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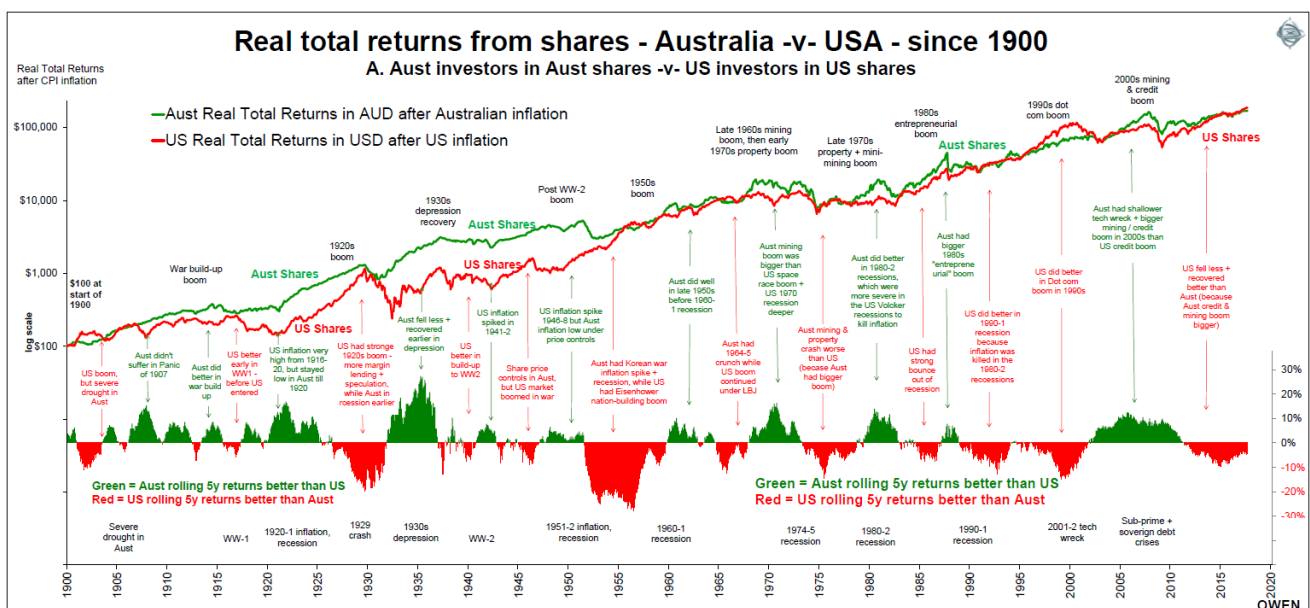
Why US will fall more than Australia in next bust

Ashley Owen

Australia and the United States are similar in many ways. Both are former British colonies with relatively stable democracies, both have strong political, administrative, judicial and educational institutions, both have strong institutional protection of property rights and the rule of law, both have favourable demographics with relatively high immigration rates, and both have withstood invasions from foreigners (although indigenous natives in both countries would argue with this).

Remarkable long-term return similarities

The stock markets in both countries have generated the same level of real total returns (including dividends, after inflation). Both have averaged 6.5% per year above inflation since 1900. US shares have returned 1% pa lower total returns, but has had 1% lower inflation, so the real total returns after inflation have been the same. The mix of capital growth and dividends is also different, with US shares paying lower dividends but enjoying higher capital growth as a result.



The chart shows real total return series for Australian shares (green line) and American shares (red) since 1900. Although both markets have generated the same returns overall and have broadly followed same boom and bust cycles, they take turns to have the bigger boom and then the bigger bust. The lower section shows the rolling 5-year difference between returns from the two markets. Green positive bars are when Australian shares are beating American shares, and red negative bars are when American shares are winning. The red negative bars in the lower right show that US shares are winning in the current cycle.

Boom and bust cycles

The main reason US shares have beaten Australian shares in recent years is that the US had a milder 2003-2007 boom than we did, and so it had a milder sell-off (even though the trigger for the GFC was the US housing market and US bank shenanigans). Australia also had a credit bubble in 2003-2007 but we had a China commodities boom as well. We are still recovering from our bigger bust while US shares are leading the next boom, which will be known as the great 2010s smart phone boom.

