Cuffelinks
Connecting investors with ideas

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Unexpected results from Federal Election survey

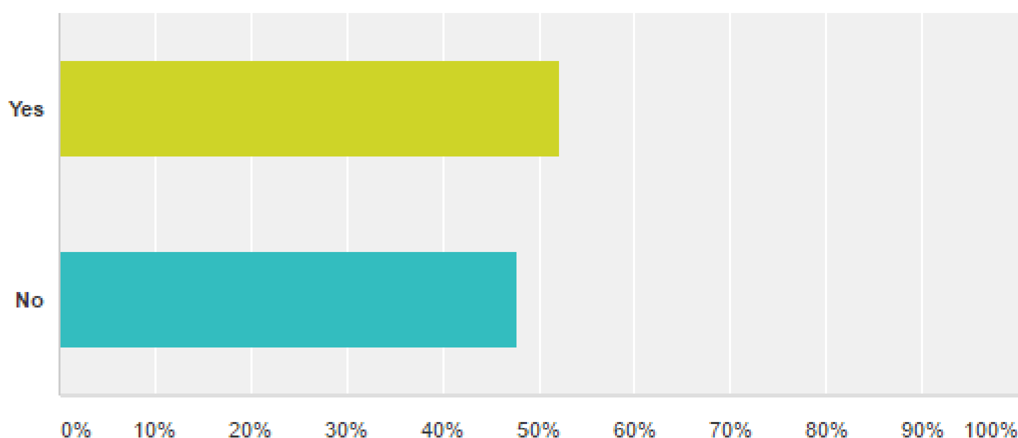
Graham Hand

Another strong response to our election survey, with some surprising results.

We should acknowledge up front that the results from opt-in polls are not as independent as using a statistical method to pick respondents. It's important how people are chosen, and where the respondents choose themselves, pollsters argue the sample does not reflect the general sentiment.

With this qualification, there were nevertheless some surprising results. The hundreds of comments in the survey give more insights into the ways our readers are thinking. The full survey results are linked here.

Q1. Did the Government's proposed changes to superannuation policies influence your vote?



The majority of respondents said the proposed super changes influenced their vote (although as one person commented, the question assumes an adverse reaction). There has been considerable conjecture in the media

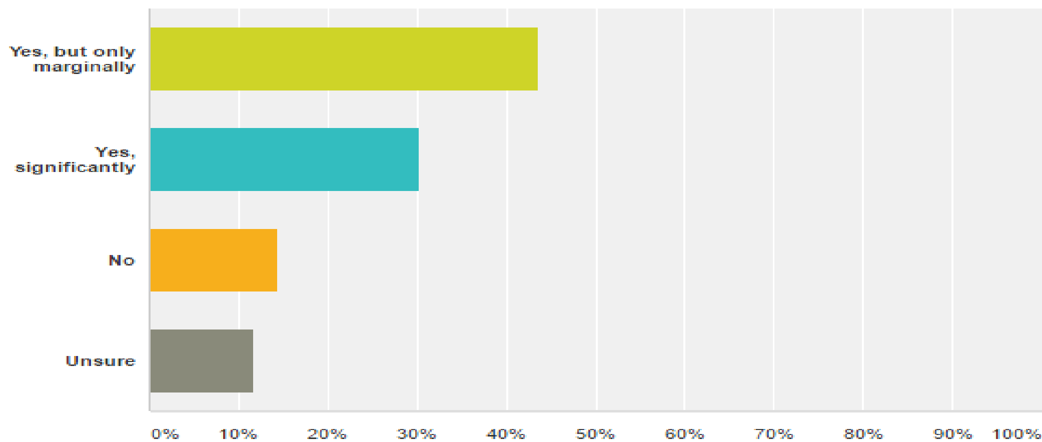
since the election on whether the superannuation issue was significant enough to change votes. This result and many of the comments provide evidence that the changes did motivate voters.

Q2. Which proposed change had a significant impact on your vote?

Answer Choices	Responses	
Backdating of $500,000 non-concessional cap to 2007	36.70%	189
Imposition of $500,000 non-concessional cap, regardless of date of inception	35.15%	181
Imposition of $1.6 million cap on tax-free pension balances	32.23%	166
Overall package of adverse changes breaks a previous commitment	40.39%	208
The changes did not affect my voting intentions	37.09%	191
Total Respondents: 515		

While responses were evenly spread and multiple answers were allowed, the breaking of a previous commitment gathered the most votes. Some of the comments mentioned the reduced concessional cap of $25,000 as a major factor, reducing the ability to salary sacrifice into super.

Q3. Do you believe the proposed superannuation changes affected the overall election outcome?



Another unexpected result, with the majority of people believing the super changes had some impact on the election result, and only 14% going for the firm 'no'.

Q4. How do you compare the Government's proposed super policy changes with Labor's?

While 36% said the changes proposed by both parties were unacceptable, 28% nominated that Labor was as bad or worse based on their proposed $75,000 tax-free earnings threshold. Only 21% said the Government was worse due to the caps on contributions and the new tax-free limits. This suggests many people not only changed their vote away from the Government but also Labor due to both parties breaking previous promises. Perhaps it explains some of the success of independents in the election, especially as a Senate protest vote.

Answer Choices	Responses	
Labor is as bad or worse because it will restrict tax-free earnings to $75,000	28.60%	147
Government is worse because it imposes caps on contributions and tax-free balances	21.01%	108
The changes proposed by both parties are unacceptable	36.38%	187
Unsure	14.01%	72
Total		514

Q5. Do you expect the election results to lead to changes in the super proposals?

Over two-thirds of respondents expect changes, due both to a backlash within the Government, and problems in the Senate. Question 6 invited further comments and the responses are worth reading.

