

This Week's Top Articles

- **Royal flush: 15 questions to ask a financial adviser now** *Jonathan Hoyle*
- **Six investment lessons from 15 years of data** *Daryl Wilson*
- **Is manager selection worth the effort for advisers?** *West and Schuesler*
- **Perverse incentives create perverse outcomes** *Vinay Kolhatkar*
- **Three reasons why current dividends matter** *Anton Tagliaferro*
- **The merit of currency exposure if equity markets fall** *Adam Kibble*
- **Three checks to make when facing earnings downgrades** *Robert Miller*
- **Rob Prugue's spiritual and physical super journey** *Rob Prugue*

Royal flush: 15 questions to ask a financial adviser now

Jonathan Hoyle

The Royal Commission has highlighted some appalling financial advice practices. Transparency, greater professionalism and higher standards are required. Corruption, cronyism and incompetence must be weeded out. A torrent of new regulations is a racing certainty, although how that will look is still to play out.

Hopefully, we will look back in a few years and say the Royal Commission was the best thing that happened to the financial planning profession. Financial planning matters. It matters because quality advice has the power to transform lives. It matters because poor, unethical advice has the power to destroy lives.

Start with two quick checks

How do you find a good financial adviser from more than 24,000 licensed Australian advisers? In November of 2017, I wrote this article for Cuffelinks on the [25 questions you should ask your financial adviser](#). This is an updated version in a post-Royal Commission world.

First, as before, start with the pamphlet, entitled [Questions To Ask A Financial Adviser](#) compiled by our industry regulator, ASIC.

Second, conduct a search of your adviser on the [ASIC register](#). This provides a list of their qualifications and records any banning orders or disqualifications made against them in the past.

Then, insist on getting answers to the following questions in writing. They won't guarantee you a good adviser, but they will reduce the odds of a dud or a crook.



The questions to ask

1. Who owns your business?

Most advice firms are owned by a handful of individuals. Be wary of those with institutional ownership, especially when those institutions also manufacture financial products, encouraging massive conflicts of interest.

2. Who provides your licence (AFSL) to operate?

You might prefer firms who have their own licence, but there are plenty of shoddy independent operators (as the RC showed), and there are plenty of excellent advice firms who are licensed by a major financial institution. You want to learn about potential conflicts of interest that might compromise your best interests. The one key advantage of being self-licensed is that these firms are free to recommend a broader universe of funds and insurance products.

3. What percentage of my portfolio is invested in funds owned by your licence provider?

It should be close to zero.

4. How many insurance providers are on your Approved Products List?

It should be a lot more than one. This gives sufficient diversity and an ability for an adviser to add value through choosing the most competitive policy.

5. Is there any connection between the investment platform you have chosen and your licence provider?

There might be. This may be ok, but it's a potential conflict as this may be the only platform offered to you as a client. Ask why they selected that particular platform for you.

6. May I see your last Compliance Audit please?

Every adviser is audited annually by an independent team. Ask to see the last three audits as they could be quite revealing.

7. How do you charge your clients?

Fees should vary depending on the job you want done. For specific project work, an adviser might bill by the hour, but not for ongoing advice. Hourly charging encourages inefficiency. Nearly all advisers will increase their fees in line with the assets to manage, but the relationship should not be linear. Managing \$2 million is not twice as involved or complex as managing \$1 million. Charging clients a fee-for-service is becoming more popular and, in our opinion, will eventually replace percentage-based fees.

8. Are your fees negotiable?

We believe fees should *not* be negotiable. Clients should be charged by the same methodology. Existing clients should not subsidise new clients (unlike certain cable TV providers we could mention), nor should those with superior negotiating skills receive favourable terms.

9. Do you receive an annual bonus?

Most advisers are paid an annual bonus for a job well done. Nothing controversial about this, but ensure that the bonus is not solely driven by introducing new clients to the firm. It should reflect exemplary client service, a spotless compliance track record, a team ethic and a commitment to ongoing education and training.

10. Can you tell me about your conflicts of interest, orally and in writing?

These must be disclosed orally and in writing. Ask to see their Conflicts Register. Some conflicts of interest are inevitable and may not be a problem, provided they are disclosed.

11. Do you pay referral fees to generate new clients?

Many advisers pay referral fees to lawyers and accountants to refer new clients. Provided this is fully disclosed, there is no conflict. It's more an issue for the referrer than the adviser.

12. What are your professional qualifications?

The Certified Financial Planner (CFP) is the gold standard in the US and Australia. It doesn't guarantee great advice, but it reduces the odds of engaging a dud. Make sure to ask for the qualifications of the Investment Committee too. The [Chartered Financial Analyst](#) (CFA) is the undisputed certificate of excellence for portfolio analysis.

13. Who manages my money?

Financial advisers are not money managers. They are not trained to do this. Look for a professional Investment Committee run by an experienced CFA.

14. How do I exit this relationship if I don't like it?

There should be no lock-ins. Financial advice firms are not mobile phone companies. Account portability is essential.

15. Can you provide me with testimonials of clients in a similar situation?

Always ask for this. We would recommend checking out a website called [Adviser Ratings](#). It contains testimonials from the adviser's clients and a rating.

Choosing your financial adviser is a significant decision

We suggest asking people in your life whose financial opinions you respect. These might be your accountant or an educated friend. And meet plenty of advisers during your due diligence. A good adviser adds value. We hope this list will help you in your search.

Jonathan Hoyle is Chief Executive Officer at [Stanford Brown](#). This article is general information and does not address the circumstances of any individual.

Six investment lessons from 15 years of data

Daryl Wilson

The latest SPIVA (Standard & Poor's Indices versus Active) results are in. They provide important lessons on where to look if you'd like to find long-term outperforming managed funds.

