

This Week's Top Articles

- **\$1 million is never worth less than \$500,000** *Graham Hand*
- **Three major financial goals after retirement** *Don Ezra*
- **Is it time for 'set and forget' to consider retirement?** *Kej Somaia*
- **Investors expect ESG issues to drive returns** *Rob Wilson*
- **How the super contribution changes may benefit you** *Mark Ellem*
- **Record award in estate of John Hemmes** *Donal Griffin*
- **A better way to measure Australian small caps** *Greg Cooper*
- **Five lessons from football and investing** *Ted Richards*

\$1 million is never worth less than \$500,000

Graham Hand

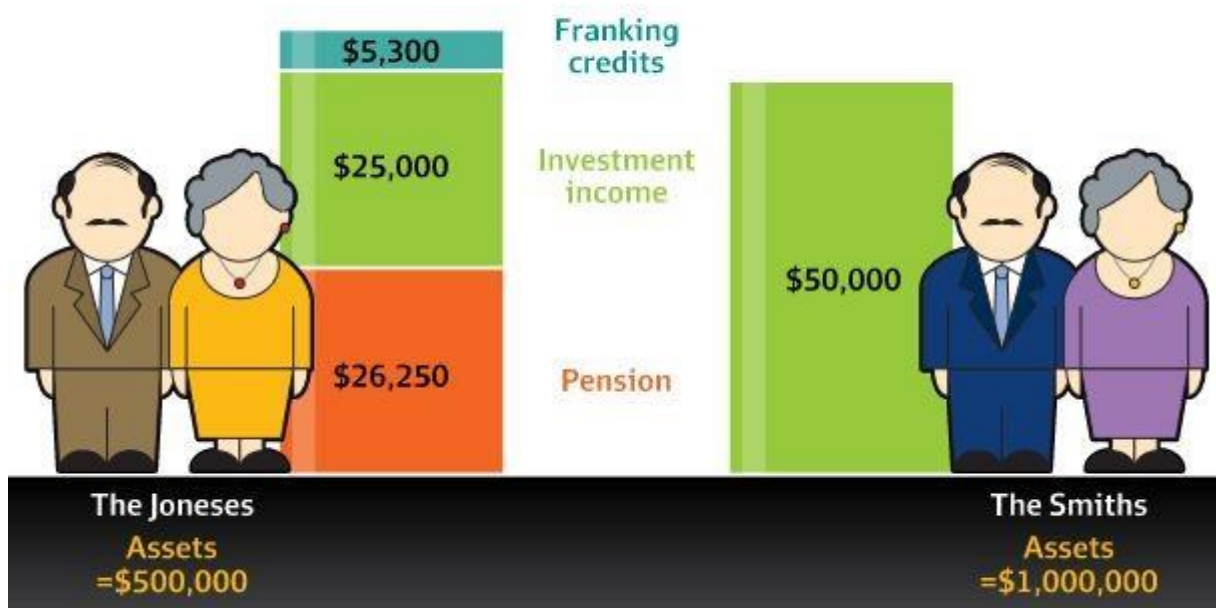
Hands up any home-owning retiree who would prefer to have \$500,000 in other assets rather than \$1 million. Anybody? What, nobody? I thought so.

So why did the headline in *The Australian Financial Review* of 7 April 2018 state, "When \$1m is worth less than \$500,000", and leading names in superannuation offered their support for the claim? The respected SMSF specialist, Meg Heffron, tweeted,

"This is such a good article ... And one of the worst things about this is not that it's dumb policy, it's the demonisation of people like the Smiths who have saved and sacrificed to get their \$1m."

The AFR article was accompanied by the following graphic:

\$56,600 TOTAL INCOME **\$50,000**



Source: Australian Investors Association, Atlas Wealth | Interactive: Les Hewitt

The analysis assumes both the Smiths and the Joneses invest half their money in a balanced portfolio earning 5% and the other half in fully-franked shares. Due to the proposed Labor policy of allowing franking credit refunds for pensioners (worth \$5,300 to the Joneses) plus the age pension itself (worth \$26,250 to the Joneses), apparently the Smiths with \$1,000,000 are “worth less” than the Joneses with \$500,000.

Accessing money to live on

Two simple examples show how the “worth less” claim can never be true.

First, suppose the Smiths renovate their house for \$500,000 and otherwise retain the rest of their net worth by holding \$500,000 in assets other than their home. Now they are instantly in the same position as the Joneses regarding income. They receive franking credits and the age pension, plus they have a beautiful extension to enjoy in their later years. In future, the Smiths will have more money if they sell their more valuable house and downsize (and perhaps put it into superannuation from 1 July 2019 using the new downsizer contribution rules). They may even access more money if necessary through a higher reverse mortgage, for example. Clearly, the Smiths are better off than if they started with only \$500,000.

Second, in case anyone argues the AFR article is more about ‘money to live on’, a previous article in [Cuffelinks by Gordon Thompson](#) charts how a wealthier pensioner is better off by drawing on capital to supplement income. This is a legitimate retirement superannuation strategy. In fact, governments have often stated the intention of superannuation is not a tax-advantaged bequest scheme but to finance a retirement **including drawing down capital**. As Thompson says, “*The goal of a retirement income strategy should be to maximise the retiree’s sources of cashflow over time. This can be achieved by drawing down savings in combination with a part pension.*” Here’s the crucial point some people are missing.

Once the Smiths have enjoyed living off the extra money, they still have \$500,000, which is as much money as the Joneses. In fact, the Smiths will receive a part-pension as soon as their non-home assets fall below \$837,000 when they also become eligible for franking refunds (assuming they do not invest via a SMSF, where the cut-off date for the 'pension guarantee' is proposed as 28 March 2018). The more they draw down on their capital, the more the age pension rises.

Real life for the Joneses and Smith

Let's re-examine the numbers with the same assumptions as above (that is, the Joneses have \$500,000 and the Smiths \$1 million, and all are homeowners aged 65. The two couples have a zero marginal tax rates and receive franking credit refunds when they are eligible for the age pension (full or part). Current age pension rules apply and calculations are presented in real term with the inflation rate at 2.5%).

