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This Week's Top Articles

Insider sales can be a powerful warning

Chris Stott

A company's directors, particularly executive directors, have more insight into a business than anyone else in the market. Therefore, we are generally sceptical when a company's board member substantially sells-down their position as it can signal a negative outlook for the company. Furthermore, a substantial reduction in a director's equity diminishes their 'skin in the game', which helps align their interests with shareholders.

Skin in the game

In our experience, when management (including directors and senior managers) have equity in the company they are running, it is likely to outperform other comparable businesses. This is particularly the case when the founder maintains a stake in the company. Managers with 'skin in the game', a term famously coined by Warren Buffet, have more exposure to the performance of the company they are running. This creates an inherent incentive for them to act in the interests of the company and its shareholders.

When we assess a company as a prospective investment, we always consider how management's interests are aligned to its shareholders by evaluating remuneration structures including base salary, bonuses and performance hurdles. Our focus on management's equity stake in the business also applies to our analysis of IPOs, particularly those businesses that are yet to generate a profit (for more, see my Cuffelinks article, 'Nine factors to assess in IPOs with no earnings').

Scrutiny of Appendix 3Y Notices

ASX-listed companies must notify the stock exchange (within five business days) using an Appendix 3Y - Change of Director's Interest Notice when directors acquire or dispose of its shares.

Appendix 3Y Notices can provide valuable insights and we closely monitor these announcements on potential investments as well as those already in our portfolio. We pay particular attention to share sales by executive directors (such as CEOs) with responsibility for the day-to-day operations. Their decision can sometimes be tantamount to a vote of no confidence in the future prospects and may be a signal for us to sell-out of a holding, or at least seek to understand the rationale for the sale. Conversely, a company's directors increasing their holding typically indicates a positive outlook and their ongoing commitment.

Director sales

Over the last 12 to 24 months, the market has seen the spectacular collapse of numerous company share prices. In many cases, the share price rout was preceded by significant sell-downs by company directors including:

Bellamy's Australia (ASX: BAL). Former Managing Director and CEO Laura McBain and then-Chairman Rob Woolley sold 14.2% and 44.2% respectively of their shares in Bellamy's. The sales in August 2016 for $14.60 were made just days before the stock hit an all-time high of $14.90 a share. The disposal of shares in the former market darling proved a portent of Bellamy's share price performance with its stock plummeting around 69% off their high to trade around $4.61 each at the time of writing.

Vocus Communications (ASX: VOC). Founder and director of the telco James Spenceley substantially sold-down his stake in the business for $26.7 million in August 2016 before the company downgraded its profit guidance in November. Shares in Vocus are now down 54% from their May 2016 high.

Estia Health (ASX: EHE). After the company missed its profit guidance, director and founder of the aged-care operator and developer, Peter Arvanitis, surprised the market in August 2016 by selling his entire stake in the company (around 10%) for $3.15 a share (which compares to a high of $7.41 earlier in the year), or around $55 million. Simultaneously, Mr Arvanitis resigned as a director. The company's share price had already declined sharply in the months leading up to Mr Arvanitis's decision to sell-out and continued its decline with the company cutting its profit outlook in October 2016. Shares in Estia have since recovered to trade around Mr Arvanitis's sale price.

Research reveals correlation

Our belief that insider sales can be a potent indicator of a company's future performance was buttressed by recent research. An analysis by stockbroking firm Wilsons (not related to Wilson Asset Management) of Appendix 3Y Notices announced to the ASX in 2016 found that, of the companies whose management sold large parcels of shares, 76% underperformed following the sale with their share prices falling an average of 14% (excluding companies with a market capitalisation of less than $50 million and listed investment companies).

The research also found the larger the value of the shares sold, the greater the risk it would underperform. Interestingly, the disposal of shares *of any size* by a director holding the position of CEO, CFO and/or COO was correlated to significant underperformance of the share price.

