Cuffelinks
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This Week's Top Articles

So bond rates are not 'lower for longer'

Roger Montgomery

For most of 2016, we have warned investors about the dangers of accepting historically low bond rates as the 'new normal'. The reality is that US 10 year rates lower than at any time since George Washington was sworn in as the first President of the United States is anything but normal.

Indeed, it is abnormal. In June this year, US 10-year rates plumbed 1.36%, lower than they were during the Great Depression, when unemployment hit 25%. Such low rates were not justified on economic grounds and therefore were evidence of central bank manipulation. In fact, we have a name for central bank manipulation of long bond rates, it's called quantitative easing.

Manipulation actually hurts consumption

As economist Herb Stein once wryly observed, if something cannot go on forever, it must stop. And there's another reason why long bond rates cannot not stay low forever. They are having the perversely opposite impact of what was desired. Denmark's interest rates have been negative for a relatively longer period, stimulating saving and acting as a disincentive for consumption; yes, savings as a percentage of GDP are up and consumption is down, which is precisely the opposite of what central banks had hoped to achieve.

Low bond rates and the corresponding flat yield curves create disincentives for investment, so why take long-term risk when the returns over the short term are the same? Bond rates are the rate against which all investments are compared through the cost of capital calculation. Therefore, low bond rates transmitted higher valuations across all asset classes, ensuring buyers paid higher prices and received correspondingly lower returns.

Companies were then forced to hand back their capital through dividends and buybacks rather than invest productively. This can be seen in the rising dividend payout ratios in Europe, the US and Australia since 2010. In Australia, the payout ratio for the ASX200 rose from 57% in 2010 to over 80% today. For the Stoxx 600 index in Europe, the payout ratio rose from 43% to nearly 60% and in the US, the S&P500's payout ratio increased from nearly 26% in 2011 to almost 40% now.

Of course, the corollary to higher payout ratios is lower retained earnings for future growth. At precisely the moment when share prices were at their highest, growth expectations were at their lowest.

Record prices for everything

The only thing low bond rates have achieved is record asset prices. Indeed, since 2012, P/E ratios for Australian stocks increased, and according to the RBA, the highest P/E ratios were attributed to those companies in the ASX200 paying more than 75% of their earnings as a dividend. Real estate, art, wine and collectible low digit licence plates have been smashing records.

A quick look through the sharemarket reveals that infrastructure stocks like Transurban and Sydney International Airport became two of the most expensive companies listed on an EV/EBITDA basis. One has to ask why Sydney International Airport, which geographically can be described as being located on a vacant block at the end of a global cul-de-sac, deserves to be the most expensive listed airport in the world?

So commentators and prognosticators who projected low bond rates forever as part of a 'new normal' were in fact unwittingly admitting 'this time it's different'.

History, however, shows that this time is never different. Bond rates will rise, in fact they already have. The 10-year Australian bond has risen from a low of about 1.8% in August 2016 to 2.7% while the US counterpart has risen from 1.36% mid-year to over 2.2%.

Bond rates will continue to rise over time because it does the world no good to keep them low. This will not be good for asset prices. Highly geared property investors will feel the full brunt of rising bond rates and those property developers under 40 will wither from the *BRW Rich List* as quickly as they were germinated.

As higher rates reduce the present values of future cash flows, so investors will devalue assets as well as the multiples they are willing to pay. When bond rates rise, the 'P' in the P/E ratio falls. And with payout ratios so high, the 'E' in the P/E ratio isn't providing the growth needed to compensate. Expect to one day look back on this period of low rates, and highly indebted investors paying record high asset prices, with astonishment.

Huge plus for global economic health, eventually

While higher bond rates will be painful for investors over the next three to eight years, it is actually an enormous positive for global economic health and investor returns. Higher bond rates mean higher returns. Before that can happen, however, there will be a much-needed adjustment.

Then come the positives. New investments will be required to meet a real return hurdle to attract funding and the total pool of capital available for investment and future growth will cease diminishing (through higher payout ratios, for example), and begin to grow. Speculative bubbles will burst, transferring wealth from speculators with no patience to long-term investors with patient capital.

Those countries, corporates and consumers with the highest debt will be hit hardest, as they always are. But the much-needed adjustments will be a net positive and very aggressive buying will be the order of the day by the early-to-mid 2020s.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is general education and does not consider the circumstances of any investor.

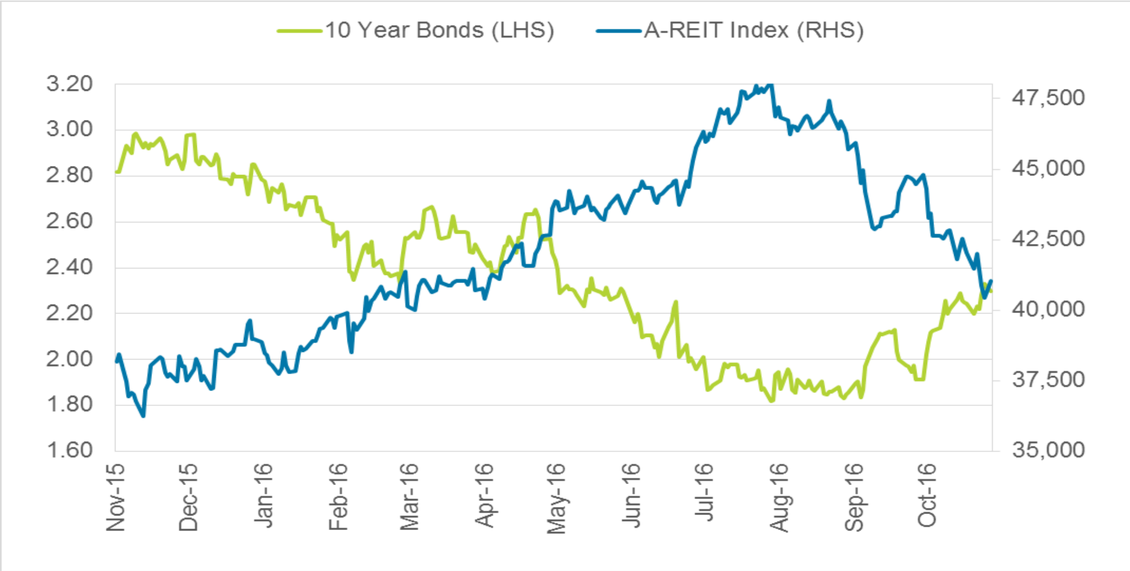
Have A-REIT share prices bottomed out?

