

### **This Week's Top Articles**

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### **What is Labor's franking impact outside of super and pensions?**

Jon Kalkman

*Cuffelinks received the following letter from a reader on the little-covered impact of Labor's proposed franking policy on those who do not have an SMSF and are not pensioners. Jon Kalkman responds.*

*To the Editor, Cuffelinks Newsletter.*

*Firstly I have to thank you for your informative and interesting newsletter. I do enjoy reading it.*

*There has been much discussion about Labor's plan to stop reimbursing excess franking credits to SMSF investors whose franking credits exceed their tax payable and I can understand why a political party would be upset to see some very wealthy SMSF owners with several million dollars paying no tax or little tax and receiving tens of thousands of dollars in reimbursed franking credits.*

*The Labor Party's attempt to claw back some of this money is not the proper way to do it as most commentators agree. However, there is another group of investors who do not seem to feature in the discussions I have seen so far. That is the retirees who have for whatever reason elected to remain outside of the superannuation system, invest in Australian equities and pay the required tax on their income. My wife and I are in that situation.*

*If I have interpreted Bill Shorten's proposals correctly, and I may not have, it seems to me that people in our position will be taxed on their grossed-up income that includes their franking credits but will end up paying tax on income they never receive.*

*Let me give you an example to illustrate the unfair loss someone like us would incur if your proposal goes ahead in the manner that you outlined.*

*Let us take the example, for simplicity, of a couple who have \$1,000,000 in Australian equities in joint names earning a fully franked 4% dividend from those shares. They cannot claim the aged pension because they have too many assets.*

*Their income would be \$40,000 in net dividends plus \$17,143 in franking credits – a total of \$57,143. Their individual incomes would be \$28,571 each. Their tax payable on that income would be \$4,121.70 each or \$8,243.40 for the two.*

*If they do not receive their franking credits of \$17,143 they will lose \$8,899.40 of the income they have paid tax on.*

*Has the Labor Party considered these tax payers? I wonder if they will take these people into account?*

*Regards, Dean Lines*

Here is Jon Kalkman's response:

### **The legal foundations for imputation credits**

The owner of an asset is responsible for the tax on the income produced by that asset. Thus, shareholders are responsible for the tax on the dividends they receive as income. The tax payable depends on their marginal rate. If the shareholder is a super fund the tax paid by an accumulation fund is 15%, and a super pension fund pays no tax on any income it earns. Some readers are astonished at this, but this has been the case since 1992 for all super funds paying a pension, including retail and industry funds as well as SMSFs.

A PAYG taxpayer has tax withheld at source. If she earns \$50,000 then her employer has to send \$8,500 to the ATO. Her taxable income is \$50,000 not \$41,500. She might claim she is paying tax on money she never sees but her taxable income includes the tax already paid.

The same applies to franking credits. They are not a gift from the company or the government. They are part of the taxpayer's taxable income. Any person whose taxable income is \$30,000 has an after-tax income of \$28,203. But under Labor's policy, the shareholder whose taxable income of \$30,000 happens to include \$9,000 of prepaid tax has an after-tax income \$21,000. This in the name of fairness?

### **Franking credits are prepaid taxes**

According to the Australian Tax Office (ATO) website (update 28 June 2017):

*"Dividends paid to shareholders by Australian resident companies are taxed under a system known as imputation. This is where the tax the company pays is imputed, or attributed, to the shareholders. The tax paid by the company is allocated to shareholders as franking credits attached to the dividends they receive."*

Shareholders are the owners of the company and therefore also owners of the profits, some of which are distributed as dividends. The effect of the imputation system, introduced in 1987, is to provide Australian shareholders (taxpayers) with a tax credit for tax already paid by the company on their behalf. This tax credit can then be applied to their own tax liability according to their marginal tax rate. Before 2001, if that tax credit exceeded their tax liability, the excess was retained by the ATO. That applied to all taxpayers. Since 2001, any excess tax paid has been refunded as cash to every eligible taxpayer (shareholder) without exception.

As the company tax rate is currently 30%, if the shareholder's marginal tax rate is 47%, the tax credit is insufficient to meet the tax liability and the taxpayer needs to pay the difference of 17%. If the marginal tax rate is below 30%, the excess is refunded to the shareholder as cash.

The purpose and effect of the present system of imputation credits is to ensure that shareholders pay tax on their dividends at their marginal tax rate.

### **Avoiding double taxation**

The imputation system applies to **all** Australian shareholders and taxpayers whether they are an individual, super fund, church, charity or some other legal entity. The refund of excess tax is identical to PAYG employees whose tax deductions are such that they find they have paid too much tax. What matters is the marginal tax rate, not the type of taxpayer.

Under the Labor policy, any taxpayer who presently receives a cash refund for the excess tax already paid will no longer receive it unless the shareholder meets one of the criteria of the policy exemptions: age pensioner or welfare recipient, a church, a charity or a union. In these cases, the franking credit **is** a tax credit refundable as cash, even if their marginal tax rate is below 30%. For some taxpayers, the franking credit will be as good as cash to pay their tax, for others it will be actual cash, and for many others, it won't be either.

Super funds have low marginal tax rates. An industry fund is a single taxpayer covering members in both accumulation and pension phase and it will have income from a range of assets, and will therefore have sufficient tax liability to be able to use these tax credits to set against that tax. It is possible for large SMSFs to mirror industry funds with some members in accumulation phase, because either they are not yet retired or

they are retired and have more than \$1.6 million and are forced to hold the excess in accumulation phase. They too will likely have sufficient tax liability to be able to use these tax credits.

