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This Week's Top Articles

Heigh-ho heigh-ho, are family trusts the way to go?

Diana Chan

An unintended consequence of the recent superannuation reforms is the increased interest in family trusts. This article looks at the principal benefits of family trusts, who might establish one, and some of the pitfalls to consider. We'll also take a clinical look at how Snow White might employ a family trust for the Seven Dwarfs … and of course, which of them lives happily ever after.

What are the benefits of a family trust?

The two most attractive benefits of a family trust are the discretion to split income to a wide range of potential beneficiaries and the extra level of asset protection.

Who should consider a family trust?

In general, an employee with most of their wealth in super and any surplus cash flow directed to repaying the mortgage may find a family trust is not appropriate. Superannuation is already a concessionally-taxed investment vehicle. In addition, deductible interest expenses from investment loans are more tax effective for those on higher incomes than distributed to trust beneficiaries.

However, those who fall into the following categories may consider a family trust:

1. Younger high-income earners who are generating surplus savings and need flexibility to access their capital.
2. Individuals who are already maximising their $100,000 super contributions and require an alternative investment vehicle for their surplus cash flow.
3. Superannuation members who have already reached their lifetime caps of $1.6 million.
4. Those who seek superior asset protection from the family's black sheep, avaricious and litigious ex-partners of the family members, or creditors of the family business.
5. Higher income earners with a non-working spouse, children at university, or even the uninspired teenager who hasn't quite decided on what to do with their life beyond becoming the ultimate Call of Duty warrior.
6. Families with wealth who have low income beneficiaries, such as elderly parents.

Snow White and the Seven Dwarfs

Each dwarf manages his personal finances but will obligingly help one another out (they're a tight-knit bunch). Collectively, they have done quite well accumulating wealth in superannuation and all profits from the mines have been shared equally. Along comes Snow White, who suggests a family trust to help the dwarfs manage their family wealth in the most tax-effective way. She reviews each dwarf's circumstances and suggests the following strategies:

Doc likes to think he's the unofficial head of the household. He is a health practitioner and the main bread-winner on the highest marginal tax rate. Doc would have little or no income distributions from the family trust given that it is not tax-effective to do so.

Grumpy doesn't like to work with anyone and runs a successful small business making and selling mining equipment to the other dwarfs. Grumpy transfers the business into the family trust, ensuring that dividends from his company are franked prior to distributing income to himself.

Happy has recently completed a degree in gemmology, is now studying for a Masters in Mineral Sciences and works part-time in the mines. He believes that money can buy happiness and frequently buys extravagant collectors' items online. Whilst he is studying and working, Snow White suggests that some income distributions be sent his way to even out the overall taxable income of the other lower-income beneficiaries.

Sneezy was made redundant this financial year and has only been able to find the odd casual job due to his sinus-related maladies. Because he has received a significant taxable termination payment, Snow White advises that income distributions would be best considered in the following financial year.

Bashful doesn't like to share much about his personal finances but has been extremely successful in the mines. He's amassed a small fortune and quietly lives off his abundant dividends. Snow White suggests that he loan the capital to the family trust and continue to draw his modest income needs from the trust. Future investment gains realised from his contributed capital can be distributed to his dwarf brethren to reduce CGT.

Sleepy is a lazy teenager and has little aspiration to study or seek a full-time job. Snow suggests that Sleepy should receive a higher distribution of income to fully utilise his tax-free threshold and low-income tax offset.

Dopey is much loved but incredibly naïve and dull-witted. Snow recommends that his wealth be transferred into the family trust to protect him from trading his wealth to the Wicked Queen for a shiny red apple.

Pitfalls to consider

Individuals on government income support should be mindful that any involvement with family trusts may affect their entitlements, as being a trustee or beneficiary may be assessed as owning all or some of the trust assets. Income distributions are also captured as assessable income and could have an adverse impact on Centrelink benefits.

Any income loss generated by assets owned by a trust are trapped in the trust and hence cannot be distributed to beneficiaries to reduce their personal taxable income. This is usually carried forward and applied against future income of the trust (such as a capital gains event). Therefore, if borrowing for investment purposes may be better gearing in an individual's name to maximise negative gearing benefits to the highest-taxed income earner. However, the discretion to distribute any future capital gains is lost.

Whilst a family trust is a good investment structure which allows intergenerational wealth transfer without capital gains or stamp duty, it is generally considered a terrible idea to transfer your existing family home into a trust as the transfer would be considered a CGT event and the main residence exemption would be lost.

Consider what will happen to the trust in the event of a death. The trust assets do not form part of an estate and cannot be given away under the terms of a will. The only 'asset' which trustees can leave in respect of the family trust is their ability to *pass control* of that trust to the executor of their estate or their children.

Although the assets owned by the family trust do not form part of your estate, if the investment capital was a loan to the trust, this is considered as an asset of the estate. That is, the family trust may need to repay the loaned capital if called upon by the will. Therefore, it would be prudent to review wills to ensure that a death does not create a sudden need for the family trust to sell assets in order to repay the loan to the estate.

On relationship breakdown, one spouse may argue that the assets in the family trust do not form part of the pool of assets to consider at separation. This is often contested in the Family Courts.

As for Ms. White and the diverse band of dwarfs …

Ultimately, through the family trust, Snow White was able to help the seven dwarfs create a structure which provided certainty and a measure of security around their mining empire. The family wealth was protected from spendthrift and vulnerable individuals, and a platform was created for tax minimisation that can be passed onto future generations.

As a sign of their undying gratitude for Snow White's guidance, the dwarfs successfully lobbied the ATO to audit the financial records of the Evil Queen's apple orchard, which then went bust and was re-purchased in an (arm's length) fire-sale by Snow White and her new beau, a handsome young prince. Snow White was last seen brainstorming plans for the orchard's transformation into a cider manufacturer.

Diana Chan is Head of Compliance at financial advisers, [Stanford Brown](). This article is general information and does not consider the circumstances of any individual (except Snow White). This complex issue should be discussed with a qualified financial adviser or tax consultant to determine whether it is in anyone's best interests.

