Cuffelinks

Connecting investors with ideas

Edition 175, 30 September 2016

This Week's Top Articles

Make alternatives mainstream and don't be sold short

Roger Montgomery

It is true that you should never ask a barber if you need a haircut. Nevertheless, I am going to argue, on behalf of my peers, that in an environment where low returns are the corollary of high asset prices, as well as the best-case scenario for most investors, any strategy that can to add alpha from short-selling needs to move from the 'alternative' space into the mainstream.

The returns that many investors have made from blindly buying infrastructure, utilities and large cap, high-dividend yielding stocks (none of which we own) are ephemeral and transitory in nature.

Before considering an alternative approach, let me set the stage. The income recession in term deposits has triggered an investor migration into those company shares with lower perceived earnings and dividend volatility. The problem of course is they tend to be the large-cap (conventionally described 'blue-chips') or infrastructure and utility companies.

In the case of the big blue chips, the S&P/ASX 200 dividend payout ratio has increased from 55% in 2010 to 80% today. Paying out more of the profits in dividends means retaining less for growth. In other words, investors are paying high prices to buy bond-like returns, but are adopting equity market risk. History has always punished this strategy.

New normal is anything but normal

In the case of infrastructure and utility companies, the valuations are high because interest rates are low and most of these companies have little or no net equity on their balance sheets, so valuations are boosted through the weighted average cost of capital calculation.

We have therefore arrived at a new normal that is anything but normal. The most expensive companies are those with little growth or a lot of debt, or both. As we previously forecast, low interest rates corrupt everyone's sense of risk.

Elsewhere art, vintage cars, low numeral licence plates, and wine are breaking record prices in auction rooms characterised by standing room only and frenetic bidding.

Additionally, Aussie investors have leveraged-up to chase asset prices higher, particularly property, increasing their debt burden to 185% from 170% of disposable income since 2008.

A role for short-selling

The mathematician Herbert Stein once observed, "if something cannot go on forever, it will stop." Investors, however, are not only ill-prepared for any reversal, they are ill-equipped. All of their investments are in assets that benefit from rising prices, and thanks to the 30-year decline in interest rates, not only have investors enjoyed rising asset prices, but they've been lulled into expecting those returns to continue.

Buying low and selling high, in that order, is the common way to generate wealth and preserve purchasing power. If, however, asset prices do not produce a large positive between the purchase and sale, and bouts of sharply declining prices ensue, selling first and buying later at lower prices, (or short selling as it is known), may not only enhance the possibility of greater returns but may also smooth them.

Short-selling receives a great deal of attention thanks to a practice of 'shorting and distorting'. For some investment managers their business model involves not only establishing short positions in certain companies, but also attempting to accelerate the returns by promoting the negative thesis widely. Bill Ackman's short trade in Herbalife through his firm Pershing Square is perhaps the most recent high-profile example of 'activist' short selling.

Critics of short selling often argue that practitioners delight in the demise of businesses and industries and some go so far as to suggest that they are the cause. From Kerr Nielsen at Platinum to the teams at Perpetual and BT however, short selling is not the exclusive domain of malicious hedge funds intent on wreaking havoc. A large number of funds count themselves among those that seek to generate uncorrelated returns for their investors or offer some insurance from declining markets and sectors.

Short selling is simply the act of borrowing stock (often from index funds that hold them indefinitely), selling that stock and buying it back at a lower price, pocketing the difference as profit.

With disruption affecting every industry from energy to television it is often easier to pick the losers than the winners. Investors can profit from the inevitable decline of some industries as they are replaced by automation, substitution, or faster rivals. And to be certain, 'disruption' is merely a synonym for change, and change has been a part of business and industry since commerce commenced.

In the United States, Jim Chanos demonstrated the benefits of short selling by being one of the first to question Enron's accounting. Questioning the efficacy of accounts, the durability of business models, industry trends and fads, is the remit of investors who look deep beneath the lofty and optimistic forecasts that dominate the investment landscape.

A necessary counterweight

The existence of short sellers discourages earnings manipulation (they'll be found out) and in a world where conflicts of interest can cast doubt on the independence of buy and hold recommendations, a band of researchers happily lifting the hood of companies to find flaws is a necessary counterweight.

