Cuffelinks
Connecting investors with ideas

Edition 211, 21 July 2017

This Week's Top Articles

And we're off: super tax risks post 1 July

Gordon Mackenzie

We had about eight months to prepare for the most significant tax changes to superannuation in a decade. While the major amendments reduce concessional contributions for some people and increase them for others, the two most important changes reduce the tax shelter of superannuation for the wealthy.

It is easy to see why these were needed. Under the pre-2007 tax system, the rules provided incentives to put as much post-tax wealth into a super fund as possible. There were tax penalties for taking out more than was considered reasonable. Yet, when they transitioned to the post-2007 system of exempting from tax all benefits from age 60, they ignored how much was accumulated under those old rules.

Now there are limits on tax-exempt pensions with a $1.6 million starting amount, and the same $1.6 million in superannuation is an eligibility condition for non-concessional contributions.

The practical consequences of the super changes

There are now two main risks both investors and their advisers should watch:

First, for exempt pension income in accounts, other than in a SMSF, that exceed the $1.6 million cap, anyone affected will now have to decide which assets should receive the tax exemption and which should be taxed at 15% on their income. Broadly, it should be decided on whether the assets are tax sheltered anyway, such as imputation credits on dividends or the one-third discount on capital gains.

Also, if there is more in super than the tax-exempt limit, decisions must be made whether to hold the excess assets inside a superannuation fund or outside. Issues include whether the income from assets transferred outside can be sheltered using the progressive personal tax rates rather than the fixed 15% rate applicable in a fund will be important. There is also the potential for income splitting between partners to further use the progressive tax rate shelter. Remember that the tax-free threshold for individuals is $18,200, and then the marginal tax rate is 19% up to $37,000.

Second, the new eligibility conditions throw up contribution timing and even due diligence risks for financial planners and other professionals who are advising their clients.

A couple of examples will demonstrate the point. Eligibility to contribute non-concessional contributions and some concessional contributions now depends on the member's account balance on the prior 30 June. While that looks straightforward, the issue of valuing illiquid assets in SMSFs could prove problematic. What if the only assets are real estate? Will a drive-by valuation suffice?

And what about transitional arrangements for balances that are close to but less than the $1.6 million cap? For example, someone with more than $1.5 million but less than $1.6 million at 30 June 2017 is entitled to the $100,000 non-concessional cap in 2017/2018, but not the bring forward ability. For balances between $1.4 million and $1.5 million, the non-concessional cap in 2017/2018 is $200,000 and the bring forward period is only two years. There are rules about bring forwards triggered as far back as 2014/2015, and the impact on co-contributions, tax offsets for spouse contributions and the role of segregated assets.

As ever in super, the devil is in the detail.

Even in the non-SMSF world, it will be risky when advising on contributions for members early in a financial year. The ATO has advised that, with the fund reporting systems currently in place, the ATO will not be certain of the member's prior 30 June account balance until November of the following financial year.

And then there are 'legacy' pension problems. Some people commenced their working life in jobs that traditionally gave them a deferred pension payable at, say 55 or 60 years of age. This was common is the public sector or large corporates. That deferred pension picked up in those early career choices a long time ago is probably worth 'two and sixpence' in the scheme of things. They sit in the bottom drawer and simply don't factor into real retirement planning. Now, unfortunately, they do factor, as the value of those deferred pensions is included in the ability to make contributions where their total superannuation balance is a factor. That, obviously, creates due diligence issues and, indeed, risks.

Welcome to the new world of tax planning around the pension income exemption and risky advice about non-concessional contributions.

Gordon Mackenzie is a Senior Lecturer in taxation and superannuation law at the Australian School of Business, University of New South Wales*. This article summarises the major points, it does not consider the needs of any individual and does not summarise all aspects of the legislation.*

7 ways acquisitions add or destroy value

Matthew Ward

Mergers and acquisitions (M&A) can add material shareholder value to companies that get it right. Conversely, failure to deliver anticipated M&A benefits will either result in destroying shareholder value, or in extreme cases, put the entire company at risk.

Acquisitions require detailed execution and integration plans that identify key issues and focus on the early delivery of synergies. M&A inevitably increases staff workloads and management will need to ensure the existing core business is not overlooked or compromised. Success rates are dramatically improved if a company has a good management team, robust systems and processes and a board with M&A capability and experience. The most successful acquisitions will typically increase earnings per share (EPS), increase the net present value (NPV) per share and provide a short payback period.

