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Labor, let's face the facts on fairness, women and franking

Noel Whittaker

"We will not allow the Government to lecture us when they argue that tax loopholes for the wealthy are actually a secret socialist mechanism to redistribute income to the least well off in this country.

I believe that Australians actually want a better tax system. They want a tax system which doesn't subsidise the high-priced medico on \$500,000 being able to split income and pay less tax than the nurse on \$50,000 a year.

Australians do not want to see a tax system which finances the lucky few who own big pools of shares. And then not only do they get the dividends from the shares, the income from the shares, and pay no tax – they shouldn't in this case be allowed to get a 30% loading for owning shares in this country and pay no income tax. It is not sustainable."

Bill Shorten's Address to the Victorian Labor Conference, Melbourne, 27 May 2018

The next federal election will be fought on tax. That's good news as reform is overdue. While politicians have been fiddling with our tax system for years, there has been no meaningful tax reform since John Howard introduced the GST 18 years ago.

But any debate on tax must be based on facts not rhetoric. Unfortunately, that's a hard thing to achieve, and many of the contributions to the debate right now are unhelpful. It appears to me that Labor, in particular, wants to divide Australians into villains and victims.

I asked a senior tax partner how Opposition Leader Bill Shorten's statement above, that a "high-priced medico on \$500,000" could pay less tax than a nurse on \$50,000, could be correct. He said it would not be possible except in a very specific case of a doctor with many children aged 18 and over with no income plus a string of loss-making investments. Last week, the Deputy Opposition Leader Tanya Plibersek vowed to make sure "the rich pay their fair share of tax".

'Rich' taxpayers already paying more than a 'fair share'

The words 'rich' and 'fair share' are highly subjective, so let's look at some facts. A person earning \$40,000 a year pays \$5,347 a year tax including Medicare levy, or 13.4% of their taxable income. A person earning \$95,000 a year pays \$24,682 tax, or 26% of their taxable income. A person on \$400,000 a year pays a whopping \$161,232 in tax. That's 40.3% of their taxable income.

According to the latest ATO statistics, just 2.9% of taxpayers earn more than \$180,000 a year, and they contributed 29.8% of the total income tax collected. There were 16.6% in the second-lowest tax bracket and they contributed 39% of total income tax. *So 19.5% of taxpayers are contributing almost 70% of our total income tax.*

I would say that those top-bracket earners are punching way above their weight.

What about women as victims of the tax system?

I have been a strong defender of women's rights long before the topic became fashionable and I am across the points that are regularly made in the media. On average women retire with much less superannuation than men, and their pay is much less than men. But working women tell me one of their biggest challenges is childcare, which can cost over \$100 a day per child. Consequently, many women are choosing to structure their employment to maximise the opportunities to care for their family at the expense of a higher income. And leaving the workforce to have children and raise children can have a big impact on their final superannuation balance. These issues will not be affected by tax policy. To make changes here, other policies would be required.

But facts don't get in the way of spin. Recently on 'The Drum', Ben Oquist of *The Australia Institute* argued that "negative gearing discriminates against women". His rationale was that the majority of investors who use negative gearing are men. Of course, that's correct: most investors in residential property are couples, and for tax deduction purposes the asset is normally put in the name of the higher income earner, who is often the bloke.

And what is Labor's solution to solve the situational problems many women face? It is to take the GST off tampons, since the tax discriminates against women, as these products are an essential item for many of them. Well, Bill, I have news for you – there is GST on toilet paper and we all need that. It's a very slippery slope. In any event, if we can believe my local pharmacist, removal of the GST would save the average woman just \$18 a year, or a couple of hours of childcare.

Another issue in the coming election campaign will be catch-up concessional superannuation contributions. They were introduced by the Coalition from July 2017 to enable people who have been absent from the workforce – usually women caring for young children – to make extra contributions when they re-join the workforce to help them catch up on their super. It's sensible and workable. Yet Labor, who claim to champion women, is opposing it. Work that out.

Who really loses from Labor's new franking policy?

Labor's latest attack on franked dividends is not a tax on the wealthy: it is a tax on widows.

Let me show you this step by step. The imputation system, which avoids dividend income being taxed twice, will stay in place. Labor proposes to abolish the refund of excess franking credits. There will be no tax collected from large retail funds and industry funds, as they can spread the imputation credits over all their members. And Labor has promised to exempt 'pensioners', so no revenue there either.

So let's think about who is left, on a case-by-case basis.

A) SMSFs in pension mode with two members holding a total balance of less than \$3.2 million

They could be seen as the prime target, because all their excess franking credits will be lost under Labor's proposal. But that is simply solved.

One option is to close the SMSF and roll the balance to a large retail fund. Another option is to cash in their entire holding of Australian shares, which can be done tax-free, and roll over the cash now freed up to a second superannuation account with one of the retail funds, choosing Australian shares as their preferred asset class. The SMSF trustees can make any investments they choose – avoiding Australian shares – in their SMSF, optimising their mix for the current tax situation.

B) SMSFs with large balances

This would appear to be an easy target, but the Coalition got there first. Think about a portfolio of \$10 million, which has a fairly standard asset allocation of cash 20%, Australian shares 35%, international shares 25% and property 20%. Let's say the annual income is \$390,000, including franked dividends of \$140,000, on which franking credits are \$48,000. When you gross up the income for the franking credits, the taxable income of the fund becomes \$438,000.

Before the Liberals changed the system last July, the franking credits of \$48,000 would have been refunded. But because the fund is 70% in accumulation now, the tax payable by the fund becomes \$46,000. Imputation credits pay all this, leaving just \$2,000 for revenue under Labor's policy. I'm sorry Bill, but Malcolm beat you to it.

C) Older, wealthy, self-funded retirees

Their situation should remain unchanged. Let's say their main asset is a portfolio of \$4 million Australian shares in joint names paying franked dividends of \$90,000 a year to each person plus franking credits of \$38,571. The tax on that will be around \$38,000 including the Medicare levy, which means they may lose possibly \$600 in franking credits. Small bikkies.

So who is left over to pay the tax? We have raised almost no extra tax so far.

Impact on widows and widowers

Think about a married couple who own their own home, have \$75,000 in bank deposits and a share portfolio worth \$710,000 returning dividends of \$32,000 plus franking credits of \$13,700. Their age pension is \$19 a fortnight combined, so total income – including franking credits and interest – is \$47,700 a year.

Let's say the man dies suddenly, leaving all his assets to his wife. Her situation will change dramatically. The assets she has inherited take her over the Centrelink cut-off point. She will lose her pension, as well as the concession card that goes with it. The good news is that she will keep the franked dividends of \$32,000 but the bad news is that under Labor's proposal she will lose the franking credits of \$13,700. Labor's proposed measures have finally raised some money!

Hopefully anybody in this situation will have taken good estate planning advice to ensure a more effective distribution of assets when one party dies, so the survivor can retain a part pension and all the franking credits.

Noel Whittaker is the author of numerous books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. See www.noelwhittaker.com.au.

Managing global multi-sector portfolios, with Pilar Gomez-Bravo

Graham Hand

Pilar Gomez-Bravo, CFA, is the Director of Fixed Income for Europe at MFS Investment Management. Pilar also has fixed income portfolio management responsibilities, having joined the firm in 2013. Prior to this, she was Managing Director at Imperial Capital and Head of Research and Portfolio Manager at Negentropy Capital within Matrix Asset Management. This discussion took place in Sydney on 15 May 2018.

