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This Week's Top Articles

Passive investment - an unwitting oxymoron

Rob Prugue

I've always loved the term 'oxymoron', and I equally love using it whenever I can. Some of my favourite examples include: unbiased opinion, deafening silence and bittersweet (to name a few). One oxymoron I have been hearing more recently and which bothers me, however, is 'passive investment'.

Given that the term 'investment' refers to the *allocation* of one asset for another, often with the sole purpose to generate a return, to describe an investment as passive is somewhat of an oxymoron. To use cash to buy equities *is* an active investment decision. To move money out of active into passive strategies is not only an 'active' allocation, but each day it is left untouched is yet *another* active allocation. One can only attach a modifier of 'low-fee investment' to this active decision.

Market cap index does not represent broad equity market

Aside from my own philosophical bent towards active investing, there is another more compelling reason why I flag this classic oxymoron. It can cloud traditional benchmarking, a central pillar of the investment management industry. It is important to benchmark and monitor the decisions taken by others. In the world of active asset management, more often than not, this is through comparisons with market cap indices. But in reality, market cap indices are not a perfect representation of the broader equity market.

All portfolios, even benchmarks, are a product of their portfolio construction equation. Market cap is a simplistic portfolio construction formula, which is derived from the summation of each company's shares outstanding multiplied by its share price. This portfolio construction method dictates that price momentum can play a significant role in how this index portfolio performs.

Let's take a simplistic example using the S&P/ASX 100. If one single stock outperforms the rest of the 99 stocks within this portfolio of 100 holdings by a ratio of two to one, its allocation/weight within the benchmark will rise, while the remaining 99 names will show a modest reduction in portfolio weight. Conversely, were this stock to underperform by half that of the remaining 99 names, its allocation within the 100 name index portfolio would fall. Price momentum, or to be specific, its relative price performance, clearly influences its final allocation and weighting. If the portfolio construction decision is based on price and shares outstanding, it is not too surprising that price momentum plays a significant role in the performance patterns of an index portfolio.

Inappropriate benchmark for a value investor

This can be problematic for index benchmarking as few active equity managers use price momentum as an active philosophy when valuing their investment. While it is true that many use price momentum as a timing indicator, active managers use other metrics in identifying their strategic investment decisions. When assessing active equity managers, is a price momentum portfolio the right benchmark?

I suspect that this is partly why a number of academics have been endorsing 'smart beta'. Academic Barr Rosenburg long ago stipulated that there were three main factors determining systematic-market returns: size, value and price momentum. Smart beta can now look through a framework of size, value, price momentum and any number of other factors that drive systematic returns.

That much is known, but what is not as widely discussed is the role that momentum plays in market cap indices. A market cap index portfolio could just as easily be deemed a smart beta option towards the price momentum factor. If so, to assess an active manager's portfolio through a price momentum benchmark could yield misleading conclusions, given that active portfolio managers use other metrics.

This is concerning as decisions about the value-add from active managers are being made on the basis of market cap benchmarks, which at some points in the cycle are heavily skewed towards a single factor (price momentum). In periods when price momentum is driving market returns, intuitively active managers will find it difficult to outperform an index. However, the reverse is also true, when momentum is not a factor driving market returns that is when the active manager should be adding real value.

Move to index introduces price momentum influences

In response to continued market uncertainty, coming at a time when many Baby Boomers are moving towards their drawdown phase, many investors are looking to de-risk their portfolios by seeking 'passive' alternatives. But there is no such thing as a passive investment. And while accessing a market cap weighted portfolio does neutralise the risk of relative underperformance from a benchmark, investors do so by embracing price momentum. In highly uncertain markets, price momentum-influenced portfolios add to overall market volatility given market caps 'buy and hold' portfolio construction.

Every investment is an active one. Investors must understand the consequences of moving towards market cap weighted, or price momentum beta portfolios. While it is true that fee budgets are lowered, everything comes at a cost in our quest to maximise risk-adjusted net returns. And an investor's goal should not be minimising cost, but maximising returns.

Rob Prugue is Senior Managing Director and Chief Executive Officer at Lazard Asset Management (Asia Pacific). This article is general in nature and readers should seek their own professional advice before making any financial decisions.

The difficulties picking fund manager winners

Sheunesu G. Juru and Jeffrey Johnson

Since its origination in the United States in the early 1970s, indexing as an investment strategy has grown tremendously, to the point that according to Morningstar, assets in US-domiciled index mutual funds and exchange-traded funds (ETFs) accounted for 38% of equity and 19% of fixed income funds as of year-end 2014. In Australia, 6.6% of total assets under management are now index funds and ETFs as at the same date. Broader industry surveys point to indexing representing 18% of assets (Rainmaker data, 31 December 2014).

