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The myth about Costello's super generosity

Jon Kalkman

It's apparent from comments posted on Cuffelinks that many people regard tax-free superannuation after the age of 60 as overly generous. They claim that tax-free super introduced in 2007 by Treasurer Peter Costello forfeited tax revenue making the system unsustainable in the long term.

Types of contributions

Let's start with the basics. There are two types of contributions to super. Concessional contributions are made before tax is paid, such as salary sacrifice, employer contributions and contributions on which tax deductions are claimed. Non-concessional (or after-tax) contributions include sums on which tax has already been paid such as the proceeds of the sale of an investment property or an inheritance or personal savings. Concessional contributions are popular because they save tax, but they may have possible tax implications later.

On retirement, the important metric is the proportion (not the amount) of super that is made of concessional and non-concessional contributions. Before the changes brought in by Peter Costello in 2007, the tax paid on your super in retirement was determined by these proportions. Today, if you access your super before age 60, these tax arrangements are still in place and determine the tax payable. And even today, everybody's tax liability on their death benefit before any money is paid to beneficiaries is determined by these same proportions.

Taxing of withdrawals based on proportions

Costello's changes made all super tax free after age 60 for those who are fully retired (or more precisely, those who 'ceased an employment arrangement' after the age of 60). Therefore, these proportions have little relevance if retirement is postponed until age 60 or the super fund is exhausted before death.

To check whether Costello's tax-free super after 60 is overly generous, consider how the tax system works and how little tax was paid on super in retirement before 2007. Tax on super in retirement only ever applied to the

concessional portion of the fund, or that portion that claimed tax concessions in the contributions (accumulation) stage.

Let's assume George today is over age 56 but under age 60. He can access his super, but his super is taxable. This treatment applied to everyone before 2007.

If George retires with \$1 million in super made up of \$800,000 of employer and salary sacrifice contributions and \$200,000 made up of after-tax contributions, then all withdrawals from his super, both pensions and lump sums, are in the proportion of 80:20. With lump sums, everyone is entitled to take a once-only withdrawal from super of \$200,000 as a concessional allowance. So if George were to take a lump sum withdrawal and pay no tax, he could take \$250,000 because \$200,000 (80%) is his concessional allowance and \$50,000 (20%) is seen as the return of his own money that he has already paid tax on.

Please note that these proportions are only examples and everyone will have their own unique proportions. Surprisingly few people know what their proportions are.

Super pensions come with a 15% tax rebate which is compensation for the 15% contributions tax and the 15% tax paid on earnings in accumulation phase. Tax concessions on super pensions were designed to encourage retirees to take their super as an income stream rather than a lump sum which could be spent before claiming the age pension.

These same proportions apply to any super pension George may take. In this example, he can take a pension of \$54,000 and pay no tax. His concessional component of the pension is 80% or \$43,250 and his non-concessional component is 20% or \$10,750. His non-concessional component is tax free because it is the return of his own money. And the concessional component is also tax free because the 15% rebate on \$43,250 is \$6,487.50, which cancels out the tax liability of \$6,468.

Even if George took a larger pension he pays very little tax. If the pension was \$80,000 his non-concessional component is \$16,000 (20%) tax free, and his concessional (taxable) component is \$64,000 (80%). The tax on \$64,000 is \$13,627 but it comes with a tax rebate of 15% which is \$9,600. His net tax is slightly more than \$4,000 on a pension income of \$80,000 when workers on the same income pay in excess of \$19,000 in tax.

Restrictions will limit large balances

With the restrictions on concessional contributions (currently \$25,000 per person including both employer and salary sacrifice contributions), it is impossible to accumulate large super balances by concessional contributions alone. It requires the contribution of large amounts of after-tax (non-concessional) contributions from the sale of properties or businesses or from after-tax savings. Before 2007, there was no limit on after-tax non-concessional contributions. With large super balances, it is likely in future that the proportions in retirement super will be heavily weighted in favour of non-taxable benefits.

For the sake of comparison, let's assume that George's proportions are now reversed. His concessional contributions are now 20% and his non-concessional contributions are now 80% of his super balance. His tax-free lump sum now is \$1,000,000 made up of \$200,000 (20%) as his concessional allowance and \$800,000 (80%) as the return of his own money.

Even though at his age, his super is subject to tax, he can now take a tax-free pension of \$216,250 because we know that 80% or \$173,000 of that is tax-free as it is the return of his own money and \$43,250 (20% concessional) is taxable. But the taxable portion comes with a 15% rebate which cancels out the tax payable, as before.

Death benefits tax

The tax on death benefits uses the same process. The tax only applies to the concessional component. Therefore, the higher the concessional proportion, the more tax that is payable. The death benefit tax is 15% plus the 2% Medicare levy on the taxable portion. If the super death benefit is an insurance payout, the tax is 30% plus the Medicare levy.

If George died with \$1 million in his super and his concessional component was 80% of the total, the tax payable before his beneficiaries received any money would be 17% of \$800,000 or \$136,000. By contrast if George's concessional component was only 20%, the tax would be 17% of \$200,000 or \$34,000.

Clearly, the larger the non-concessional proportion, the lower the tax payable on death. Large super balances are more likely to contain a high proportion of non-concessional super. The message is clear: benefits paid from

small super balances pay little or no tax and, by definition, large super balances that contain large non-concessional components also pay little or no tax on their benefits.

Costello forfeited little tax revenue

So it was easy for Costello to make super tax-free after 60 because his decision forfeited very little tax revenue and at the same time proved politically popular. No government since 2007 has contemplated reversing that decision. Such a step would be politically unpopular and it would generate little revenue.

It also explains why Treasurer Scott Morrison has capped the amount that can be held in the pension area where the fund income is tax-free. By forcing amounts in excess of \$1.6 million into accumulation phase, the government at least collects tax at the rate of 15% on income earned from both components of a super fund, whereas before 2007, the tax only applied to the concessional component.

Whether that \$1.6 million cap is too generous is another discussion but a nostalgic return to the golden era before Costello's changes would generate little or no tax from those funds with large super balances. In fact, that tax regime would collect less tax than the present system.

Jon Kalkman is a former Director and Vice President of the [Australian Investors Association](#). This article is general information and does not consider the circumstances of any investor.

How do 'direct investment options' deal with franking credits?

Tom Garcia

There has been a lot of interest from readers of Cuffelinks on the potential impact of the Labor Party's proposed changes to imputation credits, particularly SMSF members and self-funded retirees. It has highlighted differences in understanding of how super funds are taxed and the strategies available to members seeking more control over how they invest their super.

Myriads of super choices offer different levels of control. Before individuals choose a strategy, it's important that they consider how much responsibility they want to take on themselves, the investment choices on offer, the types of features they need and how much they're willing to pay for them.

Here are some of the key differences between retail wrap accounts and the 'direct investment options' offered by leading industry funds, and the potential impact the proposed changes might have on these options and SMSFs.

