Cuffelinks
Connecting investors with ideas

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Business model disruption has barely begun

Hamish Douglass

There's a lot of business model disruption in the world and many companies will be left behind by the changes. There will be winners and losers in the years ahead, and sometimes business model disruption isn't obvious. There are first-order effects when you have changes to business models, but when new technology and new businesses develop, it affects other businesses and other industries and it's often not foreseeable. This is Part 1 of a two-part transcript.

Watch for second-order effects

If you look at a photograph of the Easter Parade in New York in the year 1900, it is full of horses and carriages. If you fast forward to 1913, the photograph is full of petrol-powered automobiles. Think about what had to happen, such as rolling out petrol stations. Transportation fundamentally changed in 13 years. In 1908, Henry Ford rolled the first Model-T Ford off the production line which enabled an automobile to be mass-produced at an affordable cost.

Many first-order effects are fairly obvious. If you manufactured buggy whips, you effectively went out of business. If you collected manure in the streets, you went out of business. There were 25 million horses in the United States in 1910 and 3 million in 1960.

The second-order effects aren't as knowable. The second-order effects are what the automobile enabled to happen. An entirely new industry could move goods around far more efficiently. People could start the urban sprawl and move further away. We developed regional shopping centres due to the automobile.

Consider a simple change in technology, the automated checkout. We know automated checkouts are in Woolworths and Coles in Australia. Walmart started rolling out these automated checkouts in around 2010 at scale and the other major retailers started doing the same. The first-order effects were a loss of jobs of the people working the checkouts, and retailers reduced their costs. And if one major competitor does that, other competitors have to follow, otherwise their cost structure is out of line.

But what of the second-order effects? Chewing gum sales have lost 15% of their volume since the introduction of automated checkouts in the US. The checkouts have disrupted the business model of impulse purchases. People do not drive to the supermarket to buy chewing gum. But when you used to stand in those checkout lines, you would pick up some chewing gum. I think mobile phones have had a bit to do with it too, because you now do other things when you're standing there.

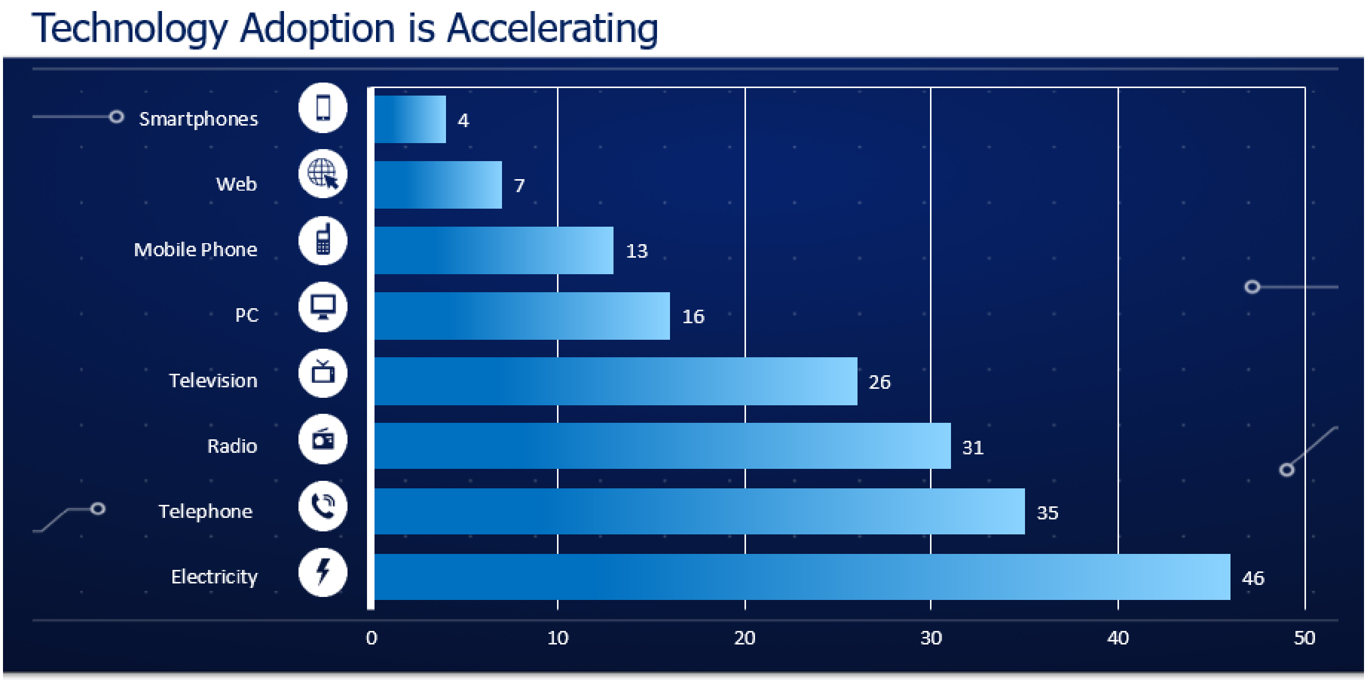
Our job as fund managers is to try and spot the next Wrigley. In 1999, at the peak of the technology bubble, Warren Buffett was asked by a group of students why he doesn't invest in technology. He said he could not predict where the internet was going but investing in a business like Wrigley will not be disrupted by technology. And look what's happened. Wrigley sales had gone up for 50 years, every year, before this change happened.

The pace of change is accelerating

Technology adoption appears to be accelerating. The chart below shows the number of years it takes to reach 50 million new users. We saw this rapid adoption with smart phones, and it only took Facebook five years to move from 1 billion to 2 billion users. These new technology-related businesses scale at an incredibly fast rate.

I think there's a whole series of factors explaining why this is happening, and a lot of things are starting to come together.

First, globalisation and the internet have enabled products to spread rapidly to much larger audiences around world. A second factor is the digitalising of goods and services. We have digitalised books, newspapers, music and videos. With Facebook, Google or Netflix, all their services are digital goods. Instead of spreading atoms around the world, we're now spreading bits around the world where an identical copy of a digital good is produced at zero cost.



