Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

Major investment themes and the fund manager's dilemma

Hamish Douglass

We've been through an extraordinary period where global asset prices have been dramatically influenced by the activities of the major central banks. We don't need to look too far to gain a perspective on whether the world is 'normal' at the moment.

Two-year government bond rates in virtually every European country except Portugal and the UK are currently negative. This includes Spain, where unemployment is above 20%. Mexico recently issued a 100-year bond, while Unilever issued a four-year bond at a zero yield. Is this the 'new normal'?

Central banks distorting asset prices

These sorts of dynamics in bond markets are having rather unusual consequences. Investors now pay Japan or Switzerland to hold their money for the next decade to achieve some semblance of a yield. This is clearly a distorted situation caused by the G7 central banks. It's also distorted by countries such as China, Saudi Arabia and (until recently) Switzerland, which are actively accumulating foreign exchange and buying bonds. The central banks of these countries have bought 70% of all debt issued by the US, Europe, the UK and Japan over the past 10 years or so.

A situation where central banks buy vast amounts of bonds is unprecedented. As more bonds are bought, prices rise and interest rates fall. This leads some investors to the conclusion that government bonds are not attractive in this environment, so they invest in the next closest asset: investment grade corporate bonds. In trying to visualise the impact of central banks pouring more money into the system, think about a champagne glass pyramid, where champagne is poured from the top and eventually overflows and floods the glasses below. In a financial markets context, flooding the market with liquidity means everything gets repriced – even emerging markets, junk bonds and commodities. The central bank actions that began in 2009 and ran through to June 2015 are having quite a pronounced impact: bond prices and equity markets have soared while junk bond spreads have halved.

The questions that need to be answered are these: when will central banks start selling the assets they have bought? When will the US Federal Reserve start shrinking its balance sheet? When will the European Central Bank stop its printing presses?

I argue that we have seen the first 'canary in the coalmine' over the past year as China, Saudi Arabia and Switzerland have started to sell some assets. And there has been a repricing of assets such as high-yield or junk bonds, and a fall in some emerging-market currencies. When central banks eventually tilt away from extraordinary monetary policy measures, other assets might find new lower levels.

The fund manager's dilemma

We are at a definitive fork in the road. As a fund manager entrusted with fiduciary responsibility for the life savings of many individuals, it's a real dilemma positioning yourself in a world where interest rates could either rise or fall from today's extraordinary low levels. In our view, the most likely scenario is a stabilising environment. Markets have bounced back from their early 2016 lows and we have seen more benign economic signals from China, so we don't expect a major fall in the renminbi.

But there could easily be further economic turmoil, which is why the Fed is holding fire at the moment. The Fed doesn't have enough evidence regarding China's economic prospects. That said, we absolutely recognise the risk of the complete opposite occurring: a world-wide recession. I put this probability at only about 15%, although a year ago I rated it at only a 5% chance of occurring.

Where we still find value

We have retained a cautious stance on equity markets for the past two years, which is reflected in our portfolio positioning in high-quality names, along with a material exposure to cash. We want to pay our investors a satisfactory return on the capital they've entrusted us with over the long term, and we are not concerned about what markets do in the short term. We are committed to achieving a total return target over time.

We invest in many companies that feature globally recognisable brands: Apple, eBay, Oracle, Microsoft, MasterCard, PayPal, Alphabet (Google), Lowes, Home Depot and Woolworths (in Australia). The positions in these names reflect some major trends that we see playing out over the medium to long term. For example, there are powerful technology platforms that are having a profound impact on the way people interact and do business.

There is a trend towards moving computer power away from offices to huge data storage facilities around the world known as the 'cloud'. Alphabet and Microsoft have large businesses here.

Think about advertising: there are two huge digital advertising platforms in the world: search-based advertising controlled by Google and social media-based advertising controlled by Facebook.

The monetisation of consumer services via smartphones is led by Apple and Google. In 10 or 15 years, cash will become largely redundant in the world as digital payment systems are entrenched in our everyday lives. We own MasterCard, Visa and PayPal, which are clear beneficiaries of this trend.

Apple's success in recent years has been tied to the iPhone, with about 70% of its profits generated from handset sales. But history tells us to be very wary of this sector. There are plenty of examples where seemingly cutting-edge devices are rapidly developed, only to become commoditised. Nokia was once the darling of the mobile phone market; today it doesn't exist. Microsoft bought the company for US$8 billion and has written down almost the entire amount. Remember the Blackberry? And the Motorola Razr was the fastest-growing consumer electronic device in history before the iPhone; it no longer exists.

But today, Apple really shouldn't be seen as simply a hardware device manufacturer. Its intrinsic value lies within the operating platform and it's the software inside the phone that reflects its future earning power. Today there are just two operating systems in the world, Google's Android and Apple's iOS. This duopoly is here to stay and it is highly unlikely we will see another operating system developed in at least the next 10 to 20 years.

Buying an iPhone for about $600 actually represents a subscription to the ecosystem, which adds about $30 a month to your phone bill. Look forward a few years and Apple won't be worried about 'winning the war' because nearly all handsets sold will be replacements. There is still plenty of new growth potential as only about 40% of people globally have a smartphone.

We believe Apple is fundamentally cheap because the market's short-term focus is on how many phones were sold in the past year.

Our job as a fund manager is to focus not on the past six months, but on the next three to five years. It's a different mindset when considering the long-term prospects for people's retirement savings.

Hamish Douglass is Chief Executive Officer, Chief Investment Officer and Lead Portfolio Manager at [Magellan Asset Management](). This article is general information and does not consider the circumstances of any individual.

