Cuffelinks
Connecting investors with ideas

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## This Week's Top Articles


- **Pleasure and pain: a personal journey buying off-the-plan** *Graham Hand*
- **Is the housing market in bubble territory?** *Phil Ruthven*
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- **Shrinking shorts not shrinking opportunities** *Matthew Ward*


## Pleasure and pain: a personal journey buying off-the-plan

Graham Hand

It's 9am on a Saturday morning and a new apartment project is being launched somewhere in Sydney's north. The queue started to form at the display suite hours earlier, and hundreds of anxious buyers crane their necks to see who is ahead of them and to watch for queue jumpers. The display includes a spectacular model of the building, while artist's impressions on large posters show wide curved balconies overlooking gardens and parklands. The strong pre-launch marketing campaign to thousands on the real estate agent's database and heavy advertising have built the enthusiasm into a frenzy. It's a nervous wait, each person knowing they will have only a few minutes to decide whether to lay down a million dollars for a small two-bedder. Does it have the right aspect, is it high enough, how may car spaces? … what, a hundred have already sold in the first hour! I'll take that one!!!

So much for the Reserve Bank's recent warning of an oversupply of apartments, the inability of many Chinese buyers to settle on earlier purchases, the tightening of lending policies by banks. The Fear of Missing Out (FOMO) drives a market where the developer can name almost any price.

This week, *The Australian Financial Review* demonstrated the differences of opinion. On the same page where it reported 230 first-stage apartments sold out in a few frantic hours in one development, Deloitte Access Economics was forecasting the 'Faustian bargain' of declining prices and bad investments.

Golden Age's first stage release of its 408-unit Park One project in Macquarie Park sold out in hours on Saturday.

**Apartment spree: 'People were snatching, not buying'**

**Property may become 'worst investment'**

Jacob Greber
Economics correspondent

Property looks set to become the "worst investment" over coming decades because of a looming bust in apartment prices and the reality that official interest rates won't stay low forever, says a leading economist.

Describing the nation's economy as trapped in a "Faustian bargain" with low borrowing costs and resurgent commodity prices, Deloitte Access Economics economist Chris Richardson warns that future risks of a shakeout are mounting.

Mr Richardson said buyers had for decades been repeatedly betting "double or nothing" on property, which until now has been a successful strategy. However, it has entrenched an unwavering belief in investing in housing over shares or other assets.

"There comes a point where past performance starts to become a guarantee of

**Key points**

Economy trapped in a "Faustian bargain", says Deloitte economist Chris Richardson.

There has been an unwavering belief in property investment.

believe will lead to falling prices.

Banks are already cracking down on lending to the sector and analysts are increasingly concerned the long pipeline in apartment approvals over the past two years means supply of new units will continue to grow through the rest of 2016 and 2017. Any reductions in new starts will only become apparent in lower supply from 2018 onwards.

Mr Richardson said everyone in Australia knows that too many apartments are

*Source: The Australian Financial Review, 17 October 2016*

**My personal experience**

In mid-2013, we bought an apartment off-the-plan for our daughter, and she moved into her new home at the end of 2015. This article draws from our experiences during the two-and-a-half years of construction and the subsequent months living there.

For those interested in a blow-by-blow description, we wrote a blog throughout the construction period, starting as the excavators first moved in, all the way to the landscaping. The blog has already received over 70,000 views as owners watched their dreams come to fruition.

The blog is attached here. It covers far more detail than most readers will want, with hundreds of photographs of the building, the anguish of delays, the dealings with the developer and the council and the amazing changes in the surrounding area of Pyrmont, Darling Harbour and The Bays Precinct.

This article does not enter the debate on whether it's a good time to buy property or not. Rather, it focusses on the risks and rewards of buying an apartment off-the-plan.

**Advantages of buying off-the-plan**

The apartment was not bought for investment reasons. It was time for our daughter to move on from the family home, and we needed a particular location, size and design to meet her needs. Some of these comments are therefore not investment-related, although I expect they will have widespread applicability.

**1. Enjoying watching the construction**

We regularly visited the site as part of creating an historical record of how an old flour mill was being converted into a modern building of 135 apartments. The mill was originally built in 1896 and, after almost a century of operation, ceased production and fell into disrepair. Only three sides of the old façade remained, held up by steel beams, in a prominent location near the gateway to Sydney heading to the west.

We loved the design, the way the new building 'stepped over' the old, retaining part of Sydney's industrial heritage in an otherwise modern structure, as shown below.

The building stands at the top of an escarpment at the edge of Pyrmont/Ultimo, at the end of a narrow road of heritage terraces. It took months to dig four floors of basement parking out of solid sandstone, and then as the building grew, the mill façade had to be 'tied' to the new structure while hoping the old walls did not fall into the massive hole.

This process of photographing the site, communicating with other owners on the blog, watching the surrounding area change and eventually moving in, was an unexpected pleasure. It created a special bond with the building, knowing so much about how it had been created.

**2. It's the way to buy a new apartment**

For anyone who wants a new apartment, buying off-the-plan is almost the only option. It is possible to wait for a building to be completed and see if some buyers sell or renege around settlement time, but unless there is a major fallout, a minority of apartments come onto the market at this time, greatly limiting the choice. It's unlikely that the pick in the building – the quiet side, the private outlook overlooking the garden, the best view or the location away from the pool and lifts – will suddenly appear. These good apartments need to be grabbed early off-the-plan.

**3. It may be possible to make some design changes**

We had some specific design requirements, and fortunately the developer accepted with considerable grace our desires to change the internal layout of the apartment. We switched the two bathrooms, redesigned the kitchen and a bathroom, removed a wall from one of the bedrooms and relocated electric switches. No doubt this was an exceptional experience, although more common in top-end apartments. It would have been extremely

difficult or expensive to make such extensive changes in an established building, but done early enough in the design and build stage, it was not costly to accommodate. It made the end result a bespoke design instead of the inevitable compromise of an established apartment.

**4. Ability to plan the funding of the balance**

The 10% deposit allows long-range planning on the funding of the balance. There is no rushing around for finance or a quick sale of assets. Of course, any gains in price for an investor are leveraged by the 100% exposure to the market, the type of gearing not available on other asset classes. This is a double-edged sword, and it is far more likely that prices will fall from this point forwards than it was in June 2013. Even when we were buying, we could feel the early stages of a price surge, although nothing of the coming Sydney stampede. Some apartments in this building were sold prior to settlement for handsome returns.

