Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

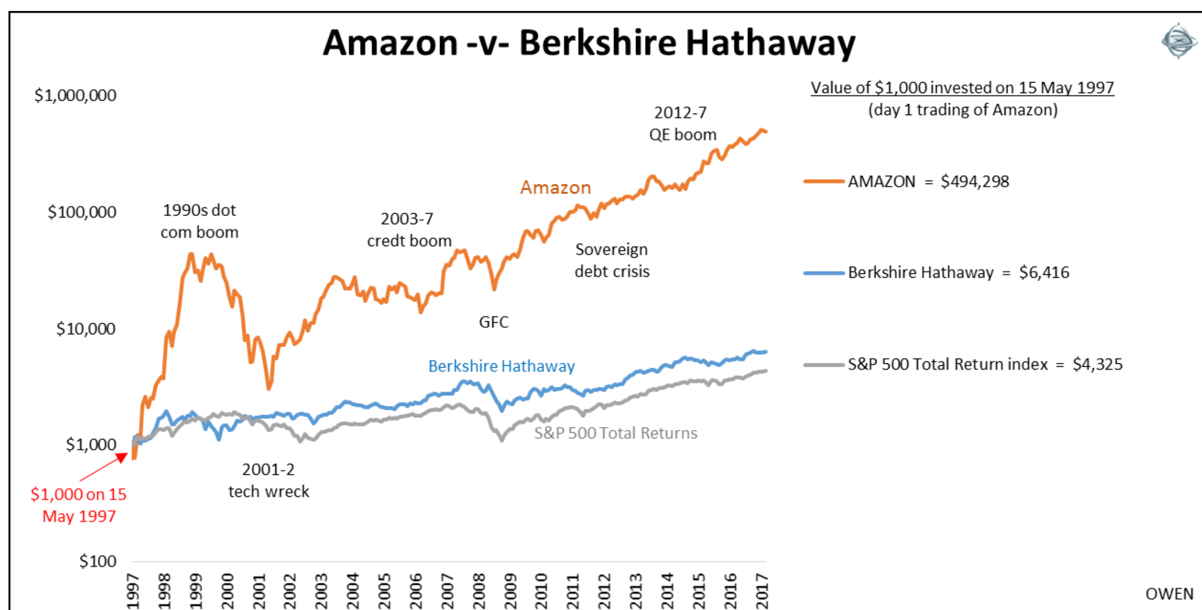
- **It's good Amazon and Buffett pay no dividends** *Ashley Owen*
- **4 rules Amazon uses to avoid excruciating decline** *Graham Hand*
- **Asset class returns by financial year, but what's next? Take our survey**
- **Unconstrained growth found in fresh places** *Julian Beaumont*
- **Let's focus on modern slavery in Australia** *Edwina Matthew*
- **Listed property headlines disguise full story** *Adrian Harrington*
- **Cybercrime response may slow the internet** *Michael Collins*
- **Third Link Growth Fund announces soft close**

It's good Amazon and Buffett pay no dividends

Ashley Owen

Local retailers have seen their shares sold off recently in a gathering fear that when Amazon comes to town it will destroy their markets and profit margins. In June, Amazon expanded into the grocery business and its shares hit $1,000 for the first time. It listed in 1997 at $23.50.

Amazon has been a fascinating company to watch but I have never bought shares in it directly. Amazon created a new global market 20 years ago - online retailing - and it has dominated the market ever since, but it has never been able to figure out how to make a profit from it. It has never paid a dividend and never plans to in the future. At first glance it sounds like a crazy business plan and a lousy investment. Surely a company that never intends to pay a dividend is a crazy gamble that can only pay off if you can find a 'bigger fool' to sell it to for a higher price in future.



Meanwhile Amazon shares have rocketed upward. If you invested $1,000 in Amazon shares at $23.50 on the first day of trading on 15 May 1997, your initial $1,000 would be worth $494,000 today. That's a return of 36% per year over 20 years (Amazon shares have split 12:1 over the period). But still no dividends!

Our obsession with dividends is misplaced

Australians have always been obsessed with dividends but I would much rather invest in a company that retains its capital instead of paying it out in dividends - ***if*** it can earn a higher rate of return on its capital than I can earn if it gave the money back to me. Over the years, my best returns from shares have been in companies that never pay dividends.

For example, I have been a shareholder in Berkshire Hathaway for many years, a company controlled by the world's greatest living investor since 1964. Under Warren Buffett the company has never paid a dividend and never plans to. Buffett and his offsider Charlie Munger can earn a higher return on the capital than I can, so they keep the capital in the company and re-invest it to grow faster than I can grow it. Returns on Berkshire Hathaway shares have beaten the broad US stock market by more than 2% per year since Amazon was listed. That's a great result, but well behind Amazon (Berkshire shares hit $1,000 per share back in 1983 and are now $254,000 per share, and that's US dollars!).

Amazon shareholders let its founder Jeff Bezos keep the money in Amazon and re-invest it to expand the business, just as Berkshire shareholders let Buffett and Munger keep the money to re-invest it and expand. Rather than declare profits and pay tax, Amazon chooses to spend the surplus cash to expand. That's how it grew to be the largest retailer on the planet. It has never had to raise equity since the initial $300 million raised in the 1997 float. Likewise, the vast bulk of Berkshire's 'profits' are unrealised gains on their investments. They rarely sell anything and they have financed it all internally by not paying dividends.

Amazon and Berkshire are very similar. Both have grown to be in the top 10 most valuable companies in the world by reinvesting their cash flows. Both are impossible to value as they have no real earnings and no dividends. But Amazon is running out of space. It can't keep growing forever at the same rate (unless it invades and populates another planet or two) and Berkshire is running out of time. Buffett and Munger are 86 and 93 years old respectively.