In their latest scorecard, S&P evaluated returns of 786 Australian equity funds (large, mid, and small cap, as well as A-REIT), 378 international equity funds, and 109 Australian bond funds. For the first time in Australia, S&P was able to provide data for a 15-year period. The results are summarised below:

Report 1a: Percentage of Funds Outperformed by the Index (Based on Absolute Return)						
FUND CATEGORY	COMPARISON INDEX	ONE-YEAR (%)	THREE-YEAR (%)	FIVE-YEAR (%)	TEN-YEAR (%)	15-YEAR (%)
Australian Equity General	S&P/ASX 200	59.00	66.77	63.00	73.94	77.00
Australian Equity Mid- and Small-Cap	S&P/ASX Mid-Small	74.04	75.00	55.67	40.00	54.72
International Equity General	S&P Developed Ex-Australia LargeMidCap	52.51	80.93	90.86	88.26	87.10
Australian Bonds	S&P/ASX Australian Fixed Interest 0+ Index	68.63	77.36	85.42	85.00	NA
Australian Equity A-REIT	S&P/ASX 200 A-REIT	43.94	66.18	83.56	71.59	78.08

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 29, 2017. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

The SPIVA study has consistently observed that the majority of Australian-managed funds fail to beat comparable benchmarks over the long-term. For example, over the 15-year period ending December 2017, more than 87% of international equity funds underperformed their benchmark after fees. In all categories, over almost all periods, a large percentage of managed funds failed to beat their benchmark.

But there are some important lessons to be gleaned. Here are the main six:

Funds that invest in smaller companies do better

The best performing group of funds by far over five, 10, and 15 years were those that invested in Australian smaller companies. More than 60% outperformed over 10 years and around 45% over 5 and 15 years. That's much better than all other categories, where success rates are generally less than 25%.

It's often pointed out (mostly by managers of funds that invest in large companies) that the Australian small caps index is poorly constructed and easy to beat, which makes it a low hurdle. There is some truth in that, but it's also true that smaller company funds delivered a greater total return compared to larger company funds, as can be seen below:

Report 4: Average Fund Performance (Asset-Weighted)					
INDEX/PEER GROUP	ONE-YEAR (%)	THREE-YEAR ANNUALIZED (%)	FIVE-YEAR ANNUALIZED (%)	TEN-YEAR ANNUALIZED (%)	15-YEAR ANNUALIZED (%)
S&P/ASX 200	11.80	8.63	10.23	4.14	9.49
Australian Equity General	11.90	8.47	10.58	4.60	9.38
S&P/ASX Mid-Small	21.16	15.79	12.17	2.30	9.66
Australian Equity Mid- and Small-Cap	17.04	14.04	12.45	5.47	10.85
S&P Developed Ex-Australia LargeMidCap	14.51	11.72	18.93	6.96	7.09
International Equity General	16.61	11.39	17.51	6.55	7.01
S&P/ASX Australian Fixed Interest 0+ Index	3.61	3.04	4.10	6.20	NA
Australian Bonds	3.54	2.79	3.82	5.83	5.32
S&P/ASX 200 A-REIT	5.72	11.00	13.23	1.89	5.99
Australian Equity A-REIT	7.26	10.96	12.98	2.09	5.90

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 29, 2017. All returns in AUD. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

Over all time horizons, mid-small company funds beat their larger company peers.

So, **Lesson 1:** It's a good idea to have some small-mid cap exposure in your investment portfolios.

Overall returns aren't as great as most people think

The Report 4 table above also shows that the best 15-year returns came from small-mid companies at around 10% p.a. Large companies would have delivered 9-10% p.a. on average, depending on whether you had an active manager or an index fund. The returns exclude franking credits, so that's pretty good.

In comparison, international shares fared worse at around 7% annual returns. This is the case even though global shares have performed much better over the past five years. We maintain a low allocation to global shares, because compared to Australian shares, they're significantly more overvalued.

Over 15 years, Australian bonds have delivered just over 5%, and A-REITs (or listed property trusts) around 6% p.a.

Thus, on average, a balanced portfolio of 60% shares/property, 40% bonds/cash might have delivered investors around 7.5% p.a. This compares well to the average balanced super fund, which according to Chant West has delivered around 6.8% p.a. over the past 15 years, after tax.

So **Lesson 2:** Recognise that average returns aren't that great, and make sure your return target is realistic.

However, many investors do far worse than this. That's because they tend to invest near market highs and sell near lows. Many credible studies show the impact of poor timing is that the average investor will achieve returns 2-3% p.a. worse than the average, mostly because of poor timing decisions.

Lesson 3: Unless you're accomplished at going against the crowd, buy-and hold strategies that deliver consistent returns should be preferred.

Growth versus value

Although the Australian study doesn't look at differences in returns from investment styles, the much bigger US study does. The US study showed that over 15 years, the difference between value and growth styles was not significant, albeit it was over short periods, e.g. over the past year, US large cap growth funds delivered almost 30% returns, compared to value funds at 15%. Other times the reverse has occurred, although rarely to the same degree.

Interestingly, over 15 years, large cap growth outperformed large value slightly. And small cap value outperformed small cap growth slightly.

Lesson 4: Allocations to both growth and value styles are likely to outperform at different times. You might get the same long-term result, but perhaps a smoother overall rise if you have both in your portfolio.

The stars from last time are more likely to be laggards next time

One of the biggest mistakes we see is the herd piling into last year's best performing funds. That's usually a big mistake. Our experience is that an equity fund delivering above 12% p.a. over ten years or more is extremely rare. So, if you invest in one that just did 20% p.a. for the last two years, chances are that a big part of that performance was due to the assets or market they have invested in is currently overvalued. Or their investment style has had a good run. Or they had a low amount of funds to manage but now they have a lot. Or all three.

Any of these things don't bode well for the next few years' returns from that fund.

So, **Lesson 5:** Be wary of funds that have delivered high returns in recent years.

The best funds might not be in the survey

The SPIVA survey is limited. They do include over 1,300 funds, which is a lot. But their data set is limited to those funds included in Morningstar's database and in the categories stated. Many of the best funds, including a sizeable number available only to wholesale investors, are not in the Morningstar database, or pursue an investment strategy not covered in the SPIVA survey.

As an example, around a third of the funds in our Affluence Investment Fund Portfolio are not on Morningstar. Another third are in categories not covered by the SPIVA study. So two thirds of the funds in our portfolio are not covered by the SPIVA study. Almost all of them have significantly outperformed their benchmarks over time.