GH: What's the first thing you check in the markets when you wake up each morning?

PGB: I manage global multi-sector portfolios, so there's a lot to cover. I check what interest rates have done overnight, what equity markets or equity futures are doing, movements in credit indices and key asset class relationships, plus the top news headlines. We construct portfolios from the top down but driven by bottom up research. We concentrate exposures on our high convictions, and we have to size exposures appropriately. We are running large issuer exposures and I check any developments that could impact them.

GH: When 10-year US Treasuries yielded 1% or less, how did you manage that and what do you think now is the argument for 10-year US Treasuries at 3%? Even with this higher rate, is there an investment case?

PGB: We have become a little immune to Quantitative Easing after 10 years of central bank intervention, but this level of liquidity injection was quite a shocking thing to do. It was an experiment and maybe there are not enough people around to remember what it was like to have central bank policy that didn't use such extraordinary measures.

The reason we had 1% rates in the US was because there were fears of deflation after the extremes of the global financial crisis, and uncertainty about how the financial system would recover. Australian banks didn't have the same degree of failure as elsewhere, but there was a lot of soul searching in markets that led to severe deflation fears in Europe and the US.

The central bank manipulation encouraged consumers and companies to spend money to recover from the shock. And that worked and now we are in a different period where we are seeing signs of inflation instead, but still not sufficiently high to worry people too much. There's a little bit of wages growth pressure in the US but nothing that indicates a sudden different paradigm of inflation.

Demographics, technology and debt will limit inflation rises

And in the back of investors' minds is the large structural headwinds against yields going higher such as demographics, the deflationary nature of technology and the amount of debt in the world. If they raise rates quickly, will consumers and companies be able to manage that increased debt load? There's also heightened sensitivity in the G20 about currency wars. So we should continue a gradual progress to higher global yields but at a pace that should be able to generate a long-term total return from fixed income.

GH: As in the US, in Australia we've seen a movement in what we call MySuper towards lifecycle (or target date) funds. What do you think of lifecycle funds and the merits of putting more into bonds as people get older?

PGB: Well, 20 years ago I took the CFA and back then we were already talking about the appropriate level of risk for different age cohorts. There's economic theory that says as people age, they have different risk return profiles. And it also shifts as people become spenders and stop earning. People are living longer and so the nature of the products they need should shift. On top of that, shocks like the financial crisis linger in the mentality of investors for a long time. Investors are reluctant to potentially lose all of their savings and they look to own some lower risk assets to protect capital by holding fixed income.

There is an increased variety of assets to invest in today than there were 20 or 30 years ago, so that gives more richness to the allocation decision for investors. For example, more ways to invest in real estate, a more targeted approach for individuals by using ETFs, or even shorting the market to take a negative view. All of that is relatively new which gives more ways to discuss the risk return profile.

Equity managers argue they can deliver income

A major development when yields went so low was that generically equity managers could go to clients and say they would be the providers of income and investors could forget about bonds. On this basis, the discussions from equity managers with company management led to dividend increases, and that's distorted the behaviour of companies around the world towards higher dividends, share buybacks and less investment. So perversely, central bank policy has led to lower levels of investment worldwide as companies have chosen to do share buybacks and dividends to appease their new shareholders with a promise of income. Hopefully, we'll see a gradual shift back to investing in the company as policy normalises and global growth stabilises.

Finally, now we can go back to saying that with bond rates rising, especially in the front end in the US, we have an asset that gives a yield and that is good for investors looking for safe assets.

GH: Can we discuss the move to passive investing in a bond context. Would you support the view that for non-government bonds, the case for passive investing is probably the weakest of any asset class? Is there evidence that retail investors understand why it's a weak argument?

PGB: There are a couple of reasons why it's more dangerous to follow passive investing in credit markets. One is that benchmarks are dominated by companies where the more debt they have, the bigger weighting in the index. Two, liquidity matters in credit and you may not be able to get out when you want to. That leads to another discussion around ETFs and derivatives. Credit markets become illiquid in periods of stress.

And three, in credit markets you have an asymmetry of risk and return. You have no upside and you have all the downside. So paying attention to potential blow-ups becomes increasingly important as the economy

reaches the end of the cycle. A keen awareness of risk-adjusted returns is needed because you don't recover from a credit default.

The role of active management

People have forgotten the value of active management. First, yields are low at the moment so any fees paid are painful. Second, with low volatility and low dispersion, it's difficult to generate a lot of alpha without adding leverage or taking concentrated risk, but with an asymmetric asset class and increases in volatility, the value of active becomes apparent. We tell clients when looking at active asset managers, ask them to show their excess performance in different periods of volatility. Obviously, you want to see performance through the cycle, but you should expect higher excess returns in periods of heightened volatility.

GH: With your own portfolios, how much of the extra returns you generate comes from off-market transactions? For example, where a company wants \$500 million quickly and they ring you up and offer say 100bp over the market.

PGB: Our strategies have two characteristics for portfolio construction: liquidity and diversification. We don't hold a lot of illiquid positions and for those exposures we need to be paid more because you lock yourself in. In the hunt for yield, there are three main ways to add yield. One is duration, which nobody wants. Two is credit risk, so we've seen huge inflows into credit and emerging markets. And third is illiquidity. There may be better opportunities at times of stress to consider more of these off-the-run illiquid positions.

GH: What do you think about the big spread contraction in the high yield corporate sector? Is there adequate reward for risk there now?

PGB: At the individual level in some cases, yes, but at the lower quality parts of the high-yield market (rated CCC), you are not getting paid enough for the traditional experience of losses. Despite the stresses seen in equity markets, the CCCs have outperformed. They have lower rate sensitivity, when the fear in the fixed income markets has been that the Fed might make a policy mistake. There's also a lot of energy companies in there that have been supported by rising oil prices. In general, we believe that high yield as an asset class is expensive.

GH: It's difficult to make statements about correlations between asset classes in advance of a stress event. We saw during the GFC correlations rose so that when you thought there was protection in your portfolio, it didn't help much. Can you give guidance on what you think about future correlations? Is there anywhere safe to hide?

PGB: You are always looking for uncorrelated returns and good sources of alpha in multi-sector portfolios. The first choice is between duration and spread and the right combination, and that decision depends on what paradigm you think you are living in. For a long time back to the 90s, the paradigm was 'risk on, risk off'. But since the GFC, the new paradigm is 'Goldilocks/QE' and 'taper tantrum', where yields and credit perform in the same direction. I think as monetary policy normalises, we will revert to the 'risk on, risk off' relationships. It provides more of a diversifier against risky assets or spread assets. The reality is that in periods of stress, bank correlations move to 1.0, even though fundamentals have significantly improved since the GFC. When fear strikes in the markets, all banks underperform.

How to create a multi asset portfolio

GH: What's your high level process for creating a portfolio?

PGB: We are really mindful of risk management at every step of the investment process. First, decide how much risk you want to take, your risk budget. Then you have to do your allocation correctly. How many uncorrelated sources of alpha can you put in. Then you need portfolio construction where you match risk allocation with idea generation. What bonds do you actually want to buy that get you to that risk allocation? Finally, monitor the risks so that under any scenario, you don't get surprised by unwanted sources of risk. So that's still the basics.

GH: You probably know we had our budget recently. Conditions are better than expected with a possibility of moving into surplus next year. Now there's a debate on whether we should spend more, tax less or repay debt. What's your view on governments repaying debt to give more security for the good times, especially for the US where trillions in debt don't seem to matter?