Many investors hold both Amazon and Berkshire Hathaway indirectly in diversified portfolios because they are both in the largest dozen listed companies in the world (each are about 1% of the global stock market value) and therefore feature in global share index funds.

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4 rules Amazon uses to avoid excruciating decline

Graham Hand

Any company whose brand becomes a common noun (without the capital letter, called an eponym) must have made a big impact. Generations have cleaned the house with a hoover, blown their noses with a kleenex, stored hot drinks in a thermos and xeroxed a document. Most of us google rather than search.

Although not exactly the same thing, the goal of many new companies is to become 'the Amazon of' something. In wealth management, many new roboadvisers describe their strategy as aiming to become 'the Amazon of financial services'.

Well, good luck with that, because not only is Amazon a unique company, it may well want to become the Amazon of financial services itself. FinancialAdvisorIQ (part of the Financial Times group) recently published an article titled 'Betterment Yearns to be Amazon of FAs. Does Amazon?', including:

"Amazon entering wealth management would cause a major disruption to the advice industry, pushing down prices and driving up demand for far faster delivery of financial services."

Jeff Bezos annual letter to shareholders

Amazon has disrupted many industries, and destroyed companies like Borders, but in its 20 years, it has had negligible impact on financial services.

We all know that Warren Buffett produces his famous annual shareholder letter which is widely quoted, but it's less well-known that Amazon's CEO Jeff Bezos does the same. It's a completely different style. Buffett focuses on his returns and investments, and it's clear that making money is the main game. In his 2016 letter published a few months ago, Bezos does not mention 'profit' once, while 'customer' receives 19 hits.

The full text of Bezos's latest letter is linked here, and it's much shorter than Buffett's.

There are a few highlights that every company can learn from, although the vast majority of large companies do not have the internal structures and processes to make them work. Bezos wants his company to always operate as if it's Day 1, as Day 2 is a step to an excruciating, painful decline followed by death. For him, Day 1 vitality requires obsessive customer focus.

He identifies four rules for making high quality decisions:

1. High velocity

Large organisation struggle to decide quickly because they fear failure. Speed matters, and where a decision is reversible, it should use a lightweight process. Most companies overestimate the cost of being wrong, whereas being slow will be expensive.

2. Don't wait for certainty

There is usually uncertainty around a decision, yet most companies want to check off on everything.

"Most decisions should probably be made with somewhere around 70% of the information you wish you had. If you wait for 90%, in most cases, you're probably being slow. Plus, either way, you need to be good at quickly recognizing and correcting bad decisions."

3. Disagree and commit

It's often difficult to achieve consensus, as nobody can know with certainty the outcome of a new initiative. He says 'disagree and commit' saves a lot of time:

"If you're the boss, you should do this too. I disagree and commit all the time … They had a completely different opinion and wanted to go ahead. I wrote back right away with "I disagree and commit and hope it becomes the most watched thing we've ever made." Consider how much slower this decision cycle would have been if the team had actually had to convince me rather than simply get my commitment."

4. Recognise misalignment

Misalignment between teams and objectives must be identified early and addressed, or the problem will lead to exhaustion.

"Whoever has more stamina carries the decision. I've seen many examples of sincere misalignment at Amazon over the years. When we decided to invite third party sellers to compete directly against us on our own product detail pages – that was a big one. Many smart, well-intentioned Amazonians were simply not at all aligned with the direction. The big decision set up hundreds of smaller decisions, many of which needed to be escalated to the senior team. "You've worn me down" is an awful decision-making process. It's slow and de-energizing. Go for quick escalation instead – it's better."

Does it work?

Many analysts have criticised Bezos over the years for reinvesting in the business rather than generating profits and paying dividends. When $10 invested in 1997 now has a value of about five million dollars, in a company with a market cap of nearly US$500 billion, it's hard to criticise success and the way Amazon is challenging other businesses the world over.

Graham Hand is Managing Editor of Cuffelinks.

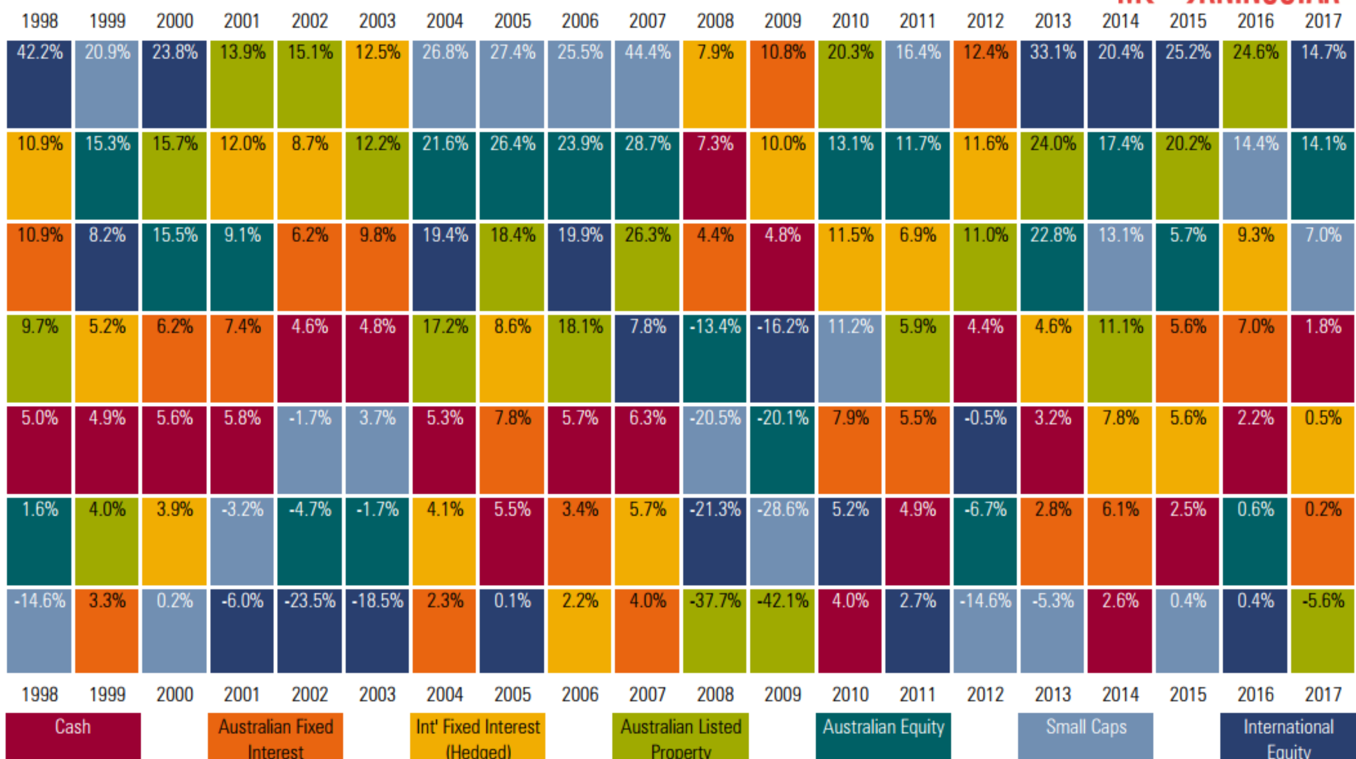
Asset class returns by financial year, but what's next? Take our survey