By definition, an SMSF exclusively in pension phase, typically run by a retired couple, only has income that pays no taxes, regardless of the size of that income. Therefore, the SMSF presently receives a full cash refund from franking credits for this excess tax paid. Under Labor's policy, many SMSFs will lose a significant portion of their income, depending on their asset allocation to Australian shares. Many believe that mid-sized SMSFs are the target group of this policy.

### **The reader question: application to individual taxpayers**

Now, more directly on to the reader question.

The proposed policy applies equally to individual taxpayers, for whom marginal tax rates are progressive. Because the franking credit is attributed to the shareholder, it is money withheld by the ATO until the shareholder's tax return is completed, just like a PAYG taxpayer. As attributed income it becomes part of the shareholder's taxable income.

*Taxable income = dividends plus franking credits*

As an example, consider a couple with \$1,000,000 invested in Australian shares outside super and no other income. Assume they earn 4.2% dividends. Their dividends are \$42,000 and their franking credits are \$18,000. Their taxable income together is \$60,000, and the franking credit represents 30% of the total which is the company tax portion of the profit attributed to the shareholder. So their taxable income is \$30,000 each and they are each entitled to a franking (tax) credit of \$9,000. The tax on \$30,000 is \$1,797 after the Low Income Tax Offset but their tax credit is \$9,000 so they are each entitled to a tax refund of \$7,203 or \$14,406 together. Their after-tax income as a couple is \$56,406.

According to Chris Bowen, they do not pay any tax so they shouldn't get a refund. Under the proposed policy, this couple's after-tax income is \$42,000 from the dividends alone or a **reduction of about 25%**. They each have taxable incomes of \$30,000 but they only receive \$21,000 each after tax. For these individuals, having their tax refund of \$7,203 withheld is effectively a new tax.

If this couple were of pension age, they would not be eligible for the age pension because of the assets test. If instead, this couple had less assets, say, \$800,000, they would be eligible for a small part age pension of about \$100 per fortnight but, because they now qualify for the exemption, they also keep their franking credits. For this couple, their dividends are \$33,600 (4.2%) and their franking credits are \$14,400. Their taxable income together is \$48,000. Their taxable income is \$24,000 each and they are each entitled to a franking (tax) credit of \$7,200. The tax on \$24,000 is \$657 after the Low Income Tax Offset but their tax credit is \$7,200 so they are each entitled to a tax refund of \$6,543 or \$13,086 together. Their after-tax income is \$46,686 plus the age pension of \$2,852. They are better off for income than the couple who have \$1 million.

### **Labor's misguided imputation policy**

This policy therefore creates perverse incentives for retirees to reduce their assets to qualify for both the age pension and the franking credit cash refund.

Any individual whose marginal tax rate is below 30% will be denied the cash refund if they do not meet one of the exemption criteria. Think of the couple with a non-working spouse where the shares are placed in name of the spouse with the lower marginal tax rate or a worker on a low marginal tax rate with some Australian shares. They will lose a refund of their franking credits under this policy.

Labor's franking policy is not a return to pre-2001 conditions. Before 2001, no taxpayer received a cash refund for excess franking credits. With these proposed exemptions, it is difficult to escape the conclusion that this policy is a political exercise rather than an economic one.

*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.*

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## Profit downgrade? Blame it on the rain

Anthony Aboud

During the late 1980's, a German pop band named Milli Vanilli became an overnight sensation. Their success was driven by the release of the album *Girl You Know It's True*, which included several top-five hits and resulted in them winning the 1990 Grammy Award for Best New Artist. One of the top songs was called *Blame It On The Rain*. The lyrics for the chorus are:

*"Blame it on the rain that was falling, falling  
Blame it on the stars that shine at night  
Whatever you do  
Don't put the blame on you  
Blame it on the rain, yeah-yeah  
You can blame it on the rain."*

Source: <https://genius.com/Milli-vanilli-blame-it-on-the-rain-lyrics>

Around the time they received the Grammy, a scandal broke out that Milli Vanilli had been lip-syncing in their performances and it was not their voices on the recorded album. They ended up having to hand back the Grammy award. The band lost all credibility and thereafter, we have found it hard to believe people who blame things on the weather.

### Never thank the weather gods

Each year during April, several companies provide quarterly trading updates to the market. They are often provided in conjunction with the annual Macquarie Conference which occurs in late April/early May and provides an opportunity for investors to meet with management teams. One trend we noticed this year was the number of companies which downgraded their earnings due to the impacts of weather.

We understand that significant weather events can have an impact on the operations of a business, however, we are sceptical when management call out the weather as a core driver for operational underperformance.

Some companies which have downgraded due to unfavourable weather include Boral (ASX:BLD), JB Hi-Fi (ASX:JBH), Village Roadshow Limited (ASX:VRL), Experience Co Ltd (ASX:EXP), and Myer (ASX:MYR). Exogenous, uncontrollable shocks can directly affect the short-term earnings of some companies and hence there is a justification for this highlighting. However, we believe there is an asymmetry whereby companies will always call out uncontrollable headwinds but almost never call out when there are tailwinds to earnings outside of their control.