Central banks have lost the plot

David Bassanese

The recent annual meeting of global central bankers at Jackson Hole came at a time when investors are beginning to question the wisdom of ongoing extreme monetary stimulus. Contrary to many critics, my concern is not that these measures have not worked. Rather, I maintain they're simply not needed, as the global economy is as good as might be expected once allowance is made for slowing potential growth and falling commodity prices. To my mind, the far bigger global risk now is the impact of persistent misguided extreme monetary measures on financial stability.

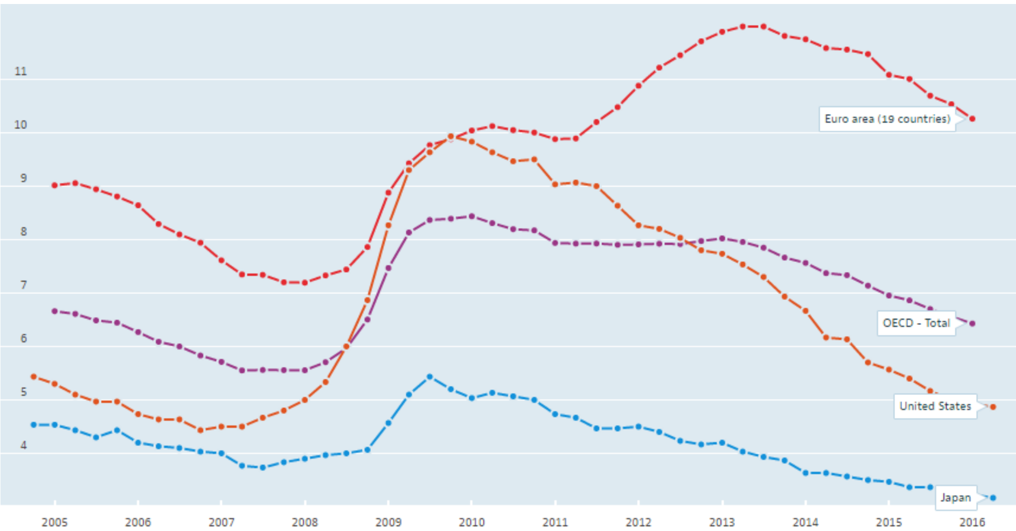
Global growth has been OK

Global economic growth in recent years has been commonly perceived as disappointing, which in turn has been attributed to the scale of the financial shock endured in 2008. Indeed, in developed economies – which are most responsible for today's extreme monetary measures – annual GDP growth among members of the Organisation for Economic Cooperation and Development (OECD) averaged 1.7% p.a. in the five years to end-2015, compared with 2.8% p.a. in the five years to end-2007.

Around half of this slowdown has reflected a decline in working-age population growth (from 0.8% p.a. to 0.2% p.a.), with the other half reflecting weaker growth in GDP per working-age person (i.e. weak productivity). In other words, most of the slowdown in growth among developed economies since the financial crisis has reflected weaker *potential* growth.

Indeed, as the chart below shows, economic growth across the developed world in recent years appears to have been *above* potential, as evident from the fact that unemployment rates have trended down. The unemployment rate averaged across the OECD has declined from a peak of 10.4% in March 2010 to 6.4% by March 2016. Only in Europe is the unemployment rate still clearly above GFC lows, but it has also fallen notably in recent years.

Unemployment rates in selected OECD economies



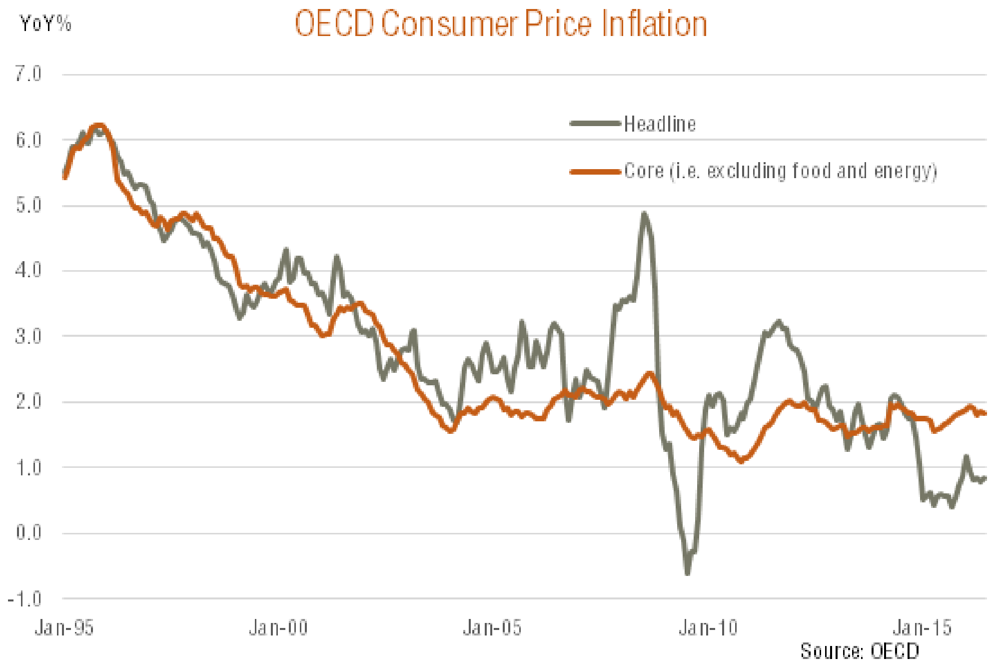
Source: OECD

The Reserve Bank of Australia acknowledged decent growth in the developed world in its August 2016 Statement on Monetary Policy, stating, "Labour market conditions in most advanced economies have continued to improve and a number of these economies are close to full employment." Crisis, what crisis?