*In a foreword to The Hobbit, published in 1937, J R R Tolkien writes: "In English, the only correct plural of 'dwarf' is '**dwarfs**' and the adjective is 'dwarfish'. '**Dwarves**' and 'dwarvish' are used only when speaking of the ancient people to whom Thorin Oakenshield and his companions belonged."*

8 ways long-term investing is rewarded

Wilbur Li

There is no denying that we live in a world of short-termism. From the 24-hour news cycle and daily market moves to the relentless focus on the latest set of company earnings, we are always grappling with new information flooding our way. We often overtrade as we become impatient and feel the need for action. This begs the question, does the market reward the investors who can sit tight and invest with a long-term lens?

A report by The Thinking Ahead Institute (part of Willis Towers Watson) explores this question and it offers interesting insights. The study identifies eight fundamental building blocks of long-term value creation. These factors can be categorised in two broad camps:

1) Strategies that provide long-horizon return opportunities

2) Strategies that lead to lower long-term costs and/or mitigate risks

Return opportunities

Active ownership
▪ Average excess return of **2.3%** was generated over one year after engagements with investee companies
Liquidity provision
▪ Long-horizon investors have the potential to earn additional returns of **1% pa** by providing liquidity when it is most needed
Capturing systematic mispricing
▪ Exploiting various mispricing effects in smart betas added more than **1.5% pa** relative to cap weighted index in the past decades
Illiquidity premium
▪ Illiquidity risk premium is worth **0.5-2% pa**-additional returns might be available to truly long-horizon investors
Thematic investing
▪ 93% of 2016 TAI New York roundtable attendees believe that it is possible to create value through investing thematically

Lower costs

Avoiding buy-high-sell-low
▪ Chasing past performance cost US pension funds **1%** (over three years post manager change)
Avoiding forced sale
▪ Liquidity-driven trading in response to redemption reduced returns of open-end mutual funds by **1.5% pa**
Lower transaction costs
▪ **26bps** could be saved in transaction costs if UK medium-size pension funds reduce their active strategies turnover to 60%

Long-horizon return opportunities

1. Active ownership and investing in long-term oriented companies

Research by McKinsey has found that firms create value by taking a long-term approach. Investors can exploit this in two main ways. The first is that skilful investors can identify and own companies who have a genuine long-term focus. Alternatively, investors can engage with companies they own to improve performance. The research suggests investors can expect to harvest an additional 2.3% abnormal return the following year.

A further study analyses the 183 companies CalPERS has actively engaged with between 1999 and 2012. Three years prior to the engagement, these companies underperformed the Russell 1000 Index by 38.9% on a cumulative basis. In the five years following CalPERS' engagement, on average, these firms generated cumulative returns of 12.3% above the index.

2. Liquidity provision

Long-term investors can act as providers of liquidity in times of market distress. Simply by providing liquidity when it is most needed, investors can harvest a premium of 1% per annum. When investors require liquidity, they sell at below fair value while long-term investors can exploit this through purchasing with cash held in reserve. Further, long-term investors who provide liquidity serve a social good as it helps stabilise markets in volatile times.

3. Capturing systematic mispricing

Exposure to smart beta strategies can help generate an additional excess return of 1.5% per annum. Rob Arnott of Research Affiliates found that all alternative weighting strategies have outperformed the cap-weighted benchmark over the long term. This may be a consequence of unintended value and small-cap tilts which are often unavoidable unless one holds a portfolio that has a positive relationship between price and portfolio weights (such as a cap weighted index).

4. Illiquidity premium

The illiquidity risk premium (IRP) estimated at between 0.5% and 2% per annum can be harvested through exposure to long-term illiquid assets. As investors invest in these illiquid assets, they demand a higher risk premium for their inability to quickly sell down their assets as needed.

5. Thematic investing

Themes are often easy to identify but the scale and rate of change is difficult to anticipate. The world is running out of oil, renewable energy can save the planet, many countries have ageing populations and technology is changing our lives. However, such investments are often neglected as they are hard to time, particularly when investing with a short-term lens. While there is no empirical evidence supporting that thematic investing generates excess return, 93% of the 2016 Institute of New York roundtable attendees believe thematic investing to be value enhancing.

6. Avoiding buying high and selling low

Investors typically sell winners and hold onto losers. As a stock performs well, we want a piece of the action, while when a stock performs poorly, we hold on and hope for a recovery. We typically end up buying high and selling low. Jason Hsu found that mutual fund investors have forgone 1.9% per year due to poor timing decisions. Short-term trading can at times be a mug's game.

Cost reduction and loss mitigation strategies

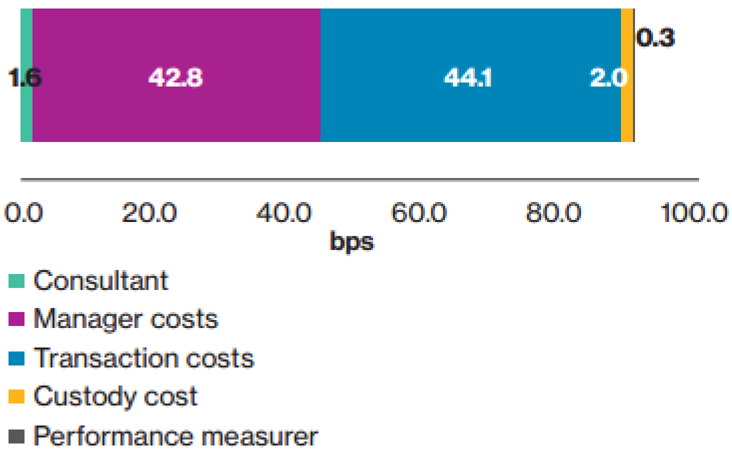
7. Avoiding forced sales

Investment funds often engage in short-term trading driven by liquidity needs. In particular, redemptions can result in 'fire sales' where managers are forced to sell assets below fair value, destroying value in the process. One study has found that liquidity-driven trading in response to mutual fund flows reduced abnormal returns in US open-ended mutual funds by 1.5% to 2% per annum. A second study found the cost to be 112 bps per annum. While closed-fund structures have limitations, forced selling can result in value destruction.

