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This Week's Top Articles

High yields may ignore fundamental weakness

Anton Tagliaferro

There's a misperception that equity income investing is as easy as ranking the market's highest-yielding stocks and building a portfolio from that basis. While on the surface stocks that yield in excess of 7% might look attractive, it may be a complete illusion if one looks closely at the market's fundamentals. It is what we refer to as an 'income trap' or an 'income illusion'.

There are countless examples of ASX100 companies that trade on attractive dividend yields. Often investors support these stocks based on yield alone, compounded further by passive 'equity income' ETFs.

In investing parlance, a 'value trap' refers to a stock that looks cheap on the surface, but the trap springs into action when the fundamentals continue to deteriorate and investors lose patience and sell out.

Watch for the 'income trap'

We call it an 'income trap' when a stock may look attractive from the headline dividend yield alone, yet is unsupported by robust company fundamentals. As a bottom-up value manager, fundamentals are crucial to us, be it the quality and transparency of the earnings, cash flow generation, gearing levels or balance sheet strength. When the fundamentals are weak or challenged for a prolonged period, more often than not a dividend cut is inevitable, springing the 'income trap'.

Additionally, while passive ETFs can play a role in equity investing, investors should be cautious when investing from a headline yield perspective. A look at 50 of the most widely-held names on the ASX ranked for yield in the table below shows the vast majority of companies yield over the ASX300 headline yield, which currently stands at approximately 4.5%. While attractive on the surface, this does not justify constructing an income-generating portfolio around these seemingly high-yielding companies.

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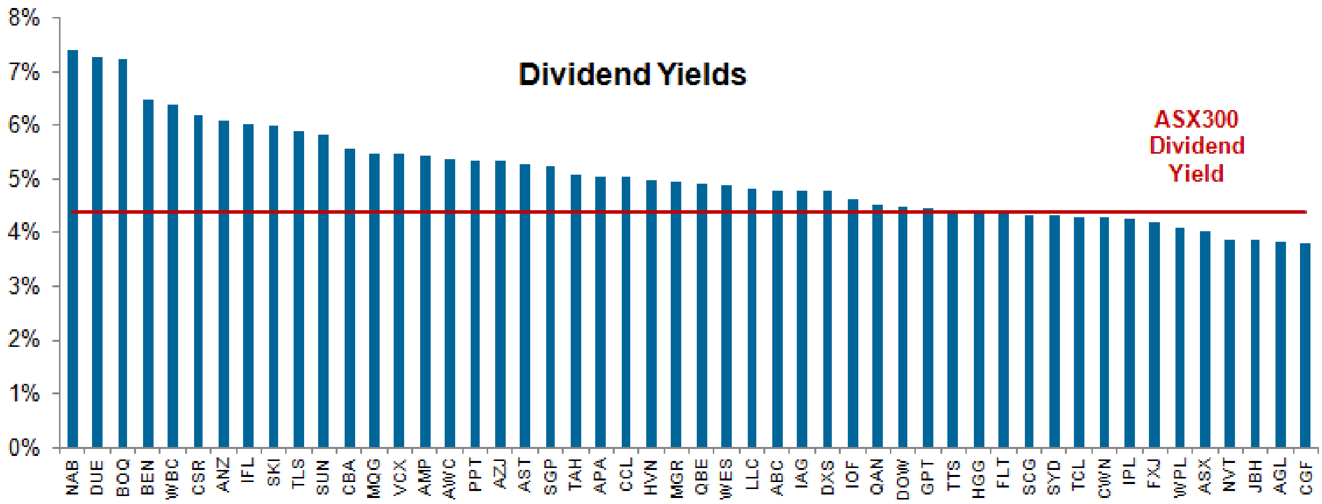
Companies yielding over the ASX300 headline



Source: Factset, 12 August 2016

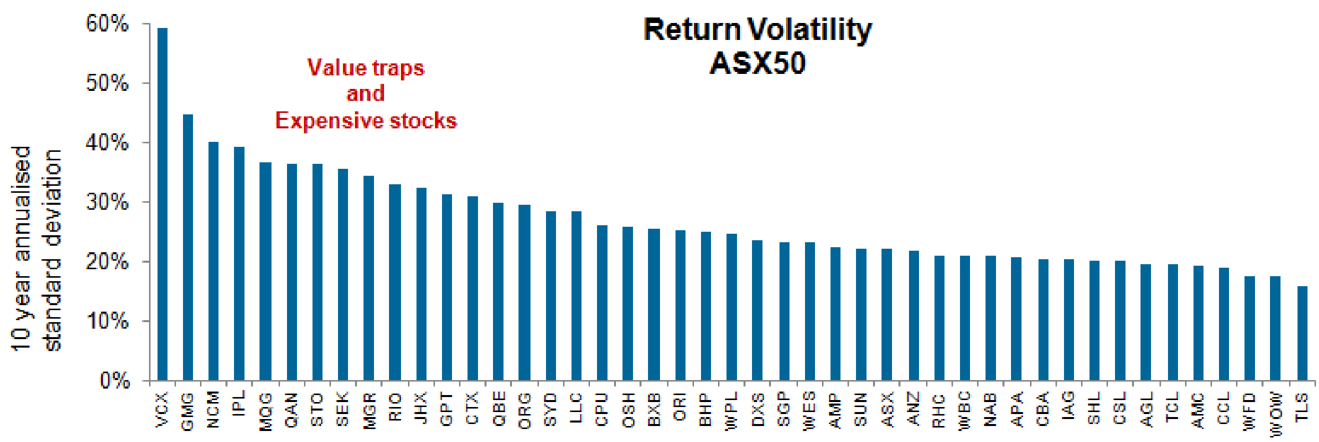
Questions to ask when investing for yield alone