Current conditions for M&A

The current environment is generally favourable for M&A as interest rates are low and the economy is expanding slowly, so companies are attracted to opportunities that supplement low organic growth. The main negative is that valuations are comparatively high. In FY16, the value of M&A exceeded $30 billion. Larger deals included:

Acquirer	Target	Value
Brookfield/Qube Rail Consortium	Asciano	$9.0bn
Dexus	Investa Office	$2.5bn
Equifax Inc	Veda	$2.3bn
M2	Vocus	$1.9bn
Duet	Energy Developments	$1.4bn
Hanes Brands Inc	Pacific Brands	$1.1bn

Over 40% of acquirers were overseas companies with private equity accounting for nearly 20% of overall activity.

Friendly takeovers traditionally result in a completion rate of ~80% compared to hostile bids with a lower success rate of ~50%. Premiums in friendly deals tend to be lower, averaging between 20-30% compared to 50% in hostile bids. Hostile acquisitions are considered higher risk due to the additional price premium and limited due diligence that is typically undertaken.

Case studies show value creation or destruction

1. Justifying the premium paid

Most companies obtain cost or revenue synergies when making acquisitions which allows them to pay a premium. The most common example is the elimination of a target's financial, legal and other head office functions, which reduce unit overhead costs as they are typically spread over a larger revenue base. This has been a reason given for acquisitions by several companies including G8 Education, although synergies may also be gained from integrating existing systems or operating the additional centres in a cluster managed by an existing staff manager.

2. Cost synergies are more convincing

Significant cost synergy savings are generally available in the financial sector. For example, Westpac's acquisition of St. George Bank and CBA's acquisition of Bankwest resulted in significant head office and systems cost reductions as back offices were integrated and branch networks rationalised.

3. Boosting future organic growth

Acquisitions that contribute to future organic growth include Motorcycle Holdings, the top motor-bike seller in Australia, acquiring dealerships as part of its growth strategy. It is the only player of scale with funding in the industry, and it is able to acquire dealerships at low prices. As several dealerships only sell new bikes, it increases acquired dealership profitability by adding second hand bike sales along with accessories, finance and insurance to supplement new bike sales.

National Veterinary Care has made several vet clinic acquisitions since listing. After an acquisition, it typically introduces its 'Best for Pet' loyalty program, which generates increased revenue and profitability. It also identifies additional revenue streams such as dentistry and trains vets if they are not already performing this work.

4. Organic growth for both acquirer and target

Telco and software company, MNF, recently acquired Conference Call International (CCI), which provides audio conferencing to 5,000 customers. MNF will obtain organic growth by offering these services to its own customer base as well as offering its own existing products and services to CCI's customers. MNF will also obtain cost savings by moving CCI's customers onto its global voice network. MNF has a history of organic and acquisition growth, having delivered double EPS growth over several years and astute acquisitions provide it with a significant future growth runway.

5. *Know what you're getting in friendly acquisitions*

Steadfast is the largest Australian insurance broker and has been a serial acquirer. A key growth strategy is to acquire interests in insurance brokers, which join its network. Steadfast's subsequent knowledge of their profitability reduces its acquisition risk as it often consolidates ownership of these brokers.

6. *Know what's in the box in hostile acquisitions*

Downer made a hostile bid for Spotless after a significant drop in Spotless' share price. Although Spotless has highlighted new long-term contract wins and renewals, formal due diligence was not permitted. Acquisition risk therefore remains despite Spotless claiming the bid is opportunistic and should be rejected.

CIMIC recently acquired Sedgman and United Group opportunistically at the bottom of the cycle. Although these were similar, hostile acquisitions, the acquisition risk was again partly mitigated as relatively low prices were paid. Unfortunately, this can't be said for Rio after it heavily overpaid for a coal asset in Mozambique and ALS, which bought an oil company at top of the cycle. Both not only destroyed significant shareholder value but also put the companies under pressure due to elevated debt levels. The assets were subsequently divested at much lower prices.

7. *'Di-worsifying' by making a large overseas acquisition with a broken business model*

Arguably, the worst type of acquisition is 'di-worsification', that is, acquiring a new, different, large-scale business, potentially in a new geographic area. Slater & Gordon's acquisition of Quindell's Professional Services Division in the UK is an example that went ahead despite questionable management practices, poor profitability and poor cash flow. It paid a high price for the operation which also required a large equity raising. The disastrous result is well known.