Let's assume both couples want a better lifestyle and live on \$80,000 initially from the age of 65. The charts below divide the \$80,000 of 'income' or 'cash flow' into four components: Age pension, franking credit refunds, investment returns and capital drawdowns.

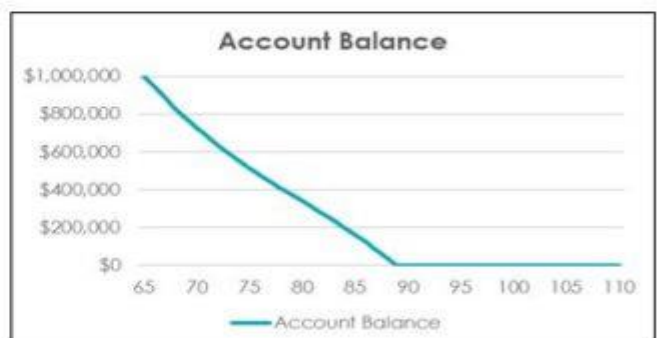
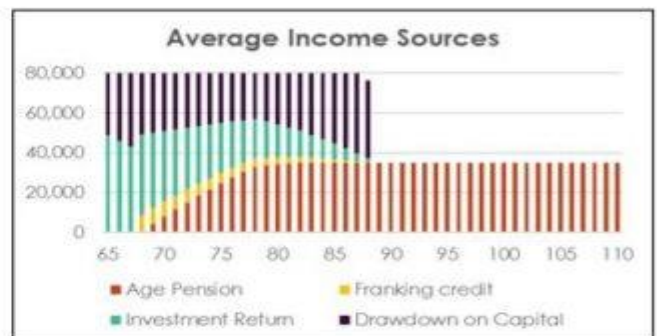
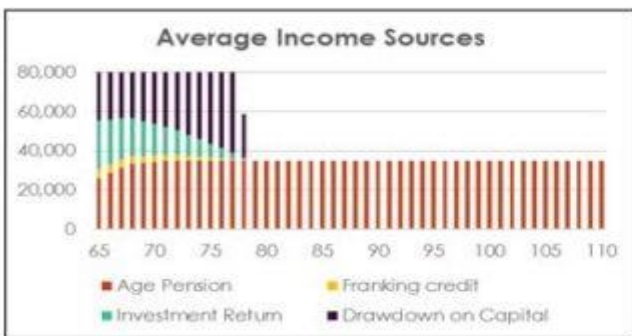
The charts show how the age pension and franking credit refunds kick in for the Smiths and how rapidly investment income falls for the Jones as they drawdown their capital.

The Smiths will reach the age of 88, or 23 years later than the start point, before they exhaust their capital and rely on the age pension. If the Joneses wanted this lifestyle, their capital would be exhausted at age 78, a decade earlier than the Joneses. It would take the Smiths until the age of 75 or 10 years to reach the \$500,000 held by the Joneses when they were 65. So much for the Joneses being better off.

Smiths versus Jones based on \$80,000 annual expenditure

The Joneses \$500K

The Smiths \$1M



The AFR article only considers the first year. As the Smiths spend more, they soon start to receive their franking credits and their age pension grows rapidly. Note that as these calculations are done in real terms, the 5% return on investments is only 2.5% and this also reduces the account balance.

We have run many simulations at different income levels and there are no circumstances where it's better to have \$500,000 than \$1 million.

The disincentive to save and the black hole

A similar argument is often made against the Turnbull Government's changes to the age pension taper test and thresholds which took effect on 1 January 2017. Some articles say it's better to spend excesses above thresholds on 'whatever you please', almost as if it's good to get rid of the money to qualify for more age pension. For example, an extra \$23,000 in age pension is 7.8% risk-free on \$300,000, achieved by reducing assets from \$800,000 to \$500,000.

For example, the SMSF Association CEO, John Maroney, wrote on 9 January 2018:

"For home-owning couples who have a superannuation balance between \$500,000 and \$800,000, the increased taper rate creates a 'black hole' where their assets above the asset test free amount cause them to be worse off in terms of income. This is caused by the taper rate of the equivalent of 7.8%, reducing their pension entitlement at a rate exceeding the income they earn from their superannuation balance above the asset free area."

John is right in specifying 'in terms of income', but superannuation involves a calculated drawdown of capital for most people. This is not only about 'income' but access to money and cash flow. The person with \$800,000 or \$1 million is better off because they have substantially more capital to draw on. They will go onto the age pension after they have enjoyed spending part of their extra capital.

Graham Hand is Managing Editor of Cuffelinks. My thanks to quantitative analyst Estelle Liu for assisting with the calculations.

Three major financial goals after retirement

Don Ezra

Decumulation is different from accumulation. Accumulation feels as though it has an indefinite time horizon that can be voluntarily stretched out if necessary. In decumulation, the time horizon is beyond your control, and constantly shortens. Also, an individual's risk tolerance is reasonably constant through most of accumulation, but risk aversion increases through decumulation.

This article is *only* about decumulation. Bequests are not taken into account.

This is about people *without* certainty that they can fund their desired lifestyle with their remaining assets. If you can afford to buy a lifetime income annuity at the desired level or if you can live on the dividend stream from your equity portfolio, you don't fit.

The long-term goals

I'll illustrate the principles via a story about a fictitious couple with **three** long-term goals, even though they can't all be reached with certainty: longevity insurance, asset growth, and safety. They want to know how much of an annual drawdown is likely to be sustainable, if they take some investment risk.

They start with one short-term goal. What if some emergency arises, and they need instant cash? Many financial professionals advocate having six months of spending as an emergency pot. They decide that the first

2% of their assets will be set aside in cash as their emergency pot. Everything else is now based on the remaining 98%.

1. Longevity insurance

Like most retirees, our couple fears outliving their assets. They fear the consequences of their uncertain longevity, particularly as they're both in reasonable health. But in Australia (assuming they cannot afford enough in lifetime annuities), they can't buy pure longevity insurance, so they self-insure.

