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This Week's Top Articles

Eight key features of successful companies

Victor Gomes

Let's start with a fundamental message: don't buy index in Australian small companies. We have found that there are eight key factors that time and again consistently distinguish a truly successful business from the also-rans, allowing for superior performance over the index.

1. Management are owners/founders or otherwise act as if they are

Our fund has owned ARB (a global leader in 4WD accessories) for more than five years. The company was listed on the ASX in 1987 and is still run by the same three men who remain large shareholders. While the company may occasionally transgress the current-day politically correct corporate governance standards of a small board and an executive chairman, shareholders have seen earnings grow by 13% pa over the past 10 years. As owners, it's not surprising that senior management also pay themselves very modestly by industry standards ($250,000-$380,000 each).

Another recent example is our investment in Wisetech Global (WTC). We like the high growth and recurring revenue of their cloud-based logistics software, and the fact that the founder and CEO, Richard White, sold very few shares into the recent IPO (about 2.5 million of his 151 million shares). Today he still owns more than 51% of the company.

2. High returns on capital will often dispense with the need for high debt

High returns on invested capital (ROIC) are an investor's best measure of a company's business franchise. TechnologyOne (TNE) is a cloud-based enterprise software business based in Brisbane. Its ROIC is not-too-shabby at plus 200% pa. By giving Adrian di Marco, its CEO and founder, your $1 of new capital (should he need it), he can earn more than $2 annually. The business is more than self-funding and doesn't require new equity capital. Consequently, TNE is not only debt free, it periodically pays out a special dividend in addition to its normal dividends, returning cash and franking credits to its shareholders.

Sirtex Medical (SRX) has a ROIC of over 80%, has no debt and pays a fully franked dividend. It may be in a higher-risk industry (medical technology), but its net cash position and stable yet fast-growing existing business (treating liver cancer using an internal radiation therapy in 'salvage' patients) mitigates some of the inherent industry risk.

3. Reinvest profits and don't perpetually raise new equity

Let's look at TechnologyOne (TNE) again. It has not issued any material new capital (other than minor issues as part of employee incentive plans) in its 16 years or so of listed life. In 2000, it had 303 million shares on issue. Today it has barely 3% more (310 million).

The power of a business with high returns on invested capital and low capital needs translates into a stable share count and high total shareholder returns (plus 800% over 16 years for TNE). With no debt and no need for new equity issues, it is a truly unique business franchise.

Sirtex is another example of the power of compounding shareholder returns on a stable shareholder equity base. It listed in 2000 with a share count of about 54 million, which today is only 57 million. This lack of dilution has helped deliver total shareholder returns of about 1100% or around 12 times its share price in 2000.

On the other side of the coin, there are many companies that don’t sufficiently re-invest profits or otherwise have such low returns on capital that they are unable to internally fund growth without debt. The global aviation sector has a poor industry structure where returns on capital are low and profits are volatile. Contrast then the share count increase for businesses like Qantas (+67% over 16 years) and Virgin Australia (+210% over 15 years). It’s no surprise that both have high debt levels and poor total shareholder returns (Qantas +48% over 16 years or around +2.4% pa, Virgin -86% over 13 years).

We could go on and on. In resources, some of the worst offenders include Beach Energy (+715% share issues over 16 years) and Cockatoo Coal (an eye-watering +6100% increase in shares on issue over the 10 years since listing).

4. Stable management that often promotes from within

If there is one overriding factor critical when investing in small caps, it is the quality of management (honesty, integrity, and competence).

Some of the good things we like about investing in small companies include; being in the earlier and faster growth stage of their development, being more focused by typically operating in only one industry sector and being better able than larger companies to exploit disruption, innovation and change. However, all these positives can quickly become negatives without good management to exploit them, and a good management team will often grow their own successors.

Contrast this to poorly performing companies who are constantly changing management and tend to appoint from external candidates. These outcomes occur because of thin resourcing or otherwise as a way of bringing in an external change agent to fix existing problems.

Domino's Pizza (DMP) and Flexigroup (FXL) are examples of the good and not-so-good. Domino’s senior management team are all long serving and internally grown. The CEO, Don Meij, started in 1987 as a pizza delivery driver. Europe CEO Andrew Rennie started in 1994 as a Darwin store franchisee, and CEO Australia Nick Knight also started as a single store franchise owner. Even CFO Richard Coney has been with the company for 20 years. Domino’s is the ultimate textbook example of a stable, high-performing and internally grown management team.