It's always fascinating to look back on a financial year and see the winners and losers, and confirm how tough it is to pick the best asset class in advance. The Morningstar Asset Class Gameboard for 2016/2017 shows the order from best to worst was:

1. International Equity (unhedged): 14.7%
2. Australian Equity (ASX/S&P200 Total Return): 14.1%
3. Australian Small Caps: 7.0%
4. Cash: 1.8%
5. International Fixed Interest (hedged): 0.5%
6. Australian Fixed Interest: 0.2%
7. Australian Listed Property: -5.6%.

Asset allocation is more important for long-term returns than stock selection, although within each asset class, there are significant successes and failures. For example, last year there was a dramatic difference in performance among Australian A-REITs and it was the big stocks than pushed the overall index down.

These equity returns are far higher than most analysts expected a year ago, and the 'lower for longer' has yet to play out. International Equities has hit the jackpot in four of the last five years. Will it do it again?



Annual Asset Class Returns - Financial Year

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
42.2%	20.9%	23.8%	13.9%	15.1%	12.5%	26.8%	27.4%	25.5%	44.4%	7.9%	10.8%	20.3%	16.4%	12.4%	33.1%	20.4%	25.2%	24.6%	14.7%
10.9%	15.3%	15.7%	12.0%	8.7%	12.2%	21.6%	26.4%	23.9%	28.7%	7.3%	10.0%	13.1%	11.7%	11.6%	24.0%	17.4%	20.2%	14.4%	14.1%
10.9%	8.2%	15.5%	9.1%	6.2%	9.8%	19.4%	18.4%	19.9%	26.3%	4.4%	4.8%	11.5%	6.9%	11.0%	22.8%	13.1%	5.7%	9.3%	7.0%
9.7%	5.2%	6.2%	7.4%	4.6%	4.8%	17.2%	8.6%	18.1%	7.8%	-13.4%	-16.2%	11.2%	5.9%	4.4%	4.6%	11.1%	5.6%	7.0%	1.8%
5.0%	4.9%	5.6%	5.8%	-1.7%	3.7%	5.3%	7.8%	5.7%	6.3%	-20.5%	-20.1%	7.9%	5.5%	-0.5%	3.2%	7.8%	5.6%	2.2%	0.5%
1.6%	4.0%	3.9%	-3.2%	-4.7%	-1.7%	4.1%	5.5%	3.4%	5.7%	-21.3%	-28.6%	5.2%	4.9%	-6.7%	2.8%	6.1%	2.5%	0.6%	0.2%
-14.6%	3.3%	0.2%	-6.0%	-23.5%	-18.5%	2.3%	0.1%	2.2%	4.0%	-37.7%	-42.1%	4.0%	2.7%	-14.6%	-5.3%	2.6%	0.4%	0.4%	-5.6%
1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017

Cash | Australian Fixed Interest | Int' Fixed Interest (Hedged) | Australian Listed Property | Australian Equity | Small Caps | International Equity

Cash - RBA Bank accepted Bills 90 Days; Aust. Fixed Interest - Bloomberg AusBond Composite 0+ Yr TR AUD; Intl. Fixed Interest (H) - BarCap Global Aggregate TR Hdg AUD; A-REITs - S&P/ASX 300 A-REIT TR; Global REITs (H) - FTSE EPRA/NAREIT Dv REITS TR Hdg AUD; Aust. Equity - S&P/ASX 200 TR; Small Caps - S&P/ASX Small Ordinaries TR; Intl. Equity - MSCI World Ex Australia NR AUD © 2017 Morningstar, Inc. All rights reserved. Neither Morningstar, its affiliates, nor the content providers guarantee the data or content contained herein to be accurate, complete or timely nor will they have any liability for its use or distribution. Any general advice or 'class service' have been prepared by Morningstar Australasia Pty Ltd (ABN: 95 090 665 544, AFSL: 240892) and/or Morningstar Research Ltd, subsidiaries of Morningstar, Inc, without reference to your objectives, financial situation or needs. Refer to our Financial Services Guide (FSG) for more information at www.morningstar.com.au/s/fsg.pdf. You should consider the advice in light of these matters and if applicable, the relevant Product Disclosure Statement (Australian products) or Investment Statement (New Zealand products) before making any decision to invest. Our publications, ratings and products should be viewed as an additional investment resource, not as your sole source of information. Past performance does not necessarily indicate a financial product's future performance. To obtain

What do you expect for 2017/2018?