For today's investor, with share prices elevated, expected returns low, earnings growth challenged, and unsustainably low interest rates supporting lofty present values, the prospect of profiting from an inevitable decline in asset prices generally, and from the decline of some businesses specifically, is one that is difficult to ignore and shouldn't be passed up.

My understanding is that 'alternatives' such as market neutral funds and long/short funds are reporting increasing inbound enquiry from planners and dealer groups and, with capacity generally constrained, it makes sense to understand whether such funds are right for your portfolio.

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.

Four ways to avoid super death benefit taxes

Mark Ellem

They say there are two certainties in life: death and taxes. Death, clear-cut, I'd agree. But with tax comes nuance, so let's take a closer look at superannuation death benefits and tax.

In the late 1970s, death duties were abolished in Australia, although a form of them remains in relation to lump sum benefits paid from a superannuation fund where a member has died and the ultimate recipient of that payment is not classified as a 'tax dependant'. In this situation, the 'taxable' portion of the benefit payment is subject to a tax rate of 15%, plus the 2% Medicare levy, a total tax take of 17% (where insurance proceeds are included in the payment it can be as high as 32%).

How can my adult child receive my super death benefit payment tax free?

A child of any age can receive a lump sum payment directly from a superannuation fund as a consequence of the death of a member, however an adult child will only receive the taxable component of the payment tax free where, for income tax purposes, they are either:

- a 'financial dependant' of the deceased; or
- in an interdependent relationship with the member, prior to the member's death.

Of course, an adult child will receive any tax free component of the death benefit tax free.

Dealing with interdependency first, two persons (whether or not related by family) have an interdependency relationship if:

1. they have a close personal relationship; and
2. they live together; and
3. one or each of them provides the other with financial support; and
4. one or each of them provides the other with domestic support and personal care.

On the face of it, where an adult child returns home to live, or actually never left the family home, you may consider that they would satisfy the interdependency requirement. However, when taking the matters outlined in the regulations into consideration, you may fall short. The relationship needs to be more than simply one of convenience. It needs to be more meaningful, for example, an adult child has moved home to care for an elderly or sick parent.

The other option for an adult child to be a dependant, for income tax purposes, is where they are a 'financial dependent'.

The ATO appears to have a narrow view of financial dependency, for income tax purposes. A number of Private Binding Rulings look at the following in relation to financial dependency:

- where a person is wholly or substantially maintained financially by another person
- if the financial support received were withdrawn, would the person be able to survive on a day-to-day basis?
- if the financial support merely supplements the person's income and represents 'quality of life' payments, then it will not be considered substantial support
- what needs to be determined is whether the person would be able to meet their daily needs and basic necessities without the additional financial support.

There is also a requirement to show a reliance on regular and continuing financial support to meet their day-to-day living requirements. Finally, you will need evidence to support the facts and the claim for financial dependency, including receipts for expenditure regarding living expenses.

Not all super death benefits paid to a non-tax dependant are subject to tax

Only the 'taxable' portion of a super death benefit is subject to tax, where a person receives it who is not a 'dependant' for income tax purposes. Any 'tax-free' component is exactly that, tax free in the hands of the beneficiary. The 'tax-free' component is basically made up of after-tax contributions that the member has made to superannuation. Consequently, a common strategy to 'wash' taxable components to tax-free, prior to a member dying, is the re-contribution strategy.

Is a re-contribution strategy still relevant?

It can be. The aim of this strategy is to convert the 'taxable' portion of a member's account balance to 'tax-free'. The greater the extent of a tax-free component means less tax on benefits paid to a member under age 60 and less tax on benefits paid to a 'non-tax dependant' on death of the member.

Tax will only be applicable on a superannuation death benefit payment where:

- A payment is made as a consequence of the death of a member; and
- The payment is made to a person who is not a dependant for income tax purposes; and
- The payment has a taxable component.

The four major ways to avoid such a tax

As 17% can be a big tax impost on substantial balances, the following are worth considering:

1. Don't die (I understand that medical science is working on this and making progress)
2. Make sure you have a beneficiary that qualifies as a dependant for income tax purposes at the time of death
3. Ensure 100% of your benefits form part of the tax-free component
4. Have nothing inside of superannuation at the time of death.

Focusing on the fourth option, as a person ages, particularly past 65, you can withdraw superannuation and hold the funds in your own name, where the member has no dependants for income tax purposes and consequently the taxable component of any death benefit payment will be subject to 15% tax, plus applicable levy.