Flexigroup on the other hand is onto their third CEO in five years. An initially successful strategy of growing in point-of-sale finance in Australia was led by CEO John DeLano. After he left in 2012, an ex-Telstra executive as CEO did not fully understand the unique culture built up by DeLano and he had neither a sales nor finance sector background. The problems just kept mounting with growth stalling due to failed initiatives. Another change of CEO saw the appointment of an ex-CBA executive as the current CEO. This time it’s a case of the right industry background but the wrong culture (they need a CEO with a challenger mindset, not an incumbent’s mentality).

5. Do not needlessly diversify a good core business

Diluting a good business by adding a lesser business is not a risk diversifier. Proper focus trumps poor diversification every day of the week. Consider the divergent strategies adopted by two mostly similar businesses, A.P Eagers (APE) and Automotive Holdings Group (AHG).

APE has remained focused on exploiting opportunities within the auto retailing sector (check out their latest initiative to disrupt used cars at carzoos.com.au), while AHG has diversified into… wait for it … the transport and logistics sector.

We all know how tough this sector can be, with the likes of Coles and Woolworths to contend with. AHG shareholders have seen more than five years of management effort and $300 million of their capital spent on a bunch of (mostly distressed) refrigerated transport businesses. We are left with a division that is highly capital intensive, offers low returns on capital, continuously misses earnings expectations and has little growth. All the while, their original core business has continued to grow and prosper.

The operating performances of these two companies have significantly diverged in recent years.

6. Earnings are all-inclusive, not 'underlying'

Some companies have financial statements that are a breeze to analyse. Their numbers are clean and simple to understand. This in itself is a strong quality signal. Their reported earnings are their earnings. Their invested capital is their invested capital – no adjustments are needed. Examples that come to mind include ARB, TechnologyOne, and A.P Eagers.

Then there are the companies that engage in the (usually repetitive) practice of offering a range of adjustments to their reported earnings. They call this their 'real' or 'underlying' earnings. Rarely do such adjustments reduce a company's reported earnings, a warning sign in itself.

Recent examples of businesses that are enthusiastic promoters of 'underlying' earnings include Super Retail (SUL), Fletcher Building (FBU) and the aforementioned AHG.

Just like AHG, SUL started with an outstanding core business in the Super Cheap Auto chain. It then diversified with acquisitions of lesser-quality businesses. Some have worked well, such as its investment in sports retailer Rebel. Most have not, including Greencross (bicycles), Workout World (fitness equipment) and Rays Outdoors (leisure products). The need to explain underlying earnings is a sign of management's failed past strategies and poor capital allocation decisions.

FBU has a mixed recent track record of acquisitions. The result has been a number of 'non-cash' asset impairments and other one-off costs over recent years, all added back to derive underlying earnings. Shareholders would surely argue with management's use of the descriptor 'non-cash', given that management has paid out real cash in the first place to buy these businesses.

7. Do not rely on a 'gifted moat', it may fade

Some companies have no obvious 'moat' around their businesses to protect them from competition, yet they succeed nonetheless (think ARB, Domino's Pizza and TechnologyOne).

Yet other companies are gifted a strong moat and then see it fade away. SAI, with its standards and assurance business, has relied on its monopoly position to diversify into lesser businesses only to see the moat weakened and threatened. Sky Network Television in New Zealand has seen its previous monopoly for showing All Blacks games eroded by streaming technology.

Our many years of investing experience have taught us to look for businesses that are successful without, or perhaps despite, a strong moat. As Andy Groves, former CEO of Intel, once said, "Success breeds complacency and complacency breeds failure. Only the paranoid survive."

8. Remuneration aligned with shareholders

Owners are always more interested in benefiting from a higher dividend and rising share price than from the stipend they can draw as CEO. A remuneration policy that closely aligns the amount that management are paid with shareholder returns will greatly enhance the management agency outcome.

On the other hand, misaligned remuneration will not tie a CEO's rewards to shareholder returns. In these cases, the temptation is to make short-term decisions that are not in the longer-term interests of shareholders.