PGB: At a basic view, whether you are a corporate or a government, you need to be countercyclical in your finances. You need to build cushions in the good times for when the bad times come, so you can then spend the money and keep growing.

There's too much debt in the world. The IMF forecasts that most countries will significantly reduce their debt-to-GDP ratios between 2018 and 2023, but the US will continue to increase. All the efforts of countries like Germany and Australia will be completely offset by the US as it's such a huge part of global GDP. The US has fiscal stimulus at a time of almost full employment when that extra stimulus is not necessary. So when times get rough, how much more can be borrowed?

Graham Hand is Managing Editor of Cuffelinks. Pilar Gomez-Bravo, CFA is the Director of Fixed Income for Europe and Fixed Income Portfolio Manager at [MFS Investment Management](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

How to become a rich old lady

Amber Moncrieff

Let me state at the start that this is not a guide to marrying a plastic surgeon!

With superannuation in the news again, I've been talking to some of my female friends about the topic and thought I'd share it more widely. Yes, super is boring, but you know what is worse? Being old and having no money and living on the pension.

The Productivity Commission report released this week showed that a combination of people having too many super accounts, and getting lower returns, will leave them up to \$400,000 poorer in retirement! That's terrible.

A quick word on my credentials – once upon a time I was a law graduate who started my career in the tax office. I then moved into a tax and superannuation advising role in Federal Parliament and then worked in the funds management division of a Big Four bank.

In my mid-thirties, I met Dr Nick Moncrieff and used my career skills to build our successful medical practice. So, I know a thing or two about dollars, but I'm not a financial adviser and won't make a cent from anything you do, or don't do, from considering the ideas below.

So here are the steps to securing your financial future, according to me:

Step 1 – Sort out your super

1.a: First you need to pick a decent fund. Like health funds, the best ones tend to be those run to profit members, rather than to profit shareholders. In super, these are known as industry or corporate funds.

I'm not going to tell you the right fund for you, but you might like to check out the [industry fund website](#) and consider your options (and see my note below about advisers if you need help).

1.b: Once you have a good fund, you need to make sure all your super goes into it. So, consolidate the accounts you know about in other funds into the main fund you now use.

And you need to tell your employer that you want your super to go to that new fund as you have the right to do. The new fund can give you the forms you need to do this. Again, boring, but necessary.

1.c: If you suspect you have some lost super accounts, you can ask the ATO to help. Again, another form is needed, or you can do it [online if you have a myGov account](#).

Step 2 – Have other assets

AKA – women need their own property!

I had bought and sold three properties before I met my husband and lived in my fourth property. The first three were purchased with a trusted friend from childhood to help fund the deposits and mortgage payments.

I strongly believe women need to start small and build property assets over time. And in an ideal world, try not to sell but use the increases in value to purchase the next property (but don't go crazy, especially in a stagnating market like we see now).

I really wish I held on to properties I sold because I thought they had peaked. Except in Perth, when the market really was inflated by the temporary mining boom (when I smartly sold) and will take a long time to recover! So, you still have to look at the fundamentals of what's driving supply and demand.

Step 3 – Understand money

I'm not a fan of, "Oh, I let him handle all the finances."

All well and good when things are good, but what happens if something happens to him? Finances can be a bit dull, but I believe you need to understand where your money is, how to access it if needed and how you are building for the future.

And don't sign documents you don't understand. It didn't work for a certain Real Housewife and it may not work for you.

A word about advisers

My financial adviser friends will hate this, but you can go very wrong with financial advice. They can charge a lot and steer you towards investments that are in their best interests and not yours.

I know this from years of working in the Tax Office, including a stint in the area that dealt with mass marketed tax schemes which were really just a way to separate higher income earners from their money and deposit it in the hands of dodgy advisers.

And I've also seen it personally – Nick made some poor choices before we met and only recently did a couple of those dodgy tree plantation schemes finally mature. They managed to turn \$100,000 investments into \$45 after 10 years. Yes – you read that right! And he was sold into those terrible investments by what was then a well-known accounting firm with a planning arm which specialised in medical clients.

I know there are good advisers out there and everyone is entitled to be paid for professional services (just like surgeons!). I'd be more comfortable with someone who charged a clear up-front fee for advice, than those who take what is known as a "trail commission" – the money they get from your investments into the future, regardless of whether you ever see them again or not.

This [government site](#) has some pretty good information about how advisers charge and the questions you should ask.

So, do I have an adviser? No. We have a great accountant (which is invaluable for understanding the shifting tax sands which are a big part of investing) but I believe that having my super in a good corporate super fund and investing in property is a good strategy for us. As we hit our 50s, and have paid off the mortgages, we might think differently but most investments would struggle to earn more than the benefit of paying off our debts can.

Yes, it sounds a bit simple, but I'd rather simple than so complex that only someone else can understand it and one day I wake up and find we have lost a big chunk of our investments because the 'clever' scheme was anything but.

Getting older sucks – Having money softens the blow

I hope that gives you some inspiration to sort out your finances and start securing your future. Getting older sucks in lots of ways, having money as you age helps to compensate for it.

Amber Moncrieff is the Practice Director of [Hunter Plastic Surgery](#). Amber previously held senior roles in business and politics in Sydney and Canberra.

Disclaimer: this is not financial advice, it is simply what has worked for me. If you want something that works for you, then consider getting advice from an accountant or financial adviser. [Choice has a good article](#) about where to start.

Link to the [Productivity Commission Report](#).

Is bigger better? Expanding the membership of SMSFs

Graeme Colley

The 2018 Federal Budget confirmed the maximum number of members in an SMSF is likely to increase from four to six people.

Benefits of a larger membership

An increase in membership could mean greater flexibility, especially for:

1. Small businesses with multiple owners who may wish to pool their super into one fund.
2. Families wanting an intergenerational transfer of assets, especially business property.
3. Limiting the impact of Labor's proposal on franking credit refunds. With more members there's likely to be a larger pool of assets in one fund. Excess franking credits could be absorbed in the fund and offset against non-franked income and taxable contributions.

At the moment, more than two-thirds of SMSFs have two members, just over 20% have one member and only about 7% of funds have three or four members. This suggests a limited underlying appetite for larger membership funds, and if passed into law, there's likely to be little impact on the SMSF sector at least initially. It may change if Labor's policy becomes law.

Downsides of a larger membership

For SMSFs expanding their membership, one possible issue could be increased administrative complexity.

Investment decisions need to cater for a larger pool of members, and this may lead to a more conventional investment mix than otherwise. Recent research by SuperConcepts and the University of Adelaide shows that as the number of fund members increases, investments tend to become less risky and groupthink leads towards more familiar assets such as cash and domestic equities. Funds expanding their membership will need to take care to properly identify and address these behavioural factors.

More members may also mean a more decentralised fund with less desirable outcomes. Think of the scenario of children outvoting their parents on investments, estate planning and other fund matters. The outcome could be undesirable and inequitable.

Six members could also result in more frequent membership changes as some members pass on, or move to their own SMSF or a publicly offered fund, placing a strain on fund administration and associated costs.

Allowing funds to have up to six members further underlines the importance of appointing a corporate trustee for an SMSF. A fund with a corporate trustee would be penalised only once with a breach. In contrast, individual trustees who breach the rules could each be penalised personally for the breach.

Weighing up the pros and cons

The main benefit of a membership increase relates to the pooling of assets that would otherwise be spread more thinly. However, there are potential downsides relating to administrative efficiencies as well as investment decisions and performance.

