Cuffelinks
Connecting investors with ideas

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Reader survey: how you invested due to super changes

Graham Hand

When superannuation rules change, it's difficult to know how investors will react, as everyone's personal circumstances are different. While some see the changes as a call to action, others throw their hands up in frustration. It's fascinating to analyse our Reader Survey on actions taken in response to the new super rules.

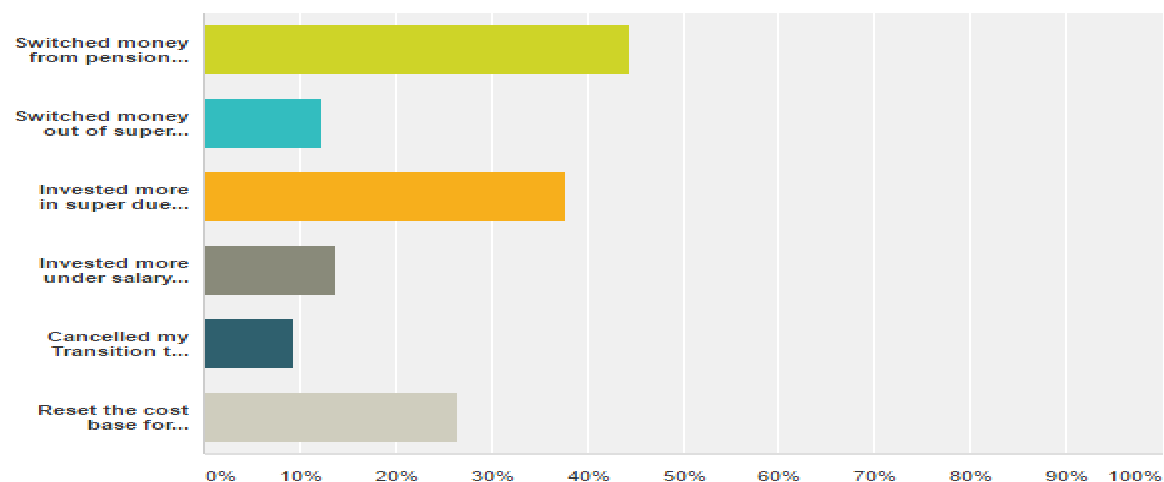
The most revealing part of any survey is often the comments, and many of these are reproduced below (only on the website version of this article) to show the actions of over 400 of our readers.

The full survey results are linked here, but some highlights include:

Q1. Did the new 1 July 2017 super rules affect your investing decisions?

Yes 58%, No 42%

Q2. If 'Yes' to Q1, in what way did your investing or actions change (multiple answers allowed)?



The two highest categories were 44% of respondents switched from money from pension to accumulation due to the new caps, and 39% invested more now due to reduction in the non-concessional caps next year. A solid 27% reset their CGT base on pension assets, but only 9% cancelled TTR arrangements.

Q3. If 'No' to Q1, why did your super investing not change?

I don't have enough in super to worry about the changes	24.36%
I don't trust super as the best place to invest	16.03%
I am waiting for some of the favourable changes after 1 July 2017	2.56%
I don't have the resources to invest more into super	18.59%
I already have plenty of money in super	38.46%

Q4. If you invested more, how did you decide the amount?

A high 57% based their additional investments on using up the existing caps, 31% based on the amount they had available outside super and 11% based on the amount they want in super.

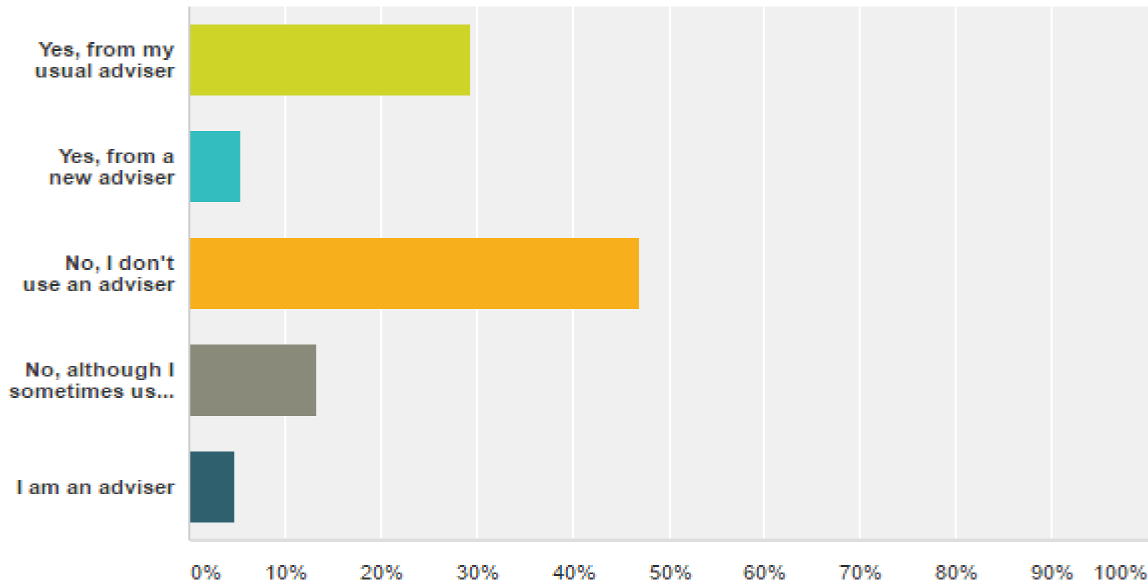
Q5. If you invested more, into which type of asset did you mainly invest?