More important than looking back is what the future brings. We attach three quick questions on which asset class you expect to come first and last in this new year, and how you expect the S&P/ASX200 Total Return Index (including dividends) to perform. The survey is linked here and will take less than a minute to complete.

Unconstrained growth found in fresh places

Julian Beaumont

Many investors appreciate the extreme concentration in the Australian stock market. Only 20 stocks account for about 60% of the total value of the market, and within those largest 20 stocks, there is a heavy weight to just a few sectors, especially banks and resources.

More subtly, there is also a heavy weighting in a relatively homogenous group of stocks with similar investment attributes.

Big caps dominate

Consider the following 12 stocks in the ASX 20 Index:

- The four big banks (CBA, Westpac, NAB and ANZ)
- Wesfarmers
- Transurban
- Suncorp
- AMP
- Telstra
- Woolworths
- Scentre
- IAG

All are commonly considered 'blue chips' and are well owned by Australian super funds and other investors. They account for approximately 27% of the total value of the All Ordinaries Index.

They all have solid core businesses with large market shares in relatively consolidated, mature and domestically-constrained industries. They generate strong and consistent cash flows but have limited opportunities to reinvest those cash flows back and so are left simply to distribute them to shareholders.

Strong dividend yields but little else

Reflecting as much, their investment proposition is generally dependable and attractive dividend yields but little earnings growth.

Despite this, these stocks should not be dismissed. At the right price, their typically fully franked yields are appealing. And, at times, they can offer some interesting growth prospects. For example, the big four banks should grow to the extent that the credit cycle allows. Alas, that is currently very little. Indeed, almost all of them rely on economic or industry conditions for their growth and struggle to achieve any if conditions are not supportive.

But it is not just economic conditions that can constrain earnings growth for these blue chips. Many are also facing a rise in competition. For example, the banks' more profitable niches are facing competition from financial technology, or 'fintech'; Telstra faces new entrants and new telecommunications networks (TPG Telecom in mobile and NBN resellers in broadband); and Scentre faces online competition pulling retail spend from its shopping centres.

There is perhaps some circularity. When the pie is not growing, growth can only come from taking it from a competitor. Taking market share entails competitive attack and response, most commonly through lower prices that reduce revenues or margins, both of which act to reduce the industry's profit pool.

For example, last decade the supermarket industry enjoyed benign competition, dominated by Woolworths, and this supported decent earnings growth. Since then, competition has intensified, with a rejuvenated Coles and the expansion of Aldi and Costco. All players have come to 'invest' in lower prices and a better service offering, and their investment has pressured the top and bottom-line growth for the industry. With lower barriers to entry, and the possibility of new entrants such as Amazon, the constraint on growth arising from the competition is unlikely to abate.

Diversification has become one investment type

The upshot is that some investors who thought they were diversifying by buying a selection of blue chips have actually concentrated their portfolios into a particular investment style, one characterised as low-growth yield plays.

For genuine diversification, investors should look to companies offering the opposite, such as:

- offshore markets in which to expand
- fragmented industry structures
- differentiated customer offerings enabling market share gains
- structurally growing markets and
- opportunities to reinvest cash flows back into the business for growth.

We typically look for companies with 'exportable competitive advantages', being those with innovation, brands or products that travel well offshore.

Examples include:

Innovation

- Proving that big isn't always boring the high-growth CSL is a blue chip that is actually the sixth largest stock on the ASX. The company is a low-cost manufacturer of plasma-derived medicines, for which global patient demand is in strong growth. CSL is investing over US$600 million annually in R&D to develop new and improved biomedicines, which allows it to gain a revenue advantage over competitors in respect of each litre of plasma collected. The company continues to leverage this competitive advantage to profitably take market share and expand internationally, including most recently into the large Chinese market.
- Aristocrat, best known as a slot manufacturer, is spending over $250 million annually on the design and development of new and improved games. Successes like 'Lightening Link' allow the company to take market share in the 90 countries it sells into, with the most important being the large US market. The company also leverages its gaming innovation into its nascent online 'social' casino-style games business, for which it now has over 1.4 million daily users around the world and counting.

Brands

- BWX owns the Sukin brand, an Australian brand of natural skincare creams that has essentially found its own spot in the 'masstige' market. BWX has a strong presence in Australia, but more importantly for its long-term growth prospects, the company is expanding into various offshore markets. It is exporting Sukin products into the UK, where it has just recently started selling through Boots, the UK's largest pharmacy chain, as well as into Canada, China and elsewhere.
- Treasury Wine Estates owns luxury and 'masstige' wine labels such as Penfolds and Wynns that are increasingly in demand in offshore markets, including most importantly in the high growth and highly profitable Chinese market.

Products

- Reliance Worldwide manufactures plumbing products, including the innovative Sharkbite branded push-to-connect plumbing fittings. These fittings are growing in popularity among plumbers worldwide, allowing Reliance to steadily take market share, most importantly in its largest market the US, and to enter and expand into other international markets, with the most promising being in Europe.
- ARB is a manufacturer of four-wheel drive accessories such as bull bars and canopies. It has a strong brand; it tailors its products to specific vehicle makes and develops innovative new products that it exports to 100 countries worldwide. The exporting of these products enable ARB to steadily grow its businesses in offshore markets.

Julian Beaumont is investment director at BAEP, a boutique partner with Bennelong Funds Management.

Let's focus on modern slavery in Australia

Edwina Matthew

Corporate supply chains are bigger and more complex than ever. Wesfarmers recently reported it has relationships with over 15,000 suppliers in more than 20 countries. Consumer pressure for eco-friendly goods and services supports the argument that sustainable supply chains can be profitable supply chains.