Before investing in an equity for income alone, ask:

- Why is the yield at an elevated level?
- Has the stock fallen and is this a potential value trap?
- Is the company's payout ratio too high?
- Is the company putting its balance sheet at risk by maintaining the dividend?
- Do cash flows reconcile with underlying earnings?

The two most important attributes of a retiree's stock portfolio are high levels of income and lower absolute risk than the overall market. By investing in a portfolio of quality companies, drawdowns are reduced with a higher probability of capital preservation.

Companies ranked by their absolute historical volatility



Source: Factset, June 2016

The left-hand side of the chart represents those companies with meaningfully higher historical volatility on an annualised 10-year basis, symptomatic of the curse of either being value traps or simply too expensive. Beholden to exogenous shocks or wider economic shifts, these companies have shown over the longer term to be much more volatile, given the cyclicality of their business or financial models. While the investment case for a number of these stocks can be made for those in the accumulation phase chasing capital growth, in our view they are simply not suitable for retirees.

Retirees have special needs

So what should we invest in on behalf of retirees? A portfolio of companies with recurring earnings that provide a healthy, consistent dividend trading at reasonable valuations can significantly reduce aggregate volatility.

The table below shows a number of blue chip companies that are well represented in retiree portfolios. When a company cuts its dividend it is a clear signal to the market that its earnings are challenged. The implications for retirees holding these stocks is bad – generated income is falling while the share price is also under duress.

Dividend per share	FY-1	FY0	FY1	12-month share price performance to June 2016
BHP	$1.7	$0.4	$0.43	-27%
RIO	$2.63	$2.96	$1.45	-10%
ORI	$0.96	$0.96	$0.58	-38%
ANZ	$1.78	$1.81	$1.6	-20%
WOW	$1.39	$0.77	$0.81	-18%

Source: Factset, IRESS, June 2016

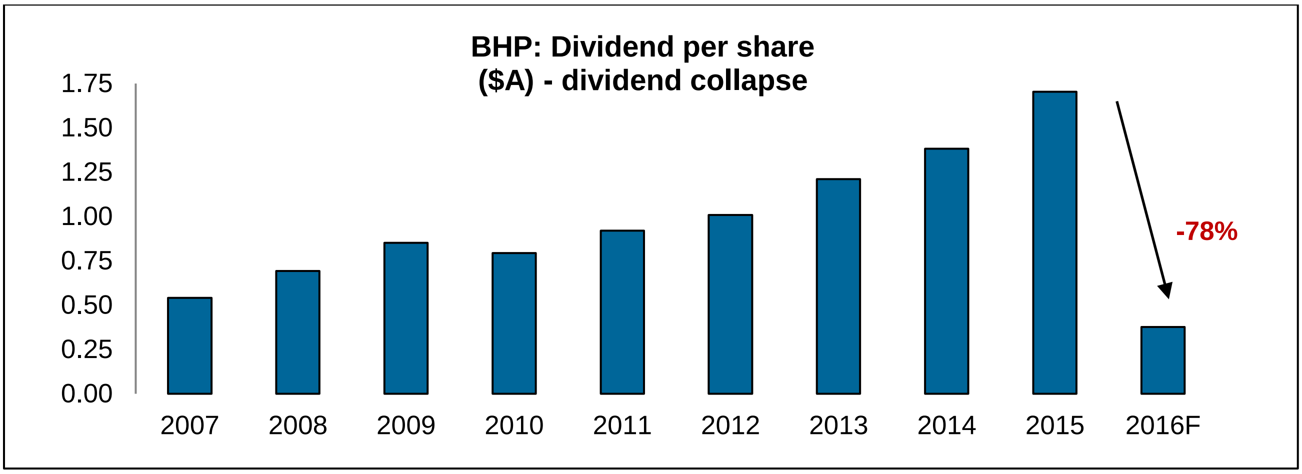
These companies have cut their dividends due in part to a low-growth environment but also because of problems with their business models. Mining-related companies are suffering from low commodity prices and supermarkets and banks are suffering from margin pressure and increased competition. Investors need to pay greater attention to the company's fundamentals and its earnings sustainability before jumping on board because it appears attractive on a dividend yield basis.