This tit-for-tat game has been going on for more than a century. The US had a bigger 1920s boom and therefore a bigger 1929 crash and early 1930s bust. Australia had a bigger 1960s mining/aerospace boom and early 1970s property boom and we had a bigger 1973-4 bust. Australia had a bigger mid-1980s entrepreneurial boom and so had further to fall in the 1987 crash. The US had a bigger late-1990s 'dot com' boom and so had further to all in the 2001-2 'tech wreck' bust.

The market with the bigger boom falls further in the bust that follows. The US is leading the current boom and US shares are more over-priced than Australian shares, so US shares will have further to fall in the next bust.

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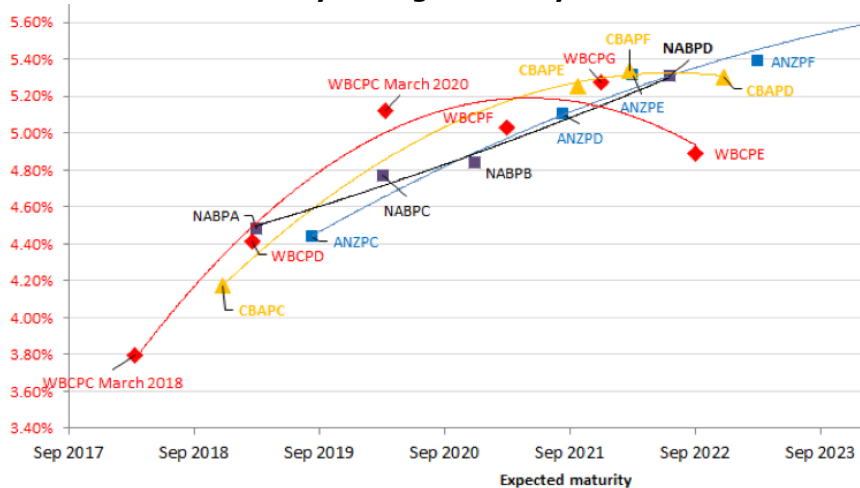
Understanding the extra return from hybrids

Sam Wylie

Avoiding complex investments is a good guiding principle for most investors. Bank hybrid notes are an exception to that rule. They are complex relative to plain vanilla shares and bonds, but their reward-to-risk ratio, and their defensive qualities are attractive. Investors should consider bank hybrids despite their complexity.

It can help to understand hybrid notes as a combination of low risk bonds plus embedded put options. It is the embedding of 'deep out-of-the-money puts' that make hybrids especially appealing to affluent investors. By way of an example, modelling of the value of these puts shows that investors in the CBAPD hybrid notes are getting a yield of about 1.30% per annum more than is justified by the risk.

Yield vs time to maturity for Big 4 bank hybrids



Source: [Michael Saba](#) of Evans and Partners, leading hybrids broker.

Australia's four big banks each have several issues of hybrid notes which trade on the ASX. The graph above shows how the yield on these securities increases with their time to maturity. Comparable hybrid note issues by the banks are CBAPD, ANZPE, WBCPE and NABPD, which all have similar maturity dates.

CBAPD notes bought at today's price of \$97.10 will yield a total return of 5.35% per year to maturity (assuming they are called) at the end of 2022.

Why CBAPD notes and not other hybrid note issues?

I like CBAPDs because:

1. CBAPDs are by far the largest issue of hybrids in the market; with the largest turnover, which makes them more liquid and more rationally priced than other issues. The \$3 billion of CBAPDs make up about 7% of the total \$42 billion of bank and insurer hybrids listed on the ASX.
2. CBA hybrids are attractive relative to CBA shares in risk-versus-return terms. CBA shares are far more risky than CBAPD hybrid notes, but the grossed-up yield on CBA shares (7.8%) is only 2.4% more than the yield on CBAPD hybrid notes (5.4%). The same yield gap between the shares and the hybrid notes of the other big banks is over 3%, which suggests that the hybrid notes versus shares comparison is less favourable to hybrid notes in those banks.