Global inflation is not perilously low

The argument that inflation across the developed world is perilously low, suggesting we are at risk of a deflationary slump, also does not stand up to scrutiny.

As the chart below shows, headline consumer price inflation across the OECD is relatively low at present, with prices up 0.9% in the 12 months to 30 June 2016, compared with an average since 2004 of 2.1% p.a. Most of this drop in inflation reflects the decline in commodity prices in recent years. In the year to 30 June 2016, core OECD consumer prices (i.e. excluding food and energy prices) were up 1.8% – equal to their (relatively stable) average since 2004.

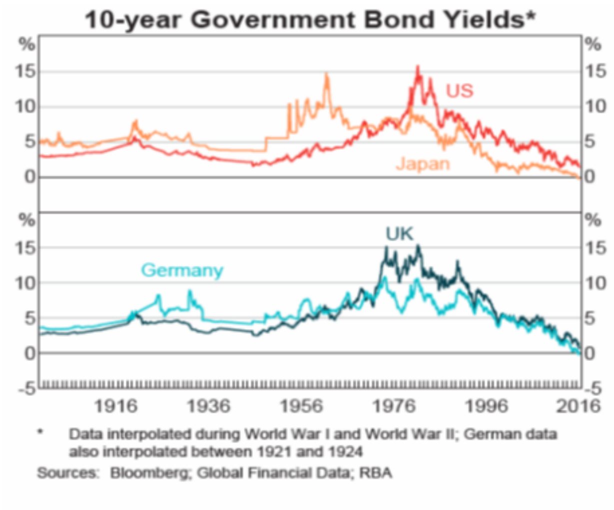


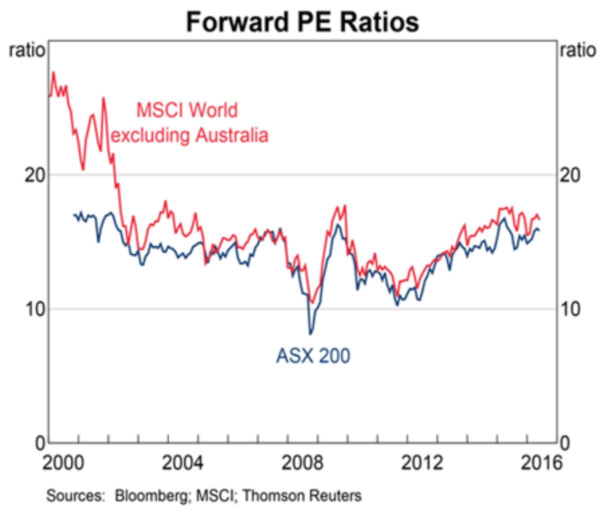
The case for extra-ordinary monetary stimulus in most of the OECD seems very weak. In the case of the Euro-zone, growth has also been above potential, though the unemployment rate remains elevated compared to pre-financial crisis levels. It's also the case that core inflation in the Euro-zone is below average. Europe seems to warrant somewhat more monetary stimulus than Japan and the United States, but even in Europe the case for extreme monetary measures seems weak – unemployment is trending down and core inflation is still comfortably above zero (at 0.9% in the year to 30 June 2016).

Financial instability is the biggest risk

Against this backdrop, it is staggering that key policy interest rates are still near-zero in many regions, and central banks have massively enlarged their balance sheets through aggressive buying of financial assets. Japan is the most extreme example, with the Bank of Japan's balance sheet now almost equal to that of Japanese GDP even though core inflation is above average and the economy is close to full employment!

The impact of these extreme monetary measures is highly distortionary for the global economy. As the charts below show, sovereign 10-year government bond yields are now at their lowest levels in at least a century, and price-to-earnings valuations across many markets are approaching levels that have not been sustained since the dotcom bubble period earlier last decade.





The worry is that the bubble in bond yields now appears to be slowly but surely flowing through into equity valuations. Unless global central banks change course – and correctly recognise the reasons for apparently low global growth and inflation have little to do with deficient demand – they are at risk of creating yet another boom-bust cycle in asset prices within the next year or so.

We're heading the wrong way and it's time to turn back.

Investment implications

For investors, the implications of aggressive central bank policy actions represent a double-edged sword.

On the one hand, despite weak global earnings, maintenance of easy credit policies may well push up global equity markets over the near term as price-to-earnings valuations (while now above average levels) are still reasonable value against the very low global bond yields on offer. As equity markets continue to rise, the risk increases of a harder and more destabilising decline in equity markets later.

While it is difficult to time when the current market euphoria will end, we are entering a period when increased caution is warranted.

To the extent investors still desire some exposure to the market – if only because of the attractive dividend yields on offer – they might consider more defensive high-income focused sectors and strategies or risk-managed equity products which offer more downside protection.

David Bassanese is Chief Economist at BetaShares. BetaShares is a sponsor of Cuffelinks, and offers risk-managed Exchange-Traded Funds such as listed on the ASX such AUST and WRLD. This article is general information and does not consider the investment circumstances of any individual.

Market winners outperform losers again

David Bell

In the spirit of recognising the many different ways in which you can pick stocks, I wrote an article two years ago about using a basic momentum strategy. I will update this article annually (last year's is here). The premise is as follows: academic researchers found that the portfolios of recent stock market outperformers subsequently outperformed portfolios of recent underperformers. A long/short equity strategy constructed this way should generate a positive return. We applied this theory to the Australian marketplace and found a volatile but high-performing strategy. So how did it perform in the past financial year?

