

### This Week's Top Articles

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### SMSFs, member-direct and Labor's franking

Matthew Collins

The refund of excess franking credits has been available since 2000. Many SMSF trustees have become accustomed to receiving a large deposit into their bank account at the end of each financial year. If Labor's proposed changes to dividend imputation become law, the refund will be a thing of the past and trustees will need to rethink their investment and tax planning strategies.

Franking credits will still be beneficial for superannuation funds that have taxable income as the franking will reduce their tax liability. However, many funds, especially those paying a pension, have little or no tax payable and currently receive a refund. They will be the funds that lose out the most.

A flaw in the policy proposal is that the burden of the extra tax will affect one group of investors, those using an SMSF, more than any other. Most large industry and retail funds will generate enough income from contributions and investment earnings to use their franking credits and pass on the benefit to members. This creates the unfair situation where two investors with the same investments, one in an SMSF and one in an industry or retail fund, will be treated differently.

#### What can SMSFs do to reduce the impact?

Given the possibility that Labor will be in power by this time next year, SMSF trustees and their advisers are already contemplating strategies to limit the effect of the potential change. These strategies include:

- Changing the investment mix to include investments that don't provide a franking credit such as property trusts, overseas investments, and companies that pay unfranked dividends.
- Many high net worth super fund members currently receive a pension simply to reduce the tax liability of their SMSF and not because they need the income. In future, this strategy may simply increase the amount of franking credits that are lost, and members may leave their superannuation in accumulation.
- Children who are making taxable superannuation contributions may join their parents' SMSF. The taxable income of the fund will rise and use up some of the excess franking credits.

- Closing the SMSF and have their investments managed by an industry or retail fund.

There is another strategy that may be of benefit to some investors: member-directed investments.

**What are member-directed investments?**

Generally, when joining an industry or retail fund, investors are given a choice as to what fund category they will invest in. For example, they may be asked if they are a 'Conservative', 'Balanced', or 'Growth' investor. Some funds also provide another alternative where the member can choose specific investments. This alternative is generally known as 'member-directed investments'.

The member-directed investments option allows the member to buy and sell investments, similar to using an SMSF. It is managed through the superannuation fund website. Brokerage is charged at rates comparable to the major online brokers, and the administration fee, usually under \$400 through industry funds, is reasonable when compared to fees charged to administer an SMSF.

Where an SMSF provides almost unlimited investment choice, this is not the case with the member-directed investment option. Investments are generally limited to:

- ASX 300
- A selection of listed investment companies
- A selection of exchange traded funds
- Term deposits
- Cash

It is not as flexible as an SMSF in other ways. There are limits on how much can be invested in any one asset, usually 20%, along with a requirement to hold a portion of your balance in cash.

Despite these restrictions, this type of product may be beneficial to some investors as shown in the examples below:

**Example 1**

Fund balance:	\$1 million. 1 member. 100% pension phase
Investments:	75% in ASX shares (mostly blue chip), 25% term deposit
ASX dividend yield:	5% (\$37,500)
Franking credit:	\$16,071

If no action is taken, the franking credits will be lost. The member would have the option to shift to the member-directed investment platform and limit their investments choice. This could potentially result in a full refund of franking credits.

**Example 2**

Fund Balance:	\$3.2 million. Two members. \$1.6 million each in pension phase
Investments:	Global equities, direct property, ETFs, LICs, and ASX listed shares (\$1.5 million is in investments on the member-directed investments list)
ASX dividend yield:	5% (\$75,000)
Franking credit:	\$32,143

The members could shift \$1.5 million into a fund providing member-directed investments and maintain their SMSF for the balance. If the new fund pays an account-based pension, a franking credit refund of \$32,143 could be received.

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## Some final words of caution

Superannuation law (SIS Reg 5.03) states that the trustee is required to allocate income between members "in a fair and reasonable way". What does "fair and reasonable" mean? In the case of member-directed investments, the good news is that currently the benefit of all credits relating to shares held are allocated to the member's account. It is hoped that this practice continues if there is a law change. However, we have no guarantee at this point.