The mandatory conversion provision in CBAPD

If Australia suffered a banking crisis in which many bank loans were defaulted on, then the shareholder equity of Australia's banks would be rapidly depleted. The equity of any firm is the buffer that allows it to suffer losses without going bankrupt. In a banking crisis banks would need to replenish their equity, and this is where bank hybrids come in. In a crisis, the banking regulator APRA can force the conversion of bank hybrids notes into shareholder equity by insisting that banks invoke the conversion provisions in their hybrid notes.

In a mandatory (APRA forced) conversion, the holders of CBAPDs would hand over their notes. In exchange, they would receive either:

1. 6.4 shares, if the share price was less than \$15.90 at the time of conversion or
2. \$101 worth of shares if the share price was more than \$15.90.

The slightly rounded numbers were fixed at the time CBAPD notes were first issued, based on the share price at that time.

Assuming mandatory conversion will only occur if the share price is less than say \$15.90, mandatory conversion provision are equivalent to CBA having the option to 'put' 6.4 CBA shares to the CBAPD note holders to discharge CBA's \$100 liability to the note holder.

Or, equally, \$15.90 of liability is discharged for every share put to the note holder by CBA, and \$15.90 is what CBA receives for every put option exercised, being the 'exercise price' of the puts.

If in a crisis the CBA share price fell to \$10, then the put options would be \$5.90 'in-the-money' for CBA because CBA could hand over a share worth only \$10 and discharge a liability of \$15.90.

CBA's share price today is not \$10, but at time of writing, \$78.30. So, the puts embedded in CBAPDs are currently \$78.30 - \$15.90 = \$62.40 'out-of-the-money'. They are 'deep' OTM puts.

Compensation investors receive for selling the embedded puts

If CBA exercised its put options when the share price is \$10, then CBAPD note holders would suffer a capital loss of $6.4 \times (\$15.90 - \$10) = \$37.75$. So, the main risk that hybrid note holders face is the risk that the put options that are embedded in the notes will be exercised when the options are in-the-money. We can estimate how much compensation CBAPD note holders receive for bearing this risk, and whether that compensation is large compared to compensation for bearing CBA share price risk.

How much would the CBAPDs be worth if investors were certain that the CBA share price would never fall below \$15.90. The notes would then be risk free. The price of the notes would rise to \$111.70 to give a yield of 2.85%, which is 0.40% (40 basis points or bps) above the yield on equivalent Australian Government bonds. The extra 40 bps is for illiquidity of bank hybrids compared to Government bonds, guaranteed by the Federal Government.

But, hybrid notes are not risk free, because of the embedded put options. And, their price is not \$111.70, but instead, \$97.10. The discount of $\$111.70 - \$97.10 = \$14.60$ is the price that new CBAPD investors are being paid for writing (selling) the 6.4 embedded put options. In effect CBAPD note holders are buyers of a risk-free note from CBA (for \$111.70) and sellers of put options on CBA shares (for \$14.60).

Is the compensation for selling the puts high relative to their risk?

Option pricing theory using the Binomial Method, the model developed by Cox, Ross and Rubenstein estimates the value of the put option being \$103.55, which equates to a yield of 4.04%. In the calculation, volatility of 40% is included as deep out-of-the-money (OTM) puts should be valued with much higher probabilities of extreme changes in prices. Comparing the yield of 4.04% with the actual yield of 5.35% on CBAPDs implies that buyers of CBAPDs at current prices are getting about 130 basis points more yield than is justified by the risk that they face.

Other risks on CBAPD

The risk of loss of capital in the mandatory conversion process is one risk, but other risks include that coupons are cut to zero (which for hybrid notes is not considered a default, and dividends would have to be cut to zero first). But, with a deep banking crisis mandatory conversion would occur anyway, although if this was not the case the results above (the 1.30% figure) only changes by a few basis points. There is also a risk that the notes will not be called.

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Watch out for the buy/sell spread on funds

Rosemary Steinfort

The management fee on a managed fund is often the focus of analysis especially in the context of low-cost investing. But, for an investor entering and exiting funds, especially in a short period of time, the spread between the buying and selling price is equally important but often ignored.

