Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

Global index flaw has many flow-on consequences

David Bell

It's not universally known (but nor is it a secret) that MSCI, the major provider of performance indices on global equity markets, understates the performance of its global indices calculated for Australian investors. On the surface you may think this doesn't mean much, but there are actually many flow-on effects worth tens of millions of dollars.

Index calculation trickier than it seems

The job of an index calculation group is much more complex than you think. At first blush, it may seem that all they do is take the index weightings, and account for dividends, corporate actions and stock movements to get the total performance. Well, not really, especially when it comes to global indices. When one invests offshore there are a variety of taxes such as withholding taxes and stamp duties which must be paid on dividends earned in different countries.

Where it gets really complex is that different countries have different tax treaties between them which need to be accounted for. It can also depend on whether they apply to a personal or institutional investor. Should an index provider like MSCI calculate a separate index for the performance of a global equities index based on the experience of different investor types in each country around the world? They don't because there would be many indices to calculate. Rather they calculate the performance using the most conservative set of assumptions. Of all possible combinations, they select the one that has the highest tax / lowest performance. Because Australia has many double tax treaties in place, the performance experience of an Australian investor using a passive approach would be higher (ignoring transaction and management fees).

Understatement is a significant issue

The performance understatement has averaged between 30bp to 40bp per annum. The understatement is larger when dividend yields are high, making it an even larger problem for indices on higher-yielding sectors such as REITS and infrastructure. The simple way to provide some evidence is to look at the reported gross performance of index funds against the index.

Below I have snipped the gross performance numbers for Vanguard's International Shares Index Fund (refer to Vanguard's website for appropriate performance disclaimers etc.). We can see that the fund has consistently outperformed the benchmark, yet it is being run in a passive manner. (The fund is the MSCI World ex-Australia Index in AUD).

Performance return (%)

	Fund gross	Bmk
1 month	6.31	6.28
3 months	0.21	0.11
6 months	7.69	7.50
1 year	26.65	26.27
3 years (p.a.)	27.37	27.01
5 years (p.a.)	16.98	16.62
10 years (p.a.)	6.64	6.29
Inception (p.a.)	6.01	5.63

Is this valuable information or just trivia?

Consider the ways we use such performance data:

<u>Assessing the relative merits of active versus passive investment</u>

Global equities make up a large part of many portfolios. Across institutional super funds, the average allocation is around 20% worth up to $300 billion of capital. The debate about active or passive investing in global equities is fierce and the numbers look tight: there appears to be little outperformance on average. However, once we account for the data issue, the average global equities fund underperforms (because the index is doing better than we think). Assuming an average active management fee of 50bp (above index fees) for institutional investors, then up to $1.5 billion p.a. is the possible fee pool being spent on active global equities. How well informed and how efficient is this decision?

<u>Calculation of performance fees or bonuses based on outperformance</u>

Some funds charge performance fees, commonly relative to the performance of the benchmark. A fund that mirrors the holdings of the index is likely to outperform the index by say 30bp. If we assume a performance fee of 10% above index, then this results in 3bp of performance fees. This isn't a big number in the context of an individual, where many other factors will impact more greatly upon their performance. However, the system wide costs can be large, simply because the assets under management can be so large. A fund with assets of $10 billion will unfairly earn an extra $3 million p.a. in performance fees.

Furthermore, investment staff at super funds are often paid a bonus based on performance relative to benchmark. They too participate in this free ride.

There can be gaming issues if the quirk is known by some but not by all within a fund. For instance, the portfolio manager in charge of selecting global equity funds, if solely aware of the quirk, may just invest passively, outperform the benchmark and receive a handsome bonus which is undeserved, at the expense of the member (directly for an industry super fund and less directly for a retail fund).

<u>Judging different products managed by the same fund manager.</u>

Some global equity managers offer different risk versions of their products. It is common to see the low risk product has a higher information ratio (outperformance divided by tracking error) than the higher risk version. A common explanation is that the lower risk version is more efficiently constructed. However, it is also true that the 30bp to 40bp pick-up is more significant in the context of a low risk product.