In commenting on an article by Michael Hutton last week, a Cuffelinks subscriber, Ramani, did an excellent summary of this issue:

*"The option of moving from a SMSF to an APRA (industry or retail) fund such that franking credits that would be wasted in the SMSFs can soak up the fund-as-a whole tax liability would make sense, but only if the APRA fund would equitably distribute the credits so saved back to the members who gave raise to the credits in the first place.*

*I would urge caution against such an automatic presumption. The black-box of calculating member earning and crediting rates (or the related unit pricing if the fund is unitised) as well as the fuzzy nature of equity among member cohorts, not to mention generic member apathy, militate against it. It would be feasible to check if the trustee would so distribute, and having confirmed it would, prosecute any failure in the new dispute resolution authority might be required. Otherwise, the SMSF members would be 'donating' the excess credits to other members without being aware of it, instead of to the Treasury as wasted franking."*

Given the issues importance, I suspect clarification will be provided by the funds before any change in the law.

It's an important opportunity. According to the Class SMSF Benchmark Report of March 2017, listed shares account for 30.2% of money invested in SMSFs. Therefore, there will be plenty of investors looking for strategies to keep their franking credits if refunds are no longer allowed. Assuming there are no legislative or other administrative impediments, member-directed investments may be a viable alternative.

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## Bank limitations create opportunities for non-bank lenders

Justin McCarthy

Since the GFC, bank capital levels and the number of bank regulations have skyrocketed in amount and impact. The unquestionable thrust of Basel III has been for global banks to massively increase capital, reduce leverage, limit risk-taking behaviour, and adhere to a far more stringent set of banking regulations. Almost 10 years on since the GFC, much has been achieved.

These developments are a significant positive for debt investors, as the bigger the equity capital buffer, the more protection for debt investors further up the capital structure. Some offshore banks now have almost three times the capital from pre-GFC levels!

Bank stocks have significantly underperformed the broader market in recent times and much has been written about the persistent fall in return on equity (ROE). Given the increase in capital and limits put on riskier business lines, this is no surprise.

The fallout from the Royal Commission will undoubtedly see a further reduction in risk-taking appetite and yet more regulatory burden placed on the banks, continuing the trend of lower risk, higher capital and lower ROEs.

### Winners and losers from new bank regulations

Small and medium sized enterprises (SMEs) are the lifeblood of an economy, but given the changes to bank regulations the sector is increasingly a 'loser'. In Australia, SMEs employ around 70% of the workforce and produce around 55% of business economic activity. However, two key changes continue to push SMEs out of the bank lending market:

1. Cost – under Basel III, banks must hold higher levels of capital against SME lending, including low-risk loans backed by residential or commercial property. This makes lending to SMEs more ‘expensive’ for the banks, and hence they pass the cost onto the SME borrowers.

2. Time – SMEs often require expedited funding. However, the ever-growing level of regulation and compliance that bank officers must comply with results in turnaround times that are typically weeks or even months. Even the highest quality loan application takes time to go through the process.

For example, if a clothing retailer is offered a 30% discount on the usual price by a wholesale supplier on Thursday, provided they place an order by the end of the week for \$100,000, the retailer is happy to draw on say, a three-month loan paying 15%. The three-month interest cost on \$100,000 would be \$3,750 versus a potential increase in the profit margin of \$30,000. This loan may also have security over the company’s assets and have directors’ guarantees or a mortgage over the owner’s home.

These high-quality SME loans (often fully secured) are leaving the banking sector in droves. The burgeoning fintech, peer-to-peer, and non-bank lending sectors are the perfect destination for SMEs. Simple, quick, and transparent processes and ultimately, access to funding in just a few days as opposed to weeks or months is what SMEs desire. And they are happy to pay up for such a service.

### **Alternatives offer a better customer experience**

Changing consumer preferences are also contributing to the transformation. Gen Ys are getting older and spending more. This rapidly growing segment of the economy values speed and ease of finance approval and this is something the traditional banking sector has difficulty providing. Credit card usage is falling with the younger generation in particular preferring alternative payment methods. Advances in technology enable operators to build systems that do all the checks of a bank, plus more, in just a few minutes and provide an approval and appropriate risk-adjusted interest rate almost immediately. With advanced IT systems, these non-bank operators can do an ID verification check, credit check, history check, social media profiling (using approval ratings for services such as Airbnb, Uber, eBay etc.), and produce a decision in a matter of minutes.

SME loans follow a similar streamlined process and while they are a little more involved with directors’ guarantees or property security and charges taken over the underlying business in many cases, the turnaround times are much faster than the banks can provide.