Source: U.S, Census, Wall Street Journal

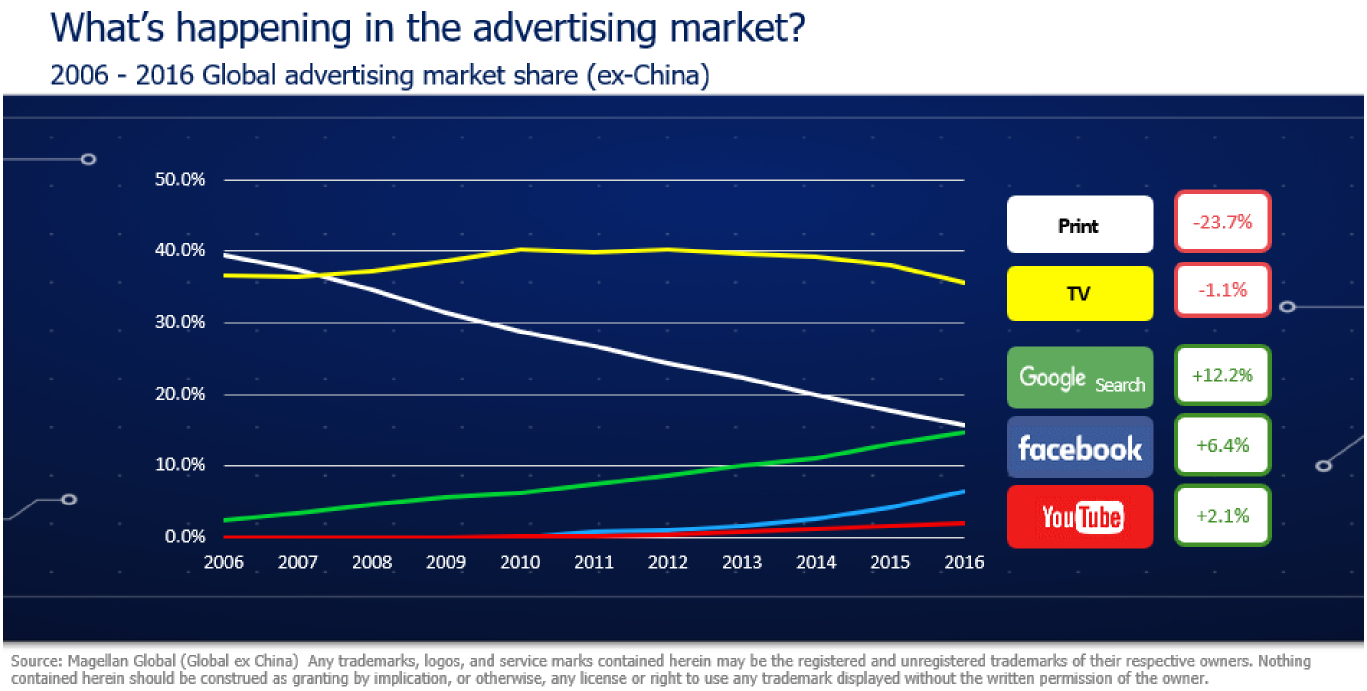
Third, the mobile phone today is more powerful than the world's most powerful super-computer in 1986, in the year I left school, which is absolutely incredible. And now we're connecting all these devices in what is known as 'cloud computing', where massive data farms don't have computers localised, and you can share all this information. So there's a whole lot of infrastructure and change that's enabling very rapid change to happen in the world.

The incredible power of two digital platforms

Consider 'GAF effect' from Google, Amazon and Facebook. I don't mean specifically those companies, but how they are affecting industries and important business models. First of all is the advertising industry. Google and Facebook know an enormous amount about their users. Anyone who uses Google has something called a Google timeline (unless you've opted out of it). On your Google timeline, in your user settings, you can go back five years and it will tell you exactly what you did five years ago if you carried your mobile phone, and most people do.

It tells you what time you left your house, whether you walked to the bus, which bus you boarded, if you went to work or not because it knows the address. If you take any photos on a day, it will put those photos on the timeline. It will tell you where you went for lunch, when you went home and if you went to dinner, it will tell you the restaurant. And this goes for every other day of your life for the last five years. It's collecting enormous amounts of data about you, as are Facebook and others. That enables these enormous platforms to start highly targeted advertising and make it incredibly efficient.

In the last decade, traditional print advertising has lost about 24% market share, and I predict this will go to zero. It is extraordinary that outside China, two companies (Facebook and Google) have taken nearly the entire market share of a global industry that had many, many players in the world – magazine producers, newspapers producers, classifieds producers. All this revenue has ended up with two digital platforms that have this massive network effect. Television advertising, which is the largest pot of money, has not yet been disrupted. We're starting to see the rise of YouTube but it is still relatively small. It's probably got between US$6-8 billion of revenue at the moment, but it's an industry with US$150-180 billion of revenue outside China.



Television is next

The television advertising business model is the next to fall due to two big factors. We're experiencing the rise of these streaming video services. Think of Netflix, Amazon Prime, Stan, and Hulu, and Apple wants to enter this game. These businesses are spending enormous amounts of money on content creation. Amazon and Netflix this year will spend US$10 billion creating original content. They are far outspending anyone else on the planet. Facebook just bid US$600 million for the Indian cricket video streaming rights and were outbid by News Corp's Fox. I think that's one of the last-ditch efforts to protect sporting rights and there's a battle going on between the television and the movie networks. Apple and Netflix are bidding for the next James Bond.

They are taking viewers away from television and pay TV which reduces advertising revenues. Then on the other side, the costs of producing the content and buying the best shows is being bid up. It is not a great business model if your revenues go down and your costs go up.

We're also seeing the advent of new video advertising platforms. The streaming services are not advertising businesses, they are subscription businesses. But YouTube and now Facebook (and they've just launched Facebook Watch) are advertising business models, and I believe that a huge amount of the revenues that are currently in television and pay TV are at risk. It's fundamentally different, because this is targeted advertising. These platforms know so much about the users that advertisements can be delivered specifically to what the users are watching on these new platforms.

The television advertising model as it currently stands gives a number of companies in the world a huge advantage because there are massive barriers to entry to promote products on television if you want to advertise at scale. It will be much easier to enter one of these new platforms. You can do very specific programmes if you are developing a new brand on Facebook, YouTube or Google compared with advertising on television.

The Amazon effect

Amazon is a business with an estimated US$260 billion in sales (including Whole Foods), the second largest retailing business in the world after Walmart. It's a fascinating company. They run a 'first-party' business, where Amazon buys the goods, stores them in their warehouse and then sells them to their users via the Amazon website or mobile apps. Then they have a 'third-party' business called Fulfillment by Amazon, where other retailers put their own inventory into Amazon's warehouse and then Amazon sells that inventory to their customers as well. So customers suddenly have a much greater selection, and Amazon charges other retailers rent for having their goods in the Amazon warehouse, then they charge a commission for selling to their user base.