When director selling is a positive

Insider sales are not always an ominous sign and director sales can sometimes be a positive for the company outlook. For example, a director that has sold shares but still holds a large parcel may be motivated to ensure a continuing and positive relationship with the buyer because they want to sell again in the future. Also, when a director is selling shares but leaving 'something on the table', it can give us confidence in the future prospects of the company. As an example, the executives at Monadelphous Group (ASX: MND) over the years have generally sold and left money on the table.

Chris Stott is Chief Investment Officer of Wilson Asset Management *(WAM). This article is general information and does not consider the needs of any individual, and WAM may or may not hold some of the investments mentioned.*

How super changes impact insurance and estate planning

Julie Steed

The introduction of the $1.6 million transfer balance cap, effective from July 1 this year, will impact the estate plans of many superannuation members. This article reviews the role of insurance as part of an SMSF's investment strategy and the changes that people may need to make to their superannuation and estate plans.

Making insurance part of an SMSF's investment strategy

Superannuation law requires all SMSF trustees to formulate, regularly review and give effect to an investment strategy relevant to the whole of the fund's circumstances. The investment strategy must set out the investment objectives of the fund and detail the methods the fund will adopt to achieve these objectives.

When formulating an investment strategy, trustees must consider:

- the risk and likely return of investments
- the diversification of the fund's investment portfolio
- the liquidity of the fund's assets
- the fund's ability to pay benefits and other costs it incurs
- whether the trustee should hold insurance policies for one or more members.

The mandate to consider the insurance needs of members has been law since 2012, but many trustees have not amended their investment strategies to comply with the requirement.

Considering the insurance needs of members generally involves the following steps:

- determining the insurance needs of each SMSF member (including death, total and permanent disability insurance (TPD) and income protection insurance).
- determining whether insurance should be held by the super fund.
- amending the fund's investment strategy.

Once the insurance needs have been determined, the investment strategy must be updated. Given the personal nature of the assessment of insurance needs, this could be documented by way of a minute, relative to each member.

The notation in the investment strategy can be quite simple and concise, for example:

'the trustees have considered the insurance needs of members of the fund and have determined that the insurances held by the members within the fund remain appropriate.'
or
'the trustees have considered the insurance needs of members of the fund and have determined that it remains appropriate for the fund not to hold insurance policies for members.

However, the notation to amend the investment strategy should be supported by more detailed information on the insurance needs and an outline of the reasons the decision were made. This may take the form of a statement of advice (SOA) prepared by an adviser. Trustees need to ensure that the information they retain is sufficient to withstand future scrutiny. For example, the widow of a deceased member who was in an SMSF with his parents may have recourse against the parent trustees if they cannot demonstrate that they considered the insurance needs of all members.

Regular review of investment strategy

Trustees are now required to ensure that the investment strategy is reviewed regularly, to ensure that trustees do not simply 'set and forget' their investment goals and insurance needs. Whilst 'regularly' is not defined, it is generally considered that at least annually is prudent.

In addition, there are events that should prompt an SMSF trustee to consider a review of the insurance needs of members and the fund's investment strategy, such as:

- the admittance of a new member
- changes in a member's personal circumstance (for example, marriage or children)
- a member commencing a pension
- significant changes in financial market conditions.

Insurance and the $1.6 million transfer balance cap

The introduction of the $1.6 million transfer balance cap is likely to prompt a review of holding insurance in super for many SMSF trustees and members of retail superannuation funds.

This is because the transfer balance cap places a limit on the amount of super that can be used to commence a pension that receives tax-free investment returns. On the death of a member, their benefit must be 'cashed' and paid to their superannuation dependants (most commonly to a spouse or child). The benefit may be cashed by paying a lump sum benefit, by commencing one or more pensions or a combination of both.

If a death benefit pension is paid, the amount that can be used to start the pension is restricted to the transfer balance cap of $1.6 million. Any amount above the transfer balance cap must leave the superannuation system. Where there are multiple beneficiaries, each beneficiary receives a proportionate share of the transfer balance cap.

If a beneficiary has commenced a pension themselves, their own pension and the death benefit pension they receive counts towards the $1.6 million cap. A member's own pension may be commuted back to accumulation phase, but a death benefit pension cannot be.