The most popular types of investment were balanced funds and the usual diversified asset allocations, with strong support for cash, perhaps parking money to wait for other opportunities. Global equities were not far behind domestic equities, which is different from the usual weighting towards Australia, and surprisingly little property allocation.

A balanced managed fund	18.62%
A diversified portfolio according to my usual asset allocation	23.94%
Australian equities (direct or fund)	15.96%
Cash (direct or fund)	18.62%
Bonds (direct or fund)	3.72%
Global equities (direct or fund)	11.70%
Listed property (direct or fund)	0.00%
Unlisted property (residential or commercial)	1.06%
Other (define below)	6.38%

Q6. Did you seek financial advice on the changes?

As reported in previous surveys, almost half Cuffelinks' readers are self-directed. The new super rules are complex so perhaps this was time when more people should have at least checked understanding or calculations with a professional. A relatively high and unexpected 13% use a financial adviser but did not in this instance.



Q7. Will you invest less in superannuation after 1 July 2017 due to the caps?

A high 57% said they will invest less in super in future, showing the industry has had a one-off boost and the top will be taken off future flows.

Thanks to all who participated for their insights.

Graham Hand is Managing Editor of Cuffelinks.

Don't ignore the 3 key principles of retirement income

Anthony Serhan

The ways financial regulation and industry evolve to serve the growing number of Australians facing retirement have huge social and economic implications. They make the Government's consultation paper, "Development of the Framework for Comprehensive Income Products for Retirement" (CIPR) (the Paper), an incredibly important step. We applaud the Paper and the opportunity it provides Australia to have the retirement income discussion. It is this sort of process that has created a system the envy of many countries and I am certain that elements of whatever comes out of this process will also be world-leading and have an impact far beyond our shores.

With all that said, I admit to being annoyed the first time I started reading the Paper because of the overly negative way account-based pensions were portrayed and what felt like rose-coloured glasses being applied to longevity insurance. Although a lot of relevant detail and context comes out later in the document, I believe the narrative and industry debate has been too heavily skewed towards product-based solutions. There is a lot more groundwork that can be laid to improve retirement outcomes before jumping straight to a product.

I do not profess to have the final solution, but there are three broad principles that need to be embraced as part of this process: mechanics, technology and preferences.

Mechanics

As a research house, we are constantly trying to cut through the noise and marketing to understand what really makes an investment tick. When it comes to retirement incomes, the amount available is determined by four main areas: contributions + investment earnings – fees – taxes (the traditional components of defined contribution or account-based solutions). Adding longevity insurance of some form adds a fifth element, mortality credits.

We believe that the CIPR should be defined as a *solution* that utilises relevant account based and longevity insurance component products as opposed to a composite product. We support the move to make longevity insurance more readily available. However, it is already a complicated product, and adding to this by incorporating additional elements or features will make it more difficult to compare these products and may prevent the formation of a competitive market. Importantly, while the components of a CIPR may be kept separate, the resultant payout profiles can still be communicated as a combined income stream to members.

The idea that CIPRs will lead to higher levels of retirement income for all Australians, an idea promulgated several times in the Paper, oversimplifies the situation and has the potential to be misinterpreted out of context. Very simply, longevity insurance transfers assets between those who die early to those who die later. This will clearly benefit some and has the potential to add certainty to many more. However, the mortality credits created have some implications relative to a simple account-based pension, including:

- product cost structures will be higher due to the additional complexity
- the capital costs associated with longevity products
- assets are likely to be allocated to lower risk and return investments due to the capital requirements placed on annuity providers, and
- higher distribution or sales costs due to the additional complexity of the product.

It's true in a narrow sense that products such as annuities can create additional income for retirees as long as they live, but this does not always equate to more utility for the retiree. Further, for retirees who wish to draw down a low percentage of their assets, have other sources of income, or are not concerned about longevity risk, a similar improvement could also be achieved through asset-based pensions with the assistance of better advice tools.

Technology

Advances in technology will see ongoing improvements in the way retirement incomes can be built for Australians. Technology has a key role to play in better forms of communication, more efficient administration platforms, increasingly sophisticated modelling engines and data-gathering techniques. Technology and advice should be the instruments used to pull together different product components into an overall retirement income *solution* for retirees.

Technology will bring down the cost of providing retirement incomes to more Australians. Technology means that it will become less important to productise solutions to make them commercially viable. These factors must be recognised in the formation of the CIPR framework. The CIPR framework must make it easier for trustees to provide online advice to address individual requirements in retirement. If safe harbour provisions are being considered for a product, they should also exist for expanded intra-fund advice.

