Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

Two Brexit visions as seen from my desk in London

Miles Straude

[Editor's note: Miles Straude works in London and voted to 'remain', and considers the Brexit result "a very sad turn of events". He received many requests for his reaction and wrote this update exclusively for Cuffelinks late during this week. In an earlier note, he wrote optimistically: "It is important to know however that the final outcome does not necessarily have to be as bad as the initial headlines have made out … If the UK can maintain access to the common market, then the actual impact will be quite mild."]

The first fight in the 'Brexit' referendum was not in fact between those in the leave camp and those campaigning for remain. It was instead a fight between two very different Brexit parties seeking the nomination to be the official leave campaign from the Electoral Commission. At stake was the ability to raise and spend a large amount of money under the Electoral Commission's campaigning rules. Grassroots Out, the party associated with Nigel Farage's UK Independence Party (UKIP), had a wide support network built up from years of railing from the political edges. Vote Leave, a movement supported by leading conservative MP's like Boris Johnson and Michael Gove, was a newer organisation seeking to run as a cross-party establishment movement. Vote Leave won the contest, becoming the official leave campaign for the referendum. This however did not stop Grassroots Out from raising a significant war chest of its own, and going on to campaign as the anti-establishment party of the referendum.

The different campaigns to leave

For many years, UKIP has campaigned on an anti-immigration platform. Over the past decade the relative economic success of the UK, combined with the free movement of labour rules which govern the EU, has led to a large increase in the number of Europeans living and working in the UK, a situation that has unsettled many voters across the country. Grassroots Out campaigned in the referendum on a similar theme, a heavy focus on the perceived risks coming from 'uncontrollable' immigration. At a time of austerity, falling living standards and rising levels of terrorism, it was an easy sell to much of the electorate.

Vote Leave in contrast ran on a much more principled campaign. The essence of the Vote Leave argument was a democratic ideal. Britain had ceded too much power to Brussels, an unaccountable, undemocratic Leviathan. Their argument ran that a UK freed from bureaucratic red tape would go on to prosper outside of the EU, striking trade deals around the world in a manner that reflected its outward-looking, free-trading nature – a nature that was inherently at odds with inward-looking continental countries.

Vote Leave's vision for Britain was for a European Singapore, free-trading and outward-looking. Grassroots Out's vision was for an end to immigration mixed with nostalgia for older times.

These two different visions matter greatly today as the UK starts on its path towards renegotiating its relationship with the rest of Europe. In economic terms, the most important feature of EU membership is the access it provides to the European common market, the largest free trading bloc in the world. Access to the common market does not only come through EU membership however. European countries like Norway and Switzerland maintain access, whilst still retaining many of the key democratic powers Vote Leave has argued needed to be returned. Unrestricted access to the common market comes at a price however, including the free movement of labour throughout the economic zone.

Towards the end of the campaign Grassroots Out came under considerable criticism for running highly emotive anti-immigration ads. In response to these ads, Boris Johnson contrasted his own position on the immigration issue as such, "I am passionately pro-immigration and pro-immigrants."

Know who will be negotiating with Europe

With these two different Brexit visions in mind, it is important to note that it will be the conservative government of the day, led by those in the Vote Leave camp such as Boris Johnson and Michael Gove, who will be the ones renegotiating the UK's arrangements with Europe. If, and perhaps it is a hopeful if, those negotiating the new arrangements are true to their cause about a return of UK sovereignty, and less concerned about immigration, then access to the single market could still be maintained. Such a result would lead to a very different, and largely positive, outcome for the UK and Europe when compared to the Grassroots Out vision for the future.

The economic case for immigration is clear. European immigrants to the UK and pay more into the state coffers than they take out in terms of benefits. They are typically younger, healthier and more entrepreneurial than the general population at large. In every economic sense, they are a tremendous asset to a heavily-indebted economy with an aging population. How well this vision is upheld over the coming months will determine what the UK's future relationship with Europe holds.

Miles Staude is Portfolio Manager at the Global Value Fund (ASX:GVF), which he manages from London. The opinions expressed here are his personal views and do not consider the circumstances of any individual.

Don't let Brexit rush you to the exit

Roger Montgomery

As I sit and pen this column, the UK has voted to leave the European Union. According to relatives of members of my team living in London, Britons on the Tube are telling Eastern Europeans, "Time to pack your bags". The Dow is down over 5%, Spain is down 12% and some individual shares have fallen by more than 20%.

Jumping at shadows is the stock market's specialty and for an industry that is paid a percentage of activity, it relishes such events. But the Greek philosophers had it right, when they said; "this too will pass".

And pass it does

In the 66 years since 1950, there have been 57 market moves downward of 20% or more in either of the US S&P 500, the UK's FTSE, Germany's DAX, and Japan's Nikkei. Think about that statistic - it means a 'crash' in a major market every 1.15 years. I would describe that as frequent and regular. As markets become more interconnected and investors more aware, anything form slowing Chinese growth to a rising oil price can trigger panic.

