Dec/2014	Aconex	Internet Software	$ 3.15	140	65.8%	na
Dec/2014	Evolve Education	Consumer Services	$ 1.00	154	9.9%	10.7x
Dec/2014	Estia Health	Health Care	$ 6.18	725	7.5%	21.0x
Dec/2014	Centuria	Real Estate Investment Trusts -	$ 2.10	114	5.0%	na
Dec/2014	oOh! Media	Media	$ 2.60	169	34.7%	16.5x
Dec/2014	Lovisa	Specialty Retail	$ 3.47	102	73.5%	12.8x
Apr/2015	Eclipx	Diversified Financials	$ 3.05	253	32.6%	11.0x
Apr/2014	360 Capital Office	Real Estate Investment Trusts -	$ 2.12	155	6.0%	na
May/2015	MYOB	Software	$ 3.38	833	(7.4%)	23.5x
Jun/2015	Gateway Lifestyle	Real Estate	$ 2.02	381	1.0%	12.1x
Jun/2015	Adairs	Retailing	$ 2.70	218	12.5%	16.3x

Source: Aurora Funds Management, IRESS & UBS

Recent action and consequences

In aggregate the market has invested $19 billion in new IPOs over the past 18 months and the weighted average return has been +13%, though with a large degree of variability in returns. Looking at the above table the most common industries for IPO listings are healthcare, real estate and IT and a successful float in one industry stimulates the investment bankers to bring similar-looking companies to market. A key factor in the companies that have done poorly has been structural issues with the business model or

overly optimistic predictions of future profits as we saw in the recent downgrade of real estate trust Industria's (floated December 2013) expected distributions.

Like all investment managers, Aurora is currently receiving around two to three 80-100 page pre-IPO research pieces a week, couriered to our desks by the sponsoring investment banks with a range of arguments why we should invest our clients' capital in these new IPOs. Whilst new issues are presented as fresh, exciting ways for investors to make money, what we are looking for are situations where the vendor is deliberately under-pricing the asset being sold. As you can imagine, this is a very rare occurrence for profit-maximising private equity owners, who often seem to have little interest in the ongoing health of the business after their exit has been achieved.

Hugh Dive is a Senior Portfolio Manager at boutique investment manager Aurora Funds Management Limited, a fully owned subsidiary of ASX listed, Keybridge Capital (ASX Code: KBC). This article is for general education purposes and does not address the specific circumstances of any individual investor.

The growing case for convertible bonds

James Peattie

Editor's introductory comment: A convertible bond gives the bond holder the right to convert the bond into a defined number of shares in a company at a predetermined price. As an example from the Australian market, the long-established Listed Investment Company, Australian Financial Investment Company (ASX:AFI) issued a convertible note in February 2012 for five years, maturing 28 February 2017. It paid a 6.25% coupon, with the right to convert the bond into shares in AFI at a price of $5.09. This was about a 25% premium to the share price at time of pricing the bond. In other words, for every $100 invested, the bond holder has the right to $100/$5.09 or 19.6 shares. The current price of AFI shares is $6.16, so not only has the investor earned 6.25% on the bond, but there is an attractive conversion to AFI shares pending. Hence the bond currently trades at about $117.5 having been issued at $100.

Convertible bonds have long been under the radar relative to other asset classes. Despite the attractiveness of convertibles they are unlikely to be the first point of call for a typical investor. Yet the relative lack of attention belies the qualities of an attractive asset class that benefits from a range of characteristics that can be of value to investors.

Over the long-term, convertible bonds have demonstrated their ability to deliver equity-like returns with significantly less volatility than equities, as shown in Figure 1. Investors can benefit from upside exposure to the equity underlying a convertible whilst retaining the intrinsic downside protection of a bond. Analysis of convertible bond returns over the long-term shows attractive risk-adjusted returns and absolute returns which have approximately matched those of global equity market indices as well as corporate bonds, with volatility almost at the mid between the two.