Preferences

The CIPR framework was originally envisioned for members who do not make a choice on retirement – defaulting members. However, even a defaulting member will have preferences. My US colleagues have published research around optimal levels of annuitisation. Two of the biggest drivers are bequest preferences and the desire for certainty in retirement incomes.

From a policy perspective, superannuation is not intended to be used as an estate planning tool. This policy objective is managed through minimum drawdown requirements and the tax treatment of superannuation and pension assets. However, it is incorrect to extrapolate this to a position where no superannuation assets should be left to dependants in any instance. Within these policy settings, some Australians will prefer to live more frugally so that their dependants may live better, while others may prefer more certainty around retirement incomes. People will have different preferences.

The fear of running out of money can be a factor in lowering drawdown rates. In some cases, this can be a justified fear. In other cases, it is more of a behavioural bias. In both instances, the result can be better informed through the utilisation of improved advice tools. If no advice is provided, it is not surprising that members gravitate towards the published minimum drawdown rates. While much progress has been made, I doubt there is anybody who would say the industry has nailed the way in which we help retirees to manage their account-based pensions in retirement.

Using an annuity as part of a default would make more sense if the recommendation could be personalised. Given basic demographic information on each participant, such as age, compensation, savings rate, and balance, coupled with plan-level data on any type of additional pension benefits, would better enable the annuity recommendation to be tailored to that participant. Even if a member hasn't communicated preferences, the ability to customise the portfolio based on available data is there today and will continue to grow. The cohort-based approach suggested by the Paper may be a good initial step on the road toward individual solutions.

Product options must include advice

In summary, a composite approach to CIPR that pairs digital advice – a low cost, individualised component driven by data and technology – with a mix of transparent 'best of breed' product options is the best path toward improving retirement outcomes for Australians. The CIPR framework needs to acknowledge likely future digital capabilities and not just the tools at hand today, and to review the regulations governing the ability of trustees to provide individual recommendations.

Anthony Serhan, CFA, is Morningstar's Managing Director Research Strategy, Asia-Pacific. Morningstar has made a submission to Treasury on the Paper. This material has been prepared for general use only, without reference to your objectives, financial situation or needs. You should seek your own advice.

Who pays if your apartment building catches fire?

Hugh Dive

The Grenfell Tower fire in London in mid-June was very tragic and resulted in 79 deaths. This terrible occurrence has highlighted the extremely negative impact that the choice of building materials can have. There have not been many significant advances in construction materials recently. The Colosseum in Rome was largely built with concrete, terracotta roof tiles were used on the temple of Apollo in Corinth in 700 BC, and plasterboard was invented in 1894. We see that due to the lack of advances in construction materials, a perception has developed that all building materials and construction techniques are safe and have been tested over centuries.

As a former building products analyst at a large US investment bank, I have more than a passing interest in construction materials. This article looks at the impact that plastic-based aluminium composite cladding may have on Australian direct property investors, and who is likely to pay the remediation costs when building materials go wrong. Past examples have shown that the home owner invariably has borne most of the costs for decisions that were not made by them.

What is aluminium cladding?

Cladding is added to a building to prevent rain from entering the building's structure, to improve sound and thermal insulation, and in many cases to improve the exterior aesthetics of a building. Aluminium cladding consists of two thin aluminium outer layers bonded to a mineral fibre core such as polyethylene or polyurethane. The issue is that not all of the polymers used in the honeycomb core are fire resistant, and indeed some of the cheaper polymers used are very flammable.

If the polyethylene core catches alight, the aluminium skin acts as a chimney to accelerate the fire up the outside of the building. The composite cladding used on the building in London was responsible for the 2014 apartment fire at Melbourne's Lacrosse building and a number of fires in Dubai. In the Melbourne fire, a cigarette left on a balcony table caused a fire to spread up the 13-storey tower in less than 15 minutes.

The prospects of Australian buildings catching fire

In the wake of the Grenfell fire, the Australian Society of Building Consultants estimated last week that there are 2700 buildings in Sydney utilising aluminium composite cladding, and 50% of the high-rise buildings built in Melbourne over the past decade also use it. The aluminium cladding commonly used in Australia and installed in Melbourne's Lacrosse building is Alucobest, which is imported from China and is cheaper than fire-resistant aluminium cladding such as Alucobond.

While not all of the aluminium cladding used in these buildings is the flammable variety, investors owning apartments with non-compliant cladding may face significant remediation costs, dramatically reducing returns. In February 2016, the Victorian Building Authority (VBA) found that 51% of the 170 high-rise residential and public buildings around the Melbourne CBD had non-compliant external aluminium cladding. Paradoxically the VBA audit concluded that this did not pose a safety risk.