Case study - Margaret

Margaret is a single parent who has two children. She has an accumulation account which holds $400,000 and life insurance of $2 million. She has binding nominations to her two children in equal shares.

If Margaret dies her total superannuation death benefit will be paid 50% to each child ($1.2 million each). Before 1 July 2017, each child could receive $1.2 million as a death benefit pension. However, from 1 July, each child will be limited to a death benefit pension of $800,000 (half of the $1.6 million cap). The remaining $400,000 each must leave the super system as a lump sum payment.

Therefore, it is essential that people with large super balances review their estate plans to ensure any benefits that may be forced out of the super system are directed to structures that can be controlled, such as testamentary trusts established via a will.

Conclusion

Consideration of members' insurance needs as part of an SMSF's investment strategy is an obligation that all SMSF trustees need to consider. The introduction of the super changes is likely to be a catalyst for SMSF trustees to review the insurance needs of members and for members of other super funds to review their own super arrangements and estate plans.

Julie Steed is Senior Technical Services Manager at Australian Executor Trustees*. This article is general information and does not consider the circumstances of any individual.*

Defined benefit pensions and the transfer balance cap

Melanie Dunn

For retirees with a defined benefit income stream, understanding how they will be impacted under the incoming superannuation reforms is a potential minefield. In this article we try to explain some of these complexities.

What are defined benefit pensions?

Defined benefit pensions promise members a defined series of payments, typically for life. Former public servants are the most common recipients, although some companies also offered these types of schemes to their employees. SMSFs were also able to offer their members defined benefit pensions up until 2005, although there was no guarantee that these funds could meet the pension payments. The amount received by the pensioner may index each year benchmarked to a factor such as CPI and the pension may be reversionary to a spouse upon death of the primary pensioner.

The Commonwealth Superannuation Scheme (CSS) and the Public Sector Superannuation Scheme (PSS) are Australia's two largest defined benefit pension schemes although they have been closed to new members for a number of years. At 30 June 2016, there were around 110,000 pension accounts being paid from CSS.

The benefits paid to pensioners from a public sector scheme are generally not tax free after age 60 like those paid from an account-based pension (ABP). This is because some or all of the benefit is paid from an untaxed source meaning it is paid directly by the Government and not from the member's accumulated superannuation contributions and earnings. The untaxed component of a benefit is treated like a salary subject to tax at the pensioner's marginal tax rate, however once a pensioner reaches age 60 they will receive a tax offset and be subject to tax at marginal tax rates less a 10% offset.

How are these lifetime pensions valued under the transfer balance cap?

From 1 July 2017 there will be a cap of $1.6 million on amounts that can be transferred into the tax free retirement phase. Defined benefit pensions must be included in the value of total retirement phase balances that count towards this cap.

For the purpose of valuing defined benefit income streams, the transfer balance cap legislation identifies specific types of annuities and pensions as 'capped defined benefit income streams'.

Members may need to talk to their fund in order to determine whether their defined benefit pension meets this definition. Typically the definition will be met where it is a pension that is non-commutable, has no residual capital value, is paid for life, and the size of the benefit payment each year is fixed or indexed according to defined terms.

A capped defined benefit income stream that is payable for life will be assigned a 'special value' under the transfer balance cap equal to **16x annual entitlement**. The annual entitlement is worked out by annualising the first income stream benefit payable in an income year.

For example, consider a pensioner who has a lifetime capped defined benefit income stream at 1 July 2017 which is paid monthly. Their first payment for the income year will be paid on 31 July for $10,000.

The annual entitlement for the purpose of the transfer balance cap is 12 x $10,000 = $120,000.

The special value of the income stream for the purposes of the transfer balance cap is 16 x $120,000 = $1,920,000.