**Disadvantages of buying off-the-plan**

Many financial planners advise their clients never to buy off-the-plan due to the uncertainties and inflated costs involved, and anyone going through this method of buying should consider the risks. Over 200,000 apartments are expected to come onto the Sydney, Melbourne and Brisbane markets by 2018, raising questions about where the demand will come from.

The two main problems experienced in our building were:

**1. Uncertainty when it would be completed**

When we bought the apartment in June 2013, we were told it would be completed by the end of 2014. The date gradually moved out quarter by quarter until it was a year late. This was not too difficult to manage since our daughter simply stayed with us longer, but it introduces great uncertainty for anyone renting or needing to sell. How long do they rollover their existing lease? When do they put their property on the market? These problems would not occur with an existing property.

You can see in the blog the progress of the building. We visited the site nearly every month, and we asked workers about progress and towards the end, completion dates. The dates gradually slipped by, not due to a dramatic event like a flooding or bad weather, but more because of its tight access in an inner city location. The building 'topped out' in August 2014 but it wasn't completed for another 16 months.

Many buyers became worried about the 'sunset clauses' in our contracts. There were news stories about developers rescinding contracts once certain dates had passed, leaving owners without their apartments and developers with massive windfall gains as they resold to new buyers. We settled three months before our sunset clause, and the NSW Government changed the law in November 2015 to prevent this unscrupulous practice.

**2. Different product than the one promised**

The overall building design delivered significantly as expected, and in fact, the quality of design and finish are probably better. As we were closely involved in the ongoing design of the apartment, there were no surprises.

But other owners had significant issues, such as layouts not as originally specified, walls where windows with views were expected, and some apartments were smaller than the original design. The contract gave the developer the right to deliver an apartment with a size variation of up to 5%, which on a 120 square metre apartment is a significant six square metres. Of course, there have been complaints about fixtures and fittings not being as expected and while these have generally been resolved, there is none of this doubt when buying an existing place.

Some of the surrounding infrastructure, such as the public lift from the property directly to the light rail station, was not completed for another six months, as the council refused to certify it until some issues were fixed. Lend Lease's construction work in Darling Harbour also compromised access to the city for far longer than was originally advised.

The following disadvantages apply more generally rather than in our case.

**3. Potential victims of clever marketing**

There is a pleasure and excitement in owning real estate that few other investments can match. On the investment side, the marketing highlights negative gearing benefits, capital gains discounts, rental returns. It rarely quotes the correct strata fees as nobody knows what the body corporate will set. Other costs such as council levies, stamp duties and maintenance costs are ignored in the colourful brochure. Instead, the focus is on the shiny new building, the landscaped gardens, the convenient location and the amazing facilities. Many new apartments cost more than established dwellings nearby, where the seller does not have the marketing gloss.

An owner occupier may not be overly concerned at paying 5-10% more to move into a new apartment, but an investor may see lower returns, and anyone planning to sell before settlement will need a strong market to recover the stamp duty and legal costs. The impending supply in eastern capital cities suggests the price performance of recent years will not be repeated.

**4. Inability to obtain finance and leveraged losses**

While most people buy an apartment with a financing plan, the actual visit to the bank or broker usually occurs as settlement approaches, which may be a couple of years after the original commitment. It is not possible to know the willingness of banks to lend in a particular suburb or on a type of property. The bank will engage a valuer to assess the property value, usually lending around 80% in the current market (this loan-to-valuation ratio has fallen due to worries about future prices). The value is not what the buyer paid, but what the bank could realise on a sale less costs. For example, a property costing $1 million may be valued at $900,000 nearing settlement, and the maximum loan may only be $720,000. The $180,000 (in addition to the initial $100,000 deposit) is a lot to find for someone who was expecting the bank to lend the full $900,000, and the risk of non-settlement rises. The buyer may face a loss of the deposit, or more if the developer takes legal action.

A valuation firm, WBP Property Group, conducted research on 1,794 off-the-plan sales in Victoria between December 2009 and August 2015 and found half the properties were valued at less than the original purchase prices, with the average loss of $40,000 or 9.4%.

**Conclusion**

Our experience buying off-the-plan had its highs and lows. We enjoyed writing the blog and watching the building rise from the sandstone, and we now have a unique record of the transformation of part of Sydney's industrial history. The end product for us has lived up to expectations after we stayed actively involved with the developer. The construction delays were annoying, and some issues with fittings needed fixing. I can certainly see the advantages of buying a finished product which gives greater certainty of the outcome.

*Graham Hand is Editor of Cuffelinks. Every experience buying a property will be different.*

*Shane Oliver of AMP Capital has written this research paper on the outlook for Australian housing.*

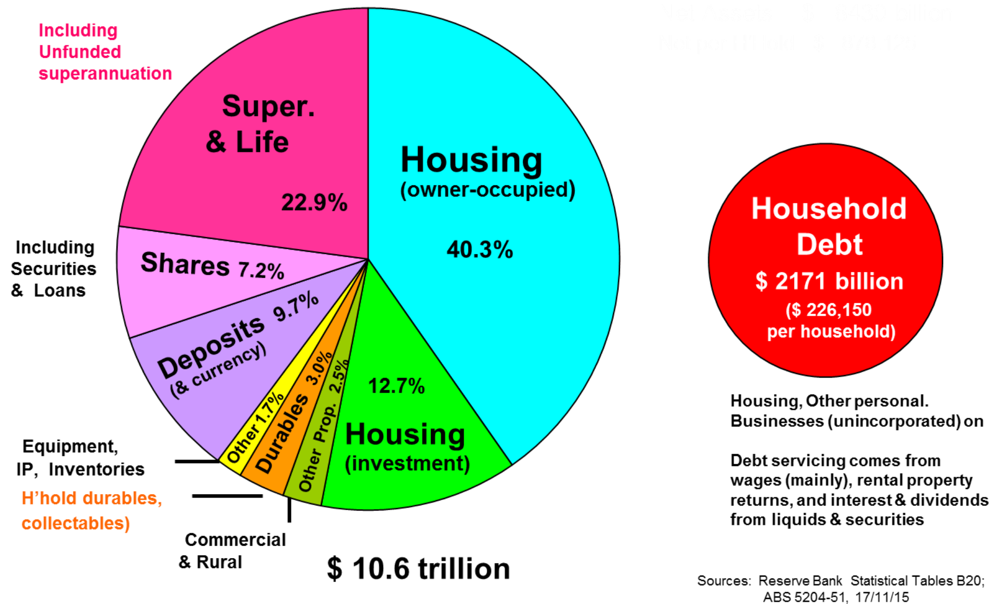
## Is the housing market in bubble territory?