Customers are even prepared to pay a higher rate than they may get from a bank if the decision process is fast. And this does not mean that the underlying credit is inferior. In fact, the opposite is often true. It is the dynamic and well-organized business owners that can see an opportunity and have the required financial information at hand to enable a quick online application and fast approval. The greater the history of online loans and repayment behaviour of an individual or company, the greater the accuracy of the decision-making engines. The fintech sector now has many years of data to back the underlying results.

The rise of fintechs for the supply of loans to SMEs was confirmed at the Royal Commission on Tuesday 22 May 2018. The ANZ’s General Manager for Small Business Banking, Kate Gibson, provided numbers showing her division was facing a substantial reduction in loans, down to 114,000 in 2017 from 131,000 in 2014. She said, “There were new entrants into the market by way of fintechs, who were also offering lending options to small business customers.”

### **Non-bank lending small but growing**

In Australia, the non-bank lending market is growing rapidly but is still relatively small, with many players fighting for scale. We expect that in just a few years, Australia’s market will be far more developed, similar to the likes of the US and UK, where consolidation has occurred, and there are now a smaller number of strong operators. Access to debt funding for non-bank lenders and fintech operators in these more developed markets can be half the cost (i.e. credit margin) of what is seen in Australia.

In recent months the major banks have been providing the largest of the domestic fintech or alternative lenders with relatively cheap funding in the form of flexible ‘warehouse’ facilities. This access to cheap funding from the banks, in volume, will be a game changer for the Australian non-bank market if it continues to grow and filters down to the mid-sized players.

We are constantly monitoring regulatory changes and the opportunities they create in the fintech, peer-to-peer, and non-bank lending sectors. Likewise, the APRA crackdown on non-resident investment lending is also presenting opportunities in providing loans to international buyers on very attractive terms. With the traditional

banks forced out of the market, high quality foreign buyers are prepared to borrow money for apartments (and houses) in Melbourne, Sydney and Brisbane with 40% deposit, 60% LVR (against an independent valuation) and at interest rates of up to 8%. The same loan to a local first-home buyer with a short employment history might be on terms such as a 10% deposit, 90% LVR, and 4.0% interest rate.

The growth of the non-bank lending market is a trend from which we believe investors can profit. Companies like Afterpay, CML Group and Heartland Bank have the operational structures, scale, and funding lines to be leaders in this sector. In the peer-to-peer space, marketplaces such as DirectMoney (listed) and SocietyOne (wholesale investors only) offer attractive rates of returns to investors.

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## Blue skies for consumers, caution for investors

Roger Montgomery

*"Blue skies, Smiling at me  
Nothing but blue skies, Do I see."  
– Composed by Irving Berlin in 1926*

The equities bull market is excited by the potential for technology to continue to change the world. Among many examples, Waymo, Zoox and Uber are developing self-driving cars, Amazon is employing AI rather than human cashiers in automated grocery stores, Facebook is mining your behaviour and predicting your next move for advertisers, Titomic and CSIRO have built the world's largest 3D titanium printer, another 3D printer manufactured a human kidney, and just about every auto manufacturer is racing towards electric vehicles. Meanwhile, global spending on [AI and machine learning](#) is forecast to grow from \$12 billion last year to \$58 billion by 2021.

It's almost impossible not to be caught up in the wave, but investors need to remember that the rapid advances in technology have been funded by a record supply of money at the lowest interest rates in history. When technology has changed the world in the past, investors didn't always win.

Often, the consumer reaps the benefits. From Moore's Law accurately predicting the doubling of transistors per chip every two years, to Koomey's Law observing that the energy of computation is halved every 18 months, or Kryder's Law showing the number of bits that can fit onto shrinking hard drives doubles every 18 months, and Swanson's Law that states the cost of the photovoltaic cells needed to generate solar power falls by 20% with each doubling of manufacturing capacity, we find a lot of evidence that companies need to run faster and faster just to stand still.

As the sales volume rises, supplier returns decline because the technology becomes commoditized and cheaper. This is great for customers and the planet, not so good for shareholders who are swept up in the excitement of the new, new thing – as investors may yet discover.

### Is Australia different?

Australia is not immune from the exuberance gripping parts of the equity market, such as the valuations of emerging disrupters such as Kogan, Pushpay, Getswift, and Afterpay.

One of the best performing industrial stocks over nearly two years has been Kogan (ASX:KGN), established in 2006. Despite the threat from Amazon, its share price has rocketed from around \$1.50 a year ago to around \$9.00 today. According to its Wikipedia entry, it has a "portfolio of retail and services businesses including Kogan Retail (the Kogan.com and DickSmith.com.au retail websites), Kogan Marketplace, Kogan Mobile, Kogan Internet, Kogan Insurance, Kogan Health, Kogan Pet Insurance, Kogan Life Insurance and Kogan Travel."