We would suggest that owners of apartments constructed over the past decade investigate whether the cladding used in the construction of their asset is of the fire-resistant variety. In the case of Melbourne's Lacrosse building, owners of the apartments are still battling through the courts over who is responsible for the $15 million repair bill. Based on our crude calculations, this represents a bill of $100,000 per apartment, a significant sum for investors in an apartment building where two-bedroom apartments are being sold for between $400,000 and $500,000. Research indicates that apartments were sold off the plan for ~ $300,000 in 2010, so the remediation costs may eat up most of the capital gains.

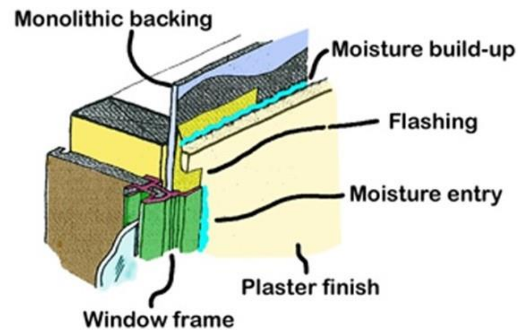
Contaminated Chinese drywall (plasterboard) no longer used

Similar to the abovementioned Chinese-made aluminium cladding was the contaminated plasterboard used in residential construction in 100,000 homes in the US between 2001 and 2009. During the home building boom in the US last decade, there was insufficient local production of plasterboard, which caused builders to source Chinese-made plasterboard that also happened to be cheaper. The high levels of pyrite in the cheaper Chinese-made plasterboard resulted in the release of sulphur gas into the home, which is bad for respiration of residents and also causes corrosion of copper pipes in the walls. The remediation costs are quite significant at around US$200,000 to remove and replace the plasterboard on a four-bedroom home.

Despite major importers of the plasterboard being companies like the giant German building materials company Knauf, affected homeowners were eventually limited to claiming only a tax deduction after replacing the plasterboard.

Who pays? Leaky homes in rainy places

In New Zealand and British Columbia, changes to the building codes in the 1990s resulted in the uptake of building materials and construction methods more suited to the sunny Mediterranean, rather than the rainy South Island of New Zealand or Vancouver where it rains on average 160 days per year. The change resulted in buildings with minimal eaves to disperse rain and wrapped in a fashionable textured cladding such as stucco or fibre cement. As water gained entry into cracks in the building structure, the timber frames began to rot and mould developed.



Despite the cause of these building calamities being changes to government construction policies, the owners of the buildings ended up bearing most of the costs of remediation. In New Zealand after many years of litigation and builders going into administration, a bailout package was put together. The costs were split with 64% covered by the property owner, 26% local council and 10% Federal Government. In Canada, the situation was even grimmer for property owners, with the best offer being an interest free loan and tax relief.

Owners are responsible

While many would assume that builders or developers would be responsible for replacing aluminium panels that are susceptible to fire, the above examples strongly suggest that owners of property with problem building materials installed are likely to bear the costs of replacement.

Hugh Dive is Founder and Chief Investment Officer, [Atlas Funds Management](). The Atlas High Income Property Fund has just been added to the ASX's mFund service.

4 key principles for measuring after-tax investing success

Raewyn Williams

For most Australian investors, tax can represent a meaningful performance drag. Large superannuation funds, facing a headline tax rate of 15%, may argue that this is only true for investors facing effective tax rates of 30%-49% (such as companies and higher net worth individuals). But our experience is that even a 15% taxpaying superannuation fund should care about the impact of tax on investment performance.

Why is after-tax measurement important?

Investing should not be dominated by tax considerations, and Australia’s tax laws, which generally prohibit strategies conducted with the dominant purpose of obtaining a tax benefit, reinforce this. US tax laws are different so investors should be careful using US research on this subject. However, the trade-off between seeking expected returns and the tax consequences of doing so should receive more attention than it does. The 2010 *Cooper Report* on the superannuation industry recognised this, and the Government responded by amending the superannuation law in 2013 to specifically compel APRA-regulated superannuation trustees to consider the tax consequences of their investment strategies.

With a few exceptions, this has not yet led to large superannuation funds integrating tax awareness into the way they invest. However, many funds are beginning this process by measuring the investment performance of

their equity managers and strategies on an after-tax, not just pre-tax, basis. After-tax performance can give answers to two important questions:

'Is my portfolio actually growing after tax?' and *'Is the tax on the extra turnover generated by my active managers, in trying to beat the market, eroding all my manager outperformance?'*

Key requirement of accurate measurement

Measuring the success of equity strategies after tax is not as simple as it sounds, but it helps to apply these four key principles:

1. Ensure the after-tax calculation methodology reflects your actual tax profile.

For a superannuation fund, this means applying a tax rate of 15%, a capital gains tax discount of 1/3 (where applicable), capital/revenue offsetting restrictions and recognising the fund's ability to claim franking credits (including a refund of excess credits) and foreign income tax offsets. Equities invested via unit trusts are unlikely to offer this because the fund pools the investments of investors with different tax profiles and usually provides standardised reporting to these investors. Discrete mandates (separately managed accounts) are therefore preferable.