What's the difference between a direct investment option and a wrap?

Typically, wrap accounts offer a broader range of investment options and fund manager choices, as well as having additional flexibility regarding transfers of assets (e.g. in-specie shares). Given the complexity and range of investment offerings, they are designed to be accessed under the guidance of a financial adviser, who can provide personalised advice on the best mix of assets for each individual. Some providers offer direct access to their platforms to retail investors but the fees can be prohibitive for members who may not be interested in, or don't have the knowledge or capability to, navigate a large investment menu.

For example, with the direct investment option offered through AustralianSuper, called Member Direct, members can choose from shares in the top 300 companies listed on the ASX, a selection of exchange traded funds (ETFs) and term deposits. Members can combine these with the managed options on offer so they can dial up or down how much of their portfolio they want to invest directly themselves. The investment menu is more limited in comparison to wrap accounts and there are trustee-prescribed investment limits to encourage members to make investment choices that maintain diversification.

Our research shows some members want the control of managing their own money, but also want the comfort that comes with having some of it professionally managed. On average, members in the Member Direct investment option invest around 30% of their portfolio themselves, while keeping the remainder invested in the Fund's other professionally managed diversified options. Some members see the option as a stepping stone to an SMSF, while it provides others with greater control and flexibility over their investments within an APRA-regulated fund.

Who offers direct investment options and how do they work?

Direct investment options are offered by a number of leading industry funds. Members buy and sell investments on an online platform, which is operated by a third-party who also provides execution services, market news and data and research. Investors need to be a member of the fund and invest a portion of their portfolio in the fund's other investment options.

While direct investment options may not offer all the bells and whistles of some of the wraps, they may be a lower cost option for people wanting to be more involved in managing their super portfolio. They offer features like real-time trading, high interest cash accounts, dividend reinvestment plans, independent company research and consolidated tax reporting.

Accumulation members can also retain the benefit of the low-cost insurance cover they have through their super fund. While the Member Direct option doesn't currently allow in-specie transfer of shares held outside the Fund, members can transfer shares from a Member Direct accumulation to Member Direct retirement income account without incurring capital gains tax on unrealised capital gains.

How are franking credits managed and how might Labor's proposed changes affect members?

Based on announcements that have been made to date, the impact of Labor's proposed changes differs according to the tax-paying status of each superannuation vehicle.

AustralianSuper is a single taxpayer which pays tax at the entity level rather than the individual member level. It pays a significant amount of tax on its contributions and investment income derived from assets that support member balances in the accumulation phase.

The Fund uses its total franking credits to offset the total tax liabilities it pays. It achieves this because the assets supporting each investment option across the accumulation and pension phases are combined in the one entity. The franking credits are then allocated to the investment options that have exposure to Australian equities. For example, franking credits received in the Member Direct investment option are attributed to members in the option so they receive their respective benefit of the credits.

While the Fund remains a significant taxpayer the proposed changes are not likely to materially impact investment returns. By contrast, other funds that have low or no investment income taxed in the accumulation phase, low or no taxable contributions and have a high exposure to Australian equities are more likely to be negatively impacted by the proposed changes. For example, SMSFs that don't have sufficient tax liabilities to fully offset imputation credits may lose the benefit of the cash refund. Under the proposal, SMSFs that have at least one member who was receiving a welfare pension (such as the age pension) before 28 March 2018 will not lose the benefit of the refund.

Tom Garcia is Head of Product and Communications at [AustralianSuper](#). AustralianSuper manages more than \$132 billion of members' assets on behalf of more than 2.2 million members. More than 14,000 members invest in the direct investment option, [Member Direct](#).

This information is general information which does not take into account the personal objectives or needs of any investor. Before making a decision about AustralianSuper, you should think about your financial requirements and refer to the relevant Product Disclosure Statement.

Shadow Treasurer Chris Bowen responds on franking policy

Graham Hand

The Federal Opposition Labor Party intends denying franking cash credit refunds except for welfare pensioners. This subject has become one of the most heated debates on our website. Although it relies both on Labor winning the next election and then passing the legislation, the most recent Newspoll for two-party preferred voting has Labor ahead of the Coalition by 52-48. However, PM Malcolm Turnbull remains well in front of Bill Shorten as the 'better PM'.

A reader of Cuffelinks forwarded this email exchange with Shadow Treasurer, Chris Bowen. The reader's identity has been removed because it reveals personal details.

Email to Chris Bowen, 21 May 2018

Dear Sir,

I have sent a letter and email previously expressing my outrage at the proposal but have never had any reply, so third time lucky.

My query is;

My understanding is that the only people who will be able to claim the cash refunds of franking credits will be those who were already in receipt of a Centrelink full or part pension on the day of the announcement.

I also understand that anyone not qualifying as a Centrelink pensioner on that date will, even if in future years they do qualify for a Centrelink pension, never be able to claim the cash refunds.

My wife and I have a SMSF which is our only source of income and we are both in the pension drawdown phase of that fund.

The combined balance of the fund is around \$920,000, 80% of which is invested in shares and last year generated \$14,000 of franking credit cash refunds.

We have a Commonwealth Seniors Health Card and a Pensioner concession card and receive the Seniors supplement.

The prospect of losing so much income is stressing me beyond belief so any clarification would be gratefully appreciated.

The policy was apparently aimed at the 1% of SMSF's who have been, based on out of date 2014 figures, claiming up to \$80,000 of cash refunds. We hardly fit into that category and anyhow these really rich people will, under your proposal, still be able to claim refunds as since 2017 they are now paying 15% tax on fund balances over \$3 million.

Once again the middle class battlers get screwed.

Thank you for reading this and I await your answer to my question.

Reply from Chris Bowen, 5 June 2018

Dear XXXX,

Thank you for your email.

Labor's reforms to excess dividend imputation credits will remove a fiscally unsustainable tax arrangement that is seeing billions of dollars in lost revenue, making it harder for the government to fund important services and return to surplus.

Dividend imputation worked perfectly well between 1987 and 2000 when cash refunds weren't sent to people who didn't pay income tax. Labor will return to that system. While I understand not everyone will like it, it is necessary and Labor is prepared to be honest about our plans in advance of an election and not surprise people afterwards.

Budgets are about priorities. And to get the budget back to surplus difficult decisions need to be made. And yes, making the public case to take something off someone can be difficult, but federal Labor believes that the policy case for reforming refundability and excess imputation credits is a strong one, that it's absolutely the right thing to do.

We have said that we'll consult with the Australian Taxation Office, Treasury and tax experts on the implementation of this policy. However, we have no plans to make changes to the announced policy.

Warm Regards,

Chris Bowen MP

Federal Member for McMahon

Email to Cuffelinks from the reader, 5 June 2018

Graham

Here is the reply I have just received from Bowen's office.

He does not accept that the very wealthy whom the plan is supposedly targeting will not be affected but that the low level SMSF of middle class Australians will be.