In the sad case of Dick Smith, management was incentivised to reach ambitious profit targets in the first year post IPO. Unfortunately, we discovered that management only achieved their financial targets by favouring certain suppliers who paid them the highest short-term rebates. The rebates were booked to profits, thus boosting the result for that year (even if the stock remained unsold).

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Why is factor investing a 'thing'?

Raewyn Williams

There's a lot of hype around a trend called 'factor investing' which (as part of broader 'smart beta' thinking) has been called "the fastest growing segment of the investment management industry" (for example, this article). But what is factor investing, why is it important and why do many believe it is more than just a fad? This is written from the perspective of a large superannuation fund equity investor.

Starting with the basics

Let's begin with the simple notions of 'beta' and 'alpha' in an equity portfolio. Broadly, beta (denoted by the Greek letter β) captures the amount by which an equity portfolio moves with the market. So, a passive strategy which tracks the broad market (for example, S&P/ASX 200 or MSCI World) will have a beta of 1. On the other hand, alpha (denoted by the Greek letter α) captures the amount of portfolio movement not related to the market. Superannuation funds often appoint active managers to generate 'positive alpha'; that is, returns above a pure market return. Of course, alpha can be negative, meaning the portfolio has underperformed the market. The typical way of thinking about equity portfolios is to examine the beta and alpha components which together explain the entirety of a portfolio's performance.

The alpha/beta distinction gives a superannuation fund investor a useful choice between adopting a fairly cheap passive approach to deliver equity beta returns or adding the costs of active management to the portfolio to (hopefully) deliver extra performance through alpha.

Enter factor investing. The insight at the heart of the factor trend is that a lot of alpha can actually be explained by some common factor risks that exist across stocks. The academic literature dates back to 1976 and the most well-accepted equity factors are Value, Quality, Size, Momentum, Dividend Yield and Low Volatility. Value and Low Volatility seem to be of particular interest to large superannuation funds at present. These investors are also exploring variations like factor combinations, timing factors and tax-managed factor approaches. There are key differences in the behaviour of factor risks between the Australian and global equity markets, which investors need to understand.

Challenging the traditional alpha/beta model

Factor investing challenges the traditional alpha/beta investment paradigm because it suggests that much of what has been labelled alpha is actually returns from simple factor bets (a type of beta). A factor-based equity approach can be constructed using straightforward 'passive-like' rules, offering transparency and control. They can be offered in a separate account or pooled fund form, including ETFs. These investment options offer superannuation funds the opportunity to outperform the market without the costs associated with active management. Avoiding the 'black box' of many active management approaches is also an attraction. Factor investing is a 'thing' because funds realise they have three choices – alpha/factor beta/traditional beta – not just two.

Our most recent factor research identified one of the common traps funds fall into; inadvertently introducing other risks into an equity portfolio while trying to construct a pure factor exposure. We also noted, perhaps counter-intuitively, that factor investing does not ring a 'death knell' for active equity managers who have been important components of the equity puzzle for many funds to date. Rather, factor investing provides an opportunity for active managers to clearly differentiate themselves from mere 'factor providers' and to negotiate generous risk budgets with their clients to deliver true alpha based on their research and unique insights.

For superannuation funds (and other investors) who embrace the factor trend, their job is twofold: to implement a well-constructed equity portfolio that reflects their factor convictions (and, as far as possible, nothing else); and to reposition their active manager partners (and internal management teams) to harvest alpha as a true complement and enhancement to the fund's factor bets.

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How SMSFs should plan for the $1.6m pension cap

Doug McBirnie

Much has been written about the Government's proposed superannuation measures, in particular the $1.6 million cap on the transfer into the tax-free retirement phase. The draft legislation shows how the Government wants the cap to work in practice and highlights what SMSF trustees should be aware of ahead of its introduction on 1 July 2017.

The transfer balance cap in brief

Under the proposed legislation, if you don't already have a pension account, you can transfer a maximum of $1.6 million from your accumulation accounts into the pension phase once you choose to retire. This applies as a total across all your super accounts and not per fund. There will continue to be no limit on the amount you can hold in an accumulation account that is taxed concessionally at 15%, regardless of your age.