2. Ensure the after-tax performances of the portfolio and the portfolio's benchmark (e.g. S&P/ASX 300) are calculated using the same methodology.

If the after-tax benchmark calculation uses a different methodology, then what looks like portfolio outperformance (or underperformance) could actually be a methodological issue. Specific questions to ask include: Are dividends treated as cash outflow or reinvested, pre- or post-tax? Is tax payable treated as a cash outflow on a monthly, quarterly, yearly or some other basis? How are off-market share buybacks (which sometimes deliver significant after-tax return benefits) treated in the after-tax performance calculation?

3. Use a 'pre-liquidation' rather than 'post-liquidation' calculation basis.

'Pre-liquidation' methods recognise only tax on income received, and gains and losses realised in the performance period, while 'post-liquidation' methods reduce performance for unrealised tax liabilities building up in the portfolio. Sometimes it is argued that large superannuation funds should use a post-liquidation methodology to align with their unit pricing (how they value the investment options that members can invest into or withdraw from). This is flawed thinking because the purpose of after-tax performance calculations is to record actual outcomes and encourage managers to be more tax efficient. While the purpose of member option pricing is to strike the price that is fairest, to both current and future assets and liabilities, and to both incoming and outgoing members. It makes sense for the performance calculation to recognise the value of a manager deferring tax compared to a manager creating a current tax liability in the same period. A pre-liquidation calculation will capture this difference.

4. Use a custom, rather than generic, after-tax benchmark.

The tax characteristics of an equity portfolio at inception can greatly influence the measured tax impacts of a manager's investment strategy. The key characteristics are the inception date, the amount of embedded capital gains and losses in the portfolio at that time and the extent to which these gains are 'long' (qualifying for the capital gains tax discount) or 'short'. A custom after-tax benchmark can mirror these characteristics, and the benchmark will also reflect continuous cash flows in the portfolio, which are outside of the manager's control. This method is the fairest for managers and provides the most precise after-tax performance calculation for investors.

Our final suggestion is to learn what to read, and what not to read, from after-tax performance reporting. For example, an active equity strategy, which has a tax impact higher than a passive benchmark, is *not* a cause for concern (in fact, this outcome is quite natural). The right question to ask is whether the excess returns more than cover the tax payable generated by the active manager.

Raewyn Williams is Managing Director of Research at [Parametric Australia](), a US-based investment advisor. This information is intended for wholesale use only. Parametric is not a licensed tax agent or advisor in Australia and this does not represent tax advice. Additional information is available at www.parametricportfolio.com.au.

5 questions that reveal good financial advice

Paul Resnik

John Wayne always portrayed a fearless lawman. As Rooster Cogburn in the 1969 film *True Grit,* Wayne was everything you'd hope a regulator would be. He'd say things like 'Young fella, if you're looking for trouble, I'll accommodate you.' Men would tremble while women would swoon. Rooster was tough, uncompromising and willing to take on the whole gang of outlaws single-handed.

Unfortunately, there is no Rooster Cogburn style regulator protecting Australian investors. There are rules - but they are weak. And there is a regulator - but it's not a 'doing things' policeman, like Rooster. ASIC does not police financial advice with gusto. Instead, it relies on advisers, or their employers, choosing to meet the standards that it sets.

In effect, investors are often largely on their own when it comes to financial advice. The good news? There are great advisers out there. But the bad news is that it can be hard to tell the good from the bad, even when you are already a client.

These five questions will reveal the good advisers. If you can answer 'yes' to all five questions, you have found an adviser with good process who acts in your interests, and one you can trust.

1. Does my adviser *really* know me and my risks?

The ASIC standard says advisers must 'know the client', but there are no rules about what that means. Advisers often only know the bare minimum in order to complete a transaction with you. That could be as little as your name and age.

Really good advisers around the world make sure they know at least three important things:

a. Your risk tolerance - How much investment risk you are psychologically comfortable with

b. Your risk capacity - How much you could afford to lose through investments without endangering your financial situation or goals, and

c. Your risk required - How much risk you need to take on to reach your goals.

There will often be mismatches in these three components of a risk profile. For example, you may not have enough money to reach your goals through conservative investments, so you have to take on higher risk to seek higher returns. That extra risk may take you outside your psychological comfort zone. The art, expertise and talent of a good financial adviser is in helping you balance these important factors of your risk profile.

2. Has my adviser helped me consider alternative strategies?

Investments should not be the only tools in an adviser's toolbox. Good financial advisers have many ways to help clients. Sometimes, the best solution is not a higher-risk investment. It might be another strategy like working longer instead of retiring, or revising your end goal to something more attainable for you.

The best choice may be to make an investment, but a good adviser will always discuss the other options with you first.

3. Does my adviser *really* know these investment products?

They will tell you that they do, but most of them don't. Advisers work from 'approved lists' of investments. Most have not evaluated those investments themselves, because that's what research people do. Most advisers only know the product is 'okay' to recommend, but they often have little clue about the investment's potential risks and rewards. Without knowing about those potential variations in asset values it is hard for you to decide if an investment is suitable for you.