Figure 1: Comparison global convertibles v other assets, 1996 to 2014

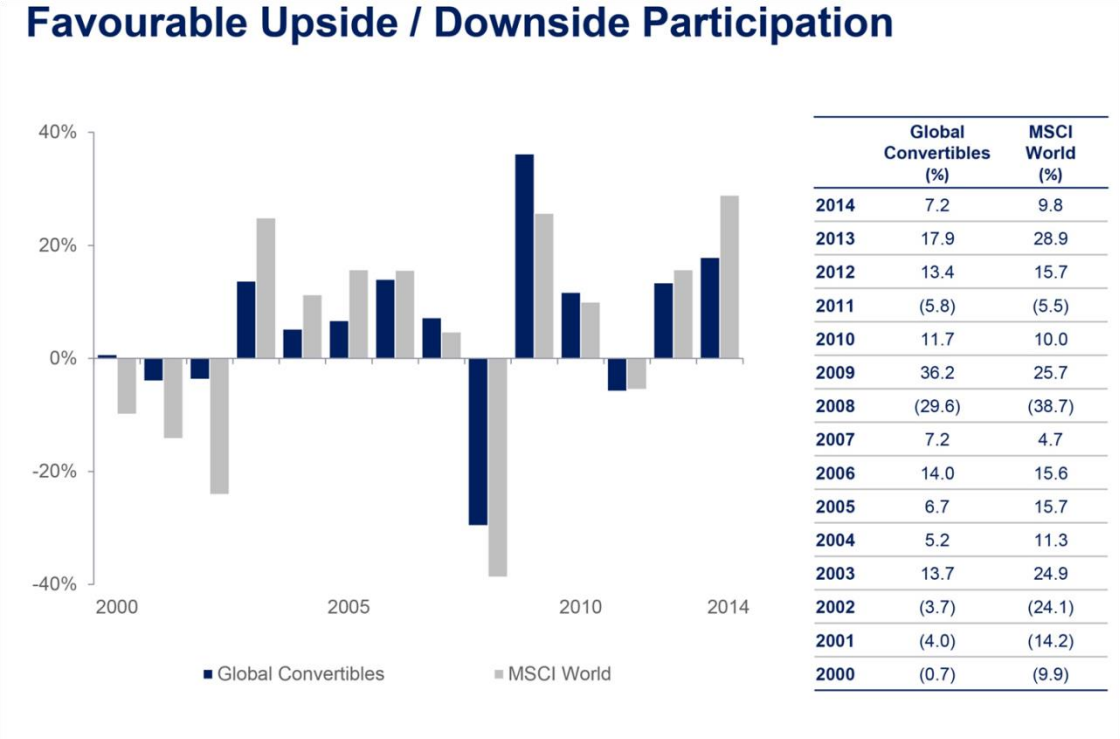
Source: CQS, Bloomberg, Merrill Lynch, MSCI as at 30 June 2014. Rebased to 100. These include historic returns and past performance is not a reliable indicator of future results. The value of investments can go down as well as up. BoAML Global Convertible Master Index (VG00), BoAML Global Broad Market Corporate Index (G0BC), BoAML: Global Government Bonds Index (W0G0) and MSCI World Index. All total return, USD Hedged from December 1996 to 31 March 2014. Please see the disclaimer at the end of this presentation for the full description of the indices above.

Income and equity characteristics

Whilst convertibles do not, by their nature, fit neatly into a fixed income or equity bucket, they can provide both fixed income and equity investors with some attractive characteristics. In discussions with investors in Australia (and globally), we have come across many different ways investors can use convertibles in their portfolios. For instance, insurance companies globally, including Australian insurers, find them attractive due to their favourable capital usage treatment relative to equities.