Everyone starts 1 July 2017 with a transfer balance cap of $1.6 million. As monies are transferred into the pension phase, those amounts will apply against this cap. Your transfer balance will be indexed proportionately each year in line with the overall transfer balance cap. For the purposes of the cap, defined benefit pension interests will be valued based on special rules outlined in the draft legislation. For most defined benefit pensions, this is expected to be the annual payment multiplied by a factor of 16.

If you already have a pension account at the start date, you will need to determine the total value of your pension interests and assess this against the transfer balance cap. If the balance is less than $1.6 million, you can use any remaining cap to transfer more capital into the pension phase in the future. If the value of your pension interests is greater than $1.6 million at the start date you are required to withdraw the excess either by rolling back to accumulation phase or withdrawing the excess from superannuation, or a combination of both.

After 1 July 2017, pension balances in excess of the cap can be subject to an excess transfer balance tax. This will initially be the 15% tax that should have been paid on earnings had the money been in the accumulation phase, but based on notional rather than actual earnings. The penalties become more punitive if you do not rectify them in good time.

Transitional arrangements

The proposed legislation recognises that commuting exactly the right amount to bring your pension balance under the cap immediately on 1 July 2017 may be difficult. As such, there is a grace period where amounts of up to $100,000 over the cap will not incur the excess transfer balance tax provided the breach is rectified within 60 days. This doesn't give a lot of time for trustees to finalise their 2017 accounts to determine their 30 June 2017 pension balances.

Relatively generous transitional arrangements regarding capital gains tax means much of the panic over realising significant gains ahead of the new regime is likely to be unwarranted. In effect, the provisions allow SMSF trustees to reset their cost base on assets currently supporting pensions on 1 July 2017. This means that funds will not have to pay capital gains tax on capital gains made on these assets prior to the start date should they have to roll them back to accumulation phase to meet the new cap.

Planning ahead

Where SMSF trustees have pension phase assets greater than $1.6 million, they will effectively have two choices:

- Commute the excess from pension back to accumulation phase, keeping the assets in the fund but now subject to a 15% tax rate on earnings; or
- Withdraw the excess from superannuation and invest it outside of super where earnings will be taxed at the individual's marginal tax rate (or alternative tax arrangement).

The tricky aspect of this decision is that once you withdraw the money from super there may be very limited capacity, if any at all, to get the money back in. This will often be an irreversible decision.

From a tax perspective it looks relatively easy to assess whether you will be better off having these excess assets in super paying 15% on earnings versus outside of super at your marginal tax rate. However, offsets available to pensioners can often make your effective tax rate lower than your marginal rate. The gradual withdrawal of these offsets can also make your marginal tax rate significantly higher for certain income bands. To further complicate the decision, what is better today may not be better down the track depending on investment performance, spending decisions and legislative changes.

Trustees will need to weigh up their options and make a choice before the start date. If the decision is to keep assets in superannuation, which for those on the highest marginal tax bands may be reasonable, then it will be useful to re-assess this regularly and move assets outside super if non-superannuation assets decrease and there is capacity within the generous personal tax offsets to accommodate greater income without paying additional tax.

Placing assets in accumulation versus pension

Many SMSF trustees will be thinking about which assets to place in accumulation and which in pension to obtain the best tax outcome. However, as drafted, the legislation largely makes this decision for them – it will make no difference. Where an SMSF has a member with super assets in excess of the cap (in any super fund), the SMSF will not be able to segregate assets for tax purposes.

This means that all the fund's assets are assumed to be held in one unsegregated pool. An actuarial certificate will be needed to determine what proportion of all fund earnings is tax exempt and what proportion is subject to 15% tax.

The Government has introduced this new measure to stop funds from cycling assets between segregated pools for each phase to avoid capital gains tax. It's worth noting that trustees can still notionally allocate different assets to different members or accounts if they want to adopt different investment strategies.

Conclusion

For those likely to have super balances at or over $1.6 million come 1 July 2017, there is plenty to think about. These new rules are still only in draft form and have to pass both houses of Parliament and there's plenty that could change. However, it is in trustees' interests to keep abreast of the changes as there may not be a lot of time between the legislation passing and the rules coming into effect.

Doug McBirnie is a Senior Actuary at Accurium. This is general information only and is not intended to be financial product advice. It is based on Accurium's understanding of the exposure draft of the Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 and current taxation laws. No warranty is given on the information provided and Accurium is not liable for any loss arising from the use of this information.

