Cuffelinks
Connecting investors with ideas

Edition 240, 16 February 2018

This Week's Top Articles

At the start of 2018, I began to question value investing …

Roger Montgomery

As the share market continued its relentless climb in early 2018, with minimal volatility, value investing was relegated to history as an anachronism from a simpler and more innocent time. Observing fund manager peers generating high double digit returns from companies whose prices at the time of purchase weren't even in the same universe as our valuations, I began to question the relevance of value investing myself.

Value versus momentum

However, a conversation with one peer cemented my loyalty to value investing, despite its inferior recent performance compared with momentum and growth. I asked my friend how he could have purchased a certain company given its price. He said that my 'problem' was "too much focus on value and too little focus on business momentum". Apparently, it was fine picking a business with strong sales or subscriber momentum in the knowledge that as the growth continued and the story spread, other investors would join the party at higher prices and a profit could be realised.

He had made a substantial return buying stocks this way, but my next question revealed a flaw in the approach. I asked: "If you are buying well above a conservative estimate of value, how do you know when to exit?" His answer left me uncomfortable: "That's a good question, you'll see it 'rolling over'."

He meant that when the price momentum starts to slow, the price will gently roll over and that would be his sell signal. If only the market were always so kind. Prices can drop sharply without warning.

Within a week, the Dow Jones Index lost 4% in a single day and at one stage was down 10%. The financial media produced some of the most breathless headlines seen in years. Many of my friend's stocks fell as much as 16% in a few days. I wondered whether those falls constituted a 'rolling over' by his definition.

Jumping aboard the fads

How can a value investor win when there is nothing cheap enough to buy in the first place? The value investor holds funds in the safety of cash and watches as prices rise inexorably higher. When the optimists are winning, as they have been recently, value investing can't hope to beat buying the 'concepts' that are simply going up the fastest.

It's easier to join the party and buy the latest theme, fad or concept, partly because commentary surrounding the companies usually supports the rises with what appears to be entirely valid theses.

In recent months, and reminiscent of the dotcom boom, we have seen companies simply change their name or strategic focus towards blockchain, and the market has rewarded incumbent shareholders with 300% plus gains.

For example, on 21 December 2017, the Hicksville, New York-based Long Island Iced Tea company announced a "Corporate focus shift towards opportunities strategic to blockchain technologies". The loss-making company's shares rallied from just under US$3 to over US$15 during the day of the announcement. At their peak, the shares were trading 411% higher than their lows only a week or two earlier.

On 9 January 2018, Kodak jumped on the buzzword and launched its own cryptocurrency, KodakCoins, which are tokens for use in the blockchain-powered KodakOne photography rights management platform. Within days, Kodak's shares were trading 390% higher.

Then eCigarette company Vapetek changed its name to Nodechain and said it would 'explore' Bitcoin, Ethereum, and other cryptocurrencies. The thinly traded shares jumped 360%.

These name or business changes are reminiscent of the adoption of those ending with '.com' during the tech boom of 1999 and early 2000. Back then, investors mistakenly believed that new technology – technology that admittedly changed the world – would render all companies involved profitable. It is a common mistake.

Australia is far from immune from this irrational exuberance. Perfectly valid arguments are being proffered for companies with revenues of barely $1 million and market capitalisations of $1 billion.

High likelihood of poor future returns

There is no question the US market is expensive. The CAPE ratio sits at 33 times the 10-year cyclically-adjusted earnings for the S&P500. I know the CAPE ratio includes the negative earnings of the December quarter 2008, but a simple calculation that grows this year's earnings by as much as 10% and drops out the 2008 number reveals the CAPE ratio is still at 30 times. It is higher than at any time since the 1800's with the exception of the tech boom.

Robert Shiller himself warns that the CAPE ratio does a relatively poor job of predicting corrections, but it does an excellent job of predicting future returns. The aphorism 'the higher the price you pay, the lower your return' sits well with Shiller's findings. With the CAPE ratio at record highs, we could see future returns at unappealing low single digits for many years.

What about volatility? The S&P500's Sharpe Ratio (generally, a measure of risk-adjusted returns) is at near-record highs and at a level history shows has never been sustained. Even if the overvaluation doesn't lead to a correction, volatility is likely to pick up. And if heightened volatility is a risk, and prospective returns are in the low single digits, the returns offered by cash offer a superior risk-adjusted alternative.

For Australian investors, while the domestic market might not seem as expensive as US indices, you can be sure of a high correlation if the US market turns down.

Timing is uncertain

I do not know with any useful accuracy when the US market will turn down more meaningfully than it did last week, but we do know some things:

- There is little absolute value available in the Australian market for quality companies.
- Irrational exuberance has emerged in some pockets of the market.
- Ultra-low volatility and ultra-high returns (the S&P500 rose almost 20% in just the six months to December 2017) are not a combination that lasts very long.
- Market corrections are usually preceded by the types of 'shots-across-the-bow' that we have just witnessed.
- On a risk-adjusted basis, there may be more attractive alternatives to being fully-invested in equities.

- History allows the recent weakness to be completely reversed and then replaced by another wildly bullish rally that sees caution thrown to the wind again and irrational exuberance itself making headlines.