### Phil Ruthven

Housing is expensive in Australia. Measured as a multiple of average wages, Sydney residential property costs nearly 1½ times that of London and over twice that of New York. All eight of Australia's capital cities are dearer than Boston, Washington, Chicago, and Tokyo.

But let's put housing in a wealth perspective. The diagram below shows the assets and liabilities of Australia's households using the latest official ABS data (2015). Housing represented 53% of all assets, but a lower 45% if net of mortgage debt. Even adding in household durables (furniture, appliances, cars etcetera) doesn't bring the total to half of net assets, so the majority of our net assets now resides in financial and commercial products.

## Australian Household Assets & Debt




We have over 10 million dwellings which had a total value of $5.9 trillion in 2016, or 3½ times Australia's annual GDP. There were almost three times as many houses as flats and apartments, the average dwelling costs just over four times average household income, and was valued at $584,000 in June this year.

Our density is just over 2.5 persons per dwelling, half that in 1901. Our dwellings are now much bigger, nearly three times, with three or more bedroom dwellings accounting for almost three-quarters of all residential properties. The table below adds some more perspective.

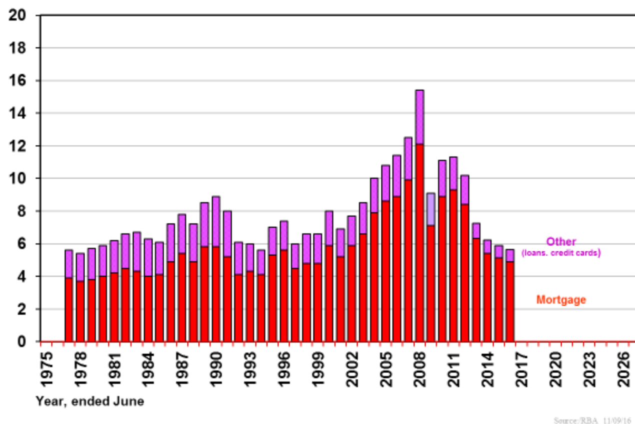
## At A Glance

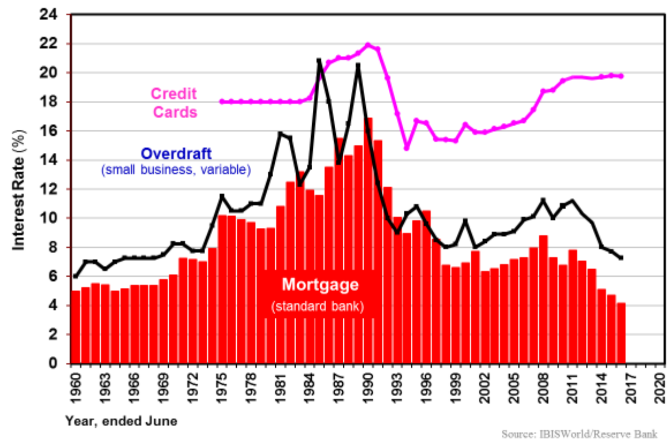
June 2016

| | | |
|---|---|---|
| ❖ **Population** | **24.1 million** | |
| ❖ **Dwellings** | **10.1 million** (9.5 million occupied) | |
| ❖ **Type** | **Houses/Flats et al** (74/26) | |
| ❖ **Value** | **$5.9 trillion** | |
| **New Finance** | **$390 billion in F2016** | |
| **Mortgage Debt** | **$2.0 trillion** | |
| ❖ **Average Price** | **Dwellings** | **$584,200** |
| | **Houses** | **$637.350** |
| | **Flats et al** | **$433,760** |
| ❖ **Affordability** | **Dwelling price 4.0 times** average household income | |
| ❖ **Median Price** | **Dwellings** | **$656,000** |
| (8 Capital Cities) | **Houses** | **$716,000** |
| | **Flats et al** | **$487,000** |

Note: * This may be somewhat higher due to a higher number of unoccupied dwellings

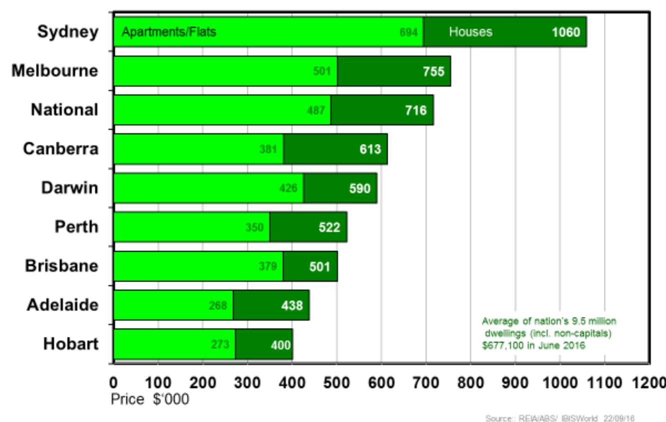
Australians borrowed $400 billion last fiscal year for new housing plus alterations and additions to existing dwellings. We can afford all this on top of existing debt, as the two following charts suggest. Debt servicing is as low as it's been in five decades, due to record low interest rates.