Populism and the changing risks of regulated assets

Ritesh Prasad

Global monetary authorities are continuing to engineer the current low bond yield environment in an ongoing effort to stave off the onset of economic stagnation. Against this backdrop, interest in infrastructure as an asset class has intensified, offering yields that look highly appealing to retail investors and liability-driven institutional investors such as defined-benefit pension funds and insurers.

But before simply treating infrastructure as a 'bond-proxy', investors need to understand its unique characteristics. Foremost of these is the presence of regulatory risk, which represents arguably the strongest case for treating infrastructure as a separate asset class from broader private equity or 'real asset' allocations.

By virtue of their monopolistic positions (underpinned by inelastic demand for essential services and prohibitively high barriers to entry), 'core' infrastructure assets such as utilities are typically subject to some form of economic regulation. Not surprisingly, regulatory risk is a key issue. In one survey, it was nominated as the biggest challenge by respondents, outstripping macroeconomic risk, manager selection and other issues.

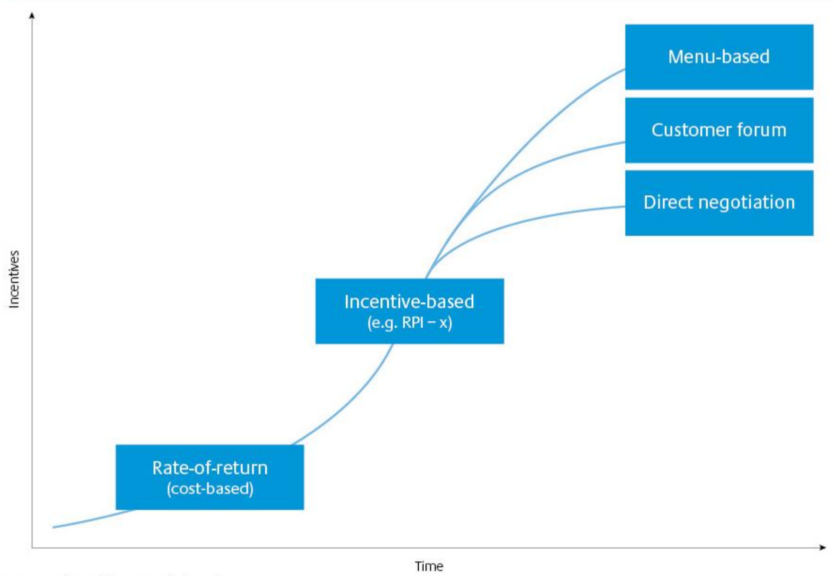
Complexities of assessing risk

However, assessing and managing regulatory risk can be difficult. For instance, regulatory and political risk are often seen as synonymous. Yet there is an argument that a business directly subject to government decisions should be treated differently to one that has the protection of a separate and independent rule-bound regulator which must balance all stakeholder interests. In the UK, for instance, the water regulator has a statutory responsibility to ensure the financial feasibility of privately owned water companies.

Prima facie, this reduces the likelihood of the regulator imposing an adverse and financially crippling decision. Contrast this with the more heavy-handed fate suffered by the Gassled investors at the hand of the Norwegian government's oil and energy ministry, and it is easy to see why rule-bound regulators are something of a shield from opportunistic politicians. This distinction has become ever-more crucial in the wake of populist election results such as Brexit and Donald Trump's US presidential victory.

A further layer of complexity stems from the fact that regulation is dynamic, and that regimes can be expected to evolve over time in response to changes in the broader economic, political, and technological environment. Across our portfolio, we have already seen a progression from cost to incentive-based forms of regulation. In some of the more mature jurisdictions we operate in, regulation has evolved further still – with regulators employing a variety of new tools, methods and approaches in response to changing regulatory priorities.

Evolution of regulatory models



Source: Adapted from Jamasb (2015).

The UK is perhaps the best example of this evolution. Developed in the 1980s in response to the 'gold-plating' observed under cost-based regimes in the US and elsewhere, the 'British model' of incentive regulation worked very well for two decades (and subsequently was adopted worldwide).

By the late 2000s, however, questions were being raised about the continued efficacy of the incentive scheme. This led to a once-in-a-generation overhaul of regulatory regimes in several UK sectors.