Conclusion

M&A done well can be highly shareholder accretive, but healthy scepticism can save investor dollars. Investors should be particularly sceptical of M&A that simply increases earnings that trigger management rewards but does nothing to increase earnings per share or NPV/share.

Matthew Ward is Investment Manager at [Katana Asset Management](#).

The journey is more important than the destination

Noel Whittaker

Half the calendar year has already gone, and all those New Year's resolutions to lose weight and get finances in order may have gone with it. Now the statements like "I've got no willpower" or "this happens every year" come out.

Take heart as the sad truth is that the human body is not wired for long term planning. Our ancestors were hunters and gatherers who lived by the rule of fight or flight. Their dominant thoughts were purely about survival.

Fast pay off preferred

As a result, we instinctively prefer an action with a fast pay off, than one with a long-term result. The scientific name for it is hyperbolic discounting, which causes people to make choices that can lead to short term pleasure, but long-term disaster.

Credit card usage is an obvious example. Who cares about paying interest at 20% on their credit card balance, living beyond their means, or getting into financial strife when they can simply swipe their credit card and get a retail fix on the spot.

Research from Johns Hopkins University reveals that only 10% of coronary bypass patients make the necessary changes to their lifestyle to prevent further attacks. The remaining 90% still opt for the short-term pleasures of unhealthy food and no exercise.

To make it more difficult, long-term progress by its nature is slow and erratic, and is often discouraging. Imagine you got excited about investing $500 a month into a managed fund that matched the All Ordinaries Index. If the market had a great year and produced 12% compound you would have $6,341 at year's end. The profit would be just $341. However, if the market had a bad year and went backwards by 5%, your portfolio would be worth $5,864. The difference is minimal.

The power of compound interest

This is the point where most people give up and move onto to something else with the lure of a quick high return. However, if you continued investing that $500 a month for 35 years, and the investment averaged 9% per annum, the portfolio would grow to $1.4 million.

It works the same when you are paying off a mortgage. If you owed $300,000 on your home at 5.5% with monthly repayments of $1,703, the term would be 30 years and total interest payable would be $314,000.

Suppose you learned about the effect of compound interest and decided to slash your home loan to 20 years by raising your payments to $2,064 a month, which would save over $119,000 in interest. It is a most exciting prospect, but after five long years at the higher payments, you would still owe $253,000, and may well be starting to feel the result is not worth the effort. But hang in there for another 20 years and it would be paid off. In contrast, if you leave the payments at $1,703 you would still owe $157,000 after 20 years.

Focus on understanding the process and the outcome will look after itself. This is a fundamental success principle, which is applicable in every aspect of your life. Success comes slowly, and you will almost certainly get discouraged and probably give up if you keep thinking about the outcome. It is like planting a seedling and then digging it up every year to see if it is growing.

The secret is to get excited about the process, in the certain knowledge that the right process, if followed through, will almost always lead to the outcome you are looking for.

Noel Whittaker is the author of Making Money Made Simple, and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

Accessing super before retirement

Monica Rule

Although earnings from assets supporting Transition to Retirement Income Streams (TRIS) are no longer exempt from tax, a TRIS is the only way a member can access their superannuation savings prior to turning 65 (although there are some exceptional Conditions of Release). You must also have reached your preservation age, which varies depending on your date of birth, ranging from 55 if born before 1 July 1960 to 60 if you born after 30 June 1964.

Yearly TRIS depends on age

There are limits on the minimum and maximum amounts of TRIS you can access from your superannuation fund each year. The minimum amount is based on your age at 1 July and is a percentage of your TRIS account balance. If you are aged 55 to 64, the minimum amount you can access is 4%, and it increases according to age until it reaches 14% for anyone aged 95 or older. If a TRIS commences during the year, the minimum amount will be calculated on a pro rata basis from the commencement date, rounded to the nearest $10. The maximum amount is 10% of your pension account balance, and this is not calculated on a pro rata basis.

TRIS is paid as a non-commutable income stream, which means you cannot convert it to a lump sum superannuation benefit, until either you reach the age of 65 or meet another condition of release. By commencing a TRIS, you can cut down on your working hours and maintain the same level of total income by supplementing what you no longer receive as salary.