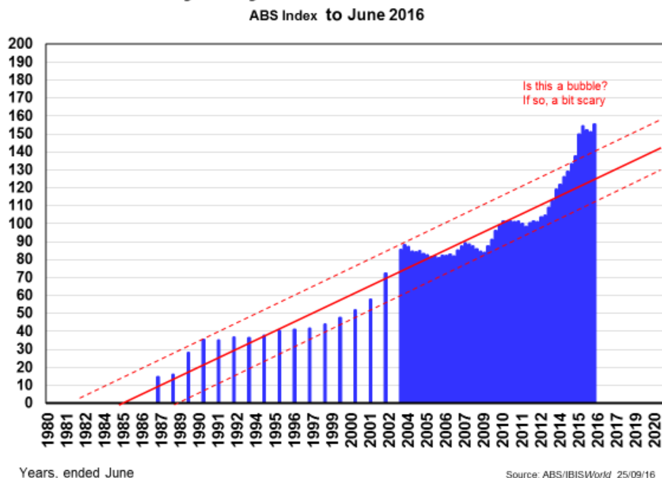



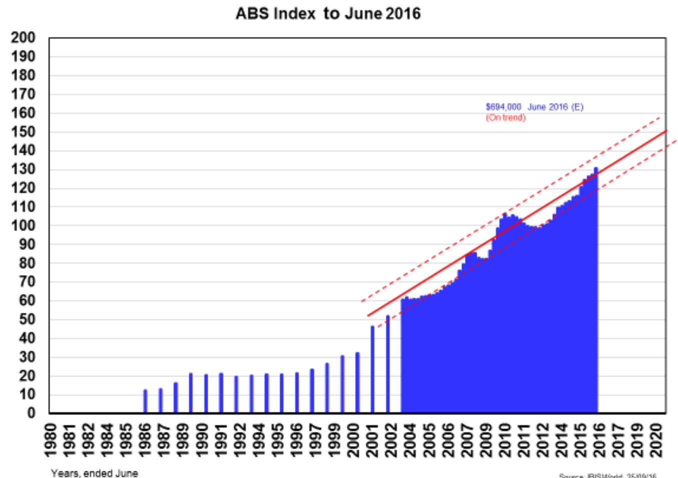

**Our capital cities**

Australia's population is one of the most urbanised on the planet, leaving aside city-states such as Singapore and Hong Kong, but prices across our capital cities vary enormously.




Sydney is the odd-one-out given its prices are so far ahead of the second priciest market (Melbourne). The two charts below suggest the degree to which Sydney prices seem to be well over trend compared with Melbourne.



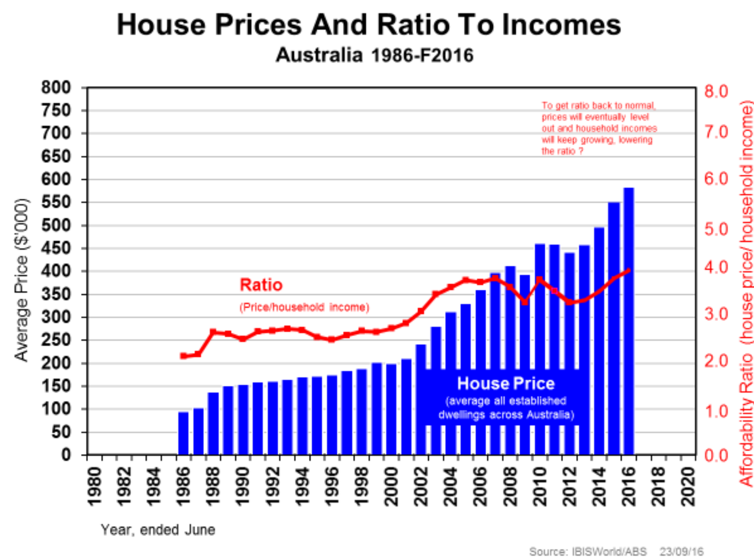



The difference is even more marked when we compare just apartments. Sydney had been under-supplied for nearly a decade, whereas Melbourne had gone into overdrive, leaving Sydney over the past year a sellers-market (prices over-trend by 12-13%) and Melbourne the opposite: a buyers-market, with prices 7-8% under-trend.

The indications are that price growth is abating as we head into 2017. In FY16 prices have fallen a little in Canberra and more in the mining states with their capitals - Darwin and Perth. – falling by 5% or more over the 12-month period.

So what?

Firstly, Australia's economy is not threatened by its world-leading dwelling prices: they are affordable as seen by the earlier debt servicing graph where the ratio is the lowest in some five decades. The chart below reinforces the fact that we have lived with an affordability ratio in the high range (3½-4 times household incomes) for a decade and a half, without dire things happening.




Yes, Australia's household debt (mainly mortgage debt) as a share of GDP is one of the highest in the world, but manageable. And our corporate and government debt as a share of GDP are among the lowest, if not actually the lowest. Overall, we are not living too far above our means compared with most other developed nations.

Sydney is the stand-out loner among our capital cities. Its economy and that of NSW are doing well, indeed the best in the nation, but that may not protect it from a dwelling price correction in the year or so ahead, or a longish period of prices flat-lining until incomes catch up to restore equanimity.

*Phil Ruthven is Founder of IBISWorld and is recognised as one of Australia's foremost business strategists and futurists.*

## Improving ETF selection based on principles and data

### Michael Turner

Exchange Traded Funds (ETFs) increasingly come in different shapes and sizes and offer efficient access to more asset classes and sectors than ever before. Growth has been rapid. Of the 150 Exchange Traded Products on the ASX, 80 have been listed since 1 January 2013. This is good news, because they usually bring access at a reduced cost compared to other investment vehicles. ETFs now play an important role in investment portfolios, confirmed by the increase in usage and popularity.

**Investors need to understand ETF transparency better**

As a research house, we contend that ETF selection processes and criteria need to move to another level beyond the current simplistic approach. Factors like funds under management (FUM), age of fund, performance (relative or otherwise), tracking error, issuer confidence, fees, ease of compliance, platform access et al are all, in our view, only the basics.

More work needs to be done to fully understand ETFs and the differences between them. A focus on only the basics misses too much critical information.

Fortunately, the transparency of underlying assets in ETFs allows a much deeper analysis, such as the sector and geographic allocations of each fund. Additionally, by applying the traditional tools of security analysis to each underlying constituent, we can develop a view of a fund's investment potential based on fundamentals such as earnings growth and valuation multiples. This is a forward-looking approach.

ETF selection should be about building the appropriate research-based 'investment case' that matches an investment criteria. Our approach facilitates this for example by distinguishing which funds are most appropriate for a 'growth at a reasonable price'-type investor versus which funds are better suited to an income-oriented investor.

As an example, a 'plain vanilla' equity ETF is simply a basket of equities that seeks to track a given index. We can calculate a detailed series of equities-specific data points (e.g., earnings growth, valuation multiples) as well as the investment exposure the fund holder receives. From there, we can begin to compare ETFs from within their peer groups and even across peer groups.

