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Real estate outlook for 2016: positive returns expected in challenging year

Adrian Harrington

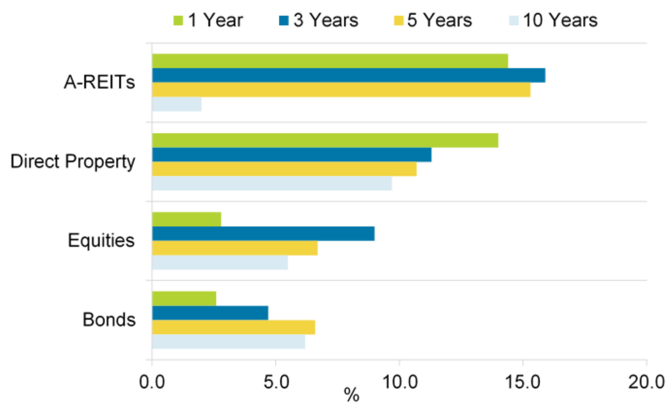
Now we're well into 2016, investors are asking the question, "Which road should I take?" Are real estate markets at, or close to, peaking ... or is there more upside in this cycle?

Since the lows of the GFC, non-residential real estate and listed A-REITs (Australian Real Estate Investment Trusts) have delivered positive risk-adjusted returns. In fact, A-REITs have been the standout performer over the past five years, taking the title as the best performer in four of the past five years.

Over the five years to 31 December 2015, A-REITs delivered a total return of 15.3% per annum, more than double the 6.7% per annum from equities and 6.6% from bonds, and higher than the 10.7% from direct property, as shown in Figure 1. The one-year 2015 performance is also strong.

It is not surprising that investors are increasingly asking, "Is this as good as it gets?"

Figure 1: Asset Class Total Returns: to 31 December 2015



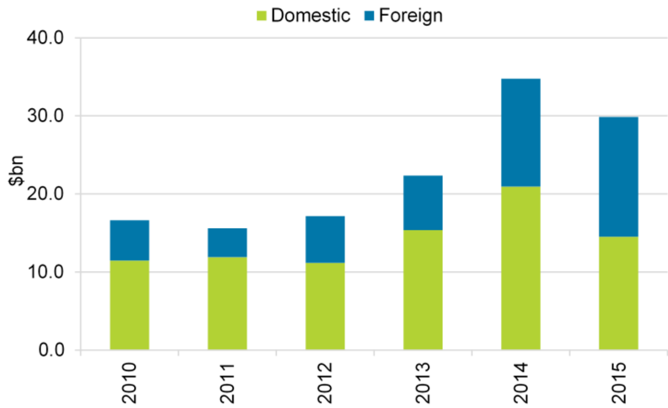
Source: S&P/ASX, UBS, MSCI/IPD

We believe the strong performance of both listed and unlisted real estate sectors won't be repeated to the same extent in 2016, but we also believe that a major downturn is unlikely. The one caveat is if the volatility and negative investor sentiment that hit global financial markets in the first two months of this year returns, leading to a major tightening of liquidity in financial markets, then real estate, whether listed or unlisted, won't be immune to the fallout. Having said that, prime real estate with secure income and strong A-REITs with quality assets and management will look relatively attractive.

Foreign investment set to continue

International capital was a feature of the Australian market in 2015 and will be again in 2016. According to Cushman & Wakefield, non-residential transactions topped $29.9 billion, with foreign investors accounting for just over 50% of total transactions by value, as shown in Figure 2.

Figure 2: Non-Residential Transaction by Sector: 2009 – 2015



Source: Cushman & Wakefield

Foreign investment activity in non-residential real estate (and also the listed A-REIT sector) has been growing steadily over the past few years driven by a confluence of factors, including:

- global investors chasing Australia's relatively high yields
- Australia's transparent and relatively stable market
- growth in Asia-Pacific focused real estate funds which are allocating capital to Australia as part of their regional mandates
- China's insurance companies targeting real estate investments, together with a relaxation of restrictions on their international investing activities
- the decline in the Australian dollar.

A challenging year to deploy capital

International investors will continue to be active buyers in Australia particularly for prime office, retail and industrial assets, making it difficult for local investors who typically have a higher cost of capital to compete. We also see the listed A-REIT market as being attractive to foreign capital in 2016 for much the same reasons as direct real estate.

We are now seven years into the up-cycle, and we see less upside to many markets than we have in recent years. Valuations in the direct market are not cheap enough in many instances to reflect the risk we see from the macroeconomic headwinds.

We expect steady real estate demand across most non-residential sectors with the exception of Perth and to a lesser extent Brisbane, which are affected by the resource sector downturn. Notwithstanding cap rates are nearing pre-GFC lows, given the weight of money chasing real estate assets, capital values for quality assets (i.e. those with strong covenants, long leases and quality locations) will rise in the year ahead.

The availability of equity from domestic and international investors and debt from lenders will be critical. Should one or both of these sources of capital contract due to concerns about economic or capital market conditions, it could place pressure on values, especially for secondary assets unless there is a clear strategy for value creation.

The challenge in this environment is to avoid broad 'beta' plays on real estate (investing in the hope that the market uplift will drive asset performance) or simply taking greater risk in search of higher (yield) returns.

Given we are close to full valuations in some markets, earnings growth rather than yield compression will be the key driver of value creation going forward.

Investors seeking higher returns by taking on more risk may not be rewarded. Instead investors should focus on value-creation through active management of assets via releasing, repositioning or refurbishing. Now is not the time to stretch on price or overcommit to acquisition-driven strategies. Be disciplined and be patient. Sometimes being defensive, including raising some extra cash, is actually an offensive move as it creates optionality when the future appears most uncertain. In our view, the next 12 to 24 months could be one of those times.