In minimising volatility within your stock portfolio, avoiding both income traps and overvalued stocks is paramount. Being aware of what cues to look for in individual companies and understanding trends of underlying fundamentals can assist greatly in picking stocks for your retiree portfolio.

Case study: BHP Billiton (BHP)

In 2015, BHP traded with a perceived healthy dividend yield of 7-8%, seemingly attractive from a retiree's perspective. However, as commodity prices collapsed through 2015, the company's fundamentals continued to deteriorate, their earnings fell and gearing levels increased. The unsustainable payout ratio reached almost 400% as the company tried to maintain its promise of increasing dividends over time. It was unsustainable.

In February 2016, the company took the prudent step of cutting their 'progressive dividend' to protect the company's balance sheet, reduce its gearing and thus preserve its credit rating. The decision was encouraging from a capital management view as it will help BHP stabilise its balance sheet. Yet, from a retiree's perspective, a cut of this nature can have a significant impact on the dividend income received as an investor.



Source: Factset

Conversely, Spark Infrastructure is an owner of regulated electricity transmission and distribution assets, primarily located in South Australia, Victoria and New South Wales. Like BHP, Spark also had a strong CAPEX programme over the past five years. However, unlike BHP, Spark took the prudent measure of de-gearing its balance sheet, whilst maintaining a low pay-out ratio, in order to assist in funding the company’s growth projects. Ultimately, Spark has a stable earnings profile given it operates as a regulated monopoly. When the CAPEX programme slowed down, Spark decided it was in a position to reward investors by raising the dividend.

Fundamental analysis is paramount when building retiree portfolios. We have always believed that companies that can grow their earnings through their own initiatives, that offer a degree of immunity to the economic cycle, and are backed by robust fundamentals are best suited for retirees.

Anton Tagliaferro is Investment Director at [Investors Mutual Limited](). This article is for general educational purposes and does not consider the specific circumstances of any individual.

Focus on LIC dividend sustainability

Peter Rae

One of the reasons investors have embraced the listed investment company (LIC) sector is the fact that many LICs offer a reliable source of franked dividend income. Based on our latest data tables, we have calculated that LICs with an Australian large cap shares focus currently offer an average dividend yield of 4.4%, with most dividends fully franked. For LICs with an Australian mid to small cap shares focus the average yield is 4.6%, although not all dividends are fully franked. LICs with an Australian shares focus and those with a blended portfolio of Australian and international shares with a dividend yield of 4.4% or higher are shown in the table below.

Table: LICs With Above Average Dividend Yields

Australian Shares - Large Cap				Australian Shares - Mid/Small Cap				Aust/International Shares - Blended			
ASX Code	Div Yield %	Franking %	Reserves Cover (x)	ASX Code	Div Yield %	Franking %	Reserves Cover (x)	ASX Code	Div Yield %	Franking %	Reserves Cover (x)
AUP	7.7	0	na	KAT	7.6	88	0.3	CDM	7.1	100	0.3
DJW	6.6	100	1.5	BEL	7.4	100	4.6	HHV	4.5	100	6.0
BKI	4.6	100	1.1	WIC	7.0	100	2.4	CAM	6.0	100	1.6
IBC	4.6	100	0.0	CIE	6.6	50	2.8				
ALR	4.5	100	2.0	WAM	6.3	100	1.4				
FSI	4.5	100	0.9	WMK	6.1	62	1.1				
MLT	4.4	100	2.1	CTN	5.5	50	1.4				
AUI	4.4	100	3.4	SNC	5.5	100	0.3				
AQF	4.4	100	0.5	WAX	5.6	100	3.6				
				MIR	5.4	100	3.0				
				NCC	5.8	100	2.7				

Source: IIR/Company Accounts

While dividends are a key consideration, investors should not buy LIC shares purely on the basis of dividend yield. It is also important to look at valuation metrics such as premiums and discounts to NTA as well as performance of the underlying portfolios. To this point, our data tables provide analysis that can help investors choose LICs to suit their own specific investing strategies.

Dividend sustainability

Dividend sustainability is a critical issue when choosing LICs. To understand whether dividends are sustainable, we first need to look at how LICs earn their profits. Most of the older, internally managed LICs, such as AFIC (AFI), Argo (ARG) and Milton (MLT) are long-term investors and do not actively trade shares. This means their earnings are largely dividend based. On the other hand, the earnings of the LICs with more actively traded portfolios and those with a focus on small or emerging companies, tend to have a greater reliance on capital appreciation. In times of a prolonged market downturn, when overall market returns are negative, LICs that have a greater reliance on capital appreciation are likely to experience greater pressure on earnings and could in fact report losses in the P&L account.