On balance, caution is more appropriate than it has been at any time since 2009. Howard Marks, founder of the $100 billion Oaktree Capital, recently told clients to stay "defensive or cautious". Robert Shiller has warned "People should be cautious now." Both investors also said its not appropriate to be out of the market altogether. Our own process has arrived at a rising cash weighting but we're still 70-75% invested. So, you could say we agree.

But we'll leave momentum investing to those who believe they can pick the top.

Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is general information and does not consider the circumstances of any individual.

Volatility and reflecting on the inflection

Paul Moore

Initial selling during a heavy share market fall has nothing to do with valuations, and that is why it is always difficult to judge the extent of any short-term correction. With a bit of space from the immediate ructions of last week, what did it tell us about the long-term position of debt and equity markets?

Finally, a reaction to rising rates

Having watched this sort of thing far more than I'd like, my summary is this: it was an interesting but not unexpected week with a technical adjustment in markets. It was investors finally reacting to the fact that interest rates are adjusting to the reality of stronger economic growth and a US central bank that has begun the process of removing excess liquidity from the system.

Eighteen months ago, I thought that we had turned a corner not yet recognised by the broader market. Interest rates had inflected. Few people thought the same, particularly given the lack of wages growth in the US and the fact that interest rates were still *negative* in parts of Europe.

Scaling the wall of Fed money

The Federal Reserve monetary base since 1950

Source: BofA Merrill Lynch Global Investment Strategy, Federal Reserve

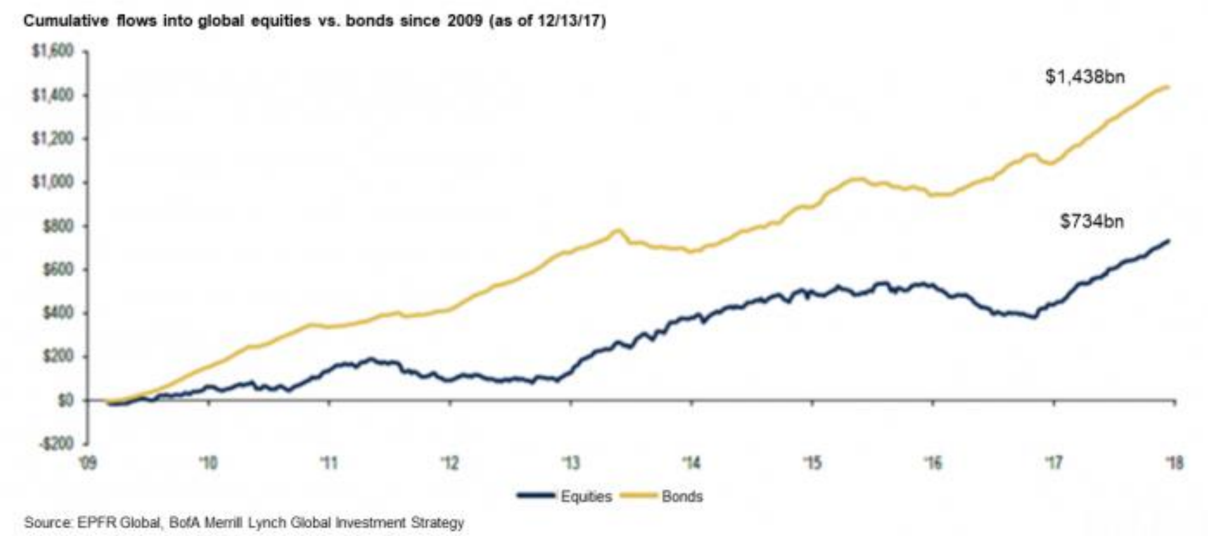
In September 2016, I expressed a view in our quarterly report that investors should note how abnormally low rates are (and remain so now) and not to allow the gyrations of the market to hide the fact that the tide may be changing. We thought the inflection point had occurred in July 2016 and there would be a different set of long-term opportunities in future.

Our expectation was that economic growth and earnings would be better than expected and the short-term price action risk would now more likely come from inflation scares and subsequent upward moves in interest rates.

Between then and now, we have invested based on our belief that markets were underestimating how tight labour markets were, with the most common complaint from CEOs in the US being the inability to find workers. Coupled with the passage of Trump's tax cuts late last year, which in theory will create significant pent up demand, interest rate markets have noticed that the inflection point had already been reached.

Flow into bonds at the expense of equities

However, investors (particularly passive ones) have been still piling into bonds at the expense of equities.



Until recently, the lack of wage growth was still a popular theme. This was looking in the rear-view mirror. Then we saw the strongest year-on-year increase in US wages for some time and market sentiment turned on its head and interest rates appeared to trigger a technical reaction in equity markets.

I suspect it is simply further confirmation that excess liquidity is starting to leave the system, the most high-profile examples being through VIX funds and even Bitcoin. Investment opportunities will now be in those companies that can grow their earnings, as opposed to those that historically benefited from a re-rating on the back of lower interest rates.

Investment opportunities, but with some cash caution

Many forecast valuation multiples seem reasonable. As examples, home builders are trading at less than 10x forecast earnings, banks and alternative asset managers at 10-12x and Pfizer is 11x. Over 50% of our global portfolio is on an average price to earnings (P/E) ratio of approximately 11. Other large sectors and stocks, as monopolistic and high growth businesses like the financial exchanges, Mastercard, Visa and Google range in P/E ratios from 18-24x, which seem reasonable for the nature of their businesses. We believe these types of businesses will give a satisfactory return in a general market environment of lower returns and choppier price action.