An indexed investment strategy seeks to track the returns of a particular market or market segment after costs by assembling a portfolio that invests in the same group of securities, or a sampling of the securities, that compose the market. Indexing (or passive) strategies use quantitative risk-control techniques that seek to replicate the benchmark's return with minimal expected deviations (and, by extension, with no expected positive excess return versus the benchmark). In contrast, actively managed funds, either fundamentally or quantitatively managed, seek to provide a return that exceeds a benchmark. In fact, any strategy that operates with an objective of differentiation from a given market capitalisation-weighted benchmark can be considered active management and should therefore be evaluated based on the success of the differentiation.

Can investors consistently pick winning funds?

Two critical questions for investors in actively managed funds are: "Do I have the ability to pick a winning fund in advance?" and "Will the winning fund continue to win for the entire life of my portfolio?" In other words, can an investor expect to select a winner from the past that will then persistently outperform in the future? Academics have long studied whether past performance can accurately predict future performance. More than 40 years ago, Sharpe (1966) and Jensen (1968) found limited to no persistence. Three decades later, Carhart (1997) reported no evidence of persistence in fund outperformance after adjusting for both the well-known Fama-French three-factor model (that is, the influence of fund size, fund style and momentum). Carhart's study reinforced the importance of fund costs and highlighted how not accounting for survivorship bias can skew results of active/passive studies in favour of active managers. More recently, Fama and French (2010) reported results of a separate 22-year study suggesting that it is extremely difficult for an actively managed investment fund to regularly outperform its benchmark.

To analyse consistency among actively managed funds, we ranked all eligible Australian funds in terms of excess return versus their stated benchmarks over the five years ended 2009. We then divided the funds into quintiles, separating out the top 20% of funds, the next-best-performing 20% of funds, and so on. We then tracked their excess returns over the following five years (through December 2014) to check their performance consistency. If the funds in the top quintile displayed consistently superior excess returns, we would expect a significant majority to remain in the top 20%. A random outcome would result in about 20% of funds dispersed evenly across the five subsequent buckets (that is, if we ignore the possibility of a fund closing down).

Figure 1 shows the results for Australian funds do not appear to be significantly different from random. Although about 30% of the top funds (42 of 138) remained in the top 20% of all funds over the subsequent five-year period, an investor selecting a fund from the top 20% of all funds in 2009 stood a 27% chance of falling into the bottom 20% of all funds or seeing his or her fund disappear along the way. Stated another way, of the 663 funds available to invest in 2009, only 42 (6%) achieved top-quintile excess returns over both the five years ended 2008 and the five years ended 2014.

The subsequent performance of funds that were in the bottom quintile in 2009 was revealing. Fully 25% of the 111 funds were liquidated or closed by 2014, and 23% remained in the bottom quintile, while only 32% managed to 'right the ship' and rebound to either of the top-two quintiles. Indeed, persistence has tended to be stronger for previous losers than previous winners.

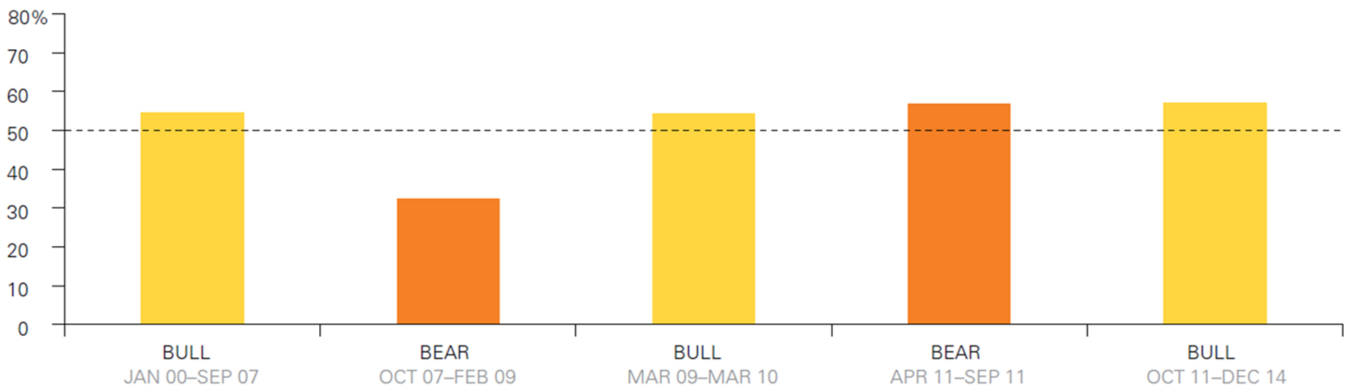
This high turnover with respect to outperformance and market leadership is one reason the temptation to change managers because of poor performance can simply lead to more disappointment. For example, Goyal and Wahal (2008) found that when US institutional pension plans replaced