So finally, and most importantly, **Lesson 6.** Despite what the SPIVA study suggests, great funds and managers who can outperform over the long term are out there.

The full SPIVA report can be found [here](#).

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Is manager selection worth the effort for financial advisers?

John West And Trevor Schuesler

A review of the *Forbes* top 100 financial adviser firms in the United States in 2017 showed that manager selection is the top service advisers market to clients, and the process required to provide the service claims a meaningful amount of a firm's resources. The determination of whether manager selection falls into the category of a low impact/high effort thankless task comes down to expectations.

If the expectation is to reduce negative alpha (i.e. underperforming the market) or to minimise regret risk, manager selection will likely have a positive impact, perhaps even enough to justify the resources commensurate with the task's difficulty. If the expectation is to produce positive alpha, financial advisers and their clients are likely to be disappointed.

How, then, can advisers operate at the optimal position in the impact–effort matrix?

The challenges advisers face

In seeking to meet their clients' financial goals, advisers face two sizeable headwinds: clients' investing biases and the difficulties in identifying skilled managers who are able to reliably produce alpha for their investors. Let's review briefly what the academic literature has found regarding these two challenges.

Retail investors are generally susceptible to a number of biases. Most notably, their returns-chasing behaviour leads to poor buy and sell decisions and disappointing investment outcomes. Barber and Odean (2000) found that the average retail brokerage investor underperformed the market by about 1.5% a year. What was even more telling was that investors who made the most buy and sell decisions had the worst performance, underperforming by 6.5%! This hazardous tendency manifests itself meaningfully when it comes to picking mutual funds and other managed products.

Hsu, Myers, and Whitby (2015) showed that investors earned about 2% less than the mutual funds they invest in because of a bias toward chasing performance (i.e., buying high and selling low). Their research also demonstrated that larger performance gaps exist in high-expense-ratio funds (again more likely to be held by retail investors) versus low-expense-ratio funds. Hsu, Myers, and Whitby concluded that less-sophisticated investors, often those who invest in retail funds, underperformed by a greater margin (i.e., suffered a larger return gap) than those who qualified for institutional share-class funds.

Advisers face tremendous challenges in overcoming such client biases. Mullainathan, Noeth, and Schoar (2012) found evidence that suggests advisers have difficulty de-biasing their clients, and as a result engage in 'catering' behaviour, seeking to please existing or new clients by being supportive of returns-chasing behaviour. Linnainmaa, Melzer, and Previtero (2016) also found that the average adviser has difficulty overriding retail investors' biases, often exacerbating them with recommendations of frequent trading and expensive, actively managed products.

A behavioural bias that favours more of what recently has provided comfort and profit and less of what has produced pain and loss often leads advisers to recommend the managers their clients want—those with the best trailing performance. Thus, clients can find themselves treading the 'hamster wheel' of manager selection, continuously replacing poor performers with good performers. Evidence shows this form of performance chasing, however, likely puts advisers and their clients on the outside track to future excess returns.

Cornell, Hsu, and Nanigian (2017) documented mean reversion in mutual fund performance, finding that, when measured by trailing three-year performance from 1994 through 2015, top-decile managers underperformed the bottom-decile managers by 2.3% a year. Arnott, Kalesnik, and Wu (2017), controlling for fund expenses, showed a similar monotonic drop-off in the subsequent performance of prior winners.

The evidence makes it pretty clear we shouldn't use historical performance as our primary manager selection criteria. Well, maybe we should – just in the opposite direction!

Advisers should focus more on three soft 'Ps'

Advisers who acknowledge the pitfalls of a pure performance selection criterion could spend more of their due diligence efforts on the so-called soft 'Ps': **philosophy, process, and people**. Indeed, the institutional investment consulting community has relied heavily on non-performance factors for decades to make manager selection decisions. Jenkinson, Jones, and Martinez (2016) found that consultants' recommendations correlate partly with the past performance of fund managers, but more so with non-performance factors, suggesting that consultants' recommendations do not merely represent a returns-chasing strategy.

But the additional insights gained by non-performance factors has not led to an ability to, on average, select 'winners'. On a value-weighted basis, Jenkinson, Jones, and Martinez found no evidence that the managers' products recommended by investment consultants outperformed the products the consultants did *not* recommend. On an equally weighted basis, they found that recommended products *underperformed* other products by approximately 1% a year, leading them to conclude that non-recommended funds performed at least as well as recommended funds.

Benefits beyond the pursuit of benchmark-beating performance can be realised through careful and well-resourced manager selection. Behavioural finance frequently references individual investors' willingness to forgo higher wealth accumulation in favour of non-monetary emotional benefits. We assert as much in Research Affiliates' core investment beliefs that investor preferences are broader than risk and return. Additionally,

benefits of a well-documented manager research effort can mitigate regret risk in performance 'blow-ups' (particularly with negative press headlines for public entities) and provide a layer of – real or perceived – fiduciary insurance; for example, by performing an extensive due diligence review before recommending a manager, the adviser or consultant best positions themselves to explain a poor-performing manager.

Nonetheless, the literature suggests that financial advisers shouldn't expect, nor communicate to clients an expectation of, market-beating results via manager selection, at least not with the current (sometimes overwhelming) investor bias of making buy and sell decisions based on performance metrics.

Is zero alpha a win?

Perhaps the biggest value an adviser can add is to save clients from themselves by eliminating their negative alpha. If, as is frequently the case, the starting point is 200 basis points of negative alpha from horrible timing on fund hires and fires, then taking this to zero should be considered a relative win for both client and adviser. Evidence suggests this is a realistic and achievable goal.

Jenkinson, Jones, and Martinez (2016) found that the returns of consultant-recommended funds were roughly in line with non-recommended products, and Goyal and Wahal (2008) found that "post-hiring returns are higher for decisions in which a consultant was used in selecting the investment manager." Our interpretation is that consultants' qualitative judgment and research slow down clients' returns-chasing behaviour. Given the sizeable literature showing the return gap between investors' returns and their funds' returns, perhaps the more constructive goal of manager selection is to 'do no harm' when replacing poor performers. Perhaps a worthwhile 'win' from manager selection is zero alpha!