Amazon also is a massive logistics company. They are expanding warehouse space by about 30% a year and they are incredibly advanced from a technology point of view. They have developed with a robotics company something called the Kiva robot, with about 45,000 of these robots in their warehouses at the moment. Humans are good at putting goods in a package, adding a label and sending them off. But it's inefficient for the human picker to run around the warehouse to find the shelf where that good is stored in these massive, multiple football field-sized spaces. So what they have developed are these robots that automatically go around the warehouse and bring the shelves holding the product to the packers.

The loyalty scheme called Amazon Prime started out with two-day free shipping, then same-day and 2-hour free shipping in a number of cities around the world. Amazon Prime members receive free video, free music and free ebooks with the service.

Amazon is a massive data analytics company. They understand enormous amounts of information about what the customer wants to buy. Amazon members see web pages that look different to anybody else. There are 50 million goods available in Amazon so customers receive a particular look into the world.

Amazon's Jeff Bezos wants to fulfil all of his customers' shopping needs. He worked out that if you want to be in their everyday shopping, you need to be in the grocery shopping habit. They started with Amazon Fresh, an online grocery shopping business that's very niche. If you want chilled vegetables or meats or ice cream, it's inconvenient to have them delivered on the verandah if you're not there for two hours. A lot of people want to look at their fresh fruit and vegetables and not have anyone else choose that for them. So Bezos bought Whole Foods, the largest fresh food retailer in the US. It had a reputation for expensive produce, lots of organics, incredible displays. On the first day Bezos took control, on the key lines people are interested in, he dropped the prices 35-45%. People shop for incredibly good, fresh groceries then everything else can be put together.

He wants to connect your home by the 'Internet of Things'. Many goods like washing detergent and milk will have computer chips on them that will connect to the internet to know when you are running out. Washing machines and fridges will automatically generate shopping lists. He's adopting a voice platform for your house with a digital personal assistant.

What's next?

There's a massive number of these revolutions. If you think Amazon's big at moment, we're in very early stages of where this technology and these businesses are heading. Advertising and retailing is changing. Next week, I'll discuss which large companies will suffer, and bring in the perspectives of Warren Buffett and Charlie Munger.

This is an edited transcript of a presentation by Hamish Douglass, CEO, CIO and Lead Portfolio Manager at Magellan Asset Management, at the Morningstar Individual Investor Conference 2017. Graham Hand attended the event courtesy of Morningstar.

Are shares a long-term safe haven?

Ashley Owen

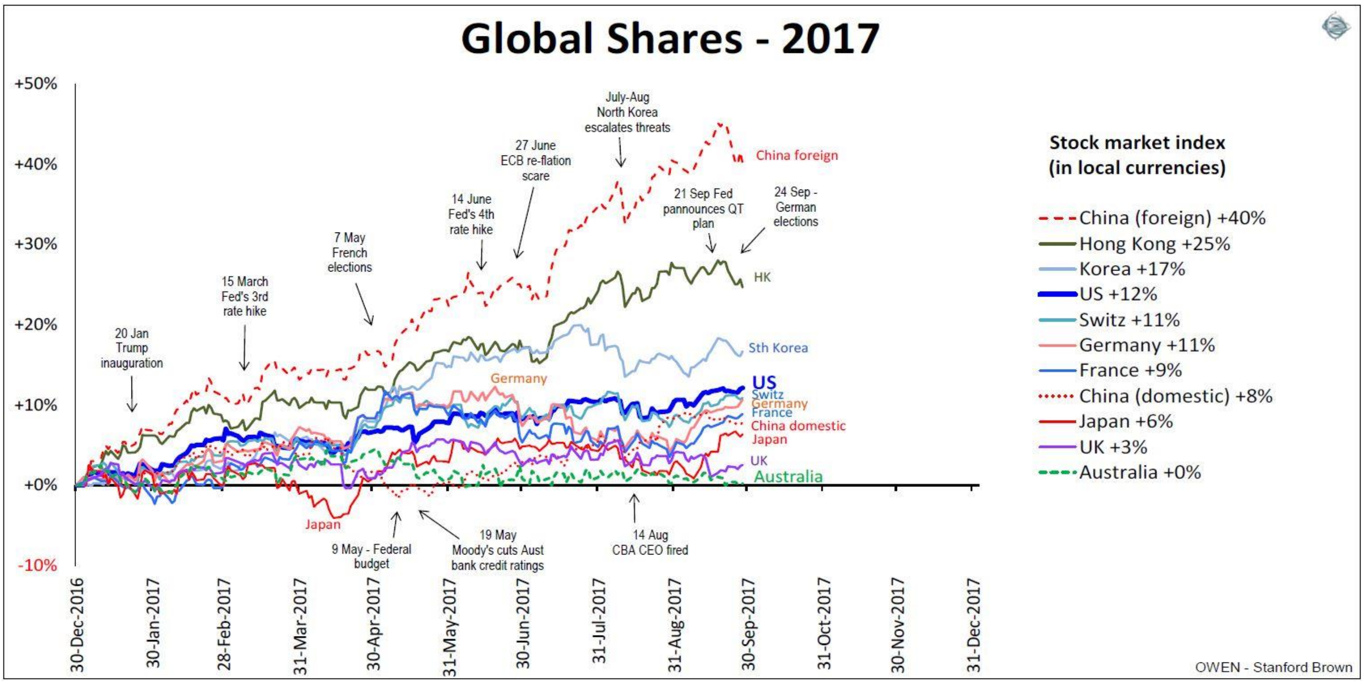
The 2017 calendar year has been reasonably good for shares around the world. Nearly all stock markets are posting gains against the headwinds of rising protectionism, monetary tightening, political fragmentation and military tensions.

Australia is crawling along at the bottom of the pack despite enjoying the highest economic growth rate in the developed world and strong rises in company earnings and dividends. The problem is that most of the increases in profits and dividends are merely making up for losses and dividend cuts last year caused by the 2014-15 commodities collapse. The turnarounds in profits and dividends this year were driven by the commodities rebound from China's stimulus in 2016, which was pure luck and totally out of our control. This rebound has flattened and will be reflected in next year's results. An economy in which company and tax revenues are at the mercy of commodities prices set by foreigners, and which runs chronic current account deficits because it spends more than it earns and so is always reliant on foreign capital, is called a 'banana republic'.