**What's under the hood: investing in Europe via ETFs**

For example, within the 'Europe' peer group, Australian investors can access five equity-based options, one of which is hedged back to the Australian dollar. These come from five different issuers and track five different indices, as shown in Table 1.

**Table1: Peer group of European ETFs in Australia**

| Fund | Issuer / Product Name | Index | Mgt Fee (bps) | Stock Count | FUM* | Listing Date |
|---|---|---|---|---|---|---|
| **ESTX** | **ANZ** ETFS EURO STOXX 50 | STOXX EURO 50 | 35 | 50 | 1.56 | 26 Jul 16 |
| **HEUR** | **BetaShares** WisdomTree Europe ETF – Currency Hedged | WisdomTree Europe ETF – Currency Hedged | 58 | 131 | 7.36 | 10 May 16 |
| **IEU** | **iShares** Europe ETF | S&P Europe 350 | 60 | 351 | 561.47 | 1 Oct 07 |
| **UBE** | **UBS** IQ MSCI Europe Ethical ETF | MSCI Europe Ethical | 40 | 441 | 6.86 | 19 Feb 15 |
| **VEQ** | **Vanguard** FTSE Europe Shares ETF | FTSE Europe | 35 | 1107 | 6.55 | 11 Dec 15 |

*Source: AltaVista Research as at 6th October 2016. / *: ASX Funds Monthly Update August 2016*

From this data, observations may conclude that older funds may generally have large and sticky Funds Under Management though they may be relatively expensive. Fees can range greatly, with younger funds generally being cheaper. There's also a premium to pay for hedging and the stock count within each fund varies widely.

When we check the underlying assets, we find all five funds have at least some exposure to each of the ten major sectors, and each is reasonably well diversified, which is not always the case with ETFs. Still, there is plenty of variation, with HEUR offering little exposure to Energy at just 1.4% versus 7.4% for ESTX. For Consumer Discretionary they flip places, with HEUR at 18.3% of assets compared with 10.5% for ESTX.

Among country exposures the differences can be significant (Table 2). For example, while IEU and VEQ put about one-quarter of assets in Great Britain, ESTX and HEUR have none. Depending on how Brexit proceeds, that's likely to have a big difference in returns!

**Table 2: Major country exposures of European ETFs**

| Country | ESTX | HEUR | IEU | UBE | VEQ |
|---|---|---|---|---|---|
| **France** | 35.6 | 24.9 | 13.8 | 15.1 | 13.3 |
| **Germany** | 32.1 | 26.4 | 13.7 | 15.0 | 13.8 |
| **Spain** | 10.0 | 17.4 | 4.3 | 4.8 | 4.4 |
| **Netherlands** | 7.7 | 12.8 | 7.0 | 8.5 | 6.3 |
| **Italy** | 6.1 | 1.3 | 2.8 | 2.8 | 3.1 |
| **Belgium** | 4.4 | 6.9 | 2.3 | 2.4 | 2.2 |
| **Finland** | 1.5 | 5.5 | | | |
| **Britain** | | | 24.6 | 10.7 | 25.8 |
| **Switzerland** | | | 14.8 | 17.8 | 14.2 |
| **Sweden** | | | 4.3 | 4.5 | 4.7 |
| **Denmark** | | | 2.7 | 3.1 | 2.8 |
| **Ireland** | | 1.2 | | | |

*Source: AltaVista Research as at 6th October 2016. Where blank, exposure is negligible or zero.*

We begin to see that the different rules of each index result in difference exposures. To quantify exactly how similar (or dissimilar) one fund is from another, we introduce Overlap Analysis, which measures the extent to which the positions in each ETF are identical.

**Table 3: Overlap analysis of European ETFs**

| Fund | ESTX | HEUR | IEU | UBE | VEQ |
|---|---|---|---|---|---|
| **ESTX** | - | 48.3% | 28.9% | 28.9% | 24.0% |
| **HEUR** | - | - | 23.2% | 24.5% | 21.2% |
| **IEU** | - | - | - | 78.2% | 80.5% |
| **UBE** | - | - | - | - | 72.3% |
| **VEQ** | - | - | - | - | - |

*Source: AltaVista Research as at 6th October 2016. Where blank, refer alternate cross-reference.*

With ESTX as a reference, the overlap with HEUR is 48.3%, meaning nearly half of the fund's positions are identical. This is important because differences in returns can only be generated from the portion of each portfolio which is distinct.

The more similar one fund is to another, the more important price becomes as a differentiator between products. For example, UBE has 78.2% overlap with IEU, and 72.3% with VEQ. This analysis cuts through sector and country allocation data and identifies an ETF's 'value for money'. It is also useful in comparing 'smart beta' products (such as HEUR) to the more traditional pure index ETFs.

**Building the investment case**

There's more though to ETF selection than sector and country allocations, fees, past performance – real or back-tested – and other minor preferences. A detailed examination of the investment fundamentals is required to build a solid investment case. Table 4 has some important fundamental factors and valuation metrics, as well as the ALTAR Score™ - our proprietary measure of an ETF's overall investment merit (like any rating, investors should consider it alongside other criteria when making a fund selection. Our calculations are based on reported results and consensus estimates for each underlying security in an ETF.

**Table 4: Investment fundamentals and valuation metrics**

| Fund | ALTAR Score ™ | Long Term EPS growth estimate | Net Margin (%) | | ROE (%) | | P/E (X) | | P/BV (X) | | Yield (%) | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | 2016E | 2017E | 2016E | 2017E | 2016E | 2017E | 2016E | 2017E | 2016E | 2017E |
| **ESTX** | 7.8% | 7.40% | 6.6 | 7.0 | 9.6 | 10.4 | 14.2 | 12.5 | 1.3 | 1.3 | 4.0 | 4.1 |
| **HEUR** | 6.5% | 8.10% | 6.9 | 7.3 | 11.8 | 12.5 | 16.2 | 14.4 | 1.9 | 1.7 | 3.3 | 3.4 |
| **IEU** | 6.9% | 8.30% | 6.8 | 7.3 | 9.8 | 10.8 | 16.4 | 14.3 | 1.6 | 1.5 | 3.7 | 3.9 |
| **UBE** | 6.8% | 8.50% | 6.4 | 7.0 | 9.7 | 10.6 | 16.5 | 14.5 | 1.6 | 1.5 | 3.5 | 3.7 |
| **VEQ** | 6.7% | 8.40% | 6.5 | 7.1 | 9.8 | 10.8 | 16.9 | 14.8 | 1.6 | 1.6 | 3.5 | 3.7 |

*Source: AltaVista Research as at 6th October 2016.*

Importantly, the data points above give investors more information on which to make a fund selection. There are usually trade-offs in fundamental data when selecting ETFs. The ALTAR Score™ is not the only thing to look at. For example, superior Net Margins and ROE of the underlying stocks bodes well for the investment characteristics of HEUR, and mid-range P/E is strong. Though its higher Price to Book Value (P/BV) impacts yield, it simply shows the underlying stocks are in favour with current investors.