They look at tables of 'joint and last survivor' probabilities, understanding that these show the probability that at least one of them will be alive over various time horizons. They feel that the 50% point is too risky a deal for them. They opt for the 25% point, which gives them a time horizon with a 75% chance of having money long enough.

Why not 10%? That would give them greater certainty. If they plan for the 10% horizon, their annual drawdown will be smaller than with the 25% horizon. So, with hope for asset growth in their hearts, they start with 25%, and remind themselves that, if they approach that point and are still in good health, they will need to take action. More on this later.

2. Growing the assets

They could lock in a lifetime income that's *smaller* than their desired lifestyle requires, but they prefer to seek asset growth. They recognise that, even if it's a reasonable long-term expectation, it isn't guaranteed. In addition, they're aware of 'sequence of returns' risk, meaning that a few years of bad equity returns in the early part of retirement could condemn them to permanent regret and a permanently much-lower-than-desired lifestyle forever after. That's a serious and difficult issue.

Clearly, not all their assets can be growthy. How much, then, in safe assets? And what are safe assets, in fact?

The couple anticipates that their psychological attitude towards risk will change over time, as their desired lifestyle settles down. They're looking forward to the immediate go-go years, when they're finally able to do so many things they've dreamed about. But that stage, that attitude, that degree of robust physical and mental health, won't last forever.

Most retirements settle down, in time, to a slow-go sequel, in which the lifestyle is downsized – not necessarily any less busy and involved, but more localised. The value of further growth, in terms of what benefit it secures for them, is reduced. Why take the risk if the reward means little? So they decide that they want as much safety as possible in their investments by the time the older one's age reaches 85.

In addition, they don't want their far-flung adult children to worry about their finances. That suggests a target of 100% in safety-oriented investments, kicking in after the couple's 'autumn crescendo' is over, as Dr Laura Carstensen beautifully describes the early stage of life after work.

That's the long-term perspective. Back to the short-term sequence-of-returns risk.

3. The ladder of safety

To enable them to focus on growth (before the slow-go), they want a sort of 'ladder of safety', a tranche of safe investments from which they'll make their drawdowns in the early years. This is important psychologically, even though it makes no financial difference to divide their pot conceptually into drawdown and growth segments.

They decide on a ladder that gives them five years of spending. Why five years?

One reason was our couple saw some (admittedly American) numbers that showed that, historically, equities had positive real returns over 5-year periods 75% of the time. That's in satisfying concordance with their longevity probability stance. Going to a safer 10-year ladder took the percentage up to 88%.

The other was that putting 10 years of spending into their safety ladder reduced the amount in growth so five years was as long as they could afford, if they genuinely wanted growth.

At 80, hoping that they'll still have a 5-year ladder, they'll gradually start to cash out of growth, so that they'll be totally in safe assets by 85.

They hope they can re-extend the ladder every year, so that it'll always be available as a safety measure. What they're betting on is mean reversion, the notion that governments or central banks will manage to intervene and prevent a prolonged equity market downturn.

Set the three choices, with annual appraisals

They now have three choices (a specific overall horizon, a specific time at which all assets should decline to safety, and a specific length of ladder) to determine a customised glide path for the growth/safety exposures as well as an estimate of sustainable annual drawdown.

But what if things don't work out?

The couple plans two sets of nudges to their position, each year.

One is whether to extend the safety ladder. They will if equities have a positive real return. They won't if it's negative, but they know there's deep trouble if five years pass that way.

The second is to reassess their sustainable drawdown each year. They won't transition to the new number but will spread the difference over their remaining horizon. If there are five lean years in a row, they will have made five adjustments gradually.

Oh, back to one other thing not working out: their longevity estimate! If they're still in reasonable health at 85, they'll be entirely in safe assets anyway, not looking for further growth, so they consider an immediate annuity at that point and do away with longevity risk.

All their geeky friends tell them that something like that, with arbitrarily chosen numbers, can't possibly be optimal. But all they want is a shot at growth combined with sleeping easily at night.

Don Ezra has an extensive background in investing and consulting and is also a widely-published author. His current writing project, blog posts at www.donezra.com, is focussed on helping people prepare for a happy, financially secure life after they finish full-time work.

Is it time for 'set and forget' to consider retirement?

Kej Somaia

The simplicity of set-and-forget investment approaches is that once established, you don't need to worry about them too much. Set ... and ... forget. It's simple and it rhymes! You will still need to determine things like rebalancing and reinvestment policies but month-to-month, day-to-day, and minute-to-minute, there's a reasonable chance of achieving your return objective over the long term by sticking to the plan. Indeed, obsessing over market gyrations can lead to investors making a mistake (for example, selling at the bottom).

Set and forget or remember to revisit?

This set and forget approach has been best exemplified in the strategic asset allocation (SAA) arena. Here, the realisation of long-term average returns and volatilities have combined with the benefits of diversification to help many to meet and exceed their objectives over several decades. Ten years on from the GFC, the central-bank-fuelled 'bull market in everything' rages on and proponents of SAA strategies can safely declare victory. Set and forget wins. Right?

Not so fast!