Concluding comments

This issue will run for months. Foreign Minister Julie Bishop said she visited 80 electorates during the campaign and told Malcolm Turnbull and Scott Morrison that she was hearing a lot of negative feedback. Two Government Senators have called for a review. On 9 July 2016, writing in *The Australian*, Judith Sloan wrote a column titled, *'That was not such a good idea after all'*, including:

"The superannuation issue came close to derailing the Liberals' campaign as floods of complaints were fielded: party resignations from longstanding members were reluctantly accepted; donations dried up; and previously willing volunteers refused to help in any way."

In my opinion, the most likely change is the removal of the backdating to 2007 of the $500,000 non-concessional (after-tax) limit. Not only will it be complex to administer and require data going back further than some tax records, but it is the change most vulnerable to the retrospective argument.

For sale: cheaper apartments

Pat Barrett

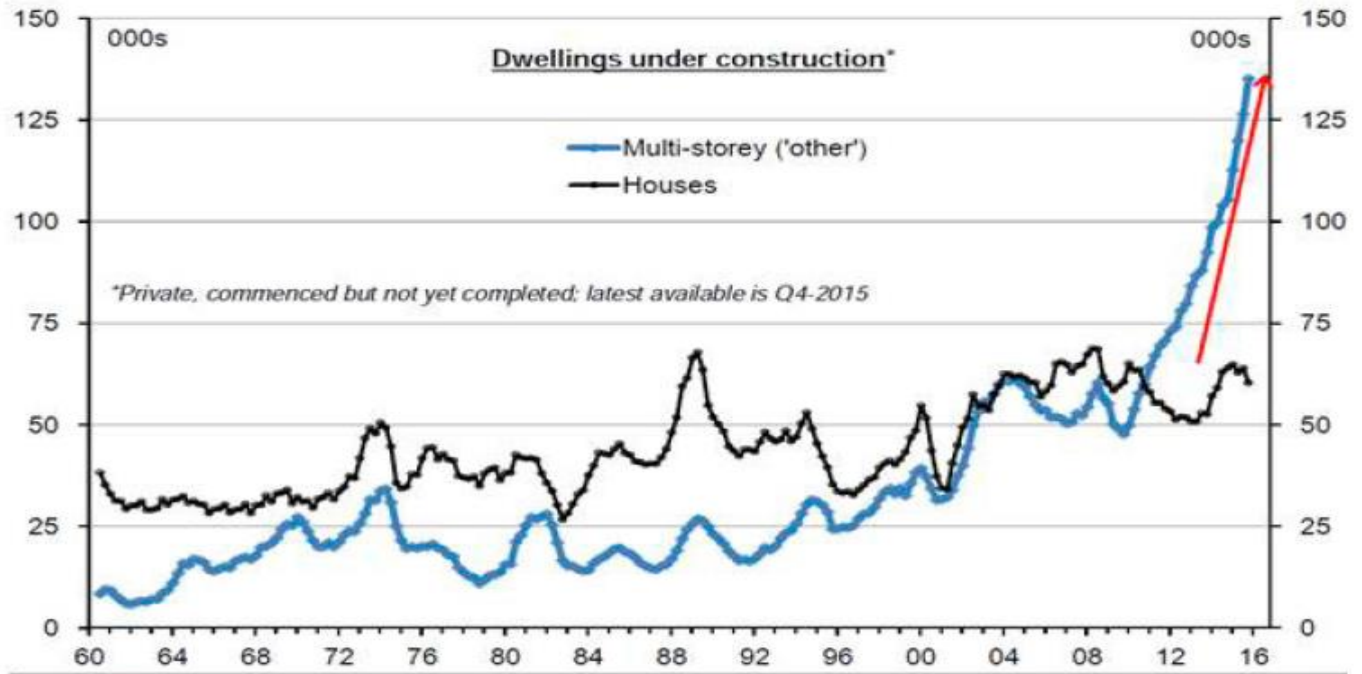
Governments and banks have reacted to concerns over the east coast housing boom by instigating cooling measures. Tighter loan criteria, additional stamp duties, and election debate over negative gearing are all designed to slow prices. However, as the charts below show, there's no need to do anything: the east coast market is about to be swamped with apartments.

The UBS economics team believes there should be a moderation rather than a downturn, as the tailwinds from record low interest rates offset the headwinds of tighter banking criteria and higher taxes. What is most concerning though, is the impending supply of stock.

Record unit approvals

Last year I wrote about the record number of unit approvals along the east coast, with particular concerns about the expected levels of supply in Melbourne and Brisbane. Roll forward to June 2016 and most of those approvals have turned into commencements, with around 137,000 medium density dwellings now under construction. This is about four times more than was under construction in 2000, with 88% of the national total in NSW, Victoria and Queensland. The spike in multi-storey apartments can clearly be seen below, while housing is within historical ranges.

Chart 1: Dwellings under construction in Australia



In absolute number terms, it's startling. Construction of multi-storey dwellings in Queensland is running at five times its levels from the year 2000, while NSW and Victoria each represent over 30% of all supply.

At the project level, supply in Queensland and Victoria is largely centred around CBDs, while NSW supply is more disperse across metropolitan areas, spreading the risk. With this supply largely hitting the market in the next year, will those who paid a 10% deposit be able to finance the settlement of the remaining 90%? As a rule of thumb, we estimate that about 70% of purchasers are local buyers (owner occupiers and investors), while about 30% are connected to foreign sources of capital.

Table 1: Dwellings under construction in Australia by type and state as at Dec 2000 and Dec 2015.