We continue to believe that real estate related social infrastructure (childcare, seniors living, healthcare and student housing) will offer attractive investment returns in the coming year. The demographic drivers and a shortage of quality accommodation in these sectors will see investors increasingly look at these investments as a legitimate part of a real estate portfolio.

A-REITs still attractive as a defensive play

The A-REIT sector has generally been disciplined in its capital allocation, including:

- focusing on core investment strategies and not undertaking risky global expansion plays like it did prior to the GFC
- maintaining relatively low leverage
- employing sustainable pay-out ratios
- growing earnings through active asset management.

We expect A-REITs to deliver a total return of circa 10% in 2016, underpinned by a dividend yield of 5%. A-REITs present well on yield relative to the cash rate and other ASX-listed equity sectors and global REIT markets and should continue to be well supported given their relatively visible earnings and distribution growth.

To access the Folkestone 2016 Real Estate Outlook paper, please click here.

Adrian Harrington is Head of Funds Management at Folkestone (ASX:FLK). This article is general information and does not address the specific investment needs of any individual.

The major weaknesses of LICs and managed funds

Graham Hand

"He who pays the piper calls the tune."

To state the bleeding obvious, sales people working for fund managers are biased towards their own product structures. It's the job of Chief Executives, Chief Investment Officers and Business Development Managers, and anyone working in distribution for a fund manager, to promote their company's particular structure. Another side of the job description requires them to point out the deficiencies of competitor structures.

So let's focus on the biggies. What is the main criticism that Listed Investment Company (LIC) folk use against managed funds, and what do managed funds folk say to criticise LICs?

Main weakness of managed funds, as nominated by LICs

Managed funds are open-ended, which means existing investors can redeem (cash out) at times of market stress, forcing fund managers to sell assets into poor markets.

Main weakness of LICs, as nominated by managed funds

LICs are closed-ended, which means the only way existing investors can cash out is by finding a willing buyer on the stock market, and this could be at a heavy discount to the asset backing.

Guess what. Both are correct. The irony is that these are also the strengths in the right markets. Let's consider each in more detail:

Managed funds are forced to sell in stressed markets

The harsh reality of the way many investors behave is that they invest more into the market when it is strong, expecting it to rise further, and redeem when markets fall, expecting further falls. The doom and gloom in the media prompts unfortunate investor reactions.

In extreme circumstances, managed fund redemptions may be suspended to prevent cash outflow, such as on mortgage funds around 2008 during the GFC. These products had a fundamental weakness. They offered next day liquidity, but their assets were both long-term and illiquid. There is no ready market for five-year mortgages at a time of distressed selling. Faced with a run on their funds, redemptions were suspended, and it was only recently, some seven years later, that the final mortgages were repaid allowing money to be returned to the investors.

Example of the problem: During the GFC, the only way the demand for cash from managed funds could be met was by selling assets. I remember one frustrated fixed interest manager telling me he could buy seven-year CBA subordinate debt (not hybrids) at over 9%, which he thought was excellent value (and indeed, it turned out to be), but he could not buy because he was desperate to sell anything to fund redemptions. Liquidity has a tendency to dry up when it is most needed.

Similarly, when markets are peaking, new applications are usually at their highest. Since most managers accept as much money as they can, they are either forced to invest when the market is toppish, or hold the money in cash and risk underperformance if the market continues to run.

So the LIC criticism of managed funds can be accurate at market extremes. But the main strength of managed funds is due to the same structure. Managed funds are open-ended, and existing investors can redeem (cash out) at the net asset value (NAV) of the underlying assets every day. They do not trade at a discount.

LICs trade at a discount

LICs are not required to sell assets as investors cash out because it is the buyer on the ASX that provides the liquidity, and the number of shares on issue remains the same. This advantage is balanced by the dependence on the strength of the market bid to support the price, and especially for larger sales volumes, the price can be pushed down relative to Net Tangible Assets (NTA).

For example, assume a buyer subscribes for an initial issue at $1, and the NTA at the start is $0.97 (due to the cost of listing). If the fund manager has a poor start to performance, or the overall market is weak, or the initial issue was not firmly placed with end-holders, then the issue can quickly drift to a further discount to NTA, and often take years to recover, if ever.