One such example was JB Hi-Fi. In a presentation to the Macquarie Conference, JB Hi-Fi downgraded its full year Group Net Profit After Tax (NPAT) guidance from \$235-240 million to circa \$230 million. The company commented that:

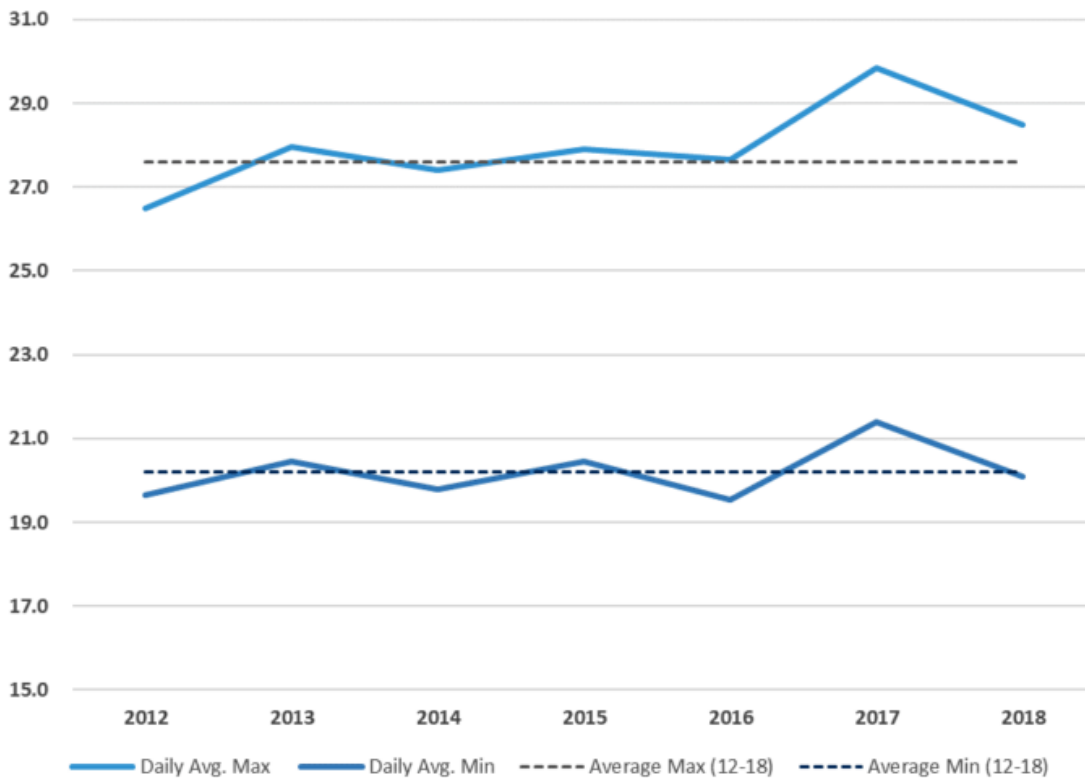
*"The Good Guys performance has been impacted by challenging conditions in the Home Appliance market, due to unfavourable weather conditions ..."*

Put simply, the company sold less air conditioners than it had budgeted in the 2018 summer because it was not as hot as the 2017 summer.

### So was 2018 too cool or 2017 too hot?

So, was it actually hotter in the 2017 summer? We looked at the average temperatures in January 2017 and January 2018. The only city where there was a material change in temperature was Sydney. In January 2018, the average daily maximum temperature fell from 29.9 to 28.5 degrees Celsius. That may not seem like much but it is enough to make a meteorologist blush.

## January Average Temperatures for Sydney



Source: Bureau of Meteorology

Therefore, if The Good Guys is represented in New South Wales (which it is), there is some justification that a material part of its downgrade was due to the cooler weather in 2018 relative to 2017. However, what we find interesting about the above chart is that 2018 was just a regression to the average temperature. It seems that rather than 2018 being colder than average, 2017 was materially hotter than average.

So, did JB Hi-Fi highlight that 2017 profit benefitted from unusually hot weather in 2017? Alas, No. In fact, when asked on a conference call, the company played down the positive impact the weather had on their sales due to the fact that they are underrepresented in NSW:

*"...the only note of caution in a sense of attributing too much to seasonal is we are underrepresented as the proportion of our portfolio in New South Wales ... so we haven't seen quite the same uplift that maybe Harvey's had."*

So, on the one hand the company called out the cooler weather in 2018 as to the reason for the downgrade when it was actually a normal summer, but on the other hand played down the positive impact of what was an abnormally hot 2017 summer. They can't have it both ways.

### Companies and fund managers both do it

We don't mean to pick on JB Hi-Fi. The downgrade was not even that big. It is just an example of something we are seeing more in company announcements. Companies are quick to blame uncontrollable headwinds for poor short-term earnings and play down uncontrollable tail winds which help performance. It could be weather, FX movement, irrational competition, or market dislocations.

Fund managers are no different. When our style is out of favour, we blame the market conditions, but when our style is in favour, we attribute all the alpha generation to our superior skills. What we are pointing out is just human nature, however it is an asymmetry across most companies we analyse in Australia.

The point of this is not to focus too much on whether or not a company makes its short-term earnings forecast. We believe that the market puts too much emphasis on next year's earnings and not enough time on understanding longer-term value drivers of a business. More important to us is the implication this sort of behaviour may have on the internal culture of a company. Just like in funds management, we believe intellectual honesty is important.

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It is hard as an outsider looking in to get a good feel for the culture of a company. We need to rely on signals. We like a culture where mistakes are owned by management and excuses are not made for poor performance. In that sort of culture, people don't make the same mistake twice and problems are fixed. Companies and employees which make excuses for not meeting goals tend not to result in great cultures.