State	2000 – 000's dwellings			2015– 000's dwellings			Increase - multiples		
	House	Multi	Total	House	Multi	Total	House	Multi	Total
NSW	10	14	24	15	50	65	1.6	3.5	2.7
VIC	14	9	23	18	44	62	1.3	4.8	2.7
QLD	4	5	9	8	27	35	2.2	5.0	3.8
The Rest	10	4	14	19	17	36	1.8	4.1	2.5
TOTAL	38	33	71	61	137	198	1.6	4.2	2.8

Source: ABS, 8752.0 Building Activity, Table 77

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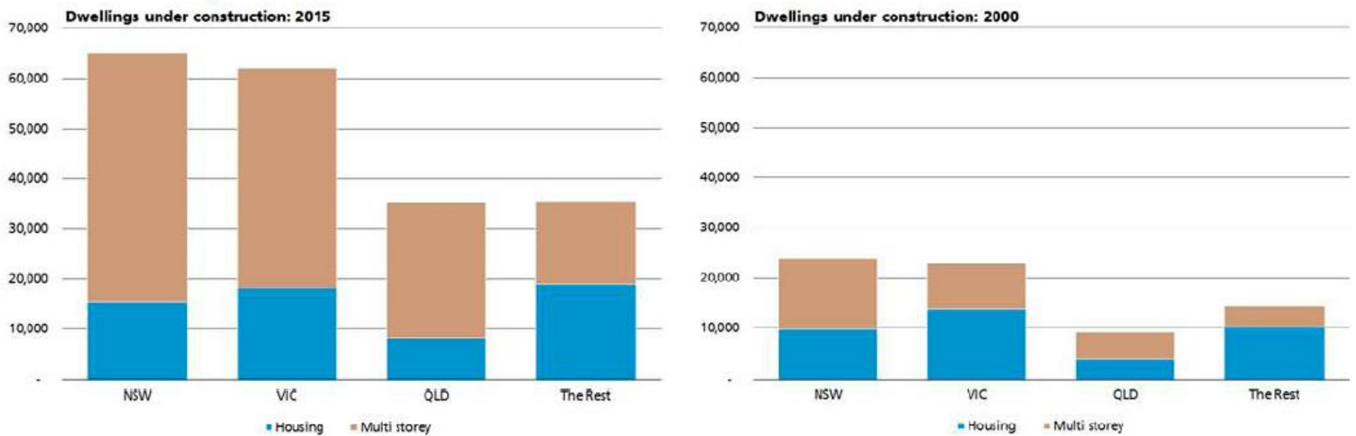
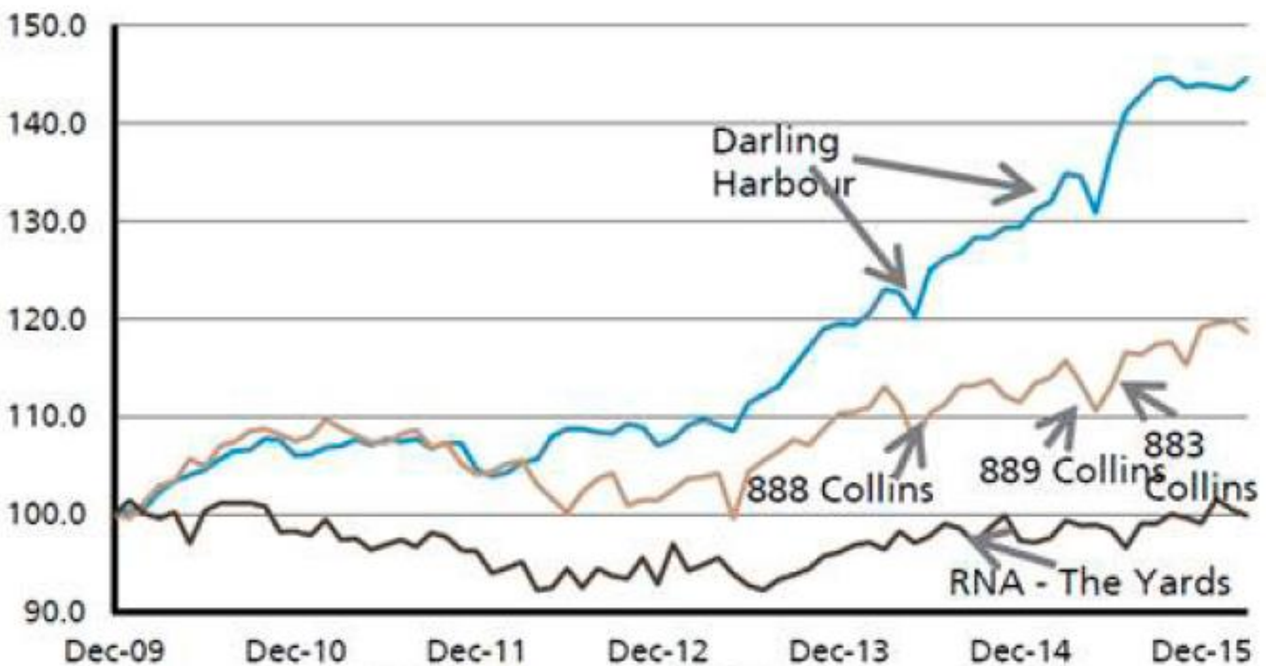


Source: ABS, 8752.0, UBS

Settlement risk

The key question is whether it's in the purchaser's best interest to settle and that will largely depend on price movements between the dates of the deposit payment (10%) and settlement.

Using Lend Lease as a guide, it appears that anyone who bought an apartment in Sydney is 'in the money' and would forego strong capital gains if they walked away from the purchase. Developments such as Melbourne's Collins Street and Brisbane's The Yards are less conducive to gains, as shown in the chart below. While a profitable re-sale in Sydney seems highly probable, it seems less so in Melbourne and more difficult in Brisbane. Interestingly, Lend Lease's highest default rate during the GFC was 3%, versus less than 1% at present. I must point out that the listed market developers like Lend Lease and Mirvac produce higher-quality units that would be more desirable in a re-sale market than some peers.