Despite the spread of interests, Kogan derives over 90% of its gross profit from its core e-commerce retail business selling private label and third-party products.

Based on most recent numbers, the founder Ruslan Kogan appears to be a solid operator of the core business. Through “sourcing, analytics and automation”, Kogan’s gross profit margin was 17.9% at the end of FY17, compared to 15.5% the year prior.

The company has also strongly improved various metrics recently. As at June 30, 2017, the company claimed to have 955,000 active customers, representing a 36% increase from FY16. For the six months to December 2017, revenue at the online retailer jumped 45.7% to \$209.62 million and reported profit was 470% higher at \$8.33 million. Keep in mind, however, that in the prior period there was \$3 million of costs associated with the IPO. Add back those costs into the prior period and the jump in profit isn’t as high.

On 23 April 2018, the company provided its Appendix 4C Cash Flow Statement for the quarter ended 31 March 2018 (3QFY18) and reported revenue growth of 46.1% and active customers of 1,288,000 or 5% of the Australian population.

But while Kogan displays growth, sound management, and popularity amongst shoppers, investment returns are determined by a company’s future prospects. We must ask whether the determinants of the company’s future are beyond management’s control.

Perhaps this is the reason new ‘verticals’ such as mobile and pet insurance are being explored by Kogan. Kogan has, for example, entered the mobile phone services space and has grown gross sales from a standing start in 2016 to \$3.6 million in FY17, and has also launched an internet service offering unlimited NBN data plans for as little as \$58.90 per month.

While they are currently small divisions, they leverage the Kogan’s database, and bring to the company a stream of recurring revenues, something retailing lacks. But these new verticals are already populated by larger and more established rivals. And in the case of internet service providers, margins are also generally under pressure.

### **Competition from the global giants**

When the much larger and deeper-pocketed Amazon announced its entry into Australia, Kogan’s response was to welcome additional competition, citing ‘online retail’ accounting for about 7.5% of the total Australian retail market, compared to 20% for economies with a large marketplace player such as an Amazon or an Alibaba.

A similar response was offered by A2 Milk, upon news the global food giant Nestle had entered the Chinese market with its own A2 protein baby-milk formula. A2M told DairyReporter.com that it is “uniquely positioned to benefit from expansion of the category over time”.

Perhaps Kogan and A2 Milk should ask Woolies and Myer how they felt after the arrival of Aldi and Zara respectively.

Amazon recently announced that a fulfilment centre would be operational in the second half of 2018 in Moorebank, south west of Sydney. The location sits in the middle of one of Australia’s biggest retail markets, ensuring fast delivery to a significant proportion of its customers, many of whom may have previously shopped with Kogan. Amazon’s move may also increase product selection and support more third-party sellers using Amazon’s marketplace and fulfilment services.

Research results from US tech giant Pitney Bowes showed widespread dissatisfaction among Australian shoppers with local merchants, with 88% choosing to shop through overseas retailers in the past year. Almost nine out of 10 Australians shop through offshore e-merchants.

With Amazon Australia now offering goods from more than 5,000 sellers — making it the fastest-growing Amazon marketplace in the world, ahead even of India – it could be more challenging for domestic e-commerce providers to continue to claim a unique selling proposition.

Australia is a small country with few global winners. However, investors are betting that all of the latest batch of upstarts are going to win despite much larger global rivals and low barriers to entry. In the short run, popularity determines returns, but ultimately share prices cannot help but follow business performance.

Australia’s crop of disrupters need to be watched closely, especially when share prices are implying uninterrupted double-digit growth.

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## The allure of business real property in SMSFs

Stephen Lawrence

The business real property (BRP) strategy for SMSFs has a reputation for being complicated to design and execute. This needn't be the case and people should not be afraid to look into it.

The 'BRP strategy' is where an SMSF acquires business real property and then leases that property to a related party who runs a business from there. It comes with no real tax law or super law risk. In fact, the law has been written specifically to encourage the use of a BRP strategy. It is a rare situation where SMSF members who are also business people are significantly advantaged by having an SMSF.

The garden variety is clear and no one thinking about a BRP strategy should fear it. It's a doctor whose SMSF owns the property where the surgery is. The tradie who has a workshop. No private use. It's just a workspace. A retail operator who wants to own the shop the business operates from.