4. Has my adviser explained all the risks to me *so I understand*?

If you do not understand, it has not been adequately explained to you. Explaining risk as 'standard deviations' is useless if you don't understand this type of mathematics, and most people don't. Similarly, giving you pages of numbers won't help you if you think in pictures, or vice-versa. Helping investors understand the risks in their financial plan and the investments within it is a critical step, which is often hurried or even overlooked.

5. Did my adviser get my 'informed consent'?

Before they operate on you, doctors must get your 'informed consent'. They must explain what they will do and all the potential outcomes, so you can then make an informed choice to proceed. Financial advice should be the same. The adviser should explain the risks - and why they are appropriate - in ways you understand. Then, they should have you 'sign-off' on the plan.

Some advisers do follow a process similar to this, but many others don't. Some are reputable, but others are taking shortcuts to make a quick sale.

Use these checks to avoid the worst

In the worst cases, there are outright crooks out there giving financial advice. ASIC should actively hunt out these crooks, and also address those who are short-cutting regulations to reach a quick, unsuitable sale. ASIC uses a 'standards-based' approach.

That's different to APRA, which supervises Australia's banks. APRA makes rules and actively enforces them by directly monitoring banks' behaviour. Recently, it demanded that banks hold more capital to offset their property home-loan books. To be fair to ASIC, it's got a tougher job! It regulates tens of thousands of people, while APRA only has a few dozen banks to watch over.

And we know that APRA-style regulation doesn't work in financial advice. ASIC used to set very detailed regulations to be followed, but it added extra work, slowed things down and often failed anyway. That's why regulators of advice around the world are adopting standards-based models.

But that's little comfort for you, the average investor. To be safe, you need tools like these five questions to protect your own interests. Because anything can happen when no-one is watching, and the reality of today's regulation is that there is no Rooster Cogburn watching over you.

Paul Resnik is Co-Founder and Director of Finametrica, a risk profiling system that guides 'best-fit' investment decisions.

Ambachtsheer on fostering 'long-termism'

Wilbur Li

[Editor's Note: When Cuffelinks published an article on index investing recently, globally-renowned pensions expert Keith Ambachtsheer wrote back to me, "Graham, it isn't as simple as 'active vs. passive'." He attached the May 2017 Ambachtsheer Letter (usually only available by subscription), *'Fostering Long-Termism in Investing'*, and gave permission for us to distribute it to our readers. This summary is for readers looking for a shorter version.]

"When one talks about market efficiency, it is important to distinguish between ideas whose implications are obvious and consequently travel quickly, and ideas that require reflection, judgement, and special expertise for their evaluation, and consequently travel slowly. The second kind of idea is the only meaningful basis for long-term investing." – Jack Treynor, 1976

Long-term investing

In the past, 'active management' once meant outperforming the market through active trading. John Maynard Keynes, who laid the groundwork for modern economic theory labelled it as "beauty contest investing" in 1936. That is, investors aim to buy stocks the market would deem to be the 'most beautiful' in the near future and sell those the market would deem 'ugly' – a zero sum game less costs. He noted professional money managers had seemingly little interest in 'real investing' – the long-term transformation of financial savings into wealth-producing capital. Since then, not much has changed. However, recently, a new form of active management has begun to unfold, with some institutional investors returning to a first principles investing approach. That is, a return to investing through a long-term lens, riding out the short-term volatility of markets in favour of unlocking long-term value for investors.

Rethinking active management

Peter Drucker's 1976 book on pension management, *The Unseen Revolution,* first foresaw the accumulation of retirement savings and the significant role pension funds play today. He raised three fundamental questions:

- What kind of organisations would evolve to manage retirement savings?
- In whose interest would these savings be managed?
- What will be the implications of the answers to these questions for how growing retirement savings pools are invested and managed?

The answers to these three questions have laid the framework for how pension funds are shaped today:

- Special-purpose vehicles would have to be created, capable of designing and managing transparent, sustainable pension arrangements. They should have a clear mission, good governance, and be able to access the requisite resources to achieve their mission.
- Pension organisations should be managed solely in the interests of their clients and beneficiaries.
- Retirement savings pools should be managed to achieve the dual goals of payment safety and affordability. This is best accomplished through managing separate payment-safety and payment-affordability sub-pools. The former pool matches asset maturities to payment obligations. The latter pool transforms the power of long-term return compounding into affordable pension contribution rates.

How does this relate to rethinking active management and advocating long-termism? It is the need for pension funds to generate sufficient long-term investment returns to make adequate pensions affordable. As Keynes noted, real investing is the transformation of savings into wealth producing capital, and it is the very quality of this transformation rather than the short-term beauty contest investing that should be at the front and centre of active management today. We will call this form of investing 'active ownership' investing.