To see how this special value is used, consider two pensioners John and Kyle who are both over age 60 and receiving lifetime defined benefit pensions at 1 July 2017:

- John has a lifetime pension paying $90,000 per annum and also an ABP in a retail fund valued at $480,000 at 1 July 2017
- Kyle has a lifetime pension paying $120,000 per annum at 1 July 2017 and no other superannuation balances

At 1 July 2017, the following amounts will count towards John's and Kyle's transfer balance cap, potentially leading to an excess transfer balance:

Pensioner	Lifetime pension special value ($)	Transfer balance account ($)	Potential excess transfer balance ($)
John	16 x 90,000 = 1,440,000	480,000 + 1,440,000 = 1,920,000	1,920,000 – 1,600,000 = 320,000
Kyle	16 x 120,000 = 1,920,000	1,920,000	1920,000 – 1,600,000 = 320,000

Both pensioners have a potential excess of $320,000 above the $1.6 million transfer balance cap at 1 July 2017.

Dealing with excess transfer balances and lifetime pensions

John has an ABP valued at $480,000 at 1 July 2017 that is able to be commuted. The $320,000 excess must be commuted from the ABP balance to an accumulation phase superannuation account (or withdrawn from superannuation) to comply with the transfer balance cap.

John establishes an accumulation account with his retail super fund and commutes $320,000 from his ABP. At 1 July 2017 he now has:

- lifetime pension paying $90,000 per annum
- ABP valued at $160,000
- accumulation account valued at $320,000

John's transfer balance account is equal to the special value of his lifetime pension plus the value of his ABP = 1,440,000 + 160,000 = 1,600,000. No transfer balance cap excess remains.

Kyle also has an excess of $320,000 however his lifetime pension is non-commutable. Special rules come into play which excuse the potential excess transfer balance. Rather than reducing the pension to comply with the cap, Kyle's pension will be subject to different tax treatment.

Changes to tax treatment of defined benefit income

Where a pensioner has a capped defined benefit income stream they will be subject to the defined benefit income cap. This is set to the general transfer balance cap divided by 16. At 1 July 2017 this will be $100,000.

There are some complex rules to determine a retiree's personal defined benefit income cap that depend on the tax treatment of income payments. Generally where a pensioner receives income solely from an untaxed source, or solely from a taxed source and the pensioner has attained age 60, at 1 July 2017 their defined benefit income cap for the 2017-18 year will be $100,000.

Income in excess of an individual's defined benefit income cap will be treated differently depending on whether it was from a taxed or untaxed source. In essence, 50% of an excess amount from a concessionally taxed source will become assessable income for the individual and not eligible for any tax offset. An excess amount from an untaxed source will not be eligible for the 10% offset in the pensioner's tax return, i.e. the tax offset will be capped at $10,000.

Pensions paid from public sector schemes often include an untaxed source amount and may or may not also contain a taxed source amount. Defined benefit income streams paid from an SMSF will not contain an untaxed source.

In 2017-18, Kyle expects to be paid $120,000 from his lifetime pension. His pension is paid from a public sector scheme and is solely from an untaxed source meaning his defined benefit income cap is $100,000. His excess untaxed amount is therefore $120,000 - $100,000 = $20,000

As Kyle is over age 60 he would normally apply a 10% tax offset to his entire $120,000 income in his tax return. In 2017-18 Kyle will only be eligible to apply the 10% tax offset to $100,000 of his assessable defined benefit income. The remaining $20,000 will be subject to his full marginal tax rates.

Conclusion

Pensioners should speak with their income stream provider to understand the type of defined benefit pension they hold and the tax treatment of income payments. This information can then be used to determine how the pension will be treated under the superannuation reforms.

Further detail on the treatment of defined benefit income streams including detail on how to treat scenarios not fully explored here can be found in Accurium's decision charts for defined benefit income streams here.

Melanie Dunn is the SMSF Technical Services Manager at Accurium, a sponsor of Cuffelinks. This is general information only and is not intended to be financial product advice. It is based on Accurium's understanding of the current superannuation and taxation laws. Examples are illustrative only. No warranty is given on the information provided and Accurium is not liable for any loss arising from reliance on or use of the information.

SMSF investments do not match objectives

Graham Hand

Most individual investors are facing the same dilemma at the moment. They don't want to sit in cash or deposits earning little in real returns (the cash rate and inflation are about the same), share markets look fully valued (the All Ords closed at its highest level since May 2015 on the day of writing, and the Dow has seen many all-time highs this year) and even that darling, residential property, is looking skittish. Yet to build retirement savings at a decent long-term target return of say 8%, risks need to be taken.