In such circumstances, a BRP strategy within an SMSF can work well. The BRP strategy has become even more attractive after recent super reforms, and SMSF members and trustees might consider revisiting it.

A qualification is that, at the margins, it can be complicated. Can a residential building, for example, be business real property? Maybe. Maybe not. People should tread carefully going into such BRP grey areas.

### The current law and attraction for businesses

Generally, transactions between an SMSF and a related party are totally out of the question. An SMSF can't buy things from a member although an SMSF can sell things to a member for full market value. An SMSF can't make loans and can't lease things to a member. It's mostly in a set of rules generally referred to as the 'in-house asset test'. But BRP is exempt from all that. Critically, this means an SMSF can own BRP and then lease it to a related party.

From a business perspective, it can be very useful to have an SMSF own the BRP. It provides the business with long-term security. The business tenant doesn't have to worry about being kicked out if the property is sold or the landlord changes direction. Having to move business premises is expensive and disruptive. It's also a great asset protection strategy for the BRP owner, the SMSF.

The SMSF can be well protected from the various risks of the business.

### The super reforms

The government's objective from the super reforms was to achieve some kind of 'reigning in' of super. A big part of this was to limit how much people will be able to put into super due to contribution limits. So:

1. The concessional contributions cap went from a maximum of \$35,000 to a maximum of \$25,000 per annum
2. The non-concessional contributions (NCC) cap went from \$180,000 to 100,000 per annum
3. Once a member has a total superannuation balance of more than \$1.6 million, they cannot make any more non-concessional contributions.

### What does that have to do with BRP?

Paying rent to an SMSF is not a contribution to super. Consider this example.

Mark is a 55-year-old designer with \$2 million in his super fund. He operates a successful design business through a company. He would like to get as much into super as possible. The lowest tax rate on his business profits is the small business tax rate of 27.5%. He knows about a commercial space that he could purchase for \$1 million that is currently rented out for \$80,000 a year. It would perfectly fit the requirements for his business workshop. He currently rents workshop space.

If he employs a BRP strategy via an SMSF then he will pay that rent from his business to his SMSF which effectively transfers \$80,000 per year from a 27.5% tax environment into a 15% tax environment. It's still his money. He saves \$10,000 in tax a year and compounds that for several years in a low tax environment. He obliterates the concessional contributions cap of \$25,000 (which he could also put in from his business) because the business entity will get a tax deduction for the rent of a workshop space.

He has just grabbed back everything the government took by reducing the NCC from \$180,000 to \$100,000. The full NCC cap of \$100,000 for the year remains intact if he happens to have some spare after-tax cash. He can keep using this BRP strategy even though he has a total superannuation balance of over \$1.6 million. Any capital gain on the property will also be derived in a very friendly capital gains tax environment.

### **Future obligations**

The main obligation going forward is the idea that the investment must be maintained on an arm's length basis. Mark's business will have to make sure that it pays an arm's length rent, calculated using well-known principles. That rule is designed to make sure that the SMSF doesn't let the related business only pay nominal rent which would clearly be providing Mark a present-day benefit. However, Mark is actually trying to do the exact opposite.

In fact, Mark is probably wanting to push the envelope in the other direction to get more into his SMSF. Perhaps Mark's property could get a rent of \$100,000 as determined by a valuer and signed off by an auditor. It's hard to see how that would violate the arm's length rule in super. It would be more likely to potentially violate the anti-avoidance rule in tax law. What is happening here is a transfer pricing type of exercise: Possibly overcharging on the yield from an asset to get tax deductions in a high tax environment, and assessable income in a low tax environment, whilst keeping control of the cash.

The super reforms limited what people can put into super. The use of a BRP strategy eases some of those limitations for small business owners.

*Stephen Lawrence is a Lecturer, Taxation and Business Law School, UNSW, Chartered Accountant and Member of the International Tax Planning Association. These views are considered an accurate interpretation of regulations at the time of writing but are not made in the context of any investor's personal circumstances.*

## **How do Active ETFs and managed funds differ?**

### **Paul Gambale**

Active Exchange Traded Funds (Active ETFs) and managed funds share many similarities, but there are important differences. With a rise in the popularity of ETFs and the introduction of more Active ETFs, the differences between the two actively managed investment options are important considerations for investors.