Possible solutions to improve the index

The industry could lobby MSCI to calculate an index for Australian investors, but there may be additional cost involved for users. Fund custodians could replicate the index in their systems and estimate the performance of the index on a like-for-like basis with how they calculate fund performance. Super funds could explicitly remind the investment committee and board that there is this understatement issue when it comes to assessing the performance of global shares.

Benchmarks are more difficult to calculate than a first glance may suggest. Our industry is so big that issues like this which appear minor can have impacts which cost tens of millions of dollars. It could lead to a significant amount of management fees being spent, perhaps on an uninformed basis, on actively-managed global equities. It's a complex system, isn't it …?

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Payroll tax distorts competition and penalises jobs

Peter Pitt

Imagine a tax payable by Myer, David Jones and JB Hi Fi that doesn't apply to Harvey Norman. What about charging a tax to Footlocker but not Athlete's Foot? Most extraordinary of all, what about charging this tax to grocery businesses like Harris Farm on the wages of hundreds of staff who unpack and sell fresh produce grown by Australian farmers but don't charge that same tax to a Ferrari dealership with a handful of staff selling expensive imported sports cars. Surely Australia doesn't do that. We're not that stupid are we?

The not-so-level playing field

Actually, we are that stupid – it's called payroll tax and it's charged based on the total wages, above a threshold, of a company. In NSW, the rate is 5.45% of a business's NSW wages above $750,000. Employers like the Ferrari dealer, with few staff, don't pay and others providing many jobs, like the grocery shops, do. The grouping provisions of Australia's payroll tax allow franchised businesses like Harvey Norman and Athlete's Foot (and many others) to avoid the tax even though via their franchise agreement they are heavily 'controlled' by a single entity. In considering whether multiple employers are centrally controlled, the grouping provisions consider only ownership, instead of a wider sense of what entity is actually in control and how. Gerry Harvey has been pushing for a level GST playing field on overseas purchases but he won't want a similar level playing field on payroll tax.

You can own Australia's largest and most valuable hotel and not pay any payroll tax on the small staff needed to manage the investment. But the hotel management company who leases the building and runs the hotel has to pay payroll tax on the hundreds of jobs needed to serve the food, clean the rooms, and make the beds. Why do we make it cheaper to be a billionaire owner of a hotel but dearer for the hotel management company to provide these low skill, entry level jobs?

Thousands of entry level jobs were lost some years ago when Starbucks closed 100 of their 120 stores in Australia. No doubt it was partly because they were paying millions in payroll tax but their four-fold bigger direct competitor, Gloria Jeans, with 400 franchised stores, paid no payroll tax on store wages. Payroll tax costs jobs, many jobs.

Why favour capital over labour?

Australia is having a tax debate and supposedly, 'everything is on the table'. If we are going to reform our tax system, let's start with this distortionary tax that favours capital intensive business whilst penalising labour intensive business. It favours franchising by distorting competition between similar businesses based on their ownership structure. Providing lots of jobs should be celebrated and encouraged, not taxed and discouraged. Payroll tax should be completely abolished and the revenue replaced in another form that encourages employment and does not distort competition.

Eliminating payroll tax removes seven State taxes with the resultant massive removal of compliance and surveillance issues. Entire departments can be eliminated in every state giving significant savings and removal of duplication. If we are not going to eliminate payroll tax at least change it substantially so that it is not linked to the size of payroll. Link it to turnover, add it to GST, add it to company tax, do anything but don't penalise job creation and don't allow it to distort competition.

Peter Pitt is a Director at a leading national retailer. These opinions are his personal views and not necessarily those of his company.

Good risk culture and how to recognise it

Frances Cowell and Matthew Levins

Risk culture in financial institutions has never been more important for their role of supporting steady economic growth. But how do you know good risk culture when you see it? We asked ten of the world's leading experts what they think the most important signals are. It's not always what you might think.