LICs that rely largely on dividend income for earnings are less likely to report losses during periods of market downturns, and therefore the dividends they pay to their own shareholders are likely to be more sustainable. However, if the companies they invest in are forced to lower dividends due to reduced earnings, then, depending on their own payout ratios, the LICs may also be forced to reduce dividends, or at best hold them at current levels. This happened following the global financial crisis when banks and a number of companies were forced to cut dividends to preserve capital. MLT dropped its dividend in both 2009 and then again in 2010, with a total reduction of 26% before resuming the upward trend in 2011. ARG's dividend was down 17% from 2008 to 2010 before resuming its upward trend. AFI was able to hold its dividend flat post GFC, but it did not start increasing again until 2013.

LICs with a greater reliance on capital appreciation were forced to take more dramatic action in relation to dividend payments following the GFC. The WAM Capital (WAM) dividend halved from 16 cents per share in 2007 to 8 cps in 2008 and then fell to 4 cents per share in 2009. With better markets, the dividend has rebounded rapidly with WAM paying 14.5 cents per share in 2016. After paying a dividend of 8 cents per share in 2008, Contango MicroCap (CTN) did not pay a dividend in 2009, with dividends resuming again in 2010. In more recent times, Westoz Investment Company (WIC) dropped its dividend from 9 cents per share to 6 cents per share in 2016. The dividend was maintained in 2015 despite the LIC reporting a large loss due to poor performance of its West Australian dominated portfolio, but this ate into profit reserves. With the company reporting a small profit in 2016 the dividend was cut to prevent further erosion of profit reserves.

In order to be able to pay dividends, LICs need to generate profits. However, it is possible for LICs to pay out more than they generate in profits in a given year by dipping into retained profit or dividend reserves from prior years, as WIC has done. So it is possible for LICs to smooth dividend payments to their shareholders by retaining profits rather than simply paying out 100% of earnings each year. The table above shows our estimates (based on published accounts) of the number of years each LIC could retain its current dividend payments without generating any additional profits. This is a good indicator of dividend sustainability when markets turn down. Coverage of one means that a LIC could maintain its current dividend payout for one year without generating any profit in the current year.

There are a number of LICs in the above table with dividend coverage of more than two years which means they are reasonably well placed in the event of a sustained market downturn. Of the LICs in the table, Hunter Hall Global Value (HHV), WAM Research (WAX), Australian United Investment Company (AUI) and Mirrabooka Investments (MIR), all stand out as having particularly strong dividend coverage.

Over the next year, we expect some LIC dividends may come under pressure as the income from their own portfolios declines due to lower dividends from resources and energy stocks and perhaps also the banking sectors. We note that Djerriwarrh Investments (DJW), one the highest yielding LICs currently, has already said it expects to cut its dividend from 24 cents per share to 20 cents per share in 2017. Based on the current share price this would lower the dividend yield to 5.5%, still an attractive, fully franked yield. This highlights the importance of watching management commentary for indications of potential changes to dividend payouts.

Conclusion

The LIC sector offers investors attractive dividend yields, but in periods of market downturns all LIC dividends are likely to come under pressure. While LICs that rely largely on dividend income from their underlying portfolios will suffer from reductions in dividends from their own investments, those with a higher reliance on capital appreciation are likely to come under greater pressure to reduce dividends. LICs with high levels of profit reserves are best placed to maintain dividends during periods of market weakness.

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Six capital gains tax and depreciation facts for property investors

Bradley Beer

One question investors often ask about claiming depreciation on a rental property is "how will these claims affect capital gains tax (CGT) when the property is sold?"

CGT can be complex for investors, particularly since it depends on the individual investor's situation.

Introduced in September 1985, CGT is basically the tax payable on the difference between what you bought an asset for and what you sold it at. When you sell a property, this triggers what is called a 'CGT event' where you either make a capital gain or loss, which you can calculate using the following method:

Selling price **minus** transaction costs	**Minus**	Original purchase price **plus** associated transaction costs	**Equals**	Capital gain (or loss)

To explain the implications of property depreciation on CGT, here are six facts investors should be aware of:

1. What is property depreciation?

Property depreciation is the wear and tear on a building and the plant and equipment items within it. The Australian Taxation Office (ATO) allows owners of income-producing properties to claim this depreciation as a deduction in their annual tax return, meaning they pay less tax. Property depreciation is made up of two main parts; capital works deductions and plant and equipment depreciation.

2. How do capital works deductions affect CGT?

Capital works deductions are available for the wear and tear on the structure of the building. Examples of items which can be claimed include bricks, walls, floors, roofs, windows, tiles, and electrical cabling. The capital works deductions reduce the cost base of the property, which will add to the capital gain and therefore increase the amount of CGT applicable on sale.