The similarities between Active ETFs and managed funds include:

- **Active management:** The investment manager is attempting to beat an index or benchmark.
- **Open-ended nature creates liquidity (the ease of buying and selling):** The fund regularly creates and redeems units, typically daily, depending on supply and demand.
- **Diversification:** Investors receive a portfolio of securities in one investment.
- **Regulated trust structure:** They are both subject to the same regulatory protections.
- **Limited disclosure:** Active ETFs disclose portfolio holdings quarterly while managed funds are not required to disclose, but usually provide top 10 holdings.

### **Investing in a managed fund**

Managed funds are not bought like shares on the stock exchange and investors only know their entry or exit price on a T+1 basis (T+1 means settlement occurs the next day. A unit bought on Monday would settle on Tuesday). The two main ways to invest in a managed funds are:

- Via a platform (also known as a 'wrap'), which generally requires investors to pay a platform administration fee.
- Direct with the fund, which requires investors to fill out forms directly with the fund manager to buy and sell units.

### **Investing in an Active ETF**

Active ETFs, however, are traded on the stock exchange:

- Units can be bought and sold like shares using a broker.
- Investors can trade at live prices during the day.
- Units generally trade at a tight spread around the Active ETF's net asset value (NAV).

Exchange trading creates a number of benefits:

- Ease of use: Active ETFs do not require time-consuming forms to buy units (although for some managed funds and through some brokers, ASX's mFund service usually reduces this workload).
- Portfolio management: Active ETF units are held alongside shares and ETFs in a broker account making record keeping and tax time easier. Dividends and income are also paid into the same account as shares and ETFs.
- Generally lower cost: While investors pay a brokerage fee to buy Active ETFs, they avoid platform administration fees and higher fees often charged when investing in managed funds.

However, there are risks that need to be considered:

- Liquidity: Although the units are quoted on the AQUA market of the ASX, there can be no assurance that there will be a liquid market for units, and no assurance that there will be a liquid market for the fund's underlying investments. In certain circumstances, the ASX may even suspend trading of an Active ETF.
- ASX trading price: The trading price of units on the ASX may differ from the NAV per unit and the indicative NAV (iNAV).
- Market making: As the responsible entity intends to act as a market maker in the units on behalf of the Active ETF, the fund bears the cost and risk of these market-making activities.

When making any investment decision, it pays to explore the alternative features.

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## **10 hints for selecting a good fund manager**

Anthony Murphy

There are a plethora of boutique and specialist funds vying for the investor dollar, complete with glossy marketing materials, up-trending graphs, Warren Buffet quotes and conflicting claims to fame.

There are long-only funds, long/short funds, credit funds and private equity funds. However, as the fine print invariably says, past performance is no guarantee of future results.

How, then, to assess the merits of competing funds? Here are 10 factors to consider.

### **1. Who owns the fund?**

We like to see funds where the employees have substantial 'skin in the game' in two ways: ownership of the management firm and personal investments in the fund. Both focus the mind when it comes to the value of

capital preservation rather than the sole pursuit of growth, no matter the risk. It also is likely to promote independence, which we highly value.

## **2. What is their special sauce?**

Fund managers should be able to articulate just what sets them apart in the way they select investments. Do they collect information others don't? Do they analyse that information using a different approach? Do they have a particular research technique to isolate important information from 'noise'? How does their fee structure compare? How are they incentivised?

## **3. What is the staff turnover?**

Unlike the major funds, boutique outfits tend to rely heavily on the expertise of a small group of key people and, if one or more of them has recently left the building, that can have a detrimental impact on results. LinkedIn can be a valuable tool in assessing the current and former staff.

## **4. What have they got to hide?**

Funds should be happy to tell you their history, operations and business structure, and to respond to requests for information promptly with clear no-bull responses. If a fund is not transparent, that is a danger signal. Audited financial statements are also a must.

## **5. How long would it take to head for the exits?**

How liquid is the fund? If the manager needed to rotate out of a large part of the portfolio, how long would it take for them to do so – days, weeks, or months?

## **6. Who is calling the shots?**

Is it clear who in the fund makes decisions on buying and selling, what their decision-making process is and how long it takes? Funds with trading-based strategies need to be more nimble than those in private equity.

## **7. About that track record?**

Yes, it is true that studies have shown little correlation between past and future performance, but that doesn't mean ignoring track record altogether. Managers should be able to articulate how their process has generated returns to date, and why it can be expected to continue or change. We also analyse a raft of factors against similar strategies and benchmarks.