When considering the best number of members for an SMSF, there's no one-size-fits-all answer. It will depend on individual circumstances, and a good first step may be advice from a qualified professional.

Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at [SuperConcepts](#), a sponsor of Cuffelinks. The material in this article is for general information and does not consider any individual's investment objectives.

Why stock selection beats macro forecasting

Graeme Forster

People tend to observe the world through a deterministic lens, with outcomes determined to be a consequence of a series of logical and 'inevitable' steps. In reality, the path of history is chaotic, with outcomes hugely sensitive to small changes in, and interactions between, thousands of variables. Future uncertainty and the fact that infinitely more things can happen than will happen, is the nature of investment risk.

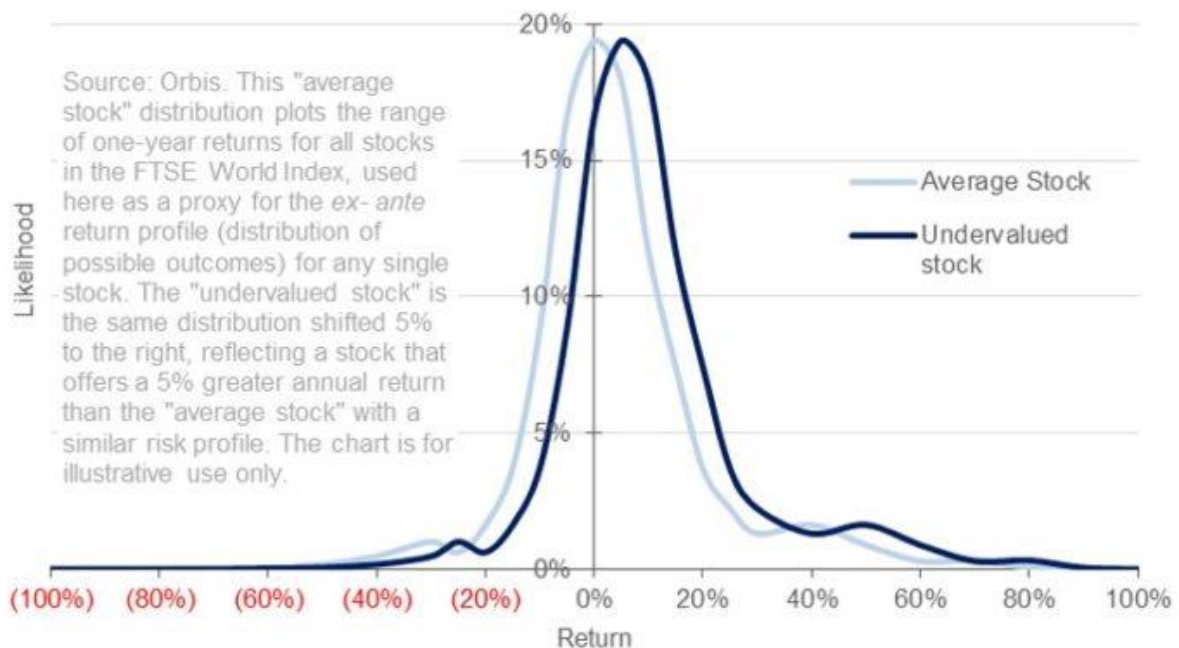
Macro trends versus stock picking

Some investors spend a great deal of time trying to predict macro trends. Where will the S&P 500 be at the end of 2018? Will the Fed raise rates three or four times? Will 'FAANG' (Facebook, Apple, Amazon, Netflix, and Google) or 'MCBM' (McDonald's, Caterpillar, Boeing and 3M, apparently pronounced 'macbim') continue to outpace the market? But the chaotic nature of investment renders predictions unproductive at best and harmful to your long-term financial health at worst.

Rather than forecasting macro trends, a better approach is to estimate what a business is worth via an assessment of the likely range of outcomes for growth and cash flow over the very long term *for that business*. If we can find instances where we believe a share price embeds a significantly less optimistic outlook for the fundamentals of the company than our estimate, then we will buy the shares. If we are successful, we create a selection of investments that have a range of outcomes that are superior to that of the average stock. An estimate of future returns might look like the chart below.

Undervalued shares should offer a better-than-average range of outcomes

Range of one-year returns for shares in the FTSE World Index



We cannot know the outcomes for any share in advance, but the estimated distribution is based on real data and should be a reasonable approximation. Such a chart shows the degree to which 'uncertainty' or 'risk' will likely dictate the outcome for any single investment. The high 'noise to signal' ratio highlights the importance of careful position-size management as well as identifying a number of uncorrelated mispricings in order to diversify risk.

It also illustrates why 'lumpy' fund returns are almost mathematically certain, irrespective of how much skill you have in identifying undervalued stocks. It is also extremely rare to find manager 'hit rates' (the ex-post ratio of winners to losers in a portfolio) that exceed 50% by any meaningful degree. Too many ex-ante 'good decisions' will end up as ex-post losers, purely by chance.

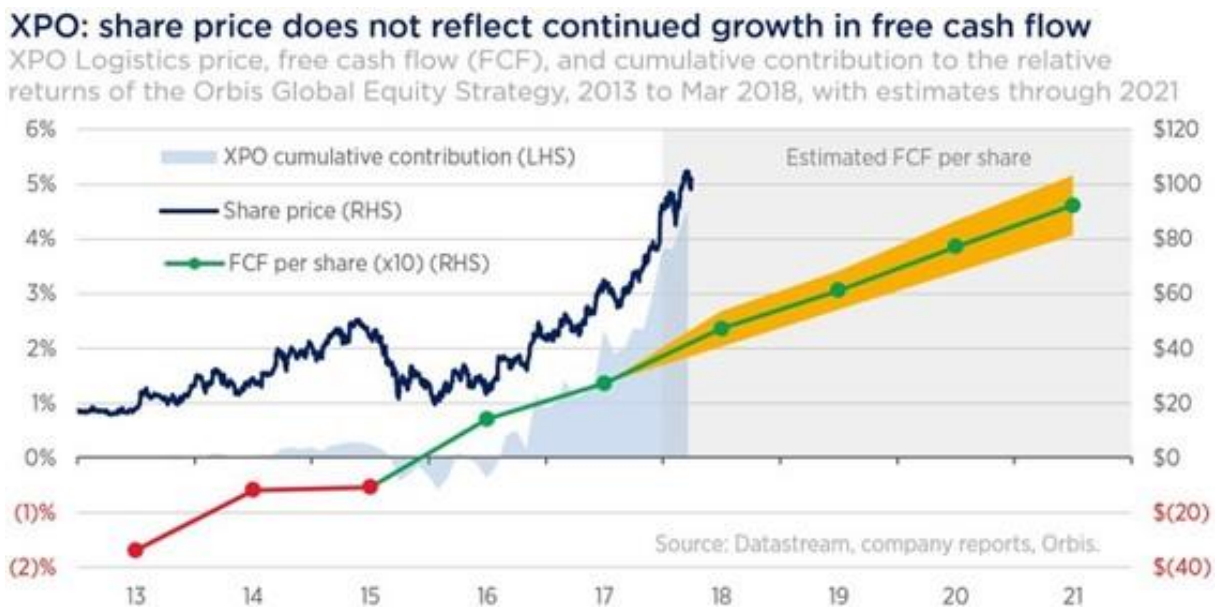
The share selection approach is especially apt today, an environment in which we find attractive opportunities in the less predictable areas of the market.