Low allocations to global shares has punished portfolios

The US has been the strongest of the developed markets, despite two further rate hikes this year and more on the way. A positive has been the 8% decline in the US dollar as the early Trump euphoria has worn off. On 21 September the Fed announced its long-awaited plans for 'QT' (quantitative tightening) to replace 'QE' (quantitative easing), where the Fed will reduce its $4.5 trillion pile of bonds it bought after the GFC to depress interest rates and the US dollar, and to lift asset prices.

European shares have also done reasonably well given sluggish growth and rising political and social tensions. European confidence was boosted early in the year by Dutch PM Mark Rutte's win in the Dutch elections on 14 March, followed by Emmanuel Macron's win in the French elections on 7 May. These early hopes were dashed by Angela Merkel's poor showing in the German elections on 24 September which saw the dramatic rise of the anti-EU and anti-immigration AfD Party.



Japanese shares are also up modestly this year, led by Keyence (IT), Sony and Softbank. The economy is finally showing signs of life but the resultant strong yen is hampering exports and share prices. PM Shinzo Abe has grabbed the opportunity for another early election to try to rebuild his support in the face of the rising military threat from North Korea and China. Three terms of 'Abenomics' have done little for economic growth and inflation, but they have certainly boosted share prices.

Chinese domestic shares (those traded inside China by locals) have edged higher this year. Whereas 2016 was a year of stimulus spending and easy money, 2017 has been a year of rate hikes and regulatory curbs to slow the housing boom and to stem capital outflows. On the other hand, Chinese foreign shares (traded mainly in New York) have been the stars. The glamour tech stocks like Alibaba, Tencent, Baidu and many others are all up between 50% and 100% so far this year. The boom in Chinese tech stocks is reminiscent of the 1990s US 'dot com' boom.

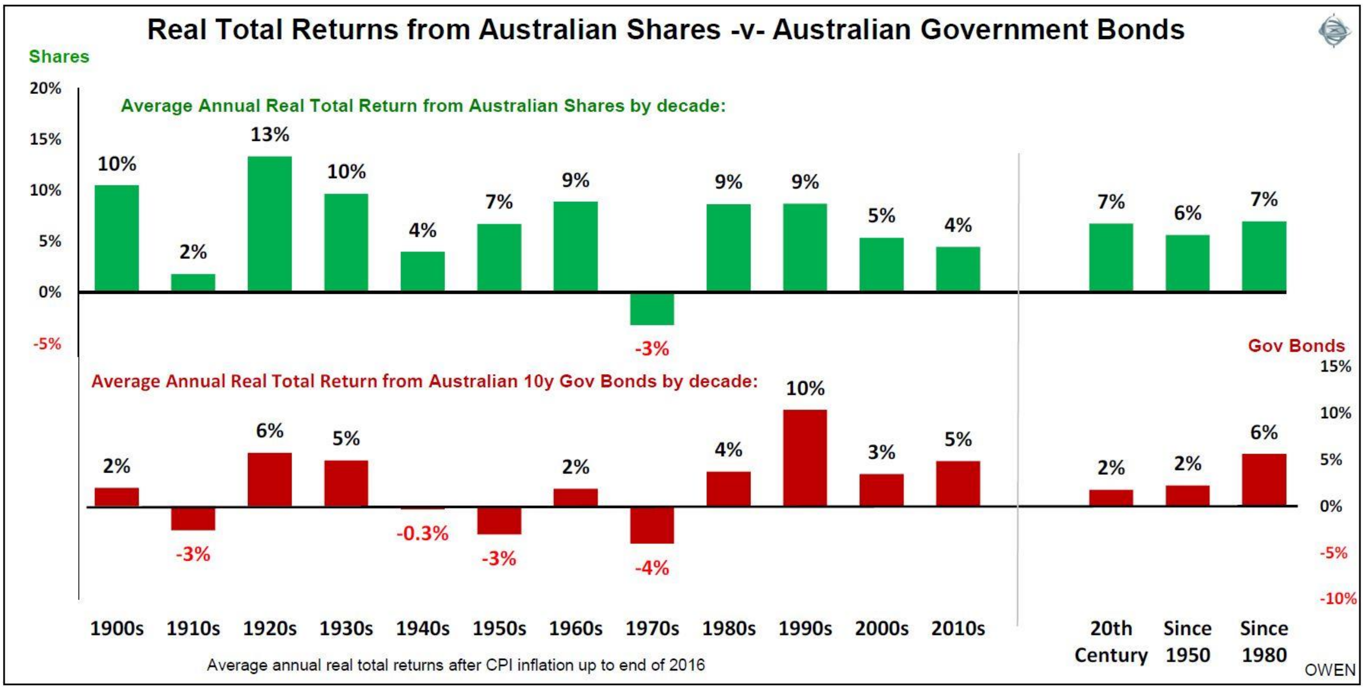
Are shares long-term 'safe havens'?

Recently I have been receiving an increasing number of enquiries asking whether investors should get out of the share market because shares are seen as 'scary' and 'risky' and instead put their money into 'safe havens' – in particular gold, bank deposits or government bonds. If you read the media headlines it seems that share prices are ultra-high, property prices are about to crash, inflation is about to take off, and now we are heading for another global war!

The problem is that even if all of these things were true (which they are probably not), broad diversified share investments are far better for long term investors than the so-called 'safe havens'. Australian shares as a whole have delivered not only higher average returns than the 'safe haven' assets but they have been more consistent and reliable for long-term investors. Shares have experienced fewer periods of negative returns, higher (or 'less bad') negative returns, and shorter times to recover their real value after downturns.

We are not talking about daily returns and daily volatility here – nor even monthly or yearly ups and downs. That's for day traders and short-term punters to worry about. Long-term investors should look through the short term 'noise' in the media headlines to understand how markets work over the long term. Even for retired couples in their 60s or 70s, one of them is likely to live to 100, so that's a 30- or 40-year investment horizon.

The chart below shows long-term real returns (after inflation) from Australian shares versus government bonds for each decade since 1900. The right of the chart shows average returns for the 20th century, returns since 1950, and since 1980.



Diversified Australian shares have generated consistently higher average returns than bonds and have suffered only one decade of negative real returns, in the high inflation 1970s.