There may be significant differences between the buy and sell prices, and the impact on performance is more notable in a low return environment. The costs of transacting in the fund are taken into account when the buying and selling prices are calculated and investors wear the cost.

Calculation of spreads

All investing comes with a cost, as both on-market and off-market transactions have different buying and selling prices, including direct share investing. In the case of funds, the difference between the buying and selling price is called the spread, often expressed as a percentage of the fund's net asset value (NAV). The manager of a managed fund covers the costs of trading and other transaction costs such as government taxes, brokerage and bank fees by setting different prices for entering or exiting the fund.

A fund may set the buy or sell prices at 0.25% either side of the NAV. This gives a 0.5% price spread, a material impact if an investor enters and exits a fund in a short period.

The price spread ensures investors are treated equally so that new investors joining the fund or those existing investors leaving the fund contribute towards the transaction costs. Investors that stay invested are not subjected to the financial cost of other investors' transactions. In fact, investors staying in a fund long term usually benefit from people coming and going, because applications and redemptions in the same period may net out but the buy/sell spread is still paid and goes into the fund.

The spreads can change without notice due to changes in transaction costs, which can include the impact of adverse market conditions or improving market conditions. Vanguard changed its spreads in 2013, with the following reason: "...reductions to buy and sell spreads across 21 wholesale and retail fund offerings reflecting changing conditions in various markets, greater liquidity in the domestic bond market, reduced volatility in global fixed income markets and improved efficiencies in trade execution".

Common transactions in a fund that attract a spread

All transactions into and out of a fund attract one side of the spread, such as:

Transaction type	Example	Unit price type
Money going in to your account	Contribution, rollover, transfer in to an investment option	Buy price
Money taken out of your account	Withdrawals, pension payments, payment of fees	Sell price
Switching investment options	Move from one investment option; and move to another investment option	Sell price Buy price

Source: REST Super Product Disclosure Statement

Initial contribution to fund attracting a spread

Transaction type	Calculation
Initial purchase of units: \$1,000 of units at buy price of \$1.0514 per unit	$\$1,000 \div \$1.0514 = 951.1128 \text{ units}$
Balance: 951.1128 units at sell price of \$1.0500 per unit	$951.1128 \text{ units} \times \$1.0500 = \$998.67$
Buy-sell spread (transaction cost): initial investment less current balance	$\$1,000 - \$998.67 = \$1.33$

Switching between investment options attracting spreads

Transaction type	Calculation
Sell 25,000 units at sell price of \$1.0500	$25,000 \text{ units} \times \$1.0500 = \$26,250.00$
Switch to another investment option: Buy \$26,250 at buy price of \$2.6624 per unit	$\$26,250 \div \$2.6624 = 9,859.52 \text{ units}$
Balance after switch: 9,859.52 units at sell price of \$2.6600 per unit	$9,859.52 \text{ units} \times \$2.6600 = \$26,226.32$
Buy-sell spread (transaction cost): initial account balance prior to switch less account balance after switch	$\$26,250 - \$26,226.32 = \$23.68$

Source: REST Super Product Disclosure Statement

Spreads can vary for the same asset class

According to the ASX's mFunds website, of the 176 managed funds available, the buy/sell spread can range from 0% to 2.2%. The spread is wider for funds investing in Asian and Emerging Markets and Australian Small Caps, while Fixed Interest funds have lower spreads. Some funds may invest in the same market such as Australian Equity but the spreads can vary, in this case from 0.33% up to 1.72% with a weighted average spread of 0.55%. The differences are likely to be due to factors such as how actively the fund trades, the number of stocks held, and the benchmark (small caps usually have wider spreads).

While management fees are quoted in per annum terms, such that a 1.2% fee is 0.1% a month, the spread is paid on entry and exit. If a 0.5% spread is paid within say three months, that equates to 2% per annum. For investors switching over short periods, the spread may cost more than the management fee.