With last week's pullback in the market, we marginally reduced some of our futures hedges, closed out short REIT positions and will, in all likelihood, marginally increase some of our existing positions. This will be done within an overall framework that interest rates have inflected, markets have done well, and an invested position of approximately 85-90% is prudent.

Paul Moore is Chief Investment Officer at [PM Capital](). This article is general information and does not consider the circumstances of any investor.

AI and an intelligent active manager's odyssey

Jack Gray

In spite of Artificial Intelligence's (AI) transformative potential, the investment management industry has been slow to invest in and use AI compared with other developed industries. This paper explores the journey of AI, a threat to active management that comes quickly behind the current shift to passive investment strategies.

Active management and the demand for hope

Much ink and some blood has been spilt over passive Exchange Traded Fund's (ETF) supposed existential threat to the active management of securities and assets. While roughly one-third of all global equity management is now passive, the threat itself is overstated. Active's survival, though in a much-reduced form, is assured by the eternal demand for **hope** – hope of beating the market, hope of being above average, hope of not missing out. Supply to meet that demand flows willingly from active managers' engaging and sometimes insightful narratives about exciting stocks, often hyped by new technologies.

That said, active *is* exposed to a deeper and longer-term threat, one that might just 'sweep it away'. The Greek C P Cafavy's poem *Things Ended* highlights how easily we miss more damaging threats:

Engulfed by fear and suspicion,
mind agitated, eyes alarmed
we try desperately to invent ways out,
plan how to avoid the obvious danger
that threatens us so terribly.
Yet we're mistaken, that's not the danger ahead:
the news was wrong
(or we didn't hear it, or didn't get it right).
Another disaster, one we never imagined,
suddenly, violently descends upon us,
and finding us unprepared – there's no time now –
sweeps us away.

The opening gambit is Blackrock's intention to replace all or many or some traditional active equity processes (of which Blackrock has $300 billion in assets under management) with quantitative active processes ostensibly because quant can generate alpha as successfully as traditional and at far lower cost. For many this is an old story. Most traditional managers rely on some form of computer-driven quant processes in portfolio construction and trading. Since 2010, the assets of quant hedge funds has doubled to nearly US$1 trillion, while according to JPMorgan, orders placed by computers now account for 60% of US trading volume, double the figure from a decade earlier. However, scale and market presence threaten to transform Blackrock's initiative into an imperative for traditional managers.

A more substantial threat is lurking: Artificial Intelligence

But 'going quant' will provide only short-term solace. Lurking under the rubric 'quant' lies the more substantial threat of Artificial Intelligence (AI) or Deep Machine Learning.

The threat of AI to routine process-driven jobs is manifest even after discounting the considerable hype. But AI also threatens the jobs of lawyers, radiologists and others demanding advanced cognitive skills with its ability to recognise patterns and images, to learn, to improve its own algorithms.

In the investment management industry, both back and front offices are threatened. Eventually, AI will probably be capable of 'thinking' about, crafting, writing and even delivering engaging, insightful and empathetic narratives. Some AI programs already pass Turing's Test in which interlocutors fail to distinguish between answers from a human and a computer.

Then AI too will sell hope.

Is this scenario, the ultimate disruptive one where machines make (almost) all investment and commercial decisions, pitch for business and report to clients? Or does it belong in the SciFi fantasy world? Doubtless some is fantasy, but less than we might hope for.

We tend to overestimate the short-term effects of new technology while underestimating the long-term effects. Campbell Harvey, a respected finance professor predicts that "in the end it will be a good thing for investors" if human judgement is usurped by machine judgement. When Amazon enters investment management that harsh reality may well emerge from picturesque fantasy. Indeed, Autonomous Learning Investment Strategies (ALIS) have been with us for some time though as yet they are not capable of crafting new insights or of selling hope.

AI's co-existence with active managers

The history of technology suggests that some form of traditional active management will survive the rise of machines. The new often co-exists with the old rather than fully replacing it … quills and slide-rules notwithstanding. Co-existence will advance through human-machine interaction where human and machine in turn leverage off the other's insights in a process of continual improvement. To thrive in that world active managers will need as yet unknown skills.

For a while at least, a traditional active approach should thrive. Traditional is likely to outperform machines in managing highly-concentrated portfolios and alternative assets, especially in heterogeneous domains where idiosyncratic risk is high and tacit security-specific knowledge is critical. To the extent that AI learns through data-mining, the relative scarcity of data in those domains favours humans.

Further, much alternative investing lacks robust, predictive theories which again favours human minds. However, both advantages will likely fade as AI overtakes the human ability to develop intuitive knowledge and insights without much data and without theories. When machines can formulate and test their own explanatory hypotheses traditional active management will raise the white flag. That fearful scenario lies ahead, as currently AI/Deep Machine Learning is poor at generalising specific information and can't provide explanations or reasons to justify or explain its decisions (see '*The dark secret at the heart of AI*', *MIT Technology Review*, May/June 2017).

Currently it is a very black black-box and even blacker than the black-box inside active managers' heads. The world chess champion *Alpha Zero,* given only the rules and aim of the game, learns to play chess by playing against itself many times, but can't explain or justify its moves and tactics.