One illustration: XPO

XPO Logistics, currently the largest holding in Orbis Global, is a good illustration. It has been the biggest contributor to Orbis Global’s performance over the past 12 months and is among its top ten contributors since inception in 1990. Today, at \$102 per share, XPO’s price has more than quadrupled since our initial purchase in 2013.

But it was hardly an obvious opportunity at the time. The company had negative tangible book value, negative earnings before interest, tax, depreciation, and amortisation (EBITDA), negative cash from operations, and negative free cash flow (FCF). We developed a deep conviction in management’s ability to create significant long-term value for shareholders through the company’s aggressive acquisition strategy in the transportation and logistics industry.

Many of our analysts vocally challenged the thesis and argued that we should sell the position. A firm with a consensus-based system would probably not have owned XPO. Similarly, those with more dogmatic approaches to valuation or style would likely have avoided the stock. And it would have been hard for many to stick with the position during the uncomfortable period when it wasn’t adding value in the short term. As the chart below shows, performance doesn’t come in a straight line and that’s why a long-term perspective is so critical. Fortunately, we empower stock pickers to express unpopular views and to stick with them in the moments of greatest opportunity.



Through strategic vision, savvy capital allocation, and strong execution, management has built XPO into a global logistics leader with highly differentiated technology and capabilities in the area of contract logistics. In particular, the opportunity to provide logistics services to e-commerce customers, which are a source for nearly a third of XPO’s revenue, is driving approximately 10% per annum organic revenue growth for XPO. This is likely to fuel mid-teens growth in EBITDA and 20-30% growth in FCF.

Even this enthusiastic outlook for XPO’s prospects does not give any credit for management’s ability to create incremental value through additional acquisitions, something management is actively pursuing. With an exceptional track record, there is significant potential to build on its tiny 1.5% share of the trillion-dollar global logistics market.

Selection diversity

Assessing that the range of outcomes are favourably skewed far from guarantees a pleasing realised return. Nobody can forecast accurately what will unfold in the coming years. The long-term value XPO is able to unlock from its acquisition and e-commerce strategies over the next decade will be sensitive to a number of unpredictable variables.

Volatile outcomes are a natural and inevitable consequence of active investing. Investors need to look through shorter-term gyrations and focus on the long term with a spread of stock selection.

Graeme Forster is Portfolio Manager at [Orbis Investments](#), a sponsor of Cuffelinks. This report constitutes general advice only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person. It reflects Orbis' views at 31 March 2018 and Orbis may have bought or sold, any of the investments referred to.

The evolution of private debt markets

Mike Davis

In recent years, the term 'private debt' has been used to describe numerous forms of debt financing including loans to micro borrowers, small and medium enterprises (SME), large private or listed corporates, as well as loans to larger infrastructure projects.

The larger corporate and infrastructure sectors have generally been well supported by the local and international banking markets, and more recently by the increasing direct participation of institutional investors. The small and medium corporate loan sector, once the domain of the banks, has since 2008-09 come to rely less on the banking sector due to the impact of Basle Banking accords (I-IV). The Basle accords increased the cost of regulatory capital to banks from such lending.

The Royal Commission and SMEs

The last two weeks of the Financial Services Royal Commission have shone a bright spotlight on loans to SMEs, examining bank practices relating to guarantees, reliance on home equity and questionable enforcement. The general expectation now is that the Commission's findings will boost opportunities for non-bank lenders (NBFIs).

The re-emergence of NBFIs has come in a number of forms: specialist loan and credit funds, opportunistic Special Situations funds, direct participation in bilateral and syndicated opportunities by large funds, online peer to peer (P2P) and B2B platforms, and private 'merchant bank' style financiers.

After the 2008-09 credit crisis, many NBFIs were forced to liquidate their credit portfolios at deeply-discounted valuations. This created a new form of participant by 2010, mainly in the US and EU markets, seeking opportunistic purchases of such portfolios out of 'weak hands'. These distressed market participants included traditional private equity firms seeking listed equity-type returns, albeit at a higher level in the capital structure.

The resilience of private debt exposures in terms of capital and income returns post-GFC has now created a new asset class which is both accessible and acceptable to a broader investor set. Demand from the SME and mid-market corporate sector in Australia remains robust.

Private debt lending statistics

Recent research of the lending opportunity to the SME and lower/mid corporate lending sectors, defined as borrowers with annual revenues ranging upwards from \$5 million to \$300 million, has identified some key characteristics of these markets:

- Less than 3% of the total 2.2 million actively-traded enterprises in Australia have annual turnover exceeding \$5 million.
- As of February 2018, these selected segments comprise more than 65% of banks' traditional business lending volumes of \$713 billion, according to APRA monthly statistics.
- Enterprises with turnover of \$5 million to \$300 million entail more than \$464 billion of drawn balances with SME balances averaging \$3.3 million and lower/mid corporate averaging \$48 million per borrower.
- NBFIs are writing as much as 15% of SME sector and 10% of lower/mid corporate business, or more than \$52 billion by volume. This is expected to increase.

- We believe that the NBFI share of the non-property backed SME sector lending is far greater than 15% due to bank capital-ratio constraints.
- Independent research also confirms that since the GFC, over 25% of the SME sector no longer nominates a big four bank as its primary lending relationship.

Uberisation of private lending markets

P2P lending platforms in their many forms are now providing access to one form of 'private debt' lending which in years past would have been the domain of traditional finance and factoring companies or other dedicated consumer lending organisations. Some P2P lenders use statistical analysis for pricing and recovery scenarios across diversified peer lending platforms.

In the ultra low interest rate and benign credit environment that the world has experienced since 2012, the allure of these providers as a solution for lower tier borrowers and small businesses (less than \$5 million turnover and \$2 million loan sizes) has recalibrated and repriced that sector of the Australian private debt markets, both in a risk/reward or pricing and availability context.

This 'Uberisation' of lower tier sectors (from a credit and loan size perspective) of the private debt markets, has now enhanced the opportunity for other investors to seek well-structured exposure to senior secured borrowers in the SME and lower/mid corporate sectors which are typically too large for P2P platforms due to concentration risk and the size of loan needed.

It has also been encouraging to see recent discussions initiated by Anthony Pratt of Visy Industries and a range of institutional investors, who are exploring this opportunity in terms of both the structural need and risk/reward profile of lending to small, medium and large corporate sectors in Australia. The growing interest in this sector is a result of the compelling risk adjusted and absolute returns available. History shows that if private debt/direct lending strategies to the SME sector are well structured and managed across credit cycles, attractive low double-digit returns can be achieved by investors through actively managed origination, structuring, monitoring and repayment strategies.

Fintech and private lending

Financial technology (Fintech) and private lending markets have experienced significant development over the past five years, fostered by the impact of bank regulation and the greater market transparency of performance and recovery data.

Fintech lending businesses are using data analytics and new credit models to find incrementally better yield and loan performance. Whether these models are P2P, crowdfunded or associated 'hedge fund' models, it is too early to judge the success that their new predictive credit models might have other than in the current benign credit environment in which they have evolved.

It appears that many P2P platforms rely on the benefits of granularity and pricing margin (higher interest rates) to buffer investor returns in the event of default experience. Considerations relating to priority of claims in default scenarios and effective recovery outcomes are yet to be tested across the various market insolvency jurisdictions where these funds have flourished.

There is no doubt that the recent advances in data analytics, social media transparency and growing sophistication of credit scoring agencies has assisted the development of these lending markets with more supportive data points. However, the application of robust credit analysis and loan structuring remains a key determinant of both loan servicing and repayment success. Combining this analysis with a background in quality origination and recovery experience is essential.