ETF spreads are usually tighter

Exchange Traded Funds (ETFs) generally have tighter spreads compared with unlisted managed funds. The buy/sell spreads for ETFs are not set by the product provider (such as Vanguard or BetaShares) or even by individual market makers that create them and quote them. The spreads depend on the competition between market makers: if spreads are too wide, the market maker will lose business to other market makers.

An example of the difference in spreads between ETFs and unlisted funds is the unlisted managed fund Vanguard Australian Share Index Fund (for retail investors). It has a buy/sell spread of 0.16%, while Vanguard Australian Share Index ETF (ASX: VAS) usually has a spread of around 0.06%. But spreads on ETFs are not static and can widen during the trading day. This can happen especially at the open and close of the market due to volatility as market participants (market makers or authorised participants) are more actively creating and redeeming the units on behalf of the ETF provider.

The size of ETF spreads may also be impacted by the liquidity of the underlying individual securities that make up the ETF. ETFs that invest predominantly in large caps will most likely have tighter spreads than ETFs that invest in small caps or more obscure illiquid securities. The spread difference can be dependent on the ease with which new units can be created or redeemed by market makers.

Check the buy/sell prices

Costs including management fees and transaction fees are a major factor in a fund's net investment performance. Transaction costs directly impact investors up front by paying for the fund's cost of transacting.

Of course, there are buying and selling costs such as brokerage involved in directly investing in shares, and it may be a similar cost if the buy/sell spread on a managed fund has been set realistically. Nobody avoids transaction costs as they are a cost of investing regardless of the manner of investment.

Beating the market is difficult, and outperforming over the longer term can be made harder by higher costs from wider spreads.

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The unreliability of inflation forecasting

Phil Hofflin

We are at a confluence of deflationary and inflationary forces. The deflationary forces of debt overhang and demography are considerable. The last 20 years in Japan illustrates that not even expansionary monetary policy can necessarily solve these problems. Yet, against that, we are in the midst of perhaps one of the greatest peacetime expansionary monetary policy experiments. This is applying significant inflationary forces to the economic environment.

When two such strong, opposing forces exist simultaneously, the net outcome is clearly uncertain but some observations can be made:

1. **Inflationary policies** (the monetising of deficit) are popular and austerity is unpopular. In fact, monetised deficit spending is the ultimate politician's free lunch with the largesse bestowed upon voters without the need for unpopular taxes or increases in debt.
2. **Deflation** is not an acceptable outcome for monetary authorities. As the former US Fed Chair Ben Bernanke explained in his famous 2002 'helicopter' speech, the Fed has the ability to prevent deflation, given that they have unlimited control over the money supply. Inflation is the only way indebted governments will be able to meet their obligations. This dynamic includes Australia, where government debt levels (albeit from relatively low levels) continue to rise and both major political parties have appeared to abandon serious fiscal discipline in the short-term.

These arguments imply that the final outcome of this global debt cycle should be inflationary, but it does not reveal the potential timing of this scenario. Inflation is not anticipated but prudent investors should prepare for a range of possible outcomes and interest rate scenarios.

Does inflation matter?

What would inflation mean for the Australian economy and the equity market? To answer, it helps to consider the starting point today:

Australia (as at 30 June)	
Unemployment Rate	5.7%
Equities	Pre-tax earnings yield of 7.5%
Bonds	10 Year pre-tax yield of 2.35%
Residential Property	Ungeared pre-tax yield of 2.3%*

Source: UBS, Goldman Sachs, Lazard Asset Management Pacific Co. *as at 31 March 2017.

Most of the world, including Australia, has negative real policy interest rates (cash rate minus inflation) and even more negative policy rates if considered in light of central bank inflation targets. Thus, if economic conditions were to 'normalise', we would experience rate rises, even without any rise in inflation. The bias is clearly on the side of rates rising from current levels.

The second observation relates to the valuations of the major asset classes. Which assets are priced on negative real spot interest rates and which ones are not?

We view equities as being on the expensive side of fair value, but not dramatically so. The pre-tax earnings yield of approximately 7.5% for the S&P/ASX200 index, as at 30 June 2017 is in-line with the average over the last 20 years.