They have no intention to alter the proposal which is incredibly discriminating against battlers. They appear proud of the fact that they will stuff up the retirement of 1000's of retirees.

[Note: Although Chris Bowen did not correct the statement, our understanding is that Labor's 'Pensioner Guarantee' will apply in future, exempting welfare pensioners from the policy. It is pensioners within SMSFs who have the 28 March 2018 deadline].

The outlook for Australian banks

Rudi Filapek-Vandyck

A good way to judge how companies are performing in Australia is to compare stockbroker price targets before and after the release of financial results. It's a straightforward measure and cuts out noise about one-offs and taxes, currency fluctuations, management ability and strategy execution.

Notable movements in share price targets

After cloud accountancy software provider Xero released its FY18 financial report in May 2018, price targets went up. When property listings platform REA Group provided an update on the March 2018 quarter, price targets went up. The same happened for News Corp, though that was largely REA-inspired. After Macquarie Group released their financial report last month, price targets jumped.

And the banks? Every one has recently seen price targets decline on the back of financial results, or, in the case of CBA, a quarterly trading update. Most commentators point at 'cheap' valuations for the banks (except Bendigo and Adelaide) given most are trading below consensus (and declining) price targets.

Banks are finding it difficult to participate in the broad-based market recovery, regardless of all the value calls, the fact that cheap-looking laggards have been regaining investor interest, and despite most banks paying above-market half-yearly dividends.

The IBISWorld view on banks

Clearly, something else is going on and it's not just about ongoing despicable embarrassments at the Royal Commission. Sector analysts at IBISWorld are widely known for their specialised sector research reports such as on retail spending and new trends in consumer electronics. They have weighed in on what lies ahead for the sector once thought of as the closest thing to 'indestructible' by Australian investors (but no longer).

On their assessment, Australian banks will be hamstrung with higher capital requirements, tighter regulation, and higher costs as a result of the public outrage over their misconduct in years past, and the regulatory and political scrutiny that follows as a result. While IBISWorld suggests higher costs will be partially passed on to clients, the analysts now forecast declining revenues for the next five years.

Another consequence of the Royal Commission should be tightened standards for lending to investors, consumers, and businesses, suggest the analysts. While this opens up a drive for increased market share by smaller competitors, including non-bank lenders, this will also have consequences for credit growth in general, which closely intertwines with economic momentum and house prices in Australia.

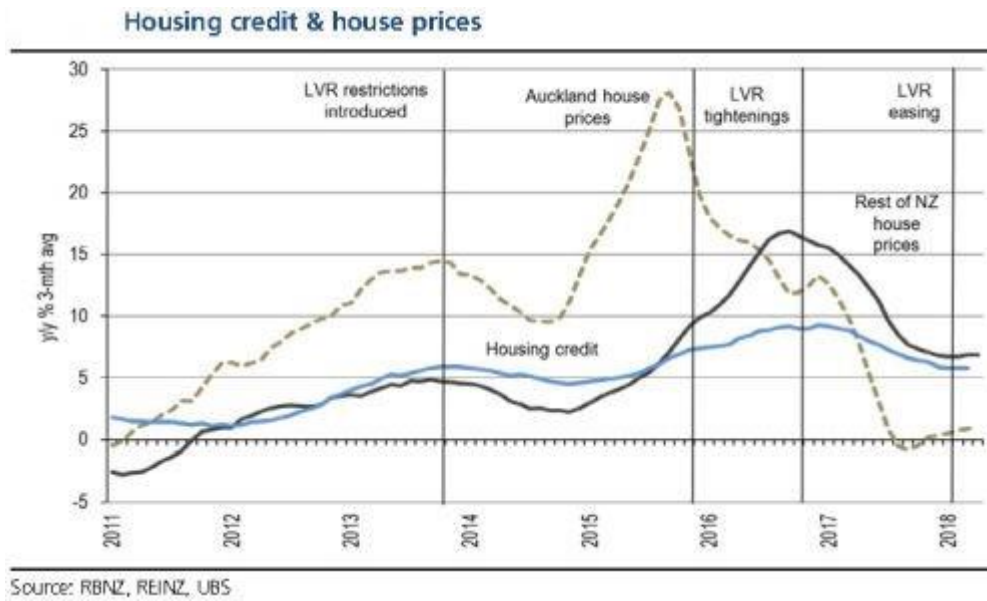
The UBS analysis of the sector

UBS's negative view on banks has consequences for the broader domestic economy with the house view fearful that tighter credit is likely to lead to weaker house prices. There will be a flow-on impact on household sentiment through a fading of the so-called wealth effect that stems from positive momentum for property prices.

No surprise then, that UBS thinks GDP growth forecasts by economists elsewhere are likely to prove too optimistic, including the 3% forecast maintained by the RBA for 2018. UBS suggests 2.75% is more likely, and this will keep interest rates on hold until the second half of 2019.

In a separate analysis, UBS economists suggest that tighter public scrutiny in Australia has the potential to spread to New Zealand. This could translate into yet more pressure for Australian banks who also dominate across the Tasman.

While further tightening of credit in New Zealand would add more downside risks for house prices and consumer spending there, and potential for bad debts to rise, an equally-intriguing observation can be made from the graph below, taken from that same UBS report on Australian banks in New Zealand.



The graph shows the tightening by banks had an almost immediate impact on house prices where there was elevated momentum (Auckland), and that a softening in lending standards once house prices were falling takes a lot longer to then stabilise the market.

The JP Morgan perspective on banks

JP Morgan recently wrote that Australian banks had let their standards slip, as was also revealed at the Royal Commission. APRA had already instructed banks to set limits on new loans in high debt- and high loans-to-income categories, in industry parlance known as DTI and LTI loans. With aggregate household debt in Australia rising to 189% of disposable income, JP Morgan believes that banks are being forced into more conservative lending practices.

A big chunk of the positive momentum in house prices in recent years stemmed from investor-borrowers, and there appears to be a direct link to higher LTI loans with both sellers and buyers in this particular bracket enjoying high LTI mortgages.

JP Morgan is predicting credit growth slowing from 6% annualised to 4% over three years. This seems like a gradual, relatively small contraction, but the impact could be significant. Consider the following maths: High LTI loans represent around 10% of total volume in new loans, but because of their above-average size, JP Morgan believes these loans represent maybe 31% of all new lending in dollar terms. JP Morgan is not predicting a crash in house prices in Australia, but a noticeable slowdown in overall activity, which translates into lesser demand for credit. A crash requires forced sellers.

Related effects of a credit slowdown

The outlook for banks has not looked as clouded since the global financial system froze in 2008, and this is understandably turning the sector into one of the major laggards in the local share market. Investors holding shares in discretionary retailers should also better prepare for tougher times ahead. This is a slow going, long drawn out process and with little in the way of a sizeable increase in average wages, I'd be inclined to think the overall landscape for consumer spending will remain subdued for a lot longer than the optimists expect.