Super contributions still possible

You may still continue to make contributions into your fund once you start a TRIS. You could consider setting up a salary sacrifice arrangement by putting your salary into your super fund and replacing the sacrificed salary with a TRIS. By doing this, your fund pays 15% on the sacrificed salary received instead of you personally paying tax at your marginal tax rate, which may be higher. Salary sacrifices are part of the concessional contributions cap of $25,000 per annum.

You could also consider receiving TRIS and re-contributing it back into your fund as non-concessional contributions. This will allow you to increase the tax-free portion of your superannuation savings in your fund. In this case the non-concessional contributions cap of $100,000 per annum needs to be considered. If you are under 65, the bring-forward rule applies, which means you can make total contributions of $300,000 in one year or over three consecutive financial years. For this to be possible your total superannuation balance must be below $1.6 million as at 30 June 2017.

Tax-free TRIS at 60

If you are aged 60 or older, a TRIS is tax-free. If you are aged 55 to 59, the taxable component of your TRIS is taxed at your marginal tax rate, but you will receive a 15% tax offset, which represents tax already paid by your fund.

Recent changes to the law will allow a tax exemption on earnings from assets supporting a TRIS with a balance of up to $1.6 million when the member turns 65. The tax exemption is because a TRIS will automatically be treated as a pension in the retirement phase because the member meets a condition of release by turning 65. It also means the member's TRIS will count towards their general transfer balance cap, which is currently $1.6 million. Any amount in excess of the cap will attract an excess transfer balance tax.

If a member accessing a TRIS meets other conditions of release such as completely retiring, suffering from a terminal medical condition, or becoming permanently incapacitated, the member will need to notify the trustee of their fund that they have met a condition of release before they are eligible for the earnings tax exemption on assets supporting their TRIS. The TRIS will also count towards their transfer balance cap from the date they notify their fund regardless of when they met the condition of release.

Monica Rule is an SMSF Specialist. She runs webinars and seminars on the superannuation law and SMSF compliance. For more details visit [www.monicarule.com.au.](http://www.monicarule.com.au) This article is general information and does not consider the circumstances of any individual.

3 key difficulties when investing in emerging markets

Craig Mercer

Investing in emerging markets is fraught with complex challenges and dealing with them calls for a new approach based on sustainability. Traditional fundamental analysis and quant models have come up short.

Investors encounter three key problems: the negative impact of state-owned enterprises (SOEs); a lack of emphasis on good governance and sustainability; and high fees and index constraints.

1. Alignment of interests by SOEs

State-owned enterprises, which make up about 30% of the emerging markets benchmark, usually have different objectives to minority investors. Investors need to understand whether their interests are aligned because shareholder wealth creation reduces risk and increases returns.

According to a report in *The Economist*, the SOEs among the world's top 500 companies lost between 33% and 37% of their value between 2007 and 2014. Global shares rose by 5% over the period. The root of the problem, according to *The Economist*, is a "huge misallocation of capital." With little need to meet the expectations of investors, SOEs invested trillions of dollars in non-core businesses that did not pay off. SOEs are also stingy when it comes to paying dividends and many have debt problems.

2. Poor governance and inadequate stewardship

Companies with poor governance and sustainability practices add cost to their operations. As a result, they have less capital for investment and less that can be distributed to shareholders. We believe ESG (Environment, Social and Governance) in emerging markets is under-researched and gives us a competitive advantage that adds value.

The single most important ESG factor is governance. Governance issues include audit quality, compensation policies, board independence, capital discipline, related party transactions, management quality, past violations and controversies involving the company.

There is strong evidence of the positive role governance plays in driving superior financial and market performance, while lowering risk. In 2012, Deutsche Bank compiled research on more than 100 global studies on the merits of ESG. The studies found that companies with high ESG ratings have lower capital costs. The most important factor was governance, with an emphasis on stewardship of capital. Harvard Business School published research in 2015 (Serafein et al) which concluded: *"We find that firms with strong ratings on material sustainability issues have better future performance than firms with inferior ratings on the same issues."*

Company sustainability reports and third-party research to assess the transparency and integrity of company disclosures are also important. We place the company's environmental and social practices in their industry context and seek to identify cases of 'greenwashing'.

3. Fees and difficulties constructing a good index

Quant funds have yet to make meaningful inroads into ESG investing in emerging markets. The available data sets are relatively immature and there are reliability issues resulting from the wide variability of company reporting. It can be difficult to compare companies on a like-for-like basis.