Seeking positive alpha is hard from two perspectives. It's hard for fund managers to beat passive benchmarks, and as we've demonstrated, it's hard for fund selectors to pick the winning fund managers of the future. Advisers can feel pressured to please returns-chasing clients. When their mandate is to replace recent bottom-quartile funds with recent top-quartile funds, advisers start at an inherent disadvantage in producing positive alpha. Reframing the goal of manager selection as the positive impact of reducing negative alpha and educating clients so that their expectations are in line with this goal can justify the effort expended by financial advisers on manager selection.

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Perverse incentives create perverse outcomes

Vinay Kolhatkar

"The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms; greed for life, for money, for love, [for] knowledge has marked the upward surge of mankind." Gordon Gekko, Wall Street (1987)

Ever since that 'greed is good' speech, in what was termed the 'decade of greed' (the eighties), the finance industry has been Hollywood's, and the public's, go-to villain. The global financial crisis emboldened that view. Public investigations satisfy a desire to vilify a maligned section of society, but vilification is not a solution.

In August 2016, 70% of respondents to a Cuffelinks survey opposed the setting up of the Royal Commission (see [What readers think about a bank royal commission](#)). Two points, 'There are already enough regulators, inquiries and committees' and 'Banks have many stakeholders and can't keep everyone happy' had three-quarters of readers agreeing.

I wonder how many have changed their minds about the Royal Commission being a bank-bashing fest and a waste of time and money. I admit I have.

The most high-profile recent backflip came after a strenuously evasive denial on national television. It was a masterful samba, even for a politician, many of whom have earned honorary doctorates in the art of evasion.

Minister for Financial Services, Kelly O'Dwyer, dodged Barry Cassidy's question on ABC's *Insiders* eight times on Sunday, 22 April. Five days later, O'Dwyer told an SMSF conference in Melbourne:

"With the benefit of hindsight we should have called it earlier, I am sorry we didn't, and I regret not saying this when asked earlier this week."

Sales or advice?

Does anyone go to a Honda car dealer and receive a recommendation to buy a Toyota instead? When was the last time real estate agents recommended a comparable property not in their portfolio? Does that make car dealers and real estate agents morally corrupt by virtue of their profession? We understand they have a duty to their principals, the sellers, and not to potential buyers. More importantly, there is no ambiguity: the agent/dealer has a sales function, not an advisory one.

Even the legal profession has a niche for advocacy. It's the court's ambit to find the truth, but advocates are duty-bound to represent their client's interests.

So how does a financial adviser become a selling agent for someone and an unbiased adviser for a client at the same time without developing a multiple-personality disorder? Watch how this exchange on Day 15 at the Royal Commission traverses toward the obvious. It's between Rowena Orr, QC, Counsel assisting the Commission (RO) and Michael Wright, Head of Advice at Westpac (MW):

RO: Do you think of yourself, Mr Wright, as a sales professional?

MW: No, I don't.

RO: I have had a look at your LinkedIn profile which lists various things about what you do, and one of the descriptors that you give of yourself is as a sales professional; is that right?

MW: It could be.

RO: Would you like me to show it to you or – I'm happy to?

MW: No, I'm happy to believe you.

RO: I'm interested in that because I want to understand whether you think of the financial advice industry as a sales industry?

MW: I don't.

RO: You don't. And do you think it's possible for a financial adviser to be both a salesperson and a trusted adviser at the same time?

MW: Well, to me, they're – they're connected. To be a trusted adviser means that you understand your customer, you tailor their needs to their needs – sorry, to their desires. Often, to realise that, you need to put strategies in place which, in essence, result in products. So, by default, if you genuinely care in taking action, there will be an element of product to bring that to life. So, yes, you could say that is a sale.

RO: Maybe there won't, Mr Wright. Maybe the right advice for a person is not to sell them products?

MW: Yes, I agree.

You can see the whole exchange [here](#).

Financial incentives have power, as do desires for professionalism, knowledge, and respect. Can we align financial incentives toward doing the honourable thing? That's where the Commissioner, Kenneth Hayne, went as well:

"Well, forget beating up on yourself, Mr Wright. Can you offer any way in which that sort of thing – I'm trying to find a neutral expression – could be reflected in management structures, organisation, or anything of that kind?"

Contradictory incentives hurt. Terry McMaster, the head of Dover Financial, collapsed while taking questions at the Royal Commission. The Commission is not falling short on its fact-finding mission, and on drama, it had surpassed Hollywood by Day 19.

Long-run outcomes gravitate toward incentives

The big players lobbied during the development of the Future of Financial Advice (FOFA) legislation for keeping the commissions not just because they had bought businesses based on cash flow models that assumed the

commissions were there to stay. They wanted to create even more products to sell. What they bought was a sales model dressed up as an advisory service, and it compromised the professionalism of advisers.

The industry knows this. We saw it in Michael Wright’s and Jack Regan’s (AMP) testimony. Executives are themselves now pleading for a law that will bind everyone to a fee-for-service model, addressing the first-mover disadvantages. Consider this exchange between Michael Hodge (MH) for the Commission and Jack Regan (JR):

MH: Do you, as the head of advice – I’m sorry, as the group executive in charge of advice, have a view about whether the taking or continued taking of commissions is compatible with the purported professionalisation of financial planners?

JR: Well, as I said before, my preference would be for fee arrangements expressly.

MH: And is that because you don’t think that it is compatible with the idea of financial planners being a profession that they continue to receive commissions?

JR: I think fees are much more consistent with a professional environment, yes.

In the earlier Round 1 interviews on mortgage broking, CBA admitted there was a conflict of interest created by the commission payments, and that brokers were likely to burden customers with debt they could not repay. In 2011, KPMG and Westpoint directors paid \$67 million to ASIC, acting on behalf of Westpoint investors. In that case, it was alleged that financial planners were receiving around a 10% commission to sell clients into mezzanine finance for property construction.