Rudi Filapek-Vandyck is an Editor at FNArena. FNArena's service can be trialled for two weeks at www.fnarena.com. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice.

The merits of investing in LICs at a discount

Peter Rae

There are many factors that help explain why Listed Investment Companies (LICs) and Listed Investment Trusts (LITs) share prices diverge from pre-tax Net Tangible Asset (NTA) values. These include, but are not limited to:

- Portfolio performance
- Portfolio size (many subscale LICs/LITs trade at discounts)
- Marketing and communication efforts by the manager
- Investor preferences
- Overall share market sentiment
- Relative interest rate and yield differentials with competing investment opportunities.

Discounts and premiums can change over time, although some LICs/LITs may always trade at a discount for a variety of reasons including ongoing underperformance and subscale issues.

In the table below, we show all LICs/LITs in our coverage with a discount greater than 5% and also compare the April discount with the three-year average. There are no LITs, only LICs on the list.

LICs at Greater Than 5% Discount as at 30 April 2018

ASX Code	Market Cap \$m	Discount %	3 yr avg* Disc %	Listing Date	Options on issue
BTI	96.2	25.2	15.6	Nov-14	No
BST	16.3	19.2	16.9	Aug-14	No
CQG	90.1	14.9	5.8	Jun-17	Yes
FSI	40.3	14.6	15.5	Dec-00	No
GC1	45.2	12.8	7.4	Aug-15	No
URB	67.7	11.1	1.4	Apr-17	No
WIC	149.0	9.0	12.4	Sep-09	Yes
WHF	396.1	8.1	7.6	1923	No
AMH	235.3	7.2	2.4	Jun-00	No
DUI	828.9	6.4	5.5	Dec-91	No
APL	439.0	6.2	1.4	Oct-16	Yes
PIA	287.0	5.9	8.0	Mar-04	Yes
WLE	787.6	5.1	1.6	May-16	No

*Average from listing date for entities with less than three years history.

There are two things that stand out from the above table.

Firstly, the LICs with the six largest discounts all have market capitalisations under \$100 million. In our view, it is difficult for small scale LICs to generate the same level of interest as larger LICs and they are likely to have poor market liquidity.

Secondly, four of the LICs have options on issue. Unexercised options can be a drag on LIC share prices until after the options are exercised. Options may be dilutive, as there is the possibility they may be exercised at a price lower than NTA. Before investing in LICs with outstanding options it is a good idea to calculate the diluted NTA.

Here are some explanations why specific LICs are trading at a discount.

Bailador Technology Investments (ASX:BTI) is trading at the largest discount to NTA, a material 25.2%. We believe a number of initial investors in the LIC have lost patience given a couple of major writedowns in individual portfolio holdings and the long lead time for realisations on individual investments. Private equity style investing requires patience and cashflows can be lumpy. Investors also need to understand that, in a portfolio of 10 private equity investments, it is not unusual for one or two investments to not perform to initial expectations. BTI continues to expect a number of realisations over the next 12 months with the potential to substantially increase NTA. The shares look cheap, but the discount may take some time to correct with the market waiting for further evidence of the realisations.

Barrack St Investments (ASX:BST), Flagship Investments (ASX:FSI) and Glennon Capital (ASX:GC1) are all examples of LICs that we consider subscale. BST and GC1 have both been in existence for relatively short periods. We expect the discounts to remain in place until these LICs can establish a consistent track record. FSI has a longer track record and the portfolio has performed relatively well. We highlighted FSI in our April LMI Monthly and noted that whilst liquidity is restricted, increased marketing and communications might help with elimination of the discount over time.

We currently see Contango Global Growth (ASX:CQG), trading at a 10% discount to options diluted pre-tax NTA, as a good opportunity for investors looking for international exposure. We also see URB Investments (ASX:URB), at an 11.1% discount to pre-tax NTA, as a good opportunity to invest in the urban renewal theme. We believe the market is not valuing the upside in some of the LIC's direct property assets. Refer to our March 2018 LMI Monthly Update for more details on URB.

Amongst the larger cap LICs in the table, three stand out in particular, Whitefield (ASX:WHF), AMCIL (ASX:AMH) and Diversified United Investment (ASX:DUI). All are trading at discounts to pre-tax NTA, yet they are the top three performing LICs (with an Australian large cap focus) over the past five years (per the above performance table). All except WHF, which has slightly underperformed, have exceeded their portfolio benchmarks over the five-year period. We note that all three LICs have historically traded at discounts, but the discounts are currently above their three-year averages.

WAM Leaders (ASX:WLE) also stands out at a 5.1% discount to pre-tax NTA. Interestingly, it is the only Wilson Asset Management Fund to trade at a discount to pre-tax NTA. WLE has only been around for two years and is yet to establish a track record but, based on the Managers data, the underlying portfolio has performed well since inception generating outperformance of 2.6% p.a. before expenses, fees and taxes. However, on a pre-tax NTA basis WLE has underperformed the S&P/ASX 200 Accumulation Index with performance impacted by the exercise of options in 2017. If WLE can build a sustained track record of outperformance (although for a large-cap fund this is likely to be harder to achieve) then perhaps its shares could at some stage also trade at a premium to pre-tax NTA.

Important: Please note that our commentary above is based on pre-tax NTA and market prices at 30 April 2018. Discounts will change on a daily basis with share price movements and movements in NTA.

Peter Rae is Supervisory Analyst at [Independent Investment Research](#). This article is general information and does not consider the circumstances of any individual.

Why active management needs a full cycle

Michael Roberge

Businessweek predicted the 'death of equities' in a 1979 cover story. It highlighted how some institutional investors replaced stock allocations with nontraditional investments such as precious metals, fine art and even Pizza Hut franchises after a decade of lacklustre returns. While the story might seem provocative now, there

was little love for the stock market in the 1970s. Stocks were hurt by runaway inflation, skyrocketing oil prices and persistently low returns, among other factors.

We're seeing similar sentiment in today's markets, but instead of disliking stocks, investors are turning away from traditional active management. More than a few prognosticators have predicted the end of active, suggesting that bottom-up fundamental security selection in particular is antiquated, overpriced and ineffective.

We believe the prevailing sentiment is wrong and that cyclical – not secular – market conditions have favoured passive approaches in recent history.

Everyone gets a trophy in these markets

Since US equities bottomed in March 2009, the S&P 500 Index returned 371% cumulatively by the end of 2017, generating strong returns for investors with passive exposure (source: Morningstar, March 2009–December 2017.) The average bull market has lasted five years, but this one is in its ninth year and there are no imminent signs that it is ending.

While a boon for passive, this bull market has been troublesome for active managers. Headwinds for active management include low volatility and price dispersion. In recent years, the market has not generally differentiated between high-quality and low-quality names. Stock prices have generally risen regardless of a company's earnings or quality. The market has been handing out participation trophies and companies have been rewarded simply for showing up.