Investment management slow to invest in AI

In spite of AI's transformative potential, the investment management industry has been slow to invest in the necessary R&D, and even slower to use AI compared with other developed industries. Investing fails to rate a mention in Stanford University's AI Index. Failure is likely explained by the comfort induced by persistently high margins, by the industry's capital-light structure which inhibits capital-intensive R&D, and by its much-vaunted essence as a human relationship-driven business. If Blackrock's initiative drives lower margins, it may encourage the development of AI in active investment management. Further, the rules under MiFID II may cause an easy target as sell-side analysts become 'AI'd'.).

Embracing the opportunity

Unsurprisingly, some hedge funds with their greater institutional and intellectual freedom have been early adopters of AI and not just to uncover previously hidden factors in capital markets but also to improve human insights and decisions. The CFA has taken a positive step by offering teaching modules in AI and Big Data. Perhaps that's a straw in the wind. Perhaps the investment industry will sacrifice its long-protected comfort and embrace the opportunity and risks afforded by on-going advances in Artificial Intelligence and Deep Machine Learning.

Jack Gray is a Special Advisor and Director of Brookvine. Jack has been voted one of the Top 10 most influential academics (in his previous life as an academic) in the world for institutional investing.

Bitcoin: digital gold or fool's gold?

Joe Davis

Over the past few months, I've taken one question more than any other: "What do you think about Bitcoin?" Through 2017, Bitcoin, the world's first cryptocurrency, rose by almost 1,200%, prompting excitement and bafflement.

My answer: I'm enthusiastic about the Blockchain technology that makes Bitcoin possible. In fact, Vanguard is using such technology. As for Bitcoin the currency? I see a decent probability that its price will go to zero.

Are cryptocurrencies currencies?

Bitcoin's creators introduced the cryptocurrency in the wake of the GFC. The goal was to bypass governments and banks when two individuals want to transact. No country, company, or institution controls the currency. But are Bitcoin and competing cryptocurrencies really currencies? Let's think about what a currency is:

- **A currency is a unit of account.** Cryptocurrencies qualify, as they can measure the value of other goods and services.
- **A currency is a medium of exchange.** I'd give cryptocurrencies a qualified yes on this point. Currently, only a limited number of vendors globally accept cryptocurrencies, and recent volatility has already discouraged increased adoption.
- **A currency is a store of value**. Bitcoin is not. Its price volatility undermines its adoption, as fewer vendors will accept a currency whose value can fluctuate so dramatically. The prices of newer currencies have been similarly volatile.

The existential dilemma

Let's call the verdict on the currency question mixed. Even if cryptocurrencies qualify as currencies for niche purposes, their prospects seem dubious.

The greatest threat is central banks, which have started to research Blockchain-based currencies and impose regulations on exchanges. Given the additional control and policy effectiveness that digital currencies could provide, central banks have good reason to adopt digital currencies in the coming decades. Those currencies would be 'legal tender', legally recognised forms of payment for all debts and charges.

If the choice were between Bitcoin or a Blockchain-based dollar, which would you rather have in your digital wallet?

Cryptocurrencies as investments

The investment case for cryptocurrencies is weak. Unlike stocks and bonds, currencies generate no cash flows such as interest payments or dividends that can explain their prices. National currencies derive their value from the underlying economic activity of the countries that issue them. Cryptocurrency prices, on the other hand, are generally not based on economic fundamentals. To date, their prices have depended more on speculation about their eventual adoption and use. The speculation creates volatility that, ironically, undermines their value as a currency.

Nor are cryptocurrencies a chance to capitalise on Blockchain technology, which is the method most cryptocurrencies use to record network transactions and ensure their accuracy. Although cryptocurrencies are built using a Blockchain, they are not necessarily tied to the value of Blockchain applications that may improve the cost, speed, and security of executing transactions or contracts. Bitcoin is an investment in blockchain in the same way that Pets.com was an investment in the internet.

For investors, adding some exposure to Bitcoin would mean reducing their allocations to tried and true asset classes such as stocks, bonds, and cash—the building blocks for well-diversified portfolios that can help them meet their goals. With no cash flows and extreme volatility, the investment case for Bitcoin is hardly compelling.

We are early in the development of Blockchain technology. We'll likely see Blockchain adopted by governments and enterprises for specific purposes in the coming decades. As innovation quickens and competition increases, the majority of networks (and their associated cryptocurrencies) may be rendered obsolete, leaving many cryptocurrencies like tulip bulbs in 17th-century Holland—soaring to incredible heights before the speculative bubble pops.

And, unlike tulips, they don't look good in a vase.

Joe Davis is Global Chief Economist at [Vanguard](), a sponsor of Cuffelinks. This article is in the nature of general information and does not consider the circumstances of any investor.