*"Whatever you do, don't put the blame on you."*

Anthony Aboud is Portfolio Manager at [Perpetual Investments](#). This article was written for educational purposes and is not meant as a substitute for tailored financial advice.

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## Have tech investors suckled for too long?

Roger Montgomery

It's natural for any parent to want more for their children than they had themselves, but one of the great challenges of any wealthy family is to imbue their kids with a drive to achieve. This is no easy task and often requires tough love. It's precisely the opposite of what comes naturally.

### Many tech companies will never make a profit

If central banks were parents, they have failed in their parental role and succumbed to the desire to see no harm come to their children. Under their tutelage, they have mollycoddled their economies, preventing their collapse or even struggle by breastfeeding way beyond an age that is considered acceptable or appropriate.

In return, the kids have exercised their sense of entitlement and misallocated their resources, often through private equity and VC funds, fuelling a band of companies that disrupt incumbents but can only exist with their parents' ongoing generosity.

Many new age tech companies are managed and funded by millennials who have never experienced a recession. The companies exist, despite being unproductive and unprofitable, due to the financial teat being available for far too long.

### Central banks have compromised real capital

Thanks to well-intentioned central bank parents, real capitalism – that which has been responsible not only for the prosperity of the western world but also its security – no longer exists. Central bank intervention and financial repression, such as the holding down of interest rates below inflation, has represented a tax on savers and a transfer of benefits from lenders to borrowers.

As is typical of wealthy parents, western central banks feared short-term *pain* for their offspring, and by withholding challenges they have passed the baton of long-term *gain* to nations that don't prioritise human rights, meritocracy and the rule of law.

The fear of deflation (officially 'feared' as inflation below 2%) has meant that the US Federal Reserve has maintained a below-inflation interest rate setting many years after the recession of 2009 while simultaneously accumulating more than US\$4 trillion on its balance sheet. Amid a fall of the US dollar and not wanting to be outcompeted by their own surging currencies, central banks from Japan to Europe engaged in quantitative easings of their own. Both western and emerging nation children have been breastfed for way too long.

The famous investor, Stan Druckenmiller, recently observed that:

*"the most pernicious deflationary periods of the past century did not start because inflation was too close to zero. They were preceded by asset bubbles."*

Unsurprisingly, debt has soared, and the assessment of risk has been corrupted in almost all asset markets. Look no further than the oversubscription for 100-year Argentinian bonds, for a country almost guaranteed to default on its debt during the life of the bond.

In the corporate debt market, the vast majority of debt accumulated since 2010 has been used for financial engineering including share buybacks, special dividends and mergers and acquisitions. Precious little has been directed towards productive use and it is indiscernible from the wealthy teen, with little experience, being given the family fortune and asked to go start a company.

With the exception of retailing, bankruptcies have been minimal despite arguably one of the most disruptive periods the business world has ever experienced.

### **Low rate cash looking for a new home**

Private equity and venture capital funds, flush with a tidal wave of money migrating from cash deposits paying punitive interest rates, have fuelled unprofitable companies that make no money for far longer than would have occurred at any other time in history. Only if the purse remains open can many of these companies continue to disrupt incumbents who themselves are shackled by the desire to make profits.

Only when we start descending the other side of this financial volcano will we see the consequences of misallocated resources and wasteful and ill-judged investments that have occurred over the last decade. Throughout history investors have routinely backed the newest, new thing from automobiles and televisions to photocopiers and commercial air travel. But more often than not they have been burnt as input costs fall, suppliers increase and declining retail prices benefit consumers at the expense of shareholders.

The current wave of enthusiasm is built on the premise that millennials have developed, or will develop, technology and business models that disrupt the hegemony of incumbent institutions and oligopolies, whether that be centralised manufacturing (3D printers), taxi companies (Uber), hotels (Airbnb), the oil oligarchs (electric cars) or even car manufacturing itself (car sharing). A concurrent investment fad is represented by the hope that technology will also enable a cleaner and greener world.

But we have to keep in mind that these hopes are only possible because of financial repression.

### **A closer look at Tesla**

All of the above trends converge in Tesla. Perhaps more than any other company, Tesla symbolises the hopes and dreams behind the wave of exuberance fuelling the current boom in tech stocks. It is therefore the poster child of what is possible, and what is so wrong, with current monetary policy settings. Elon Musk has ridden the wave of enthusiasm surrounding new technology and business models, as well as the hopes surrounding a clean green future better than anyone else.

Tesla now sits on a market capitalisation of about US\$50 billion (and US\$10 billion of debt) despite only delivering about 100,000 vehicles last year and having frequently delayed a promised ramp up in production. Put another way, Tesla is currently worth \$500,000 per 2017 vehicle produced. By way of comparison, Ford sits on a market cap of about US\$45 billion and sold about 6.6 million vehicles in 2017. Ford is worth about \$6,800 per 2017 vehicle produced.

It cannot last. Either Tesla's car production needs to rise rapidly, or its share price must fall rapidly.

Meanwhile almost every automotive brand has announced plans to offer either an electric version of their current models or an entirely electric fleet within a few years. By way of example, Volkswagen announced at the recent Beijing Motorshow the construction of six dedicated electric vehicle manufacturing plants in China by 2022.

Elsewhere and looking completely different than any other car in its line-up, Porsche has launched a four-door, four-seat car that showcases a raft of new technology including a super-fast charging 800-volt battery system and eye-tracking driver heads-up display.