Incorporating environmental, social and governance (ESG) factors into the company's sourcing and purchasing practices is now being viewed as good business practice. If a supply chain activity results in the violation of an environmental, labour or human rights standard or regulation, there can be material negative financial and reputational outcomes. For example, the Economist Intelligence Unit 2015 global survey of 853 senior corporate executives found 62% of respondents think that:

"Avoiding repeats of the Rana Plaza factory disaster in Bangladesh is primarily the responsibility of multi-nationals that purchase products from these factories not the Bangladesh Government."

It can be difficult to identify human rights risks given the complex nature of supply chains across many companies. However, changes in regulatory disclosure requirements are prompting asset managers to revisit human rights issues, including what is termed 'modern slavery'. It is tempting to believe that modern slavery only exists abroad, but it is closer to home than many realise.

Modern slavery's shape and form

Modern slavery affects the lives of millions globally. It encompasses all forms of human trafficking, forced labour, debt bondage, forced marriage and child labour which stem from cultural attitudes or human tragedies such as conflict, poverty or natural disasters. A global slavery survey by Walk Free Foundation estimates that 46 million people have been subjected to modern slavery between 2011 and 2016. Modern slavery is estimated to prevail across 167 of the most populous countries, the majority within our Asia Pacific region.

Slavery exists in Australia

Unfortunately, cases of modern slavery have been identified on our soil as well as through indirect forms, where Australian companies with offshore operations or sub-contracting arrangements have been linked to cases of modern slavery. The Walk Free Foundation survey suggests an estimated 4,300 victims of modern slavery exist in Australia. Individual cases have been cited with exploitation of workers - often migrants - being employed 'off the books' in labour-intensive work.

Modern slavery tends to be concentrated in food and agriculture production, textiles, retail and technology industries. These industries often feature the use of complex and constantly evolving global supply chains, making it difficult to monitor and manage, even for the companies involved. However, companies can ill afford to be complacent.

Historically, the absence of company data and regulation has meant it was difficult to assess the risk of exposure to modern slavery in corporate operations and across supply chains. However, a series of multi-stakeholder initiatives, legislation and engagement activity globally, including Australia, are changing the investment landscape.

Government actions

Legislation to address the issue of human rights violations and poor labour practices now exists in Canada, the US, the UK, France, The Netherlands and Switzerland. The UK is the most recent market to pass legislation through its *UK Modern Slavery Act (2015)*. Enactment of the legislation has not only made a significant impact in promoting compliance but has put transparency on corporate agendas. Public entities in the UK are now required to report on measures taken to address modern slavery in their business and supply chain. Australian companies which operate in the UK such as BHP Billiton, Lend Lease, Qantas and Wesfarmers already report on their anti-slavery efforts under this regime, so a degree of harmonisation with Australian initiatives already exists.

Globally, some of the largest retailers and manufacturers are auditing their lengthy supply chains in response to growing scrutiny. For example, Woolworths, Wesfarmers and other retail operators in Australia established the Retail and Supplier Roundtable Sustainability Council to take action against abuses in their supply chains. Early evidence suggests the legislation on human rights and due diligence in the UK and US is working to improve the

quality of disclosure practices. This in turn helps investors make better informed investment decisions and also supports stakeholder engagement with companies.

Developing a local regime that is effective

Many in the local investment community were encouraged by the announcement earlier this year by the Australian Government that it had commissioned a Senate Inquiry into the establishment of our own Modern Slavery Act. To date, over 180 submissions have been made to the inquiry, including from large Australian companies such as Wesfarmers, Woodside Energy, Rio Tinto, Woolworths, Qantas, Fortescue Metals Group and BHP Billiton.

As an investment manager, we believe failure to consider ESG factors in a company's operations or supply chain can present potential financial impacts through reputation damage, litigation and operational risks which may ultimately harm a company's social license to operate. Of course, the cost to society and the economy more broadly can also be significant and severe.

Growing power of the social conscience

Consumer preferences for eco-friendly goods and services mean the link between a company's sustainability performance and consumer loyalty is growing. Studies like the Nielsen Global Survey on Corporate Sustainability (2015) which covered 30,000 consumers across 60 countries found that 73% of millennials are willing to pay more for sustainable brands, compared with 50% in 2014.

Slavery is often a hidden risk in a company's operations and supply chain. This is not only a human rights issue, it is also a financial issue with potential material implications for investment portfolios. Violate human rights regulation and a company pays twice: the fine for the breach and the damage to your brand with a related drop in sales and possible funding.

Encouragingly, stakeholders (customers, shareholders and government bodies) are now actively engaging with businesses to take action to address their exposures. Companies that establish a whistle-blower policy, consolidate supplier arrangements and build loyalty through greater transparency will be recognised as industry leaders.

Meaningful disclosure of supply chain management when integrated with traditional financial drivers can contribute to a company's competitive advantage and strengthen its long-term financial stability. The business case is strong for integrating social issues such as modern slavery into the investment decision process. Investor and consumer voices are louder and ignorance is no longer an option.

Edwina Matthew is Head of Responsible Investments at BT Investment Management.