Financing switching from banks to mezzanine lenders

The great thing about a turning point in the cycle is that those with strong balance sheets and solid cashflows can take advantage of other groups' weaknesses. I recently spoke to three mezzanine loan providers who all said they'd never been busier. When the banks close the doors, other providers step forward and are happy to help, but it will cost more. All three have existing loans to residential developers with solid credentials but were refused construction finance from the big four banks. Two of these were working on plans to raise capital to 'mop up' developers who struggle. Those with strong balance sheets and cash resources such as Mirvac, Lend Lease and Stockland will increase their market share in the next two years.

The oversupply should lead to falling apartment rentals as investors compete to secure income. This will take the apartment yield (net of costs) to less than 2% or 50x price to earnings. Investors would do well to sit back and wait.

For those who wonder what happens to the traditional house and land site, weakness in apartments must have an impact. When inner city apartment rents decline, those renting on the fringes can upgrade location. Pleasingly, housing supply is not excessive and continues to be hamstrung by council approval processes. Note that the two markets (houses and apartments) are distinct with a large family on a suburban block with kids at the local school unlikely to switch to a CBD unit.

Of course, property investment is not only residential. A relatively high-yielding, liquid investment such as a REIT, with capital growth potential and expert management, should not be discounted. With our expectation of low rates and a healthy yield buffer above cash and bonds, we remain confident that investments in commercial property, in particular REITs, will continue to deliver solid returns.

Pat Barrett is Property Analyst at UBS Asset Management. Nothing in this document is to be taken as specific financial product advice. We have not taken into account any individual investor's investment objectives, tax and financial situation or particular needs.

Prepare to pay more for aged care

Rachel Lane

Aged care facilities in Australia are funded by a combination of resident and government payments. In 2013-14, the government spent $14.8 billion on aged care services, with about $10 billion of that going towards residential aged care.

Through a range of different measures, the government is withdrawing about $2 billion of funding from the industry over the next four years, which has left aged care operators with a tough choice - cut their costs to make ends meet or maintain their current standards and ask the residents to pay more. Given that personal care is the greatest expense of an aged care facility, it is not surprising that many operators are choosing the latter.

Levies on aged care residents

While most aged care fees and charges are government regulated, aged care facilities can levy other payments on residents by mutual agreement.

When it comes to accommodation payments, aged care facilities set the market price for each bed. Those who wish to set a price above $550,000 require approval from the Aged Care Pricing Commissioner. The price of the beds must be published in the facility's marketing materials, on their website and on the government's MyAgedCare website. Residents must also be given the choice of paying for their accommodation by a lump sum (known as a Refundable Accommodation Deposit or RAD), a daily charge (known as a Daily Accommodation Payment or DAP) or as a combination of the two. The daily charge equivalent is regulated, with the government setting the interest rate for the calculation, which is currently 6.01%.

So if the market price is $500,000 the resident can choose to pay $500,000 as a lump sum or $82.33 as a daily charge. If they chose to pay $200,000 by lump sum then the daily charge would be reduced to $49.40.

A number of aged care providers have introduced additional accommodation payments. These payments are set by the individual facilities and take a number of different forms – some are fixed daily amounts, some only

apply to residents who pay by lump sum, some are pro-rated (based on the amount of lump sum paid) and some are capped at a dollar amount or after a period of time.

Examples of specific charges

Let's look at some examples. At one group of facilities residents who pay any amount of their accommodation cost by lump sum are charged an additional $10 per day as what the facilities call a 'Capital Refurbishment Fee'. The fee is charged for as long as the resident stays. So if they stay there for two years they will pay an extra $7,300 and if they stay for five years it will cost them $18,250.

At another group, the facilities are graded and the residents are charged an 'Asset Replacement Contribution Fee' of between $13 per day and $18 per day, depending on the facility. Those in the lowest grade only pay the $13 if they choose to pay towards the cost of their accommodation by lump sum, while those in the highest grade pay the $18 regardless of how they pay for their accommodation. So in the lowest grade, residents who pay by lump sum will pay $9,490 after two years or $23,725 if they stay for five years and in the highest grade everyone will pay an additional $13,140 for staying for two years or $32,850 if they stay for five years.

There is at least one group who both pro-rata and cap their fee, which they call an 'Asset Replacement Contribution'. That fee is a maximum of $13.70 per day and is charged for up to 2.5 years and prorated based on the amount the resident pays by lump sum. So if the resident pays entirely by lump sum the cost would be $12,501 after 2.5 years, whereas if they paid entirely by daily charge the Asset Replacement Contribution fee would be zero.

While there are a handful of operators currently levying these fees and charges, there are many more considering following suit. We have already seen significant increases to what residents are paying for additional services such as wine, Foxtel and personal therapies and I expect there will be an expansion in both the services offered and the costs associated with them as operators look for more revenue opportunities.

Call the fees and charges what you like. The bottom line is that consumers should expect to pay more, and in some cases a lot more.

Rachel Lane is the Principal of Aged Care Gurus and oversees a national network of financial advisers specialising in aged care. This article is for general educational purposes and does not address anyone's specific needs.

Align by design: Steps for success in fund manager engagement

David Scobie

Investors tend to focus predominantly on investment capabilities and operational strength when assessing whether to engage or retain a fund manager. These are important factors, but something often overlooked is alignment, or the extent to which fund managers, acting in their own interest, can also act in the best interests of their investors.

Attention to fund manager alignment is part and parcel of good governance. As an investor, you want to know to what extent the two of you are 'in the same boat' – whether your partner is shoulder-to-shoulder with you or is paddling broadly in the same direction but from a separate vessel. The difference becomes most evident when the waters aren't smooth.