Four 'active ownership' foundations

The four fundamental building blocks that underpin active ownership are not new:

- 1932: In their treatise "The Modern Corporation and Private Property", Adolf Berle and Gardiner Means examine the role and internal organization of the modern corporation. They warn that wide diffusion of corporate ownership places much power in the hands of corporate boards and managements. This raises the question of how to ensure that this power would not be misused.
- 1934: Benjamin Graham and David Dodd's *Security Analysis* is published. In their view, professional investors have an obligation to thoroughly understand a business before making any valuation judgment or buy/sell decision.
- 1970: Nobel Laureate George Akerlof's article *The Market for Lemons: Quality Uncertainty and the Market Mechanism* is published. He reminds us that much of microeconomic theory assumes that buyers know as much about what they are buying as sellers know about what they were selling. If this is not the case, buyers are at an informational disadvantage, and will pay too much for too little. Therefore, if retirement savers don't know 'beauty contest' investing is a zero-sum game less fees, they will collectively pay too much for too little. A large body of empirical evidence confirms this to be the case.
- 1976: In response to the Efficient Market Hypothesis and its implications for active management, FAJ Editor Jack Treynor publishes his classic article *Long-Term Investing*. He distinguishes between the 'fast' ideas of Keynes' beauty contest investors and the 'slow' ideas of Graham/Dodd's deep investment thinkers. He argues that these 'slow' ideas are the only legitimate basis for successful long-term investing.

Outperformance by 'active ownership' investing

- Cremers and Pareek: found that investment managers with low portfolio turnover and concentrated positions outperformed managers without these two combined characteristics by a statistically significant 2.3% p.a. over 20+ year observation periods.
- Harford, Kecskes, and Mansi: found investment managers with low portfolio turnover and concentrated positions were disproportionately invested in a subset of companies that had relatively higher-quality boards, more innovation, higher returns on capital, and higher dividend payouts. The subset of low

turnover/high concentration managers outperformed the rest of the manager universe by a statistically significant 3.5% p.a. over 20+ year observation periods.

- Khan, Serafeim, and Yoon: found that portfolios made up of companies with high sustainability scores outperformed portfolios of companies with low sustainability scores weighted by SASB materiality by average annual return gaps ranging from 3.1% p.a. to 8.9% p.a. over 20+ year observation periods, depending on the degree of portfolio concentration.

These findings highlight that portfolios which embody 'active ownership' characteristics indeed produce exceptional investment results over a long time horizon.

Shift towards active ownership

Given the allures of short-term beauty contest investing, how can we accelerate the shift towards a longer-term, pragmatic and sustainable approach to investing? We can address this through both a macro and micro lens:

1) Macro:

    a) Accelerate systems-level work towards building a global financial system that is stable, credible, and transparent.

    b) Integrate 'active ownership' investing into governance and investment education and accreditation programs.

    c) Initiate 'active ownership' investment messaging to the media, and to key governmental, regulatory, and business agencies.

    d) Expand workplace pension plan coverage with effective pension delivery organizations with fiduciary mandates.

    e) Repurpose stock exchanges to promote and facilitate long-term investing.

    f) Transform the voluntary disclosure protocols developed by IIRC, SASB, A4S, and TCFD into a coherent set of mandatory principles-based reporting requirements for the corporate and investment sectors.

2) Micro:

    a) Continue to develop the ideas and protocols first proposed by Graham and Dodd in 1934. Promising exchanges are underway in both the academic and professional communities on defining and measuring such concepts as corporate sustainability, organizational effectiveness, 'value for money' measurement and benchmarking, and incentive compensation.

    b) Actually implement these ideas in 'active ownership' institutional investment programs rather than just talk about them.

It is one thing to talk and another to execute. Are you ready to become an 'active ownership' investor?

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The full May 2017 Ambachtsheer Letter is attached here.

Red wine and our green reputation in China

David McDonald

The Chinese economy is transitioning from a dependence on investment spending and infrastructure projects towards consumption and services. This provides many new opportunities for Australia in areas such as food, wine, education and tourism. These 'newer' exports are likely to continue to grow strongly and take over some of our recent reliance on commodity exports.

The Chinese Government has expressed concern about the nation's high dependence on capital investment. They appear reluctant to continue to use fiscal spending on infrastructure projects to keep economic growth ticking over. At the same time, the growing wealth of many Chinese is leading to an increased focus on consumption. Consumption as a percentage of GDP in China is much lower than in most developed economies like Australia. The emerging middle class want to spend their wealth on areas such as tourism, clean foods and overseas education for their children.

Don't underestimate Chinese domestic wealth

According to the latest Credit Suisse Global Wealth Report, China now has 5% of the world's millionaires. More importantly, China accounts for 33% of those the Report defines as 'mid-range wealth' (between US$10,000 and US$100,000), double the proportion in 2000. By way of contrast, India – often touted as the next growth story – only has 3% of the global 'middle class', and that number has not changed much in the last decade.

Australia has benefited greatly from the growth in the Chinese economy over the past 20 years by supplying the growing demand for commodities such as iron ore and coal. We now have an opportunity to take advantage of the next stage of growth by supplying the middle and upper income earners in China with food, wine, health related-products, education for their children and a destination for their holidays.