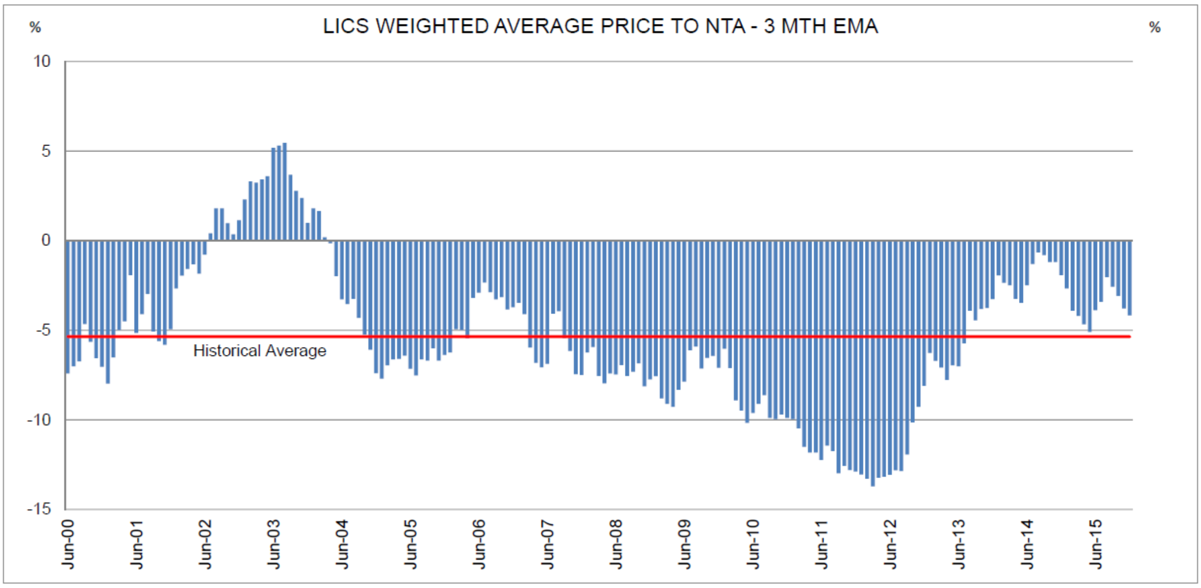
The table below shows the weighted average market price to NTA for all LICs in Australia, showing an average discount to NTA of about 5%, but it has been as high as 13%, with no positive average for the last 12 years.

These are averages, and there are some well-established LICs which have performed better, often trading at a premium to NTA. These include Australian Foundation (AFI), Argo (ARG) and some of the Wilson funds, such as WAM Capital (WAM). But since the sector as a whole is at a discount, many are at severe levels of 20% or more, and perhaps up to 30%. Examples of large discounts include Flagship (FSI), Contango Microcap (CTN) and Hunter Hall (HHV). The investor has only two choices in these LICs: hang on and hope the discount is removed, or sell and realise the loss.

The main reasons why some LICs trade at a premium are that the manager or fund is well-known, highly sought-after and communicates well with investors. The flip side is that if the manager loses the confidence of investors, it can take a long time to recover. Investors need to be convinced the manager can add value. There is no mean reversion.

Looking at the graph, it might sound attractive to buy at a discount of 13% and then sell at a discount of 5%, but it is extremely difficult to know which manager's reputation will improve, or even what caused the discount.

Example of the problem: Templeton Global Growth Fund (TGG) is a long-established LIC from a global brand with a market value of about $280 billion. Until a year ago, TGG had been trading at around NTA, with a 12-month high of $1.50, but is now at $1.13 against an NTA of about $1.30. The share price has fallen roughly twice the market fall. They recently held an investor update where a member of the public criticised the board for twice



Source: Patersons Listed Investment Companies Report, December 2015. EMA = Exponential Moving Average, which gives more weight to recent data.

issuing new shares at a discount to NTA, diluting the value of shares for existing shareholders. The investor argued that the placement had contributed to the discount to NTA. A board member of TGG admitted they had underestimated the consequences of both the issue at a discount and the placement. He said their communication must improve, especially explaining their style and in what conditions it might not work (they are deep value, which has significantly underperformed growth recently). It will take a lot of time and effort by TGG to remove the discount to NTA.

As with managed funds, the main weakness is also the main strength. LICs are closed funds, which means the manager is never forced to sell assets on market at times of stress.

Are LICs or managed funds better?

There is a lot more to the overall merit of these two structures than the two main points highlighted here. Consider the quality of the manager and investment team, the time frame of the investment, the asset class and the need for liquidity.

For investors who find high quality managers who put a lot of time and effort into nurturing their clients and who deliver consistent performance, LICs are a good structure. For investors who demand liquidity at market value and trust a large institution with a strong investment management business, managed funds can work well.

But next time you hear the predictable criticism of an alternative structure, ask about their own potential weaknesses.

Graham Hand is Editor of Cuffelinks. This article is general information only. Disclosure: Graham holds investments in both managed funds and LICs, including TGG, he is on the Board of a LIC (Absolute Equity Performance, ASX:AEG) and sits on the Compliance Committee of a managed fund business (Lazard Asset Management).

Investing in the best long-term founders

Jason Sedawie

Amazon, Berkshire Hathaway, Google, Starbucks and until recently Apple have been some of the best-performing shares in the market. They were also all led by their founders. We believe their long-term view is an advantage in a market that usually thinks short term. Most founders have a view that spans decades. This allows them to take advantage of opportunities that cost in the short term but pay off big in the long term.

It's the opposite approach and mindset of professional managers that sign on for caretaker roles for a few years. Founders tend to be more willing to disrupt their businesses. A major example has been Apple and Steve Jobs. He returned and released the iPod, a product that soon dominated the music market. At the time, investors questioned what Apple could do next. We all know what happened then as they disrupted themselves. Steve Jobs introduced the iPhone and then the iPad, two products no analysts predicted. It's a difficult decision to cannibalise your best-selling product but it's an easier decision if you're thinking out decades. Unfortunately, Apple has changed since his passing but there are other founder-led firms with a long-term view.

Jeff Bezos and Amazon

Amazon started out as on online bookstore. Now it's the most feared retailer in the world. Many retailers are getting 'amazoned', which means to watch helplessly as Amazon vacuums up the customers and profits of your traditional 'bricks and mortar' business. Amazon does not care about short-term quarterly profitability. They also created AWS, the leading cloud computing service. It's hard to imagine that an online bookstore would become the leading retailer in e-commerce and cloud computing, two of the largest growth opportunities in the world.