There is little question that the Tesla changed the world of electric vehicles. Before Tesla's Model S, nobody wanted to drive an electric vehicle. But the Model S is nearly seven years old and while it is still an attractive car, the subsequent Model X achieved only lukewarm sales and the Model 3 has significant quality issues. Meanwhile everyone else has caught up. That is the basic thesis for why we recently shorted Tesla in our global long/short funds.

And don't forget a conga-line of senior execs at Tesla have left and a takeover by another manufacturer is probably ruled out by the company's debt and market cap.

Of course, while funding is cheap, nobody cares about the bad news. It won't be until the teenagers acknowledge the problem that parents will be forced to deliver some tough love.

*Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](#). This article is in the nature of general information and does not consider the circumstances of any individual.*

## **EOFY and new depreciation rules for property**

Bradley Beer

In one of the most dramatic changes to property depreciation legislation in more than 15 years, Parliament passed the [Treasury Laws Amendment \(Housing Tax Integrity\) Bill 2017](#) in 2017.

The legislation means owners of 'second-hand' residential properties (where contracts were exchanged after 7:30pm AEST on 9 May 2017) will be ineligible to claim depreciation on plant and equipment assets, such as air conditioning units, solar panels or carpet. It is an integrity measure which addresses concerns that some plant and equipment assets were being depreciated by successive property investors in excess of their actual value.

### **What's unaffected by the new legislation?**

The good news is that there are still thousands of dollars to be claimed by Australian property investors, as there has been no change to capital works deductions, a claim available for the structure of a building and fixed assets such as doors, basins, windows, or retaining walls.

The capital works deduction is available on residential investment properties that commenced construction after 15 September 1987. These deductions typically make up between 85-90% of an investor's total claimable amount. This includes any capital works carried out by the current or a previous owner.

Existing depreciation legislation will be grandfathered. Investors can claim depreciation for plant and equipment assets that form part of a residential investment property purchased prior to 7:30pm on the 9 May 2017 (including contracts already entered into at that time). Investors who fall into this category can claim depreciation deductions until they either no longer own the asset, or until the asset reaches the end of its effective life.

Investors who purchase new residential properties and commercial property owners or tenants who use their property for the purposes of carrying on a business are also unaffected.

Superannuation funds that hold residential property (other than SMSFs) will not be affected, nor will public trusts and managed investment trusts or corporate tax entities.

Owners of second-hand properties who exchanged after 7:30pm on 9 May 2017 will still be able to claim depreciation for plant and equipment assets they purchase and directly incur an expense on.

### **Impact on new owners of second-hand residential property**

A property owner will not be able to claim depreciation on pre-existing plant and equipment assets within properties which have been lived in as a primary place of residence where the owner decides to rent the property out after 1 July 2017. Plant and equipment assets within this scenario are considered previously used. Any additional work to such a property completed by the current owner is classified as capital improvements and claimed as normal. This includes both capital works and plant and equipment.

If a property is considered to have been substantially renovated by the previous owner for selling purposes, then an investor can claim depreciation on the new plant and equipment assets along with any new or old qualifying capital works deductions available. If an entity has previously been entitled to any depreciation deductions for these assets, or if someone lived in the property before it was held by the current owner, then they will not be able to claim any ongoing plant and equipment depreciation on the assets. These assets will be included in a capital loss depreciation schedule for the purposes of claiming a capital loss, allowing the owner to adjust their CGT liabilities where applicable.

It's important to work with a specialist Quantity Surveyor to ensure that all deductions are identified and claimed correctly under the new legislation. For investors who are planning on selling a property affected by the new rules, a depreciation schedule can be provided to assist them and their accountant to perform a calculation adjustment for CGT liabilities.

More about the new depreciation legislation and how this applies to a range of property investment scenarios, is available in this document: [Essential facts: 2017 Budget changes and property depreciation.](#)

*Bradley Beer is the Chief Executive Officer of [BMT Tax Depreciation](#). This article is general information and does not consider the circumstances of any investor.*

## Investors can't afford to ignore the blockchain revolution

Don Tapscott

Blockchain has the power to change the nature of corporations. It is critical that every investor understands this new technology and its implications. For the first time in history, assets can be transferred peer-to-peer without an intermediary, using an internet of value.

### The potential of the second era of the internet

The second era of the digital revolution is here, and it has the potential to change everything about the way we interact around the world. The technology behind this new revolution is called 'blockchain' – the underlying technology behind cryptocurrencies like bitcoin and ether. Using cryptography, some clever code and collaboration, blockchain creates a decentralised network with trust built into the system.

### The 'double-spend' problem

For the past few decades the digital revolution has been defined by the 'internet of information', which has democratised the way we communicate around the world. It enables low-cost, massive peer-to-peer communication where everyone is an active participant. However, when I send an email on that internet of information, I am in fact sending 'a copy' of that email. That system works well for information, but not for things with some sort of underlying value, which depends on scarcity. Things like money, stocks, bonds, votes, carbon credits, data, intellectual property and art cannot be reproduced infinitely if we hope to maintain their value. If someone can infinitely copy the \$100 they just sent somewhere, that \$100 suddenly has no value. This is called the 'double-spend' problem.

Usually, when we want to exchange things of value online, we depend on an intermediary to establish trust – intermediaries like banks, governments, or social media companies. These intermediaries are able to ensure that when someone transfers \$100, they don't still have that \$100 in their bank account. This has worked, but it has some major problems. It's a centralised system, putting far too much power and personal data in the hands of a few. It can also be hacked, and increasingly it is. All of the computer systems in all of our financial institutions can be hacked. Most importantly, it distributes the wealth created by the digital revolution of the past 20 years asymmetrically, leaving far too many people behind.