Figure 1. Analysing persistence of ranking in actively managed Australian funds

			Quintile Rank in Subsequent Non-Overlapping Five Year Period (% of funds) Ending Dec 2014						
Quintile	# of Funds	Excess Return Rank	Highest Quintile	High	Medium	Low	Lowest Quintile	Closed/ Merged	Total
1	138	Highest Quintile (1)	30.4%	14.5%	15.2%	13.0%	15.9%	10.9%	100.0%
2	133	High (2)	7.5%	18.8%	27.8%	20.3%	6.0%	19.5%	100.0%
3	139	Medium (3)	5.0%	21.6%	30.2%	23.7%	5.8%	13.7%	100.0%
4	142	Low (4)	7.7%	13.4%	16.2%	24.6%	19.7%	18.3%	100.0%
5	111	Lowest Quintile (5)	22.5%	9.0%	9.0%	11.7%	22.5%	25.2%	100.0%

Notes: The first two columns rank all active Australian funds based on their excess returns relative to their stated benchmarks during the period cited.
Sources: Vanguard and Morningstar, Inc.

Figure 2. Percentage of managers underperforming market during bull and bear cycles



Past performance is not an indicator of future performance.

Notes: ASX All Ordinaries (XAO-ASX) Sources: Vanguard calculations, using data from Factset.

underperforming managers with outperforming managers, the fired managers outperformed the managers hired to replace them by 0.49% in the first year, 0.88% over the first two years, and 1.03% over the first three years.

Impact of market cycles on results of actively managed funds

One perspective with respect to market cycles is the performance of actively managed funds during bear markets (index down by a cumulative 20%. A bull markets is the converse). A common perception is that actively managed funds will outperform their benchmark in a bear market because, in theory, active managers can move into cash or rotate into defensive securities to avoid the worst of a given bear market.

In reality, the probability that these managers will move fund assets to defensive stocks or cash at just the right time is very low. Most events that result in major changes in market direction are unanticipated. To succeed, an active manager would have to not only time the market but also do so at a cost that was less than the benefit provided. Figure 2 illustrates how hard it has been for active fund managers to outperform the broad ASX accumulation index. In one of two bear markets and three out of three bull markets, the average mutual fund underperformed its stated benchmark. To win over time a manager must not only accurately time the start and end of the bear market but select winning stocks during each period.

The challenge facing investors is to correctly identify those managers who they believe may outperform in advance and stick with them through good times and bad. Finally, when deciding between an indexed or actively managed strategy, investors should not overlook the advantages in portfolio construction that well-managed indexed strategies bring to bear.

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The world changes, then stays the same

Morten Springborg

Over the past 25 years, economies and markets have changed markedly, and the professional investment community has seen profound change, with competition increasing tremendously. Through this period, we have gained a number of insights that we believe will be important for us to know in the years ahead, as we continue our work trawling the world's equity markets for outstanding equity investments.

These insights are:

Daring to be different – with conviction

All investors have to decide what type of investor they are. Passive investors and benchmark huggers have implicitly accepted index returns at best while having little risk of losing significantly, at least in a relative sense. Active investors disregard the false sense of security of a benchmark and aspire to returns that are better than average or even great. Going for greatness has its price, however: it is typically quite uncomfortable, because by definition disregarding the benchmark means taking radically different decisions than the market, and it is always uncomfortable not being part of the crowd. Deviating from the crowd is a prerequisite for great results but no guarantee, as you could also be wrong. Are you willing to be different and are you willing to be wrong? If so, it means that you as an investor have a choice: you can go for safety and seek index returns, or you can aspire to great results but with significantly higher risk.

All of our high-conviction positions throughout the life of our business as an asset manager have at times felt uncomfortable and looked wrong from a conventional point of view. Our major exposures in oil stocks in 2002-05 comes to mind. Like our zero weighting in oil and other energy companies since 2012. Today it seems obvious to be out of oil stocks at that time, but this was not conventional wisdom back then.