3. How does plant and equipment depreciation affect CGT?

You can claim depreciation deductions for the mechanical and easily removable plant and equipment assets contained in an investment property. When a property is sold, a gain or loss is calculated separately on these items. As outlined by the ATO on its website, you can make a capital gain if the termination value of your depreciating asset is greater than its cost. You make a capital loss if the reverse is the case. That is, the asset's cost is more than the termination value.

Learn more: [Invest smarter with a tax depreciation schedule]

4. What CGT exemptions apply for a principal place of residence?

Properties which are owned by someone who resides, occupies or lives in the property as their home are exempt from CGT so long as the dwelling is used mainly for residential accommodation and is located on land under two hectares in size.

If, as the owner of a primary place of residence, you choose to move out and rent it, a CGT exemption is available for up to six years after you have moved out so long as you don't own another primary place of residence.

If the owner moves back into their investment property, then moves out and rents the property again, a new six-year period will commence from the time they last moved out of the property. There is currently no limit to the number of times a property owner can do this so long as each absence is less than six years.

You can only class one property as a primary place of residence and therefore exempt from CGT at any one time, with the exception of the following rules which apply if you treated both properties as your primary place of residence within a six-month period:

- the old property was your primary place of residence for a continuous period of at least three months in the 12 months before you sold it and you did not use the property to provide an assessable income in any part of the 12 months when it was not your primary place of residence
- the new property becomes your primary place of residence.

5. Are property investors eligible for a discount?

A 50% exemption on CGT is available to individuals or small business owners who hold an investment property for more than 12 months from the signing date of the contract before selling the property.

6. Is it worthwhile claiming property depreciation if it will later add to the capital gain?

The short answer is yes. During the term of ownership, you can claim capital works and plant and equipment as a deduction at your marginal tax rate. These deductions will reduce tax liabilities, therefore generating additional cash flow for the investor each year.

When you sell a property, if you have held it in your name for more than 12 months, you will be eligible for the 50% exemption. This means that only 50% of the capital works deductions during ownership will carry through to the 'CGT event', making it far better for you as a property investor to claim the capital works deductions and take advantage of the additional cash flow during ownership. Depreciation claims also provide you with an opportunity to invest further or reduce loan liabilities.

When considering selling an investment property, you should talk to your accountant about the implications of CGT and your available exemptions. A specialist Quantity Surveyor can also provide advice on the depreciation deductions for any investment property.

Bradley Beer is a qualified Quantity Surveyor and Chief Executive Officer at BMT Tax Depreciation.

Why traditional asset allocators get low returns

Jonathan Rochford

In dozens of meetings over the past four years, I've learnt a lot about how institutional asset allocators (groups that aggregate capital and make investment decisions on behalf of individuals) and family offices think when picking fund managers. While no two asset allocators are the same and certainly no two family offices are the same, there are often similarities. After the small talk, the first questions from the potential investors are a good marker of how they think.

The common and hidden questions

The first questions from family offices are typically 'what are your returns?' and 'what are your fees?' The hidden question is 'do you make money for your clients or just for yourself?' Family offices are looking for managers who have a track record of meaningfully outperforming their benchmark and charge competitive fees. If you don't have these, you aren't going to be part of their asset mix and you may as well leave at that point.

The first questions at meetings with institutional asset allocators are different. The most common questions are 'what are your funds under management?', 'how many clients do you have?' and 'what systems do you use?' Here the hidden question is 'if you underperform will our peers underperform as well?' The most important filters for many institutions are what their peers are doing and their career risk, not the product itself. There's often a checklist of unspoken milestones that fund managers need to meet before asset allocators will consider investing with them.

Checklists are a good thing. I use them when making investment decisions to see if I've covered the key risks. Having a checklist and using it when making decisions relating to fund managers is a good thing too – it's something investors in Bernie Madoff's Ponzi scheme undoubtedly wish they'd used. The key questions to ask about fund manager checklists are; 'why are things on the checklist?' and 'what is the outcome on returns and fees as a result of using the checklist?' If using the checklist means you end up investing with managers that deliver low returns and charge high fees, you are buying the packaging, not the product.

Emerging managers often disqualified

In the US, it is common for pension funds to run publicly advertised tenders to select asset managers. This is great for competition, with the benefits flowing through to asset allocators and their beneficiaries. Tenders allow for asset allocators to specify what they want including milestones. Asset allocators often specify that proposed fees will have a substantial weight in determining fund manager selection. This helps drive down the fees, albeit at the risk of discouraging some high return/high fee funds from tendering.

However, the required milestones may disqualify a substantial number of high return/low fee fund managers. This often comes by specifying a high threshold for minimum funds under management or a minimum number of other pension funds that are already clients. The two diagrams below help explain the issue. Firstly, here's the outcome of the tender for fund managers based on their funds under management and ability to generate alpha.