Listed property headlines disguise the full story

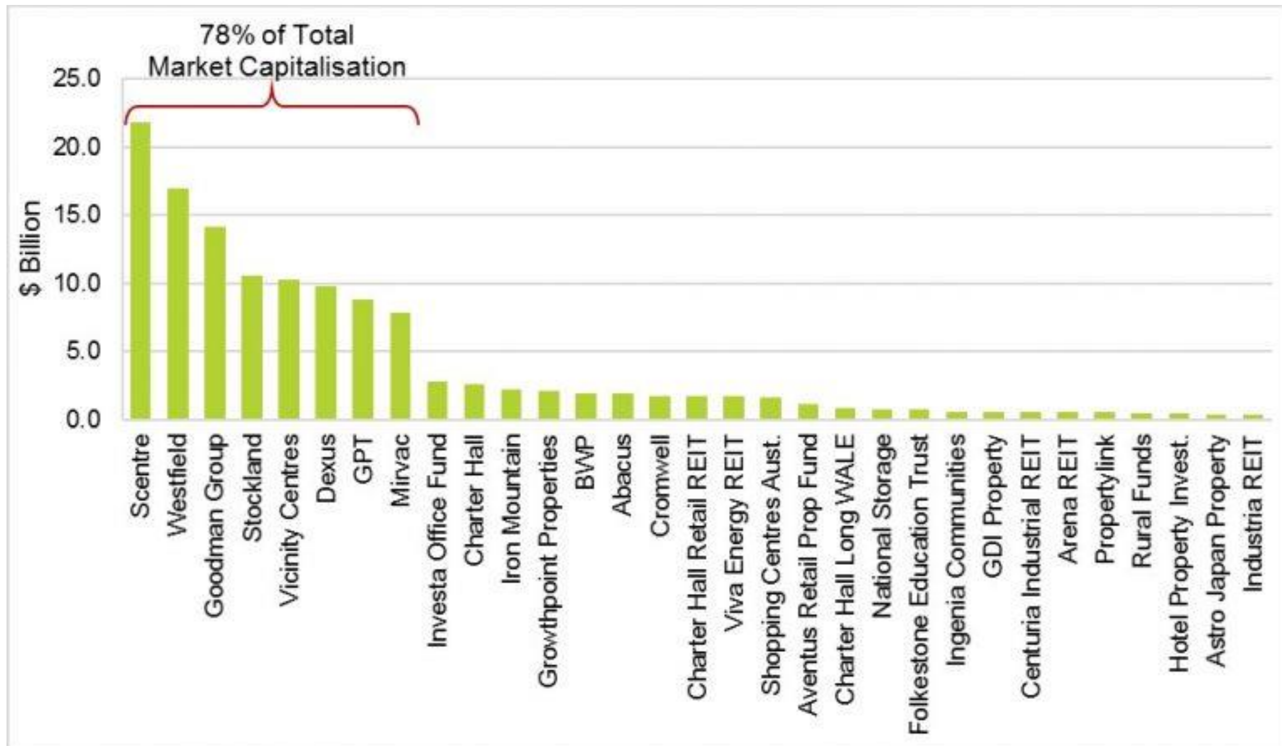
Adrian Harrington

A cursory look at the headline performance of the Australian listed property trusts, or as they are now more commonly known, Australian real estate investment trusts (A-REITs), would suggest all is not well. The S&P/ASX300 A-REIT Index posted a total return of -5.6% in the year to 30 June 2017, underperforming the equities market, which returned 13.8%. The underlying direct property market returned circa 12%.

The headline index performance is deceiving and the composition of the S&P/ASX300 A-REIT Index is fundamentally flawed. Like most indices, it is weighted by the market capitalisation of each security. The larger A-REIT securities such as Scentre (ASX:SCG), Westfield (ASX:WFD) and Stockland (ASX:SGP) have a higher weighting in the Index. It says nothing about the merit of a particular security.

Investors are continually reminded not to put all their eggs in one basket and avoid taking concentration risk. We are told to diversify, diversify, and diversify. Yet the A-REIT Index fails that test. The top eight A-REITs comprise a staggering 78% of the Index by market capitalization, as shown in the figure below. The performance of these A-REITs has a massive influence on the Index and the sector.