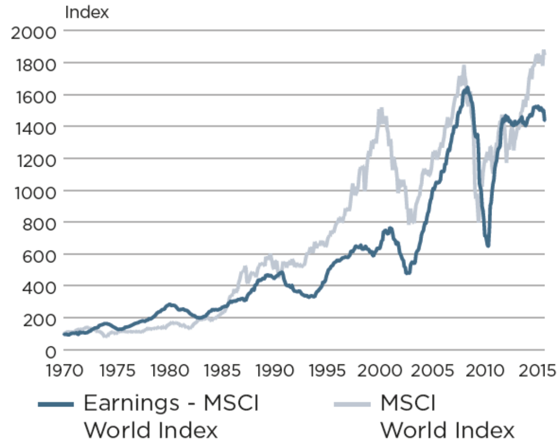
Being an active and concentrated stock picker also requires the organisation to think long-term and your clients also to be focused on the longer-term returns. Even though you as an investor will eventually prove right in your thinking, the timing may go against you. Performance is not linear: actually, our experience is that it is very lumpy. As Keynes observed, "The market can remain irrational longer than you can remain solvent."

Earnings growth is the long-term driver of share prices

We firmly believe that the long-term trend in earnings determines the returns that investors receive from investing in equities. This belief is supported by historical facts, as can be seen in Figure 1.

Figure 1

Earnings and returns



Source: MSCI

Since 1970, earnings have risen by 1,337% (USD), supporting equity returns of 1,747% (USD). Throughout this period, there have been time spans when equity markets have deviated from trend earnings growth creating shorter-term opportunities or risks. However, timing these events is difficult. Furthermore, we believe that the compounding of returns is a much less risky way of generating superior long-term returns than trading in and out of stocks and segments of the market in a desire to outperform the market.

To quote ice hockey champion, Wayne Gretzky, you "skate to where the puck is going to be, not where it has been", and you never invest in the present. It does not matter what a company has earned. You have to predict with a fair degree of certainty what the company will be earning in the future.

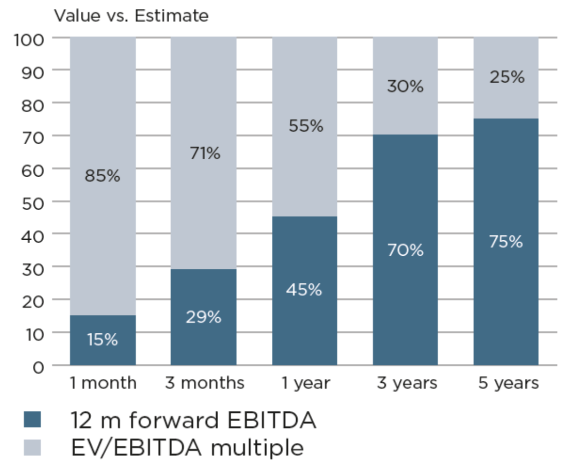
One example could be Nestlé, a company we have invested in since our inception back in 1990. Over these past 25 years, Nestlé has delivered growth in earnings per share of approximately 10% per annum, and at times the share price has looked somewhat expensive. Our view has been that structural themes such as 'premiumisation' and growth in emerging markets continue to support the company and that the growth outlook has not changed, supporting the view that the company would 'grow into its multiple'. Over this period, Nestlé has delivered a total return of 2,200% (USD), or 13.5% per annum, versus the global equity market return over the same period of 420% (USD), or roughly 6.8% per annum. Nestlé today trades at 20 times 2016 earnings, which is expensive, versus its own history (because of low interest rates) but in two years' time the company will be trading at about 16-17 times 2018 earnings with an unchanged share price. As we do not see any change to Nestlé's growth outlook for the coming years, we think it is unrealistic to expect a de-rating of the valuation multiple for the company and thus believe that the stock will continue to deliver its low double-digit return.

Business model is more important than stock valuation

Considering valuation is useful, especially if you have a shorter time horizon. However, for longer-term investment horizons, it is less useful. This is because over longer-term periods the earnings power of a superior business comes to the fore and directly drives the bulk of the performance. Timing and therefore valuation becomes less important, and the quality of the business becomes increasingly important for the long-term return, as can be seen in Figure 2.

Figure 2

In the long term, returns are driven by earnings growth



Source: Goldman Sachs, Datastream

For this reason, our main focus is to identify high-quality growth companies that will continue to deliver high returns on invested capital, thereby reducing the likelihood of multiple contraction. As Warren Buffett famously said, "Price is what you pay. Value is what you get." We do not want to pay exorbitant multiples for a stock, but we would rather pay a bit too much for the really excellent business than too little for the poor business.

Mistakes made and lessons learnt: think about political risk

Being an active investment manager means taking active and at times controversial bets, which of course is not risk-free, as mistakes will be made. The importance in being wrong is, obviously, not to be wrong too often and, when you are wrong, trying to understand what made the investment a losing proposition.