It is expensive to source data in emerging markets which can often be corrupted by companies using 'greenwashing' and other techniques to disguise the true nature of their business practices.

There seems to be a price at which an active fundamental investment manager will tolerate certain poor qualities, hiding under the veils of 'it being discounted into the price' or 'growth cures all problems'. There is a tendency to interpret information in a way that confirms already held preconceptions.

Sustainability issues often take a secondary role to price, growth and risk management considerations. Other investment managers look at valuations and short-term earnings expectations, and if they see a good deal they will explain away poor governance practices.

Index management is not a viable solution in emerging markets either, due to two fundamentally disqualifying facts mentioned above: the role of SOEs and the pervasive influence of poorly-governed companies. The inconsistent application of the rule of law across disparate geographies and weak sustainability practices ensure poor long-term returns from many companies represented by the benchmark.

Craig Mercer is Co-founder and Chief Investment Officer of Remerga*. Remerga emphasises corporate governance and sustainability in the emerging markets. Remerga's Emerging Markets Sustainable Leaders Fund does not hold any state-owned enterprises. This article is general information and does not consider the circumstances of any individual.*

Value investing from an Australian perspective

Hamish Carlisle

While the long-term returns from 'value investing' are strong and well documented, the approach has struggled over the past decade prompting many investors to question its merits.

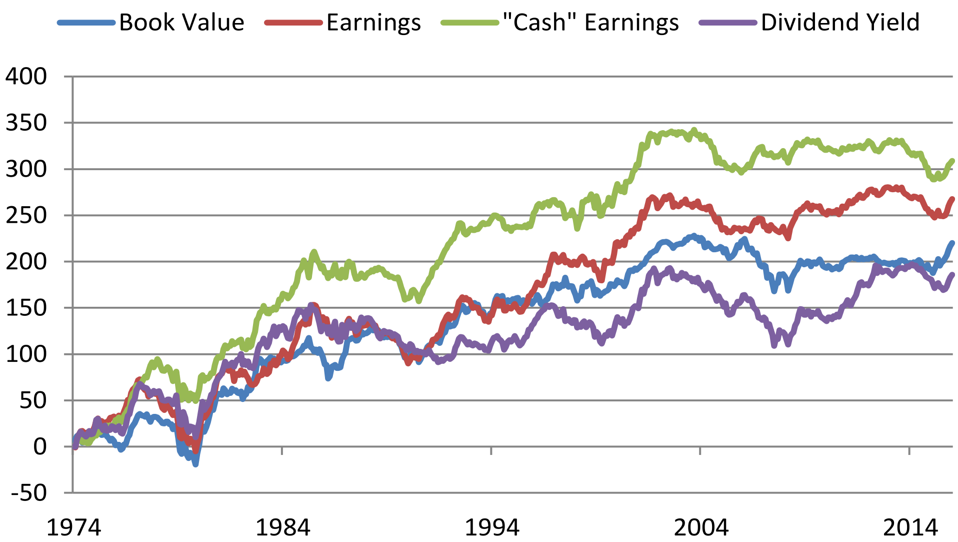
This article discusses value investing from an Australian perspective. The traditional classifications of 'value' include earnings, book value and dividends, but value investing by 'free cash flow' (FCF) has performed well through market cycles. FCF value investing has also displayed lower levels of volatility when compared to traditional classifications.

These conclusions support our investment philosophy, which is built around the notion that companies undervalued by FCF and franking will outperform over time.

A long-term perspective

The chart below highlights the performance of value investing in an Australian context using more than four decades of data provided by Professor Kenneth French.

Returns of 'value' portfolios relative to 'glamour' portfolios (December 1974 to December 2016)



Source: Professor Kenneth French. Portfolios are formed using four valuation ratios: book-to-market (B/M); earnings-price (E/P); cash earnings to price (CE/P); and dividend yield (D/P). The raw data is from Morgan Stanley Capital International for 1975 to 2006 and from Bloomberg for 2007 to 2016.