In contrast, bonds, by definition are priced on the current spot rates, with bonds yielding around 2.35%, based on the Australian Government 10-year bond yield as at 30 June 2017.

From our assessment, Australian residential property, also priced on current spot, appears to be overvalued and has a pre-tax yield of around 2.3% according to Residex Data, as at 31 March 2017. It is clear that there are signs of speculation, including very high investor participation, and widespread interest-only borrowing in this market. The price-to-income multiple in Sydney now stands slightly above that of Tokyo in late 1989 just before the property bubble burst.

Four inflation scenarios possible

For Australia, the size of the residential property market (\$7.5 trillion) and its dominance in household balance sheets make it a critical factor in assessing possible outcomes from a rise in inflation.

One would normally consider four possible growth and inflation scenarios:

- **Stagflation** – low growth, high inflation
- **Japanese experience** – low growth, low inflation
- **It's all OK** – good growth, low inflation
- **QE wins** – good growth, high inflation.

A rise in inflation and an associated rise in interest rates would most likely result in a significant price correction within the Australian residential property market. At a cash rate of only 2.5% (up from the current level of 1.5%) for example, households would be devoting about as much to mortgage payments as they did in the late 1980s when variable mortgage rates reached the high teens. A rise of the cash rate to 5%, which is a number broadly consistent with a 2.5% inflation target and nominal growth of about 2.5%, could lead to potential widespread mortgage defaults.

It is likely that a rise in inflation may be followed by a recession and a return to very low inflation or deflation. Australia's high household debt levels make the economy vulnerable to high inflation, which should be a serious concern for investors.

Potential impact on Australian equities

An inflationary environment would mean different things for different areas of the economy, especially when current starting prices for sectors are taken into account.

Assuming a local rise in inflation and potential recession, the biggest risk in the S&P/ASX Index appears to be in the banks and domestic cyclicals. Both industries are heavily exposed to high consumer debt levels. We believe that the biggest beneficiaries would be global exporters, who would theoretically become more competitive from a lower exchange rate and reduced wage pressures in a recession. It should be stressed that not every company in these broad groups would be affected to the same degree, as each company is different and importantly is trading on a different valuation. Security selection will remain critical, both in terms of sectors and the companies within these sectors.

High inflation: potential winners and losers

Strong Positive	Positive	Neutral	Negative	Large Negative
Exporters	Global Industrials	Non-Bank Financials, Domestic Defensives	A-REITs & Infrastructure	Domestic Cyclicals, Banks

Of course, if the entire world experienced inflation, benefits to exporters would be eliminated. Yet given that Australia did not fully participate in the GFC and has much higher consumer debt levels, Australia would likely experience larger deflationary pressures. Thus, it is likely that the Australian dollar would be weak, partially offsetting the adverse impacts for global businesses and assisting exporters.

In an inflationary environment, we expect the Australian stock market to be negatively impacted, but given that it is a real asset class with a fairly reasonable starting valuation, at least in the medium term it may be a relatively better option compared with nominal bonds and residential property. While the bank and cyclical sectors together account for approximately 40% of the market, this is not a binding constraint on an active manager of equities.

Plan for inflation

"There are two kinds of forecasters: those who don't know, and those who don't know they don't know." John Kenneth Galbraith

Macroeconomic forecasts are notoriously unreliable, and what we have known about inflation has been upended in the last 20 years. So, we make no predictions about the timing of a return to inflation. Yet we still believe equity investors should consider inflation risk within an asset allocation framework. Our view is that inflation is a more a likely outcome than deflation over the long term.

Dr Phil Hofflin is Senior Analyst and Portfolio Manager at [Lazard Asset Management](#). This content represents the views of the author. Lazard is committed to giving its investment professionals the autonomy to develop their own investment views, which may not be the same throughout the firm.

Investors face new choices in listed vehicles

Andrew Lockhart

The market capitalisation of listed investment companies (LICs) and listed investment trusts (LITs) on the ASX reached almost \$35 billion in July 2017, up 12% from the previous year. What is driving the interest and what are the fundamental differences between these structures?