When asked about whether he was worried about a big drop in the market, Warren Buffet's colleague Charlie Munger replied:

"In fact you can argue that if you're not willing to react with equanimity to a market price decline of 50% two or three times a century you're not fit to be a common shareholder and you deserve the mediocre result you're going to get compared to the people who do have the temperament, who can be more philosophical about these market fluctuations."

Munger's comments beg the question, why would an investor be willing to invest in any market that could halve? The answer is that the stock market is the greatest concentration of financially irrational people in any one place.

Here's an allegory used by Buffett that I like: think about a farmer in Orange, Dubbo or Parkes who has inherited a farm from a generous ancestor, and on which there is no debt. The farmer is under no pressure to sell the farm. Clearly there will be a few bad years, but there will also be a few good years. Buffett suggests you think of the stock market and its distracting and noisy volatility as the emotionally immature farm neighbour who:

"[yells] out a price every day to me at which he would either buy my farm or sell me his — and those prices varied widely over short periods of time depending on his mental state … If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming."

Despite their apparent significance, events like Brexit represent little more than the noisy neighbour panicking that his farm might fall further in price. The constant stream of discussion, prediction and introspection about interest rates, unemployment, inflation and the economy is nothing more than a distraction from the main game of investing.

Try to avoid the distractions

Now, it is true that prices may indeed fall but should we care? Is the value of a portfolio of pieces of extraordinary businesses determined by daily gyrating prices? We know that a company increases in value by adding retained earnings to its equity capital and maintaining its return on the now larger equity.

If I can find a business that is able to grow its equity tenfold while maintaining its return on the growing equity, I know that I will be able to sell it for far more in the future than I paid for it today. I don't need to worry about China, the US Federal Reserve or Brexit.

Stock market investors forget the valuation mechanics of compounding returns and allow the emotional behaviour of their fellow investors to infect their decision-making, causing them to respond emotionally too. If you didn't rush to sell your home, your hobby farm, your holiday house or your caravan during the tech wreck or the GFC, then there is no reason you should behave differently when it comes to your share portfolio. The only difference is that one is priced daily and the other assets are not.

Price is what you pay, value is what you receive. If that is true, then the value of the portfolio changes much more slowly than prices. Don't let the daily liquidity of shares combined with the noise of Brexit and other macro events dissuade you from taking advantage of bargains or influence you to sell extraordinary companies when their shares are temporarily depressed.

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 circumstances of any individual.

Department stores going out of vogue

John O'Connell

Department stores worldwide are facing challenging times. In the past few years we have seen many department stores marking down prices to move excess inventory, including Nordstrom and Macy's, the darlings among the global department stores. Others like JC Penney and our homegrown Myer and David Jones are still in the process of turning their businesses around.

Even today, with economic conditions in the US and Europe improving, department stores, which straddle the line between luxury, value and convenience, continue to lose market share. Department stores currently account for only 11% of the total US apparel market, down from 26% in 2005. This slump has given rise to questions and fears about the overall health and relevancy of the department store model in today's retail and economic environment.

Australian department store headwinds

Myer and David Jones have had some tough years with both companies taking drastic measures to turn their businesses around and make them more relevant to today's consumers. Target and Big W continue to struggle with Wesfarmers announcing major write-downs and restructuring costs in relation to Target and Woolworths undertaking a comprehensive review of Big W.

Only Kmart has been successful in growing market share. It is a well-managed business and has stayed relevant at a time when consumers were cutting back spending. This phenomenon is similar to dollar stores and Walmart in the US performing well during the GFC and is common during times of economic hardships.

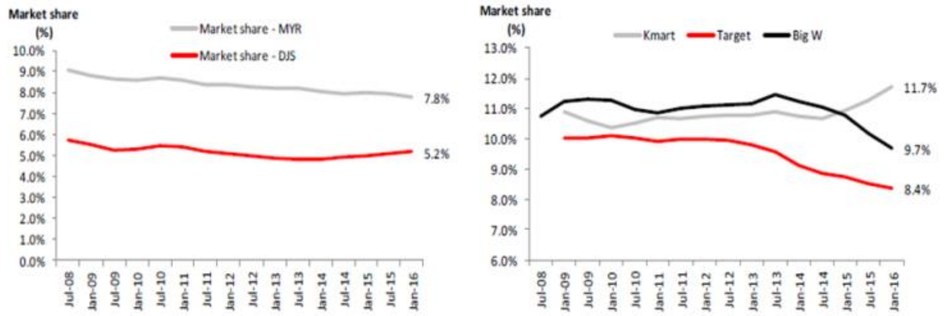
Also affecting the department store sector is the growth of speciality retailers both local and international and the advent of online shopping. A slew of international speciality retailers have set up here and this shows no signs of abating. Then there is online shopping – the elephant in the room. When the Aussie dollar was more or less on par with the US dollar, Australians discovered the joys of shopping online. While the depreciating Aussie dollar has made this less desirable, the ease of shopping coupled with the ability to compare prices means harried Australian consumers continue to shop online.