Around the turn of the century, we were invested in two Nordic stocks, Tomra and Vestas, both of which were horrible investments and had a common problem. Tomra was the largest producer of reverse vending machines used for the recycling of beverage containers. Our conviction was that the company was exposed to strong secular growth as the recycling standards spread from the Nordic region, where the system had been very successful, to other parts of Europe and eventually to the Americas.

In Vestas, the investment case was built on an idea of strong secular growth as wind turbines spread across the globe supported by countries' desire to increase self-sufficiency in power generation and reduce carbon emissions.

We sold both stocks after realising large losses on the investments. However, not everything was lost: we learned a very important lesson, namely that you should be very careful with companies that depend on political decisions to realise their growth potential. Tomra began to go wrong when the required legislation in Germany was not implemented and the large supermarket chains did not feel obliged to invest in new collection systems. Vestas' growth spurt ended when expected orders from the US evaporated because the US subsidy schemes were not implemented as anticipated.

Too much time is spent on temporary information at the expense of lasting knowledge

We live in times of great uncertainty. We question how much performance one could generate from trading the news on Greece. Too much time is spent on this kind of temporary news rather than focusing on creating lasting knowledge you can use to position your investments for long-term performance. Too much time is spent on thinking about whether it's 'risk on' or 'risk off' instead of focusing on factors about which you as an investor stand a decent chance of being correct – over the long term. A case in point could be our decade-long focus on the developing middle-income consumer base in India. When we initially invested in the Indian mortgage bank HDFC in 2005, India had an estimated middle-income population of about 50 million. Today that has increased to more than 250 million and is expected to be around 500-600 million by 2025, larger than the entire population of the European Union. When did you read in the newspaper that the middle-income population of India had just doubled?

Since our initial purchase of HDFC in 2005, the stock has risen 460% (USD) versus a rise of the global equity market of only 90% (USD). We think it is much more important to recognise this unstoppable force than to spend your time evaluating the numerous possible outcomes of the Greek tragedy and the impact it could have on asset markets – something that is highly uncertain to forecast.

Even in times of low economic growth, find pockets of high growth in thematic investments

Investors usually expend significant resources trying to predict the general macroeconomic trend, since nominal economic growth over the long term determines the earnings growth of companies. However, history has also proved that there is no direct relationship between short-term economic cycles and stock market returns.

Even during periods of low economic growth, you can always find pockets of high growth in the world economy. Over the past three years, we have seen unusually low economic growth in the Western world of approximately 2% on average and, despite this, we have identified pockets of growth. One example could be Novo Nordisk and the obesity epidemic.

Other current focus areas for us are the expansion in middle-income groups in India and other emerging economies and robotics, where we continue to see strong growth from the large-scale industrial application of robots as well as from the new emerging theme of collaborative robots. Sensors are at the core of optimisation of industrial processes as well as for improved car safety and eventually fully autonomous cars and the build-out of the Internet of Things, where machines, appliances and humans are connected in one giant network. If you can afford to step away from conventional wisdom and the benchmark, you can always find pockets of secular growth.

Conclusion

Since 1990, when we initiated our global equity strategy, the world has changed in unpredictable ways. Themes have come and gone, companies have flourished and faltered, and countries have emerged and developed whilst others have lagged. The asset management industry has changed significantly, and the abundance of information and data has shortened investment horizons.

There are important insights from the 25 years of actively managing global equities, involving consistently identifying themes and trends that drive earnings growth and hence share prices. The lasting knowledge will guide us in the years ahead.

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How are the returns on your equity?

Roger Montgomery

Through the volatility of recent weeks, the adverse impact on the market value of our portfolios has been minimised by a focus on high quality businesses, a margin of safety in the difference between price and valuation, and the ability to hold large amounts of cash when opportunities are unavailable. An extraordinary business must have bright prospects for sales and profits, a high rate of return on equity - driven by sustainable competitive advantages, solid cash flow, little or no debt - and be run by first-class managers who think like owners and treat their shareholders as such.

A good business to own is one that produces growing profits. That seems obvious. Indeed it’s what the vast majority of analysts and equity investors are looking for.

What is the ideal business to own?

Perhaps less obvious is that the best business also requires the least amount of capital invested in it to generate those profits. There is a yawning chasm in the worth of a business that grows and requires lots of additional capital, and the business that grows and doesn't need any additional capital.

A perfect business might be one that requires no staff and thus has no labour costs; no machinery and so does not require any equipment to be maintained or replaced; and no inventory, so there's no need for trucks, warehouses or stock management systems and no chance that you will be left holding products that are obsolete or out of fashion. When these things are required by a business, there is less cash to distribute to investors or less cash available to be invested elsewhere. First prize is a business that generates high returns with all of those profits available to be distributed or reinvested as the owner sees fit.