2015-16 performance

A brief refresher on the strategy, noting it is paper-based and theoretical:

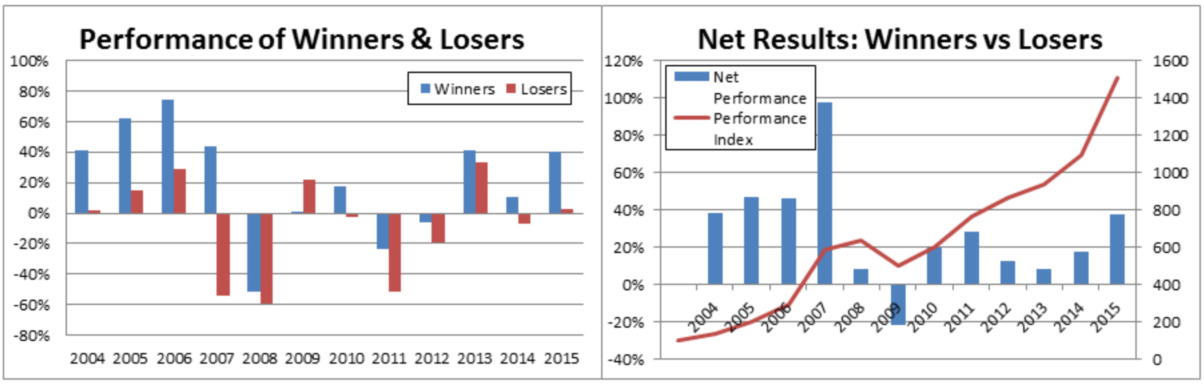
- At the start of each financial year I go long an equally weighted portfolio of the previous financial year's top 10 performing stocks on the ASX 200
- I also short an equally weighted portfolio of the previous financial year's worst 10 performing stocks on the ASX 200
- I hold this portfolio for the subsequent financial year (12 months).

The table below lists stocks I would have held, long and short, purchased from the end of the 2014/15 financial year. It is based on their performance over the past 12 months, along with their subsequent performance.

Long Portfolio			**Short Portfolio**		
Stock	Previous FY Performance	Subsequent FY Performance	Stock	Previous FY Performance	Subsequent FY Performance
QAN	151%	-11%	BCI	-87%	-62%
EVN	80%	105%	ARI	-80%	-100%
NST	80%	129%	AGO	-77%	-93%
SRX	73%	-11%	MRM	-72%	-41%
DMP	69%	93%	HZN	-69%	-47%
MFG	65%	33%	LYC	-68%	56%
TPM	65%	34%	MGX	-67%	30%
HVN	60%	8%	MML	-66%	-23%
NUF	58%	3%	RSG	-65%	321%
PMV	57%	15%	BKN	-61%	-15%
Total Long Portfolio Average Subsequent Performance		**+ 40%**	**Total Short Portfolio Average Subsequent Performance**		**+ 3%**

Using the table above if I subtract my short performance (+3%) from my long performance (+40%) I end up with a total paper portfolio performance of 37%. However, it would definitely have been a rollercoaster year if you closely followed each stock (imagine being short RSG as it rallied 321%).

The past financial year was a very good year for this strategy, above its long-term average. The chart below presents the updated track record (now 12 years).



Source: Thank you to Acadian Asset Management (Australia) for the data.

The performance numbers above only focus on the active return piece and leave out cash returns, stock borrowing fees and transaction costs (in theory if I am long and short the same dollar amount of stocks I have 100% of my portfolio size earning cash returns). Stock borrow fees can be high for stocks that have performed poorly and this would dilute the strategy's returns.

This article annoys people

Each year I write this article, it seems to annoy people. The comment below is typical:

"Looking at any strategy without considering its actual cost and the ability to implement suggests to the reader that there are larger gains to be made than would exist in practice. Could all of the stocks actually have been borrowed, and what was the cost of borrow? Would any of the (very large) individual short positions (or even the entire short portfolio) pose a problem during a counter-trend short covering rally?" – Jerome Lander

This has always been a paper portfolio and never recommended as an investment strategy. It originates from academia and historically academics have failed to incorporate transactional expenses (though this is changing). And yes, the strategy relies on you not looking at your portfolio during the year because the ride is volatile to say the least.

So what's the point?

The point of this article is to illustrate a behavioural bias that exists in financial markets. Cuffelinks is full of references to behavioural biases but rarely are these biases presented in a worked example that leaves you scratching your head and saying 'is this possible?'. If markets were perfectly efficient, then simple rules-based strategies like holding past winners and selling short past losers would not generate outperformance.

Additionally, this article is an annual reminder that there are many different ways to pick stocks. Some are based on company analysis, some are technical, and some are behavioural. You need to pick the approaches you believe you can execute well, understand the strengths and weaknesses of your approach, and the environments where it will work and where it may struggle. Cuffelinks publishes many articles on fundamental investing but less on technical approaches which account for behavioural biases.

Finally, it is relevant to reflect on what biases may be embedded in your own investment strategy. When I reflect on the winners versus losers anomaly, I find myself wondering if I am not open enough to the possibility that stocks and markets can experience a significant event that leads to consecutive years of outsized performance (positive or negative). If I have a mindset that I have missed this opportunity or that everything will bounce back (mean revert) then I have potentially hard-wired myself to not being open to important developments at a company, sector or market level which may have longer-lasting effects. I might feel I have missed an investment opportunity because it has already had a run, when in fact it may still have significant further upside.

You can have the best valuation model but if it is not populated with well-considered, unbiased inputs then it may not be successful.

David Bell is Chief Investment Officer at [Mine Wealth and Wellbeing](). He is also working towards a PhD at University of NSW.