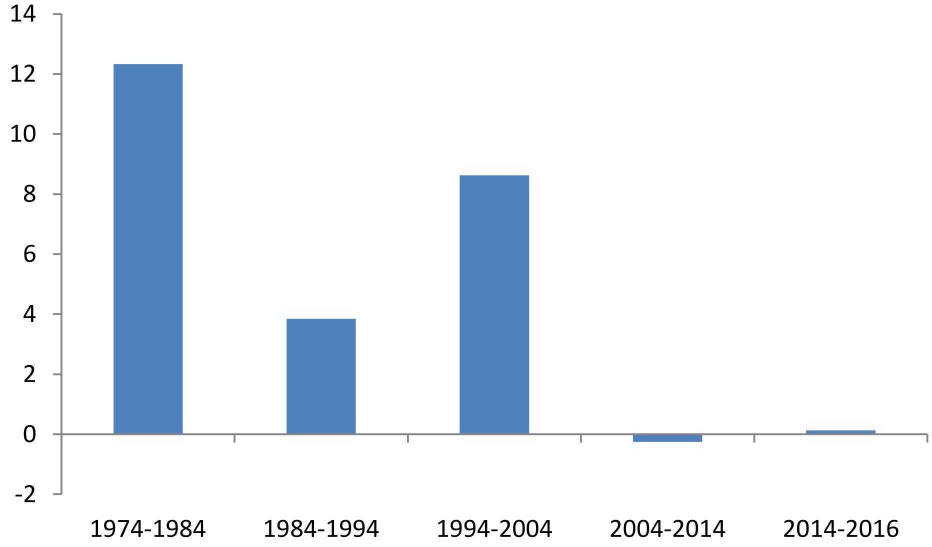
The 'value' portfolios contain firms in the top third of a ratio and the 'glamour' portfolios contain firms in the bottom third. Portfolios are formed at the end of December each year by sorting on the four ratios and then computing value-weighted returns for the following 12 months.

Over the 42-year period for which data is available, value portfolios outperformed glamour portfolios by between 5% and 9% per annum depending on the way 'value' is defined.

15 years of poor performance

The data presented below shows returns to value investors in more recent periods have been less than stellar, prompting some commentators to question the merits of the approach.

Average annual returns of 'value' portfolios relative to 'glamour' portfolios (December 1974 to December 2016)



Source: Professor Kenneth French. The raw data for Australia is from Morgan Stanley Capital International from 1975 to 2006 and from Bloomberg from 2007 to 2013. US data is from CRSP. The chart represents the average of four portfolios.

Traditional 'value' has become a crowded trade

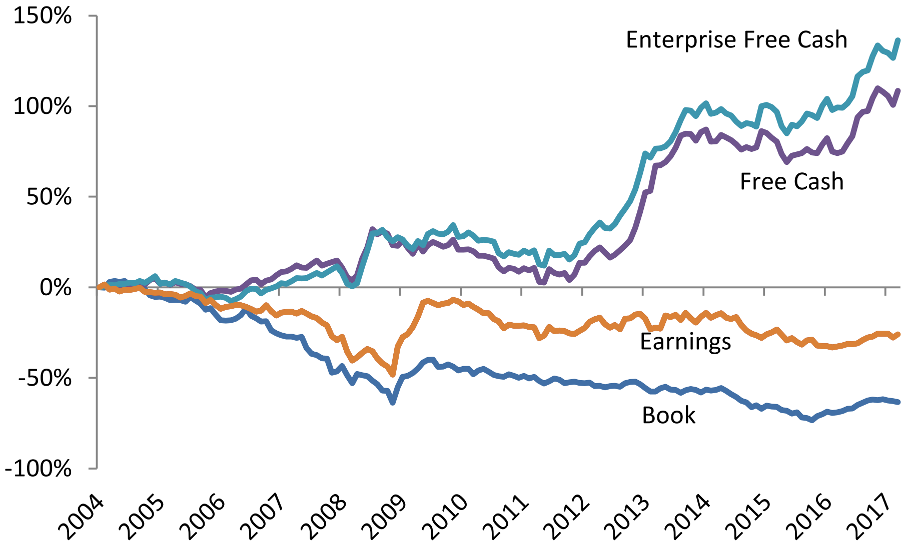
Anecdotally, there has been more institutional asset allocation towards value strategies in recent years, focusing on the traditional classifications listed above. In addition, many commonly deployed 'risk models' use the mainstream classifications to measure the extent of a portfolio's value exposure.

The focus of institutional asset allocation towards simple strategies concentrating on the four classifications may have reduced the excess returns available from pursuing such strategies. The growth of 'smart beta' strategies, which are usually focused around simple and observable value classifications, accentuates this situation.