The trouble with risk culture is that you see it only when it fails. And even then it can be hard to be sure that the risk culture itself was in some way lacking, or whether it was just plain unlucky. Spotting good – and bad – risk management and risk culture before a crisis hits is even harder. For *Crisis Wasted? Leading Risk Managers on Risk Culture*, we asked ten global risk managers what they thought the hallmarks of good risk culture are, and what progress has been made since the crisis of 2007-09 to improve it. A revealing, warts-and-all view of how risk management decisions are taken in large financial organisations is the result.

While most agree that a strong risk culture is one that permeates the organisation, the overall verdict is that progress is decidedly mixed. Two questions stand out.

1. Chief Risk Officers are commanding more status within organisations, but has this translated into influence and effectiveness?
2. It is now commonplace to note the increased emphasis on risk culture, but has this given us better risk management, or just more regulation and longer risk reports?

A corner office does not guarantee good risk culture

The skill of the risk manager is a mix of art and science. Technical competence is a must-have, but so are common sense and street-smarts. John Breit finds that:

"For me it was more about who's making money, and why is he is making money, and can he explain to me in an intuitive way how he is making it?"

Yet, much new regulation emphasises risk measurement over risk management. Objective, uniform risk indicators have obvious appeal, but statistics can conceal as much as they reveal. Risk managers generally agree that some quantitative risk reporting is essential, but they also agree that it is only a minor component of the much bigger job of managing risk, and it can even have a negative impact on risk culture. The best risk management practitioners agree that people management, the 'soft' skills: behaviour, governance and accountability, are key to good risk management. Sir Michael Hintze is clear:

"The point that I think has been missed is the fact that it is probity, it is to do with behaviour rather than models. And I think there is a transparency point that has been missed."

But this is exactly the part of the risk management job that is being squeezed out. Worse, reducing risk management to a mechanical operation carries the danger of turning it into a box-ticking exercise – the opposite of any sensible understanding of a good risk culture. When statistics displace common sense, risk managers, despite their status, add less real value and can easily be ignored or even shown the door, for example because they voice disagreement with the firm's strategy.

Regulatory reporting is not risk management

It is both unsurprising and understandable that investors and taxpayers, who pay the price when things go wrong, demand tighter regulation of risk-taking activities. But more regulation by itself is no panacea, and may even make things worse if it is not properly thought through.

Regulators and supervisors, for their part, do the best they can to guard against the worst outcomes. But with limited resources at their disposal, often the most they can do is to mandate more, and more detailed, risk reports.

Ever more extensive stress tests and longer risk reports are thus the most visible of regulatory reforms; and organisations are duly churning out ever more reams of risk data. But much risk reporting is mandated without thought to who will bear the costs of preparing and collating it, how it will actually be used, or indeed, if it is useful at all. Paul Bostok is sceptical:

"I don't know how many pages of forms would give you the information that you get from meeting somebody face to face and asking some pertinent questions."

Regulators, who receive the reports, struggle to keep up and make sense of them, often with resources intended for much more limited responsibilities. Richard Meddings sees this as a weak link in the system:

"The regulatory world is full of very able people, though I do worry there are not enough of them for the scale, size of the agenda they have in front of them."

One reason why regulators and supervisors rely so heavily on risk reporting is because they find it hard to quantify, and even harder to aggregate, things like behaviour, governance and accountability.

Meanwhile, organisations are devoting more resources to preparing risk reports, while the costs of doing so are inevitably passed on to consumers and investors in the form of higher bank charges and poorer returns. Worse, fewer resources are available actually to manage risk. This diversion of resources from risk management to reporting has real consequences for the economy, as Adrian Blundell-Wignall points out:

"… real investment and the productivity growth, that is needed to make bonds and equities worth something in 50 years' time, isn't happening."

Risk culture affects regulators too

Regulators are doing the best with the resources they have, but to pretend that this is good enough to avert, or even dampen, the effects of a future crisis is to hold one's head in the sand.

The evidence points to the need for regulators to deploy soft management skills in tandem with selective, targeted risk statistics and to ask pointy questions. Only by deploying that enlightened mix of art and science can they hope to understand properly the risk profiles of organisations.

The danger is that constructive risk culture gives way to risk reporting, which in turn can easily dissolve into box-ticking. The risk experts we interviewed agree that this does nothing to address the pressing issue of restoring the ability of the financial system to meet its social obligation of facilitating economic growth. Indeed, by engendering a false sense of security, it could be doing quite the opposite.