Investor surveys highlight opportunities for financial advisers

Alan Hartstein

Financial advisers have a great opportunity to capitalise on a shift from direct investing by SMSF trustees, as well as the large-scale financial illiteracy in the community, according to separate reports from Vanguard and Workplace Super Specialists Australia (WSSA).

The 2016 Vanguard/Investment Trends SMSF Report is a comprehensive study of Australian SMSF investment patterns, collating responses from more than 3,500 SMSF trustees and 570 financial planners. It found that increasing market volatility was affecting the way SMSF trustees were investing.

Elsewhere, WSSA found that almost two fifths of Australian workers need to improve their financial wellbeing, and that only about a third were considered financially healthy.

Both these surveys suggest potential clients have significant unmet needs, and advisers should find a way to connect and educate.

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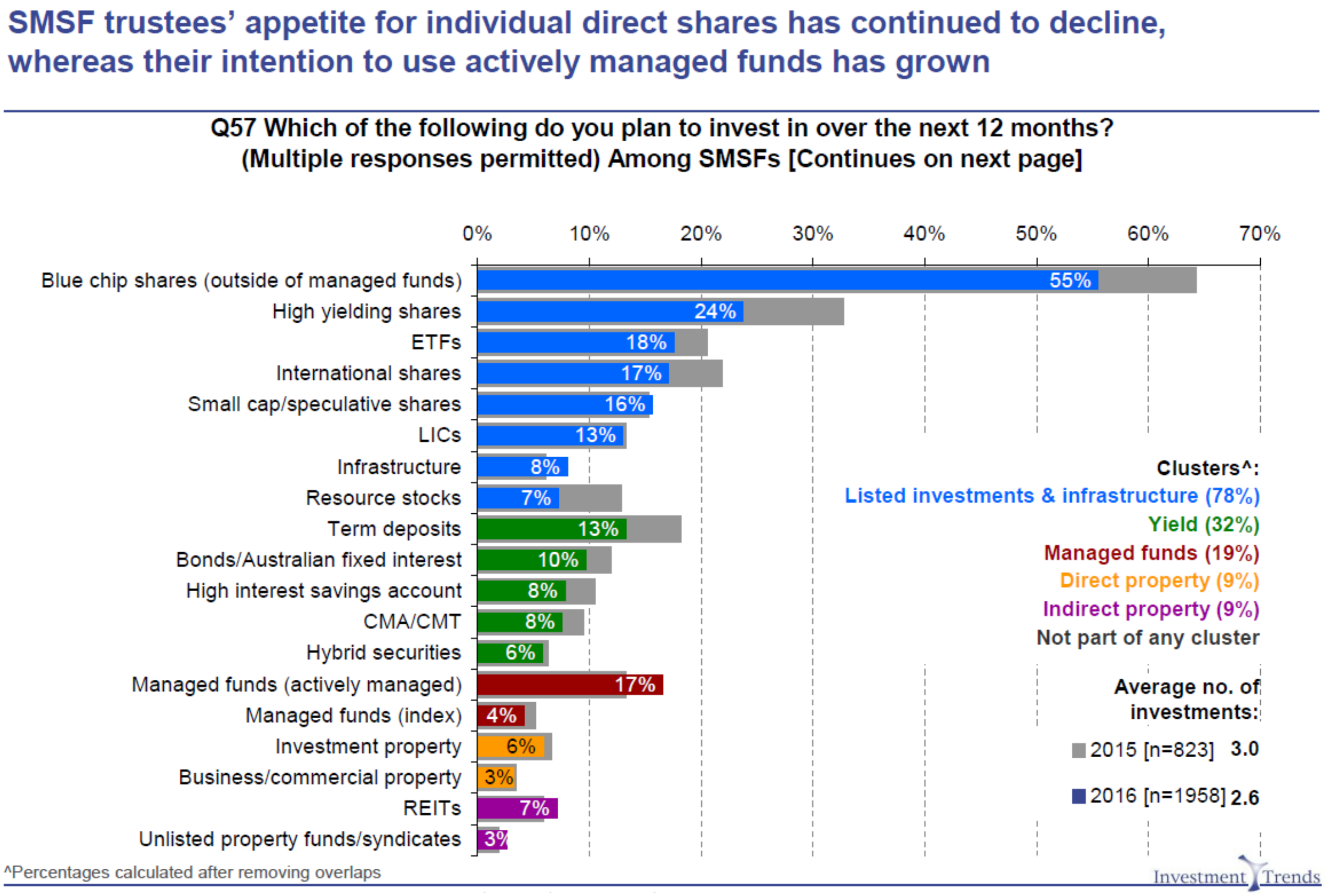
Shift from equities to managed funds

Among the Vanguard survey's findings was a significant move in fund allocation from domestic shares towards actively managed funds, infrastructure and REITs. Direct equities as a share of SMSF portfolios has fallen to 38% on average from a peak of 45% in 2013. Over the same period, the percentage of managed fund investments in SMSF portfolios has increased from 7 to 10%.



Speaking at the report's launch, Recep Peker, Investment Trends' Head of Research, Wealth Management, said,

"SMSF investors often favour blue-chip shares that promise premium dividends and franking credits. But this year we saw trustees' appetite for direct shares fall. In previous years, fixed income products have been popular in volatile times, but with interest rates at all-time lows, SMSFs want assets that diversify their portfolios, the data suggests."

SMSF sector seeks more help

Interestingly, the number of SMSF trustees who said they had 'unmet financial advice needs' rose from 212,000 to 255,000 over the past 12 months, the survey found. *"Consistent with previous years, trustees cited inheritance and estate planning, pension strategies, and longevity risk as key areas where they need more advice,"* Peker said.