Importance of 'return on equity'

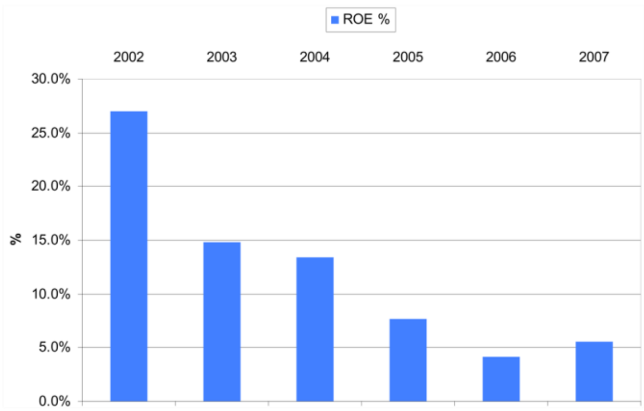
Perhaps the single most important factor in the identification of a wonderful business is a number, a simple ratio, the return on equity. That is, the level of net income as a percentage of shareholders' equity. The actress Mae West once said, "Too much of a good thing is wonderful", and return on equity is like that. It is a measure of the earning power of a business and while accounting focuses on providing an estimate of the business's performance and position, the economics reveals the true picture.

The wealthiest man alive today, Warren Buffett, is an enormous fan of return on equity as demonstrated by the statements: "Except for special cases (for example, companies with unusual debt-equity ratios or those with important assets carried at unrealistic balance sheet values), we believe [a more appropriate measure] of managerial economic performance to be return on equity capital." And: "The best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return."

The return on equity ratio tells us many things. First, it is a measure of the quality of a company's business. Many people wrongly believe that strong growth in profits over the years is an indication of a superior business. It isn't. Companies like ABC Learning displayed strong growth in earnings yet still collapsed. ABC Learning had low and falling returns on equity. Economic returns, as measured by return on equity, are a better indication of business quality than earnings growth. Return on equity helps tell us which companies display 'good' growth. It sorts the wheat from the chaff. A company with strong earnings growth prospects and high rates of return on equity is the sort of business in which you should buy shares.

Using ABC Learning as an example, the company's reported profits revealed spectacular growth, and it was not unusual for sell-side analysts to slap 'strong buy' recommendations on the shares. But ABC Learning's earnings were growing because more and more money was being tipped into the company by shareholders. You can get more earnings each year if you tip money into a regular bank account. There is nothing special about that. Because the company was asking shareholders for money to help it 'grow', the profits coming out of the business, when compared to the money going into it, showed the returns from the business were declining, as Chart 1 displays.

Chart 1. ABC Learning's Declining Returns on Equity



By 2006, the returns on the nearly $2 billion that shareholders had stumped up were about 5%. This was even less than the returns available from a bank term deposit at the time, which harbours a lot less risk than a listed business.

Would you put $2 billion of your money into a business if I told you that the best you could expect was 5%? Of course you wouldn't. And if you aren't prepared to own the whole business, you shouldn't be prepared to own even a few shares. The stock market can sometimes be a slow learner, and while share prices tend to follow returns on equity rather than the earnings, it can take a long time. So in 2006 there was plenty of warning.

Second, high rates of return on equity can also suggest sound management, although a great managerial record is often the result of the boat the managers get into – the existing quality of the business. Indeed, high returns on equity are more likely to be the result of a great business than great management. Some excellent businesses may have a combination of both - a wonderful vessel and a great skipper.

Third, high returns on equity may be an indication that the business is operating as a monopoly or in an industry with high barriers to entry. Something unique that prevents others from competing directly or successfully with the business is known as a sustainable competitive advantage.

Fourth, the return on equity can also tell us whether the company should reinvest its profits or pay the earnings out as a dividend. Because this decision is made by management and the company's board of directors, return on equity can help show us which teams understand how to allocate capital properly, and therefore those that treat their shareholders like owners.

Fifth, return on equity can tell us something about whether the auditors and the board of directors are realistic when it comes to what they think their assets are worth. If the return on equity is consistently very low, it may suggest that the assets on the balance sheet are being valued artificially high. Investors lose millions when companies announce write-downs, and write-downs usually follow a period of low returns on equity - for example, after the company paid too much for an acquisition and the promised 'synergies' failed to materialise. If a company makes a big acquisition and projected returns on equity are low, it's usually wise to sell your shares.