8 benefits of listed over unlisted infrastructure

Ofer Karliner

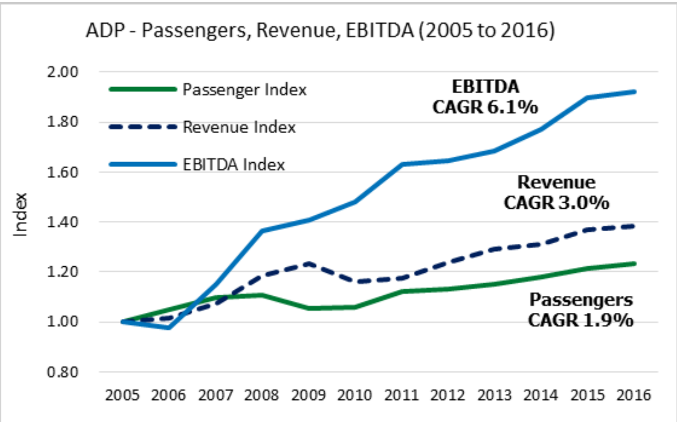
Investors who recognise the benefits of holding global infrastructure may choose the assets in listed or unlisted form. While the benefits of unlisted infrastructure are often argued, this document highlights eight advantages of listed infrastructure. It is a universe of more than 350 companies worth over US$4 trillion at prevailing market prices.

The ownership structure does not change the characteristics of the underlying infrastructure assets, such as stable and reliable real returns and income over the business cycle.

1. Access to some of the world's best infrastructure

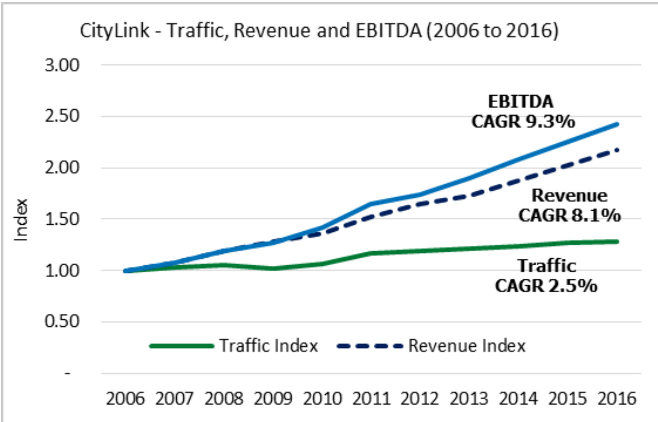
If investors want to own holdings in some of the world's best infrastructure companies, they are forced to turn to listed markets. Paris's Charles de Gaulle international airport, Melbourne's CityLink, and the high-voltage electricity transmission network in England and Wales, for example, are owned by listed infrastructure companies. Investors have been well rewarded as these companies have achieved rising returns on equity and higher earnings per share. For example:

Charles De Gaulle Airport (Paris)



Source: Magellan.

Melbourne's Citylink

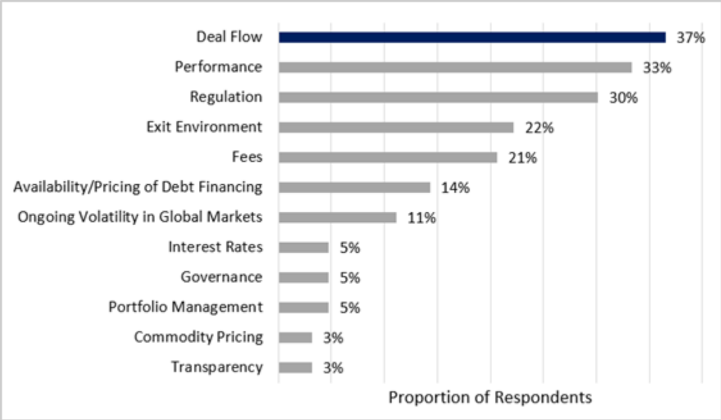


Source: Magellan.

2. An ability to invest quickly

The liquid nature of the listed infrastructure universe enables investors to achieve their desired strategic allocation in relatively short order. We estimate that an investor can deploy US$500 million in some of the world's best listed infrastructure assets within a number of weeks, while it can take investors in unlisted infrastructure a number of years to invest a similar amount. A recent Preqin infrastructure survey noted 37% of infrastructure investors are concerned with the lack of deal flow (see chart below) that has contributed to the growing levels of 'dry powder' in unlisted infrastructure funds. The amount of 'committed but not deployed' capital has exceeded US$100 billion since 2013.

Investor views on the key issues for the infrastructure industry in 2017



Source: Preqin.

3. Diversification across sectors and regions

Listed infrastructure companies own and operate assets located around the world (developed and emerging countries) and across the spectrum of infrastructure sub-sectors (including utilities, transport and social).

This compares with the unlisted world where funds typically hold a concentrated portfolio of between 5 and 15 assets with a bias to a sector or region depending on available assets, especially during the fund's investment period.

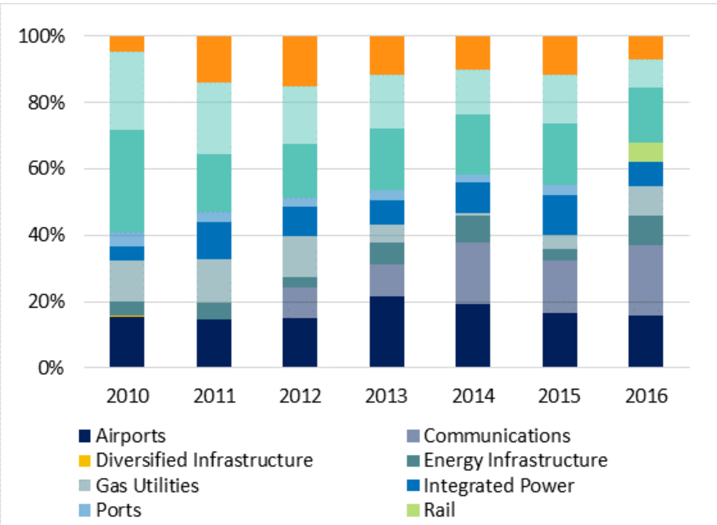
More recently, about 50% of completed infrastructure deals were focused on renewable energy assets, resulting in most unlisted infrastructure funds having a bias to one sector. Achieving portfolio diversification can be challenging with an unlisted-only approach.