## **8. How do they manage risk?**

Most fund managers have internal rules around their investment process regarding asset screening, investment size, diversification and circumstances that would prompt a sale. It is worth trying to assess not only what the guidelines are, but how well they have stuck to their own rules.

## **9. What is the bigger picture?**

How does this particular fund fit with others we've invested in? Does it fill an area previously empty or provide a better solution than a competitor we've invested in? How well are current market conditions suited to this particular fund's strategy?

## **10. How will they keep us informed if we commit funds?**

Successful investment is not only about an initial decision, but about being kept 'in the loop' with regular updates on news both good and bad. Ongoing communication is key. We place our preferred managers directly in front our investors to capture full transparency and therefore, enhance the investment experience.

*[Anthony Murphy](#) is the CEO of [Lucerne Investment Partners](#), which offers retail and wholesale investors access to 'funds of funds' designed to deliver strong returns regardless of market conditions. The information in this article does not consider the unique circumstances of any investor.*

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## Prospect theory applied to retirement planning

Alastair MacLeod

Most of us know that buying a lottery ticket is a waste of money. The chances of winning are so remote as to be unachievable, yet most of us have probably bought a lottery ticket at some point in our lives.

Prospect theory can explain this behaviour. Prospect theory is useful for investors, particularly those who are approaching, or in, retirement. Understanding how people make decisions in the real world is the best starting point for constructing investment portfolios that allow investors to stay the course.

The term 'prospect theory' describes how people choose between different options (or prospects) and how they estimate the perceived likelihood of each of these options. Human nature being what it is, estimates are often biased or incorrect.

Prospect theory was developed as a pragmatic model for explaining real-world choices and why people do not make the optimal, logical decision.

### Prospect theory in contrast to utility theory

The theory was a dramatic departure from previous models (e.g. utility theory), where decision making was assumed by academics to be perfectly rational. Utility theory claimed that probability-weighted outcomes served as the basis for determining risk

on the final wealth outcome (i.e. the probability-weighted return) and rely on this as a key consideration in decision making.

In contrast, prospect theory claims that investors are more likely to prioritise gains or losses from a current reference point and treat these gains or losses differently from a value perspective.

In other words, the path of investment returns is more important than the final wealth destination.

A critical consideration in assessing this path is the concept of loss aversion. Put simply, the pain felt from losing \$100 is sharper than the joy of making \$100. If the path of investment returns encounters losses – more probable in a volatile asset class like equities – then investors will focus on the 'journey down' and sensation of loss, rather than the longer-term probability weighted return of the asset class. It is exactly at this point that adverse investment decisions are often made.

Insurance is the mirror image of buying lottery tickets, and is a good example of how prospect theory works. Even though the likelihood of a costly event may be miniscule, most of us would rather agree to a smaller, certain loss (the premium paid) than risking a large expense. The perceived likelihood of a major health problem is greater than the actual probability of that event occurring. There's a reason insurance companies are some of the oldest on the planet.

There are numerous examples of people underestimating common risks. For example, a recent study of Australian hospital data reported that nearly 40% of all injury-related hospital admissions in Australia were due to falls, versus 13% for transport-related accidents. For Australians aged over 65, the rate for falls increases to more than three-quarters of all hospital admissions. And yet most of us perceive driving to be a riskier activity than the daily event of taking a shower.

Another consideration in prospect theory is mental accounting, which describes the process whereby people have different 'mental bank accounts' for different expenditures. For example, people tend to have a greater willingness to pay for goods using a credit card than cash, even though they draw upon the same resource. People are unable to focus on the final wealth outcome, instead they assess the individual transactions differently.

Utility theory and prospect theory do overlap in that as wealth or gains increase, the marginal value or utility progressively declines. In other words, the joy felt from a \$1000 investment moving up to \$1010 is less than the joy felt from a \$100 investment moving up to \$110. The absolute gain is the same, but we value relative gains differently to absolute gains.

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## Retirement planning with prospect theory in mind

So what does this mean for retirement planning? If a financial strategy is going to deliver the benefits and outcomes it was designed for, it is important that investors 'stay the course' and remain invested with a consistent long-term strategy.

However, at certain points along the investment journey, investors are likely to experience powerful emotional forces that can derail their longer-term investment objectives. Armed with an understanding of prospect theory, investors can recognise the pull of their emotional magnets and incorporate these into a comprehensive investment plan, making it more likely they will stick to their plans.