Vanguard Australia Head of Market Strategy Robin Bowerman said the research also revealed that SMSF trustees want professional help validating their investment strategies and portfolio construction.

Ben Marshan, Head of Policy and Government Relations at the Financial Planning Association of Australia, agreed that there were great opportunities for financial planners to develop strategies for SMSFs, but they needed to fully understand their own skill sets.

"My concern is that planners often don't have the tools required to build portfolios. They may be good at modelling and cash flow but are lacking a sufficient understanding of which balanced funds to put specific customers into."

If financial planners really want to capture more of this market share they need to make decisions about the type of advice they're providing, who they're providing it to and have a deep understanding of the best products to offer, he added.

Over the 12 months covered by the report, only 37% of SMSFs used a financial planner, which was a slight increase over last year but did represent the first rise in that statistic since 2007. It also revealed how much of the SMSF market is still untapped for planners.

The amount of revenue financial planners derive from SMSF clients was steady at 19%, however, the planners surveyed were positive about the potential to grow this to an average of 27%. The total proportion of financial planners who work with SMSF clients remained steady at 69%.

Financially unwell staff

Meanwhile, Workplace Super Specialists Australia (WSSA) has released its inaugural Financial Wellness Index of Australian workers. CoreData conducted the research for WSSA, and found 39% of employees were categorised as either 'financially unwell' (12%) or having 'room for improvement' (27%). Under a third (29%) were 'on the way to wellness', while 26% were 'financially well' and 6% were rated 'superstars'.

WSSA represents workplace superannuation specialist advisory businesses and its members currently provide financial advice to thousands of corporate super funds.

"This data should be regarded as a cry for help from everyday Australians and their day-to-day reality," WSSA President Terry Rhodes said. *"It is a situation that is both stressful and costly for employees and employers."*

The most common behavioural impact of poor financial wellness in the workplace described by employers is stressed employees (61%), unengaged/distracted employees (43%), and low morale (30%).

The survey also found a key driver of financial wellness was financial literacy: more than half of the 'financially unwell' have poor or very poor financial literacy, whereas 93% of 'superstars' have strong or very strong financial literacy.

Marshan said only 20% of consumers currently seek out financial planners and 10% have ongoing relationships.

"For many people, understanding their own financial position and what their choices are can be overwhelming. These statistics highlight how broad the market is and the extent of the opportunities available."

He said financial planners looking to take advantage of consumer demand should carve out their own niche, acquire as many professional certifications as possible and belong to the most relevant associations for contacts. They should also take full advantage of tools such as social media including Facebook, Twitter, Pinterest, and Linked In.

Australian employers do support improving financial literacy: more than 60% said employees' financial literacy was extremely or very valuable. An overwhelming 90% of employers said one-on-one sessions with advisers was the most valuable way to improve financial literacy.

Both these surveys confirm there is a strong role for financial advisers in improving long-term outcomes and enhancing the financial literacy of their clients.

Alan Hartstein is Deputy Editor at Cuffelinks.

Annuities have come a long way

Alex Denham

The practice where I work as an adviser has, for various reasons, predominantly attracted older senior clients over the years. While we do have a growing representation of wealth accumulators, there has been a strong focus on retiree, seniors and ageing-related issues.

One would think then that we have been signing our clients up to annuities left, right and centre for a long time. However, until this year, this hasn't really been the case. The recovering share market of recent years, strong franked dividend yields from 'defensive' market sectors and low interest rates have made annuities relatively uninteresting as a long-term investment option for most of our client base.

Until recently, that is. This year we've noticed a major shift in investment attitudes, and suddenly those in their advanced years are looking at annuities with increasing interest, even with current interest rates at record lows.

We've seen more global uncertainty in 2016 than at any time since the GFC. Brexit, falling fuel and oil prices, wars, political uncertainty, a slowing Chinese economy, and record low bond yields are contributing to a wary economic outlook and elderly investors are nervous about their share market exposure. Couple that with some innovative annuity enhancements over recent years and changes to the age pension assets test kicking in on 1 January 2017 and suddenly annuities are on the radar.

What is an annuity?

An annuity is simply a guaranteed income stream purchased from a life company with a lump sum. The payments are promised up front by quotation, so the investor knows what they're signing up for from the outset. The 'guarantee' does not refer to a government guarantee that applies to bank accounts and term deposits. However, the life companies are closely regulated and their reserving requirements make their guarantees solid.

The annuity can be paid until the holder dies (a 'lifetime' annuity), or for a fixed number of years (a 'term' annuity). It can be linked to inflation, or not, and can have a residual amount paid back at the end of the term. The annuitant chooses the features that determine the income level.

By way of illustration, let's look at an investment amount of $100,000, and how the features selected change the income that it pays. The results in the table below are based on quotations received from a leading annuity provider on 5 September 2016 for a 70-year-old male with monthly annuity payments. Note for these quotes, I have not included upfront or ongoing Adviser Service fees – these can also be built in to the quotations.

Type	Comments	Indexation	Payment pa	Effective Rate
7-year term	Nil RCV [1]	Nil	$15,807.84	2.95%
7-year term	Nil RCV	Full CPI	$14,897.88	3.76% [2]
7-year term	100% RCV	N/A	$3,202.68	3.25%
Lifetime	100% withdrawal guarantee	Nil	$3,433.80	3.43%
Lifetime	100% withdrawal guarantee [3]	Full CPI	$3,066.60	3.07%

[1] Residual Capital Value – the amount remaining at the end of the term.
[2] Inflation assumed at 3% p.a.
[3] Means 100% of the purchase price is guaranteed to be able to be withdrawn after 15 years.