While traditional SAA strategies have delivered in the past, there's no guarantee this will persist. In fact, we would argue that market conditions are such that an SAA approach will likely fail to deliver in the period ahead. Further, SAA has typically focused on the theoretical long term and realising long-term returns in a shorter-term reality may not happen. That reminds us of a famous quote whose true source is 'unknown' but is mostly attributed to part-time philosopher and full-time athlete, Yogi Berra, NY Yankee Baseball player:

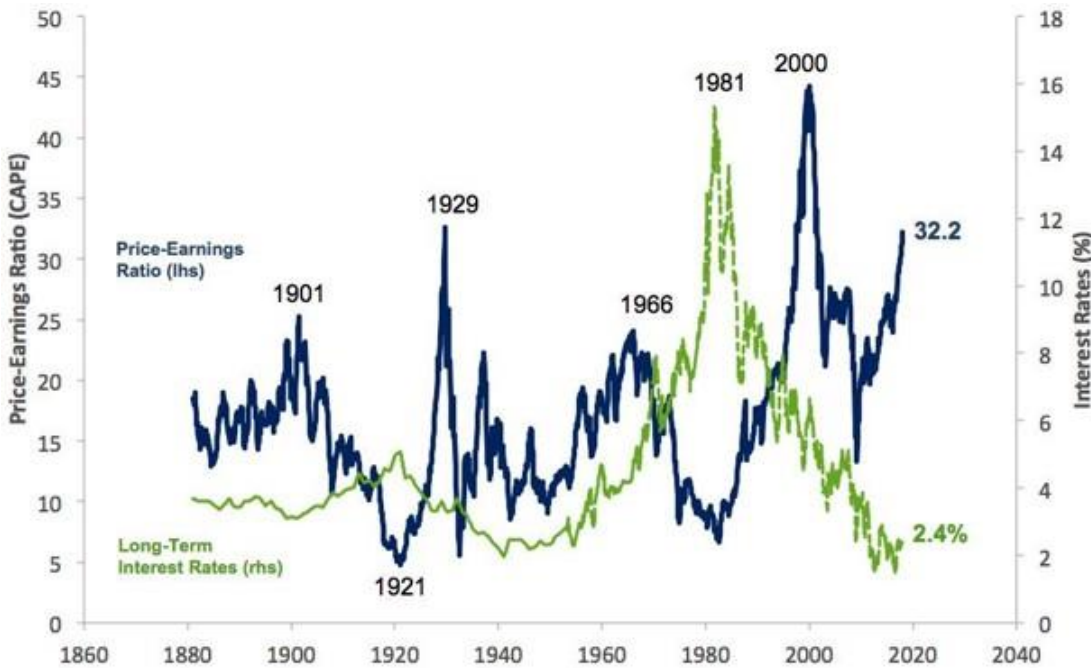
"In theory, there's no difference between theory and practice ... in practice there is."

Sometimes the long run is too long

Unless you have an infinite time horizon, you cannot necessarily rely on 'long-run average market returns' to deliver on your investment objectives. Historical averages don't foretell the future. In particular, long-term averages don't contemplate current valuations, future correlations, and certainly don't consider the path to get there.

Taking each of those points in turn.

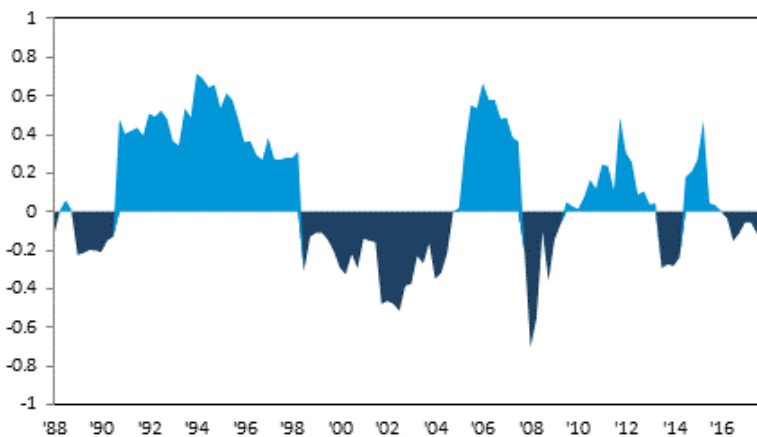
First, consider the elevated level of valuations across equities and fixed income (illustrated in the chart below), with P/E multiples at extreme levels and bond yields around record lows. The starting point matters, even for the theoretical long term. Even with a relatively optimistic outlook, it's safe to say that expected returns in the period ahead are lower than seen historically.



Source: Robert Shiller, Yale University, data to 31 December 2017. US 10-year sovereign interest rates or equivalent.

Second, the assumption that fixed income is defensive at all times and always offsets underperformance in growth assets is not borne out in the data. In fact, correlations between asset classes vary from period to period (see below). The average historical rolling 3-year correlation between global equities and global bonds of around 0.1 masks extreme changes in this relationship which has profound implications for diversification (maybe that lunch wasn't 'free' after all).

Historical correlation between MSCI World and Global Bonds



Source: Bloomberg, CFSGAM as of 31 December 2017. Rolling 3-year correlation based on quarterly data on the MSCI World Net Total Return USD and Citi World Government Bond Index (WGBI) USD Indices

Finally, and perhaps the most concerning of all, is that set and forget SAA strategies have never really contemplated the problem of sequencing risk (or the order in which events, often negative, happen). Those approaching retirement should care deeply about the path taken to achieve objectives, since there is much less time to overcome a major negative event such as a 40% equity drawdown. In this sense, SAA strategies have never really considered the retirement phase, and we believe investors with more defined investment horizons, should consider phasing out of SAA strategies at the appropriate time.

The options

So what options do investors have?

We believe there are three strategies:

1. Do nothing: Accept potentially lower returns and/or higher volatility in an existing SAA strategy.
2. Increase risk: Increase growth assets, ride the inevitable volatility, and hope for the best.
3. Increase active management: This could take many guises, including more dynamic asset allocation strategies, allocations to alternatives or appointing more active security selection.

Despite the challenges outlined, we think achieving long-term objectives is possible without materially increasing portfolio risk.

Kej Somaia is a Senior Portfolio Manager at [CFSGAM](#). This article is for general information only and does not take in account your individual financial circumstances.

Investors expect ESG issues to drive returns

Rob Wilson

Once seen as a niche market segment for socially-conscious investors, Environmental, Social and Governance (ESG) investment research has gone global, including here in Australia. In the financial sector, many institutional players realise issues such as climate change, human rights, and workplace diversity can drive risks and returns. They recognise the need to be more knowledgeable on the matter and are looking for ways to integrate ESG factors into their investment process.