4. An ability to tilt across regions and sectors

Once investors have built a well-diversified portfolio, they can readily adjust holdings across sectors and regions to take advantage of different pricing conditions across markets. This ability can enhance the risk-return profiles of portfolios.

Unlisted infrastructure funds are generally unable to make medium-term tilts across regions and sectors during the life of the fund to take advantage of pricing opportunities.

Active sector tilts across the Magellan Select Infrastructure Strategy 2010-16



Source: Magellan.

5. Live prices reduce illusionary risk reduction

The intrinsic value of any long-dated asset is a function of its future cash flows and associated risks. Because of the predictability of their cash flows, the intrinsic valuations of infrastructure assets tend to be stable over time. Despite this, stock prices fluctuate above and below this intrinsic value, presenting the opportunity to achieve superior risk-adjusted returns.

The more infrequently asset valuation takes place, the less accurate the accounting value of an asset is likely to be. Assets in unlisted infrastructure are usually less-frequently valued. For some funds, the liquidity mismatch created by offering members the ability to transact (often daily) more regularly than the assets are valued increases the risk of prices being misrepresented to investors.

6. More mispricing opportunities

The nature of listed markets provides skilled investors with the opportunity to purchase assets at a material discount to their intrinsic value or to sell them at material premiums. In recent years, the demand-and-supply dynamics for private-market infrastructure has shifted such that many of these assets have been acquired at valuation premiums to their publicly traded alternatives.

With UK utilities valuation differences have been pronounced. Despite the country's sophisticated regulatory regime that permits utilities to earn a set, fair return on their regulated asset base (which can be thought of as net tangible assets), and regardless of ownership, valuation premiums have persisted over the past decade. However, private-market transaction valuations have exceeded the trading multiples of listed utilities by between 20% and 50% to the underlying net tangible assets.

These mispricing opportunities are also available within global airports, with transaction multiples in the unlisted market well ahead of what investors are paying for similar cashflow streams in the listed market.

7. Transparency of assets from the outset

In listed securities, investors are well informed and aware of the likely assets that will form part of a listed infrastructure portfolio. This contrasts with private infrastructure funds that can often involve a 'blind commitment' to a fund that may, at the end of the investment period, hold lower-quality non-core assets than promised at the outset.

8. No forced asset sales

Another factor in favour of listed securities is that there are no forced asset sales. The closed-ended nature of private infrastructure funds can result in redeeming assets at sub-optimal market conditions. The open-ended nature of listed assets means exposure can be held indefinitely.

Ofer Karliner is a Portfolio Manager at [Magellan Asset Management](). Magellan is a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

Asset class and portfolio management skills are different

Pauline Vamos

Technology is having a profound impact on our access to information and our ability to transact has made investing easier, yet ironically, more difficult.

Our expectations of investment managers are higher, our reliance on their professionalism increasing. Mandatory superannuation means that balances are getting larger, mandates are broader, and institutional investors are shouldering increasing responsibility for investor outcomes.

Endowments, charities, and family offices are required to be more transparent and longer term focussed. At the same time, we are living longer, while average super balances are low, which means self-funding is imperative for many of us.

The problem is that, as in any field of endeavour, with evolution comes the need for greater specialisation. And one of the most important specialist skills is the ability to manage a portfolio as a whole, in many cases via multiple investment managers. This is different from the ability to successfully invest in different asset classes individually.

It is often argued that portfolio management, in the form of asset allocation, is the largest determinant of long-term investment performance. The question now is whether investment managers have the skills required to successfully navigate a sea of changing financial imperatives. And whether asset owners have the skills to oversee them.

What standard should you expect of investment managers? And how do we define and monitor standards?

Portfolio management goes well beyond financial advice or analysis

The challenge of successfully managing an investment portfolio goes beyond making a series of good individual investment decisions. Analysts analyse data and risks and give opinions based on the results. This is a fundamentally different skill from the ability to think about overall risk the right way. That is the job of the portfolio manager, who must be able to identify risks including externalities such as material environmental, social, and governance risks.

The skill of the portfolio manager lies in the ability to structure a portfolio so that unforeseen events do not result in the loss of the entire, or even a significant portion, of the fund. And that can mean managing interactions between a number of underlying managers to ensure diversification and correlation.

Portfolio management skills require specialist training, including tracking the progress of investments, knowing when to sell and how to get the mix right at any point in time. More of us are assuming we can take on this role of building portfolios. The major superannuation funds obviously do it, but so do SMSF trustees, Family Offices, and even individual investors.

We all have a responsibility to make good decisions. In the case of institutional investors, decisions have far-reaching consequences - the influence on corporate Australia, the performance of individual asset classes, and on individual investor outcomes can't be overstated.

How do we achieve the necessary level of professionalism?

The short answer is a robust qualification with the requirements for ongoing maintenance and work.