Who Wins the Tender?	Low Alpha	High Alpha
Low Funds Under Management	Disqualified due to milestones	Disqualified due to milestones
High Funds Under Management	Will not win due to low returns	Will win the tender, subject to fees

Managers with both high funds under management and high alpha generation (excess returns) will win the tender. If the focus is solely on fees, an index fund is likely to win. Emerging managers will either not submit or will be disqualified due to the required milestones.

Good managers closed to new investments

The next matrix shows the reality of the funds management industry when it comes to negotiating fees and terms.

Investment Choices	Low Alpha	High Alpha
Low Funds Under Management	Open to new investments, high ability to negotiate fees	Open to new investments, good ability to negotiate fees
High Funds Under Management	Open to new investments, some ability to negotiate fees	Typically closed to new investments

The bottom right hand corner is where everybody wants to invest. As a result, managers that have both high funds under management and high alpha are typically closed to new investments and in some cases may be giving capital back to their investors. Existing investors who ask for lower fees are likely to be reminded of the waiting list or to have their capital returned.

For fund managers that have both high funds under management and high alpha and that continue to accept new investments, their returns will suffer. Eventually, they will migrate to the low alpha column as their size will impede their ability to take advantage of market mispricings. Asset allocators with high milestone thresholds are essentially limiting themselves to these fund managers. This means consigning themselves and their beneficiaries to managers with lower returns and medium-to-high fees, or to index funds.

Early-stage investing

This is where family offices and non-traditional asset allocators can outperform traditional asset allocators. By looking for managers with high alpha but low funds under management they can achieve high returns with reduced fees. The more enterprising investors will also look for seed opportunities, where a share of the equity or a royalty stream of the fund manager is granted in return for allocating a game-changing mandate to an emerging manager. Early-stage investing also gives investors priority access to the fund manager when their funds are large enough that closing the fund or returning some of the invested capital is required.

Conclusion

The different approach to investing by family offices and institutional asset allocators can be categorised as focussing on the product or the packaging. By focussing on the product, family offices and non-traditional asset allocators look for emerging managers that can deliver high returns as well as lower fees. By focussing on the packaging, traditional institutional asset allocators are often limited to investing with lower return, higher fee managers or with index funds.

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You want an inquiry? Have one on Australian real estate

Robert Simeon

Forget about a royal commission into our banks, what Australia really needs is a full and transparent inquiry into Australian property markets. Australia's population currently sits at 24 million. By 2026, our single households are projected to increase by a staggering 39%. A recent planning report found that, within the Greater Sydney basin, just 340,000 potential housing lots remain. What do we need to be implemented to ensure we have healthy cities?

Just imagine the terms of reference

There are thousands of questions and they need answers.

Why is Sydney in a pattern where we currently have the lowest amount of established homes on the market? Why are we seeing the lowest ever number of first home buyer sales? What is the impact of negative gearing on Australian residential real estate? What is the precise impact of state taxes on our property markets? Why does the federal government allow 100% of off-the-plan sales to foreign buyers? What transport infrastructure needs to be built to meet this growing demand? Why have foreign student numbers increased by a record 11% in the year to July 2016 when foreign students are allowed to purchase real estate with no price restrictions while studying? Why has the federal government never policed the sales of these properties when the students complete their studies?

Why have the baby-boomers decided to stay put in their principal place of residence? When and what caused these changes in homeowner behaviour? What is the best housing practice – a principal place of residence that allows for tax deductions on all outgoings and a tax charged on the sale? Or a principal place of residence that attracts no tax deductions and no tax payable on the sale?

Why do Australian property prices always figure among the most expensive in the world? Why are governments at all levels intent on driving new red tape initiatives through businesses, yet have absolutely no accountability for the way they manage their own economies of scale?

The list just goes on and on, and the federal government doesn't even have an appointed housing minister. Why don't our elected politicians want to know anything about these issues? Australia does not have a single major transport infrastructure model in place for discussion. The only problem as I see it is that such an inquiry would deliver scathing findings on federal and state and territory governments. This conversation is seriously overdue, although nobody wants to start it.

Arrivals highly concentrated

Brisbane, Sydney and Melbourne remain the hotspots for new arrivals, recently capturing a record 85% of Australia's total population growth. Sydney is setting the wrong records with workers in the age bracket 20 to 29 years packing up and leaving. Earlier this year, the NSW population soared past 7.7 million and we don't have to guess where the vast majority of them want to live. Why has net overseas immigration been allowed to accelerate into NSW and Victoria only?

The average price of a Sydney home has jumped a staggering 44% since 2013, when real wages have only managed a 2% increase. Australia's housing affordability is now at crisis levels. The only time that we collectively hear about such problems is in the run–up to a federal election.

There has never been a better time to hold such a real estate inquiry. It has never happened before simply because these questions fall on deaf ears.