### The solution

Blockchain presents a solution. It's a vast, distributed ledger with thousands of computers working to verify transactions. As a decentralised system, it can't be hacked, and it enables you to bypass the complex network of intermediaries currently needed to verify transactions. For the first time in history people can trust each other without an intermediary. Blockchain allows people to manage, use, and interact with assets peer-to-peer. This new internet of value will be owned by investors, so rather than a bubble there is a case to be made that this is the biggest investment opportunity in history.

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## What is blockchain and how does it work?

Blockchain is an incorruptible digital ledger of economic transactions that can be programmed to record not just financial transactions but virtually everything of value. Each unit of value is represented by transactions recorded in a blockchain, which leverages the resources of a large peer-to-peer network to verify and approve each transaction. The main differentiating features of blockchain relative to traditional ledgers of transactions are:

- **Decentralised:** it runs on computers provided by volunteers around the world with no central database to hack.
- **Public:** anyone can view it at any time because it resides on the network, not within a single institution charged with auditing transactions and keeping records.
- **Encrypted:** it uses heavy-duty encryption involving public and private keys (rather like the two-key system to access a safety deposit box) to maintain virtual security.

Broadly, the steps in any blockchain process are:

1. Any transfer request is broadcast out to a global network of millions of computers each using the highest level of security.
2. At regular intervals, the programme creates a block that contains all of the transactions in that period. In the case of bitcoin, it is every 10 minutes.
3. All around the world there are a group of people called 'miners' who compete to validate the transactions in the block. The first miner to validate the block gets paid part of the crypto currency from that blockchain.
4. Importantly, that block gets connected to the previous block to create a chain of blocks and it is sealed with a digital wax seal. The structure permanently time-stamps and stores exchanges of value. If the block can't be validated it will not be connected and is referred to as an 'orphan block'.
5. Records cannot be altered retroactively without the alteration of all subsequent blocks and the collusion of the network. Therefore, to hack a new validated block you would need to hack the entire chain simultaneously, not just on one computer but across millions of computers with each of the computers using the highest level of cryptography.

## What is the potential impact?

With blockchain, trust is built into the network, which is why in our book *Blockchain Revolution*, Alex Tapscott and I refer to it as the 'trust protocol'. This trust protocol has enormous implications and opportunities for business. Here are three real-world examples:

### *Global payment systems*

The global payment system, for instance, can finally be brought into the 21st century. Right now, it can take days or even weeks to bypass the complex, inefficient network of intermediaries set up to move money from one party to another internationally. These intermediaries also take a significant cut, which is especially harmful for remittances. When looking at the process of immigrants sending money back to their country of birth, the implications of reduced transaction costs would mean more money in the hands of local people and improved local economies in emerging markets.

### *Verifying land titles*

Blockchain has the potential to ensure the largesse of the digital age is distributed more equitably. The famous Peruvian economist Hernando de Soto pointed to land titles as one of the key points of failure for economic development in the Global South. There is as much as \$9 trillion in capital yet to be used because of tenuous land titles, meaning that the people who own those farms, businesses, or homes can't borrow against them to improve their lives.

As an immutable public ledger with a single version of the truth, blockchain enables us to establish a secure link between an individual and their land. This increased governance, and therefore security, may also have a significant impact on the appetite for foreign investors to invest in emerging markets.

### Data protection

Blockchain also has the capacity to assure that citizens are able to exercise more sovereignty over their data. A person's digital identity – currently controlled by large digital conglomerates who amalgamate and sell that data – could be stored in a digital 'black box,' secured on a blockchain.

### The investor perspective

These are just a few of the potential opportunities for blockchain, and there are already companies working to capture these opportunities today. The most successful companies in this second era of the digital age will be those that have the willingness and ability to harness the power of blockchain, directly or indirectly. The most successful investors will be those that can identify the impact of blockchain on their investee companies.

*Don Tapscott, CEO of The Tapscott Group, is one of the world's leading authorities on the impact of technology on business and society. He has authored over 15 books. This document was commissioned by [Insight Investment](#) and is not investment advice.*

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## Retail yield enhancement via wholesale funds

Matthew Lemke

Cash returns from 'traditional' cash investments such as cash management trusts and term deposits are extremely low with little prospect of climbing higher soon. Investors are reluctantly leaving funds in equities or property markets, but alternatives exist in the professional or 'wholesale' securities market where investors can improve their returns.

### The wholesale debt market alternative

The wholesale market gives investors access to a multitude of securities, allowing tailoring of portfolios to enhance cash returns. However, investors must satisfy a minimum \$2.5 million net asset test and/or minimum \$250,000 annual income test, and there is a minimum transaction size of \$500,000. This high barrier for retail investors can be overcome by accessing this market via 'cash funds' and 'cash enhanced funds' which have a much lower minimum investment and often also offer quick redemptions.

It is important that investors review how each fund operates and what each fund means by 'cash' as this can vary widely. Investors should pay attention to the liquidity and credit characteristics of the fund's portfolio as poor liquidity or creditworthiness can compromise redemption requests. Some cash funds offer franking credits which may further enhance returns.

The wholesale market, at approximately \$2 trillion, is larger than the market capitalisation of the ASX (\$1.6 trillion) and has existed for decades. It is where most bonds and capital instruments are issued (primary market) and bought and sold (secondary market).