Adrian Harrington

Record low bond yields have supported the valuations and profitability of Australian real estate investment trusts (A-REITs) over the past few years. A-REITs outperformed equities in 2014 (26.8% vs 5.3%) and 2015 (14.4% vs 2.8%).

The A-REIT/bonds correlation has been about -0.5% in 2016 (Figure 1), one of the highest on record. As a result, A-REIT prices have been driven down more by bond yield movements than other factors such as the real estate cycle.

Figure 1: 10 Year Bond Yields & A-REIT Total Returns: 12 Months to 31 October 2016



In recent months the yield curve has steepened as markets embrace increased fiscal stimulus from China, Japan and now the US (following Donald Trump's election victory), and greater expectations of higher global inflation.

Australian bond yields have followed, rising from a low of 1.8% in August 2016 to 2.3% at the end of October 2016. Since then, they've risen a further 0.40% to 2.7%.

Property trust prices continue to fall

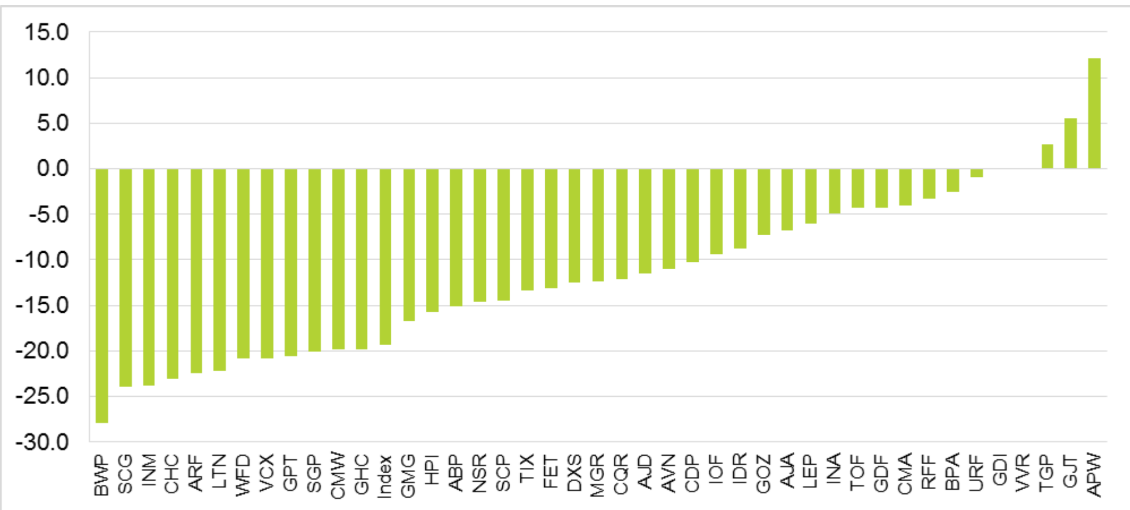
This year, what was looking like another solid period for A-REITs is in danger of evaporating. Since the start of August, the sector has fallen 18.7% and is now down 2.8% YTD, while equity prices are up 0.7% YTD.

A-REITs aren't alone. Global listed REITs in the US, UK, Singapore, and Hong Kong are down, while listed infrastructure and utilities equities have also been sold off.

Figure 2 ranks A-REITs in size. The largest have been hit the hardest – Scentre (SCG down 24.0%), Westfield (WFD down 20.9%), Vicinity (VCX down 20.9%), GPT (GPT down 20.6%) and Stockland (SGP down 20.1%).

In the hunt for yield, these large cap A-REITs have been well supported in recent years by generalist equity funds who have taken advantage of the liquidity they offer to park their money there. It is therefore not surprising that when the herd stampeded towards the exit then switched into more cyclical, growth-oriented stocks, the largest, most liquid A-REITs were hit hard.

Figure 2: A-REIT Prices – 1 August–16 November 2016



With the recent sell-off, the A-REIT dividend yield has risen from 4.2% in July to 5.3%, but there is still a cushion of 260bps relative to the 2.7% 10-yr bond yield, which is above the long-term average of a 196bps spread.

The current yield is based on an average payout ratio of 84%, well below the 100% recorded pre-GFC, not that one wants to see A-REITs go back to those dark old days to boost their distribution yield.

The A-REIT sector is now trading at a price to NTA premium of circa 14%, down from 50% in July. There have been seven periods over the past 25 years when bond yields rose by more than 60 basis points. Figure 3 shows the performance of A-REITs relative to equities in each of these periods.

Figure 3: A-REIT and Equities Performance in Periods of Rising Bond Yields

Period	10 year bond Yield Beginning	10 year Bond Yield End	Movement in 10 Year Bond Yield	A-REIT Price Movement	Equities Price Movement
Jan 1994 – Nov 1994	6.36	10.53	417	-13.9	-18.4
Oct 1998 – Jan 2000	4.91	7.14	223	-11.7	+21.3
Dec 2008 – Jul 2009	3.99	5.62	163	-13.7	+14.4
Aug 2010 – Mar 2011	4.76	5.50	74	-1.3	+10.2
May 2012 – Dec 2013	2.87	4.14	126	+5.3	+30.3
Mar 2015 – Jun 2015	2.29	2.95	65	-3.9	-7.3
Jun 2016 – Nov 2016	1.82	2.70	88	-14.3	+8.6

A-REITs produced positive returns in only one period of rising bond yields (January–November 1994), a period when A-REITs also outperformed equities.

This time round we've seen the largest A-REIT sell-off compared with other periods of rising bond yields, despite the fact that bond yields have not risen as much as they did in 1998–2000 and December 2008–July 2009.

The extent of the recent sell-off is not surprising given the level to which bond yields fell and A-REIT prices rose. The dramatic bond sell-off over a short period has affected many yield-sensitive investments, and A-REITs have not been immune.

Will the pendulum swing back?

The question investors need to ask is whether the rapid rise in bonds will continue and A-REIT prices fall further, or has the pendulum swung too far, too quickly?

The A-REIT sector will remain captive to the gyrations of capital markets in the short term. Clearly, if bond yields continue to rise further there could be additional price risk.

However, the recent sell-off in the A-REIT sector has created some attractive buying opportunities. Investors with a longer-term view who can see out the short-term volatility can acquire some of the best real estate in Australia at more attractive prices than they could have three or four months ago.