8. Lower transaction costs

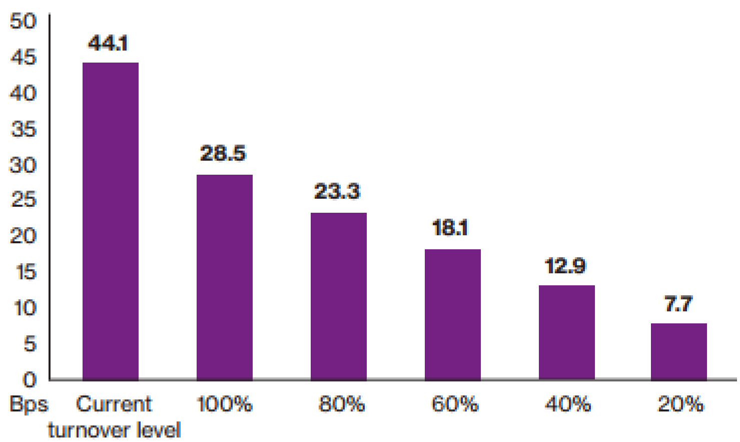
Willis Towers Watson's 'UK Food Chain' study estimates the size of each component of fund expenses based on a medium-sized UK pension fund. Transaction costs account for 44 bps, or almost half of all fund expenses, as shown below.

Components of fund expenses



In addition, the next figure shows that reduced turnover levels can substantially reduce transaction costs, significantly improving investment outcomes.

How reduced turnover leads to lower transaction costs



Note it is not appropriate to sum the return potential of the eight building blocks, which would yield an incremental return of approximately 10%, as these factors are correlated.

A snapshot of additional incremental returns

Bringing together all eight factors, the table below presents potential benefits for a large asset owner investing with a long-horizon approach. The Thinking Ahead Institute observes this investment approach yields a potential incremental return of 1.5% per annum over the long run.

To put this into perspective, a $50,000 portfolio invested for 20 years returning 6.5% per annum would net a healthy $176,000. However, a return of 8% per annum would turn $50,000 into a whopping $233,000. What a difference a few percentage points can make in the world of compounding.

Actions	Incremental annual governance costs	Return gain at the fund level
Reduce turnover for all active mandates	Small	20bps pa
Avoid chasing past performance when hiring managers	Medium	15bps pa
Move 20% of the total portfolio from open-ended funds to a more fit-for-purpose structure to avoid being forced sellers	Small	15bps pa (20%*75bps)
Move 40% of total passive exposure (20% of total AuM) to smart beta	Medium	15bps pa (20%*75bps)
Set aside 5% allocation to cash to exploit forced selling	High	25bps pa* (net of opportunity cost)
Become active owners for 30% of the equity holding (18% of total AuM)	High	41bps pa (2.3%*18%)
Invest 10% in illiquid assets	High	20bps pa (2%*10%)
Allocate 5% of total portfolio to thematic exposures	High	10bps pa**
Total	**Say 8bps pa ($80m)**	**161bps pa**
	Total net benefit	**~1.5% pa**

There is a strong belief that a long-term premium exists. The challenge, of course, is to harvest it.

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Do your homework on 'granny flats'

Brooke Logan

When we hear the term 'granny flat', we envision a self-contained unit attached to a private home. Often, this may be rented out or used by an elderly relative.

A 'granny flat interest' may be different than the 'real estate' description above. In the context of social security, the term 'granny flat right' is used to assess living situations where money, assets or the title to one's home have been transferred in exchange for a right to a lifetime accommodation in a private residence. The person obtaining the granny flat interest does not have legal ownership of the property they live in.

In most cases, this is an informal family arrangement created to provide support for an elderly person. However, there are no age or family relationship rules or requirements. Centrelink's 'granny flat' exceptions are designed to encourage people to stay out of supported care. They may, however, leave openings for financial detriment or abuse. A granny flat right or interest only exists during the person's lifetime and is not part of their estate.

Establishing and valuing granny flats

A granny flat right can be created in a number of ways. The value of a granny flat interest will generally be the amount paid (or assets transferred) in exchange for the interest.

Let's consider some examples:

1. Doreen transfers $80,000 to her daughter, Lynne, for the right to live in her home. The value of the granny flat interest is prima facie $80,000.
2. Max transfers $100,000 to his son, Tom, to pay for expenses to modify Tom's home and build a stand-alone granny flat in exchange for a lifetime right to live there. The value of the granny flat interest is $100,000.

3. Lucy pays $400,000 to her nephew and niece, Bryce and Wendy, to purchase a new home. She moves into this home with them with the right to permanent accommodation. The value of the granny flat interest will be $400,000.

4. Travis transfers title of his home to his daughter, Katie, and receives a lifetime right to continue living in that home. Katie and her family may or may not move in with Travis. Katie will pay stamp duty on the transfer and may commence to be subject to capital gains tax if the property does not become her principal residence. The value of the granny flat interest will be the market value of the home of $500,000.

If the client only transfers part of the title of their home to another person, a granny flat right has not been established. This is because the client still has legal title to the property. The transfer will be assessed under normal gifting rules and the client remains a homeowner, with their share of the home an exempt asset.

Where the granny flat needs to be valued differently

In some cases, the Social Security Act 1991 prescribes that a granny flat interest should be valued at a different amount to the amount paid. This is known as the 'reasonableness test'.

The reasonableness test could be used when a person transfers title to their home or pays for construction of the premises but at the same time transfers additional assets, such as cash. In this circumstance, we need to compare the value of the home or construction with the amount determined under the reasonableness test. The reasonable value of the granny flat interest (i.e. the amount not considered a deprived asset) will be the greater of the two amounts.

Under the reasonableness test, the value of the granny flat is calculated as follows:

Reasonable Value = Combined annual partnered Age Pension rate (on the date the granny flat interest was created) multiplied by an age based conversion factor (based on the age next birthday of the client or younger member of the couple, if relevant)

Determining whether the client is a homeowner

When a person has a granny flat interest, special rules apply to determine whether they are a homeowner or non-homeowner for social security income payments.

This is determined by comparing the 'entry contribution' to the 'extra allowable amount'.