A major reason for Amazon's success is Jeff Bezos's long-term customer focus. For $99 a year, customers access 20 million items with free two-day shipping. This Amazon Prime service increased its membership by 51% last year. I'm still waiting for it to be available in Australia. Investors initially thought he was crazy to offer free shipping but now it's a key competitive advantage. Bezos knows that technology changes quickly so he focuses on what won't change in the longer term, knowing no matter what happens customers will always prefer cheaper prices, more choices and free shipping. While both Prime and shipping are short-term costs, it creates longer-term customer loyalty with these customers spending 140% more than non-members of Prime.

Amazon's cloud computing business was started 10 years ago and is now a $10 billion revenue business at a 28% operating margin (they disclosed sales and profitability last year for the first time.) It would

have been hard to establish this business without the backing of an entrepreneurial founder.

Amazon is also taking the long-term view by moving into homes. Their dash buttons have been a big success (see picture below). Prime members can purchase brand-specific buttons such as for Tide detergent, attach them to their washing machine and press the Tide button every time they run low on detergent. If that's not easy enough they have introduced voice ordering with Amazon Echo. If you run out of toothpaste while brushing your teeth, you can tell Echo to reorder without bothering to open your smartphone. What's better than a store that sells everything, open 24/7? A voice-activated store that buys you everything you need without you having to remember it.

Larry Page and Google (now Alphabet)

Google is another famous founder-led company. Not many companies I follow have a category for investing in moon shots. Google takes the long-term view investing in driverless cars instead of just incremental search improvements. Google's founder Larry Page is an inventor but also a great businessman. Some of their investments have worked out extremely well. They paid around $50 million for Android and the $US1.65 billion acquisition of YouTube in 2006 has been one of the best acquisitions of all time. When investing they don't look at the profitability but at the long-term usefulness of the product. Products must pass his toothbrush test. They invest only in products that are as useful and meaningful as a toothbrush that you use twice a day. This approach means Google now has seven products with over a billion users.

Google spent $3.6 billion in moon shots last year, an increase of 84% on the prior year. A non-founder is unlikely to make these longer term investments. Now that it is called Alphabet (Google is its largest division) it will be interesting to see what comes next. It might seem strange for Google, an internet company, to invest in health care (longevity is a focus) but it makes more sense for a conglomerate like Alphabet. What potential employee wouldn't be inspired to join a company that is willing to take on long-term problems?

Howard Schultz and Starbucks

Technology founders get the lion's share of people's attention but I am constantly amazed by what Howard Schultz, the founder of Starbucks, has built. Coffee is an extremely competitive market with low barriers to entry but there is still only one global coffee chain. Starbucks serves 85 million customers around the world every week at an average sale of $5. Most people buy from Starbucks not because of the coffee but because of the brand and how they treat their employees and customers. Howard not only helped create the business but came back and turned it around when Starbucks overextended its growth in 2008. He shut stores to retrain baristas, stopped reporting monthly sales and introduced technology to make ordering easier.

Taking the long-term view, Starbucks invests in its employees. It recently offered full college tuition coverage with a goal to graduating 25,000 employees by 2025. The technology investments were also a major hit to the bottom line but Starbucks now processes the most mobile payment transactions in America (21% of transactions) and it has introduced mobile ordering. No more waiting in line. Starbucks is also trialling delivery e-commerce based on a coffee app.

We believe that some of the best growth investments are found in founder-led firms. They have the advantage of longer term views and the ability to take advantage of opportunities that most companies couldn't or wouldn't invest in. In a quarterly focused world, it's a major advantage.

Jason Sedawie is a Portfolio Manager at [Decisive Asset Management](), a global growth-focused fund. Disclosure: Decisive holds Amazon, Google and Starbucks. This article is for general purposes only and does not consider the specific needs of any individual.

Leadership skills of a crusading communicator

Jeremy Duffield

This is the second in a series of articles highlighting the leadership attributes that can help the superannuation industry move from its historical emphasis on accumulation to a whole-of-life focus and particularly on retirement income provision.

If one person is renowned in funds management globally as a leader who truly made a difference, it must be Vanguard Group Founder, Jack Bogle. Over a career spanning seven decades, Jack not only created a company that has become the world's largest mutual fund company, but profoundly influenced millions of investors and the industry itself.

I had the great privilege to work directly with Jack over the 16-year US-based component of my Vanguard career and have maintained close contact ever since. I saw up-close the many dimensions of a great leader.

Jack demonstrated exceptional leadership in many ways. The most obvious include his *organisational design leadership* in creating Vanguard in 1975 as a 'mutual' fund company, operating at-cost, solely in the interests of its investor owners. It's a unique structure in the US which has allowed Vanguard to assert price leadership and, over time, become the lowest cost mutual fund provider. Jack is, of course, well known also for product leadership, as the creator of the first index mutual fund (in 1976), among a number of other significant product innovations. Further, he has been an investment leader by articulating a clear 'common sense' philosophy for investors to follow. And, he has demonstrated moral leadership in countless ways, but mostly by speaking out on what's right for investors, and what isn't, and by making the case for a greater fiduciary and a lesser sales attitude within the industry.

Leadership in communications to build trust

However, to pick just one leadership strength that fascinates me and is relevant to all leaders in our industry, I'll focus this article on his *communications leadership.* Jack Bogle has been a remarkable and tireless communicator over many decades. Communications counts in investment services and superannuation, much more than most people credit. We're dealing with an intangible service. We must build trust. The fundamental source of trust is communication and actions that correspond to the communications. The 'talk' then 'walking the talk'.