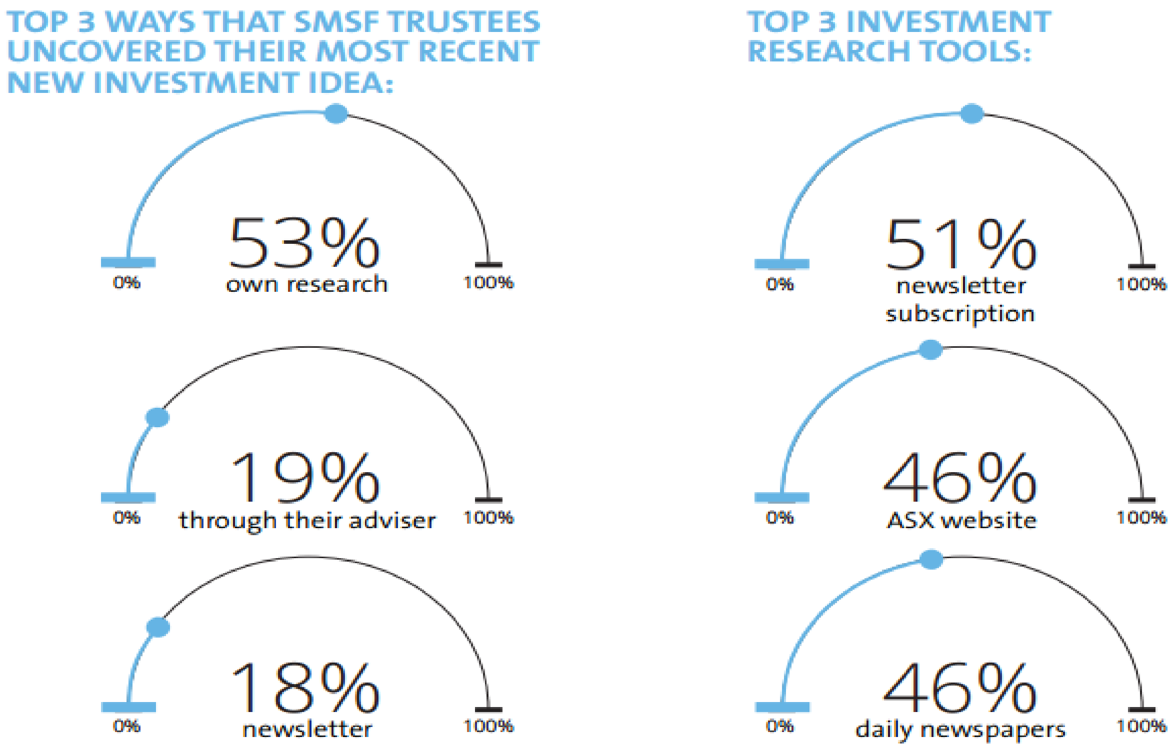
Unrealistic return expectations in current market

It's one reason why recent research by AMP Capital into the investments of 800 SMSF trustees shows a disconnect between growth aspirations and actual asset allocations, and the difference is stark. The annual 'Black Sky Report' shows SMSF trustees expect a 10.9% return on their portfolio in 2017, made up of 6% capital growth and 4.9% income. Yet about 55% have moved to a more defensive asset allocation in the last year as they worry about market levels. Only 18% have increased their allocation to growth categories.

A typical balanced institutional portfolio will have an asset allocation of about 30% cash and fixed interest, 35% Australian shares, 20% global shares, 10% property and 5% others (such as infrastructure, hedge funds or private equity). However, although most SMSF trustees know they need a diversified portfolio, over half their fund balances are invested in only one investment type outside of managed funds.

How do SMSF trustees make decisions?

About three-quarters of trustees report they do not use any tools to assist with portfolio construction, which seems to leave plenty of scope for financial advice to assist with an investment strategy. Trustees also rely to a surprising amount on their own research to make their decisions.