ESG benefits for investors with longer investment horizons

Investors have become more aware of the wider implications that ESG issues can have on a company. For example, a recent explosion in the US state of Colorado caused the shares of an oil and gas exploration company to drop significantly. This was not due to the damage to equipment or problems with production, but because investors feared the fallout from protests and mounting pressures to increase regulation. A decade ago, the market likely would not have reacted so swiftly or aggressively.

Investor focus on ESG is growing in all regions of the world, from the Nordics and the Netherlands where ESG has been on investors' radars for decades, to the US, Canada and Australia. In Asia, China is focused on improving air and water quality and Japan is busy implementing the new stewardship code put forth by Prime Minister Abe's government. Closer to home, the local Financial Services Council (FSC) launched Australia's first compulsory asset stewardship code in July 2017. Compliance with this code will be mandatory for all asset manager members.

One of our recent investments in China shows how an investor can take an integrated approach to ESG research. For an investment in a Chinese beverage manufacturer, we found that 80% of the company's facilities were located in areas of high water stress and scarcity, according to data from the Chinese Statistical Yearbook and Aqueduct's water risk map. We queried the firm's investor relations director, whose response supported the case to include water scarcity in our valuation model. Our analyst placed the highest valuation discount on this firm, which resulted in a 20% lower share price target.

This example demonstrates investors must take a step back and re-evaluate the stocks they own or are planning to buy. Investors can no longer just review standard financial measures such as profits, sales and the

order pipeline. They also need to look at factors such as safety policies, accident rates, and carbon reduction targets. Are the policies helping the company avoid controversies? Moreover, what are the risks if something goes wrong?

Consider local and global issues

Local issues are also important. Does the company operate in a country rife with corruption risk? How are the locals reacting to a given project? Investors taking a broader viewpoint can potentially reduce their investment risks, spot new opportunities, and allow ESG to add value, especially over the longer term.

A clear example of the rise of ESG is found in the number of financial parties who have become signatories to the Principles for Responsible Investment (PRI), the world's leading proponent of responsible investing. Currently, there are 1714 signatories with a total of \$68.4 trillion under management. The PRI helps investors to incorporate ESG factors into their investment decisions.

The trend in society calls for more ESG awareness and it is a self-reinforcing process. Society expects investors to enhance their ESG research processes and the resulting improvements in investment decisions create more momentum for the societal trends.

Worldwide, for many, ESG investing is still focused solely on creating a list of companies to exclude from a portfolio. Asset owners and asset managers will need to broaden their efforts away from simple exclusionary lists, as stakeholders increasingly expect true integration across an entire portfolio not just a small portion of the investable universe.

Millennials will force this change and we see this drive has already begun here locally with ESG questions coming from both Australian institutional and retail clients alike. As they grow older, this generation will demand ESG-integrated investments, as they are already asking about the ESG policies of the companies they do business with and their own employers. In addition, this new group of investors will demand competitive returns, as they don't believe societal value and financial performance have to be mutually exclusive.

Rob Wilson is an ESG Specialist and Research Analyst at [MFS International Australia](#), a sponsor of Cuffelinks. This article is for informational purposes only and should not be considered investment advice or a complete analysis of every material fact regarding any investment.

How the super contribution changes may benefit you

Mark Ellem

The superannuation changes that started on 1 July last year were not just about capping the amount of capital that can be transferred to the retirement pension phase. They also included big changes to tax deductible and non-deductible contributions.

Given that we are in the last quarter of the financial year 2017/18 (FY18), let's have a look at those changes that apply now and others that will start from next financial year. With only a couple of months until 30 June, it's time to review the basic rules in case these opportunities apply to you.

Concessional contributions

For FY18, the concessional contribution cap is \$25,000 for everyone who is eligible to make these contributions. There is no longer a higher cap for anyone 50 or over. Anyone who has a salary sacrifice arrangement in place and has previously contributed more than \$25,000 of concessional contributions in an income year should now make adjustments to these arrangements to ensure they don't exceed the lower \$25,000 concessional contribution cap.

Tax deduction for personal contributions

The change allows a tax deduction claim for personal contributions, but there is a bit of a catch as personal super contributions claimed as an income tax deduction count towards the concessional contribution cap of \$25,000 for FY18. The cap also includes contributions made by your employer such as employer contributions for super guarantee purposes or under salary sacrifice agreements.

Don't forget to tell the fund if you are claiming a deduction for super contributions by completing a notice and keeping it with the fund records. If you do make deductible contributions, the amount you claim cannot create or add to a loss that you may have made in your personal tax return. Any personal contributions which are not claimed as a tax deduction (or the deduction is disallowed) count towards your non-concessional contribution cap.

Remember what it was like before 1 July 2017. If you were an employee you could only claim a personal tax deduction for superannuation contributions if you qualified under the '10% test'. This meant that nearly all employees missed out on claiming a tax deduction for personal super contributions, but things have changed since 1 July last year.

Non-concessional contribution cap linked to total super balance

The annual non-concessional contribution (NCC) cap for FY18 is \$100,000 (reduced from \$180,000 in FY 2016/17). However, if the total amount you have in super on 30 June in the previous financial year is not less than \$1.6 million, you won't be able to make a NCC for that financial year.

For example, if we look at FY18 and the balances of the following two individuals, we can see what a difference a small amount either side of each person's total superannuation balance (TSB) can have on their respective NCC cap.

Member	30 June 2017 TSB	2017/18 NCC cap
Malcolm	\$1,599,000	\$100,000
Barnaby	\$1,601,000	\$nil

A person's TSB also determines how many years of the standard NCC cap a person can 'bring forward' where they qualify under the bring forward rule. This means that there are now 'trigger points' for the NCC cap, as follows:

Total superannuation balance on 30 June 2017 (trigger point)	Non-concessional contributions cap for the first year	Bring forward period
Less than \$1.4 million	\$300,000	3 years
\$1.4 million to less than \$1.5 million	\$200,000	2 years
\$1.5 million to less than \$1.6 million	\$100,000	No bring forward period, general NCC cap applies
\$1.6 million or more	Nil	N/A

The TSB test for NCCs is also important where a person qualifies for the bring forward rule but does not fully use the maximum bring forward amount in the first year.