In the 1980s and 1990s, Vanguard became a dominant retail firm, after having abandoned the commissioned broker sales force which built its predecessor, the Wellington Funds. Vanguard would go 'direct' and a strong voice was needed to articulate a winning proposition for fund investors. Jack believed the consumer would be king and would somehow find their way to Valley Forge, Pennsylvania if we built the proverbial 'better mousetrap'. But someone had to tell them about it, long before the days of social media and viral campaigns. Vanguard, the low cost provider with little money to spend on marketing, had to get the word out.

Jack started with the existing client base. He made sure they knew what he and Vanguard stood for. He personally wrote a letter in all client investment reports. He replied directly to every client who wrote to him. (It's amazing how powerful it is when the Chief Executive writes a personal letter to a client, particularly when it's beautifully articulate and elegant.)

He made it clear what investment philosophy Vanguard stood for. He talked common sense, not investment gobbledygook. He differentiated Vanguard's investment beliefs from those of the masses by focusing on long-term investing and keeping costs low. And he made sure it was a consistent body of investment beliefs that investors could adopt for themselves.

Beyond the client base, he worked hard to create a distinctive voice for Vanguard in the marketplace. It was his voice. It was strong, insistent and opinionated but common sense, and it was emotionally appealing to consumers. He sought press attention and, because he gave them a strong story, he got the attention, time and again. There's nothing quite like free and positive press to get a direct business going.

What's the evidence that communication mattered? Firstly, despite its modest marketing budget, Vanguard began picking up market share. Secondly, the growth of indexing in retail investors' portfolios went from nothing to trillions today. There is no question in my mind that without Jack Bogle's advocacy of indexing caused the swelling of retail indexing usage we've seen over the past three decades. Third, as Jack likes to say: "you can't be a leader without followers." Jack has millions of followers, even a fan club, called the Bogleheads.

Remarkably, Jack didn't stop his communications push with investors once he stepped down as CEO. He has now written 10 books, and tells me he's working on his 11th (at age 86!).

Lessons for retirement income providers

One of our greatest leadership needs – as we go beyond an accumulation-focused industry – is to communicate in a powerful way with our members. We have to be agents of change and we're going to need our best communications skills to bring members with us.

In helping our members manage the transition to retirement here are some of the communications challenges we face:

- Switching the members' focus from balances and lump sums to sustainable retirement incomes
- Engaging them with the need to build an adequate nest-egg when today's compulsory contribution levels are patently insufficient
- Conveying to the members our intention (and ability) to help them during retirement
- Helping members at retirement make the right choices with the difficult task of deciding how to invest for a sustainable retirement income
- Guiding members through market cycles when they no longer have access to salary income. In Jack Bogle's lingo, helping them "stay the course"
- Earning members' trust so that they are receptive to our help and advice.

How Bogle might approach the problem

You don't have to tackle it like Jack Bogle, but here are a few lessons from close observation:

Have something to say and be different: Lack of substance doesn't cut it. Bland doesn't cut it. Jack was a crusading agent of change. He had strong beliefs and expressed strong opinions and was prepared to back them up. He sought to differentiate.

Convey passion and conviction: Show your audience you care and bring a sense of urgency to the matter. For Bogle, caring is an essential theme of leadership.

Respect communications: Too few executives think communication matters. They don't put the work or time in that's needed. They may just delegate it and pay little attention to the quality of the work of their communications department – and it shows. Jack loved communications having a deep respect for his audience and the English language.

Work hard at it: Communications is an art that improves with practice. Jack followed the preacher's rule: 20 minutes of prep for every one minute of speech.

Be genuine: Admit your humanity. Make a connection. Be genuine. People know if you're not the real deal. If you don't really care about the investor, don't pretend to.

Make the emotional connection: We tend towards dry rational thinking in our industry, but our audience is diverse and human and it values emotional connection. Bring your communications to life with stories, anecdotes, humanity. It is much more than logic and numbers.

Get your team on board: Don't overlook the importance of great communications with your team. Jack shared his vision with his colleagues and convinced them to share his vision. He used an old-fashioned device, the speech, but he used it brilliantly. We all knew what Vanguard stood for.

Repeat (but stay fresh): Repeat the key messages over and over again. That's how lessons sink in. Finding new and fresh ways of getting the key points across is a challenge but a worthy one.

Even if you're not going to lead communications yourself, it's essential that you build communications capabilities that allow your firm to lead. Jack's successors totally respected the value of communications and expanded the institution's abilities to communicate well with clients using newer media as the digital age dawned.

It's going to take some crusaders to move this industry to a new focus on retirement incomes. And communications will be a powerful part of their armoury.

To hear more from Jack himself, here's a recent in-depth interview by the good folks at AQR: https://www.aqr.com/library/words-from-the-wise/words-from-the-wise-jack-bogle

Jeremy Duffield is CoFounder of SuperEd. See www.supered.com.au. He was the Managing Director and Founder of Vanguard Investments Australia, and he retired as Chairman in 2010.

Fundamental indexing over the cycle

David Bassanese

Due to the tendency of stock prices to over and undershoot fundamentals over the economic cycle, both finance theory and empirical evidence suggests that 'fundamentally weighted' equity indices (FWIs) should, over time, outperform more traditional market-cap weighted equity indices (MCWIs). It's also the case that FWIs endure periods of underperformance, usually arising when 'momentum' rather than valuation-based 'regression to the mean' is driving market performance.

Contrast cap-weight index and fundamental-weight index

As should be clear, MCWIs weight stocks according to their price-based market capitalisation. If the combined capitalisation of stocks in the S&P/ASX 200's Index was $1.5 trillion, and company X had a market capitalisation of $150 billion, its weight in the index would be 10%.