We can see this clearly over the five-year period ended 31 December 2016. Historically, high-quality stocks have outperformed low-quality stocks, but over this time, high-quality and low-quality largely moved in lockstep, as shown in Chart 1.

Chart 1: Little distinction between companies with positive or negative earnings



Source: Compustat earnings per share (EPS) data, December 2011–December 2016 for the S&P 500 Index. Each portfolio of positive and negative earnings companies is rebalanced monthly and market-cap weighted. Data labels are cumulative returns, as of December 2016.

Earnings are an essential ingredient for favourable stock prices. Investors should expect the stocks of companies with positive earnings to outperform those with negative earnings over time. There was less separation between the negative earners and positive earners which is why the passive approach outperformed. It didn't matter what was owned because just owning 'the market' via a passive vehicle provided strong returns. While a bear market could help produce more investment opportunities for active strategies, it's not a downturn, but rather a full market cycle that allows active managers to succeed. For example, the dispersion of stock prices — when driven by company fundamentals such as growth, profitability and cash flow — is an essential ingredient for traditional active managers.

Misalignment between investors and their managers

This passive phenomenon has created a misalignment between investors and their asset managers, which could cause investors to forfeit the full value of active management. The disconnect is most evident through

mismatched investment time horizons, where investors expecting alpha over increasingly short time periods don't invest through a full market cycle, leaving alpha on the table.

(Alpha is a measure of the portfolio's risk-adjusted performance. When compared to the portfolio's beta, a positive alpha indicates a better than index performance. Beta is a measure of the volatility of a portfolio relative to the overall market. A beta less than 1.0 indicates lower risk than the market).

In our 2016 investor sentiment survey, most institutional investors acknowledged that full market cycles last seven or more years but most wouldn't wait that long for performance to turn around. At least 70% of the investors would only tolerate underperformance for three years or less. (Source: 2016 MFS Active Management Sentiment Study: Global Insights. The global sample totaled 845 respondents, with 500 financial advisors, 220 institutional investors and 125 professional buyers responsible for the management of investments).

Since active conditions change through a full market cycle, making portfolio changes in as little as three years can lead either to missed opportunities or a failure to let the best insights from a manager mature and pay off.

We believe alpha opportunities are cyclical in nature, and that skilled active managers aligned with the long-term interests of their clients are best-positioned to capture those opportunities over time. A skilled active manager is one who demonstrates conviction through low portfolio turnover and high active share, is capable of adding value in volatile markets, integrates research and rewards collaborative thinking.

Correcting the misalignment by helping investors define long-term objectives and more effectively assess and measure active skill could result in better investment outcomes. (Source: 2015 Holding Horizon: A New Measure of Active Investment Management. Short-horizon funds, on average, hold stocks for 1.91 years, whereas long-horizon funds hold stocks for 6.85 years.)

Creative destruction and signs that dispersion has increased

Market breadth, or stock price dispersion, is a cyclical factor that ebbs and flows over time. Dispersion increased in 2017, as shown in Chart 2, improving conditions for active managers. Investors are beginning to differentiate between high- and low-quality stocks in some pockets. Some of the rising dispersion is likely related to a recent acceleration of digitization, creative destruction (i.e., innovation) and the collapse of intellectual property.

Chart 2: Dispersion continued to historical norms in 2017



Source: Compustat earnings per share (EPS) data, January 2017–December 2017, for the S&P 500 Index. Each portfolio of positive and negative earnings companies is rebalanced monthly and market-cap weighted. Data labels are cumulative returns, as of December 2017.

While electronic platforms and widespread digitization are destroying intellectual property, the massive inflows into passive investment strategies signal that many investors believe that markets are structurally efficient and that alpha is permanently, not cyclically, elusive. We don't think that anything in life, much less the markets, is linear. We believe future cash flows will migrate to the new owners of intellectual property. Margins, growth and profits will shift from incumbents to different entities. This is creating multiple alpha levers for active managers.

It's not just about spotting the innovators and disruptors, but also avoiding the over-earners that have peaked and are at risk of margin erosion.

Active management is waiting out a cycle

The 'death of active' narrative is misguided, just as the death of equities was in 1979. Investment alpha, like the markets, is cyclical, which is why it is prudent to be patient and wait for a thesis to bear fruit. Markets tend to be irrational over short periods and prices can overreact to irrelevant factors such as elections and the weather. These events typically have little material impact on a company's fundamentals or long-term growth prospects. Eventually, at some point in a cycle, prices reflect the things that really matter — a company's growth, cash flow and earnings.

Michael Roberge is Chief Executive Officer and Chief Investment Officer at [MFS Investment Management](#). The comments, opinions and analysis are for general information purposes only and is not investment advice or a complete analysis of every material fact regarding any investment. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Cuffelinks.

The case for Australia to restore its gold reserves

Jordan Eliseo

Despite the fact that gold has increased in price from below AUD450 an ounce to over AUD1700 an ounce since the turn of the century, investors in developed markets remain reticent to invest in gold today.

In the late 1990's, gold was languishing below AUD500 an ounce, having suffered a near double decade bear market. No yield, ongoing storage costs, and significant opportunity cost does not a happy investor make.

It wasn't just investors, with central banks net sellers of the metal from the late 1980s until the onset of the GFC, divesting close to 6,000 tonnes over this 20-year period. One of those central banks was the RBA, which in 1997, sold off roughly two-thirds of Australia's national gold reserves, netting some AUD2.4 billion in the process.

What was the RBA thinking?

The rationale for the RBA gold sale was in a detailed memorandum prepared in December 1996. The memo noted that gold represented some 20% of foreign exchange reserve assets, and that there was considerable cost of holding this reserve, especially in terms of income foregone. When looking at the outlook, the memo noted that *"it would be optimistic to expect sizeable increases in the price of gold in the near term"*.

It also included the table below, which contains the returns on physical gold vs. US Treasuries.

Compound annual returns (percentage)

Time Period	Gold	US Treasuries
1900-1970	0.9	2.8
1970s	31.8	6.8
1980s	-4.2	8.4
1990s	0.1	4.3

This analysis was partly used as justification for the gold sale, with the memo stating that:

"The value of \$100 invested in US Treasuries in 1900 would now be about \$3,700 (assuming all coupons were reinvested), which is about twice the value of a similar investment in gold."