For example, Cynthia, aged 60, at 30 June 2017 has \$1.48 million TSB and has not previously triggered the bring forward rule. Consequently, for FY18, her NCC cap is \$200,000 (refer to the table above). If Cynthia makes the maximum NCC of \$200,000 in FY18, her NCC cap in FY 2018/19 is zero. Further, her TSB is likely to exceed \$1.6 million after the NCC and fund earnings are allocated. However, the test is based on her TSB on the previous 30 June, not what her TSB is after the contribution is made.

Let's say, however, that Cynthia does not make her maximum allowable NCC in FY18 but makes an NCC of \$160,000. Based on the above table, Cynthia may think that she can make a further NCC of \$40,000 in FY 2018/19, being year two of the two-year bring forward period.

This is only true if Cynthia's TSB at 30 June 2018 is less than \$1.6 million. If, however, her TSB at 30 June 2018 is more than \$1.6 million, which it could be once you allocate fund earnings, then even though she has

not fully utilised her bring forward amount, her NCC cap is zero for FY 2018/19, and she is unable to make a NCC without it being treated as excessive.

The 'work test' lives

The work test still applies for those 65 and above when they make a contribution to super (no personal contributions after age 75). This requires a person to be 'gainfully employed' for at least 40 hours in 30 consecutive days in the financial year the personal contribution is made. This test should be satisfied before the contribution is made.

Downsizer contributions

For those aged at least 65 (no age 75 cut off for this one), from 1 July 2018, there is a new type of personal contribution which allows those who qualify to contribute up to \$300,000 to superannuation from the sale of their family home that has been owned for at least 10 years on a once-only basis. This only applies where a contract for the sale of a qualifying home has been made on or after 1 July 2018.

The eligibility criteria and more details are on the [ATO's website](#).

Changes were not all bad

So, if you think the super changes shut the door on concessional and non-concessional contributions you may need to think again. For some, it may have opened the door a little to claim personal tax deduction for super contributions and, if you sell your family home, it may let you to make non-deductible contributions to super after you have reached 65.

Mark Ellem is Executive Manager, SMSF Technical Services at [SuperConcepts](#), a sponsor of Cuffelinks and a leading provider of innovative SMSF services, training, and administration. This article is general information only and does not consider the circumstances of any individual.

Record award in estate of John Hemmes

Donal Griffin

In February 2018, the son of a six-year affair between the late business mogul John Hemmes and Fiona Cameron was awarded \$1.75 million [Estate Hemmes; Cameron v Mead [2018] NSWSC 85] from Mr John's (as he was known) estate. This is a new record and, while the facts were unusual, it should be factored in when managing disputes in large estates.

The legal community was watching this case with interest for a few reasons. One was that it seemed that Mr John led an affluent life style yet he had minimal assets and secondly, he had never acknowledged the son to be his own.

Justice Lindsay awarded the sum to Edward Cameron, the son. Mr Cameron was born in 1990, a product of an affair between his mother and the deceased. The deceased refused to acknowledge the son until Family Court orders were made in 1995 following a DNA test. Over 13 years, the deceased was compelled to make child support payments to the sum of \$300,000. He made no other contribution to the upbringing of the plaintiff.

The plaintiff sought family provision relief under Chapter 3 of the Succession Act 2006 (NSW) in relation to the estate of the deceased.

Details of the estate

Mr John owned his large home in Vacluse, 'The Hermitage', as joint tenants with his wife Merivale. The property was valued at \$34 million. The legal implication of this is that such an asset did not go into his estate but passed on the moment of death to Merivale. Mr John died on 1 March 2015 and by a will dated 14 January 2015, he left \$2 million to a person named as his 'general manager administration' and the balance of his estate to his widow and his two adult children. He left a gross estate valued at \$363,964, with liabilities totalling \$661,969. This left his estate with a negative value of \$298,005.

The plaintiff amended his family provision order to contend that the 'notional estate' be the subject of the claim. Although the defendants to the proceedings opposed the claim, they agreed to set aside a fund of \$4.1 million to be held in the controlled account of their solicitor. The plaintiff made a claim on the fund for his 'proper maintenance, education and advancement in life'.

The defendants rejected the provision of the order on three grounds:

1. The deceased made adequate provision for the plaintiff through the child support payments
2. The deceased had no relationship with the plaintiff and only had 'bare paternity'
3. The plaintiff is an adult who can take care of himself.

They alternatively claimed that the provision should not be any more than \$1 million. This ceiling on damages has now been smashed by this decision.

The decision on a 'notional estate'

Justice Lindsay stated [at 56]:

"No provision was made for the plaintiff in the deceased's will. Neither a person guided by wisdom and justice, nor a person guided by current community standards, could reasonably conclude that the deceased's bare payment of child support payments, under compulsion of law, has left the plaintiff with adequate provision, etc, from the estate, or notional estate, of a father of the deceased's affluence. The plaintiff is a young man, unaided by paternal support beyond child support payments, who certainly has the advantages of youth and potential, but accompanied by a lack of substantial wealth that commonly accompanies youth. The defendants' primary case (that the plaintiff's summons should be dismissed) must fail."

The Court held that provision for Mr Cameron come out of the 'notional estate' of the deceased. This is a concept unique to NSW in Australia and applies where the deceased may have kept his estate small by leaving his assets in trusts set up while he was alive. 'Notional estate' means that attempts to keep estate assets 'out of harm's way' may well not succeed.

The sum of \$1.75 million was awarded (with some costs). We understand that this is a record award for such a case in NSW.

These types of issues can be addressed earlier with some good estate planning, as we are doing in other cases for our clients.

Donal Griffin is a Principal of [Legacy Law](#), a legal firm specialising in protecting family assets. The firm is not licensed to give financial advice. This article does not consider any individual circumstances.