Robert Simeon is a Director of Richardson Wrench in Sydney's Mosman and Neutral Bay and has been selling residential real estate in Sydney since 1985. He has also been writing real estate blog [Virtual Realty News](#) since 2000.

What role should hedge funds play now?

Mark Story

Almost against the better judgement of retail investors, the hedge funds they took speculative bets on during and after the GFC, then quickly abandoned for falling dismally short of their promises, are now creeping back onto their radar.

Unsurprisingly, the 180-degree about-face in investor sentiment is mirroring the recent performance of traditional assets, which after a strong run over the past five years, have unceremoniously fallen. But while they're being forgiven for not behaving true-to-label when required, only certain pockets of the hedge fund universe are capturing the market's attention.

What we're currently witnessing, says Donald Rice, head of Alternative Investments Asia Pacific at Credit Suisse Private Banking, is an admission by investors that relying on traditional asset classes like shares, fixed income and cash isn't going to get them to where they need to be within a historically low earnings environment. "People had major objections to hedge funds following the GFC, and those who returned have favoured single managers and avoided fund-of-fund managers," Rice says.

Genuine diversification

What's becoming clear, adds Rice, is that retail investors' need for genuine diversification and low correlation to traditional asset classes is driving them towards those hedge funds that deploy market neutral and uncorrelated alternatives to fixed income strategies. Credit Suisse's allocations to hedge funds are driven by strategic views around the most relevant strategies in the current environment. Currently, some of the favoured strategies include insurance-linked, quantitative funds, and traditional managed futures (sometimes called Commodity Trading Advisors, or CTAs).

"Interest in alpha capture is less algorithmic and more about research and social media," Rice says. "For one manager, the biggest returns in the last two years are from machine learning, and the implications of this for investors shouldn't be overlooked."

Stephen Cabot, head of Investment Consulting Private Banking Australia at Credit Suisse says that with equity markets arguably stretched and fixed income currently where it is, clients want to take some of the allocation out of long only and put it into equity market neutral with low net exposures. "Our clients' portfolios have typically had between 5 and 20% exposure to hedge funds, but we recommend 20% exposure to alternatives," he says.

The big-end of town is no different. When Credit Suisse surveyed 369 institutions globally, 87% said they would be increasing their allocation to equity market neutral, and reducing traditional market exposure (or beta) in their portfolios.

"Within markets like this, people have enough beta, and feel comfortable with lower net exposure to the market," Cabot says. "Rather than shooting the lights out like they were supposed to before the GFC, the role of hedge funds is now less about turbocharged returns and more about stabilising a portfolio composed of bonds and equities with something that's truly uncorrelated."

Alternative beta strategies

A longstanding problem with most hedge funds, adds Gareth Abley, head of Alternative Strategies at MLC, is that it's expensive to pay for market beta wrapped up in a hedge fund, especially when it could be acquired more cheaply on listed equities. While all of Abley's current hedge fund exposures are offshore, he's typically attracted to Australian managers with a more diversified exposure. "We prefer managers who exploit the law of large numbers in lots of small bets to achieve a more reliable return stream."

Abley is attracted to uncorrelated risk premium strategies that don't rely on the skills of a manager to deliver. He cites natural catastrophe reinsurance or mortgage repayment risk as two examples. MLC didn't invest in hedge funds until 2007, due to major concerns over having beta wrapped up in a hedge fund, as well as fee and liquidity considerations, but since then allocations have grown steadily.

"They have to be the right hedge funds and this is a very small subset of the universe," Abley says. These include long/short exposure to factors like quality, value, carry and momentum across different asset classes, and Abley expects this trend to continue. He also expects these alternative beta strategies to achieve a decent risk-adjusted return, which within the current environment is cash plus 3 to 4%, and close to zero correlation to equities.

Dumb luck

Having screened out the 80+% of the hedge fund universe that has too much correlation to equities, Abley has hand-picked a dozen funds for MLC's portfolios. But due to the difficulty finding those that genuinely stand out after thorough due diligence, there are only 12 hedge fund managers in MLC's portfolio after 10 years.

One of the biggest dangers confronting investors, warns Abley, is the number of seductive-looking funds with great track records that have got there purely through dumb luck. He uses the analogy of a coin tossing contest. If 10,000 people toss a coin each year, after three years there will be 1,250 that have called heads three times in a row. After five years, there will be 312 that have called heads five years in a row. The problem, he says, is that they may start to believe that they're skilful. It's the same with the 10,000 or so hedge funds. While it's statistically guaranteed that some will have great returns purely from randomness, Abley reminds investors there's no guarantee they'll call heads again next year or the year after.

"We're constantly trying to work out what's driving returns – luck, skill or a favourable environment for a certain type of strategy," Abley says. "Performance doesn't always tell you the right story and if you can find a good manager that's done poorly for three years, it could be a good time to back them."