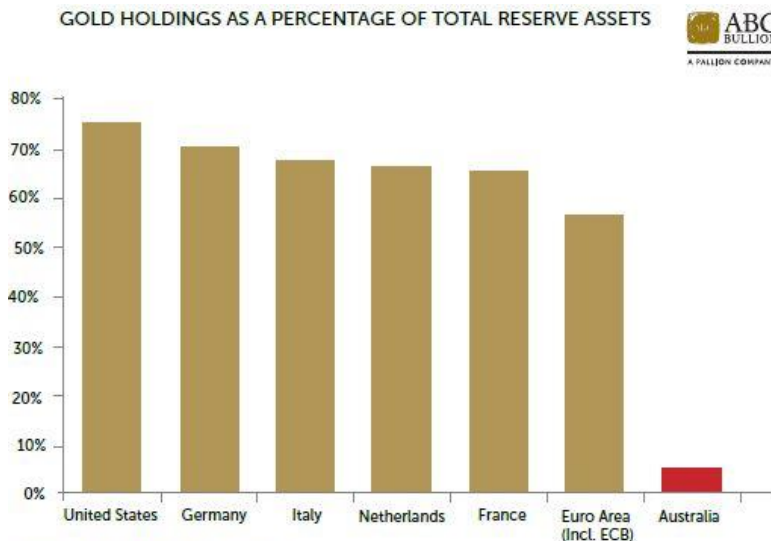
Source: December 1996 memo to RBA board discussing RBA gold holdings

Whilst the data is accurate, the insight drawn was questionable at best, for the memo itself noted the gold price was fixed until 1971. Had the 70-year period where gold prices were fixed been removed, then the return comparison of gold versus US Treasuries would show that the yellow metal's performance was double that of Treasuries.

Impact of the physical gold sale

Those 167 tonnes would be worth close to AUD9.4 billion today. The decision to sell at an almost double-decade low has cost some AUD7 billion in capital gains foregone. In fairness to the RBA, we must acknowledge the growth of the proceeds they received for the gold sale. Given the duration profile of their assets, and the countries they invested in, the return on 2-year US Treasuries between March 1997 and March 2018 would give an annualised return of 2.54%. The proceeds of the gold sale would be worth some AUD4.1 billion by now, meaning the decision by the RBA to sell back in 1997 has likely cost the nation back closer to AUD5.3 billion.

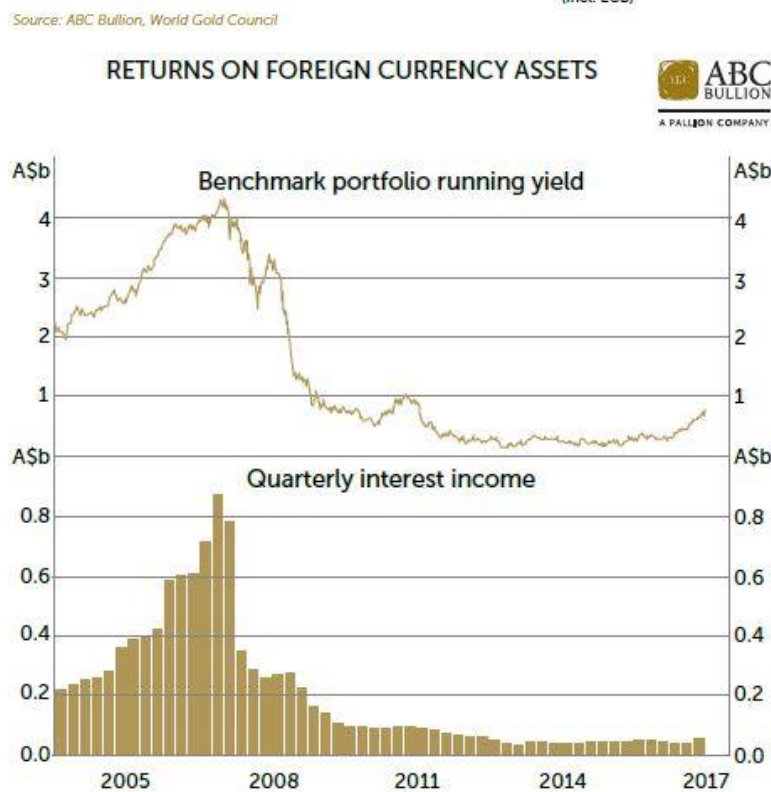
Make Australia gold again



RBA gold holdings currently make up less than 5% of our foreign reserve assets, a number that is alarmingly low compared to the holdings of other developed market nations, as the top chart shows.

There is now a lack of income being generated on our portfolio of foreign exchange assets. The latest RBA Annual Report includes the bottom chart, which highlights the fact we earn less than 1% on our assets.

Given the RBA actually earns roughly 0.20% on its gold loans (contrary to popular opinion, one can earn a yield on gold), the opportunity cost of holding gold is now far less.



A central bank (or any investor) might look to trim their gold holdings if they could earn over 4% in 'real' terms investing in low-risk, low-volatility financial assets, but we are not operating in that environment today, and likely won't be for years to come.

The deterioration in public sector balance sheets across the developed world will almost certainly result in higher inflation in the coming years, adding weight to the argument that the RBA would benefit by topping up our physical gold reserves.

Central bank gold buying is a global trend

Since the GFC, central banks have turned net buyers of physical gold. Collectively, they've purchased the better part of 3,000 tonnes of gold in the past eight years with total official gold reserves now back to where they were in 1999.

The buying has been spearheaded by emerging market nations, including China, India, Russia, Kazakhstan, and Turkey, many of which are likely to be accumulating for

some time too, as on average, they still have less than 8% of their reserves in gold, far below that of the United States and many European nations.

Since the GFC, Austria, Belgium, the Netherlands, and Germany, have all either moved, or are taking steps to move some of their gold holdings back within their own borders. Central banks are in no doubt as to the importance of holding gold, and the RBA should take note.

Time to move back to 1997

Given the paucity of yield on offer in sovereign bonds, the prospect of higher inflation and gold's unique attributes as a monetary asset, now is the time for the RBA to begin increasing our gold reserves. A 15-20% weighting would be appropriate, in line with our holdings prior to the 1997 gold sale, and roughly equivalent to the proportion of foreign reserve assets that gold constituted when the ECB was formed back in the late 1990s.

A significant portion of these reserves should be held within Australia. Australia is a politically stable, AAA-rated sovereign. There seems little point in mining and refining physical gold in Australia, only to have all of our national gold reserves held offshore.

Storing national gold reserves locally would also send a positive message to Asia, where gold is seen as money by both citizens and central banks alike. Provided it was leveraged the right way by the private sector, it could grow our banking and financial services links with the region.

Rebuilding our national physical gold reserves will better balance out the RBA's reserve assets for what may be some rough years ahead.

Jordan Eliseo is the Chief Economist for [ABC Bullion](#), Australia's largest private bullion dealer and precious metal depository. This article is in the nature of general information only and not intended as investment advice.

Robots and AI will automate workplaces at a frenzied pace

Michael Collins

Believe it or not, a [motion to the European Parliament](#) recommends that autonomous robots be deemed 'electronic persons'. The motion suggests that self-learning robots, those that make independent decisions and interact freely, be held to have an 'electronic personality'.