Challenges facing SMSF trustees

The respondents identified three main areas of concern for the next 12 months:

1. Market volatility (18%)
2. Investment selection (11%)
3. Regulatory changes (10%).

Although most trustees rely primarily on their own research, most want to learn more and nearly 60% are willing to use a financial adviser. About 37% of trustees nominated 'retirement strategies' as the area requiring most assistance.

There is an increasing recognition of new opportunities in active ETFs and unlisted managed funds which diversify away from the usual ASX index exposures. AMP Capital's Tim Keegan noted:

"If trustees continue to be exposed to significant portfolio concentration risk and remain in more defensive assets without seeking financial advice, they may struggle to achieve their retirement goals. We can see through the report that their interest and understanding in ETFs have increased, but there is definitely a demand for more education ... I strongly believe that is going to be an ongoing theme because the Australian market is concentrated on banks, miners and telcos, so there's a very limited range of industry sectors and markets to be exposed to."

The SMSF trustees surveyed by AMP Capital are higher users of managed funds than most trustees, due to the more regular use of advisers, and they see the benefits of ETFs as:

1. Ease of diversification 45%)
2. Access to out-of-reach investments (41%)
3. International diversification (36%).

Why SMSF trustees set up their own funds

The research also confirms the widely-held views on why SMSFs are being set up by the thousand each month:

1. More control over investment (56%)
2. Choose specific shares to invest in (32%)
3. Save money on fees (31%)

On a positive note, the trustees are aiming for an average of about $2 million in investible assets before they retire, and 72% say they are on track to achieve this goal.

The 2017 Black Sky Report can be downloaded here. AMP Capital is a sponsor of Cuffelinks.

Interest rate duration: how exposed are you?

Jarod Dawson

It is no secret that Federal Reserve Chair Janet Yellen is preparing the market for higher interest rates, but how many investors and their advisers know how exposed their portfolios are to meaningfully higher interest rates?

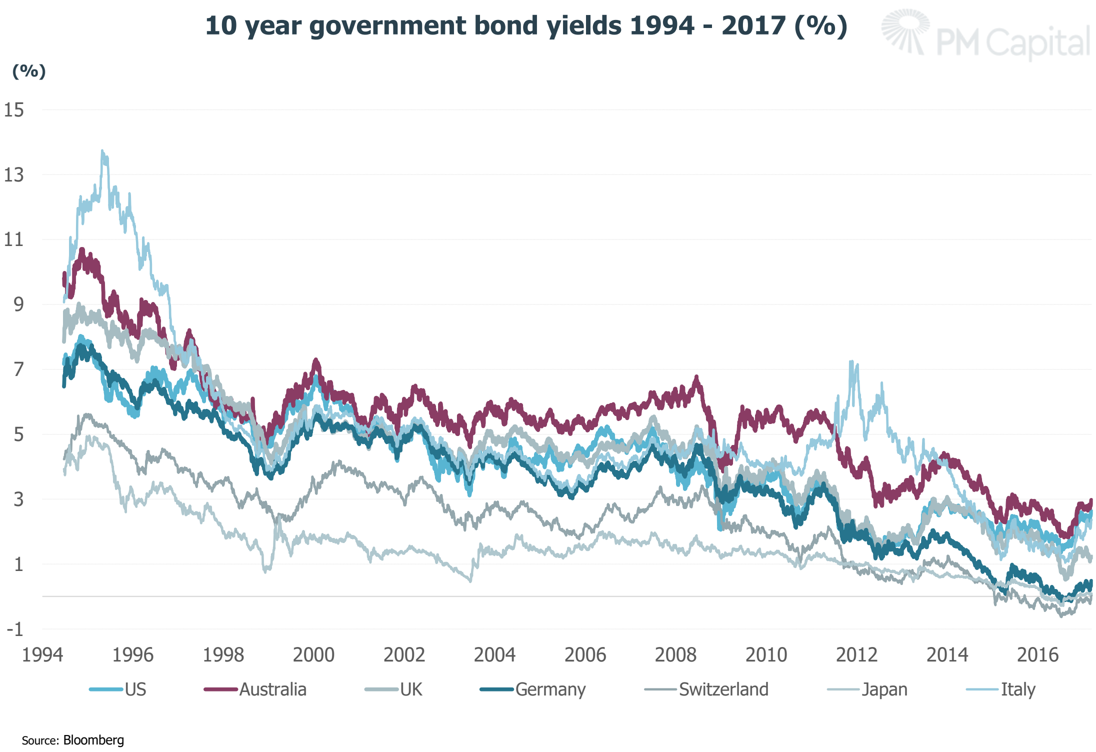
We have been doing the client rounds lately and have been taken aback by how intimidated some clients seem to be by the world of fixed income, and particularly the notion of interest rate duration. Eyebrows rise when we walk them through the potential impact of higher interest rates.