S&P/ASX 300 A-REIT Index Market Capitalisation – June 2017

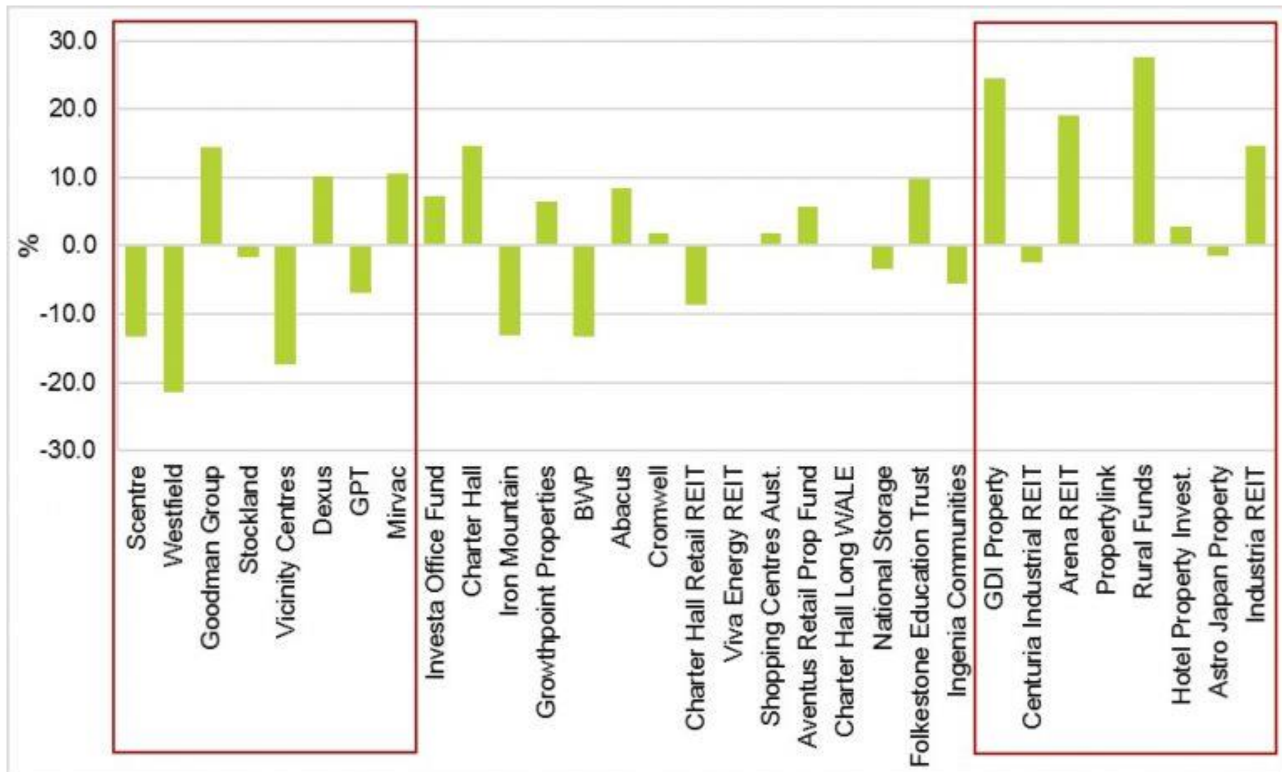


Source: IRESS

Impact of the largest companies

The median performance of the top eight A-REITs by market capitalisation was -3%. The big guns, apart from Goodman Group (14.3%), were hit particularly hard – Westfield (-21.5%), SCentre (-13.4%) and Vicinity (-17.3%) as can be seen in the figure below.

A-REITs Performance – 12 Months to 30 June 2017



Source: IRESS

The sell-off in the larger cap stocks was driven mainly by two factors.

Firstly, concerns about the retail sector saw Westfield, Scentre and Vicinty sold-off (like several of the listed retailers) despite all three owning some of the best retail assets in the country.

Secondly, in recent years the A-REIT sector has attracted significant inflows from institutional and global capital chasing its attractive yield. However, as bond yields started rising (the 10-year bond yield rose from 2% to 2.6% during FY17) the sector's 'bond-like' defensive characteristics become less attractive to some investors. The larger, more liquid A-REITs, in particular, came under pressure. Some institutional and global investors started to rotate out of A-REITs into other cyclical sectors of the equities market or redeployed their capital into offshore markets.

At the other end of the scale, the median performance of the smallest eight A-REITs in the Index was a positive 9.9% for the year to 30 June 2017. Of these, Rural Funds Group, GDI Property and Arena REIT were the standouts, delivering stellar returns to investors.

Index does not cover the whole market

Another flaw in the Index is that it only captures 31 listed A-REITs. There are another 15 that are considered too small to be included, typically with a market capitalisation below $350 million. For institutional investors, these A-REITs are not big enough to invest in. Many outside the Index are well managed, have excellent real estate portfolios and performed well in the past year, including Centuria Metropolitan Office REIT (25.5% return) and Australian Unity Office Fund (11.4% return).

Finally, the Index is flawed given its sector composition does not reflect the broader real estate market. Retail A-REITs comprise 45% of the Index, well ahead of diversified A-REITs at 27%, office and industrial A-REITs both at 12%, and specialised A-REITs is a minnow comprising just 4% of the Index. Office, retail and industrial are far more dominant sectors across the real estate landscape.

If we drill down to the underlying asset level and include the retail centres owned by the major diversified AREITs – GPT, Stockland, Mirvac – the exposure to retail is more than 50% of the total assets owned by the sector. Given the structural and cyclical issues currently facing retail, that is a massive bet on the retail sector for anyone invested in the Index.

The arrival of international retailers in recent years including Zara, H&M and Uniqlo has reshaped retail. At the same time, local retailers such as Dick Smith, Payless Shoes and Rhodes & Beckett have disappeared. Retail sales numbers reveal anaemic spending, and the growth of online retail spending continues to gain momentum, even before the Amazon juggernaut hits our shores. It is not surprising that the past year median performance of the retail A-REITs was down 9.5%.

As the past year has shown, the overall performance of the A-REIT Index masks a wide variation in performance across individual A-REIT securities. FY18 is unlikely to be any different given the way the Index is constructed and the likely on-going short-term volatility in A-REIT pricing. Investors who are prepared to avoid using a passive market cap index fund can go hunting for individual A-REIT securities based on merit and attractive pricing. Otherwise, investing with an A-REIT securities fund manager that utilises a high conviction, benchmark (index) unaware investment process, will be well placed to deliver returns well above the headline A-REIT Index in the year ahead.

Adrian Harrington is Head of Funds Management at Folkestone (ASX:FLK).

Cybercrime response may slow the internet

Michael Collins

In mid-April, the 'Shadow Hackers' online group made public some malicious software that had been stolen from the US government's National Security Agency. A month later, 'ransomware' dubbed WannaCry that incorporated the bugs pilfered from US intelligence penetrated perhaps 300,000 computers running outdated Microsoft software in an estimated 150 countries.

While that might well be the most chilling cyberattack ever, it's perhaps not the most significant cyberattack because hackers have tried to influence elections, most notably the US election last year. While it will never be established how much the hacked emails from Hillary Clinton's campaign helped Donald Trump, it's apparent that cybercrime is all too common. It is already a US$1 trillion-industry worldwide, according to some estimates.

Nothing is safe on the internet

Whatever the true figure, identification theft, fraudulent online transfers, payment-card frauds, network assaults, denial-of-service attacks by malicious networks of computers (botnets), ransomware, cyberbullying, trolling and online child pornography are too common. They show that nothing is safe on the internet – apart from criminals, it seems.

If people, businesses, governments and other bodies including hospitals can't trust the internet to protect data, share files, host websites, seamlessly send and receive messages and make payments, an internet slowed by protections and precautions could assume a lower profile in everyday life – or fall well short of its potential anyway. To maintain the public's trust in the internet, policymakers are making cybersecurity a top priority while an industry has sprung up to protect cyberspace. It will be a never-ending battle.

To be sure, billions of interactions happen every day on the internet without hassle. A cyberattack is yet to trigger a catastrophe. Firewalls, virus antidotes and sophisticated behavioural defenses help protect systems. The payments companies have never suffered a significant breach. Neither have the big digital-platforms. That may not last. The core problem is that the foundations of the internet are insecure. After all, they were designed to allow a few trusted parties to communicate, not billions worldwide.