Overall, A-REITs are in relatively good shape and almost incomparable to those in the lead up to the GFC. Gearing is lower (circa 30%), refinancing risk over the next few years is low (the majority of debt is due to expire in 2021 and beyond), asset quality has significantly improved, payout ratios are respectable and the exposure to offshore real estate is limited (Goodman and Westfield are the two exceptions).

Yet now is not the time to take a passive approach to the sector (i.e. indexing). We expect the variation of performance across the A-REIT universe to widen in the year ahead. Individual characteristics of each A-REIT will be more of a key performance driver than it has been in the past year or so.

Investors now more than ever need to focus on those A-REITs that have quality management and can generate real value from their portfolios rather than simply relying on lower debt costs to support earnings and firming cap rates (property yields) to drive underlying asset values higher. As Warren Buffet says, "only when the tide goes out do you discover who's been swimming naked".

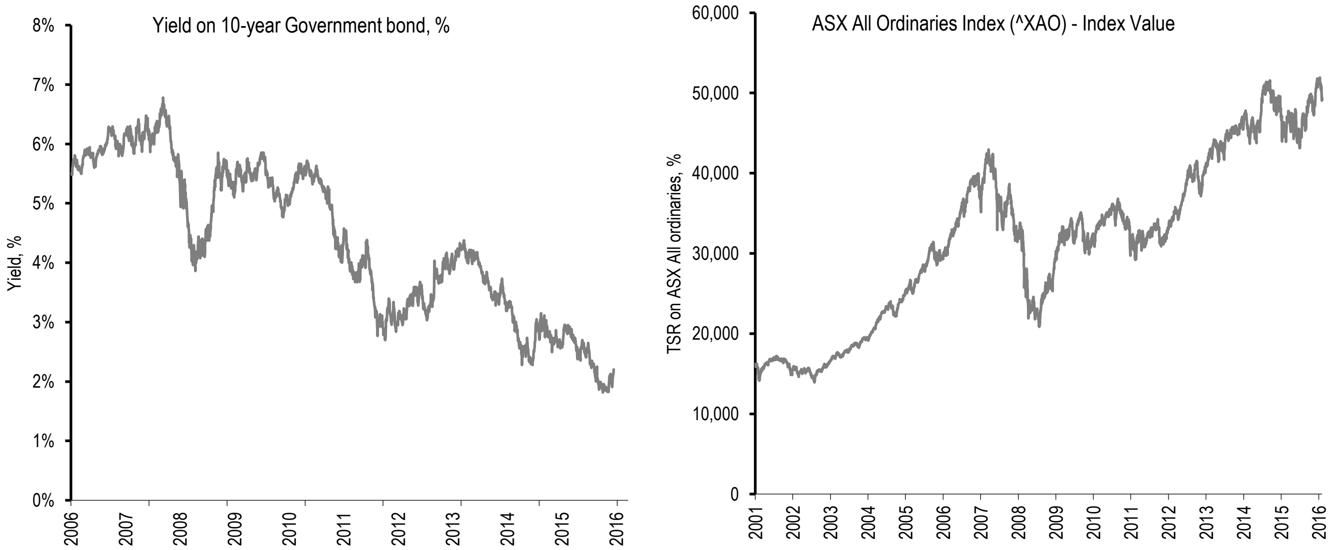
Adrian Harrington is Head of Funds Management at Folkestone Limited. This article is general information and does not reflect the circumstances of any individual.

The impact of bond rates on asset valuations

Julie Wolstenholme

Yields on long-term bonds issued by many developed nations, including Australia, have declined significantly since about 2008. In Australia, 10-year Government bond yields have fallen from 5.8% in 2008 to the current rate of about 2.7%. In October 2016, the Government issued a 30-year bond at a yield of about 3.3%. These low yields are also evident in the overnight cash rates, currently at an historically low 1.50%. Compared with long-term historical averages, these yields reflect a number of factors including quantitative easing and the intervention of central banks, reduced public sector investment, strong investor demand for low-risk quality assets such as government bonds, and lower long-term growth and inflation expectations.

Historical Yields of 10-year Government bonds and ASX All Ordinaries Index performance



Source: RBA, Capital IQ

Impact of low bond rates

In valuing assets, the income approach is often applied, using the discounted cash flow methodology. This effectively requires forecasting future cash flows from the asset, which are then discounted to present value at a rate that reflects the time value of money and riskiness of the cash flows. The discount rate applied in this method is usually a blend of the cost of debt and the cost of equity in the relevant sector, based on the market-average level of gearing.

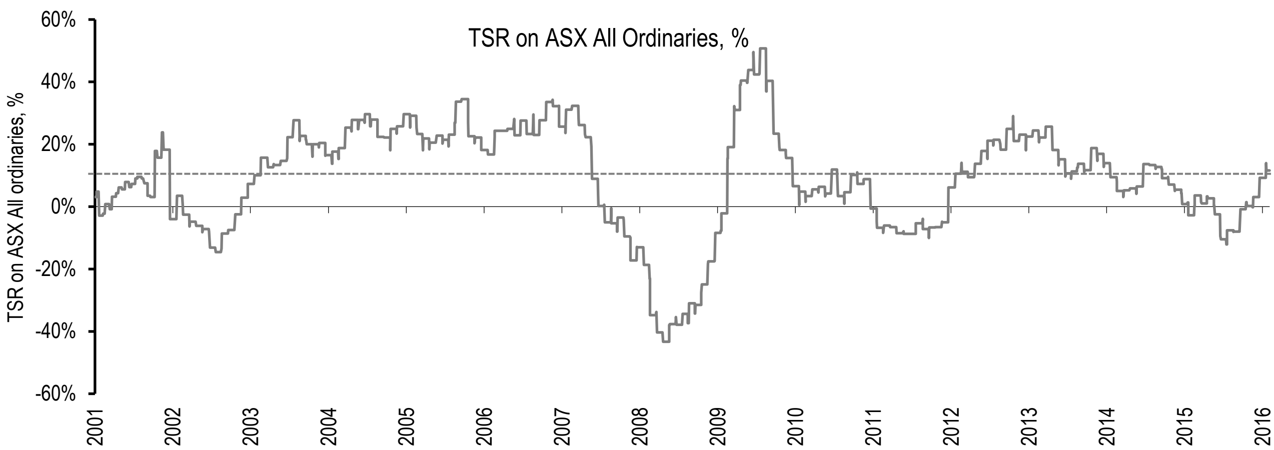
One of the key inputs to the discount rate is the cost of equity. This is commonly derived by adding a premium to the 'risk-free' rate to reflect the excess return required on equity investments and the proportion of that premium applicable to the asset. The link between government bond yields and valuation is due to the common practice of basing 'risk-free' rates on long-term government bond yields, the best observable proxy for a riskless asset. All else being equal, lower yields on 'risk-free' assets would result in a lower discount rate, and therefore an uplift in value. However, while expected returns on risk-free investments have fallen over the past few years, the market is not pricing in a direct corresponding increase in the value of equities.