Other sectors for private debt

NBFIs including specialist debt funds are now becoming more prevalent in the leveraged buyout and syndicated loan sector as well, targeting loan sizes of \$50 million upwards as some of the larger institutional funds seek to participate directly. Secured lending across a diverse portfolio of the small and medium enterprise sector for amounts ranging from \$5 million to \$25 million is also an attractive complement to the syndicated loan and P2P sectors.

Many yield-oriented investors are becoming more comfortable with including this bespoke area of private debt as part of their alternate debt investment exposures, although professional advice in the analysis of credit and risks is required for investors less familiar with the opportunities.

Mike Davis is Co-founder and Director of [Causeway Asset Management](#). This article is for general information only and does not take into account the circumstances of individual investors. Investors should seek financial advice before considering private debt opportunities as many structures are more suitable for sophisticated investors.

High yield downturn will be long and ugly

Jonathan Rochford

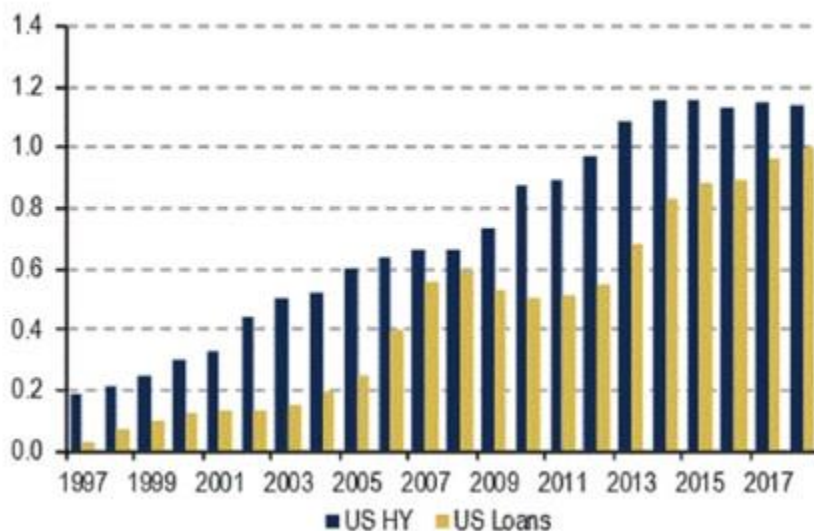
The US high yield market has grown larger and riskier since the financial crisis. Issuers of debt have the whip hand as buyers compete to gain an allocation in the face of surging demand from CLOs and retail funds. Companies are emboldened to seek ever-weaker covenants and are taking advantage of the current conditions to borrow more at lower margins. It's as if the financial crisis never happened.

High yield bonds carry a lower [credit rating](#) than investment grade, and in the case of Standard & Poor's, a rating below 'BBB-'. High yield was previously called 'junk bonds'. Whilst the timing of a downturn in high yield debt isn't predictable, the outcomes when it does happen are. More debt, riskier quality, and weaker covenants means the coming downturn will be bigger, longer, and uglier. A quick review of some key data makes this clear.

The data tells a story

The size of the US high yield bond market and leveraged loan market are both close to double what they were in 2007.

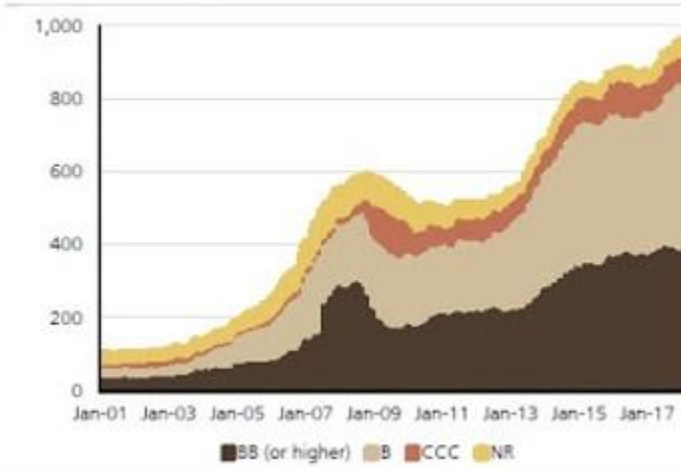
Chart 1: Loan market catching up to bonds



Source: BofA Merrill Lynch, Global Research LCD

Not only is the outstanding debt larger, but the credit ratings have shifted downwards on leveraged loans. Lower credit ratings mean a higher default rate when liquidity dries up.

Figure 1: Growth in leveraged loan debt outstanding by loan rating (\$ bn)



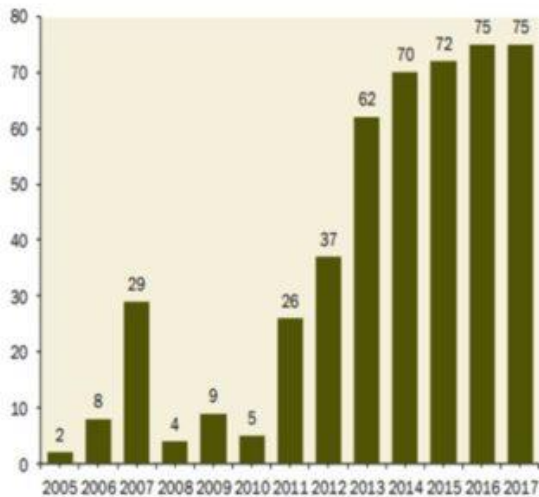
Source: UBS, S&P LCD

The other key indicator to watch is the share of the loan market that has weak covenants. In 2007, 17% of outstanding loans were covenant-lite. Today, [over 80% of new issuance](#) lacks decent covenant protections. Weak covenants delay the occurrence of an event of default, which allows zombie companies to continue operating until they either exhaust their cash reserves or cannot refinance maturing debt.

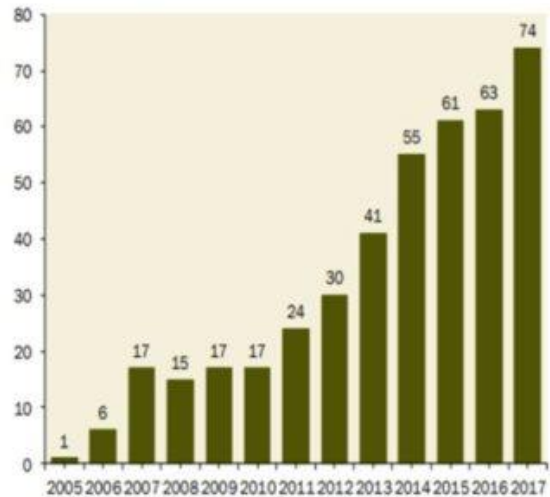
CORPORATE BOND INVESTORS HAVE LITTLE PROTECTION

United States: Covenant-Lite Loans

% of Total Issuance



% of Leveraged Loans Outstanding



Source: BofA Merrill Lynch, S&P LCD, Guggenheim Investments. Published by: Gluskin Sheff & Associates Inc.