**Understanding the trade-offs**

Investing in ETFs — as with almost everything else — involves trade-offs. Table 4 illustrates some of the trade-offs that result between attractive valuations and profitability and growth. The beauty here is that the transparency of an ETF shows those trade-offs clearly. With the appropriate fundamental investment data and selection tools, more informed investment decisions can be made, ultimately creating a better match between an investor's objectives and the available funds. If you invest in ETFs, as an individual, an advisor, a robo, a super fund, whatever your stripes: what criteria do you value?

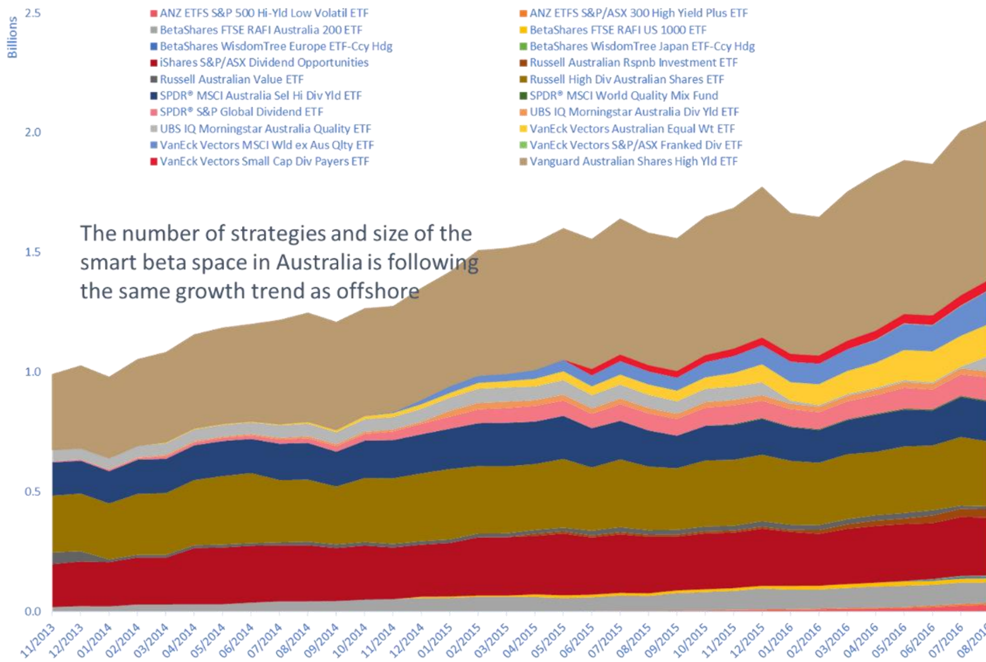
*Michael Turner is Head of Sales & Corporate Development at AltaVista Research, which is based in the US and has been operating in Australia since 2008. As a specialist ETF researcher, AltaVista covers 1,100 ETFs in the US valued at some USD2.15 trillion. In Australia, research covers 104 equities and fixed income ETFs. This article is general information and does not consider the needs of any individual.*

## Five types of smart beta ETFs on the ASX

### Leah Kelly

Do you prefer regular or smart investing? Smart, of course, which is why fund marketers invent catchy names for investment products. 'Smart beta' is one such product category.

Smart beta ETFs are not new. Globally, there were 1,123 smart beta ETFs as at 30 June 2016. In Australia, there are 154 ETFs and 21 are known as smart beta, accounting for about $1.4 billion or 8.4% of the market, up 20% from a year earlier.




*Source: Morningstar, Owners Advisory, September 2016*

**What are smart beta ETFs?**

Smart beta is a name given to investment strategies that aim to either enhance returns or reduce risks of the existing traditional market-capitalisation-weighted indices – the most referenced one in Australia is the S&P/ASX 200. One of the simplest examples of a smart beta version of the ASX 200 is the equal-weighted version. As the name suggests, this strategy invests 1/200th in each stock on the index. Smart beta strategies differ from active strategies in that:

- they are rules based
- they are transparent (we know what the rules are)
- they are typically low cost when compared with actively managed funds.

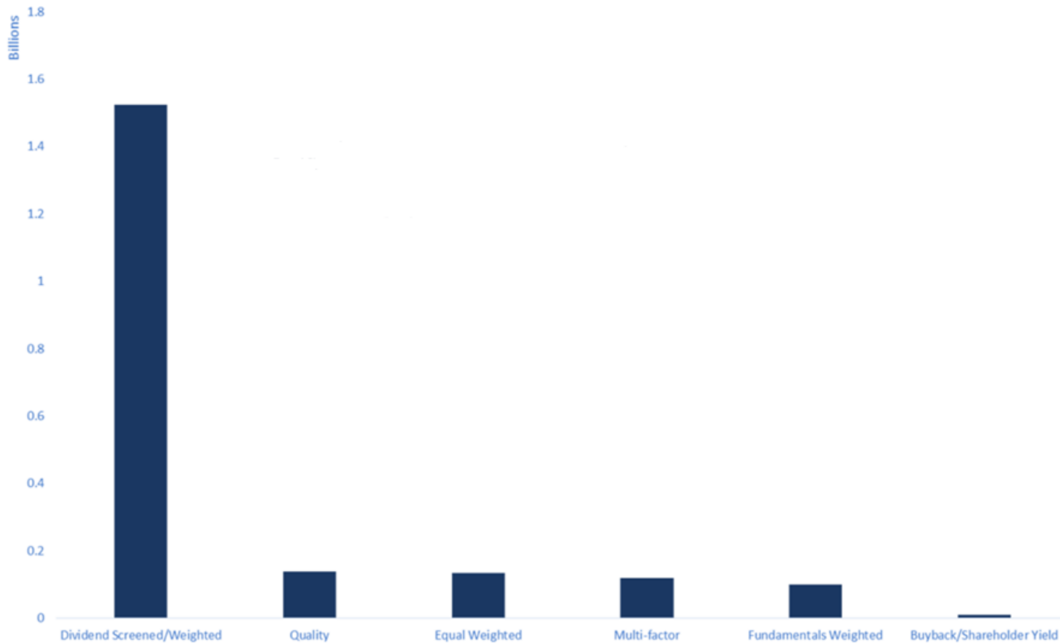
Most of these strategies aim to exploit a weakness in a market-cap index and fundamental to their investment philosophy is 'just because a company is big doesn't mean you should own a lot of it'. It is common to see so-called 'factor' ETFs – smart beta ETFs that increase the weight of smaller companies relative to larger companies or value, momentum, quality or any of the other common factors that are known to perform over time.