Looking at the performance of the ASX All Ordinaries Index since 2008 (as shown in the chart above), there has been significant volatility. Yet the share prices of ASX All Ordinaries companies have generally risen over the same period. Some of the factors driving share prices up, despite the low-growth environment, include:

- As overnight cash rates have fallen, companies having taken advantage of lower borrowing costs
- Debt levels have generally fallen across the market, arguably strengthening balance sheets
- The low growth environment has highlighted the need for strong management focus on long-term cost savings and efficiencies, as well as innovation and technology developments
- Investor demand for defensive or lower risk assets
- Falling yield expectations from investors
- Achieving real growth through acquisitions, offering the potential for growth and scale/cost savings.

However, on average, share price rises have been less than the direct impact of the lower risk-free rate on discount rates. In fact, total shareholder returns, calculated as share price growth plus dividends, have fallen in recent years, with average returns of 5.9% over the three years to October 2016, lower than the average returns for the past 10 years (10.3%) and 15 years (8.4%).

ASX All Ordinaries Total Shareholder Return (TSR) performance



Source: Capital IQ

Other factors than low bond rates reflected in share prices

So, while on average share prices have risen in recent years, the market is arguably not fully reflecting the fall in government bond rates in equity prices. Other factors must be in play.

Many valuation professionals consider the impact on valuations of the current lower yields by:

- Critically examining the expected future cash flows to ensure they reflect lower long-term growth and inflation expectations
- Considering the impact of volatility and expected returns in assessing equity market risk
- Using a blend of current actual rates, historical averages and views on longer-term investment yields.

Valuers may also form a view on a 'normalised' long-term yield for a 'risk-free' asset allowing for the long-term history of Australian Government bond yields, fundamental real return expectations, inflation forecasts and implied equity market returns. This has generally resulted in an additional risk premium being applied, over and above the current bond rates, in assessing an appropriate cost of equity and overall discount rates.

While there is no consensus on the correct approach, most equity analysts apply some form of adjustment in assessing their discount rates. These will likely unwind as and when government bond rates increase. Ultimately, the reasonableness check on values for investors is the earnings multiples implied by companies trading on the stock exchange and prices paid in recent transactions.

Julie Wolstenholme is a partner in EY Australia Transaction Advisory Services. The views expressed in this article are the views of the author, not Ernst & Young. The article provides general information, does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Liability limited by a scheme approved under Professional Standards Legislation.

Four industry leaders debate objectives-based investing

Matt Olsen

There are various ways to think about objectives-based investing. Individuals form objectives. They may work with a financial adviser to map out their goals and quantify how much those goals will cost, working backwards from there to design an investment programme.

How managers meet objectives

Managers of defined benefit pension funds invest to meet the objectives of a scheme that contains many members. The scheme defines the future benefits paid out to the members based on rules that are explicitly defined. At any point in time a scheme has a 'funded status' which is the ratio of the assets in the pool divided by the present value of the future benefit payments.

Managers of annuity products invest in ways that meet the obligations made in issuing those products. The statutory fund from which annuities are issued also has a funded status. Regulators of life insurance companies require the marking to market of liabilities at the onerous risk-free rate.

Growth equities managers invest to achieve a return objective defined by their product disclosure statement.

The range of investors listed above represents a spectrum. Some pay no attention to the client or member's objectives. They merely seek to grow wealth as a component of an overall objectives-based regime.

Others seek to specifically match the asset pool performance with the fluctuations of the liabilities over time as the investor or scheme becomes fully funded. Over time these investors shift their mix of assets from growth assets into liability hedging assets. These are the hard core liability-driven investors. They optimise their portfolio differently than traditional asset-only portfolio constructors. They optimise to funded status and funded status volatility, rather than to asset return and asset price volatility (return and risk).

Others such as the annuity product providers seek to provide a middle ground via approaches such as income layering, where a layer of income is built on top of the age pension. These and others, such as financial advisers, suggest to their clients this middle ground approach via defining objectives not so much in terms of explicitly measured liabilities and liability drivers, but rather in terms of an income objective in retirement.

Panel discussion

At our recent SuperRatings Lonsec Day of Confrontation industry conference, we hosted a panel on objectives-based investing. The key question posed to the panel was whether it represented the future or the past.

Troy Rieck, Executive Officer, Investment Strategy at Equip Super

Troy Rieck oversees about $8 billion of funds under management in both Defined Benefit and Defined Contribution, and therefore he intimately understands the need to manage assets with respect to liabilities or objectives.

Rieck is strongly in favour of objectives-based investing, arguing that fiduciaries should prioritise clients or member's objectives when making investment decisions.

He is constantly trying to strike an appropriate balance for members in terms of risk, fees and return across life stages to deliver financial adequacy in retirement. Central to his considerations are member segmentation and recognising that risk changes during members' lifetimes.

He also questions whether the industry has sufficiently defined what it is trying to achieve, has a fundamental aversion to peer comparisons over short time periods, and strongly believes that a one dimensional focus on fees rather than net returns is sub-optimal.

Interestingly, Rieck mentioned to me prior to the session that his DB Scheme is fully funded at the Asset Return type discount rate of about 7%. On that measure, his Scheme is well over 100% funded. His challenge is to manage the assets so they deliver a high return and offset the risks and factors that drive the liability value such as inflation and interest rate risk.

Richard Howes, Chief Executive, Life at Challenger

Richard Howes manages the Challenger Life business and the design, specification and implementation of their annuity products. He believes objectives-based investing is hugely relevant and will continue to be so.

He also recognises a spectrum of approaches from long horizon wealth accumulation to investing to precisely match objectives. In managing his annuity products he has to abide by capital rules. That is, his business needs to provide enough risk capital to ensure payment of these obligations even under highly stressed market conditions. He is obligated to mark to market his liabilities using a risk free discount rate and to hold additional capital to cater for 1-in-200-year shocks for risk.

Richard likes to think about individual investors as "life companies of one" in that individuals have liabilities in terms of the spending they need and want to do. He notes the importance of financial advisers in this process in helping individuals to define goals and design solutions.