Baring Brothers, a merchant bank that stood proud for 223 years, was brought down by a perverse incentive structure. Nick Lesson was an accident waiting to happen. Give someone \$10,000 to play at the casino all night, every night. They keep 20% of the winnings, none of the losses. Will they play every night? You bet.

Incentives matter a great deal in both directions. Fund managers and equity analysts must look deep into incentive structures in the companies they put a valuation on. Perverse incentives will eventually create perverse outcomes.

Vinay Kolhatkar is Assistant Editor at Cuffelinks.

Three reasons why current dividends matter

Anton Tagliaferro

Recent headlines on dividends have been primarily focused on the proposed removal of some of the more favourable tax treatments if the Labor Party secures government. While franking credits certainly enhance the attraction of dividends for many investors, we believe there are other reasons why the dividend income earned from an equity portfolio is an important element to consider when constructing an equity portfolio.

There are three key reasons why dividends have always been an important component for investors:

1. Dividends are a more reliable source of return than capital gains

Returns from equities come from two sources – capital appreciation and the dividends received from the shares held.

The returns from the S&P/ASX300 of these two components over the last 20 and 40 years are:

	20 years p.a.	40 years p.a.
Total ASX300 return	+ 8.3%	+11.1%
Source of return:		
Capital growth	+3.9%	+ 6.6%
Dividend income	+4.4%	+ 4.5%
% of returns of ASX300 from dividends	53%	40%

Source: Calculated using IRESS data indices

The importance of the dividend component of an Australian equity portfolio to investors is evident: around half of the returns of the S&P/ASX300 in the last 20 and 40 years have come from dividends.

2. The level of dividends received is not affected by the level of the sharemarket

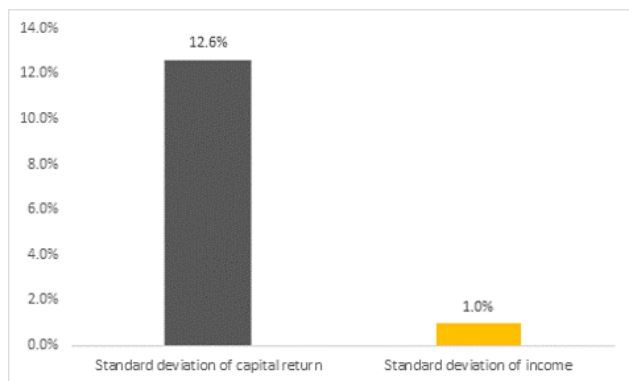
While the level of capital returns from an equity portfolio over any defined period generally depends on the movement in the sharemarket, the level of dividends is dependent on the performance of the underlying companies, not the movement in share prices.

The level of dividends and the dividend payout ratio of any company is set by the Board of the company. It is generally a reflection of the overall profitability of a company and is independent on the level of its share price.

An investor’s level of dividends from a diversified portfolio – if made up of quality companies with the right attributes – should not vary greatly from year to year and is irrelevant to what is happening on the overall sharemarket, including during price falls.

Over the past 20 years, for the S&P/ASX300, the volatility of capital returns was 12.6% and dividend volatility was 1.0%.

Chart 1: volatility of returns of capital and income of the S&P/ASX 300 over 20 years

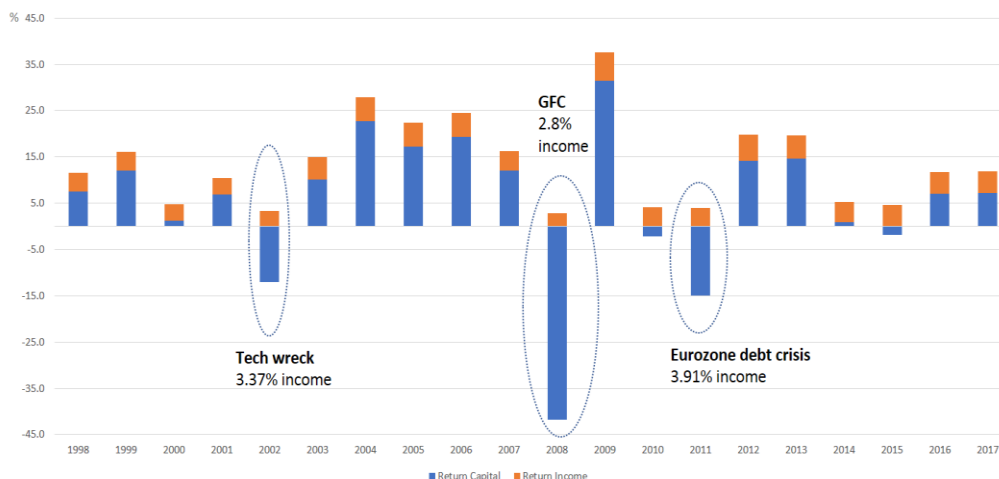


Source: IML, S&PASX300 31/03/1998 – 31/03/2018

Chart 1 shows that the volatility of capital returns has been high over the last 20 years, which is not surprising perhaps as it contains periods such as the tech boom and bust, the GFC, and the Eurozone crisis. However, the volatility of the dividends for an investor in the S&P/ASX300 has been very low.

This trend is true also on a year on year basis. Chart 2 shows the breakdown of the level of returns from the S&P/ASX300. The level of dividends paid (the orange bar) has been much less volatile than the level of capital returns (the blue bar) over the last 20 years.

Chart 2: Returns to shareholders over the past 20 years



Source: IML and Morningstar Direct, S&P/ASX 300 01/01/1998 – 31/12/2017

Regardless of share price performance, the vast majority of companies in the S&P/ASX300 continue to pay dividends which to some extent compensates sharemarket investors for a share price often beholden to the whims of the market.

3. The dividend yield on stocks can act as a 'safety net'

The movement in the sharemarket – particularly over shorter periods of 6 to 12 months – is often driven by market sentiment. This in itself is affected by predictions as to the future level of economic activity, inflation, and interest rates, as well as perceptions of geopolitical stability.

Often, minor events in hindsight from an economic standpoint can cause the mood of investors to sour markedly and lead to large declines in the sharemarket. For example, Iraq's invasion of Kuwait in 1991 led to gloomy predictions about an impending global recession by many market analysts and economists.