The 'entry contribution' is determined as follows:

- If the client was not assessed under the reasonableness test, the entry contribution is the amount actually paid, or
- If the client was assessed under the reasonableness test, the entry contribution is the value of the granny flat interest, if assessed as paying more than the reasonableness test amount, or the amount actually paid, if assessed as paying less than the reasonableness test amount.

The 'extra allowable amount' is the difference between the Age Pension homeowner and non-homeowner asset value limits at a point in time. Based on current Centrelink thresholds, this is equal to $200,000.

The implication of the entry contribution for Centrelink homeowner status.

Entry contribution	Homeowner status	Asset test treatment entry contribution	Rent assistance
Less than or equal to extra allowable amount	Non-homeowner	Assessable asset	May be payable
More than extra allowable amount	Homeowner	Exempt asset	Not payable

Home Care Packages

Clients living in a granny flat arrangement may be eligible to access a Home Care Package regardless of how the granny flat interest was established. This offer assists them to live at 'home' for longer and may include:

- Transport for shopping and appointments
- Home maintenance or modifications
- Assistance with domestic jobs, such as cleaning and washing
- Assistance with personal care, such as washing and dressing

To be eligible, the client will need to be assessed by the Aged Care Assessment Team (ACAT). The amount the client pays for the Home Care Package is means tested and comprises a Basic Daily Fee (currently $9.97 per day), plus a potential income tested fee (up to $10,416 per annum for self-funded retirees).

Moving out of the granny flat and into aged care

Once a person moves into an aged care facility, they will generally become a non- homeowner at the time their granny flat interest ceases. Assuming the granny flat interest was in place for at least five years, the value of the granny flat interest will not be an assessable asset.

Placing a loved one in a granny flat and then into aged care just a few months later is a strategy that has been used to try to circumvent Centrelink asset assessment and minimise aged care fees. However, it will not work if the need for care could have been anticipated.

If a person moves out of the granny flat within the first five years of creating the interest and a move to aged care could have been expected at the time the granny flat interest commenced, the full amount transferred for the granny flat may be treated as a gift and subject to deprivation for five years (from the commencement of the granny flat interest).

This may increase the means tested care fee payable by increasing the asset and income components when calculating the Means Tested Amount (MTA). This rule exists to avoid people manipulating the rules and artificially creating a granny flat right to reduce assessable assets.

The deprivation rules do not apply if a person is temporarily absent from the home for up to 12 months. If the temporary leave is due to loss or damage to the home, this period may be extended for up to two years.

Importance of a legal agreement

The granny flat arrangement allowed by Centrelink is an excellent opportunity to provide solutions for elderly parents looking for a stable home and family support in their retirement.

A granny flat interest can be created even if nothing is in writing. However, it is recommended that a legal document be drawn up by a solicitor to have evidence and outline the terms of the arrangement. This can help to prevent problems in the future if one or both party's personal circumstances change. No matter how close a family may be, a falling out or disagreement can occur, leaving the child wanting the parent out and the parent seeking return of their money.

Therefore, there needs to be provision for what happens if things turn sour or the parent needs money for a bond to go into an aged care facility.

The agreement should:

- Confirm the client has security of tenure.

- State any responsibilities of the client, such as liability for upkeep of the property or payment of rent.

- Outline how the client will be compensated if the property owner cannot maintain the life interest.

Impact on estate planning

A client should review their estate plan when the granny flat right is established. The amount used to create the granny flat right may be a significant portion of the client's estate. This amount no longer forms part of the client's estate. The right only exists during their lifetime.

Upon the death of the client, any property or money handed over for the granny flat interest will not be distributed in accordance with their will. Therefore, it is a good idea to make sure wills and enduring powers of attorney are updated, so assets will be fairly distributed amongst the children.

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Oil price projections are no longer gushing

Rudi Filapek-Vandyck

It has taken this long, but many oil market observers are now succumbing to the realisation that the present global oil market dynamics are likely to keep a ceiling on the oil price above US$55 per barrel (bbl) and a bottom below US$45/bbl.

As long as OPEC and Russia remain disciplined, and no major supply disruptions or geopolitical tensions occur, these are the levels at which swing producers in the Permian basin in the USA either thrive or perish, adding more supply or less into a well-supplied global market.

Repetitive scenario for the oil price

It is not unthinkable for the global oil market to go through the same scenario over and again: oil price rises, US frackers add more supply; oil price weakens, the highest cost and most price sensitive producers retreat; oil price rises, those swing producers join in again.

As long as these dynamics remain in place, and demand stays within reach of supply with and without US marginal producers, it seems the current range can remain in place for a long time.

The first seven months of 2017 have seen oil priced below expectations. Research updates on the energy sector in July have led to lowered forecasts, resulting in reduced valuations and price targets. Predictably, this has weighed on share prices.

Consider, for example, that FNArena's consensus price target for Woodside (ASX:WPL) has fallen to near $30 from almost $33 in two months only. For Oil Search (ASX:OSH), the consensus target has fallen from $8 to $7.49. BHP has felt the impact too, with its consensus target falling to $27.45.

Another headwind from stronger A$

An interesting new dynamic for sector investors in Australia stems from the divergence in USD priced oil and the surging AUD/USD on the misguided belief the RBA will soon embark on a tightening course. As such, the stronger Aussie dollar has now become yet another valuation headwind for a sector whose main product sells in USD. On Credit Suisse's modelling, fair value for Woodside sunk to $17.50/share (not a typo), for Oil Search $4.15, for Santos (ASX:STO) $1.90 and for Origin Energy (ASX:ORG) $4.10.

Of course, these numbers are rubbery by nature, and nobody at this stage is expecting oil to remain steady at the current level, nor the Australian dollar to remain near 80 cents against the greenback. But, the broader issue here, argues Credit Suisse, is whether investors should now be paying closer attention to the currency and its possible impact on share price valuations. Credit Suisse thinks the answer is ‘yes’. Oil sector investors should be incorporating AUD/USD into their risk and valuation modelling, and accept it as another negative (‘valuation headwind’).