A better way to measure Australian small caps

Greg Cooper

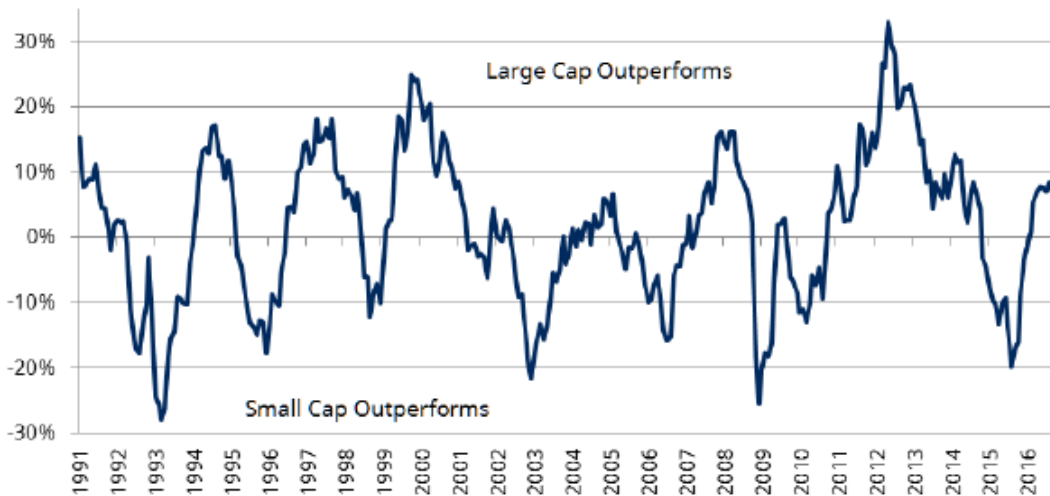
In a quest to diversify portfolios from the concentration biases found in the large cap Australian equities market, investors often allocate a defined (and usually static) weight to Australian small cap investments. This intuitively makes sense, because we expect to achieve superior diversification by investing outside the large cap stocks, and because of the belief smaller companies will have stronger earnings growth opportunities.

But these views may be flawed.

The small cap index is a dud index

Over the long term, the small cap index has underperformed the large cap index by around 2.8% p.a. (since 1990) and has done so with 25% higher risk. That's not to say there are not significant opportunities in small caps from time to time, with the performance differentials between small and large cap Australian equities significant over the short term. Actively managing the rotation in and out of the small cap market should be a consideration, and timing is important.

1 Year Rolling Return Difference



Source: Schrodgers, Global Financial Data. Returns from 1 Jan 1990 for S&P/ASX Small Ords and S&P/ASX 200 (All Ords before 1/4/2000).

The index construction that provides risks and opportunities

In Australia, the lack of a mature venture capital industry results in listing rules that do not consider a business's profitability or financial viability (as opposed to other global markets). There are times where our market is built around a large number of no-revenue or no-profit generating mining companies. For small cap equity managers, when one of the most effective portfolio construction methods is to avoid the losers, is it reasonable to pay an active or performance fee based on this market anomaly?

Our belief is that while the average active manager in Australian small caps has been able to outperform the index, this is due in a large part to the inefficiencies in the index construction. On average, small cap managers earn a fee 60% higher than that for large cap portfolios. While at a base fee level there is some justification for this given the relative size of assets that can be managed in each market cap segment, we would suggest investors should be wary of the potential for large performance fees to be accrued versus the poorly-constructed small cap index.

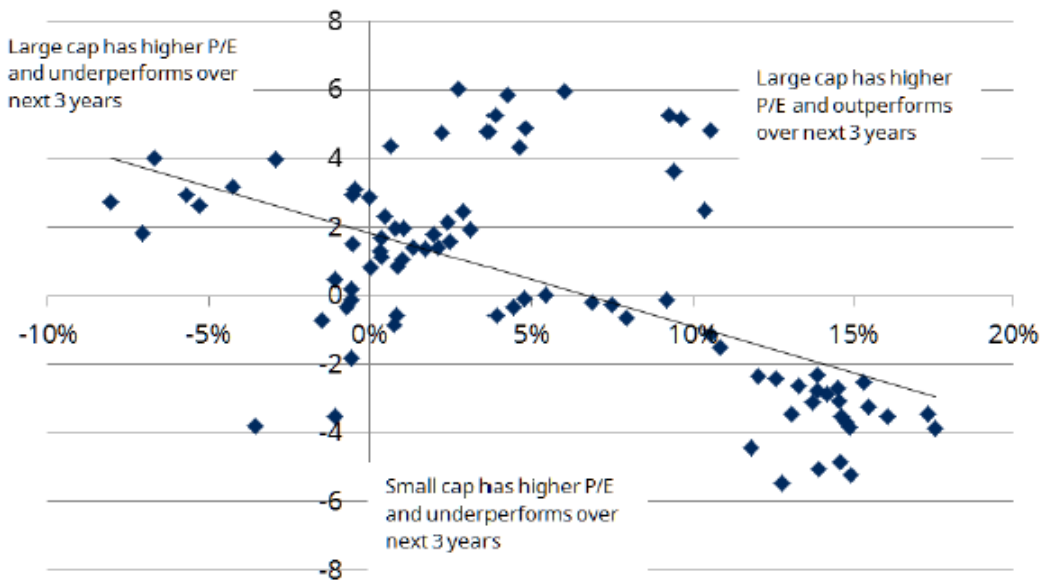
A broad-cap flexible approach should be adopted

Valuation is a strong indicator of future returns and this belief is supported by analysis of starting point Price to Earnings ratios (P/E) and the subsequent 3-year performance, as shown below.

There is a distinctive trend towards higher valuations in small caps leading to subsequent underperformance relative to large cap. Interestingly, higher valuations in large caps don't necessarily lead to underperformance of small caps. At present, small cap P/Es are relatively high compared to history (at 18.7x) and higher than the large cap market.

On this analysis it clearly makes sense for investors to explicitly consider the valuation differences between small and large cap stocks in making their investment allocation decisions. Not all investors have the skill and tools to either monitor the timing of asset allocations or the ability to change the incumbent investments. We believe the decision and implementation for actively managing Australian equities is best made by a broad-cap investment manager with skills to understand when the opportunity is right across the full market cap spectrum (large, mid, small and micro-cap sectors). This ensures stock specific ideas can be prioritised rather than esoteric ideas coming from a specific cut off point in a benchmark.