By just considering the $18,200 tax-free threshold and assuming an assessable earning rate of 6%, that's around $300,000 of superannuation that you can hold in your own name, with no personal tax (assuming no other income).

Conduct regular reviews

Given the potential for significant tax to apply in relation to a payment from a superannuation fund as a result of the death of a member, an overall estate plan review should consider intergenerational wealth transfer and preserving that wealth by reducing tax.

Mark Ellem is Executive Manager, SMSF Technical Services, at SuperConcepts. A more comprehensive paper on this subject is attached here. This article is general information only.

Investor sentiment can be highly misleading

Don Stammer

Investor sentiment - the dominant feelings of investors inside investment markets - has a powerful influence on the prices at which shares, bonds and property are traded. But this sentiment is often wrong: recall the famous observation of Paul Samuelson, a famous and much-read US professor 50 years ago that the US share market "has predicted nine of the preceding five recessions".

It’s in the interest of investors to think about:

- the key features of prevailing sentiment
- whether those expectations are well-based
- whether sentiment is likely to change in the near future.

Here are two recent examples of how swings in investment sentiment had big effects on markets in 2016, and a thought on what the next big shift in expectations might be directed at.

Fears of a hard landing in the Chinese economy were overdone

In the early weeks of 2016, investor sentiment turned far too negative on China. Market commentary, along with the prices of shares, bonds, commodities and currencies, reflected a dire view of China’s economy. It was expected to soon fall into a deep recession and Chinese authorities would be powerless to avert the looming crisis. Most likely, it was thought, their policies, particularly regarding management of the renminbi, would worsen the situation.

The dominant investment position was to be short everything that could be affected by China’s hard landing – global shares, bulk commodities and Australian and ASEAN currencies. Little attention was paid to how ‘crowded’ those trades had become as so many large hedge funds had adopted positions that were in line with the prevailing sentiment.

The Chinese crisis turned out to be a false alarm, and an expensive one, especially for those who were late in taking positions in line with the prevailing market sentiment. Chinese growth slowed just a little, expectations of a recession abated and global shares recovered.

Brexit fears were also exaggerated

Another sharp change in investor sentiment followed the UK vote in late June to leave the European Union. The prevailing expectation, for a time, was that global growth would slump, shares would suffer sustained falls and the pound would take a battering.

While market positions were small when compared with the situation regarding China, expectations again turned gloomy. Sentiment soon focused, however, on how long disengagement from Europe would take, giving the UK economy time to adjust, and markets recognised the exaggeration.

Monthly statistics can mislead

There’s a lesson for investors from the two faux crises of 2016: don’t read too much into the monthly statistics such as the Purchasing Managers’ Index (PMI). The PMI is a measure of business conditions in a wide range of economies, both for each economy and for the main sectors of manufacturing and services. PMI data is based on monthly surveys of purchasing managers, who are asked if various aspects of their businesses are better or worse than they were a month earlier.

The problem investors face is in interpreting the summary results. Each month, the people who organise the survey deduct the percentage of ‘worse-than-expected’ results from 100; if the score is less than 50, the economy (or sector) is said to be ‘contracting’, whereas if the score is more than 50, the economy (or sector) is said to be ‘expanding’. Thus the Chinese economy was reported as contracting in the early part of 2016, and the same thing was reported for the UK economy in July. These assessments were the stuff of headlines and were given a lot of attention in broker and news reports. As Mark Tinker of AXA puts it:

“The mantra that a PMI above 50 means expansion and below 50 means contraction continues to be widely repeated and in my view is highly misleading. The PMI is a diffusion index and as such measures changes in expectations on a ‘compared to last month’ basis. Thus, above 50 means ‘better than last month’. If last month saw 7% growth (as it did in China) and this month’s reading is below 50, that does not mean growth will be negative. It means it is likely to be slower than 7%. Earlier this year, we saw headlines that ‘Chinese manufacturing is contracting’ when the PMI was below 50, yet it continued to grow, just at a slower pace. In truth it was because the market was looking for evidence to support its own (incorrect) pre-conception that China was in recession and as such it paid to be a contrarian.”

Monetary policy will not remain as friendly

For several years, the majority of investors have been of the view that interest rates will remain 'lower for longer' (in July and August the expectation seemed to shift to interest rates being 'lower forever'). This view has been reinforced by the expectations that central banks would continue their accommodative policies and inflation would remain just about non-existent. The resulting hunt for yield has pushed shares and bonds much higher.