Filters

To select 130 to 140 exposures within clients' portfolios, Rice uses a four-pillar approach, including legal reviews, market risk management, manager due-diligence, background checks, CFO, team member and third-party service provider checks, plus peer group analysis.

"While we could see merit in a CTA trend-following approach, we're also not so quick to write-off non-performing quality managers," Rice says. "It's important fund performance is understood, and the time may suddenly be right for quality funds that experienced lack-lustre performance over the last two years."

While Cabot's clients are keen to invest in both Australian and offshore hedge funds, he admits that certain strategies are harder to access locally. He says it's less about Australian hedge funds not being sophisticated enough, and more about networks and access to certain markets. "For example, it's easier for European-based managers to trade distressed credit in Europe," he says. "For CTA and managed futures, having suitable scale and infrastructure enables US and European trading when those larger markets are open."

Better transparency

Complementing improving investor sentiment is greater transparency, courtesy of a better post-GFC regulatory environment. But given that it can be a primary source of competitive advantage, disclosure into individual holdings is not something hedge funds are necessarily willing to provide. For example, while it's no secret that US-based pure alpha fund Bridgewater is MLC's largest exposure by capital allocation, little is known about the other 11 hedge funds within its portfolio.

But insufficient transparency can come at a price. For, example, when selecting hedge funds, Rice will overlook top performers that refuse to provide sufficient insight into their underlying exposures.

Similarly, investors also lack detail when it comes to fees. While Abley is also reluctant to talk about fees, he concedes it is critical to negotiate strongly for a deal that stacks up net of fees.

“While we don’t mind paying managers fees for delivering high alpha, anything that isn’t alpha is discounted from the return stream and we have no interest in paying hedge fund fees on beta.”

Mark Story is Executive Director of [Prime Strategy Media] and specialises as a financial and business journalist.

ASIC creates a level playing field on fees

Annika Bradley

The countdown is on. From February 2017, managed investments and superannuation products must adhere to ASIC’s new fee disclosure guidelines. The changes create a level playing field across products, leaving little doubt that any fees or costs reducing the ultimate investment return must be disclosed. But for products that have avoided indirect (or ‘look-through’) cost calculations up until now, the changes are far reaching and require considerable thought and preparation. ASIC has indicated that the deadline will not be extended.

ASIC has tried to even things up such that consumers can make meaningful and consistent comparisons between products.

The amended *Regulatory Guide 97—Disclosing fees and costs in PDSs and periodic statements (RG 97)* was released in November 2015 and ASIC consider 18 months is ample time for product providers to ready themselves for the changes. The changes are extensive. The regulatory guide has increased by 45 pages with the main change relating to indirect costs.

Clarifying disclosure of indirect costs

Previously, the disclosure of indirect costs was open to interpretation, but this guide makes it crystal clear that product providers should look-through all the way to the actual investment providing the return and count any amount which will directly or indirectly reduce this investment return. This means, for example, with an investment in a hedge fund or private equity ‘fund of funds’ with multiple underlying vehicles - which ASIC has termed ‘interposed vehicles’ – the product provider needs to count all the fees and costs of those underlying structures.

ASIC has also applied this concept of interposed vehicles to over-the-counter (OTC) derivatives. That is, if there are any fees and costs embedded in an OTC that are intended to remunerate the counterparty for managing or creating the derivative, these too should count towards total indirect costs. An example might be a swap specifically designed by an investment bank to replicate the return of a standard commodity index. This product needs to be tailored by the investment bank and they seldom do anything for free. There is normally a cost embedded in the swap, but not typically called a ‘fee’, that goes to the investment bank for their work. A fund that purchases this swap will need to firstly be able to calculate this embedded cost, and then ensure that it is captured and disclosed to comply with ASIC’s new rules.

What are ‘income-sharing' arrangements?

Another interesting inclusion is the section dedicated to ‘Reducing costs through income-sharing arrangements’. RG97 specifies that any income or benefit derived from the fund’s assets that is retained by the product provider should be recorded as a fee or indirect cost. This captures circumstances where a service provider’s fee is reduced because they are earning revenue from the use of the assets of the fund. The classic example is a favourable custody fee whereby the custodian reduces its headline fee as it’s using the assets of the fund to generate revenue through a securities lending programme. This illusory ‘discount’ will need to be included in the indirect costs under the new arrangements.

Stretching across 68 pages, there are several other changes for product providers to consider and it will be interesting to see the change in fee levels disclosed from early next year. There’s no doubt there’ll be some innovative interpretations of the new legislation from product providers. But ASIC has tried to even things up such that consumers can make meaningful and consistent comparisons between products.

Annika Bradley is a financial services consultant who is passionate about financial literacy and adequate retirement incomes for Australians. The information in this article should not be considered financial advice. Readers should consider their own personal circumstances and seek professional advice before making any financial decisions.