The proposals in the 2017 motion aren't as bizarre as it might seem because companies are already 'legal persons'. Such a status means businesses can be held responsible for damages and can insure against such costs. Giving the same status to robots before they become ubiquitous in the workplace and elsewhere would allow likewise.

Even so, about 150 experts in science, law, ethics and other fields slammed the recommendations as inappropriate, ideological and non-sensical in a [petition to the European Commission](#). A core complaint was that deeming robots as 'persons' would absolve from liability the humans behind a malfunctioning robot.

Political challenge of robots and AI

The legal status accorded to robots is one of countless political issues policymakers must resolve ahead of an expected leap in automation driven by gains in artificial intelligence and robotics. The biggest political challenge arises if the automation likely during the 'fourth industrial revolution' were to cause massive unemployment – and a huge number of jobs are thought to be at risk. A just-released [OECD study](#) says that 46% of jobs in 32 developed countries are likely to be "significantly affected" by automation over the next 20 years. Other (but not all) studies offer similar forecasts.

Economically, automation will make sense, especially in ageing societies where shrinking workforces put upward pressure on wages. [Boston Consulting Group](#), for instance, says that automation, once installed, cuts manufacturing costs by up to 20%. Robots and algorithms will thus boost productivity and in general, long-term living standards.

At a political and social level, however, the ramifications of automation could be fraught. Robots and algorithms are poised to destroy countless low- and semi-skilled jobs. While they will create jobs, these jobs are likely to be of the type (higher- and lower-paying ones) that hollow out the middle class. The social safety nets in place to limit any populist backlash against automation and society's ability to retain the displaced appear inadequate to cope with any lasting increase in unemployment and inequality. To stop political disgruntlement nullifying automation's economic benefits, policymakers will need to find better solutions than those offered so far, such as taxes on robots, jobs for all or universal basic income. It could be this era's defining political challenge.

Room for more optimism

Some caveats. A lasting rise in joblessness due to automation is just speculation. It may never happen. Warnings about automation are perennial. The mistake the pessimists usually make is to underestimate the number of jobs that advances create. Many service jobs are immune, even if robots might help these occupations.

The challenge for policymakers, though, is that the upcoming automation threatens to be unprecedented in terms of scale and speed. While the rise of robotics and artificial intelligence herald a more prosperous longer term, fewer opportunities and reduced financial security for voters could jolt politics in unpredicted ways in the nearer term.

Policymakers can see that the dangers of the 'gig' economy are likely to demand greater government intervention against market forces. They have time to find solutions.

Michael Collins is an Investment Specialist at [Magellan Asset Management](#), a sponsor of Cuffelinks. The full version of this article is [available here](#).

Trends in internet, technology and devices

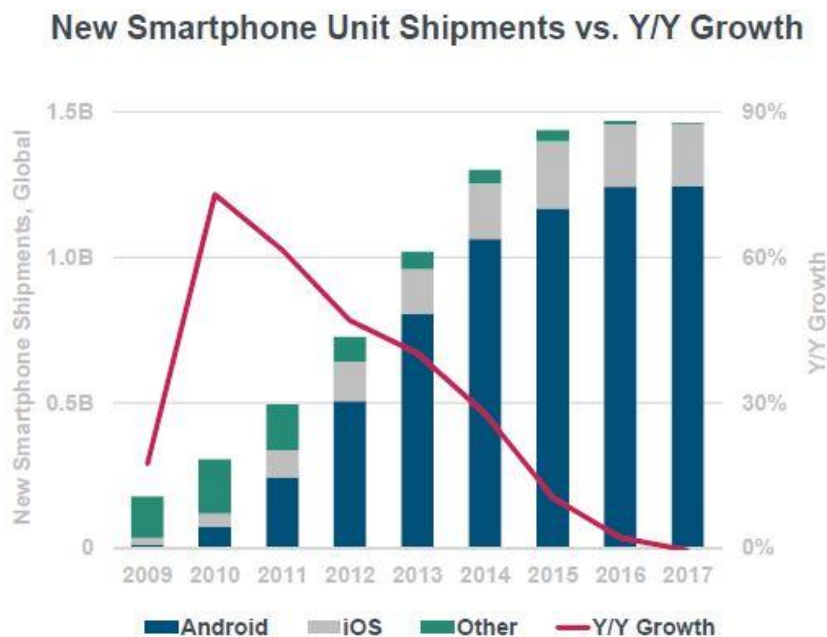
Marcus Tuck

One of the most anticipated slide decks in Silicon Valley is Mary Meeker's [Internet Trends Report](#). The Kleiner Perkins Caufield & Byers partner (and former Morgan Stanley tech analyst) has just released her 294 slides at the *Code Conference* in Rancho Palos Verdes, California.

Smartphone sales and internet usage

Here are some of the key takeaways as reported by recode.net:

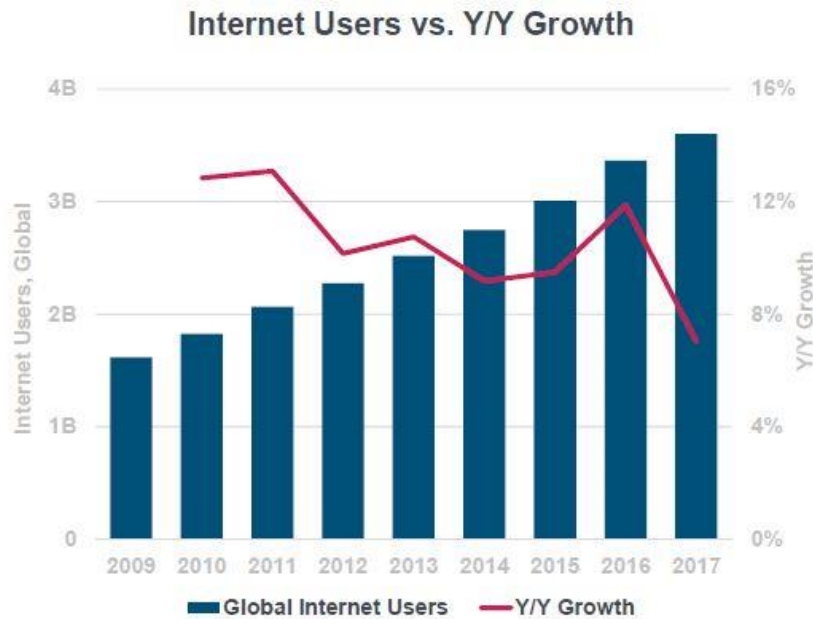
2017 was the first year in which smartphone unit shipments didn't grow at all. As more of the world become smartphone owners, growth has been harder and harder to come by (see first chart).



Source: *Internet Trends 2018* by Mary Meeker/Kleiner Perkins Caufield & Byers, IDC.

Internet user growth has also been slowing. It rose 7% in 2017, down from 12% the year before (see second chart). With more than half the world online now, there are fewer people left to connect.