Fragile and flawed

Amateur hackers were around in the early days of computers. Nowadays, cybercriminals operate in sophisticated packs. Thanks to technological advancements that allow for mass criminal activity while protecting anonymity, cybercrime is lucrative, hard to detect and even harder to prosecute.

Government, businesses and households are taking cybersecurity more seriously with each attack. The major responsibility for keeping the internet safe, however, lies with the operating system developers such as Apple, Google and Microsoft.

Microsoft software products include Windows XP, the model that WannaCry exploited. As is typical, Microsoft puts a finite life on its software versions because software is costly to update and patch.

Despite the negligence of enterprises that still use Windows XP while refusing to pay for support after its 'end of life', in the aftermath of the WannaCry attack, Microsoft stood accused of holding back on issuing a free repair for Windows XP that could have protected users.

Critics suggest that Microsoft would have provided support if not for its profit motive to sell software patches, and that it has an incentive to avoid providing security updates on old software, to force people to buy the latest versions. A bugbear for many people is that companies such as Microsoft bear little or no responsibility under US law if their software is vulnerable to attack.

Invisible but lethal

While governments are giving greater priority to cybersecurity, the most likely catastrophic assault on the internet is by a state-sponsored cyberwarfare attack.

Rogue governments are adept at cyberattacks, and cyberwarfare is likely to be a never-ending arms race. Democratic governments need to develop cyberwarfare technology to gather intelligence to protect their populations. The more weapons they create the more insecure adversaries feel, which prompts them to step up efforts. Another quandary is that intelligence agencies must decide whether or not to warn software manufacturers about flaws in their code. If they inform software makers (and they often do), intelligence agencies risk making worthless their cyberweaponary edge. Another concern is that cyberweapon technology is easy to steal.

Such are the unending challenges of guarding the internet against the next WannaCry.

Michael Collins is an Investment Specialist at [Magellan Asset Management](). Magellan is a sponsor of Cuffelinks.

Third Link Growth Fund announces soft close

[Editor's note: In September 2016, Chris Cuffe wrote to our readers with an update on the Third Link Growth Fund (the Fund). He said in part:

"I started Third Link in 2008 with a unique idea. What if I established a fund where all the fees received for managing the investments, net of some tiny expenses, were donated to charities. After a long career in wealth management, I felt I had an ability to select good fund managers who could outperform over time. If I could convince the managers and administrators to provide their services for free for a worthy cause, everyone could win."

At the time, the Fund had recently exceeded $100 million, and Chris recommitted to close the fund to new investors when it reached $150 million. Since September 2016 there has been significant inflows to the Fund, to the great benefit of the many charities the Fund supports. Chris has this week issued a Media Release announcing that the Fund has almost reached this soft close target, and he has set a firm closure date. New investors will not be accepted after this date].

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Third Link Growth Fund will be closed to new investors at the end of August 2017.

Launched in May 2008, the Fund invests in Australian equities via third party professional investment managers. Management fees are donated to charity.

Since its inception the Fund has donated more than $6.5 million to charity, predominantly those helping to support children and young people. It presently donates over $150,000 per month. This amount is expected to continue growing in future even with the Fund closed to new investors.

The Fund takes a portfolio approach to charitable giving, forging long-term partnerships with quality organisations such as Australian Indigenous Mentoring Experience (AIME), National Centre for Childhood Grief, The Song Room, batyr, Foundation for Rural and Regional Renewal, Dismantle, SHINE for Kids, BackTrack, Mirabel Foundation, Raise Foundation and Children's Ground.

Chris Cuffe said, "I am extraordinarily proud of Third Link and the generosity of its pro bono fund managers and services providers that have made it possible. It was always my intention to close the Fund to new investors once it reached $150 million, and having exceeded $144 million at the end of June 2017, I have decided it is appropriate to close the Fund to new investors at the end of August 2017."

The Fund commenced as a multi sector growth fund but, following investor feedback, altered its mandate in February 2012 when it became a purely Australian equities fund.

In the more than five and a half years since it has been an Australian equities fund, Third Link Growth Fund has produced a compound return of 14.0% per annum after fees, outperforming the S&P/ASX300 Accumulation Index by 3.1% per annum. This has demonstrated the success of its active management approach. Since inception over nine years ago, the Fund has delivered a compound return of 9.5% per annum after fees, despite the impact of the global financial crisis. During this same period, the bank bill rate was 3.6% per annum and the Australian share market returned 4.6% per annum.

Chris Cuffe is Founder and Portfolio Manager of Third Link Growth Fund.

The pro bono fund managers used in Third Link Growth Fund are Aberdeen Asset Management, Bennelong Australian Equity Partners, Colonial First State Global Asset Management, Cooper Investors, Greencape Capital, Harness Asset Management, JBWere Wealth Management, L1 Capital, Lazard Asset Management Pacific Co, Lennox Capital Partners, Montgomery Investment Management, Ophir Asset Management, Paradice Investment Management, and Pengana Capital.

The pro bono service providers to Third Link Growth Fund include Bennelong Funds Management (Responsible Entity), RBC Investor Services Trust (custodian and administrator), Minter Ellison (legal work), Deloitte (auditors and tax advisers to the Fund), Ernst & Young (auditors of the Manager) and Nexia Australia (tax advisers to the Manager).

If you would like to consider whether to invest in the Fund, please see the Product Disclosure Statement (PDS) and the Additional Information to the PDS here. The information above is general information only. It does not constitute financial, tax or legal advice or an offer or solicitation to subscribe for units in the Fund. There can be no assurance that the Fund will continue to achieve its targeted rate of return and no guarantee against loss resulting from an investment in the Fund.

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