What sets annuities apart from term deposits is their tax and social security treatment. Term annuities that only pay out the interest component (100% RCV) are basically the same as term deposits, but nil RCV and lifetime annuities have distinct advantages.

In the 7 year, nil RCV, nil indexation example above, the tax and social security rules recognise that a large portion of the $15,807 payment is in fact return of capital. That return of capital is calculated simply as:

$$\frac{\text{Purchase price – RCV}}{\text{Term}} = \frac{\$100,000 - 0}{7 \text{ years}} = \$14,286$$

With $14,286 of the $15,807 annuity payment considered return of capital, only $1,521 is assessed as taxable income and income-tested income.

Life expectancy (taken from the Australian Life Tables 2010-2012) is the denominator when the calculation is on a lifetime annuity. So for the lifetime examples above, the return of capital amount is:

$$\frac{\text{Purchase price – RCV}}{\text{Life Expectancy}} = \frac{\$100,000 - 0}{15.31 \text{ years}} = \$6,532$$

This is more than the actual income the annuity pays, so no income is assessed for tax or Centrelink purposes.

Under the Assets Test, the return of capital is deducted off the purchase price each year to determine how much counts.

Who wants annuities?

Jack and Mary are in their late 70s and in good health. They've sold their home and bought into a retirement village, leaving $360,000 of capital to invest. They have an existing share portfolio and are comfortably living off the dividends and their part age pension. However, the pension is set to halve as a result of Centrelink counting the capital released from the home as an asset, then halve again from 1 January 2017 with the new Assets test.

They are adamant that they do not want any further share market exposure, and term deposits are not appealing with their low rates. We showed them an annuity product that guarantees income for the life of the annuitant and has a 'withdrawal guarantee' that allows a guaranteed amount to be withdrawn after 15 years, if required.

Lifetime annuities of old lost their appeal as there was little or no guarantee that any capital would be repaid from it after purchase. But recent products have largely solved this problem and allows for a withdrawal amount along the way up to 15 years.

Annuities can also have generous tax, income and asset test treatments compared with term deposits, so over time Jack and Mary's age pension may improve at a faster rate than if they had invested in term deposits, fixed interest or shares.

Suitable for older clients who dislike market volatility

Then there's Keith and Leanne, each about 80 years old and utterly risk averse. They are attached to their age pension and, like Jack and Mary, have downsized and unlocked capital from their home that is going to eat into their pension now and from 1 January. They were looking for something with no market volatility that would also allow their pension benefits to increase over time.

They chose two 7-year annuities with nil RCV. Splitting the investment by half to give them an annuity each, they now have a known cash flow and optimised age pension. If one passes away before the 7-year term expires, the annuity continues to the survivor. If they both pass away, the estate will continue to receive the payments until the term is complete, or it can opt to get a lump sum payout.

Then we have Neville, who is single with $2 million in rolling term deposits. Shares (or managed funds) were never an option for him. While not a pensioner, Neville was equally determined to qualify for whatever government benefits he could, and his attachment was to the Commonwealth Seniors Health Care card. The interest on the term deposits was going to disqualify him from holding that card.

Neville had made provision for $500,000 worth of cash bequests and wanted to retain at least that much for his estate. In his words, he wanted an investment that provided the same or similar level of capital security as term deposits with a competitive return and tax efficiency.

Again, the lifetime annuity that provides for a withdrawal guarantee came into play, his taxable income was reduced so that he retains his CSHC card.

Annuities generally don't make for lively dinner conversation. Those that remember the old products are surprised that, given global economic volatility and product innovation, they are more appealing now.

Alex Denham is a Senior Adviser with Dartnall Advisers in Berrima. Prior to becoming an adviser, she spent 20 years in senior technical roles with several financial services companies. This article is general information and does not consider the circumstances of any individual.

The silver lining really is in the cloud

Warryn Robertson

The appeal of companies that can deliver sustainable and attractive earnings growth in difficult economic conditions seems obvious. But has this appeal pushed their valuations to unsustainable levels?

Broadening the definition of 'quality'

Many global consumer stocks have outperformed the market and now appear expensive. Companies such as Colgate Palmolive and Unilever, for example, are trading at historically high valuation multiples. To find value in quality stocks today, in our view, investors need to broaden the definition of what makes a quality company beyond just a brand.

Our definition of quality refers to what we call 'economic franchises'. These are companies with characteristics such as market-leading positions, a long history of stable financial returns, relatively low leverage, and large, sustainable competitive advantages.