Qualifications such as CFP and CFA remain vital, but a portfolio management qualification is needed to fill the gap:

- The qualification should be international and set the bar for investment managers involved in any aspect of constructing multi-manager portfolios.
- It must require rigorous ongoing CPD points.
- Ethics must be a major part of the qualification, as ethics drive conduct and conduct drives outcomes.
- ESG is no longer a 'nice to have'; climate change, for example, is increasingly posing a real risk to financial stability.

We are at a point in the evolution of portfolio management and portfolio governance. Specialisation is now essential. With investors living longer and usually relying on retirement savings for many decades, the consequences of poor decisions are serious and the expectations of stakeholders higher than ever.

Pauline Vamos is CEO of Regnan Governance Research & Engagement and is also the chair of CIMA Society of Australia (formerly IMCA Australia). She was CEO of the Association of Superannuation Funds of Australia (ASFA) between 2007 and 2016.

Five ways Australian super is a global outlier

Graham Hand

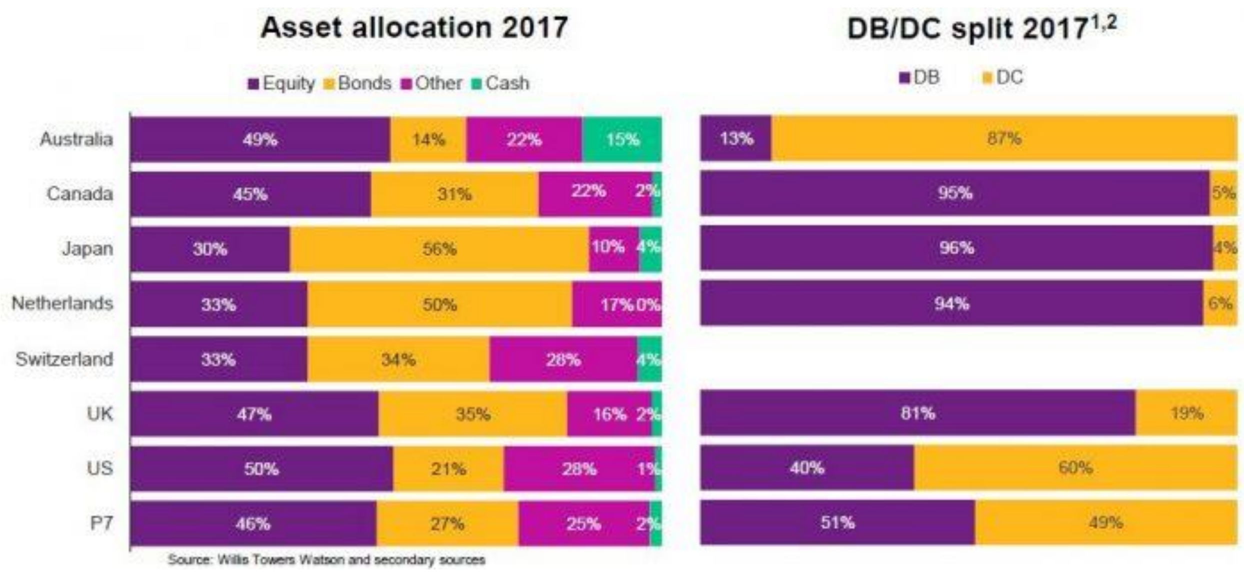
The most obvious expectation is that Australian superannuation should have similar asset allocation to the retirement money in other developed countries. Major asset managers are global, consultants advising big super funds are global businesses, finance executives study the same markets and theories, and investment markets follow a herd mentality. Surprisingly, the differences are stark.

The Thinking Ahead Institute's 'Global pension assets study 2018' of 22 pension markets with assets of USD41 trillion shows Australia has been the fastest grower over the last 20 years, up 12.1% per annum. This is driven by mandated contributions and dominance of defined contribution schemes. Note that although the study refers to 'pensions', in Australia's case, it includes the entire balance in superannuation funds (pre and post retirement).

What's most notable is how Australia is an outlier in many important ways, including:

1. The **highest allocation to equities** at 49% of any of the 22 countries, with Switzerland and Netherlands as low as 33% and Japan 30%. What do the Gnomes of Zurich know that we don't?

Asset allocation and DB/DC split in 2017 by country



Equity markets are usually more volatile and subject to larger drawdowns than bonds, leaving Australian savings more exposed to the vagaries of the market. Countering this worry is that fact that shares offer better long-term returns, and with increasing longevity, pensions need to last 30 to 40 years, not the 10 to 20 years of the past. Australia also has relatively high dividend yields and the benefits of franking credits.

(The Australian data uses the ATO's reports on asset allocations, which have shortcomings as documented here, especially in not recognising SMSF exposure to global equities).

The concern about capital protection is one reason why many MySuper funds are 'target date' or 'lifecycle' funds, where the defensive or bond allocation increases with age.

There is also an issue with sequencing risk, where the market falls heavily shortly before retirement, when pension balances are at their highest, about to face withdrawals to fund a retirement, and with little ability to top up.

For example, on 18 January 2016, the Chairman of the Future Fund and former Treasurer, Peter Costello, wrote in the Herald-Sun about the risk of investing too much superannuation money into shares, including:

"The compulsory superannuation system has hooked the earnings and savings of millions of Australians into the stock market. I don't think it was a conscious decision. It started off small and now it has grown big. Stocks are at the riskier end of the investment universe. Government policy has directly hooked the wealth of individual citizens to rises and falls in share prices.