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'Silent seconds' are the landmines of Australian residential property

Jonathan Rochford

Many investors know about US subprime lending from 2004 to 2007, and the infamous NINJA loans, where the borrowers had no income, no job and no assets. They were a marker of the crazy lending in the US, and it became a major factor in causing the GFC. Although second mortgages were common in Australia prior to deregulation in the 1980's, a far more common but just as deadly development in the boom leading to the GFC was the 'silent second' mortgage. At the late stages of the boom, it was estimated that 35-40% of US home buyers had both first and second mortgages. The presence of a second mortgage was often not disclosed, hence the name 'silent'.

How do buyers raise their deposits?

For borrowers who have a decent income but don't have a good deposit, there are three main options:

1. a gift from their parents to cover the deposit
2. a high loan to value ratio (LVR) loan with lenders mortgage insurance
3. taking on a second mortgage.

In some cases, the gift from the parents isn't really a gift but rather an undocumented loan that everyone hopes can be repaid at some point in the future.

In Australia, residential lenders frown upon second mortgages, and will often refuse to be the primary lender if the borrower is intending to have a documented second mortgage. The paperwork involved and the potential legal hassles if the loan goes bad simply aren't worth the effort. The lack of a formal second mortgage lending market in Australia (which is arguably a good thing) encourages some borrowers to pursue silent second mortgages. Most often this comes from drawing down on undeclared credit cards or personal loans to 'create' a deposit.

Second mortgages can stretch borrowers

However, some Chinese borrowers are being offered the opportunity to obtain a second mortgage and purchase an Australian property without necessarily having a deposit. For example, the second-largest insurance company in China by premium income, PingAn Insurance, offers loans to Chinese investors for Australian residential property at real estate conferences in Shanghai. The Chinese borrowers will use the second mortgage as a deposit for an off the plan apartment, with the expectation that a senior loan will later be obtained from an Australian bank to pay the final 70% when the apartment is completed. This is a potential landmine for all involved.

Second mortgages can be deadly for the primary lender, the property vendor and particularly the second lender. For the primary lender, the second mortgage reduces their risk of loss if the borrower defaults as it increases the buffer between the house price and the primary loan. However, it dramatically increases the risk that the borrower will default. Borrowers are often stretching their income to cover two loans, with the second loan often having an interest rate above 10%. The property vendor has received a solid deposit, but the risk of a failed settlement is higher and that means that the developer may be forced to re-sell the apartment, possibly at a lower price. There could be many apartment buyers in the same building using second mortgages, with the potential for the developer to be hit with a higher than usual number of failed settlements. There's nothing like an overhang of supply to depress prices.

For second mortgage lenders in the US in the subprime era, it was a classic 'picking up pennies in front of the steamroller' investment. The higher yield on the loans looked attractive, but the much higher default rates and the abysmal recovery rates meant losses were substantial. Notwithstanding the experience, originations in the US are picking up again but this time around the subprime portion is currently less than 1%.

We should know more about silent seconds

I'm not aware of any research into the presence of silent seconds in Australia. It is generally known that some borrowers are not declaring their credit card debts, personal loans and peer to peer/marketplace loans, but the prevalence is very difficult to know. The voluntary nature of credit reporting in Australia makes it much harder for lenders to know when borrowers have other debts outstanding. It will probably take a crisis before politicians and regulators understand the importance of compulsory credit reporting of both positive and negative incidents. (Positive reporting shows that payments have been made on time, negative reporting shows payments missed.)

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Anchoring holds back your investing

Marcus Padley

We all have a lot of trouble buying stocks that have gone up and selling stocks that have gone down. If that's you then I regret to inform you that you are being affected by a well-established financial concept called 'anchoring'.

> "**Anchoring** or **focalism** is a cognitive bias that describes the common human tendency to rely too heavily on the first piece of information offered (the "anchor") when making decisions. During decision making, anchoring occurs when individuals use an initial piece of information to make subsequent judgments. Once an anchor is set, other judgments are made by adjusting away from that anchor, and there is a bias toward interpreting other information around the anchor. For example, the initial price offered for a used car sets the standard for the rest of the negotiations, so that prices lower than the initial price seem more reasonable even if they are still higher than what the car is really worth."