Difference in P/E vs Subsequent Difference in Performance over 3 Years (% p.a.)



Source: Thomson Reuters Datastream, Global Financial Data, Schroders Analysis

Benchmarks and active management

An objective look at the opportunities presented across the small and large cap Australian equities market suggests that segmenting the allocation by market cap (as defined by some arbitrary stock number) isn't necessarily the best way for investors to manage their portfolio. While investors may wish to consider a bias toward smaller caps to take account of the greater economic diversity from this part of the market, we present a number of reasons why an alternative broad-cap exposure is a different way to structure a client's aggregate Australian equities exposure versus separate small and large cap portfolios.

In particular, we conclude that:

1. The small cap index is poorly constructed and suffers from significant structurally lower long-term performance, higher risk, and poorer earnings growth characteristics.
2. Active management of this part of any Australian equity exposure is both essential and rewarding.
3. The appropriate benchmark against which performance should be measured and fees calculated is a broader market index or the large cap index, rather than a specifically small cap index as this is more representative of the opportunity set and removes the bias created by an arbitrary index cut-off.
4. The performance differentials between small and large cap stocks, while biased in favour of large cap, have shown significant historical variability and this represents a greater opportunity for investors with broad-cap research capabilities to add value.

Greg Cooper is Chief Executive Officer at [Schroders Australia](#). This article is in the nature of general information that does not consider the circumstances of any individual.

Five lessons from football and investing

Ted Richards

Football and investing are both incredibly competitive. As a professional footballer for 16 years, I spent the better part of most weeks training and working to be the best I could be. At the same time, though, I was preparing for life beyond the football field, first by studying for a Bachelor of Commerce then for a Masters in Applied Finance.

During these years of blending football and finance, I learned some interesting lessons that link two professions that many might think have little in common.

1. It's better to be a hedgehog than a fox

There was a time in my football career that I tried to be able to play pretty much every position. I thought that I would improve my chances of being picked for the senior team each week if I could attack up forward and defend down back. After reading Jim Collins' book 'Good to Great' in 2010, I changed my approach entirely. Collins builds on Isaiah Berlin's famous essay, *The Hedgehog and The Fox*, which itself was based on an ancient Greek parable: "The fox knows many things but the hedgehog knows one big thing."

Instead of aiming to be good at everything, I narrowed my focus to being the best defender not just in the team, but in the whole competition (the hedgehog concept). My football improved dramatically with this focus.

I believe investing is similar. It's not about how big your circle of competence is but knowing what your strength is and being better than anyone at that. Six Park is not about being everything to everyone but helping our clients by being the best robo-advisor.

2. More data doesn't always mean better outcomes

Technology keeps providing new ways to analyse and measure player and team performance. However, diving too deep into data can distract from what is fundamentally important to a player and the team. At times, I noticed young players focusing a lot on GPS distances and average speeds, but that data was only useful if it complemented a review of their game. Instead, it was shifting their focus away from the fundamentals of what made them great footballers.

Finance often dives even more deeply into data than football, but it's important to distinguish between what generates investment returns and what's merely a distraction. There are key measures that deserve consistent focus but much of the data beyond this could be little more than white noise.

3. Humility trumps hubris

The best teams find ways to improve, regardless of the result of the last game. Humility can prevent hubris from ruining an individual's career or eroding the culture of a team. Former All Blacks player Richie McCaw would write down the same words before each game – "Start again" – as a reminder that he needed to prove himself again that day despite every previous success.

By the end of my 16-year career, I could acknowledge that I was far from knowing it all. However, what I did know was that my approach to the continual process of training Monday to Friday would have the biggest influence on my weekly performance. I hope to be working in the asset management world in 30 years and, if I am, I should still be learning new things every day.

4. A healthy dose of paranoia is not a bad thing

Football and finance are intensely competitive, and a healthy dose of paranoia helps ensure you're constantly improving, aware of risks, and pushing beyond your comfort zone. There's a quote that's relevant to both football and investing:

"If you don't worry, then you need to worry. If you do worry, then you don't need to worry."

A former coach of mine, Essendon legend Kevin Sheedy, once said that a premiership can choke a player's football career if they're not careful. Sydney Swans coach John Longmire was often on edge with nerves during training sessions in November despite our first game being five months away and having had a good season the year before. He was always aware that 17 other teams were working hard to improve. In investing, your competitors are all working hard to find ways to outperform your team and it's good to be aware of not only who's ahead of you, but of who's behind you.

As Andy Grove (CEO of Intel) once said, "Only the paranoid survive."

5. Defence is more important than attack

AFL premierships are usually won by the best defensive teams, not the best attacking teams. There is a big difference. Good luck to your long-term performance if you just want to get into a high-intensity shootout each week with the other team.

In investing, too, there are differing approaches to diversification and uncorrelated returns and some focus on high risk. I'm not going to enter a debate about what's right or wrong. What is consistent is that the best *portfolios* have a strong defensive element.

American investor Howard Marks said: "Avoid the losers in investing and let the winners look after themselves." I think this is relevant to football too. At the risk of contradicting my third point, I've always said that in football the defenders will help win the premiership, while the forwards will help fill the salary cap!

Success in one week, one quarter, or one year in no way qualifies that the next time will be any easier. That's what makes it hard, but that's what makes it enjoyable. I think this constant challenge is why I am passionate about both football and investing. Each has helped me learn something new every day, and I don't expect that to ever change. It was a privilege to play professional football and it's a privilege to be trusted with someone else's money.

Ted Richards is Director of Business Development at [Six Park](#). This article is for general information and does not consider the circumstances of individual investors.

Disclaimer

This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.

For complete details of this Disclaimer, see <http://cuffelinks.com.au/terms-and-conditions>. All readers of this Newsletter are subject to these Terms and Conditions.