The table below outlines securities available in the wholesale market:

Securities	Issuers	Investors
<p><b>Short term:</b> Certificates of Deposit, Bank bills, Treasury bills</p> <p><b>Medium/long term (max. 30 years):</b> Bonds and floating rate notes, subordinated/ mezzanine bonds, hybrids, asset-backed securities, Social impact bonds, indexed annuity bonds</p>	<p>Australian and state government borrowing authorities, offshore government entities, private and publicly-listed companies, supra-national and major international agencies, local and offshore banks, insurance companies, other financial institutions, finance companies</p>	<p>Banks, insurance companies, other financial institutions, councils, some large not-for-profit organisations, asset managers, funds, super funds, central banks and governments, private individuals, SMSFs, and family trusts</p>

Securities are typically rated by Standard & Poor's, although unrated bonds are increasing.

## A comparison with bank retail products

The table below shows the returns offered on securities issued by a major bank in the wholesale market against the traditional term deposits offered by the same bank on the same day.

Maturity	Term Deposits	Wholesale Market (NCDs, Bank Bills and Bonds)
1 month	1.50%	1.97%
3 months	2.00%	2.07%
3 years	2.70%	2.90%
4 years	2.75%	3.10%
5 years	2.80%	3.28%

Sources: Bank website, Thomson Reuters, Broker rate sheets, Prime Value sources as at 5 June 2018

The predominant risk on wholesale securities is 'counterparty' risk, meaning the risk the issuer will not meet its obligations to pay coupons and then principal at maturity. The holder of a term deposit also has this risk, however, the Australian Government guarantees deposit accounts up to \$250,000 per entity (or individual) per ADI (bank). An investor can place multiple such deposits with different ADIs. Hence, a strict comparison of rates between deposit accounts may require an adjustment for the guarantee, given the Australian Government's credit rating (AAA/Aaa) is higher than any bank (the major four banks have a rating of AA-/Aa3).

Wholesale securities are traded instruments hence their price varies with interest rates and credit risk although eventually converging to par at maturity. With term deposits, being non-traded, their redemption value does not vary directly with the market but if the money is required before maturity, the redemption proceeds will depend on the bank's policy. Generally, there will be penalties for early withdrawal possibly including the foregoing of interest, and redemption proceeds may vary with how rates have moved since the deposit commenced.

## Enhanced cash yields

There are several ways cash yields can be enhanced in the wholesale market:

1. Security selection: investors can add 0.10%-0.40% to NCD rates via Floating Rate Notes (FRNs) or bonds that may be coming into maturity.
2. Credit risk: 0.10%-0.30% can be added by investing in the NCDs of a non-major bank or ADI.
3. Tenor: Extending maturity will add yield, but instruments beyond a 12-month tenor are not considered 'cash products'.

Other strategies to enhance cash yield and reduce portfolio risk are listed below, but they each involve additional risk:

Strategy	Example	Comment
Diversification	Buying several securities across tenors, issuers, security and sector types	Diversification is proven to achieve a better return from the same risk
Arbitrage	Buying a security which has a yield well over comparable securities	Arbitrage opportunities do not tend to last
'Overlay' strategies	Buying offshore securities and hedging back to AUD	Can add significant complexity, but can also open up yield-enhancing opportunities
Interest rate options	Selling an interest rate option to enhance portfolio yield through the premium received	Option strategies require expertise and must be consistent with the investment mandate
'Directional' risk on base rates	Adding duration through physical bonds or using receive-fixed swaps to benefit from an expected yield decline	Must be consistent with the investment mandate
'Directional' risk on the credit curve	Buying an issuer's securities to benefit from an expected rating upgrade	This strategy requires research and market experience

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## Investor decisions

Security selection must take into account many factors, such as:

1. Credit risk
2. Term
3. Ranking (senior unsecured, senior secured, subordinated, etc.)
4. Issuer type (local, offshore, company, government entity, etc.)
5. Security type (bond, certificate of deposit, bank bill, hybrid, etc.)
6. Fixed or floating rate
7. Franking credits
8. Liquidity risk (can the security be readily sold and what bid/offer spreads apply)
9. Inflation protection

Investors must also choose between trying for a 'real' (inflation protected) return or a 'nominal' return. Investors can map their 'risk/return paradigm', i.e. how much return above the 'risk-free' return is desired and what risks the investor is willing to bear to achieve this return. They must consider risk/return 'tradeoffs', such as:

1. earning a higher return for taking term (maturity) risk
2. earning a higher return for holding subordinated risk
3. earning a lower return as the cash is needed in the near future
4. earning a higher return even though liquidity in the security is poor.

Finally, the investor must set out any other strategies they are prepared to employ to add yield, such as using options. The kaleidoscope of securities available in the wholesale market allows investors to tailor their portfolio to their desired risk/return paradigm. Bank deposits are limited in this regard.

### Hybrids and franking

Franking benefits can significantly enhance cash yields but can only be accessed on dividend-paying securities, such as shares or hybrids, which are riskier and rank lower in the capital structure of the issuer. Shares and hybrids are not 'cash products', they are 'yield products'.

### Retail investors using managed funds

Retail investors will struggle to access these opportunities directly as they are often available only to large institutions and funds, but the benefits can be accessed through a range of managed funds in various structures available to most investors.

*Matthew Lemke is the Fund Manager of the Prime Value Cash Plus Fund, an enhanced cash fund which was established in 2014. See [www.primevalue.com.au](http://www.primevalue.com.au). This article is meant for educational purposes and is not a substitute for tailored financial advice.*

## The Chinese consumer and rising political risks

### Michael Collins

Where does the US café chain Starbucks have the largest of its 28,200 company-owned and licensed outlets that are found in 76 countries? In Shanghai, China.