**Main types of smart beta ETFs**

There are five main types of smart beta ETFs currently available in the Australian market, with more types expected to follow:

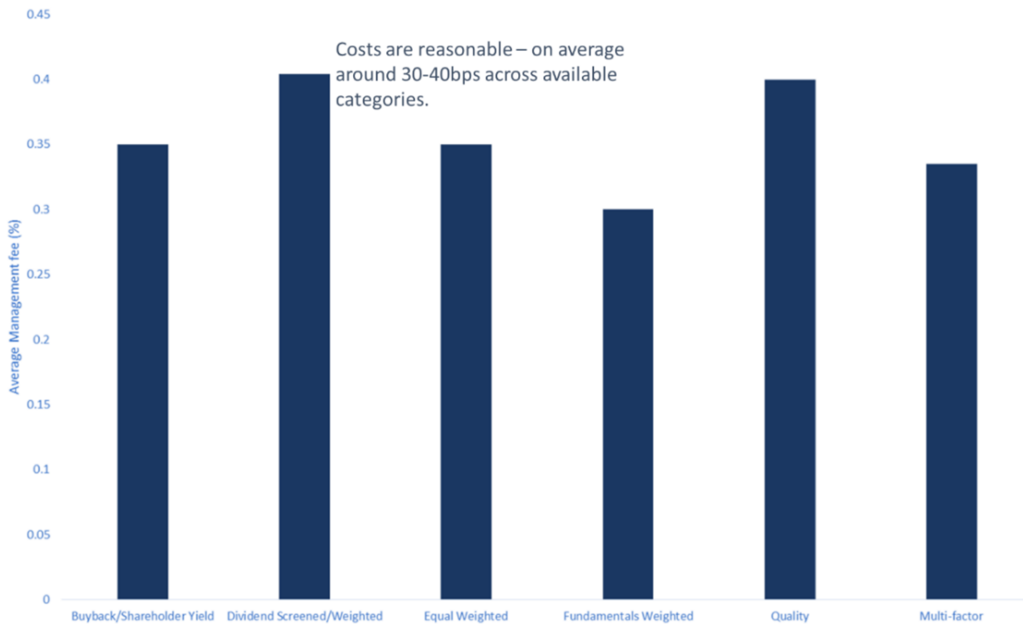
1. Dividend screened – as the name suggests, this one seeks higher-income stocks and is currently the most popular of the smart beta ETFs available. This trend is occurring globally as yields on fixed income products fail to meet investors' income demands.
2. Fundamental – this one typically weights or positions each stock based on company fundamentals derived from balance sheets/cashflow statements and profit/loss statements.
3. Quality – weights are determined according to the quality of each stock's earnings.
4. Equal weighted – the name says it all.
5. Minimum variance or volatility – these are designed to exhibit lower price variability than the market capitalisation index.

**Dividend seeking investment strategies are extremely popular globally**



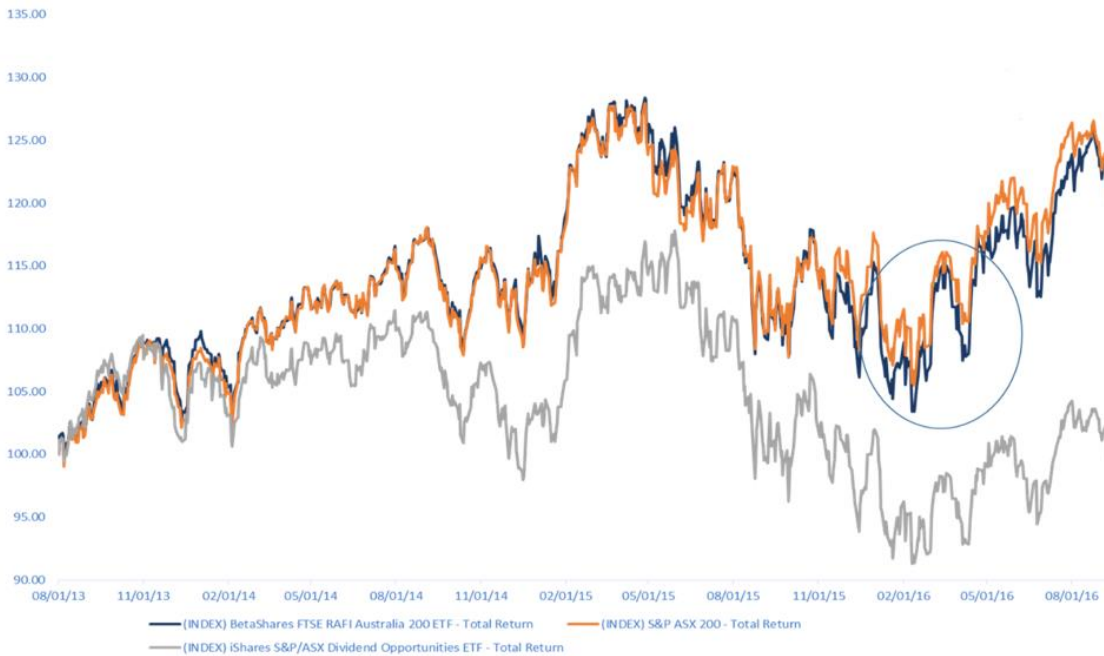

*Source: Morningstar, Owners Advisory, September 2016*

Fees for the smart beta products are usually cheaper than active management but dearer than the traditional market-capitalisation indexes, as shown below.