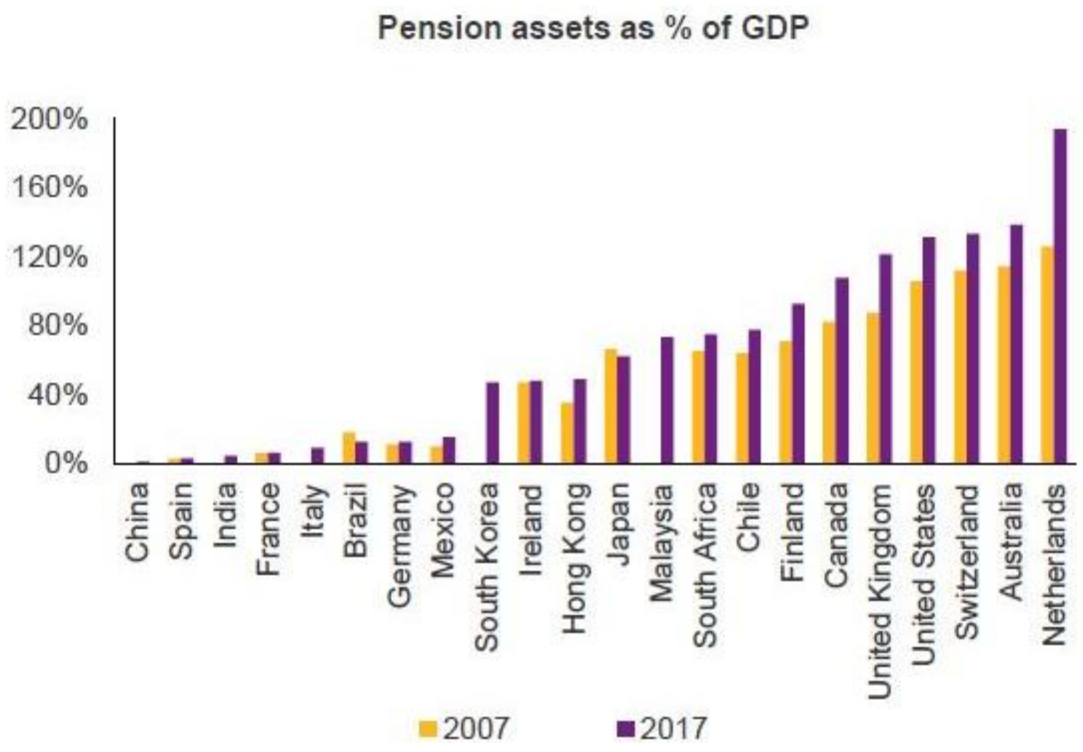
Our stock market is still 30% below its level of eight years ago. There's a lot of lost years for people to make up and a lot of lost wealth. You can see why people prefer to put their voluntary savings in less volatile assets like residential housing. They're more careful with their money than the Government is."

2. The **highest allocation to cash**, at a heady 15%, when cash rates are negative in relative terms, in contrast to The Netherlands at nil and a global average of only 2%. Do Australian investors use their 'risk budget' on equities and compensate by holding lots of cash? There is probably a distortion that explains some of the difference: the Australian numbers include SMSFs, a uniquely Australian vehicle which comprises one-third of all superannuation balances. SMSF trustees are individuals, notoriously conservative and protecting their own capital with cash and term deposits. The Australian number is being compared with predominantly institutional investors in other countries.

3. The **lowest allocation to bonds** at only 14%, versus the global industry average of 27% and a country like The Netherlands as high as 50%. Some of these countries have negative interest rates on their government bonds, although they have a far more active non-government market than Australia. And note previous comment about SMSF allocations.

4. The **highest proportion of assets in defined contribution schemes** (where the amount invested is defined) rather than defined benefits (where the final benefits of the scheme are defined). Defined contributions require the investor to decide how money will be invested (although most are in defaults and do not make an explicit decision on how the money is managed). It is the investor who takes the full risk of the outcome, rather than receiving the protection of a pension with the risk borne by an institution. Australia has only 13% of assets in defined benefits versus over 94% in Canada, Japan and The Netherlands, as shown above.

5. Australia's system is second only to The Netherlands in the **ratio of pension assets to GDP**, showing the maturity of our compulsory superannuation system relative to the size of our economy. Pension assets now stand at 138% of GDP. This looks like it's up from 114% in 2007, but the 2017 data includes SMSFs.



Other comments by the Thinking Ahead Institute include:

- Global institutional pension fund assets in the 22 major markets reached USD41 trillion at year end 2017, increasing USD5 trillion over the year.

- With DC models in the ascendancy, it is important that governance issues and the shift in risk on to the end-saver are closely monitored.

- Reduced home bias for equities in the last 20 years, falling to 41% in 2017 from 69% in 1998. Private assets rose from as little as 4% of allocations in 1997 to around 20% today, showing a sophistication of strategies in allowing funds to go beyond traditional means of diversification.

Graham Hand is Managing Editor of Cuffelinks. The Thinking Ahead Institute is a global not-for-profit member organisation whose aim is to influence change in the investment world for the benefit of savers. The Institute is an outgrowth of Willis Towers Watson Investments' Thinking Ahead Group. The full study is linked here.