In my view, we're now seeing the early signs of a major (and lasting) change in this sentiment, but there's a lot at stake. As Allianz Group's Mohamed El-Erian observed recently, the extremely easy setting in monetary policy has "delivered to investors the dream team of high returns, low volatility and profitable correlations".

There are four main reasons why monetary policies globally are unlikely to remain, in aggregate, as highly accommodative.

First, the US is well on the way to returning to full employment and inflation is likely to return to its target range of 2% and climbing. The US central bank will likely respond with timid and gradual increases in its cash rate, but still move ahead of the glacial pace of monetary normalisation that's been the prevailing view in financial markets.

Second, the European Central Bank seems unlikely to move its cash rate further into negative territory, as market sentiment has been expecting. The earlier adoption of a negative cash rate in the euro-zone hasn't delivered the hoped-for boost to spending – but has made it harder for banks there to borrow and lend, and weakened their capital positions. Also, stronger economic numbers from China, the UK and Australia suggest monetary policies in those countries will be eased less than has recently been anticipated.

Third, there's growing recognition among policy makers that, as BetaShares' David Bassanese puts it, "the global economy is as good as might be expected once you make allowance for slowing potential growth".

Fourth, many countries (but not, as yet, Germany) are considering stepping up the role of fiscal policy, especially in increased infrastructure spending, to somewhat reduce the heavy reliance placed on accommodative monetary policy.

These are the consequences for investors:

- Shares and bonds are likely to be volatile as sentiment allows for, and often changes its views on, prospective increases in US and inflation rates moving higher.
- Equities and bonds may be sold off more than is justified at times, as happened in the US 'taper tantrum' crisis of May 2013.
- Even as monetary policies become slightly less accommodative, a lot of liquidity will still be sloshing around from the massive expansion of central banks' balance sheets. The global economic recovery that's been running at a modest pace since 2009, needn't run out of puff.
- In my view, shares can cope with an increase in bond yields of up to a percentage point without tipping into a bear market, provided profits are strengthening. The current sell-off in shares, when it's run further, could present a buying opportunity, whereas the current sell-off in bonds could mark the end of the longest and largest bond rally ever.
- There's good common sense in the view that Allianz Group has expressed: "Rather than be determined by extraordinary liquidity injections, investment returns and the success of risk management will probably depend a lot more in future on economic and corporate fundamentals."

Don Stammer was Director of Investment Strategy at Deutsche Bank. He is currently an adviser to the Third Link Growth Fund and to Altius Asset Management, and writes a fortnightly column on investments for The Australian. The views expressed are general in nature and are not related to the specific needs of individual investors.

Decarbonisation, energy efficiency and energy storage

Rebecca Sherlock

This paper discusses current themes in the electric utility sector, specifically in decarbonisation, energy efficiency and energy storage.

Are renewables cost competitive?

The cost of onshore wind energy declined by 65% between 1988 and 2014 (according to the International Renewable Energy Agency) due to economies of scale, technology innovations and operational and maintenance improvements. Onshore wind can compete with fossil fuels, with the levelised cost of onshore wind estimated to be below €0.05 per kilowatt hour (kWh) versus coal at €0.049 / kWh and gas at €0.041 / kWh.

The expectation is that wind will continue to get cheaper as better siting, longer blades and taller towers drive productivity gains. In the UK, load factors have risen from around 34% in 2003 to around 45% in 2014. This is set to increase due to the high levels of R&D now being spent in an industry that has gone from a standing start to having key global turbine manufacturers such as Siemens, General Electric and Vestas.

Are renewables growing as part of the energy mix?

Renewable capacity additions represented about half the world's total capacity additions in 2014, supported by:

(1) country and state decarbonisation targets eg US renewable portfolio standards (RPS) and EU carbon targets

(2) carbon taxes and UK carbon floor

(3) tax incentives eg US production tax credits and investment tax credits

(4) the social implications of burning fossil fuels such as smog, and

(5) reduced fossil fuel subsidies in countries including India, Indonesia and Spain.

We expect renewables will represent a growing portion of new generation capacity in the future, due to the above points and a lack of economically viable clean coal plants.

Is energy storage a game changer?