Shopper habits change during economic hardships

During the GFC, shoppers didn't stop shopping but they did look for cheaper and newer options. They stepped out of their comfort zone and tried new formats and new stores. Those who used to shop at Macy's ventured into Walmart and dollar stores. Those who shopped at Myer and David Jones tried out Kmart, Target and Big W. This changed shoppers' perception of value and some continue to frequent these discount chains even as economic conditions improve.

Ibis World reports that the department stores sector in Australia declined by a compounded annual growth rate (CAGR) of 0.1% over the past five years while the discounted department stores sector grew at an annual rate of 2.1%. Myer and David Jones continue to lose market share in Australia while Kmart has been successful in increasing its market share.

Figure 1: Australian department stores losing market share (except Kmart)



Source: Company data, ABS, Macquarie Research, April 2016

The department store model is losing relevancy

The root cause of the problem goes deeper than shoppers looking for cheaper options. Department stores are unable to remain relevant and viable in an environment characterised by changing consumer behaviour. As Kevin Graff, retail consultant, says, "Department stores are being 'out-retailed' by specialty retailers." Department stores were formed on the premise of convenience, but this exact business model is now working against them.

Younger consumers with little time to spare find department stores inconvenient and time consuming – they are difficult to get to (most are situated in malls which means you have to park elsewhere and walk to the store), they are difficult to navigate (consumers have to walk past myriad sections that they have no interest in to buy just that one product they're looking for) and they do not have enough staff or pay counters (consumes even more time as clients have to go in search of these). And to top it all off they are usually more expensive.

On the other hand, speciality retailers who also straddle the luxury–discount border and thus compete directly with department stores may offer a smaller range of products but boast a better selection in their chosen product range (i.e. women's clothing, swimwear, active wear or toys), more competitive prices, higher quality merchandising, better in-store and service experience as well as a comprehensive online presence.

Department stores' autumn and winter styles usually consist of the traditional dark and dreary clothing. However, hipper specialty retailers like Uniqlo have bucked this trend and are selling bright colours all year round. International specialty retailers like H&M, Zara and Uniqlo have been successful in growing their presence in Australia. While they only accounted for around 1.1% of total sales across clothing, accessories and department stores in Australia in 2015, Macquarie Research expects them to continue to grow their footprint within the country, accounting for around 1.7–2% of sales in 2016.

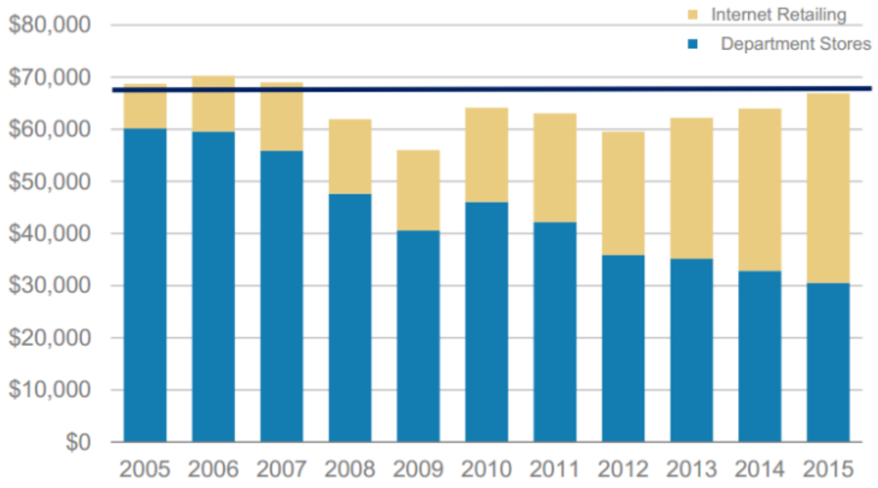
Figure 2: International specialty retailers increasing presence in Australia

Source: Company data, Macquarie Research, Owners Advisory, April 2016

Online shopping is the elephant in the room

Shoppers can go online while travelling home on the train and order a pair of shoes from the US or China at a fraction of the cost, time and effort it would take to shop at a department store. This trend continues to play havoc on retailers. Amazon is now referred to as middle class America's new department store, and Morgan Stanley reports that "internet retailers (led by Amazon) have added US$27.8 billion to their apparel revenue since 2005, while department stores have lost US$29.6 billion". It expects department stores to only account for 7% of the total apparel market in the US by 2020, down from 26% in 2005.