Source: Wikipedia

You hear the issue every day in a broking office and in stock discussions. It's when someone says "I can't buy that because the share price is up X%" or "You can't sell that, the price is down Y%". An even more soft-brained development on the theme is when you find yourself saying "It's down X% so it's cheap" or "It's up Y% so it's expensive."

It's the future that matters

Making money in shares is about where the share price is going in the future. Where the share price has been in the past is pretty much irrelevant. What you paid for a stock and what price it was in the past is a distraction from what the company is worth now or in the future and where the market might take the price.

Anchoring, also known as 'focusing bias', is the use of a reference point against which to judge value. For share prices it means using past share prices as a reference point for the current share price even though the past price is not a factor in assessing current value.

How often do you reference how much a stock has moved from the lowest price it hit or the highest price it hit? Those prices form an anchor point from which we judge the current price and, left to idly ponder, we tend to develop a bias that says something is expensive or cheap.

Past performance is simply a statement of where the price was. The more important consideration is where the price is now relative to what the company is worth. On the basis that the market's appreciation of the value of a company changes as time progresses, past prices become redundant as a reference point as soon as the value of a company changes, which arguably it does every day.

Academic studies suggest that the less known about the subject matter, the more prevalent the use of anchoring. In other words, the higher the level of guesswork involved, the more likely we are to employ anchoring, to use (even randomly generated) reference points to help us make a decision we have to make. It's grasping for an 'irrelevant crutch'. There is no wisdom in basing investment decisions on anything other than an estimate of current value.

When forecasters 'herd' together

On a related matter there is an interesting phenomenon in forecasting which says that the more uncertainty there is and the more difficult it is to forecast something, the more tightly grouped the forecasts tend to be. You would imagine the opposite but it seems that one of the biggest drivers for forecasters is the fear of getting it wrong, of standing out from the crowd alone ... and being wrong. This manifests itself in 'herding' in the face of heightened uncertainty. When something is difficult to forecast, the moment the first forecaster publishes their forecast, rather than reflect the wide range of uncertainty, others herd to the first forecast. This 'rallying to the flag' creates a tight forecast range which makes it even harder for other forecasters to 'go wide'.

Using anchoring in negotiations

Back to anchoring. Anchoring is also a tool for the smart negotiator.

The skill of the second hand car salesman, for instance, is to put down an anchor as quickly as possible that will then act as a standard for the rest of the negotiation. It is a technique used by flea market stall holders. As a buyer, the worst mistake is to feed into this process by asking the price (rookie error), you're simply going to open the negotiation at the top price straight away.

A smart buyer will go in hard and early with their own anchor price point so the negotiation starts at the bottom rather than the top and it is the stall holder who has to pull it up, rather than you spending the rest of the negotiation trying to drag it down.

You see anchoring in the stock market all the time. Look out for anyone that starts their assessment of a stock with "It's up X% from the low", as they are clearly an amateur or lazy investor with no 'intrinsic value' reference point.

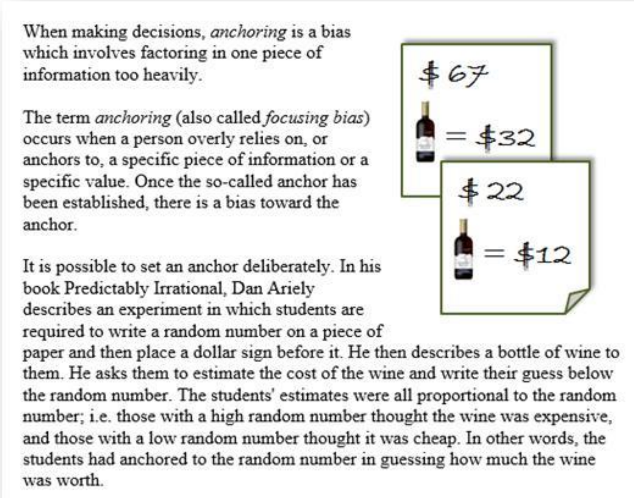
You'll know if your trading is driven by anchoring if you are the sort of trader that buys stocks because they have fallen a lot. This is technically wrong anyway but also ignores the fact that the market's assessment of the value of the company has been changing constantly for the worse.