Finally, return on equity is an essential ingredient in establishing the true worth of a company and its shares. Ultimately, investing is about buying something for less than it is worth. Do this consistently, over a long period of time, and you will beat the market and the majority of other investors. And at the heart of working out what a company is truly worth is the return on equity ratio.

Return on equity can tell us much, and it is a very powerful ratio essential for success in the stock market.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any investor.

State of play in listed real estate

Adrian Harrington

Australian Real Estate Investment Trusts listed on the ASX (A-REITs) entered the August 2015 reporting season with a black cloud hanging over the global financial markets. Over the course of that month, both the global and the A-REIT sector experienced a roller coaster ride and by the end, the heavens had opened and markets across the globe capitulated.

So how has listed real estate performed recently and over time?

Table 1: Total Returns - Listed Real Estate (local currency): 31 August 2015

Regional Real Estate	Week %	Month %	6 Month %	YTD %	1 Year %	3 Years %	5 Years %
Continental Europe	4.7	-1.9	-7.1	12.3	16.9	16.2	12.9
United Kingdom	2.4	-2.8	1.4	12.4	19.9	21.7	18.1
Australia	3.4	-4.1	-4.9	8.1	14.2	16.4	13.2
United States	-0.6	-6.1	-9.8	-6.8	0.1	7.8	12.3
Japan	0.5	-6.5	-6.9	-5.0	2.1	26.0	17.6
Singapore	4.0	-7.0	-15.3	-9.5	-9.1	1.8	2.0
Hong Kong	1.8	-12.6	-14.5	-11.2	-12.2	2.7	2.5
World (USD)	0.0	-5.9	-9.5	-5.3	-4.0	7.2	9.9

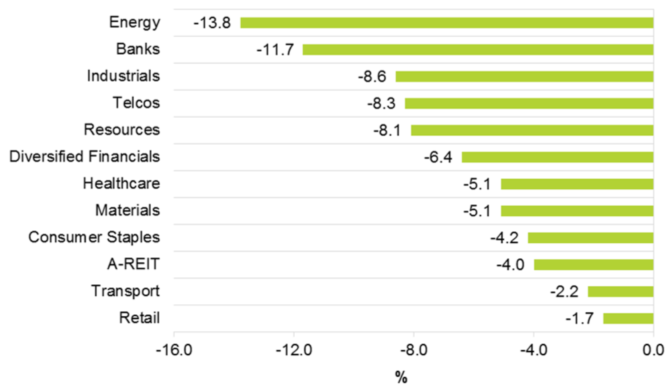
Source: DataStream, FTSE EPRA/NAREIT. Data as at close prices 31 August 2015

A-REIT performance

The A-REIT sector held up quite well and offered a relative safe haven amongst the market turmoil. Taking the global comparison first, in local currency terms, Australian A-REITs out-performed the global REIT index by 180bps (-4.1% vs -5.9%) (Table 1). On both a year to date and one year basis, A-REITs have also done well compared to their global counterparts.

Turning to the domestic comparison relative to equities, A-REIT's outperformed equities by 3.6% in August (-4.1% vs -7.7%), and over one year have outperformed equities by a massive 17.4% (14.2% vs -3.2%). Figure 1 shows there were few places to hide in the equity market sectors.

Figure 1: Total Returns – S&P/ASX300 Sectors: 31 August 2015



Source: Bloomberg

Despite posting two of the best results, the larger A-REITs in Stockland (-8.0%) and Mirvac (-7.4%) underperformed as investors focused on the growing headwinds in the residential sector. APRA investor lending controls, deteriorating affordability levels and Mirvac CEO's frank assessment of where we are in residential cycle:

> *"Previous cycles would suggest that activity, i.e., volume of sales, should moderate over the next year or two by 15%. Importantly, we don't believe this will lead to price falls, but rather we expect price growth to moderate away from the high double-digit growth rate that it's been experiencing in recent years."*

A positive for the sector was the move by many of the A-REITs to follow the Property Council's Guidelines for Reporting and adopt Funds from Operations (FFO) to more closely align the underlying cashflow generated by the business with reported earnings. It has long been a frustration that there were so many inconsistencies across A-REITs particularly in relation to their treatment of tenant incentives (which for the office A-REITs remain elevated), trading profits and lost rent on developments to name a few.