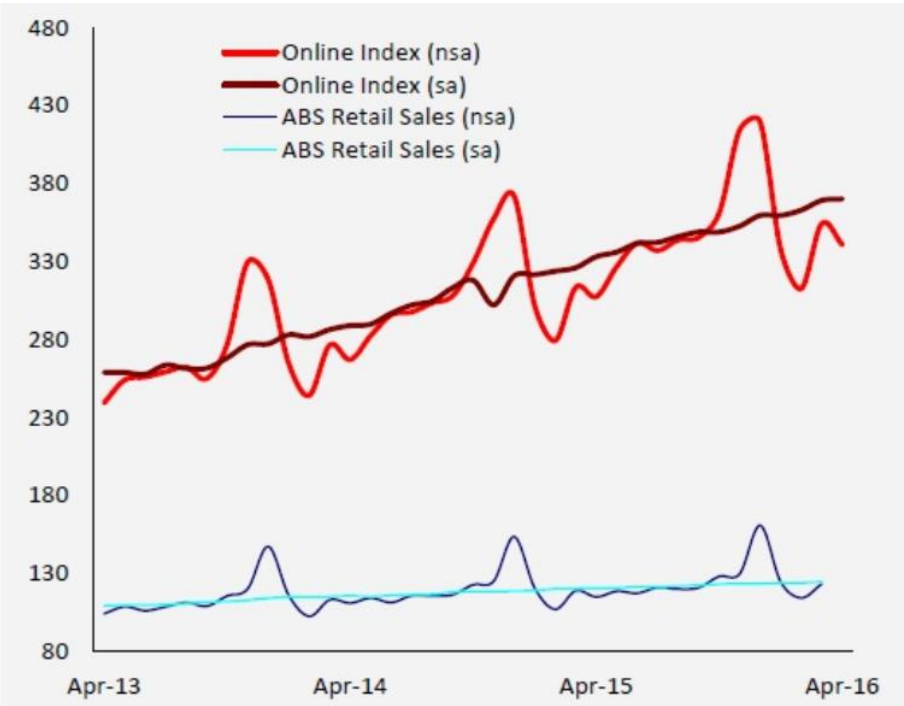
Figure 3: US department stores in a losing battle with internet retailers



Source: Morgan Stanley Research, Business Insider Australia, May 2016

The story is no different in Australia. NAB's latest online retail index reports that Australian online retail sales surged 10.8% in the year to April 2016 reaching a phenomenal A$19.6 billion, growing 3x faster than traditional brick and mortar retail sales.

Figure 4: Australian online retail sales growing 3x faster than traditional retail sales



Source: NAB, Business Insider Australia, June 2016

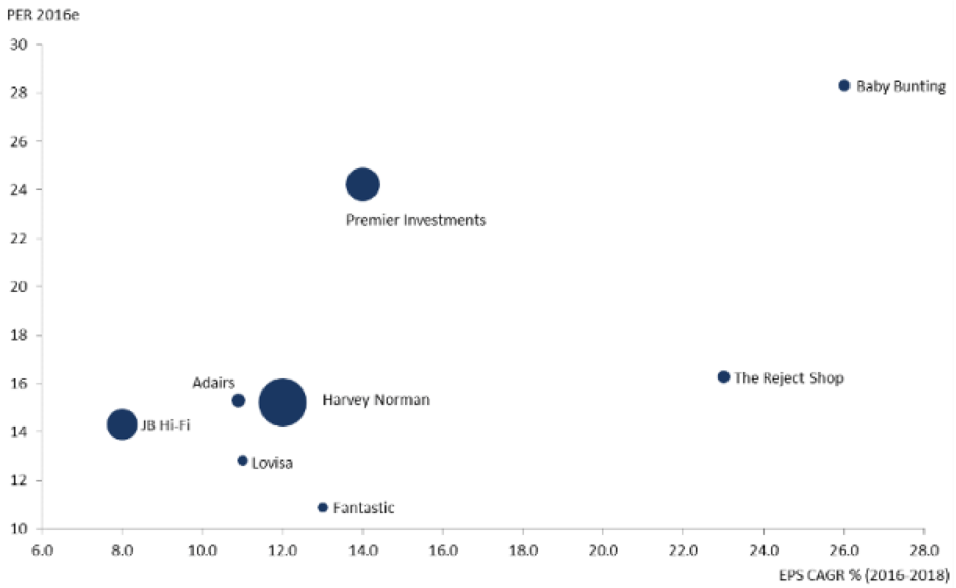
Australia's biggest retailers entered the online game late and are still playing catch up to international retailers. Citigroup reports, that on average, online sales at Australia's largest 10 retailers, represent only around 6% of total sales - well below global online sales penetration of 11%. Australian consumers are bypassing these giants altogether and opting to shop at international e-commerce sites such as Amazon, eBay, asos.com and boohoo.com.