In short, yes. Effective energy storage can help back up intermittent renewable power and be used to power electric vehicles. Similar to renewables, the level of investment into lithium ion storage has seen prices decline dramatically. Tesla's Gigafactory is currently producing batteries at US$190 per kWh, with an expectation of 30% reduction coming from economies of scale, reduction of waste, a closer supply chain, vertical integration and process optimisation.

Much as RPS targets were first introduced on a state by state basis in the US, some US states are now starting to commit to targets for battery storage. So far, California and Oregon have set targets for the development of storage, with Massachusetts potentially the next to implement. California has stipulated that its three large investor-owned utilities (Edison International, PG&E, and Sempra) must commit 1,324 megawatts of storage by 2024, which is around 2% of California's peak load.

Is energy efficiency real?

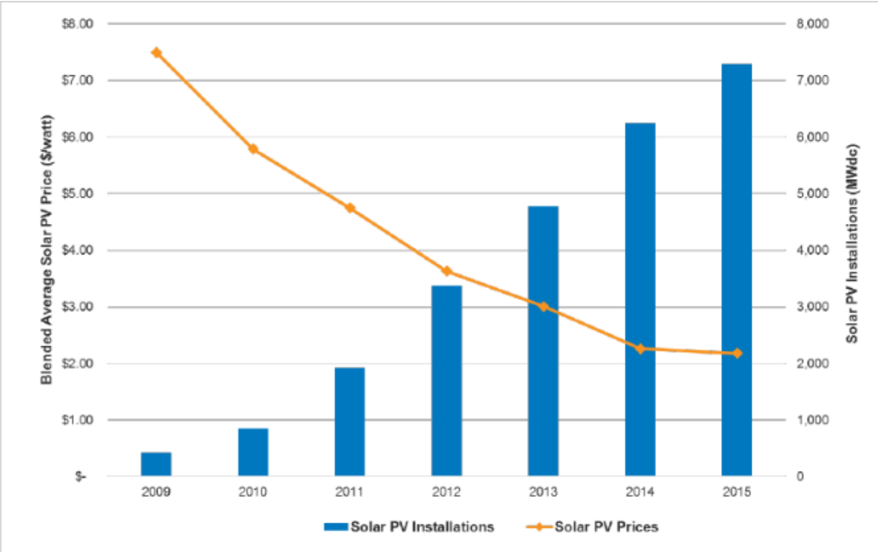
Energy efficiency is having an undeniable impact on electricity consumption. Energy intensity, a measure of energy consumption per unit of gross domestic product, declined by nearly one third between 1990 and 2015. Companies in the US are tending to report flat to negative load growth. Some US states, led by California, are promoting energy efficiency by decoupling utilities' revenues from volume usage.

The driving force behind energy reduction is more energy-efficient homes and appliances. More homes are being insulated, efficient condensing boilers are replacing standard boilers, houses are being double glazed and appliances are more efficient. This trend in energy consumption per household will continue as buildings and appliances get smarter and more energy efficient.

Make hay whilst the sun shines

Rooftop solar has declined in cost significantly. The subsidies that many countries offer encourages residential customers to install rooftop panels on their homes.

Solar photovoltaic – lower costs, higher capacity



Source: Solar Energy Industries Association

However, a mismatch can occur between when solar energy is generated and when it is used. At these times, the distribution grid is used much like storage so that energy can be used when it is needed rather than when produced. For example, New York State is developing a system that compensates both the customer for excess energy sold to the grid, and the grid company for providing the transmission infrastructure to the household. New York aims to transform utilities such as National Grid and Iberdrola into distribution system platform providers, changing their responsibilities to include overseeing the interconnection of distributed resources. We believe this puts these utilities at the forefront of changes that could later be rolled out across other states with sunny climates.

Rebecca Sherlock is a Senior Investment Analyst at [Colonial First State Global Asset Management](#).

Is it time for an SMSF rethink on deposits?

Damien Wood

Australians have long liked bank deposits, a traditionally simple and safe investment and a $2 trillion market. However, upcoming bank regulations mean investors will not be able to simply break a bank term deposit investment. They will need to give 31 days' notice and may forgo interest. The regulations may also favour rates given to individuals while small businesses and others, including SMSFs, may be worse off.

For investors who want a degree of safety and access to funds, an Australian dollar corporate bond fund may make more sense. It's a little riskier, but bond funds typically generate better returns than deposits with ready access to funds.