We identify three key parties:

- funds management firm (including the owners)
- portfolio managers and investment staff
- investors (including advisers).

Biologists might call this scenario 'obligate disjunctive symbiosis', where two or more species live separately but depend on each other for survival. Each party does not necessarily benefit equally, although that is surely a worthy goal for a successful long-term relationship.

Benefits of alignment

To quote Charlie Munger of Berkshire Hathaway fame: "Show me the incentives and I'll show you the outcome."

Incentives drive human behaviour and we underestimate them at our peril. It's not that the majority of fund managers don't fundamentally want to deliver good outcomes for their clients. Rather, Munger's quote highlights the importance of embedding a natural proclivity for that to happen.

The right alignment structure:

- motivates the investment team to 'go the extra mile' to the benefit of all parties
- creates an atmosphere where there is less second-guessing as to what the other party is doing and what their motives are
- should result in less fund manager switching over time. Changing managers is typically costly, time-consuming and subject to transition risk – in short, where possible it is best avoided.

Steps to improve alignment

Co-invest for success

Assume you have a large amount of money to invest. Would you want your portfolio manager to have a significant amount of their own money similarly invested or not have that sort of skin in the game? Why would they not invest in the same product?

A significant co-investment supports the notion that the manager is going to actively manage the risks in addition to pursuing as much upside as possible.

It's more the exception than the norm to see disclosure details on co-investment, but it does happen. To quote an actual factsheet of an equity manager: "The portfolio manager has $100,000 invested in the fund, and staff have $1.5 million invested in the fund, as at quarter-end." We can make a judgement call as to how meaningful such amounts are to the staff concerned.

Share a mutual timeframe

As an investor, do you have a long-term investment mentality and have you discussed it with your fund manager? A lot tends to get assumed.

If a portfolio manager detects that his/her client base is likely to react to short-term outcomes, they are not encouraged to make longer-term strategic decisions that may well be in the best interest of clients. Good investments often require patience and a side benefit is lower trading costs from lower portfolio turnover.

Defer a portion of rewards

If your portfolio manager performs well and gets a bonus – preferably reflecting a multi-year outcome – then great. But what should happen to that bonus? Would you rather it was released straight away as cash, or half of it was invested in the investment product for a minimum of say three years?

Most of us would take some comfort if the manager had that sum locked away for a while. Then there's less inducement to take risks in the portfolio which may pay-off in the short term but 'come home to roost' later.

Support board independence

As an investor, would you want the board of the funds management entity to have independent directors or consist entirely of internal executives?

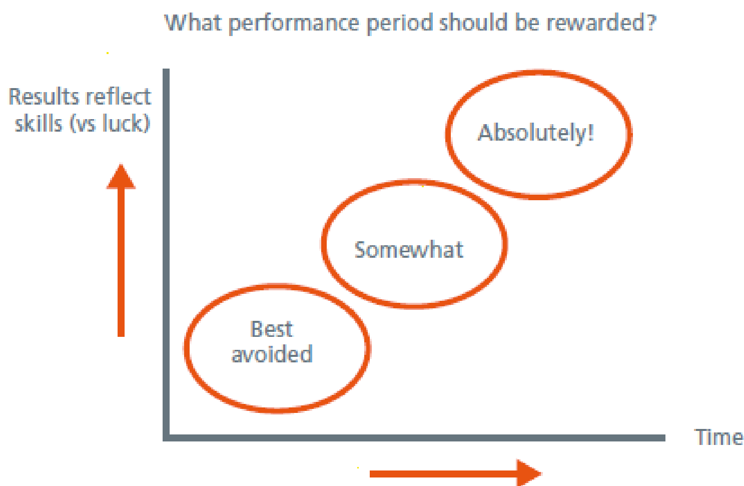
Some board independence helps balance the interests of the three parties referred to earlier – shareholders, staff, and stakeholders such as clients. While their presence is no guarantee that investor interests will be at the fore, they offer an increased chance of broad representation at the board table.

Think strategically about fees

When it comes to fees it is useful to establish some principles:

- Fund managers are entitled to rewards that reflect the true value of their skills
- As an investor you want to reward skill, though the real question is how much is too much?
- When it comes to performance-based fees (PBFs) the devil is often in the detail, but a well-designed structure will help create an alignment of interests. This means a benchmark-like performance will receive a lower fee while a great performance should garner a higher fee due to higher investor returns.

Fund managers generally prefer their performance to be judged over a period of years rather than months, as that is the timeframe over which their efforts can crystallise. This is fair enough, though by the same logic, it makes most sense for PBFs to accrue based on a similar time period, as depicted in the area towards the top-right in the chart below. The longer the period, the higher the confidence that skill rather than luck is being rewarded.



Discourage personal trading

There's plenty of merit in your portfolio manager co-investing in a product, but would you want them to be able to trade in the same asset class separately on a personal account?

In part this represents a compliance issue (prohibiting or making transparent certain trade activity), but even if personal trades are cleared through internal compliance teams, the scope for conflict of interest is hard to eliminate. And, as a fund management firm, why open up the risk in the context that, as a general statement, portfolio managers are fairly well compensated for their 'day jobs'.

Consider the ownership structure

Where investment staff have an ownership stake in the firm, does that promote alignment?

On the positive side, ownership by key individuals can help with staff retention, amplify incentives for the business to succeed, and help foster a longer-term mindset.

On the other hand it ties individuals more directly to the interests of the business, being the total revenue picture, rather than the out-performance of a certain product per se. This is particularly relevant if the product you are invested in does not represent a large part of the overall business, i.e. the success of the firm may not be closely tied to how well that product does. And there is an issue of what to do if a staff member is a shareholder but the strength of their contribution diminishes. Arrangements can be a bit hard to unwind, even though parting company may be the best outcome for the business and for clients.