On 6 December 2017, as a long line of Chinese waited to be let in, Starbucks opened a 2,800-square-metre roastery in the coastal city's retail hub that people describe as about half a football field in area. Opening the outlet proved a bonanza because the Shanghai Roastery became Starbucks's biggest revenue earner on day one. "We shattered every sales record in the history of the company," said Starbucks chairman Howard Schultz. Such a result explains the Starbucks ambition to nearly double the number of outlets in China from 3,200 now to 6,000 by 2022, which would entail opening more than a store a day.

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## Risks and opportunities for multinationals in China

Starbucks' plans for China mimic the strategy of countless other multinationals since China modernised its economy from the late 1970s – namely, to seek a slice of the 1.4 billion strong consumer market that is growing in wealth every year. The World Economic Forum this year forecast Chinese consumption to grow 6% p.a. from 2016 to 2027, to nearly double in size to US\$8.2 trillion.

China's consumer market is expanding for two reasons. The first is that China's economy is poised to grow at a 6% to 7% pace in coming years and will be, after India, the world's fastest-growing major economy. The other reason is that Beijing is trying to change China's economic model to one driven more by consumption. The results point to a surge in consumer spending power in coming years.

### China's strength comes with global political implications

China's emergence as the world's number two economy carries political implications that complicate the ambitions of foreign companies, especially retailers. China's increased economic might is making the country more assertive in global politics at a time when other countries are fighting back against the loss of their global influence (in what is a zero-sum situation), especially against China's 'unfair' trading practices.

Foreign businesses in China risk being stigmatised, if not targeted, amid such disputes. One of Beijing's options is to stoke boycotts against products from a country, a frequent Chinese response to international tensions and one that predates the Communist takeover in 1949.

Boycotts are effective in China because once a country's products are stigmatised, enduring damage is usually done to sales. Last year Beijing initiated a boycott of South Korean products after the country installed a US missile-defence system to protect itself against North Korea. The extent of product targeting included:

- Boycott of Hyundai and Kia cars
- Blocked streaming of Korean TV shows and K-pop music videos
- Near-halt of Chinese tourists to South Korea
- Forced closure of over 80 Lotte stores in China because the South Korean company handed over land for the missile shield.

The boycotts are estimated to have shaved 0.4% off South Korea's economic growth in 2017. Foreign companies seeking to profit from China's growing consumption must recognise that political events might harm their investments.

Political considerations have long governed foreign investment in China. Chinese consumers value global, and especially US, brands, which gives these goods some protection from Beijing-inspired boycotts. Perhaps China and other countries including the US will resolve their differences, which some days looks likelier than others. But heightened nationalism among Chinese, Beijing's growing confidence in international affairs, and a backlash against China's emergence as a world power, especially in the US, are global political shifts that are likely to endure. Foreign investors must allow for political risks.

### The secret behind the export miracle

In 2007, China's then Prime Minister Wen Jiabao said the country's export- and investment-led economic model was causing "unsteady, unbalanced, uncoordinated, and unsustainable" development. Beijing's response was to shift more to personal consumption, but this new model came with challenges. The under-pricing of land and money (in the form of the exchange rate and interest rates) and cheap, labour-favoured investment over consumption had resulted in China spending about 50% of its GDP on new capital stock. At the same time, personal consumption only stood at about 35% of GDP compared with 50% to about 66% of output for most advanced economies. A cheap yuan made imports expensive for consumers while it helped exporters. Low interest rates cheated household savers of income while governments and enterprises enjoyed subsidised loans. Land grabbed for factories left peasant farmers impoverished while suppressing production costs. Low wages gave people less money to spend while they reduced manufacturing costs. The result was a massive trade surplus, especially with the US.

## China-US goods trade relationship since 1981



Source: Thomson Reuters Datastream/Financial Times

### A paradigm shift by boosting wages

Untangling the under-pricing of land and money while boosting wages was a risky step for Beijing because it heightened the risk of an economic slump. Policymakers needed to set GDP growth at a slower pace than consumption growth to enable consumer spending to become a bigger part of output. By allowing the yuan to move closer to its market value, liberalising many interest rates, boosting wages and compensating farmers for lost land and livelihood, Beijing has met this challenge.

Household spending has now become a bigger driver of the economy while growth has been maintained at about 7% p.a., even if policymakers relied on an increase in debt the equivalent of China's GDP to achieve this feat.

The World Bank readings of China's economy show household consumption has risen to 39% of GDP in 2016 from a record low of 35.8% in 2007. Perhaps a better way to highlight consumption's growing importance is that since the start of 2016, household spending, on average, has propelled 65% of China's growth each quarter.

### What may the future hold?

For China, boycotts hold advantages over the other options. They are easy to orchestrate via social media while Beijing can hide its meddling. Boycotts appeal to the growing nationalism among Chinese that Beijing is stoking. Victim companies can only respond by applying political pressure at home to resolve whatever issue is angering China.

But boycotts carry risks for Beijing too. The first is that other countries retaliate like they would with tariffs. Another is that foreign companies might freeze expansion plans and shut off a source of innovation for China. Hundreds of thousands of Chinese are estimated to work for the companies of any one foreign country and they might resent any loss of income. Far more numerous (and so a bigger political concern) are Chinese consumers who respect foreign brands. Chinese shoppers might resent being told to avoid foreign brands and could ignore government sanctions against Nike runners and Apple iPhones.

The full version of this article is [available here](#).

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