Consequences of revised liquidity regulations

Soon after the GFC, the Basel Committee on Banking Supervision released a revised set of guideline regulations for banks around the world. These rules were significantly adopted in bank liquidity measures imposed by the Australia Prudential Regulation Authority (APRA).

Specifically, the Net Stable Funding Ratio (NSFR) encourages banks to retain a minimum level of 'stable' funds to help ensure they can withstand a sudden outflow. Australian banks will need to comply with the NSFR by 1 January 2018.

The NSFR is defined as the ratio of: the amount of available stable funding (ASF) to the amount of required stable funding (RSF). The ASF is weighted from 0% to 100% to reflect the likely stability of the funding. Retail and small business deposits are considered more stable than other sources.

These rules will therefore encourage banks to take deposits from retail and small businesses as well as longer-dated deposits. This should benefit individual direct investors who want to deposit their money for a reasonably long period, and receive relatively higher interest rates.

For everyone else, including SMSFs and larger businesses, it is bad news for two reasons:

- investments from these sources become relatively less attractive to banks and could reduce the interest rates received, and
- term deposits will become illiquid. Previously, depositors could call a bank, request a break in the term and the bank would typically pay on the spot with full interest accrued, or perhaps some adjustment. Now, 31 days' notice will be required and interest earned to that date may evaporate.

For example, in Australian Prudential Standards (APS) 210, Attachment A, page 19, APRA specifically defines retail as from 'a natural person'. A 'legal entity' such as an SMSF falls into the wholesale deposit category.

"… 'retail deposits' are defined as deposits placed with an ADI by a natural person. Deposits from legal entities, sole proprietorships or partnerships are captured in wholesale deposit categories."

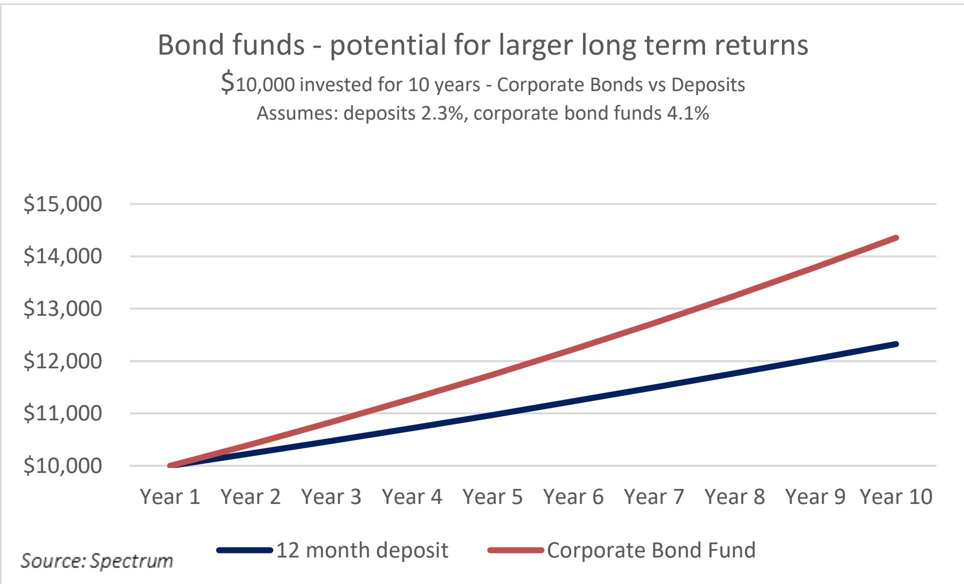
In fact, APRA goes further and explains why SMSF deposits are less stable:

"APRA considers SMSF depositors to be self-selected, financially sophisticated individuals, which is an indicator of a greater propensity to withdraw funds in a stress situation. As such, SMSF deposits are appropriately categorised as less stable."

Collapsing yields

Yields have fallen for deposits, bonds, equities, and just about every asset class in Australia over recent years. In a higher-yielding environment, a 1 or 2% difference in returns did not make much difference to relative long-term returns. Nowadays, it has a huge impact.

The graph below shows the accumulated total returns of two types of investments: a 12-month deposit of 2.3% compared to the running yield of a corporate bond fund such as Spectrum's at 4.1%. Both are presumed to keep the same yields over the period.