Hence we can regard the self-ownership model as positive in many respects for alignment purposes, but not purely so.

Improve and monitor implementation

Some challenges present themselves when trying to execute material change to alignment structures. Many investors are not big enough, relative to the size of a manager's total client base, to have meaningful influence. Existing fee structures may be so ingrained that there is little chance of affecting change. In some cases, managers have been so successful that they do not feel obliged to be flexible on arrangements – 'there is plenty of demand so if you want to invest with us, these are the terms'.

The reality is that negotiation is mostly evident when (a) the investor is large and/or prestigious and (b) the manager or strategy is in its relatively early stages – as they saying goes, he who is most hungry is most flexible. In some cases, smaller or boutique-type firms are well-placed to apply flexibility given relatively smoother pathways to implementing internal policy changes.

Notwithstanding some implementation challenges, fund managers should be open to ways to improve mechanisms for stronger investor alignment.

Conclusion

While it is not realistic to expect every fund manager to tick every alignment box, investor interests need to be at the forefront of the manager selection process.

To sum up, well-structured alignment arrangements:

- underpin a sense of partnership between investors and fund managers
- promote strong performance and risk management, and
- minimise costs related to intensive monitoring and changing managers.

David Scobie is a Principal in Mercer's Investments business, based in Auckland. David advises institutional clients on their investment policies and structures. He is also involved in evaluating fund managers, linking in with Mercer's research capability in Australia and globally.

For a copy of the more detailed paper on manager alignment, click on this link.

Diversification in thinking and practice

Jack Gray and Steven Hall

In 2015, Brookvine ran a workshop modestly entitled 'WhiteBoarding 2.0' where advisors and Chief Investment Officers to High Net Worth (HNW) clients and Family Offices (FO) assessed the role of diversification in their thinking and practice.

The wisdom of diversifying is ancient: Warren Buffett has stated that it's a hedge against ignorance and a modern version of the biblical instruction to 'divide investments among many places, for you know not what risks might lie ahead'. A millennium later, the Talmud offered an explicit and not unreasonable uniform diversification, to divide equally across 'buying and selling things' (equity), 'gold coins' (cash) and 'land' (real estate).

Selling diversification to HNWs

Until Modern Portfolio Theory (MPT) came along, diversification was justified by the slogan 'don't put all your eggs in one basket' as opposed to the less common but for some equally valid, 'put all your eggs in one basket but watch it very carefully.' By quantifying risk, Nobel Prize winner Harry Markowitz transformed diversification from a slogan to an explanatory and operational tool. Diversification went from theoretical insight to black letter law in a mere 20 years and became an investment truism, the 'single most important thing' in portfolio construction. Superannuation funds must 'have regard to' diversification and for MySuper funds, it is compulsory. Yet many private wealth portfolios and SMSFs are less than 'optimally' diversified … often for sound reasons.

Most wealth is created by HNWs through direct investment in a single business. That makes it hard for wealth creators to appreciate the logic of diversification in their investment portfolios as they transition from getting-rich to staying-rich. Sensitive advocacy is needed to convince HNW families of the efficacy of diversification in preserving capital, especially in explaining the need for unconventional asset classes such as private real estate lending, catastrophe bonds, real assets like agriculture and timber, infrastructure, oil/gas, and collectibles including art that are unfamiliar and hard to access. Advocacy can be re-enforced through 'diversification' of a different type in which portfolios are structured around different purposeful 'themes' such as income, aspirational/opportunistic, security, legacy/philanthropic, and fun/trading.

Whether diversification is a free lunch led to vigorous discussion among participants at the workshop. Forceful comments were made on the cost and risk of 'diworseifying', a consequence of agents minimising business risk, consistent with Berkshire Hathaway's Charlie Munger's statement that "diversification is a veil to hide behind". A more direct cost flows from the added complexity of more asset classes demanding more advisor time, thus making fees an issue. Costs led to an engaging debate around the perceived recent failure of diversification exacerbated by the one-way path in asset prices clients have experienced for almost a generation. Some advisors saw a consequent need for more dynamic approaches to diversification.

Two brothers with different goals

A case study involved two brothers who were distinctly different investor types with different goals and objectives. Because decisions have financial as well as emotional or psychological dimensions, advisors need to appreciate families' experiences, expectations and idiosyncrasies lest diversification remain an abstract notion. These include:

- any relevant friction within families
- what they most worry about
- the time horizon they think in terms of
- the level of control they want
- any roles they want to play in decision-making
- their biases and strength of their convictions
- the extent to which unrealised taxable gains are an impediment to change

- their personality types
- how they think about and describe risk
- any comparative advantages the trusts have.

These can be partly expressed in a 'family governance document' that can help link investment strategies to financial and emotional well-being.

Klyde, an entrepreneurial businessman who created his wealth by building a narrowly focused business, established a trust for the benefit of his immediate family and future generations. He struggles to relinquish control, making the trust's implicit purpose somewhat ambiguous and therefore a challenge for an advisor wedded to the tenets of MPT. His brother, Cerry, a delegator with minimal interest in investing, established a perpetual philanthropic trust to support the arts with an explicit objective: spend 5% per annum to maintain its tax-free status.

Klyde had tried to diversify his businesses with disastrous results, an evident source of resistance to portfolio diversification. His trust's initial configuration, dominated by the idiosyncratic risk of a single business, was seen as dangerously under-diversified, exposed to a meaningful risk of a sizeable capital loss that could be materially reduced through diversification. Advisors favoured slowly but tax-effectively reducing the weight of legacy assets and crafting a portfolio with more calculated bets, and direct ownership of some other assets. They recognised cash as a very active component of the portfolio and favoured a program of sizeable shifts in allocations.