*Source: Morningstar, Owners Advisory, September 2016*

The relative performance of smart beta-style ETFs that are rules-based investment strategies are often tied to the investment cycle. For example, those based on value or fundamental factors can underperform the market-capitalisation-weighted index for a period of time – such is the nature of value investing. Likewise, those screening for dividends also will have periods where they will underperform the market. The chart below shows periods where smart beta strategies can overshoot to the downside as well as the upside.




*Source: Factset, Owners Advisory, September 2016*

Rules-based funds, such as smart beta funds offered on the ASX, straddle the spectrum between active and passive investment management. Like active funds there is the possibility of outperformance, but also underperformance when the 'rules' are not favoured by prevailing market conditions. However, compared to their passively managed peers, net of fees beating the market is still possible. Smart beta strategies offer access to a form of active management without the need to filter through the vast array of mixed-performing stock pickers.

*Leah Kelly is Portfolio Manager at Owners Advisory. This article is general information and does not consider the circumstances of any individual.*

## Shrinking shorts not shrinking opportunities

### Matthew Ward

While shorting stocks (selling borrowed shares) receives a lot of media attention, particularly when stock markets are falling, the total value of all short positions has actually been declining throughout most of 2016, based on reports compiled by ASIC. Despite this, shorting opportunities remain in particular sectors.

**The strange case of the shrinking shorts**

Since the ASX All Ordinaries Accumulation Index bottomed in mid-February 2016, it has made higher highs and higher lows, while the overall value of short positions has progressively decreased. As a snapshot, the trend in the value of short positions compared to the Index is shown in the table below.

| Date | Short Positions (Top 50 Coys) | All Ords Accum Index |
|---|---|---|
| 4 Jan 2016 | $18.5 billion | 47,594 points |
| 12 Feb 2016 | $22.5 billion | 43,104 points |
| 31 Mar 2016 | $19.5 billion | 46,664 points |
| 30 Jun 2016 | $17.6 billion | 48,530 points |
| 29 Sep 2016 | $16.9 billion | 51,405 points |

Short positions typically represent less than 2% of overall ASX market capitalisation and have a much more significant effect on individual stock prices than against the broader market index.

Investors short equities for a variety of reasons but generally it's because they perceive such stocks as over-valued. This may be due to a belief that profit forecasts are overly optimistic or that the stock may face cyclical, structural or regulatory challenges.

**Traditional shorts**

Consumer retail stocks are popular shorting territory with Myer having the dubious honour of having the highest percentage of its share capital shorted. This is currently a whopping 16%, although it has fallen from almost 21% in early 2016. Many believe that increasing competition from large international retailers such as Zara, Top Shop and Uniqlo, as well as online retailers, will take a slice of Myer's revenue base and crimp its operating margins.

Similarly Flight Centre, with over 10% of its shares sold short, is facing intense competition from online travel and accommodation companies such as Expedia, Priceline, and Webjet. Woolworths has over 7% of its shares shorted along with Metcash at over 11% as supermarket margins look increasingly vulnerable, partly due to the national expansion of Aldi.

The future of retail looks challenging, as global giants such as Amazon, which rarely make a profit but are rapidly increasing market share, are expected to expand into Australia.

Media companies involved in free-to-air TV, newspapers, and magazines were disrupted many years ago and Nine Entertainment still has short positions against its stock of over 5%. Even the initial disruptors such as Seek and REA Group have attracted reasonable shorts of over 5% and 3% respectively.

**Fashionable shorts**

More recently, short positions have been creeping up in ANZ, NAB, and Westpac on the expectation that earnings growth, dividends and outlook statements will disappoint. Challenges in the banking sector such as increased competition, low credit growth, potentially higher bad debts, and greater regulation are well known. At the end of September 2016, short positions across the Big 4 banks exceeded $6 billion.

Other companies recently caught in the cross-hairs include market darlings Bellamy's and Blackmores, where short positions have increased to over 11% and 8% respectively. While both companies are forecast to deliver future earnings growth, they were priced to perfection and increasing regulation on the import of certain 'clean and green' products into China combined with short-term over-supply issues were the catalysts.

Aged care service providers Estia Health, Japara, and Regis have also been added to the shorters' shopping list, with previously negligible short positions increasing to over 7%, 5% and 4% respectively. These companies were also highly priced and the future has become less positive due to the federal government seeking to reduce residential aged care funding outlays.

Short positions remain elevated on select resource companies including Independence Group, Alumina, and Rio Tinto, despite the recent rise in certain commodity prices. Similarly, shorts remain high on resource services companies exposed to the commodity capex cycle such as Worley Parsons and Monadelphous.

**Short squeeze opportunities**

There may be opportunities to take advantage of a 'short squeeze' where short sellers are forced to cover their positions by buying the stock which can result in the price rising. This may be applicable if an investor has a high conviction in a company's favourable future earnings and their own valuation is above the market price. While the initial implementation of short positions typically results in share price underperformance, investors should look to take advantage of large, existing short positions in stocks and the timing of when they need to be covered.

An example of a highly shorted company that subsequently 'shot the lights out' is Fortescue Metals, which had 7.5% of its shares shorted in February 2016. Fortescue benefitted from iron ore prices holding up above expectations, materially reducing its production cost base, and paying off a decent chunk of debt. Not only did the share price run on the news and is currently up over 200% in less than eight months, but short covering boosted the upward move as in excess of 100 million previously shorted shares were bought back.

Similarly, Mineral Resources had nearly 15% of its share capital shorted in mid-February. It also reduced production costs, benefitted from a relatively higher iron ore price, exceeded earnings forecasts, and received greater market interest in its lithium assets. The share price increased from $4 to over $11 and short positions were reduced by 90%. Other notable beneficiaries include Whitehaven Coal, which is up over 600%, predominantly on higher coal prices and 60 million shares previously shorted were also bought back.

The reduction in these shorting opportunities on resource stocks is one reason for the fall in overall level of market shorts.

**Shorting done well can improve returns**

The share market, with or without short selling, is inefficient and price distortions are par for the course. In an environment where many stocks are considered to be priced to perfection, short selling provides certain investors with an additional strategy to improve on their returns.

*Matthew Ward is Investment Manager at Katana Asset Management. This article is general information and does not consider all the risks associated with shorting stocks or the circumstances of any individual.*

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