Sector threatened by long-term price projections

By far the largest threat to energy sector valuations is represented by long-term oil price projections used to make projections about cash flows, revenues and project returns. Short-term oil prices can swing heavily and they impact on share prices through short-term traders and algorithm robots, but large investors take their cue from longer-term projections and assumptions. If investors were to give up on the prospect of oil prices breaking out of the current range in the foreseeable future, this would have significant impact on valuations for energy producers today.

Worldwide, most sector analysts are working off a long-term oil price of US$65/bbl. In July, Citi decided to abandon that anchor and replace it with a long-term oil price forecast of US$55/bbl. Argue the analysts: signs of continuing productivity gains onshore USA have compressed the oil cost-curve.

Citi's research concludes the incentive price to meet future demand has now permanently reduced to US$40-60/bbl. Putting the new long-term price forecast through Citi's models causes valuations in Australia to deflate by between -8 to -23% while profit forecasts fall by between -12 to -50%.

One day before Citi released its valuations, JP Morgan/Ord Minnett had come to the same conclusion. Their new long-term oil price forecast is also US$55/bbl, down from US$60/bbl prior.

JP Morgan/Ord Minnett highlighted why these lower price projections are likely to have a major impact on the outlook, and thus valuation, of Woodside Petroleum:

"Sustained low oil prices have had the effect of not only lowering our estimated value for Woodside, but also potentially delaying or deferring the company's growth projects."

Prediction of moderate price recovery by 2020

To date, most teams of energy sector analysts continue to work off US$65/bbl longer term. At a recent seminar, leading industry consultant Wood Mackenzie reiterated its view of a moderate price recovery for oil remains on the agenda by 2020, when US$65/bbl should be back.

Shorter term, the second half of 2017 could see a bounce in the oil price, while consensus is converging around global over-supply in 2018. The major risk for investors in the sector does not come from marginal surprises in timing and volumes, or from daily volatility which makes perfect timing difficult, but from the fact that more analysts might join the conclusion that US$55/bbl is now likely the new anchor, long term.

Bottom line: crude oil prices remaining range-bound for a prolonged time significantly increases the risk profile for investment opportunities in the sector, with capitulation by financial analysts on the long-term price average representing a tangible threat. Investors should adjust their strategy and exposure accordingly.

Rudi Filapek-Vandyck is Editor of www.fnarena.com. *This article is general information and does not consider the needs of any individual.*

The investment bias against smaller companies

Tim Koroknay

Since the financial crisis ended, the risk/return relationship that underpins the accepted investment wisdom in Australian equities has been challenged. Median smaller company managers are showing lower levels of volatility and price falls in market pullbacks.

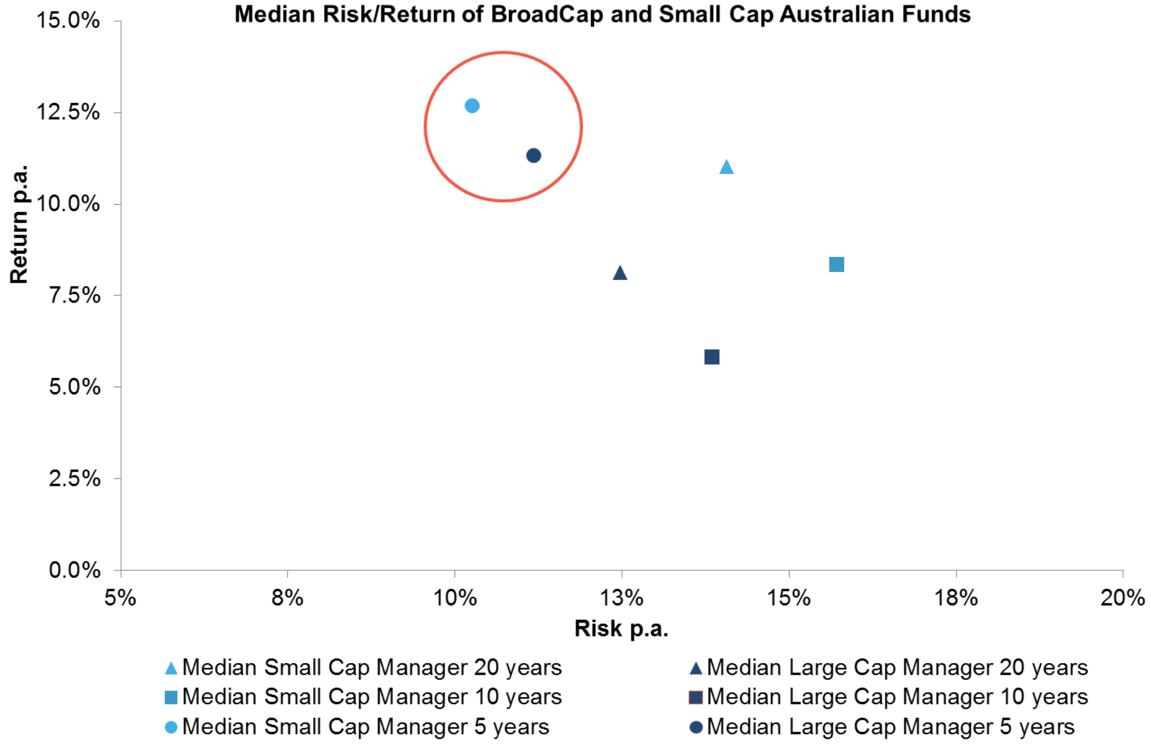
This article considers several explanations for the lower risk seen across smaller company managers and whether we could expect this to continue.

Exploring the risk and return of large and small cap median managers

To analyse the different risk/return characteristics of broad cap and small cap managers, we have used the monthly median Australian fund manager returns since 1990. Managers are split using the Morningstar classifications of Broad Cap or Small Cap from all the available retail funds in the Morningstar database. Using point in time monthly data removes survivorship bias, and all returns are recorded after fees.

Figure 1 below charts the risk/return characteristics of the broad cap manager compared to the smaller cap manager over multiple time periods. Over longer time periods (10-20 years), the traditional risk/return theory holds. However, over the shorter time period (5 years) the median small cap manager has experienced superior return at lower levels of risk.