Government bonds provided hardly any protection against neither shares nor inflation. Nor were they a store of wealth, with four decade-long periods of negative real returns. They generated low average returns over the whole period, at about 5% per year lower than shares, and four times as many decades of real losses than from shares. In the only decade when shares when backwards - the 1970s - government bonds did even worse.

Briefly, what lies ahead?

Notwithstanding the long-term benefits of shares, there are plenty of risks to local and global markets. The widely-feared global 'reflation' scare - which raised bond yields and the US dollar late last year and immediately following the Trump election - has faded. The US dollar and bond yields have subsided as optimism faded. We believe there are more risks in global slowdowns than in runaway inflation.

The US has gone from Trump euphoria to Trump policy stagnation. Economic activity and jobs growth have picked up this year but is likely to slow again if Trump fails to achieve the big stimulatory actions of tax cuts and infrastructure spending. If passed, the tax package will probably be favourable, in particular the reductions in taxes on companies and on foreign profits, and measures to repatriate the $3 trillion of cash from past profits of American companies. Working against this will be Trump's rising list of trade protection measures.

Europe is seeing a continuing trend away from integration toward nationalism, as witnessed by the rise of the right wing in the German elections. Europe needs young immigrants to work and pay taxes to fund the rapidly-growing rump of retirees. Immigration has always been the driver of economic growth but xenophobia and racism are more powerful forces.

Global tightening of monetary policy should ordinarily be seen as a good sign that economies are strong enough to allow rate rises. This is the case in the US and China. But in Europe and Japan, where there is early talk of scaling back QE asset buying and negative/zero interest rates, it is because central banks and governments have simply run out of ideas on how to stimulate growth, employment and price inflation. They have finally realised that 'QE' and negative interest rates have done little more than distort markets and artificially inflate asset prices.

Ashley Owen is Chief Investment Officer at privately-owned advisory firm [Stanford Brown] and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

CEO appointments: internal or external?

Chris Stott

The appointment of the Chief Executive Officer (CEO) and succession planning is one of the more important responsibilities of listed company boards. When a board starts the process of replacing a CEO, the company will typically announce both an internal and an external candidate search.

Commonwealth Bank and Fortescue Metals Group are currently searching for new CEOs with each company canvassing internal and external candidates. Over recent months, Blackmores and Wesfarmers have made CEO appointments from within their executive ranks, while Primary Health Care and G8 Education have opted for outsiders.

Shareholders may then wonder, is it better to appoint an internal or an external CEO?

Internal CEO appointments

Successful companies invariably have clear CEO succession plans to ensure the business is well-positioned to manage leadership transition. Based on our investing experience, boards of these companies tend to appoint 'tried and tested' candidates from within to ensure the business continues to employ the winning strategy and, more importantly, maintain its culture.

PWC's latest annual study of CEO succession revealed that the rate of internal CEO appointments had reached an all-time high in Australia. The report also found that increased internal CEO appointments, coupled with better succession practices, have led the average CEO tenure rising to 5.5 years, which exceeds the global average of 5.2 years. The report's authors found that insider CEOs not only stay in the role longer, they deliver better and more consistent shareholder returns compared with external hires.

Companies that have consistently and successfully promoted senior managers (including CEOs) from within their organisation include Macquarie Group (ASX:MQG), Wesfarmers (ASX:WES), Challenger (ASX:CGF) and Flight Centre Travel Group (ASX:FLT).

Notably, electronics retailer JB Hi-Fi (ASX:JBH) has appointed all three of its CEOs from within the company since it listed in 2003. Over that period, the company's share price has risen from $1.55 to more than $22.60 at the time of writing.

External CEO appointments

Outsider CEO appointments have fallen sharply since 2004 according to PWC, with internal candidates providing obvious advantages. However, external CEO appointments can provide benefits too, particularly when the company needs to be reinvigorated.

When a company is underperforming, frequently its turnaround can only be achieved by an outsider, not a manager entrenched in the business's operations. An effective CEO, often with a new management team, can rapidly turn around the company's fortunes delivering shareholders returns via share price growth.

When an underperforming company appoints a new CEO, we look for a strong leader and a proven performer with an articulated strategy to turnaround the company and the support of the board to effect change. When the CEO has a clear mandate from the board to 'shake things up' this can be a catalyst for us to take a position in the company.

Clough Limited (no longer listed on the ASX) is a prime example of an external CEO who successfully implemented a turnaround strategy. The Perth-based engineering company had floundered for many years under the leadership of various CEOs before Kevin Gallagher took the helm in 2011. The new CEO overhauled the company's operations, reducing fixed costs and transformed the organisational culture. During his two-year tenure, the company's share price steadily climbed from around 65 cents a share and in 2013 shareholders received $1.46 a share when South African firm Murray and Roberts Holdings acquired Clough.

In our view, the best external CEO appointees have a track record of performance in the same or a comparable industry. For example, Shaun Di Gregorio was a key person in the early success of REA Group, as it transitioned from a start-up to the largest media company in Australia as owner of online real estate advertising portal realestate.com.au. In 2010, he was appointed CEO of Malaysia-based iProperty Group that serviced the Southeast Asian property market. Shaun brought the relevant skill set, knowledge and experience to iProperty and during his four-year tenure the company's share price rose from around 15 cents to over $3.00 a share. iProperty was subsequently taken over by REA Group in 2016 for $4.00 a share.

Alignment of interests

Whether a CEO is an internal or an external appointment, it is critical to consider how their interests are aligned with the company's shareholders through incentive structures. Ideally, remuneration is a combination of short- and long-term incentives that focus on earnings per share (EPS) and total shareholder return (TSR). For more, see my Cuffelinks article, *5 factors to look for when assessing management*.

The CEO's interests are further aligned when they are also a major shareholder in the company. This can also ensure their long-term commitment. In our experience, CEOs with substantial 'skin in the game' typically have longer than average tenure and outperform other comparable businesses.

Jamie Pherous, Managing Director at Corporate Travel Management (ASX:CTD) is a substantial shareholder in the company. As founder of the business, he has led Corporate Travel Management since listing in December 2010 at $1.00 a share. The company is trading at more than $22.00 per share at the time of writing.