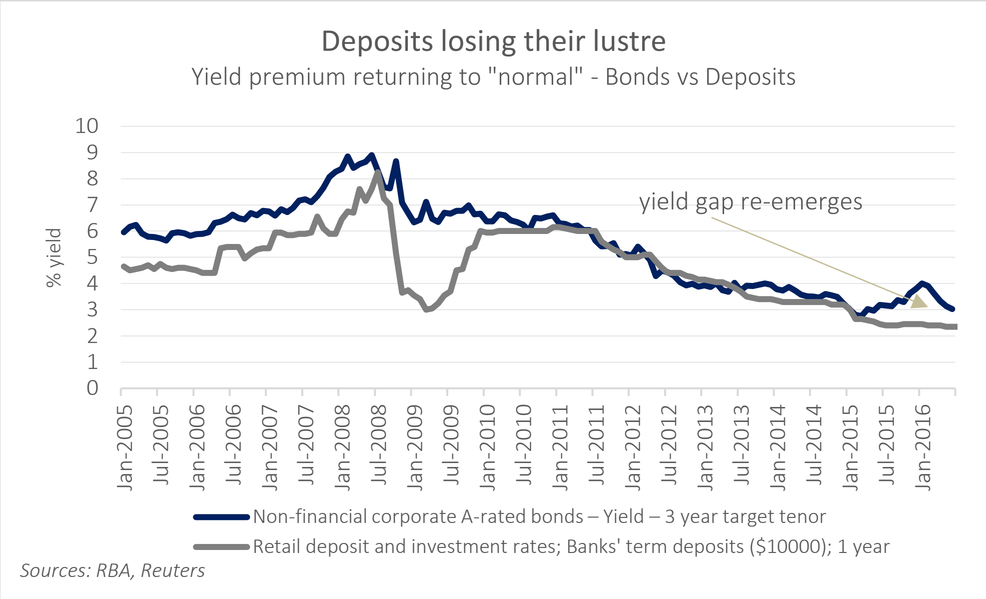


$10,000 invested in the bond fund would theoretically generate around $4,400 in income over 10 years whereas the deposits would generate around $2,300.

Bonds versus deposits: back to normal

Post GFC, Australian banks were told by regulators and rating agencies that they relied too much on international bond investors and that their balance sheets required more local deposits. The banks responded by paying up on deposits to bring their yields near those of a 3 year 'A' rated corporate bond.

As the graph below shows, there is now a more normal yield premium for corporate bonds over deposits. This reversal to 'normal' helps investors, in general, get better returns from a corporate bond fund compared with bank deposits.



Sources: RBA, Reuters

The growing $600 billion SMSF sector holds about $160 billion in bank deposits, while little SMSF money is invested in bonds, and many appear to use deposits as a proxy for bonds. This made sense in the past, but not anymore, particularly because SMSFs may now get worse deposit rates than an individual.

Liquidity or return

For many bank depositors, it now looks like they can either have yield or liquidity but not both. Corporate bond funds offer higher returns and the ability to sell at short notice.

This is not to say there will not be nuanced competition for deposits. The new regulations mean that not all deposits are equal in satisfying regulations. This means it is highly likely there will be differential deposits pricing depending on who and for how long the deposits are for.

The NSFR will only be applied to larger, more complex banks or authorised deposit-taking institutions (ADIs). Smaller ADIs with balance sheets comprised predominantly of mortgage-lending portfolios funded by retail deposits are likely to have stable funding in excess of that required by the NSFR. Regulators see limited value in applying NSFR standards to these entities.

Damien Wood is a Principal at Spectrum Asset Management, and manages the Spectrum Strategic Income Fund. Spectrum and the author have investments in either securities mentioned in this report or comparable securities. This article is for general information purposes only and does not consider the circumstances of any individual.

Liquid asset benefits agriculture and the environment

Rich Gilmore

Impact investing might be a new buzz phrase, but it's here to stay. Estimates of the amounts that will be directed towards impact investing over the next decade run as high as $32 billion in Australia and US$1 trillion globally. This article looks at an example of an impact investment.

A delicate balance

The Murray-Darling Basin is one of the largest and most important river basins in the world, sustaining $19 billion in agricultural production and providing one-third of Australia's food supply. Increasing global demand for Basin-grown almonds, walnuts, hazelnuts, olives, table grapes and dried fruit combined with decreasing water supply and a three-year depreciation of the Australian dollar mean investment in irrigated agriculture is expected to accelerate over the medium term.