We prefer specialty retailers and remain cautious on department stores

While the department store model may be outdated, not all is over for retail. Experts believe that adopting an omni-channel strategy will allow these department stores to stay relevant even in today's environment. However, they have to act quickly and decisively. Those who take measures to complement their retail presence with a well laid out online strategy, superior customer service and who provide an experience rather than a service stand to gain in this day and age.

Our preference in the retailing sector is specialty retailers like Baby Bunting (baby goods), Adairs (high end linen and homeware), JB Hi-Fi and Harvey Norman (electronics) and Premier Investments (Smiggle – children's stationery). These companies have built a sustainable competitive advantage within their chosen products, boast good growth prospects and continue to exert their dominance by expanding locally and internationally.

Figure 5: Performance of Australian specialty retailers



Source: FactSet, Macquarie Research, Owners Advisory, May 2016

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Nine factors to assess in IPOs with no earnings

Chris Stott

Investors are regularly presented with opportunities to invest via initial public offerings (IPOs) in companies that may appear to be promising businesses, but have not yet turned a profit. Without a track record of earnings, how can investors assess their future prospects?

IPOs without a track record of profits

Before listing, a company must comply with a number of admission rules, including a financial test to satisfy the Australian Securities Exchange (ASX) it meets minimum requirements for size, quality and operations. A company can satisfy this financial requirement by either demonstrating it has a track record of delivering a profit (the profit test), or alternatively has sufficient assets (the assets test). In turn, the assets test can be met in one of two ways, with a minimum of $5 million in net tangible assets (NTA), or a minimum $10 million market capitalisation (the ASX has proposed changing the profit and assets tests thresholds).

Companies in the early stages of their lifecycle, such as IT and biotech start-ups and mining exploration companies, may be more likely to use the assets test to meet the admission requirements.

Here are nine factors we consider at Wilson Asset Management when assessing an IPO:

1. ***Management quality and track record:*** When assessing an IPO with no earnings, management is the most important factor to consider. As I have written in Cuffelinks previously, there are a number of aspects we assess when valuing a company's CEO and management team, including their track record and whether or not they have had previous success in a similar venture.

   In 2009, the former CEO and Managing Director of REA Group Ltd (ASX: REA), Simon Baker, joined iProperty Group together with some of REA's senior managers. As this management team had achieved great success with REA, we had confidence in their ability to achieve the same results with iProperty. Our faith was affirmed when the business was sold last year for $4.00 per share (to REA) after listing at 25 cents per share in September 2007.

2. ***Management's interests:*** When a company floats, the management, including the founder(s), have the opportunity to realise the value of their equity in the business by 'selling-down' their stake to new shareholders. It is critical that the management (particularly, the board and senior managers) holds equity in the company after the IPO. Their level of 'skin in the game' reflects their faith in the future success of the business. This is always a key factor but it is particularly important for early stage companies given their greater potential upside.

   A relevant example is the high profile internet streaming business Guvera which was recently barred from listing by the ASX. With a market valuation of $1.3 billion and no earnings, the management team's intention was to sell-down the majority of their holdings in the business, according to media reports.

   Provisions in the prospectus to escrow shares in the company owned by management, and the length of these escrow periods, are important in determining if management has an interest in the company's success over the longer term. It is also critical to ensure the interests of management will be aligned with the future shareholders' interests through remuneration and incentive structures.

3. ***Capital required to break-even:*** It is crucial to understand when a business anticipates it will reach a break-even point and determine how much capital is required to get to this stage. While an IPO provides an injection of capital to fund a company's operations, it may require additional funding before it will break-even.

4. ***Revenue:*** Although a company may not be turning a profit when it lists, it may be generating revenue which can be a good indicator of future earnings. While valuing an IPO based on its revenue multiple (valuation over revenue) is often shunned by Australian investors, it is commonplace in the United States. In our more recent experience, companies valued on this basis can perform strongly in the aftermarket.

   Technology company Aconex Limited (ASX: ACX) listed in December 2014 and is currently incurring additional costs as it invests in its future profitability. While it is approaching profitability, it is generating revenue through quality contracts with significant corporates. Importantly, it has actual revenues and shareholders are rewarding them with its shares soaring close to 300% since its IPO.

5. ***Prior capital raisings:*** If a company listing has recently raised capital, the price at which it was raised and the 'uplift' the existing shareholders will receive at IPO is important in understanding if the shares represent fair value.

6. ***Intellectual property:*** If a company's business model is reliant on the commercialisation of some intellectual property, investors need to understand those assets and ascribe them value over the longer term. For example, given the declining rate of cash withdrawals as Australia transitions from a cash-based to a cash-free economy, the value of an ATM software business would have been considerably greater ten years ago.

7. ***Competition and barriers to entry:*** A business's competition and the barriers to entering their market will potentially impact its future performance or viability. Potential competition from large industry players that can draw on their scale, networks and other existing assets to compete aggressively should be analysed. Three years ago, Mint Payments Limited (ASX: MNW) caught investors' attention with their innovative wireless payment software. Inevitably, major nationals and multinationals like Apple, ANZ and Commonwealth Bank began competing with Mint through the launch of comparable products. Mint's share price has dropped sharply.