On balance

Considering the merits of an internal versus an external CEO appointment is highly dependent on the company, including its performance and stage of growth. In our view, companies that appoint the CEO from within the organisation on balance deliver better returns for their shareholders than companies that recruit externally. However, turnaround stories from an external appointment can provide investors with good short-term trading opportunities. When evaluating any CEO, it is critical to consider how their interests are aligned with the company's shareholders through incentive structures and equity exposure.

Chris Stott is Chief Investment Officer of Wilson Asset Management. Entities managed by Wilson Asset Management own shares in PRY, CBA, GEM, FLT, MQG and WES.

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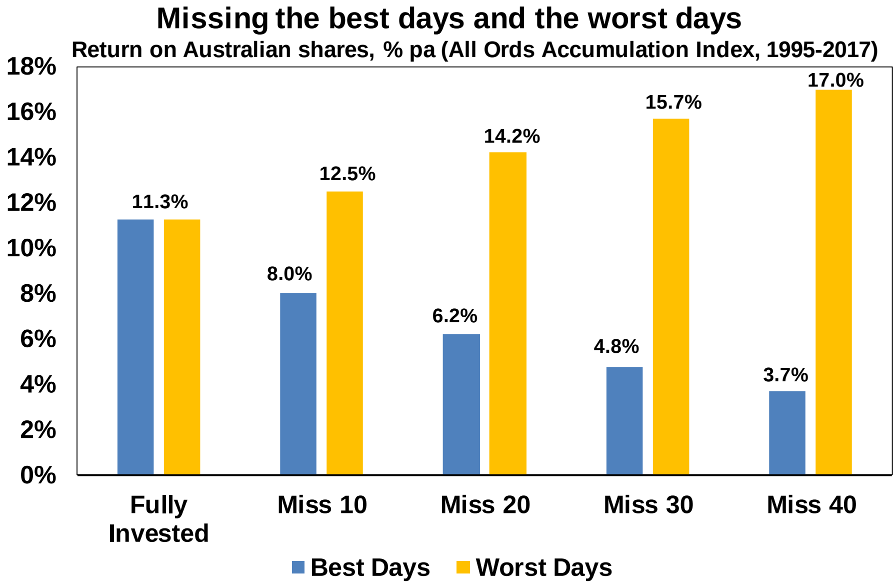
Five fundamental investing lessons

Shane Oliver

As Warren Buffett once said: "There seems to be a perverse human characteristic that makes easy things difficult." This has particularly been the case with investing where complexity has multiplied with new products, new ways to access various investments, tax changes and new regulations, all with social media adding to the noise. But it's really quite simple and this can be demonstrated in these charts and table.

#1 Time in the market versus timing the market

Without a tried and tested asset allocation process, trying to time the market, i.e. selling in anticipation of falls and buying in anticipation of gains, is very difficult. A good way to demonstrate this is a comparison of returns if an investor is fully invested in shares versus missing out on the best (or worst) days. If you were fully invested in Australian shares from January 1995, you would have returned 11.3% per annum (including dividends but not franking credits, tax and fees).



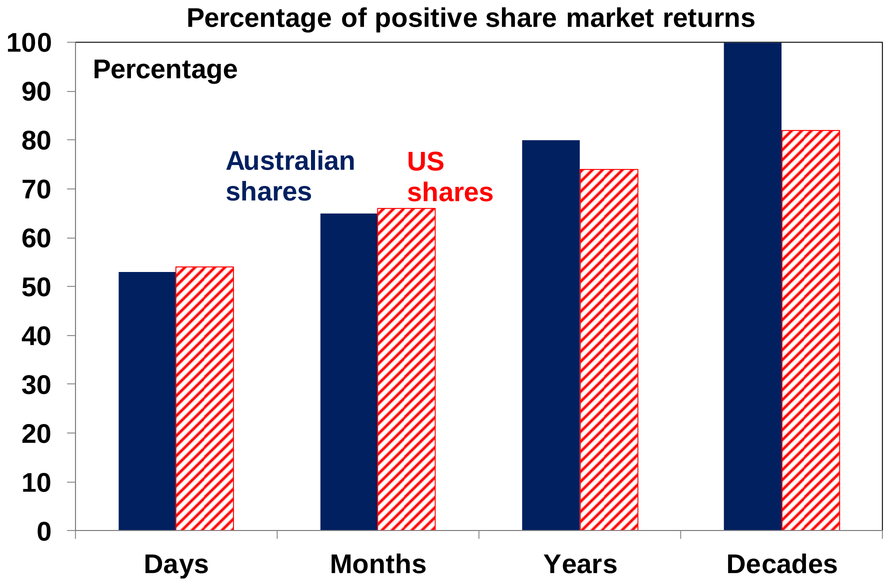
Source: Bloomberg, AMP Capital

If by trying to time the market you avoided the 10 worst days (yellow bars), you would have boosted your return to 12.5% pa. If you avoided the 40 worst days, it would have been boosted to 17% pa. But this is difficult and many investors get out after the bad returns have occurred, just in time to miss some of the best days. For example, if you miss the 10 best days (blue bars), the return falls to 8% pa. If you miss the 40 best days, it drops to just 3.7% pa.

Key message: market timing is great if you can get it right, but without a tested process, the risk of getting it wrong is very high and if so it can destroy your returns.

#2 Look at your investments less

The daily movements in the share market are down almost as much as they are up, with slightly over 50% of days seeing positive gains. See the next chart for Australian and US shares. Day-by-day, it's pretty much a coin toss whether you will get good news or bad news. But if you only look monthly and allow for dividends, the historical experience tells us you will only get bad news around a third of the time. Looking out further on a calendar year basis, data back to 1900 indicates the probability of a loss slides to just 20% in Australian shares and 26% for US shares. And if you go all the way out to once a decade, since



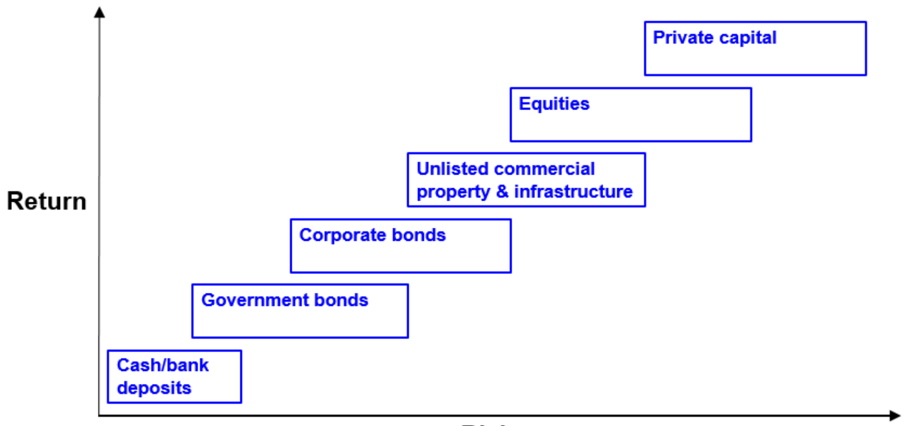
Daily and monthly data from 1995, data for years and decades from 1900.
Source: Global Financial Data, AMP Capital

1900 positive returns have been seen 100% of the time for Australian shares and 82% for US shares.