The effect of a general rise in interest rates is straightforward. A bond's interest rate duration is a measure of its price sensitivity to changes in interest rates. The greater the time to maturity, the longer it takes to receive all the coupons and principal back, and hence generally the more exposed to a change in market interest rates.

A simple way to think about duration

If a bond has a duration of five years, for example, for every 1% move in the nominal level of market interest rates, its price will move by about 5%. In other words, if market interest rates were to rise by approximately 3%, the capital value of the bond would fall by around 15%.

To take the issue of interest rate duration to the next level, and indeed to start to apply some magnitude, it is important to understand how low interest rates are around the world:



There have been some shorter-term peaks and troughs, but the long-term trend has been going down for decades. Market interest rates went negative in Japan and Germany, and some parts of their interest rate curves still are. However, we now think that we have seen the inflection point in this long-term trend.

The US is a good example. For the better part of a decade, official US rates have been at or below 1%. For a considerable part of this period, the Federal Reserve was injecting huge amounts of liquidity into the system via their quantitative easing program. So, will a more normalised level for US rates longer term be at a lower peak than previous as most of the market is expecting today? Or with the enormous amount of stimulus that has been injected into the US economy over the past eight years, could the peak in the next cycle be notably higher than the market is currently expecting?

Note that prior to the GFC, official US rates peaked at 5.25%, over 4% above where they are today. Additionally, in the 20 years prior to the 5.25% peak, official US rates still averaged just under 5%.

On the ground concern about inflation

When we talk to US companies, for the first time in a while we are hearing management report that they are competing for staff and this is pushing up wages. Unemployment in general is low and we are well into the recovery in the US housing market.

Additionally, for years now many US companies have been borrowing at very low rates, in some cases less than 3%, and sometimes with time horizons as long as 10 to 15 years. They are investing that capital back into their businesses, often with the objective of earning around 10-20% type returns or higher.

All of these points will likely feed into growth and inflation over time, suggesting that interest rates should move materially higher in the US in the medium to longer term. This potentially has significant implications for interest rate securities, especially those with meaningful duration.

At PM Capital, we have in effect removed all interest rate duration from our portfolios. This should avoid material negative capital falls due to higher rates, but also, as rates rise over time, the floating rate yields on the securities we own will ratchet up.

Investors should find out the interest rate duration of their fixed income portfolio. Only then can they make a proper assessment as to whether, in a rising interest rate environment, their investments are positioned to deliver the outcomes they are expecting.

Jarod Dawson is Director and Portfolio Manager at PM Capital. This article is general information that does not consider the circumstances of any individual.

Fairer performance fees for limited capacity managers

Dr Steven Vaughan and Sriram Srinivas

Some years ago, we tagged the crowding out of super funds from investing in limited-capacity smaller funds as the 'Allocation Gap'. Many larger funds and consultants like the performance of these managers but with insufficient capital allocation for a large super fund to move their total performance needle, it was not justified.

At the same time, limited-capacity managers did not want a concentration of money with a single client. Hence money stopped flowing to good small managers and alpha was left on the table for other investors, but not the big super funds. The Allocation Gap is still alive today, especially in the microcap space, except now there are further considerations around performance fees that challenge investors.

The investment rationale for limited-capacity equity investment managers is well known; small boutiques focused on less scalable ideas because of liquidity, for example. But to harvest good things in small packages requires a sustainable business model and appropriate pricing. In the case of microcaps, where liquidity is limited and managers need to cap their FUM, performance fees are widely used to bolster the business economics.