8. ***Third party endorsement:*** Third party support adds to a company's credibility and can be a positive indicator of future performance. The presence of large corporates on a company's share register is one form of endorsement. For example, given their considerable industry insight and experience, having Australian-based carsales.com Limited (ASX: CAR) on their register is a plus for iCar Asia Limited (ASX: ICQ).

9. ***Future earnings valuation:*** It is worth considering how the market will value a business once it starts generating earnings to ensure it uses a sensible valuation tool such as price to earnings ratio or enterprise value.

Investing in a company without a track record of earnings via an IPO is a high risk game requiring investors' patience. To determine if an IPO represents a good investment proposition, prospective shareholders must consider a range of factors and invest time to gain an in-depth understanding of the company and its operations.

Chris Stott is Chief Investment Officer at Wilson Asset Management.

Regtech evolution as compliance drives us crazy

Claire Wivell Plater

Counting the volume of in force regulation hardly sounds exciting, but it was the necessary starting point for the Federal Government's deregulation agenda. The results were startling to say the least.

It turns out that two years ago, the Federal regulatory footprint consisted of about 1,800 acts and over 83,200 subordinate instruments and quasi-regulations. And that doesn't include state and territory regulation or global regulation that impacts on Australian businesses.

Deloitte Access Economics puts the cost of compliance with Federal and State regulation at $95 billion p.a. and - even more disturbing –the cost of complying with self-imposed red tape at an additional $160 billion. That's $28,000 per household! According to Deloitte, compliance workers are now an alarming one in every 11 workers in Australia!

While the Federal Government reports some progress in reducing the cost of compliance through its deregulatory agenda, it appears to be taking three steps forward and 2.9 steps back as new regulation continues to proliferate.

The problem isn't limited to Australia. Thomson Reuters' 2015 Cost of Compliance survey reported that regulatory fatigue was expected to increase globally due to snowballing regulation. Firms were facing difficulties finding and retaining suitably skilled compliance staff due to increased stress and potential personal liability. And regulatory matters are reportedly consuming disproportionate amounts of board time, from correcting non-compliance and preventing further sanctions, to implementing structural changes to meet new rules.

Financial services bears its fair share, probably a disproportionate share, of this burden. Indeed, managing regulation and compliance is one of the biggest challenges for financial services businesses today. It's all very well to aspire to offer world-best customer service, but in many areas, attempts to do so are stymied by compliance and reporting obligations.

So its little wonder that businesses are increasingly turning to technology to help solve the problem. We've seen two distinct waves of regulatory technology development – and we are on the cusp of a third and even more exciting wave.

Wave 1 – Governance, risk and compliance programmes

Governance, risk and compliance (GRC) programmes are a 'linear' response to the proliferation of regulatory requirements (that I fondly think of as 'list and tick'). They offer an online database of regulatory obligations. More advanced applications offer users the ability to customise the obligations to their unique business requirements, add internal business rules, allocate responsibilities and capture reports on the progress and success (or otherwise) of compliance efforts. Worthy Australian providers include CompliSpace, SAI Global and LexisNexis.

Modelled on enterprise risk management tools, these systems have become essential to businesses operating in complex environments to help catalogue and manage the ever increasing regulatory burden.

One thing they don't do is reduce that burden.

All those tasks still need to be allocated to someone. And policies, procedures and tools still need to be developed. Employees need to be trained, supervised and monitored. Regular internal and external audits need to be undertaken to check that the policies and procedures are working. And periodically, the entire system needs to be reviewed for effectiveness. It's exhausting just to think about!

The other thing they don't do is detection.

List and tick programmes are only as good as the data that users contribute. If a person falsely self-certifies, if an overworked compliance manager 'fudges' a monitoring report (just this once!), if a regulatory obligation gets missed or misinterpreted - the assurance reports on which boards rely so heavily could be compromised.

Are they useful? Absolutely. Are they effective to prevent or deter regulatory breaches? Only in the same way that an inventory is useful to tell a business how much stock it has on hand.

Wave 2 – Surveillance

The excesses that led to the GFC, the financial planning and insurance scandals and even the alleged bank bill swap rate rigging are testimony to the fact that the comfort that boards and compliance teams have taken in Phase 1 GRC programs is somewhat misplaced.

After the GFC, in response to the need to prevent such catastrophic market failures going forward, a new wave of surveillance tools emerged.

For example, NASDAQ's SMARTS surveillance technology, which ASIC began using in 2010, enabled regulators and trading marketplaces to analyse trends in market data and identify suspicious trading activity such as insider, high-frequency and algorithmic trading. Today, ASIC has the capacity to continuously monitor suspicious trading patterns that can indicate market misconduct in real time. Because ASIC will investigate and, as we have seen, prosecute such conduct, trading houses can ill afford not to invest in similar technologies.