Key message: the less you look at your investments, the less you will be disappointed. This matters because the more you are disappointed, the greater the chance of selling at the wrong time.

#3 Understand risk and return potential

This chart is basic to investing. Each asset class has its own risk (in terms of volatility and risk of loss) and return characteristics. Put simply: the higher the risk of an asset, the higher the return you will likely achieve over the long term and vice versa. The next chart shows a stylised version of this. Each step up involves more risk and this is compensated for with more return.



Source: AMP Capital

Key message**:** Investors who don't mind short-term risk (and illiquidity in the case of unlisted assets) can take advantage of the higher returns growth assets offer over long periods, but there is no free lunch.

#4 The value of diversification

But this is not the end of the story. The next table shows the best and worst performing asset class in each year over the last 15 years.

The best-performing asset each year varies with no pattern and last year's top performer is no guide to the year ahead. For example, those who loaded up on listed property after their strong pre-GFC performances were badly hurt as they were amongst the worst-performing assets through the GFC. It makes sense to have a combination of asset classes in your portfolio, especially assets that are lowly correlated i.e. that don't just move in lock step with each other.

Key message: diversification is like the magic of compound interest, since a well-diversified exposure means your portfolio won't be as volatile. This can help you stick to your strategy when the going gets rough.

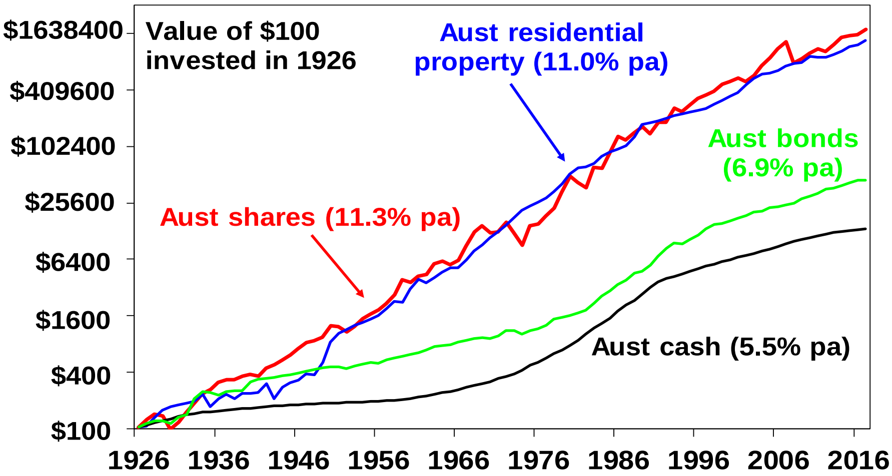
Year	Best asset class	Worst asset class
2001	Aust listed property	Global equities hedged
2002	Unlisted infrastructure	Global equities unhedged
2003	Global listed property	Global equities unhedged
2004	Global listed property	Cash
2005	Aust equities	Cash
2006	Global listed property	Aust bonds
2007	Aust equities	Global listed property
2008	Aust bonds	Aust listed property
2009	Aust equities	Unlisted property
2010	Global listed property	Global equities unhedged
2011	Unlisted infrastructure	Aust equities
2012	Aust listed property	Cash
2013	Global equities unhedged	Australian bonds
2014	Global listed property	Cash
2015	Unlisted infrastructure	Cash
2016	Unlisted infrastructure	Cash

Note: refers to the major asset classes. Source: Thomson Reuters, AMP Capital

#5 The power of compounding (and residential property has a role)

This chart highlights the power of compound interest, with a comparison showing the value of $100 invested in various Australian asset classes since 1926.

Long term asset class returns



Source: ABS, REIA, Global Financial Data, AMP Capital

Over very long periods, the power of compounding works wonders for shares compared to bonds and cash. But it can also be seen to work well for Australian residential property with an average total return (capital growth plus net rental income) of 11% pa, which is similar to that for shares.

The key is to allow for the different 'risks' experienced by property versus shares. Property prices are less volatile than share prices as they are not traded on share markets and so are not as subject to the whims of investors. Movements in their values tend to relate more to movements in the real economy. But residential property takes longer to buy and sell and it's harder to diversify as you can't easily have exposure to hundreds or thousands of properties in different sectors and countries like you can with shares.

Key message: Given their long-term returns and diversification benefits, there is a key role for residential property in an investment portfolio (putting aside issues of current valuations).

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at AMP Capital. This article is general information and does not consider the circumstances of any investor.

Meeting investor needs with human capital reporting

Pauline Vamos

The disruptive effects of technological change occupy a lot of space in the business press, and for good reason. Investment markets have witnessed significant value destruction in sectors exposed to disruption over the past 15 years, and there is much more to come with rapid advances in automation, big data, machine learning, and artificial intelligence. Some commentators describe these forces as combining to create a Fourth Industrial Revolution, with profound implications for businesses.

Few companies or industries will escape investor scrutiny as technology-enabled business models proliferate to compete with incumbents. In this rapidly changing business landscape, the information available to understand risks and opportunities is increasingly inadequate for investors to develop informed views on a company's future prospects. Can companies protect existing products from new online competitors? Can they adapt their business models to grow new markets? These are the types of questions investors continue to struggle with.

How are people managed in the face of disruption?

Rarely are we adequately told how *people* are managed and organised strategically to respond to risks and opportunities from disruption. Technology is only one response to disruption. Disclosure of human capital management falls well short of market needs, especially viewed from the perspective of investors seeking to gain insights into a company's future prospects. Where human capital reporting is absent and strategic human capital risks are material, companies may not be meeting their disclosure requirements.