By contrast, a FWI weights stocks according to non-price related measures of economic importance. In the case of the FTSE RAFI Australia 200 Index, for example, weights are based on four equally weighted factors: a company's cash flow, dividends, sales and book value, with the first three of these measures averaged over the previous five years, and the last based upon the most recent accounting value.

As seen in the chart (top, right), the upshot of this approach is that FWI's will tend to be underweight stocks (compared to a MCWI) when their prices are relatively high compared to sales, earnings, book value and dividends, and over-weight these stocks when their prices are relatively low compared to these other non-price measures of a company's importance.

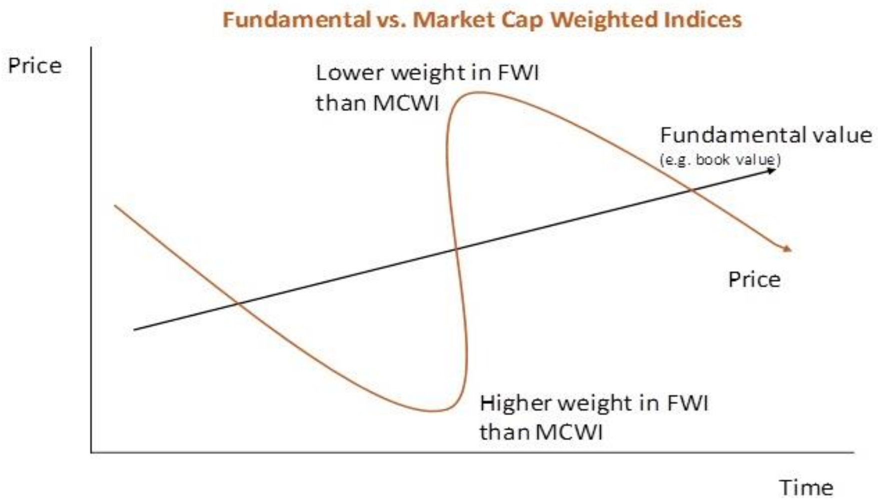
Regression to the mean

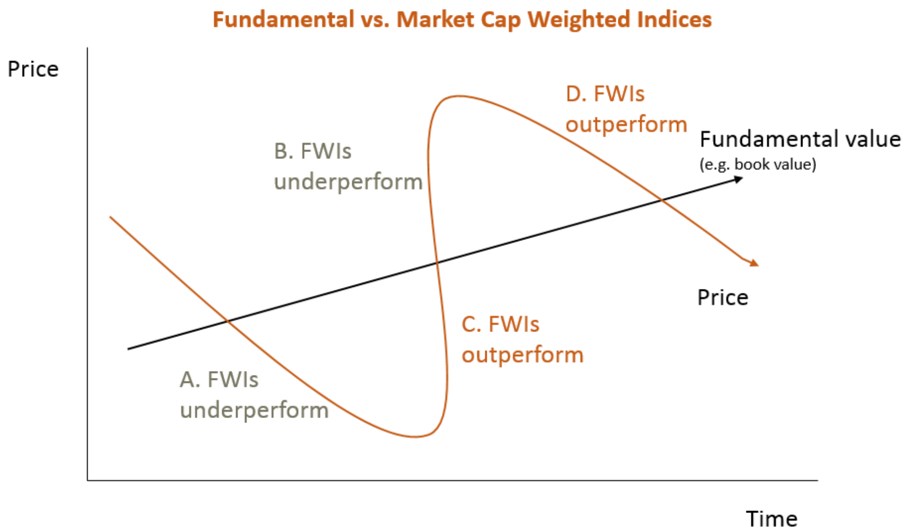
In what's known as 'regression to the mean' in value, to the extent relatively high price stocks eventually tend to underperform, and relatively low priced stocks eventually tend to outperform, finance theory suggests the FTSE RAFI Australian 200 Index should tend to outperform the S&P/ASX 200 over time.

Of course, this theory does not suggest FWIs will necessarily *always* outperform MCWIs. At least conceptually, the periods of over and under-performance of a FWI are outlined in the second diagram (bottom, right).

This diagram suggests that when stocks with a high price to fundamental value are continuing to outperform (as during the late stages of a speculative bull market at point B) or when stocks with a low price to fundamental value are continuing to underperform (as during the late stages of a bear market when despair is at its most extreme as at point A), FWIs will tend to underperform MCWIs.

FWIs then tend to outperform when beaten down cheap stocks rally relatively strongly in the early