Howes views his firm's products as part of an income layering approach, which is something of a middle ground between the two extremes of using an outcomes-based approach and merely investing for long-term wealth creation via return maximisation. A layer of lifetime guaranteed income in the form of an annuity forms income which together with any entitlement to the Age Pension enables a retiree to be comfortable that their *needs* will be met. The account based pension forms the third layer which is about meeting *wants* or more aspirational retirement spending objectives.

His team invests statutory fund assets in a highly diversified portfolio comprising predominantly fixed income (to deliver return and hedge against interest rate risk) and also commercial property and infrastructure (to deliver return to the portfolio and hedge against inflation risk). To the extent that there are residual risks such as credit or property risk, shareholder's capital is held to cover that.

Howes' believes it's all about security and peace of mind. The more a client, member or individual wants peace of mind, the more they should secure this via an objectives-based approach.

He cautions against thinking about assets in terms of buckets. While buckets can protect against selling growth assets during periods of market stress, prolonged stress periods can result in imprudent allocations to risk assets. Richard asserts that you would not want to be at age 78 with all money in equities because the low-risk buckets have run out.

Roger Montgomery, CIO and Founder of Montgomery Investment Management

Roger Montgomery is an equities manager who believes in growth at a reasonable price. He seeks to buy stakes in 'wonderful businesses' to maximise their long-term investment returns. He is passionate about client outcomes, preferring to focus on returns rather than levels of funds under management.

I invited him onto the panel because every objective-based process needs a growth component to both progress investors towards being fully funded and to offset longevity risk.

Roger is concerned that components of objectives-based investing expressed elements of a fad. In particular, he expressed concern that the stock market cannot be relied upon to deliver everyone's ideal outcome. As a growth investor, he said his goal is to always maximise returns by buying stakes in great businesses at good prices, and that is the most valid approach to equity investing over the long term.

He also asserted that the industry should stop focusing on fee levels and instead highlight net returns. He argued strongly that, to deliver great investment returns, fund managers should employ and retain high-quality investment talent. In other words, you get what you pay for.

Wade Matterson, Practice Leader, Australia at Milliman

Milliman is a large global actuarial consulting firm. Matterson believes objectives-based investing is crucial and that, as an industry, we need to think about product returns not in relation to an asset class benchmark, but in relation to an individual's bespoke objectives. That is, compare their asset return to the movement in the value of their liabilities.

His firm assists those holding growth assets to manage downside risk by providing overlay products. These utilise futures to either set a volatility target or to replicate the payoff profile of a put option at the design of either the client or of a managed risk product.

He passionately believes that the way forward for the retirement industry is to work toward meeting the challenge of utilising technology and investment skill to manage portfolios bespokely for individuals based on their unique liability profiles.

True believers

From Lonsec's perspective, we believe in objectives-based investing. Investors can take two approaches. Firstly, working with an adviser, they may want to define their objectives in terms of an income in retirement and a program of drawing down on accumulated assets to meet their retirement spending aspirations. The annuity provider may be of some assistance in this approach.

Secondly, to more precisely manage their outcomes, they could try to define both the present value of their liabilities and the factors which drive this present value. In that regard interest rates, inflation and currency movements may be factors to consider. Over time as these investors become fully funded, they gradually shift their assets from growth assets into hedging assets, which change in value in line with changes to the value of their future liabilities (objectives). They may hold some residual growth assets to offset longevity risk. Their growth assets may be managed with a low volatility target or in a risk-managed fashion.

The key challenge for the industry is to shift the mindset from 'how good is this investment product and will it meet its stated objective', toward the eventual holy grail of evaluating a product with respect to 'how will this product perform in relation to various individual investors' bespoke objectives'?

In a pension scheme, the actuary assists the scheme manager to assess the value of the objectives (liabilities) and how well-funded the scheme is. An asset consultant might advise how to structure the portfolio to optimise the asset performance with respect to those liabilities and recommend gradual shifts in growth versus hedging splits over time.

The challenge for a research house servicing retail advisers and investors is how to develop tools to help both of these groups in an individual context. We believe that objectives-based investing is definitely the way of the future, not merely a fad.

Matt Olsen is the Chief Executive Officer of Lonsec Research.

Startups, innovation and the Australia-Israel bridge

Graham Hand

Excitement about the future of technology and innovation is contagious when attending a conference like The Bridge. It's an annual two-day event showcasing startup Australian and Israeli companies, many seeking funding for new ideas. Robotics, virtual reality, drones, artificial intelligence, e-health and fintech were on display this year, and some of the speakers had already launched and sold 'unicorns' (companies valued at over US$1 billion). A great idea that can potentially change society can also be richly rewarding financially and emotionally.

Australia needs more innovation spice

The Israeli startup scene is widely regarded as second only to Silicon Valley as an ecosystem for new venture capital and technology adoption. Australia is rapidly growing and improving, and each year many Australian delegations go to Israel to see what that country is doing right. According to Doron Goldbarsht, Chief Executive

Officer of the Israel Business Club Sydney, each delegation is themed around a different industry and the objective is to deliver commercial benefits to the delegators and strengthen the Australian economy.

How can Australia improve its startup ecosystem? Speakers said speed to market is essential, and Australians are too slow reaching a 'minimum viable product'. There's often the wrong mindset, as it's not about simply expanding but aspiring to be the best and global. Life in Australia is relatively easy and we don't dream of going to California and conquering the world the way Israelis do. Australians don't collaborate enough, we compete, while startups in more successful countries share knowledge – they solve problems together.

Success, '100 doors' and the Adversity Quotient

Dov Moran is a megastar of venture capital and was one of the keynotes at the conference. He is the inventor of the USB stick, and his company M-Systems was sold in 2006 to SanDisk for US$1.6 billion. He is now an entrepreneur, investor, and co-founder of Grove Ventures, an early stage venture capital fund which focusses on media, e-health and the internet. He said there is still a lack of risk-taking appetite in Australia, and he wants to see more acceptance of failure and greater resilience to get over the disappointments and hurdles.

He began his talk with a challenge, which he calls the '100 doors', to illustrate the difficulties faced by an entrepreneur. Suppose a room has 100 doors, and there's a 1% chance of any door being unlocked. He asked, *what is the chance that someone can get out of the room*? He wanted people to answer instinctively, as business often involves making quick decisions under pressure.