LICs and LITs popularity boost

While LICs have traded on the ASX for nearly 100 years, it is only relatively recently that a wide range of investors have taken advantage of their benefits, spurred on by regulatory changes and market conditions.

One of the key factors driving the increased interest was the introduction of the Future of Financial Advice (FoFA) legislation in 2013. FoFA abolished the generous upfront, trail and soft commission structures that had, until then, been enjoyed by advisers who recommended their clients into managed fund products. This directly resulted in an uplift in appetite from investment managers, financial advisers and investors in using LICs.

The number of LICs listed on the ASX now exceeds 100, double that of five years ago. While many people are familiar with LICs, LITs are less well known and less common in the Australian market.

So, what is the difference between LICs and LITs and what does it mean for investors?

LICs and LITs give exposure to a broad range of assets in one transaction. Both are traded on the ASX, which is appealing to a lot of self-directed and SMSF trustees.

Unlike a managed fund, however, their assets are held in a closed pool, which means they usually don't issue new shares or cancel existing shares as investors join or leave. If investors want to exit, they have to sell their shares (or units) on the stock exchange. They can't be redeemed.

Differences between LITs and LICs

The biggest difference between LICs and LITs lies in the way they are structured. A LIC is a company, which pays dividends to investors, whereas LITs are incorporated as trusts and must pay out any surplus income to investors in the form of distributions.

Some of the fundamental differences:

Tax transparency

A LIC treats the dividends from underlying investments and capital gains as income on its profit and loss statement. The LIC then deducts operating costs to derive a profit before tax figure. This is then taxed at the company rate before dividends are paid.

By contrast, a LIT more closely represents an unlisted managed fund in that all net income and realised capital gains must be distributed on a pre-tax basis, and the end investor pays any taxation.

Capital gains tax treatment

A major advantage of the way LITs are taxed is most individual investors will be eligible for discounted capital gains tax concessions applicable to investments held for more than 12 months.

Corporate entities are generally not eligible for this discount, although some LICs may qualify for a concession from the Australian Tax Office to pass on this benefit to shareholders.

Ability to pass through income can lead to predictable returns

A LIT may also provide the manager with more flexibility in paying distributions, allowing them to pay out more than the underlying income levels, through a return of capital. This can be useful when the manager wants to pay out a set portion of the fund each year, to give investors a predictable income stream.

By comparison, a LIC is limited by its ability to pay dividends, requiring the accumulation of retained profits before a dividend can be paid.

With an ageing demographic of investors who will be increasingly focused on income, it is likely that more LITs will come to the market as more investors grow to understand these products and realise their advantages.

Whether investors choose to invest in a LIC or a LIT, or both, it is highly likely the growth of the market is set to continue.

Andrew Lockhart is a Managing Partner at [Metrics Credit Partners](#) (MCP), an Australian debt-specialist fund manager with significant direct lending expertise in the Australian corporate loan market with more than \$2 billion of assets under management. MCP is offering investors exposure to the corporate loan market through the MCP Master Income Trust, which will list on the ASX in the third quarter of 2017. This article is general information and does not consider the circumstances of any investor.

Managed accounts enter the mainstream

Matt Heine

Over the past two years, as a result of changing global consumer and economic trends, investor use of managed accounts has grown exponentially with increasingly mainstream adoption. In 2016, Morgan Stanley estimated funds under administration (FUA) in managed accounts in Australia would reach \$60 billion by 2020.

A managed account provides consumers access to a range of professionally-managed multi-asset investment models which can be tailored for the individual investor. Investments within a managed account can typically be combined or co-mingled with other assets held by investors and reported on as part of a broader portfolio.

Often compared to managed funds, where money is pooled with other investors, managed accounts differ in a vital way. Investors hold the underlying assets in their own accounts, which gives them greater control, transparency and flexibility over those assets.

Technology and changing attitudes drive demand

Superior technology and a change in consumer attitudes have been big drivers of this new interest, as well as regulatory change in the financial services industry and even the GFC of almost a decade ago. The GFC rocked financial advice practices and consumers alike, creating an appetite for change and a desire for increased accountability and transparency.