The downside of these technologies is that the sheer volume of data produced by these systems can create unmanageable overload. It's all very well to know about a problem but if you have so many that you can't effectively deal with them, the information is of limited use.

There is a clear scope for further development of trading surveillance using artificial intelligence which mimics the way the human brain works. Together, data mining, pattern recognition and natural language processing have the ability to distinguish conduct which poses serious risk of non-compliance. This advanced intelligence will help regulators and compliance workers to make better informed and faster choices about prioritising, mitigating and managing regulatory risk. Everyday compliance tasks like fraud detection, currency monitoring and reporting to regulators are increasingly being automated.

Wave 3 – Prevention, rather than cure

Wave 3, which is in its early stages, is being driven by the fact that Wave 2 technologies can only focus on real time or after-the-event detection and reporting. This inevitably requires considerable compliance resources to monitor, manage and rectify problems once detected. The challenge has been exacerbated by social media which has exponentially expanded what needs to be monitored.

When 9% of our workforce is engaged in compliance work, we have surely reached an inflection point. Diverting ever more productive resources into regulatory activity doesn't make economic sense. And the deregulation agenda is hardly likely to solve the problem in any timely fashion. So there appears to be a golden opportunity for more innovative technology solutions.

What might they look like? Well, an 'ounce of prevention' has been worth a 'pound of cure' since the expression was coined by English jurist, Henry de Bracton in 1240. It's time for technology to turn its attention to prevention. Real time. Before the event. And as operational processes are increasingly being automated, compliance requirements can and are increasingly being built into the technology.

The exciting advance offered by Wave 3 technologies is the ability to deploy artificial intelligence and other machine-learning techniques within process gateways so that breaches can be detected when, or even before, they occur and rectified before completion of the activity.

Wave 3 technologies, or regtech as they're now known, will enable firms to detect and manage regulatory and other risks before they even occur. Although Anti Money Laundering – Counter Terrorism Financing identification and verification currently appear to be the most well developed applications, a number of novel applications are evolving out of stealth mode as artificial intelligence capabilities are advancing.

Regulators worldwide are watching these developments with interest. In the UK, the Financial Conduct Authority has called for input on how regtech can deliver outcomes that improve efficiency, transparency and collaboration. The Bank of England has announced an accelerator to work with fintech firms on its unique challenges. And a global regtech capital markets conference is taking place in London in July to debate the need for a 'regtech commons'. Closer to home, ASIC is about to establish a dedicated regtech team and AUSTRAC is actively reaching out to fintech startups.

In a world where poor conduct can be detected and prevented at source, we might even see an acceleration of the deregulatory agenda!

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Index inclusion delayed for China but positives abound

Patrick Ho

China is one of the world's most dynamic economies and the opportunities for investors to benefit from its growth story are tantalising.

While there was a degree of disappointment at MSCI's (a leading provider of global indexes) recent decision to delay the inclusion of China A-shares in its emerging markets and other indexes, investors are keeping their eye on the bigger picture. The long-term impact of the latest delay is likely to be minimal. The momentum is on China's side: it's a matter of 'when' China A-shares are included and not 'if'.

MSCI recognises progress and changes

As a long-term investor in China (we've been there since 1997 and were the first Australian institution to secure a Qualified Foreign Institutional Investor (QFII) quota), it was positive to see MSCI recognise the ongoing reform efforts in China and the progress that has already been made to make China A-shares more accessible for global investors. MSCI noted the 'clear commitment' by the Chinese authorities to bring the accessibility of China A-shares closer to international standards.

The improvements made during the last 12 months include the resolution of issues regarding beneficial ownership, trading suspensions and capital mobility policies.

MSCI's announcement clarified areas requiring further improvements, such as the abolition of China's quota system, liberalisation of capital mobility restrictions, and alignment of international accessibility standards. The 20% monthly repatriation limit of the prior-year net asset value remains a significant hurdle for investors that may be faced with redemptions such as mutual funds. This must be satisfactorily addressed for MSCI inclusion.

How investors would benefit

Investors are already benefiting from the process towards inclusion. The moves undertaken by China to improve accessibility have made the China A-share market more efficient, making it more attractive to international investors. The weighting in various indexes will be minimal to start, at about 5% of the China index, which equates to a 1.1% weighting in the emerging markets index.

Even a small initial partial inclusion will attract greater flows to the China A-share market, particularly from institutional investors. These investors, such as pension funds, are also more likely to invest for the long term compared to the local retail investors that make up the bulk of China A-shareholders. Retail investors are notoriously focused on the short term and, given their weighting in the China A-share market, this contributes to some of the market's volatility. Diluting the retail shareholding will hopefully have the added bonus of making it a less volatile place to invest.