A perceived crisis can cause many investors to panic, and the prices of shares can fall heavily initially, often indiscriminately and independent of their quality. Once the panic subsides, companies with sustainable earnings that can support a healthy dividend stream are often the shares that can recover the quickest.

The reason for this is fairly obvious. Rational long-term investors are always attracted to companies that pay a healthy dividend from a sustainable earnings stream. Once shares in quality companies fall to a level where the dividend yield is attractive, long-term investors buy these shares to 'lock in' attractive dividend yields, despite a volatile sharemarket.

Conclusion

Dividends provide sharemarket investors with a consistent part of their total return and can also act as a 'safety net' in down markets.

While the proposed changes to the tax-effective treatment of dividends in Australia via franking credits is potentially a negative development, dividends will remain an important factor when investing in the sharemarket. They will continue to provide investors with a relatively stable part of returns through the delivery of real cash flow, irrespective of the market cycle.

Fundamentals should remain crucial to deciding which companies ought to be included in a portfolio – mainly the quality and transparency of the earnings, cash flow generation, gearing levels, or balance sheet strength – which ultimately determines the level of dividends.

Anton Tagliaferro is Investment Director at [Investors Mutual Limited](#). This information is general in nature and has been prepared without taking into account of the objectives, financial situation, or needs of any investor.

The merit of currency exposure if equity markets fall

Adam Kibble

Is the Australian dollar set to lose its shine for a prolonged period? Australian investors are concerned that the currency will come under downward pressure due to an eroding interest rate differential between US and Australian rates.

When investing in foreign assets, Australian investors are exposed to losses when the AUD appreciates against other global currencies, and make gains when the AUD depreciates. This currency exposure, or risk, can be neutralised through hedging. However, it is common for investors to retain some unhedged foreign currency exposure, particularly for more volatile assets such as global equities. Investors typically fully hedge their currency risk on more defensive assets, such as fixed income, to prevent currency volatility dominating returns.

The temptation now is to reduce this type of currency hedging, but we urge caution as this strategy also increases portfolio risk.

Traditional interest rate differential gone

The AUD has long been a preferred 'carry trade' (that is, borrow in one currency and invest in another) due to the higher interest rates in Australia compared with the record low rates in other developed countries. However, the US Federal Reserve (Fed) hiked rates to a target of 1.5-1.75% in March 2018, which is the sixth increase since the near-zero levels in December 2015. The Reserve Bank of Australia meanwhile has kept rates unchanged at a record low of 1.5% since 2016.

Traditionally, investors and analysts believe that the interest rate carry trade is an important driver of AUD performance. This current negative differential is therefore raising concerns that the AUD is set for a sustained period of weakness.

The AUD/USD carry impact is a complex story

Investors generally believe that AUD rates above USD rates deliver better returns from buying AUD/USD. An analysis of the monthly AUD/USD returns, conditional on the difference between Australian and US interest rates, suggests a more complex story, as shown below.

Historical AUD/USD monthly performance statistics (Jan 1995 to Dec 2017)

Interest rate differential	Negative	Low (0-2%)	Medium (2-4%)	High (>4%)
Average monthly return	-0.60%	0.26%	0.31%	-0.25%

Source: Insight Investment

For low and medium interest rate differentials, the average historical monthly returns are 0.26% and 0.31% respectively. When there has been a negative interest rate differential, the average monthly return falls to -0.60%. Surprisingly, for high interest rate differentials the average historical monthly return is also negative at -0.25%.

A deeper dive into the statistics also reveals that as interest rate differentials have reduced historically, so has the volatility of monthly returns. In addition, under medium and high carry levels, the AUD tends to experience more large-negative moves, known as negative skew. This analysis leads to a reasonable hypothesis that the AUD/USD is a lower risk currency when carry is lower.

Correlation and diversification

If both AUD/USD returns and volatility are lower when carry is low or negative, then reducing the level of currency hedging for foreign-currency-denominated assets, in our view, could make sense in the current environment. However, it is important for investors to also consider the correlation between Australian dollar returns and the foreign assets they are hedging.

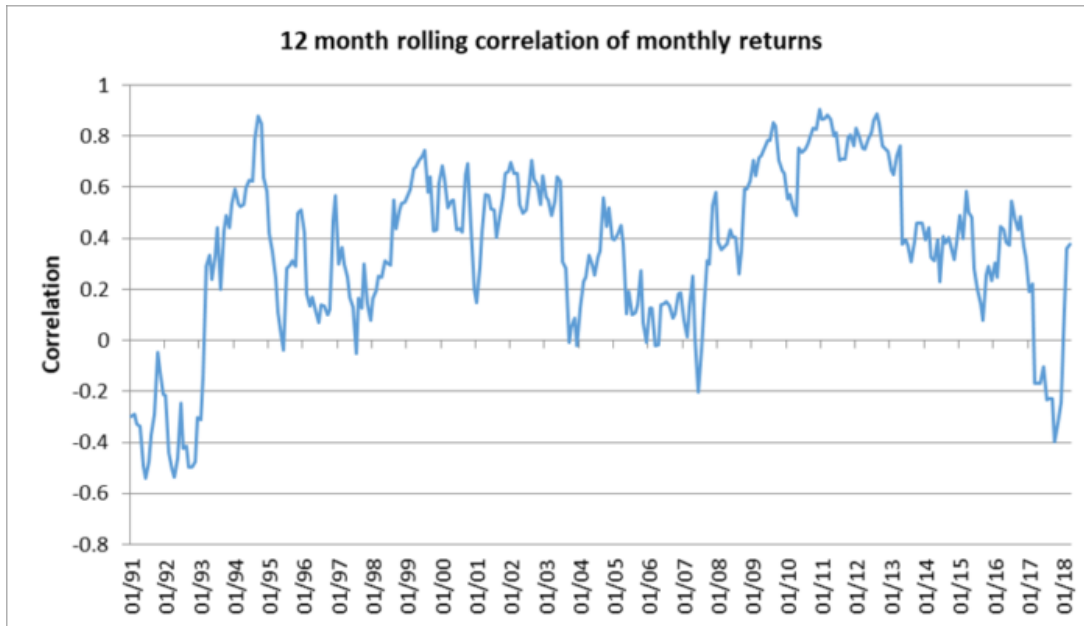
Our analysis of the data suggests investors need to proceed with caution.