A hallmark of the new systems included smarter mechanisms designed to overcome the classic information asymmetry that exists between a typical regulated utility and the regulator. They also included an emphasis on innovation, 'capex-lite' solutions and more direct customer engagement. Regulators worldwide are also seeking to design systems incorporating behavioural economics insights, which have revealed how customer inertia and biases can lead to perverse and costly outcomes.

Investors in Australia are taking note, as it is only a matter of time before some of these features are introduced here. The current political machinations aside, our vast power networks have to contend with the economic reality of high maintenance costs, an increasingly distributed generation landscape and a fit-for-purpose model of regulation.

Changing risk-reward profile of regulated assets

Our view is that these latest innovations in regulatory design will fundamentally change the risk-reward profile of regulated assets. Specifically, they have the potential to increase both outperformance and underperformance. Investors will therefore need to evaluate the 'alpha' potential of specific companies rather than seek generic 'beta' exposure to a given sector.

Another lesson is that, with so many potential triggers for change, it is dangerous to characterise a historically 'benign' regulatory regime as less 'risky'. Indeed, the opposite could be argued: a regime that has just undergone a step-change can be viewed by investors as 'de-risked' for a period of time.

So what are the keys to success in this brave new world of infrastructure regulation? In our view, they include a sufficiently long-term investment horizon, strong shareholder representation and associated control, a proactive approach to stakeholder management and a focus on sustainable, operationally efficient, and customer-driven outcomes.

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Four benefits of an unblemished credit score

Bessie Hassan

As a nation we don't have a good understanding of what a personal credit score is and how we can benefit financially by having an untarnished score. Our research found the majority of Australians (82%) have never tried to improve their credit score, while 20% don't know how to correct their score. Of those who did try to improve their number, the most common tactics were:

- Increasing savings by paying down debt (56%)
- Consolidating debt into a 0% balance transfer card (27%), and
- Taking out a new credit card to establish a credit history (25%).

The age group that was most likely to be proactive about improving their score was Millennials with 34% having tried to correct their number. This is higher than other age groups including Gen X at 17% and Baby Boomers, where only 10% tried to rectify their score.

The problem is that a good credit score can be instrumental in accessing competitive financial deals and helping to protect a financial future, and not having a good credit score can be a huge financial setback.

The gap in our financial knowledge surrounding credit scores is quite confronting. The research found few of us can accurately identify what affects a credit score. A quarter of the survey respondents thought their score could be affected by their bank balance, by checking their score, or by not paying their credit card off in full each month. In reality, none of these factors influences the credit score. However, actions that *will* improve your credit standing include:

- Obtaining a copy of your credit file to check for any errors, and to identify areas that need improving.
- Ensuring you pay bills and make loan repayments on time. A pattern of late payments is detrimental to your score. Perhaps consider automatic payments.
- Avoiding making numerous credit enquiries in a short space of time. Do your research first, then apply for the most suited options for you.
- Keeping an eye on changes to your report. There are agencies you can register with to help do this.
- Advising your finance providers of any change to your address, credit card details, or financial circumstance.

Here are four ways to benefit from having a blue-chip credit score:

- **Access to lower rates**

When applying for finance, a good credit score could mean the difference between a competitive rate or an average rate. For instance, when you're applying for a personal loan, the lender will review your credit score and an untarnished score and a strong repayment history will probably lead to a lower rate.

To illustrate, if you borrowed $10,000 at 14.5% interest over five years, your monthly repayments would be $235 and total interest paid would be $4,117. However, if you had a good credit score and repaid the loan at 13.5% interest, your monthly repayments would be $230 and total interest would be $3,806. This translates to an interest saving of $311.

- **Increased borrowing capacity**

A healthy credit score will also give you greater borrowing capacity, which will come in handy when applying for products such as an investment loan. The lender will review your credit score, credit history, total assets, total liabilities, income and expenses when determining your ability to repay a loan, and set the maximum amount accordingly.

- **Greater choice of financial products**

A good credit score will open more doors to the range of financial products available across a wide range of borrowing products.

- **Shorter application process**

A good credit score should also speed up the application process as the lender won't require additional documentation to prove your creditworthiness.