He has found when he asks this question that people working in 'finance' are the most pessimistic, usually giving a number less than 10%. People who call themselves optimists or entrepreneurs often give numbers above 90%, because there are so many doors.

He then showed the audience the maths … but first, you have a guess.

<u>The calculation</u>

What is the chance that all the doors are locked?

X = 0.99 ^ 100 = 36.6%

The chance that there is at least 1 door unlocked (ie not 'all the doors are locked') is:

1 – X = 63.4%

So the chance that someone can exit the room after trying to open all the doors is 63.4%. In this analogy, if a startup has to overcome 100 hurdles with the chance of success for any one of them only 1%, then if they try 100 doors, their chance of success is a healthy 63.4%.

Why is the success rate across the world only about 1% for startups? He gave four reasons:

1. They stop after receiving too many 'nos'
2. They are at an unlocked door but they do not open it
3. They are knocking at the wrong door
4. They exit through an unlocked door, but it goes to … a new world with another 100 doors.

He said that if a startup went through seven worlds, each with 100 doors and a 63.4% chance of exiting each time, the chances are 63.4% times seven, or only 4% that they will exit at the end. That's why it is difficult to succeed. While success needs the right people, the right idea and the right timing, the most important is a high, AQ or Adversity Quotient. There will be problems with customers, staff and product quality.

Moran said he receives over 200 emails a day, and cannot read them all. The ones who eventually reach him are those that refuse to give up until he responds.

Why is Israel successful?

Ethy Levy is Israel's Trade Commissioner in Australia. She said that successful technology companies in Israel often feature in the news and on the front page, whereas this rarely happens in Australia. Israel has a small population of about eight million and no natural resources, and companies need to think globally and access external markets to succeed. There is a great emphasis on education. Other speakers said the culture of innovation was a state of mind, and a discipline aided by compulsory military training. In other countries, failure was embarrassing, but in Israel, attempts to innovate are admired. Entrepreneurs in Israel have the same status as sports people in Australia.

Speakers also believe Israeli children are not overly sheltered. They are allowed to walk to school and the local park at a very young age, they join youth groups and later travel the world. It is a diverse and complex society, and its immigrant population helps innovation.

Doron Goldbarsht said the Israel Business Club provides platforms for Israeli companies operating in Sydney, with 30 companies from sectors such as utilities, health care, information technology and telecommunications setting up offices in Sydney in the past year.

A look at the Israeli companies who presented at The Bridge showed how the military impact and necessity to use scarce resources leads to global solutions. 3DSignals can 'listen' to machines and detect a potential fault before there's a break down, delivering savings in down time. Mobileye is a leader in AI (and already a unicorn), applying its technology to driverless cars. Equinom is breeding resilient seeds. OurCrowd has 15,000 investors in early-stage companies who find 150 new startups to invest in each month. Airobotics specialises in automatic drones, and recently raised US$30 million and employs over 100 staff. Sidekix is a smart walking navigation app.

It is not all one-way traffic. Australian presenters included three agricultural startups. Agriwebb has developed an app which uses data to make farming easier, Neotop technology reduces evaporation from dams and SwarmFarm Robotics (presented by former Queensland Premier, Campbell Newman) is a maker of smarter farm machinery.

The legal side of Israeli companies listing on the ASX

At time of writing, six Israeli companies are listed on the ASX, and another two should complete backdoor listings this year. According to the Andrew Whitten, a lawyer specialising in small cap listings, a company must satisfy the minimum admission criteria (profit, assets, number of shareholders, etc) and go through a seven-step process that takes approximately 19 weeks. The process includes:

1. Appointing advisers, such as lawyers, accountants, corporate advisers or brokers
2. Preparing the prospectus and due diligence
3. Commencing the institutional marketing programme
4. Lodging the prospectus with ASIC
5. Applying for listing application with ASX
6. Entering the formal marketing and Offer Period
7. Closing the offer, allocating and commencing trading.

The due diligence focusses on the rights and liabilities attaching to shares offered, the assets and liabilities in the company's structure, the financial position and the profit and loss prospects of the issuer. Shirel Guttman-Amira from Israeli legal firm Agmon & Co, noted that the deal must comply with the legal requirements of both Israel and Australia, and the ASX has become a valuable source of capital for many Israeli companies.

Graham Hand is Managing Editor of Cuffelinks and attended The Bridge courtesy of the organisers.

Understanding LIC fee structures

Nathan Umapathy

Nearly 60% of the Listed Investment Companies (LICs) in our coverage have delivered strong benchmark outperformance over the past decade, and LICs still look compelling as part of an investment portfolio.

Fees are part and parcel of any investment vehicle, including LICs, and can significantly affect real value, so they are always important. This article examines the costs associated with LICs and why some managers have higher fee structures than the average.

Types of fees

Fees and expenses generally take three forms:

- management fees
- administration fees
- performance fees.

Management fees seek to recover general day-to-day expenditure of the investment process. Traditionally, management fees range between 0%-2% of total cost, within the LICs in our coverage. Administration fees incorporate all other expenses incurred in the fund's management such as director's fees, rent, audit, and legal.

These fees are charged regardless of performance and may vary considerably depending on the fund manager's investment mandate, style and approach.

Performance fees seek to directly align the profitability of the manager and the performance of the underlying fund. A performance fee is best described as a reward for performing above the fund's stated benchmark. Typically, performance fees range between 10%-20% of the value above the benchmark, and as an investor you need to consider the performance fee's structure and whether you think it's fair and aligns the interests between the portfolio manager and investor.

While lower fees do not guarantee superior performance, they are less of an impediment on returns. In fact, many of the higher fee mandates operate in less-efficient sections of the market and often outperform the market, i.e. smaller caps mandate LICs.

Indirect Cost Ratio = Indirect Cost/Average Pre-Tax NTA

The Indirect Cost Ratio (ICR) measures a LIC's total indirect cost. These expenses generally include management fees, performance fees, legal, accounting, auditing and other operational and compliance costs.

The aggregation of these indirect costs is divided by the average pre-tax net tangible asset for the year and presented as a percentage.

Throughout our coverage, we produce both the ICRs with and without performance fees.

Comparing fee structures

Our analysis of the LICs in our coverage alludes to some interesting facts.

First, certain strategies are more cost-intensive to execute than others. This could be due to the heavy resourcing required to effectively implement a mandate (international assets), a lack of research coverage in an underlying market (small caps) or sophisticated investment strategies (long/short infrastructure assets).