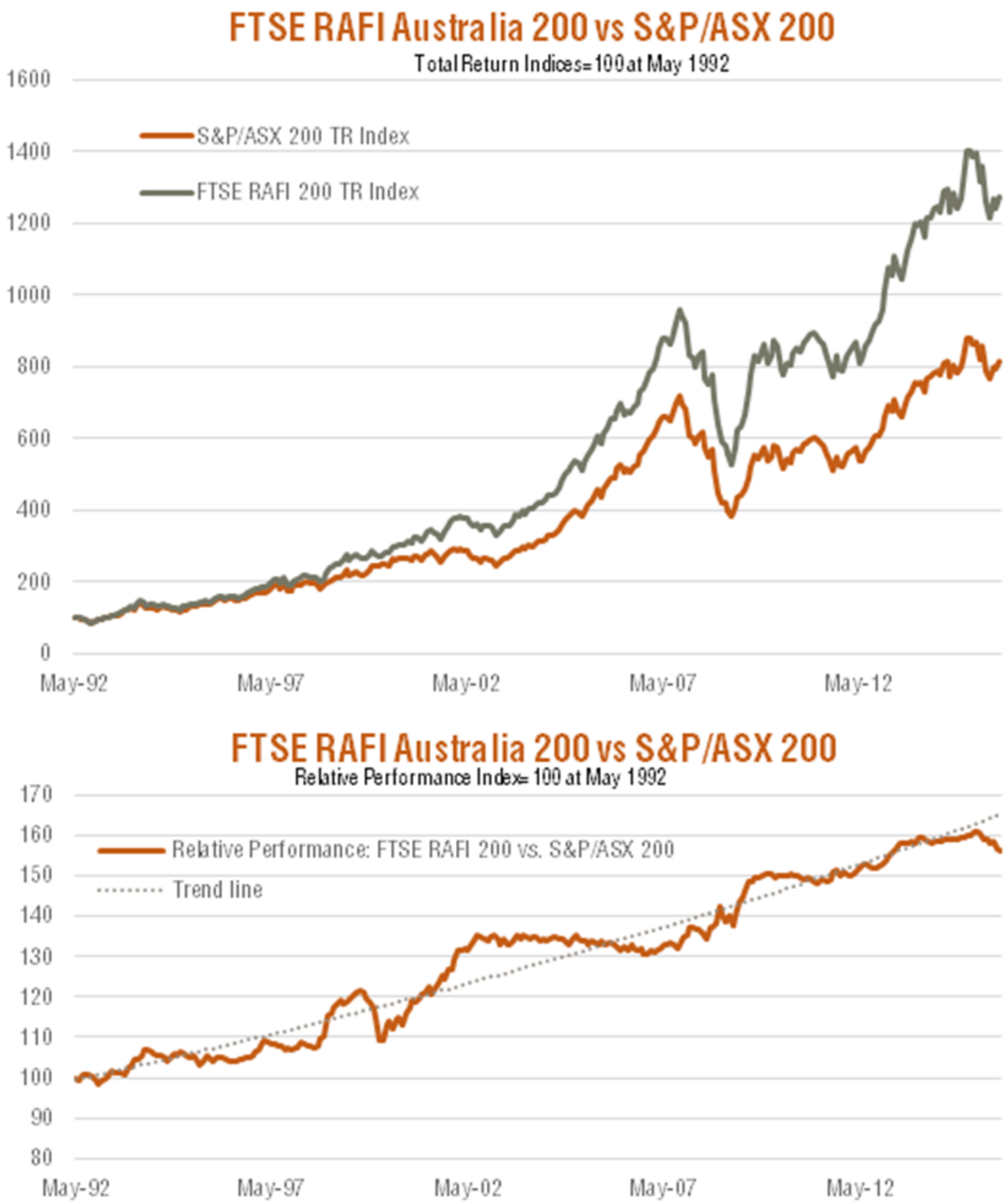
stage of a bull market (point C in the chart), and again when expensive stocks fall hardest in the early stage of a bear market (point D in the chart).

Simulated and actual performance

So much for the theory. Whether FWIs outperform MSWIs over time is ultimately an empirical question. Note that the FTSE RAFI Australia 200 Index was launched in August 2009. Index returns prior to launch are simulated based on Research Affiliates' non-capitalisation weighted indexing system. Actual investment results may differ from simulated results.

As seen in the chart below, the FTSE RAFI Australia 200 Index (simulated plus actual) has tended to outperform the S&P/ASX 200 index over time,

Relative Performance: S&P/ASX 200 Index v FTSE RAFI Australia 200 Index: May 1992-December 2015



Source: Research Affiliates and BetaShares. Graph shows performance of FTSE RAFI Australia 200 index relative to S&P/ASX 200 index, not ETF performance and does not allow for ETF management costs. You cannot invest directly in an index. Past performance is not an indicator of future performance of index or ETF.

though relative performance has nonetheless varied over shorter time periods. Through most of the early 1990s, the RAFI Index outperformed, culminating in a strong surge of outperformance 1998-1999.

The most abrupt period of underperformance was during the height of the dotcom bubble between mid-1998 and early 2000. But the Index then again outperformed as tech stocks crashed.

Recent RAFI underperformance

More recently, the RAFI Index has underperformed again, with a return of only 0.4% in 2015 compared to 2.6% for the S&P/ASX 200 Index. RAFI underperformed largely due to two factors: an overweight sector exposure to the underperforming resources sector, and an underweighting to the strongly performing health care sector.

In view of these cycles in relative performance, perhaps the most important statistic is that since the early 1990s, the since-inception outperformance of the RAFI Index over the S&P/ASX 200 Index has been 2.1% p.a.

Notwithstanding the recent underperformance, both finance theory and empirical evidence supports the view that the fundamental indexation strategy has the potential to add value to an investor's portfolio.

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BetaShares currently has two ETFs which track indices based on the RAFI fundamental indexation methodology – the BetaShares FTSE RAFI Australia 200 ETF (ASX: QOZ) and the BetaShares FTSE RAFI U.S. 1000 ETF (ASX: QUS).

Takeovers: what would '*The Gambler*' do?

Hugh Dive

"You've got to know when to hold 'em
Know when to fold 'em
Know when to walk away
And know when to run
You never count your money
When you're sittin' at the table
There'll be time enough for counting
When the dealin's done."

The Gambler, written by Don Schlitz and made famous by Kenny Rogers

Analysing the lyrics to country music songs can strangely provide insight into managing money and in particular in dealing with the game theory that investors must analyse when faced with a takeover offer. Recently we have been receiving quite a few requests from clients about the takeovers of Asciano and Investa Office Trust asking about what to do in various takeover situations. In this Kenny Rogers themed piece, we are going to look at the different kinds of takeovers and the strategies investors should employ when a stock they own receives a takeover bid; namely '*hold 'em*', '*fold 'em*' and '*know when to walk away and know when to run*'.