When a 100% inclusion factor is applied, China A-shares would represent approximately 18.2% of the emerging market index, according to MSCI, making it the largest constituent within the index, exceeding even Korea. But it will be a gradual process. For instance, it took six years for Korea to go from 20% to full inclusion and nine years for Taiwan to go from 50% to full inclusion.

Ultimately, MSCI has stated that the future pace at which China's partial inclusion factor is raised will depend solely on the development and further reform of the Chinese market. Given the speed at which China develops and the commitment towards addressing the remaining accessibility issues, China's growth path may be faster than other countries.

China A-shares will remain on MSCI's 2017 review list for partial inclusion but it may happen sooner than June next year. MSCI has flagged it may bring forward a decision before the scheduled timeframe if significant positive developments occur ahead of time.

Patrick Ho is Head of Asian Equities at AMP Capital. This article is general information and does not consider the circumstances of any individual.

Longevity risk cures worse than the disease

Gordon Thompson

Picture this. You and your wife have worked hard all your life. You've raised a family, put your kids through school and paid off a mortgage. You've done alright financially, accumulating a combined superannuation balance of $1 million, putting you in the top 5% of retirees. Now is the time to reward yourselves for the hard slog and sacrifice over all those years, before time catches up with you and it's too late. However you want to be sensible so you go see your financial adviser.

Now you're the adviser sitting across the table from this couple. You congratulate them on their retirement. They're asking about safe withdrawal rates and making sure their money lasts as long as they do. Luckily, having recently read Morningstar's 'Safe withdrawal rates for Australian retirees' you have the answer. Their safe withdrawal rate is a dollar amount calculated as 2.5% pa of their initial retirement balance, indexed each year for inflation.

Less than the age pension

The couple does the maths and realises that this would give them an annual income (adjusted for inflation) of $25,000 pa. They say to their adviser that this cannot be right because if they had nothing they could qualify for the aged pension and receive an annual income of around $34,000 pa. The adviser helpfully points out that age pensioners also received reductions on property and water rates, energy bills, public transport and motor vehicle registration making the total pension package worth around $36,000 pa. Under the asset test changes effective from 1 January 2017, our couple would not be eligible for any age pension.

Based on a full pension package worth $36000 pa and Morningstar's safe withdrawal rate of 2.5% pa, our couple would need a retirement balance of $1.44 million to derive an income from their account based pension that equals the aged pension. A combined balance of $1.44 million would put them in the top 2% of retirees. So unless you are advising only very wealthy clients, Morningstar's safe withdrawal rate is of limited utility.

The gap in Morningstar's analysis is that the minimum level of acceptable income for the self-funded retiree needs to offer more than they would receive on the age pension. Further, the definition of 'ruin' used to assess the safe withdrawal rate is flawed. Morningstar's safe withdrawal rate is based on the likelihood of not running out of money. However, the 98% of retirees who's retirement balance is less than $1.44 million would be better off (in terms of annual income) running down their account balance and becoming eligible to receive the aged pension rather than living a lifetime below the pension income.

What about an annuity?

Our couple leave their adviser's office feeling discouraged. However, they recall seeing an amusing advertisement featuring a retired gentlemen setting off for a drive in the country in his sports car. So they look at what income they can receive with an annuity.

Our couple are both aged 65 and they consider purchasing a joint lifetime annuity with full inflation protection. The quoted rate of income is $3,109 per $100,000 investment. With their million dollar balance this equates to an annual income of $31,090. Our couple can lock in a higher annual income with a lifetime annuity than with Morningstar's 2.5% safe withdrawal rate, but are still locking in a year one income below what they would receive on the aged pension.

Consider the 'Rule of 5s'

What advice would I give our now woebegone couple? Try following the Rule of 5s:

- Take 5% of their account balance ($50,000 for our couple) and spend it on an overseas holiday, a renovation of their kitchen, a new car or whatever the couple desires. This satisfies a behavioural desire for a reward after years of toil. It's also recognition of premature mortality risk. That is, the risk of dying early and leaving too much money to your children.
- Set a variable payment rate from their account-based pension at 5% of their balance recalculated each year. Taking 5% of their account balance would give our couple a first year income of $47,500, a reasonable increment on the aged pension. By making the income variable (as a % of the portfolio balance), the portfolio is more able to handle volatility in values as the drawdown adjusts to the ups and downs of the balance over time.
- Invest in a mix of growth and defensive assets with a long-term expected return of at least 5% pa. I would say a growth / defensive split of 50/50. If the portfolio can generate a return of 5% pa, with the client redeeming 5% pa, then over time the dollar value of the portfolio should be constant (although it will gradually run out of purchasing power over time due to inflation).

Ultimately, even in the unlikely event their money ran out, the age pension is a back up, after many years of enjoying a lot more from life than 2.5% offers.

Gordon Thompson has worked for a range of major financial institutions in banking and wealth management since 1999. This article is general information and does not consider the financial circumstances of any individual.