While domestic and export markets make the Murray-Darling one of the world's most productive river basins, it is also one of the most vulnerable. Decades of engineering, over-allocation of water entitlements and the drying effects of climate change have significantly reduced runoff to rivers, creeks and wetlands. As a result, 80% of the Basin's ecosystems are now in poor or very poor health.

Its rivers and creeks are the lifeblood of many Australian farmers, but its wetlands are also home to endangered fish, mammals and birds. And therein lies a problem: there's not always enough water for both.

The Australian water market

Australia has a large and most sophisticated water trading market. A water entitlement is a perpetual or ongoing entitlement to receive exclusive access to a defined share of water from a consumptive pool. Entitlements are classified according to their seniority or security, with those classed as higher 'security' or 'reliability' receiving priority in gaining access to water in a given year.

A water allocation is the volume of water allocated to an entitlement, which can be accessed and used or sold in a given period. Water allocations are announced by the relevant water authorities throughout the year based on volumes held in storage, inflows and seasonal expectations. Water allocations can be traded within and between connected rivers in Victoria, South Australia, and NSW.

Over recent decades, federal and state governments have implemented a series of regulatory reforms that aim to provide investment certainty and encourage efficient water deployment. Key regulatory reforms include: the separation of water ownership from land title; development of a nationally compatible water market; and the establishment of a cap on water extraction from the Murray-Darling Basin.

A world-first investment

To help meet this challenge of enough water for both the environment and agriculture, the Nature Conservancy and Kilter Rural developed the Murray-Darling Basin Balanced Water Fund, a world-first investment model generating returns to investors while providing water security for people and nature.

The fund acquires permanent water entitlements and distributes annual allocations between agriculture and nature on a 'counter-cyclical' basis. When water is scarce and agricultural demand is higher, more water is leased or traded to irrigators. When water is abundant and agricultural demand is lower, more water is made available to wetlands. This novel approach seeks to reinstate the wetting and drying rhythms that occurred naturally across the Basin before it was interrupted by the development of irrigation infrastructure.

The Fund's financial returns are generated by the capital appreciation of its water entitlements, by proceeds from the long-term lease of water to irrigators and by the sale of annual water allocations not used for environmental watering.

Up to 60% of the Fund's entitlement portfolio is currently under long-term lease to irrigators. By entering into a lease with the Fund, irrigators achieve the same level of water security as they would with ownership, while also receiving a capital injection into their businesses. This capital is often used to pay down debt, expand farming operations or improve water-use efficiency.

Outcomes to date

The Fund's first capital raising closed oversubscribed in December 2015, raising almost $22 million from investors and $5 million in debt from National Australia Bank's agribusiness division. A second raising of up to $73 million is currently open.

The initial capital from the first raising was fully deployed to entitlement purchases covering 8,322 megalitres (8.3 billion litres) of high-reliability water entitlements across NSW and Victoria, with leases established on close to 60% of the portfolio.

The Fund's largest transaction to date is a long-term water purchase and lease-back agreement with Murray River Organics (MRO), a pioneering horticultural business near Mildura in Victoria, focused on the production of organically certified dried vine fruit. MRO has developed an innovative process to quickly and efficiently convert unprofitable wine grape vineyards to profitable dried vine fruit varieties which enables a significantly faster path to full production at a much lower capital cost than a greenfield development. The transaction delivers stable lease income for the Fund, and provides capital and secure water, allowing MRO to expand to meet its growing domestic and export demand.

In addition to the agricultural and financial returns achieved to date, the first environmental watering supported by the Fund has been completed, with 950 megalitres of Commonwealth water delivered to the Carrs, Cappitts and Bunberoo (CCB) wetland system west of Wentworth in NSW. The progress of the Fund is being monitored with an eye to developing similar models elsewhere including Chile, China, and the United States.

The Murray-Darling Basin Balanced Water Fund is one of the many impact investment transactions that will be featured at this year's Impact Investment Summit Asia Pacific. To learn more about the Summit, view the program here.

Rich Gilmore is Country Director of The Nature Conservancy Australia. For information on the Fund, see www.kilterrural.com. Cuffelinks is not recommending this Fund but offers this article as an example of new opportunities arising in impact investing. We have no opinion on the investment or environmental merit of the transaction, and investors should undertake their own enquiries.