This practice should not bother serious investors provided the fee structures are fair.

Smaller companies can produce dramatic relative outperformance

As the table below shows, the performance of ASX small and emerging companies indices varies considerably relative to the broader All Ordinaries index. The relative performance of the Emerging Companies index and the other indices has been very high in the past 10 years, ranging from negative 33% (-15%) to positive 56% (+38%) versus All Ords and Small Ords respectively. When the smaller companies 'run' they can produce dramatic relative performance in both absolute and relative terms.

	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
All ordinaries	11.6%	3.8%	5.0%	19.6%	18.8%	-11.4%	3.3%	39.5%	-40.3%	17.9%
Small cos	13.2%	10.1%	-3.8%	-0.8%	6.6%	-21.4%	13.0%	57.3%	-53.1%	17.0%
Emerging cos	24.6%	12.0%	-11.0%	-13.3%	-8.4%	-23.3%	25.7%	95.5%	-61.4%	28.4%
Emerging cos vs Small cos	11.4%	1.8%	-7.2%	-12.6%	-14.9%	-2.0%	12.7%	38.2%	-8.3%	11.4%
Emerging cos vs All ords	12.9%	8.2%	-16.0%	-32.9%	-27.2%	-11.9%	22.4%	56.0%	-21.1%	10.5%

Further, the small and microcap managers' performances can add an additional volatility in investor returns. It is well established that small and micro-cap managers outperform their relative benchmarks strongly in some periods and yet underperform in others, whilst importantly many outperform over the longer term.

A set of eight microcap managers we reviewed outperformed the S&P Emerging Market index by an average of 3 to 4% per annum during the past 13 years and by about 7% per annum over a 10-year period. Managers outperformed by double-digit amounts in some years and would have charged very high performance fees. In subsequent years, underperformance was common. Other research has found that smaller cap fund managers have a higher probability of generating larger value add compared to the average large cap fund manager.

Investor carry the costs of fee structure

The important point is that this manager excess return volatility can have significant implications for the investor's periodic fee expense. With a typical performance fee of 20% in excess of the benchmark, a manager may earn a multiple of its base fee in one year only to underperform in subsequent periods. When the high-water mark recovery period is long, and it can be many years, it is the investor who carries the cost of having paid out for unsustained outperformance.

Such is the potential for high performance fees in bumper years — think 20% fee on excess performance of 10 - 20% — questions come to mind. Does the presence of a performance fee change a microcap managers' behaviour? Further, can there be temporal alignment of interests between the manager and the client, when the shorter the period under review for paying out performance fees, the less reliable is the track record data. We know good managers can underperform or have very little value-add primarily because of market noise, and the reverse applies for unskilled managers who experience a run of better fortune.

Managers should 'smooth the impact'

To deal with this, where performance fees are accepted practice (as with microcaps), we suggest smoothing the impact of large performance fees on the investor by staggering the payment of the fee for a vesting period after it is earned. For example, the manager might be paid in three one-third installments. This method could be applied over shorter or longer periods with different proportions and can be integrated into the high-water mark.

In the longer term, the manager will receive its duly-earned fee while the investor will incur a smoothing of the cost. The investor would have gained a put option by deferring the fees of the manager in case the performance deteriorates after the initial period (that is, strong first-year performance, say 10% excess return, is not followed through in the second and third year, say -5% in the second year and 0% in the third year).

Opportunity to harvest returns left by large funds

The Allocation Gap is crowding out big super funds from microcap alpha and beta opportunities because of their scale and the manager's capacity allocation across clients. This is an opportunity for smaller funds and investors to harvest the returns 'left on the table' by their larger peers. Performance fees can be an acceptable feature of limited-capacity microcap funds, but it is important that the impact of high periodic performance fees on the investor is reasonable, as such performance is often not sustained.

Dr Steven Vaughan is Managing Director and Sriram Srinivas is Research Assistant at Queen Street Partners. This information is general only and does not take into account the personal circumstances or financial objectives of any reader.