Knowing your credit score and being proactive about improving it can go a long way to helping you achieve your investment objectives.

To access your credit score and to learn more about how it's calculated, make the most of online tools so you can put yourself in the strongest position to obtain finance and achieve your financial goals.

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Managing dynamic asset allocation in unusual times

Nader Naeimi

"The dreamers need the realists to keep them from soaring too close to the sun. And the realists? Well ... without the dreamers, they might never get off the ground." - Modern Family

What better way to describe the importance of diversity of opinion? For a healthy functioning society, the existence of both dreamers and realists is critical. So too in markets. Disagreement, bulls and bears play a critical role in market stability. The problem arises when the balance is tipped too much in either direction or when disagreement is replaced with group think.

Taking the good with the bad

Consider 2006/2007's extreme in greed versus the recent years' extreme in aversion. Too many dreamers and no realists saw markets soaring too close to the sun. Having been burnt badly following the GFC, global growth still can't get off the ground. It feels like a low-flying plane that constantly hits air pockets causing both occasional lifts and near-death experiences.

This is good and bad. It's good because blind optimism hasn't led to economic excesses and greed that tend to end in disasters. But it's also bad, because there is little conviction in investing for the future at both corporate and household levels.

Still, good and bad is not necessarily unwelcome when it comes to investment opportunities. The divergence in investor opinion and the general lack of conviction in economic growth is leading to many opportunities as well as risks, and a world of extreme divergences.

At the heated extreme (not too far from the sun) is anything yield related, while down near the ground is anything risk related. The rationale is clear: the world is a mess, central banks are out of ammunition, the population is aging and judging by the experience of the past few years, growth will continue to disappoint for many years to come. It's hard to argue with that logic and we don't intend to. Our investment philosophy is built on scepticism. The sceptic in us says "when it is so obvious, it's obviously wrong".

And that must be what Mark Twain had in mind when he said: "It ain't what you don't know that gets you in trouble. It's what you know for sure that just ain't so."

What's certain?

So what does the market know for sure? That inflation will never come back, growth is as good as it will get and interest rates will remain near zero for many years to come. The polar extreme in relative performance and relative valuation of the low volatility theme (for example yield and defensive growth) versus the risk theme (for example value and cyclical growth) and the fact that more than 40% of the global sovereign bond index has a negative yield reflects the perceived 'no growth, no inflation forever' backdrop.

In fact, much of the market appears crowded away from risk and value and into quality and low volatility.

Irrational investment behaviour

The search for yield started as a perfectly valid strategy following the GFC. But by now, a theme that was anchored around perfectly rational investment logic has morphed into irrational investment behaviour (when shares are bought for income and bonds are bought for capital gain).

The chase for yield, low volatility and quality has now become a crowded momentum trade. The self-fulfilling cycle of money pouring into low volatility and quality stocks leading to strong price gains, further supressing volatility, encouraging more flows and price gains has led to a false sense of security and confidence in making easy money. Our inner sceptic tells us it can't be that easy. The momentum spring can't stretch forever. Eventually it will snap or it will spring back.

Here's why: five years of fiscal austerity is giving way to fiscal neutrality, and while important risks persist and need ongoing assessment, there are signs that 2017 could mark a return to a more synchronised global economy, at least in US dollar terms.

The stability in the US dollar, improving commodities performance and rebounding inflation expectations all point to an unfolding regime shift. If so, the recent back up in sovereign bond yields has further to go. This poses both risks and opportunities.

Subsequently, this is how we're managing our dynamic asset allocation funds:

- To manage downside risk where diversification is extremely hard to achieve, we are increasingly using option strategies.
- We're staying away from low interest rate/low inflation winners of the past few years such as nominal bonds and bond proxy equity sectors.
- We have a diversified exposure to low interest rate/low inflation divergence theme such as commodities, global banks, Japanese shares, emerging market equities, and currencies.
- We have higher cash holdings as a defensive buffer.

Bottom line

The world's glut of savings has now ended back in the US where it started, this time in low volatility, defensive, quality themes. These themes are expensive, over-owned, over-loved and vulnerable (ticking all the boxes for 'avoid' under our investment process). Still, we doubt any unwinding to be disorderly as central banks remain friendly, real yields remain negative (despite rising nominal yields), and global growth is showing signs of broadening.

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