Figure 1: Risk and return characteristics of Australian equity funds



Source: Morningstar, Fidante Partners

Have the risks in larger companies today changed?

Whilst volatility should retreat after the generational losses seen in 2007-2009, the volatility of larger company manager portfolios has not reduced at the same pace as smaller company manager portfolios.

Economic sensitivity is generally considered to be higher in smaller companies. This is a reason why these stocks will at times underperform when economic conditions deteriorate. However, analysts may be underestimating the impact on the large end of the Australian stock market from low economic growth due to the sector concentration and the increasing use of new ETF structures that are impacting how large-cap equities are held and traded.

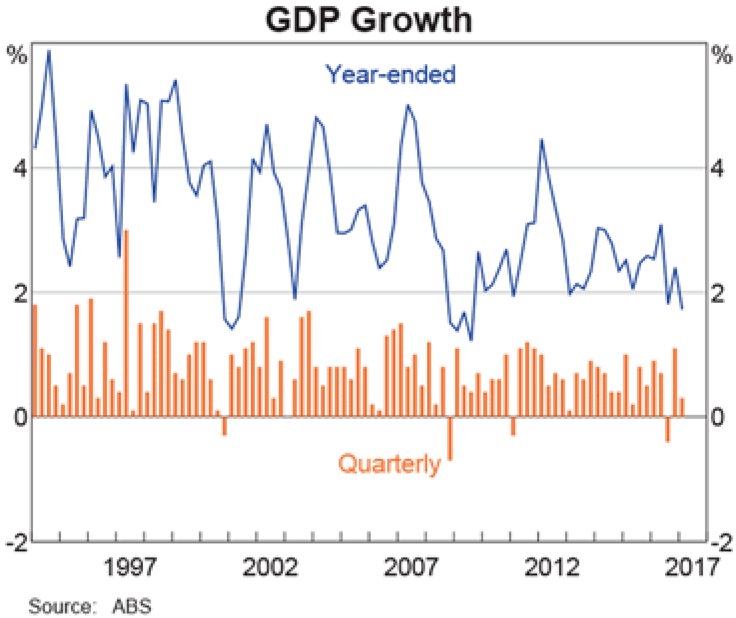
Large companies need economic growth

The long-term growth potential of the stock market is dependent on the level of nominal gross domestic product (GDP). With consumption growth weakened, investments curtailed and the government attempting fiscal prudence, growth has been restrained.

Larger companies especially will more likely proxy and mimic the growth of the broader economy. Larger companies have collectively benefitted on the one hand from falling interest rates and benign cost inflation, however, these benefits are symptoms of a lacklustre growth environment. As proxies for the domestic economy, the aggregate of the larger company market has struggled to achieve strong real organic growth.

For smaller companies, the problem of growth is a different one. Growth rates are more commonly defined by the operational and strategic success of the business. That is not to say that many smaller companies have themselves not had their own challenges, but there generally is more organic growth potential.

Figure 2: Australian GDP

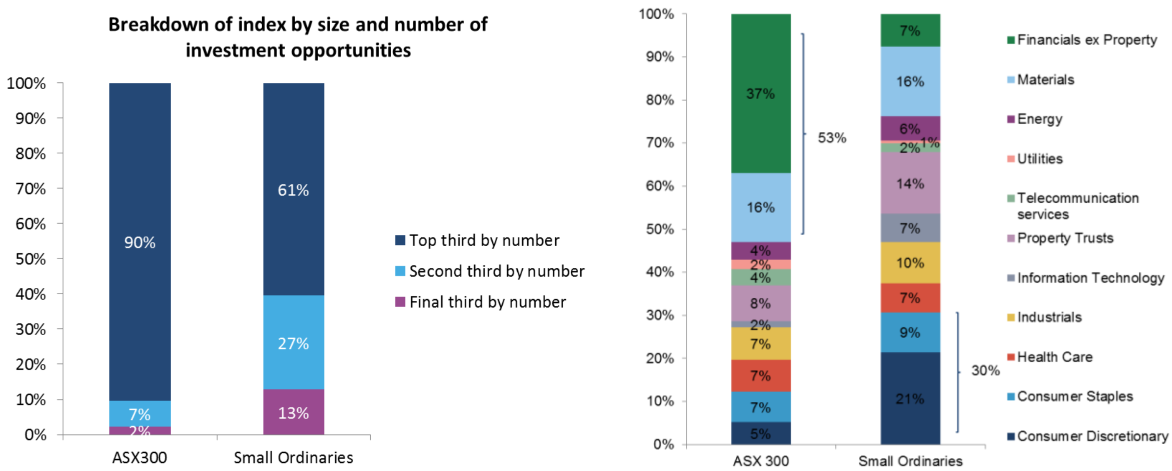


The smaller company market is structurally diversified

Australian funds management is dominated by a handful of bank financials and resource names comprising over 50% of the S&P/ASX300 index. Whilst an active manager can produce a well-diversified portfolio in Australian larger companies, it necessitates the manager hold a very different looking portfolio to the index.

The concept of index concentration in smaller companies is less, if non-existent, without the stock concentration and sector concentration, as shown in Figure 3. An obvious point maybe, but the smaller company universe has a pressure valve, where concentration risk is reduced as stocks move up and out of the index. Whilst a bubble may have its origins in the smaller company universe, it is likely in the large-cap index where the bubble will take hold and do the most damage.