Traditional classifications of value are more often based on accounting earnings and management's manipulation of dividends. The recent ramp up in dividend payout ratios and the growing divergence between statutory and 'underlying' earnings are examples of this. Of course, this unsustainable situation can lead investors to mistakenly classifying stocks as 'cheap' at particular points in time leading to poor investment outcomes.

This situation will be helped by classifying stocks based on their capacity to generate cash flow above that needed to sustain and grow their businesses ('FCF'). The use of FCF rather than accounting earnings or dividends is important because management can less readily manipulate the measure.

Returns of 'value' portfolios relative to 'glamour' portfolios (March 2004 to June 2017)



Source: Merlon Capital Partners. Portfolios are formed using four valuation ratios: FCF-to-price (F/P); enterprise-FCF-to-enterprise-value (EF/EV); earnings-to-price (E/P) and book value-to-market (B/M). Monthly portfolio returns are calculated by equally-weighting all sample companies and sorting from top to bottom by each valuation ratio. The method is described under the first chart above. The 'value' portfolios contain firms in the top one third of a ratio and the 'glamour' portfolios contain firms in the bottom third. The analysis is based on S&P/ASX200 constituents, and the raw data is from Bloomberg.

The performance of a value strategy that classifies stocks based on FCF has performed well with lower risk compared with traditional accounting-based alternatives. This finding supports our investment philosophy built around the notion that companies undervalued by FCF and franking will outperform over time.

Why do cash flow-based value strategies outperform?

We do not believe that value stocks outperform simply because they are 'cheap' but rather because there are misperceptions in the market about their risk profiles and their growth outlooks. A good investment requires market concerns to be priced in or deemed invalid. We incorporate these aspects with a 'conviction score' that feeds into our portfolio construction framework.

In a second paper to be released next quarter, we will explore the question of why value strategies based on FCF outperform the broader market. We will present findings that dismiss the notion that value investing is 'riskier' than passive alternatives and support the presence of persistent behavioural biases in investor expectations.

Hamish Carlisle is an Analyst and Portfolio Manager at Merlon Capital Partners, *an Australian-based boutique fund manager specialising in equity income strategies. This article is general information and does not consider the circumstances of any investor.*

Clear winner and loser in 2017-18 performance survey

Graham Hand

Over 400 readers completed the short survey on expectations for market returns in this new financial year, and the results suggest optimism for overall share market performance.

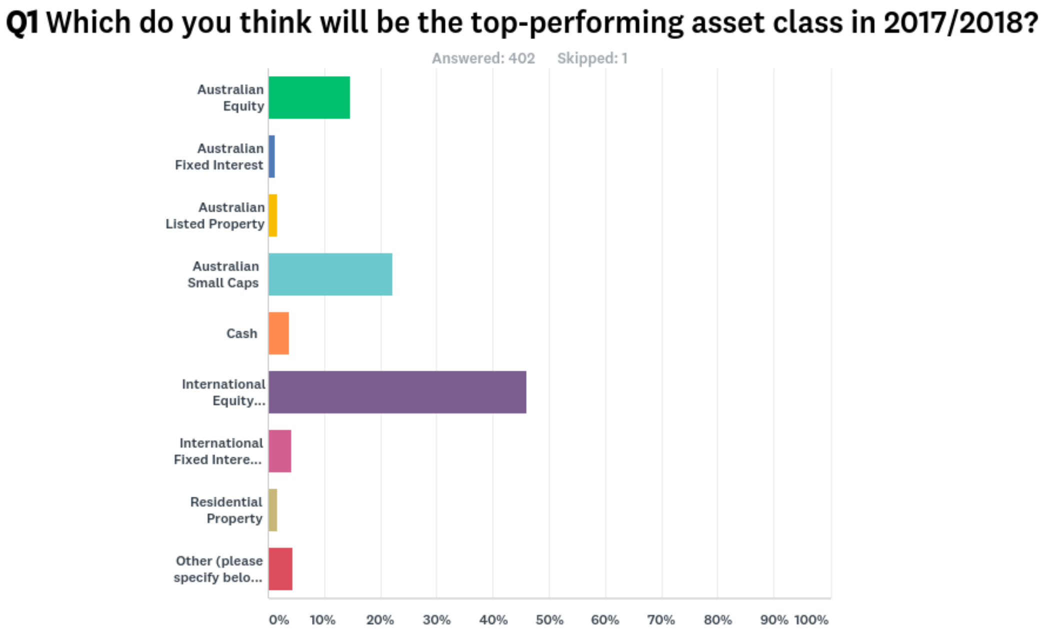
Winner of the expected best-performer category

Unhedged international equities (46% of votes)

Equities received strong support, with unhedged global shares (46%), Australian small caps (22%) and Australian equities (15%) adding up to 83% of votes. There was little support for fixed interest, and with cash at only 4% of votes, few investors see a market rout.