Alternative investment models: entrepreneurial and transitional

The entrepreneurial model favours a concentrated set of investments familiar to Klyde, combined with interests in operating businesses aligned to his experience a bias away from co-mingled funds. This model needs to be managed by an in-house team supplemented by external advisors. The initial lack of diversity may be partly compensated for by its unique deal-flow advantages.

The transitional model reduced the weight of the legacy business and favoured a far higher weight to non-operating assets with a more conventional notion of diversification through a planned transition to a broader array of assets. This model is more accepting of co-mingled funds, and of public markets and alternative assets. Nonetheless, it is avowedly opportunistic and ready to work with Klyde in vetting opportunities originated through his networks. It demands more sophisticated external advice for origination, due diligence and monitoring.

Cerry's philanthropic trust was less problematic. Its purpose is explicit and tax plays a marginal role, while on the psychological side Cerry is unlikely to argue for greater concentration or control. Advisors saw the initial configuration, dominated by Australian real-estate, as dangerously under-diversified, exposed to a meaningful risk of a sizeable capital loss which could be materially reduced through sales, with the proceeds directed towards diversification. Cerry's trust also has paintings: legacy assets where he has a strong emotional attachment. Such collectibles can play a powerful diversifying role.

For Cerry, a third outsourced model was preferred where management is primarily delegated to an investment advisor with a portfolio that blends traditional public markets with a heavy mix of alternative assets. Benchmarks and tracking error were, by institutional standards, irrelevant because, being perpetual, the trust should have considerable tolerance for short-term variability and should favour long-duration and particularly real assets such as infrastructure and timber.

Conclusion

WB2.0 re-enforced the view that diversification is an effective way of reducing risk of capital loss and of lowering volatility. It is almost a free lunch. For large institutional funds it should be weakened only under justifiable circumstances. For smaller Australian private wealth funds its full benefits are harder to achieve due to tax, liquidity needs, access to unfamiliar assets and the technical nature of arguments. It is difficult for advisors to convince clients of the need for some diversification given the concentrated approach founders relied on to accumulate wealth and their strong emotional attachment to their businesses.

WB2.0 did show that the nuances of diversification are not fully understood. Its value will be questioned again if the next crisis sees all assets go down together. Nonetheless, thinking and practice have evolved. Advisors are seeking unconventional assets that offer stronger diversification benefits; they are questioning the 'optimal'

level and type of diversification, thinking about diversifying across risk factors and exploring more dynamic approaches to asset allocation. As one participant wisely observed, "Diversification is harder to deliver, but the results are better and you have happier clients."

Jack Gray is a Director and Advisor, and Steve Hall is the Chief Executive Officer of investment manager and advisor Brookvine. Whiteboarding 1.0 and 2.0 are available on request via www.brookvine.com.au. Jack has been voted one of the Top 10 most influential academics in the world for institutional investing.

Bond indexes do not reflect the market's diversity

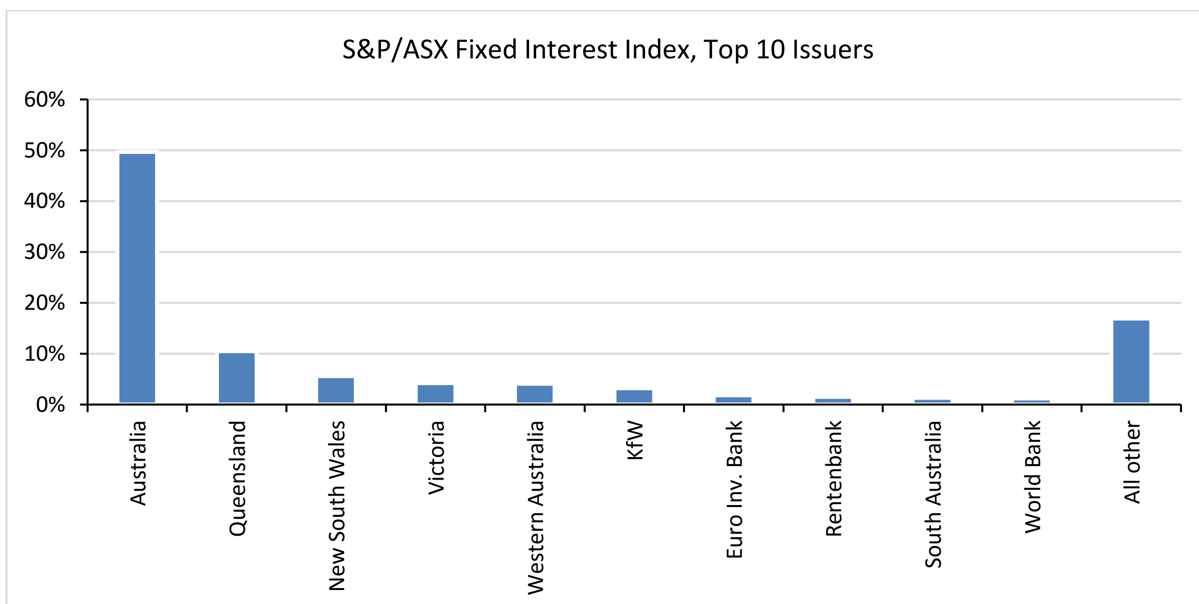
Alexander Austin

Superannuation funds generally benchmark their domestic fixed income asset allocation against a market capitalisation weighted investment grade bond index such as the S&P/ASX Australian Fixed Interest Index or the Bloomberg Composite Ausbond Index. Bonds are included in these indices if they meet certain criteria (such as Australian dollar denominated, fixed rate, minimum issue size, investment grade rating) and are weighted in proportion to their market value.