Figure 3: Composition of Australian broad cap and small cap market indexes as at 30 June 2017

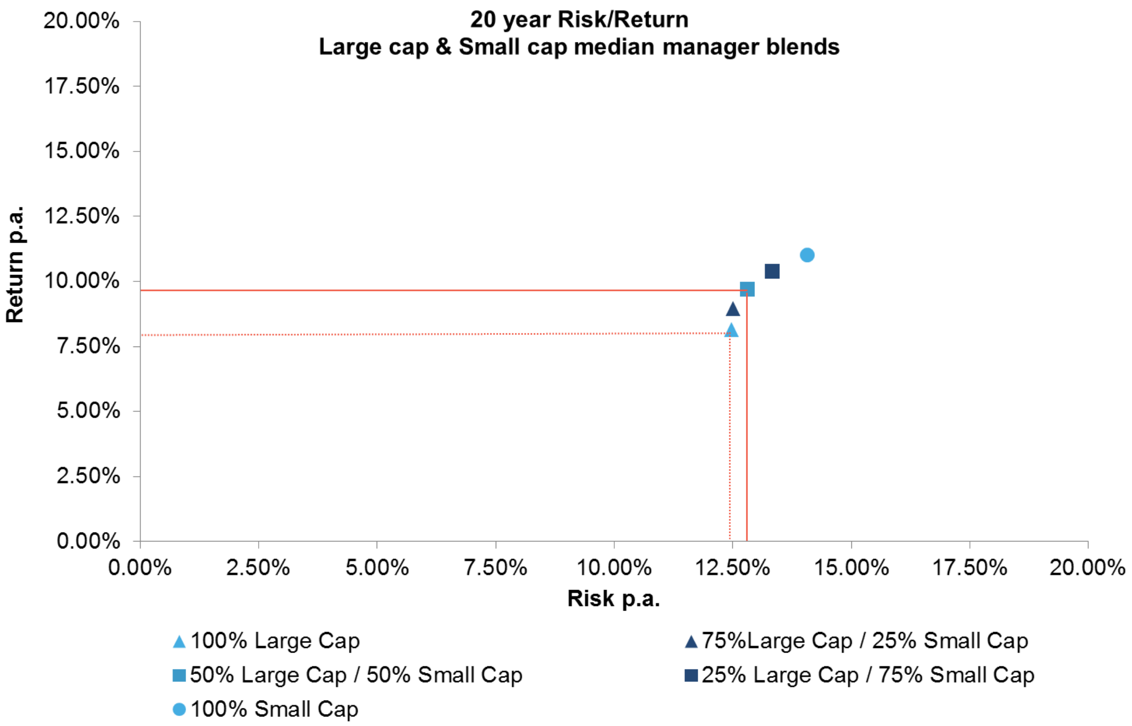


In addition, as investors use of ETFs, thematic factor buckets and other pseudo market proxy strategies increase, a lot of stock trading is largely unrelated to the condition of the underlying instruments. The holding period for many stocks is now measured in days and weeks, which is inconsistent with real investing. Liquidity requirements of ETF structures and the belief in the market proxy disproportionally impacts larger companies.

Role in portfolio construction

The analysis of risk-adjusted returns (as measured by the Sharpe Ratio, which is approximately return divided by risk as measured by volatility) of blended small and broad cap median managers shows over the last 20 years, the most efficient portfolio is one which includes 100% smaller companies. This is a theoretical exercise and in practice behavioural biases and preferences of an individual will dictate if an investor can tolerate increased volatility. However, the chart below shows it is possible to incrementally allocate to small caps (below 50%) without meaningfully increasing the overall risk of a blended portfolio.

Figure 4: Portfolio construction: Blending large and small company managers



Source: Morningstar, Fidante Partners

For example, in Figure 4, the blue triangle with the lowest risk and return is 100% allocation to large companies. The blue square is 50% large and 50% small companies, with a significantly larger increase in returns than risk, and hence an increase in the Sharpe Ratio.

Over the last 20 years, whilst little has changed in the smaller company market, a lot has changed in the larger company market. The combination of low economic growth, sectoral concentration and the size of the transient short-term trading may require the investor to carefully consider their exposure to smaller companies versus larger companies.

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What happened in the last Korean War?