Second, the specialised nature of these strategies in less efficient parts of the market may give the managers the consistent ability to outperform the market or deliver an effective risk-weighted return. However, you need to clearly evaluate this in the context of the offering.

Table 1: 5 year and 10 year Investment Performance of LICs

ASX Code	ASX Listed Investment Companies	Pre-tax NTA Performance (%) Yr 5	Pre-tax NTA Performance (%) Yr 10	Pre-tax NTA Value-add+ (%) Yr 5	Pre-tax NTA Value-add+ (%) Yr 10
Domestic Equity					
AFI	AFIC	10.7	5.9	-0.5	0.8
ARG	Argo Investments	11.1	5.1	-0.1	0.0
DJW	Djerriwarrh Investments	8.5	3.9	-2.7	-1.2
AUI	Australian United	10.0	4.6	-1.2	-0.5
	Ave. Performance of Large Cap	**10.1**	**4.9**	**-1.1**	**-0.2**
MLT	Milton Corporation	11.3	5.5	0.3	0.3
BKI	BKI Investment	9.0	5.5	-2.0	0.5
CIN	Carlton Investments	17.6	10.0	6.4	4.9
DUI	Diversified United	11.9	5.1	0.7	0.0
WHF	Whitefield	16.0	4.7	0.1	-1.7
PIC	Perpetual Equity Invest Co	n/a	n/a	n/a	n/a
AMH	AMCIL	12.1	7.5	0.9	2.4
QVE	QV Equities	n/a	n/a	n/a	n/a
WDE	Wealth Defenders Equity	n/a	n/a	n/a	n/a
CAM	Clime Capital	3.2	3.5	-7.8	-1.7
FSI	Flagship Investments	12.2	5.3	1.2	0.1
CBC	CBG Capital	n/a	n/a	n/a	n/a
	Ave. Performance of Large/Medium Cap	**11.6**	**5.9**	**0.0**	**0.6**
WAM	WAM Capital	12.9	9.8	1.9	4.6
MIR	Mirrabooka	15.2	8.5	5.0	5.0
WIC	WestOz Investment Co.	3.6	n/a	-1.7	n/a
WAX	WAM Research	15.6	7.1	4.6	1.9
OZG	Ozgrowth	4.3	n/a	-6.7	n/a
	Ave. Performance of Medium/Small Cap	**10.3**	**8.4**	**0.6**	**3.8**
CTN	Contango Microcap	6.4	3.8	1.1	2.4
ACQ	Acorn Capital	n/a	n/a	n/a	n/a
BTI	Bailador Tech Investments	n/a	n/a	n/a	n/a
	Ave. Performance of Small/Micro Cap	**6.4**	**3.8**	**1.1**	**2.4**

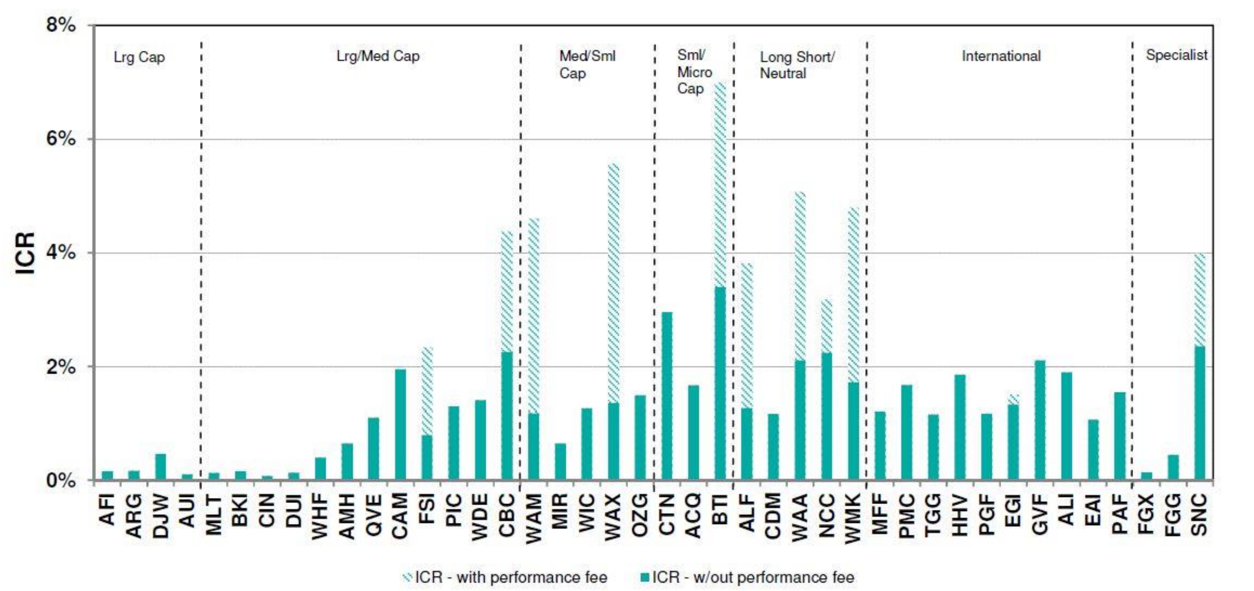
ASX Code	ASX Listed Investment Companies	Pre-tax NTA Performance (%) Yr 5	Pre-tax NTA Performance (%) Yr 10	Pre-tax NTA Value-add+ (%) Yr 5	Pre-tax NTA Value-add+ (%) Yr 10
Domestic Equity					
ALF	Australian Leaders Fund	13.3	8.7	2.3	3.5
CDM	Cadence Capital	5.8	n/a	-5.2	n/a
WAA	WAM Active	7.5	n/a	-3.5	n/a
NCC	Naos Emerging Opportunities	n/a	n/a	n/a	n/a
WMK	Watermark Market Neutral	n/a	n/a	n/a	n/a
	Ave. Performance of Long Short/Market Neutral	**8.9**	**8.7**	**-2.1**	**3.5**
International Equity					
MFF	Magellan Flagship Fund	22.2	n/a	7.5	n/a
PMC	Platinum Capital	11.2	4.3	-4.8	0.2
TGG	Templeton Global Growth	13.3	1.3	-2.7	-2.8
HHV	Hunter Hall Global Value	16.0	4.4	-1.1	0.2
PGF	PM Capital Global Opp	n/a	n/a	n/a	n/a
EGI	Ellerston Global Investments	n/a	n/a	n/a	n/a
GVF	Global Value Fund	n/a	n/a	n/a	n/a
ALI	Argo Global Infrastructure	n/a	n/a	n/a	n/a
EAI	Ellerston Asian Investments	n/a	n/a	n/a	n/a
PAF	PM Capital Asian Opp	n/a	n/a	n/a	n/a
	Ave. Performance of International	**15.7**	**3.4**	**-0.3**	**-0.8**
Specialist					
FGX	Future Generation Invest Co	n/a	n/a	n/a	n/a
FGG	Future Gen Global Invest	n/a	n/a	n/a	n/a
SNC	Sandon Capital	n/a	n/a	n/a	n/a
	Ave. Performance of Specialist	**n/a**	**n/a**	**n/a**	**n/a**