As Australian investors start paying more attention to the pension phase of their investment programme, they should increasingly see the appeal of the equity upside participation with downside protection offered by convertibles. Convertibles have characteristics that enable an investor to tailor a portfolio to meet their risk/reward requirements. For instance, for investors looking for an equity substitute, the portfolio can be tailored to have more upside participation (higher delta). For investors looking for a little upside for their bond portfolio, securities with more bond-like characteristics offering more downside protection (and less upside participation) can dominate the portfolio. Figure 2 shows how global convertibles can deliver less downside but with upside participation. A portfolio manager in a fund can also actively manage the average credit quality, regional allocations, industry exposures, types of convertibles and currency exposures (most convertible portfolios are fully currency hedged) to tailor the portfolio.

Figure 2. Global convertibles v MSCI annual returns, 2000 to 2014



	Global Convertibles (%)	MSCI World (%)
2014	7.2	9.8
2013	17.9	28.9
2012	13.4	15.7
2011	(5.8)	(5.5)
2010	11.7	10.0
2009	36.2	25.7
2008	(29.6)	(38.7)
2007	7.2	4.7
2006	14.0	15.6
2005	6.7	15.7
2004	5.2	11.3
2003	13.7	24.9
2002	(3.7)	(24.1)
2001	(4.0)	(14.2)
2000	(0.7)	(9.9)

Source: CQS, Bloomberg, Merrill Lynch, and MSCI as at 31 December 2014. These include historic returns and past performance is not a reliable indicator of future results. The value of investments can go down as well as up. Please see the disclaimer at the end of this presentation for the full description of the indices above.

The prospect of interest rate increases in the US is focusing attention on the tactical attractions of convertibles. In addition to their low correlation with government bonds, convertibles have shorter duration than traditional corporate credit and may therefore be more resilient during periods of rising interest rates.

The growth of the convertible universe is offering an increasing number of opportunities to investors. The global capitalisation of the convertible market is around $400 billion and is comprised of issuers across a diverse range of geographies, sectors and credit quality. The rate of convertible issuance has risen as companies increasingly identify the convertible bond market as an attractive source of capital for investment initiatives and for M&A activity. The technology and healthcare sectors in particular have been at the forefront of this trend.

Historical data shows that convertibles have demonstrated low correlation to government bonds and only moderate correlation to broader corporate credit markets, making convertibles an attractive diversification tool which can play a valuable role in portfolio optimisation.

Prospects for convertibles

The first quarter of 2015 witnessed solid year-on-year growth in global convertible issuance. We believe this trend will continue, as companies seek to secure a higher proportion of their funding from bond issuance and to reduce reliance on bank borrowing. Higher equity market valuations and the consensus expectation of rising US interest rates are also likely to have positive effects on new issuance, again providing an increased opportunity set for convertible investors.

Finally, investors can benefit from decreasing competition in the convertibles space. In recent years, bank proprietary trading desks have, by and large, closed and capital flows into convertible arbitrage hedge funds have been muted, creating valuation dispersion that may be exploited to achieve attractive returns. This is particularly topical as M&A activity has picked up in recent months. Many convertible bonds have attractive structural features that allow significant upside participation in the event of takeover.

Although not indicative of future performance, historical performance suggests that a strategic allocation to convertibles can reasonably be expected to increase a portfolio's expected return for a given level of risk, given their low correlation to other fixed income assets, making the convertible market an attractive

tool for investors. In addition, the present macro environment, with the potential for increased interest rates, possibly higher equity market volatility and increased M&A activity, should prove supportive for returns from the convertible bond market, proving it an asset class worthy of more attention from investors.

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Editor's note: Convertible notes issued on the ASX are listed in the Interest Rates Securities section at the back of The Australian Financial Review and the ASX has more information here. Many bond funds also make an allocation to convertibles bonds. Neither Cuffelinks nor CQS is recommending any of these investments and readers should take financial advice before making investment decisions.