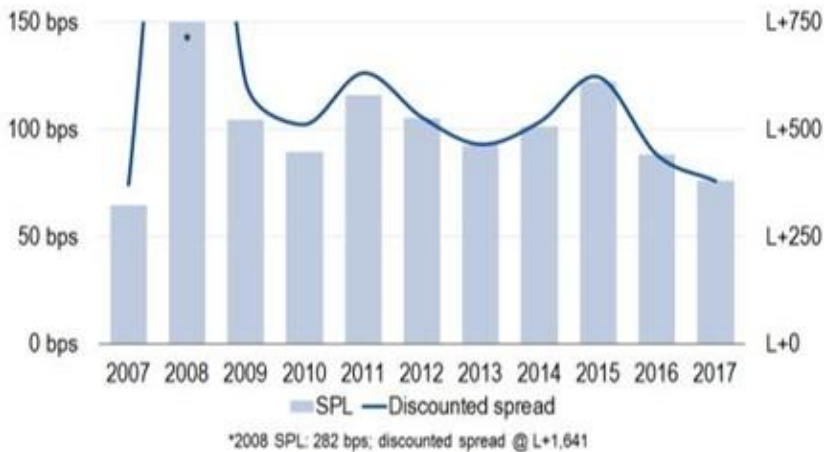
High yield bulls are likely to cite the substantial equity contributions from sponsors and healthy interest coverage ratios as reasons not to be overly concerned. These are definitely much better than 2007, but these indicators do have some inbuilt weaknesses. Equity contributions are only as good as the market valuations they are based on. As US equities are arguably overpriced, sponsors are having to pay more than they historically would have to purchase a company. If price/earnings ratios revert to lower levels, company valuations will fall wiping out some of the equity cushion and making the debt a higher proportion of the enterprise value.

Interest coverage ratios are also benefitting from two deviances from historical levels. Libor has been low but is now on an upward path. For companies that have hedged, either via interest rate swaps or by issuing fixed rate debt, their protection will last for a time. For those with floating rate debt and no interest rate swaps, their interest coverage ratios will generally have started to fall already due to higher Libor.

The average margin paid on top of Libor for leveraged loans is now at close to the lowest levels since 2007. When adjusted for the risk, spreads are at the lowest levels since 2007. When spreads revert, issuers with near term maturities will be the first to feel the impact with higher interest bills pushing their interest coverage ratios down.

Risk vs. Reward for Loans Outstanding

Spread per Unit of Leverage (S&P/LSTA Leveraged Loan Index)



Source: LCD, an offering of S&P Global Market Intelligence

The shape of the next downturn

We can use the size of the high yield debt market and the probabilities implied by the current credit ratings to estimate how much debt might default. Using the historical average three-year default rates, we would expect over \$250 billion of debt to default in the next three years. However, high-yield-debt default rates have long periods below the average and short bursts way above the average. Looking back to the downturns immediately following the tech wreck and the financial crisis, those three-year periods posted roughly double the average default levels. This points to the next downturn seeing over \$500 billion of high yield debt defaulting. There will be plenty of opportunities for the [\\$74 billion of dry powder](#) held by distressed debt funds.

However, the substantial increase in covenant-lite loans will flatten and lengthen the default cycle. Zombie companies will struggle on as the lack of maintenance covenants stops lenders from forcing equity raisings, asset sales, or bankruptcies that would better protect their positions. Whilst this will delay inevitable restructurings, investors will see their returns impacted far earlier as markets will reprice the debt of zombie companies to distressed levels well before the losses crystallise after a default.

Some managers dispute the impact of covenant-lite levels on recoveries. They point to data to argue that [their investors have little to worry about](#) from the growth of covenant-lite. But few managers are willing to hand back capital or to substantially change strategy when conditions in their market segment are unfavourable.

[Moody's takes a different view](#) and is forecasting an average recovery rate of 60% on first lien loans, well below the historical average of 85%. They cite more covenant-lite lending and lower levels of subordinated debt as increasing the risks for lenders. In 2007, covenant-lite loans were almost exclusively made to lower-risk borrowers. Today, both lower and higher risk borrowers benefit with less cushion provided by second lien loans and unsecured high yield bonds.

How can investors respond?

There are three main options: switch to cash, de-risk, or change sectors.

Switch to cash: As the spread in high yield debt is barely covering the average expected losses from defaults, this isn't as extreme as it might seem. The increasing return on cash-like investments in the US has recently risen above the dividend yield on the S&P 500. Add in the expectation of additional increases in the Federal Funds Rate and going to cash is a legitimate alternative whilst waiting for a correction in high yield debt. The lost carry of 3-4% per annum is the main downside and investors need to be prepared to pay this price for an unknown period, potentially several years.

De-risk: Switching from B and CCC rated debt to BB rated debt, selling covenant-lite loans/bonds and targeting shorter duration debt are ways to reduce the risk but still stay invested in high yield debt. Like switching to cash, this will reduce the carry on the portfolio but the give-up is only 1-2% per annum if an investor is starting with an average portfolio. Execution of the switch may be tricky though, as there will be a very limited universe left after applying two or more of these de-risking filters. What remains will mostly be older vintage debt, which is often very tightly held.

Change sectors: Another common strategy is to give up some liquidity by shifting from public loans and bonds to private debt. The higher historical returns and stronger covenant packages would make this a very obvious shift if not for the huge amounts of capital that have flowed into private debt in recent years, competing away some of the returns. This may turn out to be a case of past returns not being a reliable indicator of future results.

The Australian option

In Australia, we have been implementing a switch to property debt for our clients. The pullback of the major Australian banks from investor lending, interest-only loans and foreign buyers has opened up a substantial gap for others. Senior loans secured by completed residential property, borrowers with substantial excess income, low duration (2-5 years) and low LVR/LTV ratios (60-70%) are delivering net returns of around 6.5%. The illiquidity of these loans is substantially lessened by their low duration, which will see principal returned over the medium term when other credit investments are hopefully offering a better risk/return proposition. There is capacity for at least one institutional investor to put significant capital to work in this strategy.

Jonathan Rochford, CFA, is Portfolio Manager for [Narrow Road Capital](#). This article is for educational purposes only and does not address the circumstances of any investor.

5 red flags on active manager trading costs

Raewyn Williams

Many active managers turnover shares in their portfolios regularly as they seek to outperform. This activity might be to lock in a gain, reduce or prevent a loss, manage portfolio risks, reinvest dividends or manage liquidity. Trading is a 'bread and butter' activity in any active equity portfolio which must keep churning to keep its insights current.

It is surprising, then, that the science – or perhaps art – of trading efficiency is something of a 'black box' inside equity portfolios. There are *explicit* costs of trading equities – brokerage and commissions (and transaction taxes in some countries) – as well as *implicit* costs of buy-sell spreads and price impacts (also called moving the market, meaning pushing the market price higher as a fund buys into it or lower as the fund sells out of it). Institutional investors with large equity portfolios should care about this 'black box' because whether a manager trades efficiently or inefficiently can materially affect net returns. Retail investors also feel the impact via a decision to choose active.

The baseline costs of 'patient' trading

To test how returns are affected by such costs, we simulated a range of institutional-size portfolios across Australian and international equity markets. We used as a baseline trading efficiency measure passive (market cap weighted) portfolios in S&P/ASX200 and MSCI World ex-Australia equities which used an execution-only (agency execution) arrangement and adopted a patient trading style. The baseline portfolio trades were a \$100 million slice in Australian equities, representing 2.4% of the market's liquidity (median daily volume) and a \$500 million slice in international equities, representing 0.2% of the market's liquidity.

A fund trading this kind of baseline portfolio could expect to pay about **0.21%** of the total value of the Australian equity trades in trading costs, being **0.05%** in explicit costs and **0.16%** in implicit costs. For international equity trades, it could expect to pay **0.11%** of total trade value in transaction costs, being **0.05%** in explicit costs and **0.06%** in implicit costs. These *baseline* results are encouraging and, for most funds, probably don't create much of a hurdle for the trades to add value to the portfolio post-trading costs.