Particularly notable is that international equities have come first in four of the previous five financial years, so there's either little support for 'reverting to the mean', or people are extrapolating from recent performance. How much does the concentration in Australia's market among banks, miners and retailers play a role?

Only 2% expect residential property to be the best, but as in all years, that's where most of the investment dollars will go.



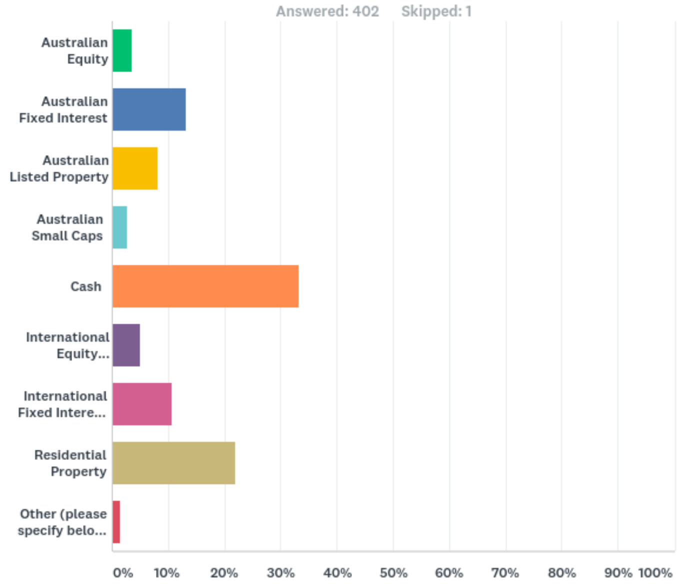
Winner (or loser) of the expected worst-performer category

Cash (33% of votes)

Expectations for the worst performer were somewhat more balanced, with cash and fixed interest adding up to 57% of nominations. Taking a look at the Morningstar numbers for each financial year since 1998, cash has only come bottom twice. There are usually one or two other asset classes that put in a bad year and underperform the defensive characteristics of cash. Last year, cash outperformed listed property and fixed interest.

A healthy 22% expect residential property to perform worst, which is a decent vote for the market finally losing its head of steam (in Sydney and Melbourne, at least).

Q2 Which do you think will be the worst-performing asset class in 2017/2018?

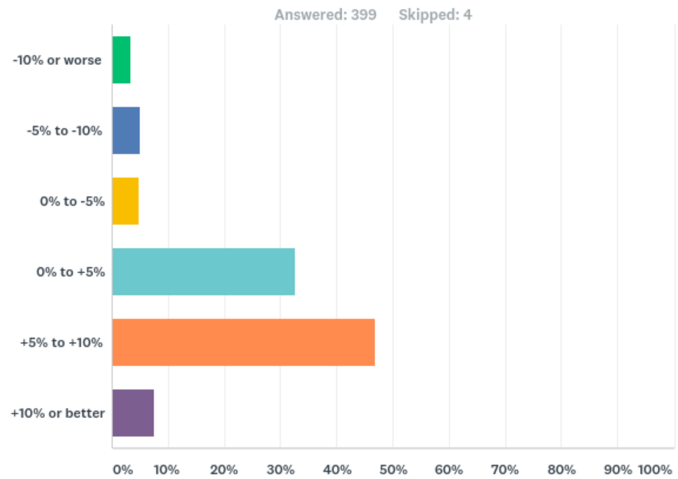


<u>Most nominated range for S&P/ASX200 Total Return Index</u>

+5% to +10% (47% of votes)

A strong 87% of votes placed the Australian index in the range of 0% to 10%, with most above +5%. Given the US market is at all-time highs and Australian and global valuations look stretched, and with US rates rising, this is an optimistic note for steady performance. There was stronger support for +10% and better (7.5%) than a bad result of -10% or worse (only 3%).

Q3 What will the S&P/ASX200 Total Return Index (including dividends) deliver?



We will report on the results of these predictions at the end of 2017/2018.