Based on this, it makes sense for investor portfolios to address three key issues:

### 1. Losses are felt more acutely than gains

As the GFC proved, retirees are more likely to disinvest during market stresses at precisely the wrong time than other age groups. This behavioural bias during drawdowns is compounded by the separate concept of sequencing risk, which can also serve to materially impair outcomes for retirees.

As such, capital protection is vital during periods of market weakness. This usually only comes at some cost of foregone investment returns. Capital protection cannot be considered in isolation (without some risk there can be no return). As a result, some approaches to capital protection such as a high allocation to cash can perversely increase risk as they simply increase the certainty of investment returns not delivering a portfolio's objective.

The key is to improve the shape of returns to minimise drawdowns, delivering a growth profile with capital protection.

### 2. Investors value more certain returns above more ambiguous returns

In equity markets, this helps explain the typical Australian retail investor's focus on distributions, where regular bank account deposits can unfortunately be prized more highly than the accompanying capital fluctuations in the unit price. While there may be some comfort for retirees from regular payments, the more important metric is 'total return', which includes movements in the unit or share price alongside distributions.

Within this total return focus, income can play a critical role by providing:

- greater certainty, especially in low growth environments when real returns are difficult to generate, and
- increased predictability, as the range of possible investment outcomes can be narrowed.

### 3. Investors' sense of value diminishes as gains increase

Underperformance in a strong positive market is less important to an investor's sense of value, especially in relation to stronger performance in a lower growth or negative market.

To help manage these issues, it makes sense to build retirement portfolios that are designed to deliver growth, but with a return profile that mirrors our humanistic biases and include elements of loss aversion and income certainty.

For investors, this can assist in dialling down the pull of our emotional magnets, and result in an increased likelihood of adhering to long-term plans and thus achieving better outcomes.

*Alastair MacLeod is Managing Director of [Wheelhouse Partners](#), a boutique asset manager partner of Bennelong Funds Management. This article is in the nature of general information only.*

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## The benefits of investing via a bare trust

Lydia Carstensen

Bare trusts can be used to let a small number of sophisticated or wholesale investors access their investment through one legal entity. This is particularly useful when an investment can only be made by one entity, or a 'single investor'.

## How do bare trusts work?

In a bare trust, the assets are held in the name of a trustee who holds them legally and on trust for each beneficiary. Sometimes, the trustee is an investment manager who has helped source and access the investment. In other situations, the investors have made their own assessment of whether to invest without any advice from an investment manager.

One of the benefits of a bare trust is that the trustee has no say in how the capital or income of the trust is distributed. The beneficiary can call for the capital, assets, and income of the trust whenever they want. The trustee is just responsible for distributing the profits or returns and transferring the asset to the beneficiary if they ask.

To set up a bare trust, each investor signs a separate trust deed with the trustee. The investor's funds are not pooled to purchase the investment, as this would create a managed investment scheme.

As this is truly a single investor model, it can only be used where each asset can be separately identified as being held on trust for each beneficiary. That's why it works well for investments like shares or notes.

Once set up, you can use the bare trust for other investment opportunities in the future. It's also simpler and less expensive to operate than a unit trust.

## The costs associated with a bare trust

Trustees or investment managers often charge a fee for their services, but friends or family may offer to be a trustee for free. Any fee should be deducted from the returns or dividends that the beneficiary is paid.

Bare trusts may also incur stamp duty. This is a one-off amount that is paid when the document is executed. The amount of stamp duty paid depends on the state where the trust is set up.

It's not possible to 'jurisdiction-shop' for the best stamp duty rate though. The courts have held that trusts should be set up in the state where the trust has the most real and substantial connection. For example, if the trustee, beneficiaries, and the investment asset are all located in New South Wales, the trust deed should be stamped in New South Wales.

The beneficiaries should also seek advice about their capital gains tax liability and any other possible issues that may affect them before they use a bare trust.

## Do bare trusts need to comply with other regulatory requirements?

The trustee and investment manager may need to hold an Australian financial services licence (AFSL) if they are advising on the investment. They may also need to be licensed if the asset is a financial product.

If the trustee or investment manager does not hold an AFSL to provide custodial services, the bare trust cannot have more than 20 investors.

*Lydia Carstensen is a Paralegal and Writer at the law firm, [The Fold Legal](#). This article is a brief introduction to bare trusts and any investor considering their use should consult a specialist. The article does not consider the needs of any individual.*

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