Last minute tax deductions in a public ancillary fund

Chris Cuffe

Although it's only days until the end of the financial year, there is still time to establish a tax deduction by establishing a sub-fund within a public ancillary fund, such as the Australian Philanthropic Services Foundation. Unlike a private ancillary fund (PAF), there is no requirement to establish a new trust or trustee company, so a sub-fund within a public ancillary fund can be established immediately, and there's no set-up cost to do this.

(Declaration of interest: I am the pro bono Chairman and Founder of Australian Philanthropic Services (APS), a not-for-profit organisation which sets up and administers private ancillary funds and public ancillary funds as well as providing grantmaking advice. See this link for more details).

What is a public ancillary fund?

A public ancillary fund is a philanthropic structure that allows a planned approach to charitable giving. Amounts donated by you to your own sub-fund within a public ancillary fund are immediately tax deductible, while donations to eligible charities from your sub-fund can occur over many years.

The ATO has a fact sheet for public ancillary funds here.

The benefits of public ancillary funds include:

- Simple – the fund has the administration, investment and governance activities as the trustee, leaving donors solely to think about the charities they would like to support.
- Taxation benefits – the money donated into a sub-fund is tax deductible in the year of the donation and the fund is a tax exempt structure, so the philanthropic dollar goes further.
- Portability – in certain circumstances, it's possible to transfer assets from a public ancillary fund into a private ancillary fund, or PAF.
- Naming – the sub-fund can have a specific name, such as a family name, and grants to charities from the sub-fund will refer to this name. Anonymous grants are also possible.

Public and private ancillary funds are growing rapidly and becoming the preferred philanthropic structure for wealthier Australians.

There are a few things to consider when comparing public ancillary funds:

Compare	What to look out for
Fees	Look for a low all-inclusive fee.
Performance	Pick a fund that has performed well over a rolling 3 year period
Access	Ensure you can access information about your sub-fund at any time, including investment return, grant making and donation activity.
Trustee	Ensure the Trustee has breadth and depth of experience across both the investment and philanthropic sector
Transparency	Funds must report their financial activity to the Australian Charities and Not For Profit Commission (ACNC) who publish it to a public register. Is the Fund complying with its reporting obligations?
Portability	Check that the fund allows for portability in the event you want to move your subfund

Grantmaking and choosing a charity

Last year, APS surveyed clients about the challenges and satisfaction they experience in giving away money. The responses and needs identified were varied, reflecting the diverse and personal nature of private philanthropy. The biggest challenge identified across the board however, was deciding which charities to fund.

Charities supported from a public ancillary fund must have DGR Item 1 status, of which there are around 25,000 in Australia.

In choosing a charity, many clients want to know that their donation makes a real difference.

It is important to note that there is no right or wrong way when it comes to giving. While some will approach it more scientifically, for others it's the act of giving itself that is important. For most, grantmaking is a journey that evolves and changes over time.

Here are a few key things to consider:

- Work out what you want to achieve. The more specific you are, the easier it is to work out whether you've made any progress. Who do you want to help? Where? What kind of approach resonates most with you?
- Less is more. You can't solve all the problems of the world. Choose whichever issue you feel most connected to, and leave the rest to others.
- Make sure that the organisation you want to support has clear goals defined, and is measuring their progress towards achieving these goals.
- Ask yourself is it more important to you to reach a certain, sizable number of beneficiaries, or hear individual stories and know that you've made a tangible difference in the lives of a few?
- Decide whether you are okay with a change of plan and lessons learned from the process, or would you consider the project a failure if it didn't achieve the outcomes as planned?
- Keep in mind that building the capacity of a charity may be another valuable way to support a charity: measuring impact (evaluation), fundraising, and effective management (administration) also cost money.

APS offers services to assist clients with grantmaking, but obviously for this financial year, anyone interested will need to move quickly. For next financial year, the best results come from getting started early to identify your philanthropic goals and learn about your areas of interest and the charities you might want to support.

Chris Cuffe is co-founder of Cuffelinks and Chairman and Founder of Australian Philanthropic Services. This article is for general education purposes and does not address the specific circumstances of any individual investor.

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