The underlying assumption is that the unhedged currency exposure will provide a diversification effect at the total portfolio level. For this diversification effect to be present, there needs to be a high positive correlation between the returns on the Australian dollar and global equities.

By way of illustration, when equity markets have suffered periods of negative returns, these have tended to coincide with a weaker AUD. For example, the AUD/USD spot rate fell 19.7% in 2008, while the S&P 500 Index also lost 38.5%. If the investor was unhedged in terms of currency exposure, the S&P 500 Index loss in AUD terms was much lower, at 18.8%. In this case, the weaker AUD has added value to the portfolio, partly offsetting the losses suffered on foreign equity investments. Investors were better off unhedged.

This relationship depends on the correlation between the investor's domestic currency and equity market performance. The chart below shows the rolling 12-month correlation between the monthly returns on the AUD and the MSCI World Equity Index in local currency terms. While the correlation is generally positive, it is not stable and was negative for most of 2017.

12-month rolling correlation between the Global Equities and AUD/USD exchange rate



Source: Bloomberg and Insight Investment as at 30 March 2018. *Global Equities = MSCI World Local Currency Index.

As interest rate differentials increase, the correlation between the performance of AUD/USD and global equities has also increased. By contrast, with low interest rate differentials correlation falls, while at negative levels, the correlation is close to zero. Investors may need to reassess their assumptions regarding correlation and the diversification effect in the current environment.

Conclusion on the merits of hedging

We believe, based on the above analysis, that low or negative interest rate differentials have two key implications for AUD investors with global equity exposures:

1. The impact of carry on the AUD’s performance is more complex than analysts suggest. Our study shows that the AUD is a more risky currency during periods of high carry. As carry levels fall, monthly returns also fall and the temptation for investors is to lower their currency hedging.
2. If the objective of lowering hedges is to improve returns on foreign equities, we suggest investors proceed with caution. Lower correlation could mean the worst-case scenario occurs where the AUD appreciates when global equity prices are falling. In this case, the investor will face losses both on the underlying assets and their currency translation.

Adam Kibble is a Product Specialist at [Insight Investment](#). This article is general information and does not consider the circumstances of any investor.

Three checks to make when facing earnings downgrades

Robert Miller

“The market doesn’t care how you feel about a stock or what price you paid for it.” – Howard Marks

Most stock market participants are required to deal with earnings downgrades from time to time: they can hurt, or they can be a fantastic buying opportunity. When a downgrade occurs in a company within our investment universe, we follow a checklist. If we can comfortably answer yes to each item, it helps rationalise our thought process. If supported by a foundation of quantitative and qualitative analysis of the company, industry, and competitors, there may be an opportunity to either enter a new position or add to an existing holding. If not, we are unlikely to invest or may reduce or exit an existing position.

The three items to check are:

1. Has management been consistent in their rhetoric?

"There's a big difference between probability and outcome. Probable things fail to happen—and improbable things happen—all the time." – Howard Marks

From our experience, a high-quality management team is the biggest factor to consider when investing in small companies. We meet with management teams on a regular basis, and over time, we gain an understanding of actions versus words. Management rhetoric – whether it is consistently good or consistently bad – is a key factor. We would prefer a management team deliver downbeat news consistently rather than being too hopeful and incorrect. The market tends to look through poor divisions or issues if they can be siloed from the rest of the business, or if the issues are short term in nature. The market is much less forgiving on failed hype.

A recent example is BSA (ASX:BSA), a telecommunications and engineering services business. Its HVAC construction operation has been consistently underperforming. It is a competitive market sector and there does not appear to be significant improvement on the horizon. However, management has been consistently upfront with investors about the health of this division which is dragging heavily on earnings. Ongoing poor results with no unexpected negative surprises make it easy to 'look through' and focus on what is going well in the rest of the business, namely its unique exposure to the maintenance of the NBN which is beginning to contribute to company earnings.

2. Has there been a change in strategy?

"To be an investor you must be a believer in a better tomorrow." – Benjamin Graham

In our view, investing in small companies requires a long-term investment horizon (three years+). Internally we have a minimum hurdle rate of 20% p.a. return over a three-year period when assessing a company to invest in. Taking a long-term view means we are 'buying into' a strategy set by a company's board and management team. It is difficult for a business to perform to expectations all the time, however if the strategy remains on course then we are likely to be more tolerant of downgrades.

If there is a sudden change of direction from the previous strategy, then this is a concern. This should not be confused with pragmatic management, which we would define as being flexible within an overarching plan, as opposed to a change of plan itself. An unexpected change in strategy can often indicate a shift from acting in the best interest of shareholders, to the board and management focusing on their own interests.

For example, during 2015, CML Group (ASX:CGR), an invoice financing business, experienced unexpected losses due to outstanding construction loans. The loans were unrecoverable and caused a large P&L hit at the time. Management made it clear that the construction industry was not part of their strategy for growth and it should diminish as an exposure over time. We felt the overall business strategy had not changed.

3. Would I buy it lower?

"Unless you can watch your stock holding decline by 50% without becoming panic stricken, you should not be in the stock market." – Warren Buffett

Sell-side analysts will typically release their updated (or downgraded) reports within 24 hours of a result. This can mean you see a further decline in stock price after the fact, as bearish medium-term outlooks are often applied by analysts. The inverse usually happens following a positive announcement. Oversold and overbought stocks are most likely to exist at this point in time.

If the information released to the market causing the downgrade doesn't impact your original investment thesis, then your margin of safety has improved, potentially dramatically. Despite the short-term facts changing, you should ask yourself 'does this change my two- or three-year target price?' Furthermore, if the share price continues to decline 'would I be again happy to buy at lower prices?' If we can answer these questions with confidence, then this will contribute to our decision to either enter or exit a position.