The Future of Financial Advice (FoFA) regulations introduced in July 2013 increased the burden of compliance on financial advisers, while also raising the need for transparency. The changes in the regulatory environment gave managed accounts a platform to thrive.

Managed accounts, which have the ability to monitor, transact and rebalance across multiple tailored portfolios in a cost efficient and transparent way, were the answer to many consumer concerns as well as adviser business challenges. Technological advances also made it easier to store and process data, allowing more complex portfolio construction and greater levels of customisation.

Although historically managed accounts were typically niche, stand-alone and separate products to an investor's main wrap or investment service, managed accounts can now be accessed via many investment and super platforms making them far more convenient.

Key benefits of managed accounts

Transparency: Managed accounts allow transparency to view the underlying assets that make up the investment portfolio to truly understand and know which companies and assets are held. Unlike a managed fund or an Exchange Traded Fund (ETF), which will often provide limited information such as the top 10 stocks held, when you invest in a managed account you know exactly the construct of the portfolio and the actual underlying investments – which may in fact also include managed funds, domestic and international shares and / or ETFs for different sector exposure.

Tax effectiveness: Managed accounts provide tax benefits which are attributable to an investor's own holdings and not netted out or reversed by the actions and cash flow of others, as is often the case in managed funds where the assets are pooled. The managed account structure also means investors avoid embedded capital gains (CGT) tax implications accrued within a managed fund, which although they may have been generated historically, may be held over and attributed across all investors.

Control: The unique ownership structure also gives investors control to exclude assets from their portfolios, a level of detail not possible in managed funds. For example, if there is concern about the social or environmental actions of a company, it could be excluded from the portfolio.

Like managed funds, managed accounts give access to professionally managed investment portfolios. Given the dominance of managed funds in Australia and our familiarity with them, a comparison is a good way to understand and assess if managed accounts are right for a particular circumstance.

Whilst there are many benefits to investing via a managed account they are not always the best solution for everyone. For example, a typical Australian equity managed account may hold between 25 and 30 stocks and would therefore not be appropriate for someone with a small amount to invest or looking to further diversify across other asset classes.

Likewise, because managed accounts typically offer concentrated listed portfolios they do not give the same diversification benefits of many managed funds or asset class access. For example, a typical Australian or international managed fund may hold in excess of 80 stocks or seek to deliver a long short strategy which is not possible through a managed account given the need to short stocks.

Financial advisers look to deliver a better client service

Managed accounts have also given financial advisers tools to more efficiently manage their client portfolios, freeing them up to provide the support and services consumers are looking for.

The highly-regulated environment in which financial advisers currently operate means they must demonstrate they are operating in the best interests of their clients, providing them with a consistent and repeatable level of quality service.

In the recent *Netwealth AdviceTech Research Report*, of more than 200 advisers surveyed, 35% reported they were currently using a managed account with their clients. A further 22% said they intend to use them in the next 18 months and 27% were considering them.

Selecting a managed account

The key question consumers need to ask is whether the managed account product offers the sophistication that is now possible. Investors should consider:

- Can they access a range of investment styles and assets in a single portfolio?
- Is it possible for assets in the managed account to be bought, sold and managed as part of their broader portfolio?
- How does the provider trade the portfolio and potential CGT implications of switching models?
- What is the legal structure of the managed account and does it provide suitable protection against administrative or mandate errors e.g. is it a Managed Investment Scheme (MIS), a Managed Discretionary Account or some other structure?
- What is the performance drift impact of heavily tailoring a portfolio by including, excluding or substituting assets?
- Who is the managed account investment manager that will be relied on for investment decisions, and are these right for the investor?

The next wave of managed accounts will see investors even more vigilant over what their chosen provider can offer them, and as the industry enters the next phase, innovation and competition will ultimately benefit both advisers and consumers.

Managed accounts are not for everyone, and like other financial products, it is always prudent to speak to a financial adviser to understand not only their benefits but their risks.

Matt Heine is Joint Managing Director at [Netwealth Investments Limited](#). This article has been prepared by Netwealth Investments Limited (Netwealth), a provider of Managed Accounts. It contains general financial product advice only and does not consider the objectives, financial situation or needs of any individual

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