SOURCE: COMPANY DATA, IRESS & BELL POTTER

Putting this into perspective, the average performance (pre-tax NTA) of large-cap focussed LICs in our universe is 10.1% over five years and 4.9% over 10 years, large to medium cap LICs is 11.6% and 5.9% respectively, while medium to small is 10.3% and 8.4%. Small to Micro LICs is 6.4% and 3.8%, Long Short/Market Neutral is 8.9% and 8.7%, International is 15.7% and 3.4%. However, there is not sufficient data for specialist LICs over those periods.

Overlaying this with average Indirect Cost Ratio, you will note the different fee structures across each mandate:

Graph 1: Listed Investment Company Indirect Cost Ratio (as at 30 June 2016)



SOURCE: COMPANY DATA, IRESS & BELL POTTER

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Table 2: Average Indirect Cost Ratio across each LIC's investment mandate

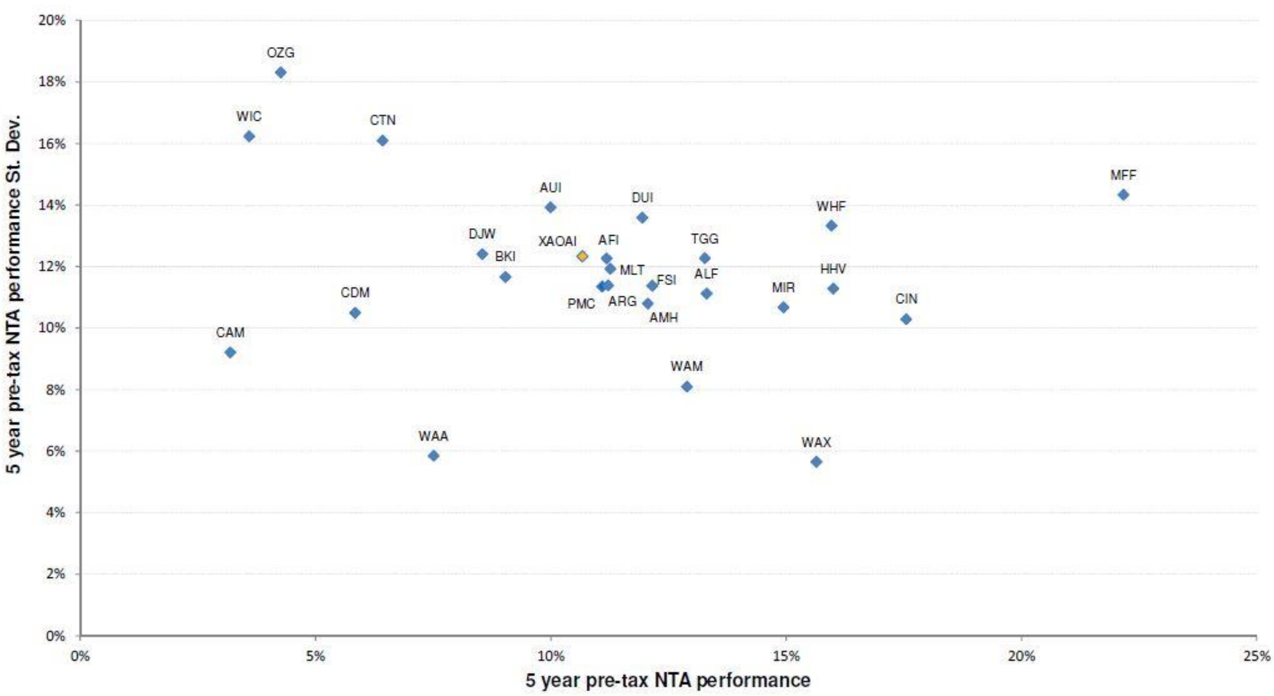
Mandate	Average ICR (w/out perf. Fees)	Average ICR (with perf. Fees)
Large Caps	0.22%	0.22%
Large to Medium Caps	0.86%	1.17%
Medium to Small Caps	1.19%	2.72%
Small to Micro	2.67%	3.87%
Long Short/Market Neutral	1.70%	3.60%
International	1.50%	1.52%
Specialist	0.98%	1.53%

SOURCE: COMPANY DATA, IRESS & BELL POTTER

Broadly speaking, there are seven LICs with an ICR of below 0.20% These are a viable option if cost is a major factor in deciding to invest in a LIC. This ICR is materially lower than most industry funds, retail funds, index funds and exchange traded funds (ETFs) listed on the ASX.

However, if investors focus purely on cost, they would neglect some of the better performing LICs, particularly on a risk-adjusted basis. The graph below reflects the risk return of each LIC over the past five years. The vertical axis highlights the standard deviation of the investment performance, while the horizontal axis displays the LIC's pre-tax NTA performance (investment performance).

Graph 2: Pre-Tax NTA Performance Standard Deviation vs Pre-Tax NTA Performance



SOURCE: COMPANY DATA, IRESS & BELL POTTER

On a five-year risk adjusted perspective, the best performing domestic LICs are WAM Capital (ASX:WAM) and WAM Research (ASX:WAX). These funds outperform all other vehicles by a material margin while offering a lower risk profile. The Magellan Flagship Fund (ASX:MFF) was the best-performing international LIC. We attribute these strong performances to a more cost-intensive mandate and performance fee structure that some of these LICs apply.

Conclusion

Fees clearly weigh on performances, and an excessive fee structure will make it increasingly difficult for a manager to outperform their benchmark. However, investors also need to consider whether the fee structure is appropriate. It is the manager's ability to consistently deliver an effective, risk-adjusted return after fees and taxes, that counts in the long run.

Nathan Umapathy is Research Analyst at Bell Potter Securities. This document has been prepared without consideration of any specific client's investment objectives, financial situation or needs and there is no responsibility to inform you of any matter that subsequently may affect any of the information contained in this document.

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