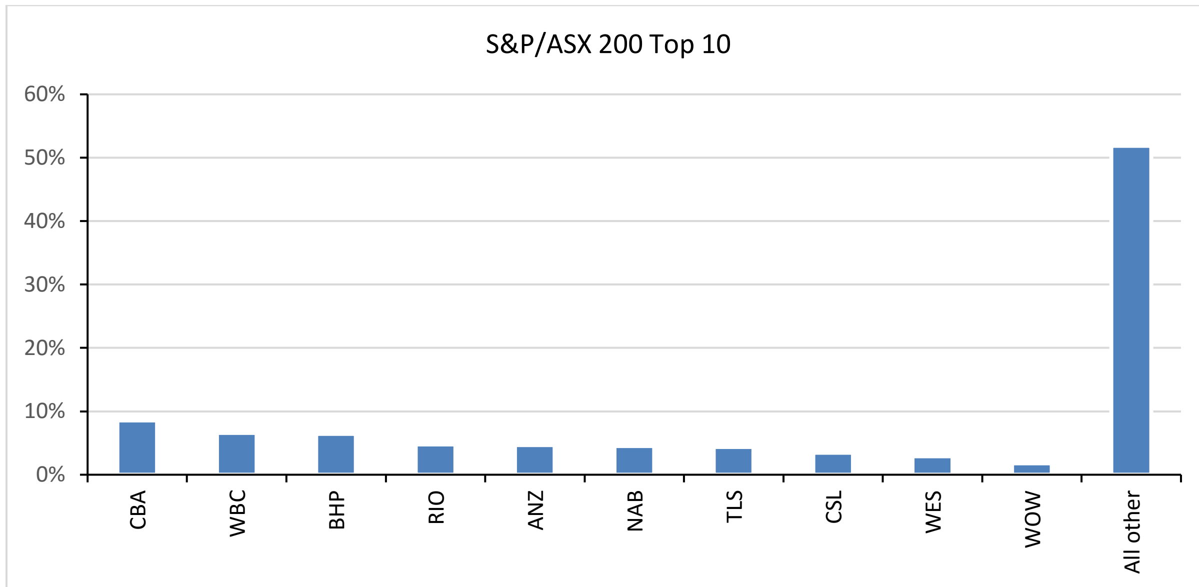
Index is heavily concentrated and unrepresentative

Diving into the S&P fixed interest index, the top 10 issuers are either Commonwealth or state governments or European development banks. The largest non-government issuer is KfW (Kreditanstalt für Wiederaufbau), a German development bank.

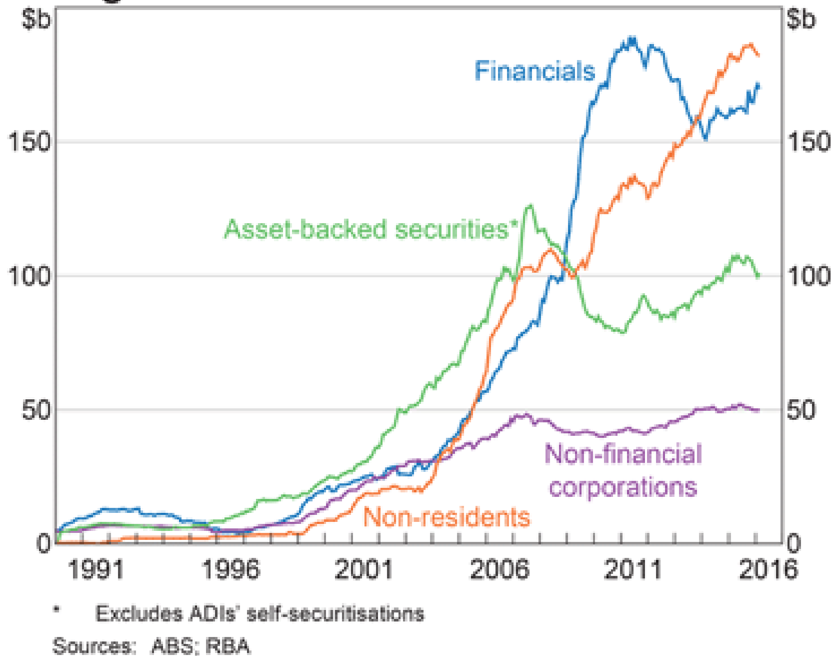
The top 10 issuers comprise 83% of the index. The total index has a modified duration of 5.2 years and a yield to maturity of 2.14% (at time of writing). Investors might be surprised that no Australian company (for example, any of the big four banks) makes the top 10, while Australian governments occupy the top five positions.



By comparison, the top 10 issuers in the S&P/ASX 200 equity index account for only 48% of the total market value, and even this is concentrated by global equity index standards.



There are approximately $650 billion worth of government bonds and $500 billion of non-government bonds on issue in Australia. About a third of the Australian non-government bond universe is comprised of bonds issued by non-residents, rising dramatically from last to the largest share in the last 15 years, pausing slightly during the GFC (but nowhere near as much as asset-backed securities).



The next biggest category is financials, which is dominated by the bonds of the big four banks.

Only about $50 billion are comprised of domestic non-financial corporates. That is, only about 10% of non-government bonds are what you would typically consider Australian corporate credit.

This is tiny when compared with the loan market. According to APRA data, Australian banks have loans to Australian non-financial corporates of more than $650 billion.

Traditional composite bond funds are meant to provide investors with a balanced exposure across borrower types. Investors should understand the components of any fixed interest index and judge how representative of the desired underlying investment universe the index really is.

Alexander Austin is Chief Executive Officer of Infradebt, a specialist infrastructure debt fund manager. This article provides general information and does not constitute personal advice.

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