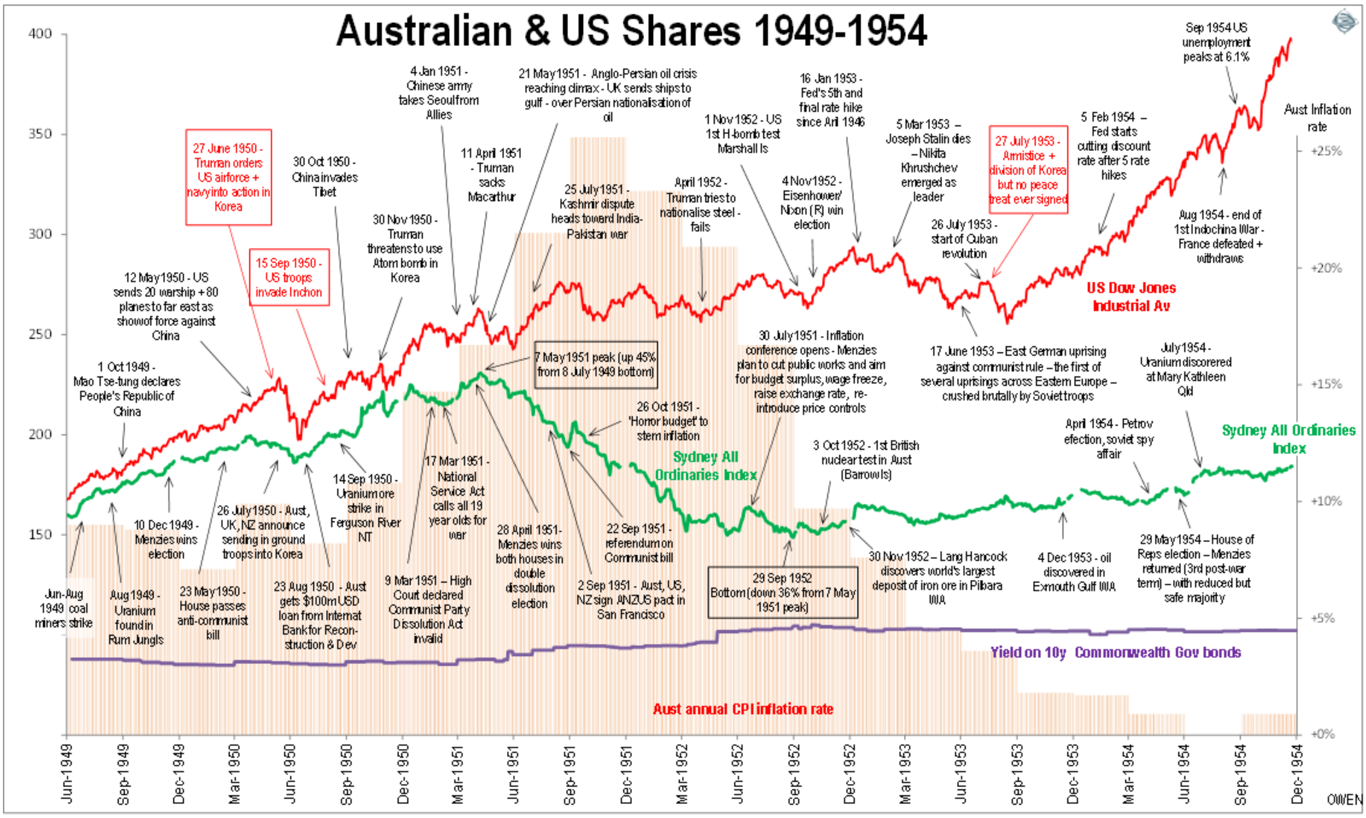
Ashley Owen

As the drums of war beat ever louder in Korea, many people have asked me about what happened to share prices during the last Korean War. It is a fascinating story as the 1951-52 stock market fall in Australia was the only instance of a major sell-off here that was not accompanied by a fall in the US market. At all other times, we follow the US market up and down.

Australian and US markets diverge

Share prices surged during the early stages of the War but then the Australian market fell by 36% from 7 May 1951 to 29 September 1952 and then rose only very weakly in 1953-54. In contrast, the US market remained strong throughout the War, pausing only briefly at the end of the war in 1953 before surging strongly again in 1954.

Here is a daily chart of the Sydney All Ordinaries Index (green) and the US Dow Jones (red) from the middle of 1949 to the end of 1954.



When the Korean War started it was feared it may start World War III but it ended in a stalemate in mid-1953 with Korea divided in two, as it remains today. The prelude was Mao Zedong declaring the People's Republic of China on 1 October 1949, and the US sending the first war ships and planes as a show of force against China in May 1950, before sending in troops in September. Australia supported the US by also sending in troops.

Other global events

In addition, there were a number of other cold war skirmishes around the world at the time, with the Soviets brutally suppressing uprisings in Eastern Europe, the French losing the first Indochina war, the Anglo-Persian dispute in May 1951, the Kashmir dispute in July 1951 that threatened to reignite the India-Pakistan war, and the start of the Cuban revolution.

The US was testing atom bombs and H-bombs in the Pacific while Australia was allowing the UK to test nuclear bombs here on our flora, fauna and aboriginal population. The threat of communism drove domestic politics in Australia and the US. In Australia, Chifley was trying but failing to nationalise the banks, and was defeated by Menzies. In the US, Truman was trying and also failing to nationalise the steel industry, replaced by Eisenhower. In Australia, we had the Petrov defection and the Soviet espionage affair, and the US had McCarthyist witch-hunts for suspected communists. Everywhere there were union agitation and strikes that were quickly branded as communist inspired.

Why was the Australian market so weak?

Why did Australian share prices fall while US shares powered through it all? The answer is inflation (shown in the chart as orange bars) and the War was only partly to blame. Inflation in Australia was already running at 9% in 1949 and 1950 but shot up quickly to 25% by the end of 1951. It was partly due to the surge in post-

WW2 demand as war-time price controls were lifted, but it was made much worse by our centralised wage fixing system that increased wages as prices rose, creating an inflationary spiral. The 30% devaluation of the Australian pound in 1949 (when Sterling devalued and we stuck with Sterling not the US dollar) did not help.

Another major factor was the trebling of the price of wool (our main export earner) as the US bought up all of our wool (and many other commodities) in advance for the War effort, leading to a surge in export revenues. The banks were also to blame, ignoring the regulator's various attempts to rein in their profligate post-war lending boom. Runaway inflation was only brought back below 5% in 1953 by a combination of savage sales tax hikes, tariff hikes, spending cuts and lending controls.

The differences between Australia and the US were mainly in our domestic policy responses to inflation, not the War itself. The US also had an inflation spike in 1951 but it peaked at 9% and fell to very low levels again (below 2%) by 1952 as the Fed raised interest rates. The Korean War hyperinflation episode in Australia and the deflationary recession that followed in 1953 provided much of the impetus that led to the formation of the Reserve Bank and the short-term money market in 1959 that would allow credit and economic activity to be controlled via short-term interest rates as it was in the US.

What might the future hold?

First, war is usually a disaster for investors on the losing side – their assets are generally confiscated, their debts are repudiated, companies are expropriated and ownership rights in shares, bonds and property are confiscated. Examples include: the Paris Bourse after the Waterloo loss, Confederate bonds and shares after the American Civil War, St Petersburg stock market after the Russian Revolution, the Shanghai stock market after the Chinese Revolution, Berlin and Tokyo shares after WW2, Saigon shares after victory by North Vietnam, etc. The victors take everything and impose their own new laws.

So, if you believe the next Korean War will lead to Australia being invaded, occupied and subsumed by China with all privately-owned assets confiscated (as Mao Zedong did when he won the revolutionary war in China in 1949) then you should probably sell all your assets while there is still a free market for them. But the chance of Australia being invaded and absorbed into a greater Communist China any time soon is approximately zero. Even when China absorbed Hong Kong in 1997 and Macau in 1999, private commercial interests were retained and indeed flourished.

Otherwise, wars and rapid military build-ups are generally good for business. Commodities prices skyrocket because demand suddenly accelerates as the government buys up everything for the war effort. Governments often control prices (and perhaps share prices) to prevent excess profiteering. Even in Australia's darkest year in WW2, 1942, with Japanese bombs raining down across Northern Australia after the fall of Singapore and with Sydney Harbour bombed by Japanese subs, Australian shares returned 18%, or a healthy 9% after inflation.

Since the GFC, every central banker in the world has been dreaming about how to revive inflation, and they are fully aware that military conflict is the only sure solution. As military build-ups escalate in China, the US, Japan and Russia, central bankers are likely to allow inflation to rise for a while before taking steps too little and too late to bring it back under control.

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