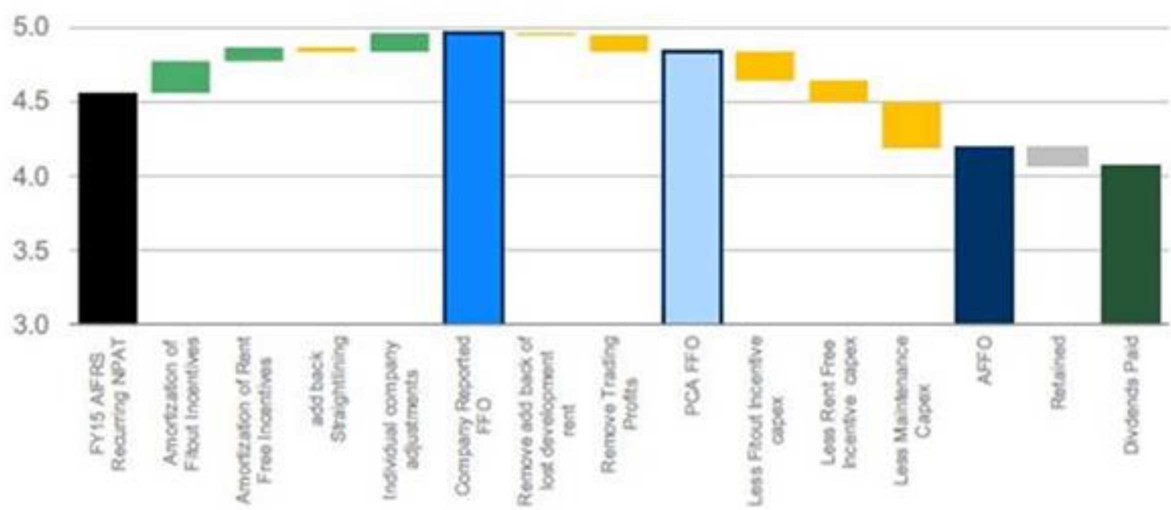
Dividends and revaluation rates

In an environment where investors are focused on sustainable earnings and income, the A-REIT sector's dividend remains sound. As Figure 2 shows the dividend yield is cash covered, even after adjusting for cash received from trading activities which are typically one-offs.

As Morgan Stanley's Research team point out, the A-REIT sector:

> *"… currently retains enough capital to fund ongoing capex requirements - despite an increase in the number of stocks supporting dividends via non-*

Figure 2: Reconciliation Between NPAT and Dividend Paid – FY15 ($Abn)



Source: Morgan Stanley Research, Company Data (Units in $Abn) *recurring profits (eg, trading profits) … FFO/DPS growth is likely to remain smooth and sustainable for the majority of A-REITs as the debt cost lever is likely to offset cyclical weakness in operating conditions or the year-on-year impact from trading profits."*

At the asset level, retail and industrial assets performed well with specialty retail sales growth stronger than it has been in years. Income growth from the office sector was the one negative, with rising tenant incentives offsetting FFO growth. Strong demand for real estate assets has driven cap rate compression, although there still appears to be a lag between A-REIT cap rates and recent market evidence (the Chinese sovereign wealth fund, Chinese Investment Corporation's $2.45bn acquisition of the Investa office portfolio on a 5% yield and Ascendas, a Singaporean REIT's, $1.1bn acquisition of the GIC industrial on a sharp yield of 6%). This should support further increases in the carrying value of A-REIT assets in the year ahead.

Memories of the GFC remain

Capital management remains high on the agenda for both the A-REITs and investors. The GFC may have been seven years ago but fortunately memories still remain. Across the board, capital management is much better now and A-REIT's balance sheets are in a stronger position. With record low interest rates, the A-REITs have not been tempted to increase gearing (with some exceptions such as Cromwell following its acquisition of the Valad Europe funds management platform). In fact, the A-REIT sector's gearing fell almost 2% in the past year to circa 30%. At the same time, a number of the A-REITs took advantage of the yield curve to blend and extend their interest rate costs. Lower debt costs will continue to be a key earnings driver in FY16.

M&A activity could prove a positive catalyst for A-REITs in the year ahead. Rising asset values, historically low interest rates and intense competition for assets means that A-REITs will find it increasingly difficult to grow organically.

After the sell-off in August, the valuation of A-REITs looks more attractive. At the end of August 2015, the sector was trading on a FY15 cumulatively-adjusted EPS/DPS yield of 6.4%/5.3%, a healthy premium to bank bill rates (yielding around 2.2%) and 10-year bonds (2.7%). This is above the average distribution spread over the past ten years, normally less than 2%. The sector was trading on a 3% discount to Net Asset Value and a 27% premium to Net Tangible Assets (in fact, most funds are trading at a premium to NTA). Given the number of stapled securities in the sector who have funds management and development platforms that are not captured in the NTA, the relevance of NTA as a measure is becoming less relevant.

Stock selection as always remains key. Quality management and portfolios, together with conservative balance sheets and sustainable earnings growth, are fundamental, especially with financial market volatility expected to continue.

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