For the majority of companies, a significant portion of company value *is* deeply connected to its people, through intangible value. This under-recognised proportion of corporate value has grown with the decline of manufacturing in OECD economies and increasing representation of service-oriented businesses, technology and finance. Today, the majority of value is held in intellectual property, brands, and people. It follows that investors need information beyond that available in financial accounts to inform invest decisions.

Companies should explain more effectively how they are applying people to maximise long-term value. Companies with superior management and advanced communication of their people strategies should be rewarded in investment markets, or should be less severely punished where businesses are highly exposed to disruptive forces.

The biggest challenge to improving human capital disclosure is joining up relevant human capital information with corporate strategies and actions. It's common practice to disclose metrics on employee engagement or employee turnover at highly aggregated levels, which may be meaningless. Such disclosures have limited value to investors seeking to understand, for example, how a company is positioned to respond to disruptive risks and opportunities in its markets.

OFR addresses gaps

Fortunately, Australian listed companies have an existing structure to frame investor-focused human capital disclosure in annual reports through the Operating and Financial Review (OFR). OFR reporting requirements were introduced in Australia about five years ago. It's not a big leap to see multiple linkages here to human capital, where delivery of strategy requires significant organisational restructuring, retention of key people, or acquisition of skill sets in high demand. Human capital linkages are also apparent in other OFR reporting areas including operational status, prospects and risks.

A leading example is Primary Health Care (ASX:PRY), whose business success relies fundamentally on attraction and retention of health care professionals (HCPs) to achieve targeted return on capital invested in its medical centre, pathology and imaging service assets. Primary discloses material information in the OFR on strategic changes to HCP contractual arrangements designed to improve attraction and retention of HCPs, HCP expenditure trends, and tailored metrics on HCP attraction and retention rates for exposed business segments. Such reporting remains the exception in the ASX however, hence there is significant scope to extend and improve human capital disclosure.

Restructuring in response to disruption

Rather than an additional reporting burden, human capital disclosure is an opportunity to give greater confidence to investors about future prospects. This is especially the case where business models are vulnerable to disruption, and human capital led responses are required to engender greater workplace agility and flexibility. For example, ANZ divulged that it would comprehensively restructure its work organisation by removing hierarchies and bureaucracy, adopting organisational structures akin to those in fast-moving tech companies as a direct response to disruption risks.

Disclosure approaches to communicate fundamental human capital reorganisation on this scale is only beginning to emerge. For example, how do workforce reorganisation strategies integrate with business strategies? How is ongoing operational delivery affected by the reorganisation of human capital for product groups? What are the key human capital-related risks to execution of workforce strategies? How is progress on execution of human capital strategies measured? What bearing is human capital management likely to have on future prospects?

If you were to survey experienced investors, most would say that financial data provides a limited picture of corporate health and investment attractiveness. Most analysts achieve a more complete picture by analysing industry structure, and gaining comfort with the quality of company management, for example. Enhanced disclosure of human capital management fills information gaps to round out assessment of outlook.

Advancing meaningful human capital disclosure is a less onerous task where corporates are some way down the track of integrating their strategic and human resource functions. The opportunity to link with investor relations to improve reporting outcomes should be apparent, and the task should be one of making a case for greater integration of human capital strategies and actions in reporting. This is clearly a bigger hill to climb where HR functions are siloed or disconnected from other functions. If the company is highly exposed to disruption and management actions to address risks are poorly communicated, the market will make the case.

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What do investors value in financial advice?

Jim Parker

Challenged on one front by robots and on the other by a general reluctance among the wider public to pay for advice, some financial planners have been experiencing an existential crisis in recent years.

One obvious response among advice firms has been to fight the technology-led commodification of advice by going for scale, cutting costs and industrialising processes as much as feasible. A second response has been for advisers to stop and ask themselves exactly what it is that investors (or at least those willing to pay for financial advice) feel they value most from the human side of the service. A third response, and one pursued in a new global survey, is to ask investors themselves what they value.

The survey of almost 19,000 investors (clients of 436 participating firms in eight countries) by Dimensional Fund Advisers offers insights for firms reflecting on what they can offer and charge for beyond what's available in an app.

Investment returns rank below security and peace of mind

The most notable outcome of the survey, which covered Australia, New Zealand, the US, Canada, the UK and Europe, was that investment returns rank well below other more qualitative factors for end investors. Asked how they primarily measure the value they receive from their adviser, investors' most cited benefit was a sense of security and peace of mind, which was the top value among 35% of respondents. Second on the list was the adviser's knowledge of their personal financial situation (23%), followed by a sense of making progress toward their goals (20%). Investment returns came in fourth among the key benefits at 14%. While all this might seem predictable at first glance, it's arguable whether many financial planning firms really position themselves primarily in that light, as wealth counsellors and behavioural mentors.

While advisors may be tempted to promote their value as 'generating good returns', the real value they offer is getting clients to where they want to go. Returns are part of that, of course, but the advisor's main value-add is keeping clients focused on the areas within their control. Promising 'good returns' only means having to explain when markets don't deliver.

For instance, a financial plan that involves taking big risks in volatile assets whose ups and downs are more than the client can comfortably live with is probably not going to be a successful plan in delivering on the goal. In contrast, a plan that works within the clients' risk preferences that allows them to sleep at night and that is built according to their own lifestyle and circumstances may be more successful, even if short-term returns are less eye-catching.

In other words, the destination is more achievable if the journey is tolerable. And that's the value proposition for advisers that surfaced in this survey.

Investors want a sense of security

According to Dimensional's co-CEO and Head of Global Financial Adviser Services, Dave Butler, the value that investors place on a sense of security is really an outcome of advisers setting the right expectations with each client. "By helping clients understand what they can and cannot control, advisers can create a different experience to help ease their concerns," Butler says. The importance of the day-to-day experience also came through in answers to the question about what attribute investors consider most important in the adviser relationship. Of the survey sample, 31% cited the client service experience, while 26% said they ranked the adviser's experience with clients like themselves.

Knowing how much to spend rates highly

With Australia's superannuation system moving away from a lump sum to a retirement income goal, the survey's findings were revealing. Asked to identify the most valuable retirement planning information they receive, 28% of respondents cited knowing how much they will be able to afford to spend each year, ranking ahead of the total amount they will have for retirement (22%). Correspondingly, the single most cited fear about personal finances was not having enough to live on comfortably in retirement (37%), followed by experiencing a significant loss in a market downturn (31%).

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