Arguably rising Australian corporate cash balances, global historically low interest rates and fading memories of the GFC will lead to increased takeover activity. A feature of the recently concluded February reporting season was slowing organic growth across most Australian listed companies, as the levers to drive profit growth of cost cutting and renegotiating debt have mostly already been pulled. In this environment, an acquisition funded by cheap debt can allow a management team to satisfy the stockbroking analyst's demands for profit growth that supports a high price to earnings multiple.

Know when to hold them

Even when there is only one suitor, the initial offer is rarely the final price. This occurs for two reasons: the first offer is usually a deliberate 'low ball'. This provides the bidder some 'wiggle room' as the Board of the target usually rejects the initial advance. When the bidder offers a second higher price it paints the picture that they are being generous to investors and secondly it allows the takeover candidate's board to claim that they fought hard for shareholders, rather than merely rolling over. In the case where there are competing bids for a company the best strategy is generally to sit back and enjoy the action.

There is little incentive for an investor to tender their stock to a particular bidder before the outcome has been determined, as you may be giving away additional gains. In 2006, anatomical pathology products Vision Systems was the subject of an intense three-way bidding war which pushed the company's share price from $1.64 to quite dizzying heights in a short amount of time. Three separate parties over a six-month period made cash offers for Vision Systems' stock and all managed to amass significant holdings in the company. Investors who accepted Cytyc Corporation's antepenultimate cash offer of $3.25, ultimately saw Cytyc selling those same shares shortly afterwards to the winning bidder for $3.75! Obviously this represented a transfer of wealth from Australian shareholders (including the fund that the author of this piece was helping to manage) to a large US corporation. Similarly, during the bidding war for *Commonwealth Property Office Fund* in 2014, investors that accepted *GPT*'s initial bid effectively gave GPT a free option over the rights to these shares. GPT ultimately used these shares to extract five of Commonwealth Office's office and retail assets from the winning bidder Dexus.

Know when to fold them

Whilst it is often profitable for investors to remain cool and do nothing in the face of a flurry of strongly worded *"last and final offers*", there are also situations where investors can be better placed to take the offer and move on to another investment. Typically, this occurs where there is only one bidder in the picture, the bidder is under no pressure to do the deal and that bidder has a longer investment horizon than most investors.

When car brake maker Pacifica Group received a $2.20 per share offer from German manufacturing giant Robert Bosch GmbH, I viewed that this offer was below the intrinsic value of the company and also significantly below our average entry price for the 14% stake in the company owned by my investors at the time. However, given the clouds massing on the horizon for the Sport Utility Vehicles in the US market and after doing some research into the acquirer, the best move was to sell into the offer. The company remained listed on the ASX, but made life unpleasant for the remaining shareholders after cutting dividends and selling off assets. Three years later Bosch GmbH ended up paying $0.23 for the shares it did not own and which was readily accepted.

It can also be a wise move to fold if you suspect that the bidder may withdraw their takeover offer after due diligence or the regulatory authorities (such as ACCC) may oppose the transaction. In late 2013 Graincorp fell 33% after a surprise decision by the Federal Government to block the $3.4 billion takeover of Australia's largest grain handler by US firm Archer Daniels Midland. Similarly, in 2012 and 2013 Billabong's price plunged after several private equity groups withdrew takeover offers after conducting due diligence on the troubled surf retailer. Investors could have sold their holdings for around $3, whereas the stock currently trades at $0.311.

Know when to walk away

Far too often we see that when competition hots up in a takeover battle, the end result is a transfer of wealth from the shareholders of the acquirer to those owning the takeover target. An example of this phenomenon can be seen in the Australian regional banks. In early 2007 Bank of Queensland put forward a proposal to merge with Bendigo Bank with an offer that would have delivered $17.18 to Bendigo Bank shareholders and as a shareholder I was delighted by the proposal. However, Bendigo countered with a proposal to defeat this, by merging with Adelaide Bank, whose primary business was in "low-doc" loans and tax-driven lending for agricultural managed investment schemes (MIS), funded not by deposits but via global wholesale funding markets. Bendigo's shareholders ended up paying close to $2 billion for Adelaide Bank's business which has both been earnings dilutive and an ongoing headache for the conservative bankers from central Victoria. BEN's earnings per share remains well below pre-merger levels, the bank had to raise capital numerous times to bolster its balance sheet, and the stock price has never come close to matching BOQ's original $17.18 offer.

This is relevant when we look at the Asciano bidding war, because as shareholders of both Asciano and Qube, we would have preferred Brookfield to win the bidding war as the price was a very full one; see our piece Company Changing Events. However, rival suitors Qube and Brookfield decided to call a truce and submit a joint bid for Asciano rather than further bid up the price. The bidders took a leaf out of the playbook of Dexus and GPT in the takeover of Commonwealth Office and decided to split up the assets. While this is a positive for Qube shareholders, it limits the final price received by Asciano shareholders.

Final thoughts

When one of the securities that an investor owns becomes the subject of a takeover offer a measured approach is most often the best one to take. The acquirer (and their advising investment banks) will deliver hundreds of pages of offer documents (Asciano investors received over 1,000 pages in the last few months). Inevitably these documents will have firm closing dates and tough language to inspire the investor to vend their stock into the takeover bid and thus strengthen the bargaining position of the acquirer. An investor tends to lose in a takeover situation where they suspect the acquirer may walk away or may face regulatory hurdles.

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