In considering different kinds of portfolios and trading approaches, here are five 'red flags' to watch for:

1. Trading on a principal, rather than agency, basis increases trading costs

Most equity trading, especially in Australia, is not agency based. In principal-based trading, the fund investor or manager is legally transacting with a broker who takes the equities onto the broker's own books and requires additional compensation for assuming this risk. The broker often bundles additional non-execution services into the commissions charged, which in Australia can easily be three times as much as an execution-only commission rate. Are these additional costs worth paying? Perhaps, but because the costs are embedded in brokerage charges on trades inside portfolios, the fund investor rarely considers this question.

2. As portfolio trade sizes get larger, trading becomes costlier

Our baseline cost of trading Australian equities, 0.21%, almost doubles to 0.38% for a \$500 million passive portfolio trade and reaches **0.48%** for a \$1 billion passive trade slice. Our baseline passive international equity trading cost, 0.11%, rises to 0.13%-0.26% when the trade size increases to \$1 billion – \$5 billion. These trade sizes are not unrealistic when you consider that the capital managed by superannuation funds collectively has now reached \$2.6 trillion and APRA-regulated funds, whose portfolios are being rationalised, invest an average 51.5% of their capital (close to \$900 billion in total) in Australian and international equities.

3. Active portfolios are costlier to trade than passive portfolios

Active portfolio trades typically demand more liquidity than passive portfolios. We modelled two types of active Australian equity portfolios which, compared to our baseline passive trade, demanded between 12.7%-62.9% of market liquidity for the same-sized trade. This pushed the total cost of the trade up from 0.21% to **0.37%-0.66%**. Our hypothetical active international equity portfolios demanded 1.2%-3.4% of market liquidity, which pushed trade costs up from our 0.11% baseline to 0.19%-0.25%.

4. Australian equities are costlier to trade than global equities

Explicit costs to trade in Australia are relatively high by global developed-market standards, and it is not clear why. Implicit costs are also higher because the Australian equity market is roughly one-fortieth of the size of global developed equity markets, so it is easier to adversely move the market.

Superannuation funds and other large investors tend to show a 'home bias' towards Australian equities and support active rather than passive management. They are favouring an asset class and investment style that is more expensive to trade. Further, the redundant trading that occurs in multi-manager equity structures (absent centralised implementation) is particularly a problem in Australian equities where there is potential for different managers to trade against each other, to no net benefit in the overall portfolio.

5. Aggressive trading styles significantly increase trading costs

Finally, an equity manager's view on how quickly, or urgently, to 'work the trade' in the market significantly affects trading costs. In our best-case scenario (international equities, passive, smaller trade size), a very aggressive trading style increased trading costs to 0.16% by almost doubling the implicit cost of passively trading the same order. In our worst-case scenario (Australian equities, active, large), a very aggressive trade pushed up transaction costs from an already concerning **0.66%** (patient trading style) to **1.24%**.

Considerations for investors

Large investors who recognise their own 'red flags' in these scenarios should also remember that most trades are 'round trip' – selling one stock, buying another – which doubles the trading cost impacts we have identified. The cumulative impact of these higher transaction costs, with the higher taxes and higher fees that come with active management, creates a hurdle that for some equity managers may be just too high to clear.

Raewyn Williams is Managing Director of Research at Parametric Australia, a US-based investment advisor. This information is intended for wholesale use only and does not consider the circumstances of any investor.

Additional information is available at parametricportfolio.com.au.

Young people, not employers, should choose super fund: Productivity Commission

Michelle Grattan

Young people entering the workforce should choose their own superannuation fund, rather than the present system of their employer selecting the fund for them, according to a Productivity Commission report released on Tuesday.

It recommends that these workers should be given a “best in show” shortlist set by a “competitive and independent process.”

Technically – unless a particular EBA or workplace determination restricts the choice of fund – young people, and others who enter the workforce or change jobs are currently able to choose their own fund. In practice, the employer nominates a fund which people are defaulted into if they don’t make a choice. That happens every time someone starts a new job.

The present system has twin risks for a ‘default’ member – that they default into multiple funds and/or they default into an underperforming fund, according to the Commission in its draft report, “Superannuation: Assessing Efficiency and Competitiveness”.

The government commissioned the report, and is already taking action to improve the superannuation system. In the Budget it announced it was making it easier for people to find their lost superannuation, capping administration and investment fees on low balance accounts, and abolishing exit fees. It is also cracking down on expensive insurance policies being sold to younger people.

Earlier, it moved to change governance arrangements, especially in relation to the boards of the big industry funds, which it regards as too close to the trade union movement. But this has not passed the parliament.

At present the default members are usually directed to an industry fund.

The inquiry found that most, though not all, underperforming products were in the retail rather than the industry segment of the market.

“The default segment generated average net returns of about 7% a year over the 12 years to 2016. Top performers were typically (but not always) larger, not-for-profit funds,” the commission report said.

“For-profit funds as a group, have delivered returns below several benchmarks and significantly below not-for-profits funds. These differences do not appear to be fully explained by fund size, asset allocation or reported administration expenses”.

The commission says that “while the default segment has on average outperformed the system as a whole, and worked well for the majority of default members, it fails to ensure members are placed in the very best funds and places a sizeable minority in underperforming products”.

In these cases there is a “pernicious cost” – a reduction in their retirement balance of 36% or \$375,000 for a typical new job entrant today.

Default arrangements should be recrafted to harness the benefits of competition for default members.

The report identifies the key problem currently to be linking the choice of default fund to the employer, rather than to the member.

The best default model would be the “assisted employee choice” model. “It would best harness healthy competition and ‘nudge’ members into the very best products,” the report says. In contrast, assisting the employer to make the choice “performs less well in ensuring employees are placed in the very best funds, due to the inconsistent incentives with leaving the decision to the employer”.

The proposed model would apply to all new workforce entrants – about 474,000 members a year with about \$1 billion annual contributions initially. It would also help “many existing default members through extending to them any lower fee offers made in the course of best in show selection, and signalling whether funds are really best”.

Under the Commission's recommendations, the Fair Work Commission would be stripped of its power of administering the process for becoming a default-listed fund in awards. This would be put in the hands of an independent expert panel appointed "through a robust selection process" and reconstituted every four years.

With the release of the report, the Commission Deputy Chair Karen Chester said: "Australia's \$2.6 trillion super scheme has become an unlucky lottery for many Australian workers and their families. The system is working well for many members, but not for all".

The system's architecture was outdated, she said, emphasising the "structural flaws" of unintended multiple accounts and entrenched underperformance.

Chester said about a third of accounts – 10 million – were "unintended multiples", with the excess fees and insurance premiums paid on those accounts being about \$2.6 billion annually.

"These problems are highly regressive in their impact – and they harm young and lower-income Australians the most," Chester said.

Over one in four funds underperforms. This could lead an average member in the fund over their working life with nearly 40% less to spend in retirement.

"Fixing these twin problems of entrenched underperformance and multiple accounts would lift retirement balances for members across the board. Even for a 55-year old today, the difference could be up to \$60,000 by the time they retire. And for today's new workforce entrant, they stand to be \$400,000 ahead when they retire in 2064," Chester said.

[Michelle Grattan](#) is Professorial Fellow at the University of Canberra. This article was originally published on [The Conversation](#).

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