Purchase price as the anchor point

The other very widespread use of anchoring is when traders use their purchase price as a reference point. "I'll sell it if it goes up 10%" or "I'll sell if it goes below my purchase price." All very nice but not rational (although, in its defence, anything, even unscientific anchoring, is better than nothing when it comes to having some trading discipline).

The best way to avoid anchoring is to forget the past price as a reference point and simply assess 'cheap or expensive' on some other criteria (PE history perhaps, or price relative to an intrinsic value calculation would be more useful).

Meanwhile you can amuse yourself by listening out for anyone (you, perhaps) making comments or decisions on the basis that a stock is up X% or down Y%. Your sole focus is whether a stock is *going* up or not. Whether it's *gone* up or not is irrelevant.



When making decisions, *anchoring* is a bias which involves factoring in one piece of information too heavily.

The term *anchoring* (also called *focusing bias*) occurs when a person overly relies on, or anchors to, a specific piece of information or a specific value. Once the so-called anchor has been established, there is a bias toward the anchor.

It is possible to set an anchor deliberately. In his book Predictably Irrational, Dan Ariely describes an experiment in which students are required to write a random number on a piece of paper and then place a dollar sign before it. He then describes a bottle of wine to them. He asks them to estimate the cost of the wine and write their guess below the random number. The students' estimates were all proportional to the random number; i.e. those with a high random number thought the wine was expensive, and those with a low random number thought it was cheap. In other words, the students had anchored to the random number in guessing how much the wine was worth.

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Results from the 2015 Reader Survey

Our thanks to the 1,161 readers who completed our Reader Survey. This is a great response and the feedback provides valuable guidance for us.

Cuffelinks is a community of investors sharing ideas, and in the spirit of openness, we attach all the charts representing the answers, and comments from two of the questions, warts and all. We have edited out only personal references in the interests of privacy and confidentiality, and we have not touched the spelling or grammar.

The bar charts on responses to every question are linked here.

The verbatim comments from the two questions that required a written response can be accessed here: Question 5 'How is Cuffelinks different from other newsletters and website?' and Question 12 'How can we make Cuffelinks more useful to you, plus other general feedback?'.

In brief, some of the findings are:

- Almost 50% of our readers identify themselves as SMSF trustees while 30% are investors without an SMSF and 30% are retired from paid work (multiple selections were allowed so the numbers add to more than 100%). Industry professionals make up about 40% of respondents, many of whom would also manage an SMSF.
- 70% say the length of our articles is about right, while 17% say it depends on the subject. Overall, we think we are writing appropriately in length for our audience.
- 80% say our articles are easy to understand, while another 20% say it varies by week.
- 91% say our content is credible and professional, and we hope we are selecting the best writers for our audience and aspirations.
- There is decent support for macro and economic forecasting, so we will explore that further in 2016. Podcasting, conferences and webinars received solid interest, but not too regularly. There is not a high expectation that we will provide stock picking, but there's some interest.
- Almost 70% have shared Cuffelinks with a friend. Thank you very much, the word-of-mouth support is crucial for our growth.
- The most popular asset classes for allocation in the last year were domestic equities, global equities and term deposits. Alternatives had a respectable 5% but are not yet mainstream.

The comments on all the questions are a treasure trove of useful insights. Most readers value our independence and variety of expert opinions, and want us to avoid overt product promotions. There is recognition of our focus on quality of analysis and information rather than grabbing the headlines or reporting the daily noise. We sometimes worry our articles err on the side of being too technical, as they are written by market professionals, but this does not seem to be an issue for most. Hopefully, each edition has something for everyone.

We appreciate the time many of you took to complete the survey.

From the team at Cuffelinks

Chris, Graham, David, Ashley and Leisa