However, people are still increasing the amount of time they spend online. Adult Americans spent 5.9 hours per day on digital media in 2017, up from 5.6 hours the year before. Some 3.3 of those hours were spent on a mobile device, and that is driving overall growth in digital media consumption.



Source: Mary Meeker/Kleiner Perkins Caufield & Byers, UN, US Census Bureau

Despite the high-profile releases of the US\$1,000 iPhone X and Samsung Galaxy Note phones, the global average selling price of smartphones is continuing to decline. Lower costs help drive smartphone adoption in less-developed markets.

Trends in e-commerce

Mobile payments are becoming easier to complete. China continues to lead the rest of the world in mobile payment adoption, with over 500 million active mobile payment users in 2017.

Voice-controlled products like Amazon Echo are taking off. The Echo’s installed base in the US grew from 20 million in the third quarter of 2017 to more than 30 million in the fourth quarter.

Tech companies are facing a “privacy paradox”. They’re caught between using data to provide better consumer experiences and violating consumer privacy.

Tech companies are becoming a larger part of the US economy. In April 2017, they accounted for 25% of US market capitalization. They are also responsible for a growing share of corporate R&D and capital spending.

E-commerce sales growth is continuing to accelerate. It grew 16% in the US in 2017, up from 14% in 2016. Amazon is taking a bigger share of those sales at 28% last year. Conversely, physical retail sales are continuing to decline.

Big tech is competing on more fronts. Google is expanding from an ads platform to a commerce platform via Google Home Ordering. Meanwhile, e-commerce giant Amazon is moving into advertising.

People are spending more on health care, meaning they might have to be more focused on value. Ms Meeker asks, “Will market forces finally come to health care and drive prices lower for consumers?” Expect health care companies to offer more modern retail experiences, with convenient offices, digitized transactions and on-demand pharmacy services.

The speed of technological disruption is accelerating. It took about 80 years for Americans to adopt the dishwasher. The consumer internet became commonplace in less than a decade.

Expect technology to also disrupt the way we work. Just as Americans moved from agriculture to services in the 1900s, employment type will again be in flux. This time, expect more on-demand and internet-related jobs to predominate.

Internet leaders like Google and Amazon will offer more artificial intelligence (AI) service platforms as AI becomes a bigger part of enterprise spending.

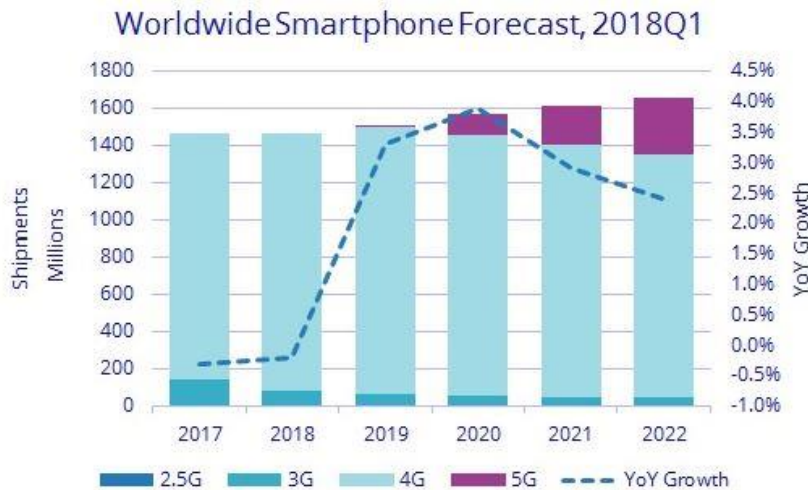
The key players – China and the US

China is catching up as a hub to the world’s biggest internet companies. Currently, China is home to 9 of the world’s 20 biggest internet companies by market cap, while the US has 11. Five years ago, China had 2 and the US had 9.

Immigration remains important for US tech companies. More than half of the most highly valued tech companies in the US are founded by first- or second-generation immigrants. For example, Uber, Tesla, WeWork and Wish all have first-generation founders.

Specific smartphone forecasts are provided by International Data Corporation (IDC), a leading global provider of market intelligence for the IT, telecommunications and consumer technology markets with over 1,100 analysts worldwide. According to new IDC data, the global smartphone market declined 0.3% last year and will contract again this year before returning to growth in 2019.

IDC expect worldwide smartphone shipments to drop 0.2% again this year to 1.5 billion units, but expect a roughly 3% annual growth from 2019 on with shipments reaching 1.7 billion in 2022, giving a 5-year CAGR of 2.5%. IDC’s forecasts can be seen in the chart and table below.



Source: IDC 2018

Platform	2018 Shipment Volume*	2018 Market Share*	2018 Year-over-Year Growth*	2022 Shipment Volume*	2022 Market Share*	2022 Year-over-Year Growth*	2017-2022 CAGR*
Android	1,240.6	84.8%	-0.5%	1,410.7	85.3%	2.4%	2.5%
iOS	221.4	15.1%	2.6%	242.5	14.7%	2.5%	2.4%
Others	0.7	0.1%	-66.8%	0.9	0.1%	5.0%	-16.3%
Total	1,462.7	100.0%	-0.2%	1,654.1	100.0%	2.4%	2.5%

Source: IDC Worldwide Quarterly Mobile Phone Tracker, May 30, 2018

* Table Note: 2018 and 2022 figures are forecast projections.

The biggest driver of the 2017 downturn was China, which saw its smartphone market decline 4.9% year-on-year. Tough times are expected to continue in 2018 as IDC forecasts consumption in China to decline another 7.1% before flattening out in 2019. The biggest upside in the Asia Pacific region continues to be India, with volumes expected to grow 14% in 2018 and 16% in 2019.

Chinese mobile phone manufacturers will continue their strategy of selling large volumes of low-end devices by shifting their focus from China to India. So far most have been able to get around India's recently introduced import tariffs by doing final device assembly at local Indian manufacturing plants. As for components, almost everything is still being sourced from China.

The other catalyst to watch will be the introduction of 5G smartphones. IDC predicts the first commercially ready 5G smartphones to appear in the second half of 2019, with a ramp up across most regions happening in 2020. It also projects 5G smartphone volumes to account for roughly 7% of all smartphones in 2020 or 212 million units in total. The share of 5G devices should grow to 18% of total volumes by 2022.

Although overall smartphone shipments will decline slightly in 2018, IDC projects the average selling price of a smartphone to reach US\$345, up 10.3% from the US\$313 average in 2017.

There is no question that Google's Android is the operating system of choice for the mass market (rather than Apple's iOS) and nothing leads IDC to believe this will change. Given the large number of Chinese phone makers dependent on Android, as well as components from other US companies such as Qualcomm, it will be interesting to see how things develop given all the discussion about a potential US-China trade war.

Marcus Tuck is Head of Equities Research at [Mason Stevens](#). This article is general information and does not consider the personal circumstances of any individual.

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