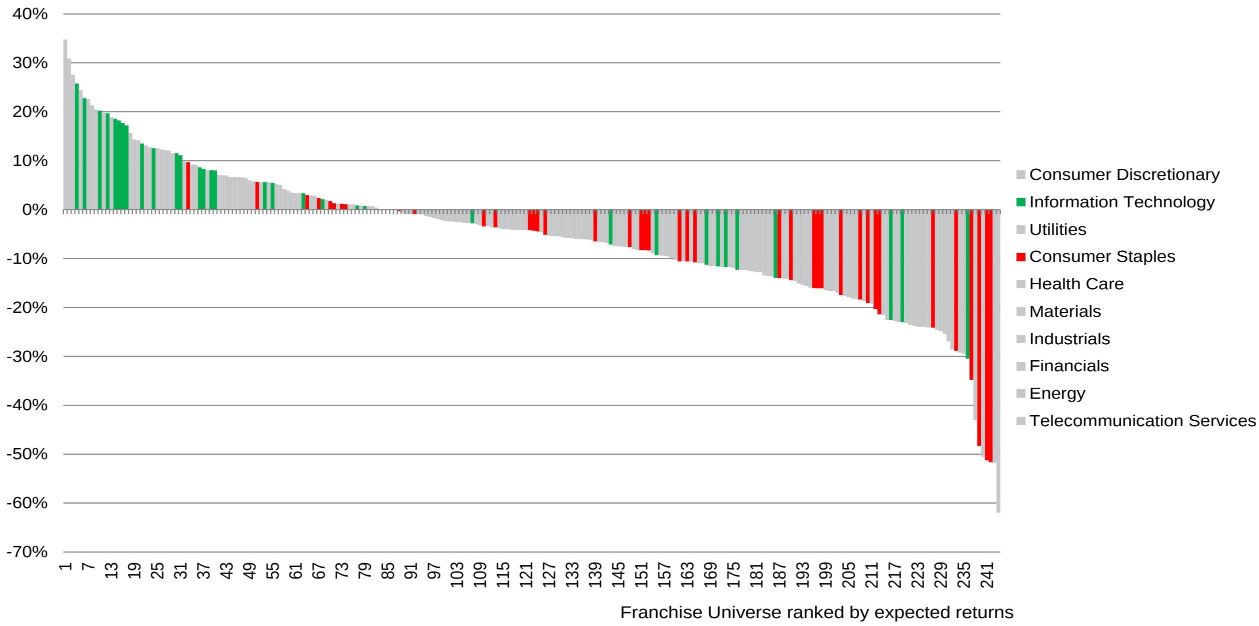
Franchises in the past built their competitive advantages (or 'moats') from intangible, industry- or product-related features such as brands, intellectual property, network effects, or high customer switching costs.

These companies are by definition rare, and we believe there are roughly 250 of them globally. This includes consumer staples companies, but also many businesses operating in sectors such as information technology, consumer discretionary, health care, materials, infrastructure, and industrials.

Quality stocks can be cheap or expensive

All stocks in our franchise universe are ranked according to our estimation of their potential upside, with reference to the differential between their ascribed 'intrinsic value', as determined by our fundamental analysis, and the current prevailing market price. In the table below, the red lines are consumer staples, and based on our analysis, they look expensive. However, many IT franchises, the green lines in the table, offer high expected returns and look attractive.

IT vs Consumer Staples, Expected Return



As of 30 June 2016
1 Over 3 years, assuming all the stocks trade at our valuation in 3 years time.
The opinions and estimates contained in this graph are based on current information and are subject to change. It should not be assumed that any investment was, or will be profitable. Expected returns do not represent a promise or guarantee of future results and are subject to change.
Shown for illustrative purposes only.
Each bar represents an individual stock's expected return per annum for the next three years. This is based on a comparison of Lazard's Global Equity Franchise team's intrinsic valuation of the stock three years out, the market price of the stock today and the interim forecast dividends. Currency: AUD

Compared with the consumer staples sector, certain IT companies offer higher returns on capital and higher growth at materially lower earnings multiples (see table below).

	Information Technology Stocks	Consumer Staples Stocks
Return on Capital Employed [1]	69%	26%
Long run EPS growth (consensus) [2]	10.9%	7.4%
EV:EBIT [3]	12.7x	17.4x
Weight in Global Equity Franchise*	**39.7%**	**0%**

As of 30 June 2016.

*Based on the representative account.

[1] Return on Capital Employed = Net Income/(Net Debt + Equity). 12-mth trailing average. Source: Factset, Lazard

[2] Long run EPS growth estimate based on Factset consensus estimates

[3] EV:EBIT is Enterprise Value divided by FY1 EBIT. Source: Factset Consensus

The appeal of technology

Start-ups would not qualify for our franchise universe, but within the IT space there are long-established companies with leading market positions that do. In the software sector, Microsoft, SAP, and Oracle have dominant market shares with products that make it difficult or costly to switch to an alternative vendor. In addition, the marginal cost of production for a software product is close to zero, underpinning operating margins of 35–45%, returns on tangible capital of 300–400%, and huge amounts of free cash flow every year. As a result, software companies are currently some of the most profitable businesses in our franchise universe.

Many dominant software companies now appear cheap, partly due to market fears that cloud computing will erode their economic moats. In most cases, we believe the reverse is actually more likely. The value proposition to customers is primarily the cost savings and flexibility they can achieve through replacing on-site servers, IT staff, and ongoing maintenance, with off-site cloud hosting. Importantly, that will typically enable the software vendor to charge more for their cloud-based products while still saving their customers money.

Since cloud-based software (often called 'software as a service') is sold by subscription rather than periodic licence renewals, software vendors' total revenue over time increases by effectively compressing traditional renewal cycles of 3–5 years into much shorter periods. Customers can no longer defer upgrades, as non-renewal means no more software.

It is true that the transition to the cloud may give new entrants a foot in the door in some market niches. However, overall we see the revenue upside far outweighing any market share losses for incumbent software vendors with their vast installed customer bases, strong brands, and proven technology. Moreover, the switching costs that underpin their competitive advantage appear at least as high in the cloud, since the upgrade events which traditionally trigger tenders become a thing of the past.

It's still early days, but the evidence to date indicates that the dominant software vendors are succeeding in their transition to the cloud.

Investors face a quandary at the moment. Global bonds offer close to zero yield, and some equity markets have hit multi-year highs. Developed economies appear fragile and political uncertainty continues to shake confidence. The appeal of quality companies is clear, but only at the right price and the right multiple. When shopping for quality, you may want to update your software while avoiding the toothpaste aisle.

Warryn Robertson is a Portfolio Manager at Lazard Asset Management. This article is general information and does not consider the circumstances of any individual.