The overall message is not to view every earnings downgrade as a negative. If we can become comfortable with these three key checklist items, we believe opportunities can present themselves which may not seem so obvious to other market participants.

Robert Miller is a Portfolio Manager at [NAOS Asset Management](#), a boutique funds manager investing in emerging and small-mid cap industrial companies. This content has been prepared without taking account of the objectives, financial situation, or needs of any individual.

Rob Prugue's spiritual and physical super journey

Rob Prugue

Managing Editor's note: Rob Prugue is a leading figure in Australian funds management. He was most recently Senior Managing Director and CEO of Lazard Asset Management (Asia Pacific), responsible for the business across Asia. I know Rob from my role on the Lazard Compliance Committee, and he is one of those executives and fund managers who always takes a broad view of the world. Conversations were not only about markets and economics but philosophy and social obligations. He left Lazard earlier this year to give himself a long sabbatical before considering his next role.

Part of this break from work includes an 800-kilometre walk along El Camino. The Camino de Santiago pilgrimage ends in the Spanish province of Galicia, believed to be the resting place of St James the Apostle. This has been a trail for pilgrims since medieval times and it has no real starting point. Rob thinks of his trip in thirds:

"The first third is one of physical exhaustion, or getting our bodies into its rhythm. The second third is about 'letting go', while the final third is about understanding what El Camino has taught us. I like this, not because I look forward to the final third, but because I too am learning to let go of certain things."

This journey of self-discovery took a remarkable twist, as Rob describes in this extract from his blog (which can be followed [here](#)):

"As I entered this little stone chapel, I noticed it wasn't a church after all, but a shrine. I asked the gardener to whom it was for, and he answered it was for Archangel Michael. Perfect, I thought. A place to pray for family and friends fighting for health."

A few hours later, I received a message from my brother-in-law in Lima, Peru. He said a few hours earlier, my 92-year-old mother's heart just stopped. My beautiful mother, Norah Salkeld de Prugue, passed away on the morning of 24 April 2018 in Peru.

I now realise that my being compelled to enter the little stone chapel was no coincidence. My mother's soul was speaking to me, asking me to come in to say goodbye. While my prayers were for family and friends, I interestingly enough did say an extra-long one for my lovely mother.

I still cannot believe this. As I later entered into Carrion, my final destination today, I immediately went to the lovely church, said a prayer, and lit a candle. A sister saw me weeping and asked if she could help. I told her the story and she said she would speak to the local priest. The nun made sure the evening service was in my mother's honour. The priest and the town congregation were so very kind in giving that service in her name. The town people all came around to wish their sympathies. Truly generous hearts here in rural Spain.

Before you roll your eyes, I appreciate this is likely a coincidence. But perhaps, just perhaps, it's my mother suggesting I continue and finish this 500-mile walk."

Then a few days later, this update:

"Clearly the Camino must think I'm one bad ass as only hours after my pulling myself up from my mother's funeral half a world away, I now learned that my brother in Miami's wife, Paloma, had just passed away following her 13 year battle with breast cancer."

Wow, that's turning into quite a journey.

Earlier, Rob had sent me this email:

"Oddly enough, as well as reflecting on life, my reflections have been on superannuation. A recent article in The AFR about industry funds got me going. Here's my thoughts from El Camino"

Superannuation: Clowns to the left of me, jokers to the right

Coming to my second month of my three-month sabbatical, and now 200 kilometres into my 800-kilometre Way of St James (the Camino) here in Spain, I was hoping to find some sort of spiritual self-fulfilment through my daily routine of 30,000 steps. And while perhaps I was in such a path towards some self-introspection, it took an opinion piece in the Australian Financial Review on 11 April 2018 titled [Why Industry Funds Are Not So Super](#) to remind me just how much superannuation is a part of me.

As Al Pacino said in *Godfather 3*, just when I thought I was out, they pull me back in!



Peer rankings useless for superannuation

What bothered me most was less the continued division between industry and for-profit super providers, but the continued persistence on peer rankings. In all my years of learning and working within superannuation, I have yet to find ANY academic book which suggests that the best way to immunise a pension liability (i.e. matching future assets to future pension liabilities) is by choosing a top quartile performer.

And while of course it's true that returns do matter (to be precise, net of fees and net of taxes), pension liabilities are acyclical whilst asset returns are cyclical and subject to market forces. Peer performance rankings, therefore, are futile within superannuation.

Funds in net outflow compounds problem

This bee in my bonnet is equally founded on demographics, as an increasing number of both retail and industry funds are experiencing net outflows given baby boomers have already begun to retire. Once retired, pension immunisation is all the more important. The ability to forecast steady cash outflows off an increasingly cyclical economic environment is paramount in planning retirement years. Yet, the media and agents remain consumed on metrics that play no part in pension management. Perhaps this is due to the fact how within the financial services industry, wealth management is itself a big component therein.

Whatever the reason, superannuation is not wealth management, it's about optimising assets around returns required to immunise pension liabilities. Pure wealth management, on the other hand, cares little about asset/liability immunisation.

Let's move beyond political name-calling

My secondary beef about this opinion piece is the obvious political affiliation intended behind their defining what is an 'industry fund' and what is a 'for profit fund'. Calling an industry fund a 'union fund' is either naive or intentionally misleading. I neither belong to a union nor do I belong to a party, yet I have my super within a so called 'union fund'. Having attended conferences run by both sides, I've always rolled my eyes when discourse turned to political affiliations. Who the hell cares? If super fails, it will affect ALL tax payers as neither party will allow its retired voters to live in the streets. How we tax any fund may be politically aligned, but their policy for superannuation is nonetheless apolitical.

I pose this piece not to continue to divide, but to hopefully remind us to challenge anyone who feels it necessary to divide superannuation funding into an 'us versus them' debate. What defines our industry isn't 'for profits vs not for profits', but superannuation itself. Sadly, both sides are guilty of this division, and equally, both sides will need to come together if we are going to achieve our true purpose.

Rob Prugue was Senior Managing Director and CEO at [Lazard Asset Management](#) (Asia Pacific) for 15 years until March 2018.

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