In tourism, Chinese visitors to Australia have overtaken New Zealand as our most numerous short-term visitors. Sydney airport now has six Chinese airlines providing regular scheduled flights between Australia and China. Some of these Chinese airlines are also offering Australians very competitive deals on flights to Europe. According to ABS data, visitors to Australia (from all countries) delivered almost $45 billion to the economy in 2015-16. This compares to around $48 billion in iron ore exports and $35 billion in coal in the same year. Exports of beef have overtaken aluminium and copper in value.

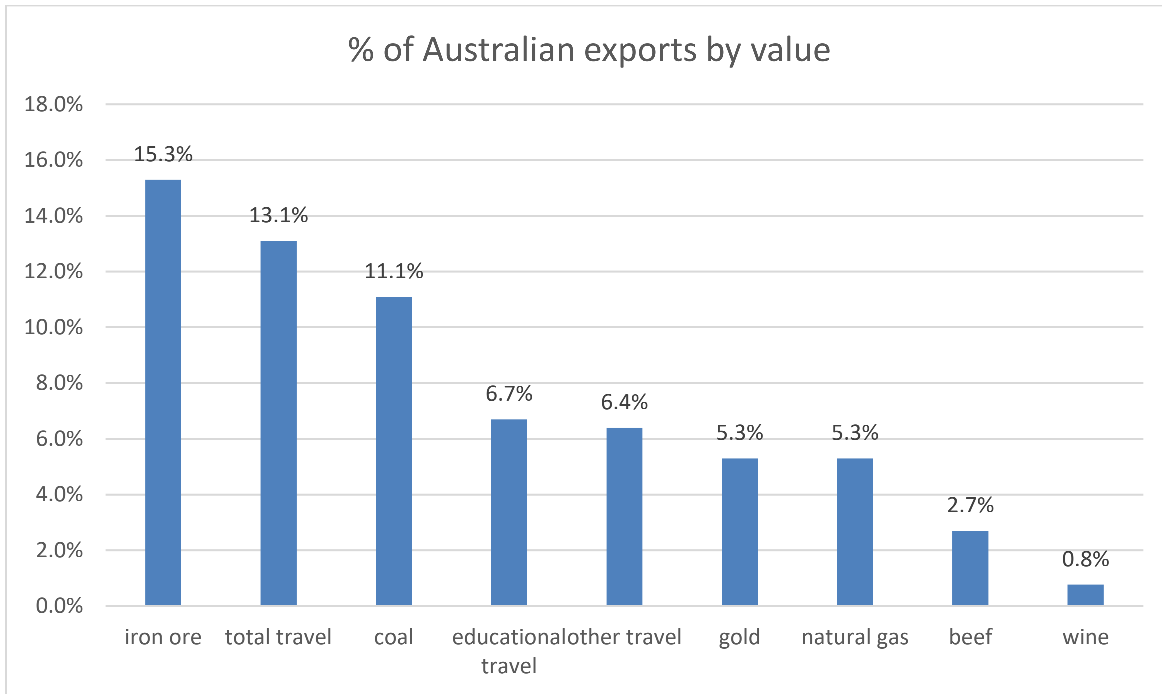
Wine is the big mover

The growing Chinese demand for our food, wine and related products has been most evident recently in the Australian wine industry. Total Australian wine sales to China in 2016 jumped 40% to $520 million. To put this in context, however, total wine exports are currently only 5% of the value of iron ore exports and less than 1% of our total exports. Nonetheless, the Australian Bureau of Agricultural & Resource Economics (ABARE) estimates that total agricultural exports will reach $48 billion in 2017-18, the same value as iron ore exports in 2015-16. The growth story is also backed up by ABARE estimates of a 5% growth in wine exports in 2017-18 (together with a 14% growth rate for cheese – perhaps a related commodity!).

For example, Australian Vintage, which sells wine brands including McGuigan and Tempus Two, has joined forces with COFCO, China's largest online wine retailer, receiving an equity injection as part of the deal. Swan Wine Group last year exported a reported 250,000 bottles of Australian wine to China. It's latest rather unique marketing move was to market an 'Ambassador' label wine, complete with a sketch on the label of former Australian Ambassador to China, Geoff Raby. The visit of President Xi Jin Ping to Tasmania helped to showcase that state's 'clean, green' food products to the Chinese market.

The other sector with potential is professional and financial services. The Australia-China free trade agreement offers some longer-term hope for growth here. Professional service firms such as lawyers, accountants and engineers are developing a significant market in China for their expertise. Australian knowledge in areas such as investment management, banking and insurance all offer potential.

Demand for iron ore, coal and other commodities will always be a staple of Australia's exports, although the value will vary as commodity prices fluctuate. However, the growth export sectors of the next 5–10 years will be food, wine, health products and tourism.



Source: ABS, ABARE. Data for FY2015-16

David McDonald is an experienced investment professional who has spent several decades in the Australian wealth management industry. He was previously Chief Investment Strategist in Australia for Credit Suisse Private Banking.

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