

This Week's Top Articles

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Not too big, not too small: the advantages of mid-caps

Dawn Kanelleas

The mid-caps space on the ASX is characterised by successful companies with strong growth profiles, which can offer attractive diversification benefits for Australian equity portfolios. In this article, we highlight some of the favourable characteristics of this often-overlooked segment of the market.

What are mid-caps?

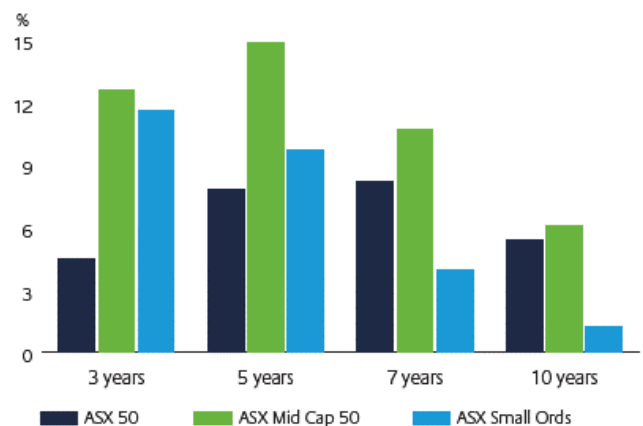
'Mid-caps' generally refers to Australia's 51 to 100 largest companies and are represented in the S&P/ASX Mid Cap 50 Index. Companies that sit in this band have outperformed the S&P/ASX50 Index and S&P/ASX Small Ordinaries Index over three, five, seven and ten years.

Despite this consistent outperformance, mid-caps usually comprise only a small proportion of broad-based portfolios which invest in the S&P/ASX300, and are omitted altogether in small cap portfolios which are limited to the S&P/ASX Small Ordinaries Index (ex S&P/ASX100).

Mid-cap stocks generally trade on a higher price to earnings (PE) ratio to the broader S&P/ASX300, to account for the strong growth phase of many companies in this space. This PE 'growth premium' has remained reasonably consistent over the past 10 years, moving from a 16% premium in June 2008 to an 18% premium in June 2018, despite the sector's outperformance compared to large and small caps during the same period (Source: S&P and Factset).

This is owing to the fact that the expected earnings growth has largely kept pace with the price growth over the last decade.

Chart 1: Annualised performance of large, mid and small cap indices



Source: Bloomberg. Data to 31 May 2018. Returns are annualised. Past performance is not an indicator of future performance.

Due to the concentrated nature of the Australian share market, roughly 70% of an S&P/ASX300 portfolio – and fund manager’s attention – is invested in Australia’s top 50 companies. The remaining market capitalisation of the S&P/ASX300 is split roughly evenly between mid-caps (15%) and small caps (15%), as shown below.

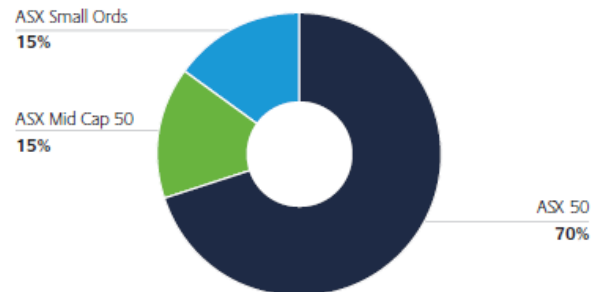
Such a relatively small exposure means that investors may be missing out on a rich seam of successful, growing companies which characterise the mid-cap space.

Strong alignment with management

The senior management teams of mid-cap companies have often been with the company for many years. In some cases, the CEO is the original founder of the company, for example David Teoh of TPG Telecom, Andrew Bassat of Seek, Don Meij of Domino’s Pizza Enterprises, and Gerry Harvey of Harvey Norman.

The management team often has significant equity in the business, usually as a result of participating in the initial public offering or sharing in the company’s success. For example, the original three founders of Flight Centre still hold 40% of the public company’s stock and one of the founders, Graham Turner, is the CEO. This equity in the business, combined with long service, aligns management’s interests with other shareholders. It also encourages a prudent approach to investment decisions and risk management.

Chart 2: Composition of Australia's largest 300 companies by large, mid and small cap indices



Source: Factset at 31 May 2018.

Table 1: CEO tenure and insider share holdings - mid and large cap indices

	% CEOs with 5+ years' service	% Shares held by CEO	% Shares held by insiders
S&P/ASX 50 Mid Cap Index average	46	1.71	2.77
S&P/ASX 50 Index average	32	0.06	1.27

Source: Bloomberg at 31 May 2018.

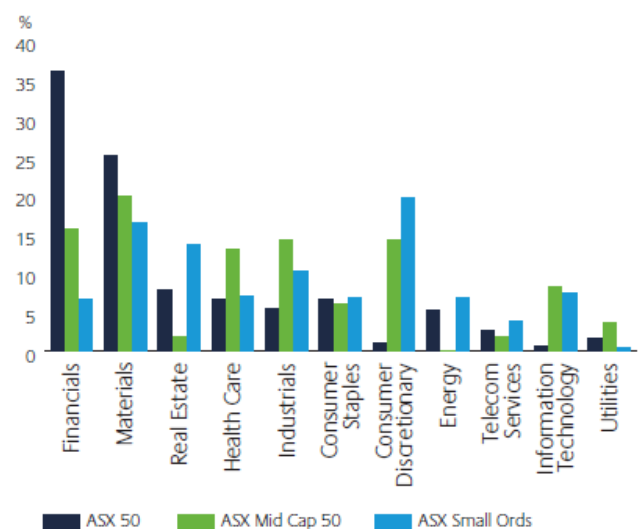
Sector distribution

The mid-cap universe offers sector diversification to investors. Most apparent is the reduced exposure to the Financials and Materials sectors, which together comprise more than 60% of the S&P/ASX300, yet only 36% of the mid-cap universe. Mid-caps also provide relatively more exposure than either small or large caps to Health Care, Industrials, Information Technology, and Utilities.

Company size by market capitalisation is also more evenly spread across companies. The top 10 stocks by size, for example, comprise 40% of the S&P/ASX Mid-Cap 50 Index. By comparison, the largest 10 stocks account for 60% of the S&P/ASX50 Index.

Because mid-cap sector exposure is more evenly distributed across market sectors, it is less susceptible to movements due to macro themes, such as weakening commodity prices. This particularly suits bottom-up stock pickers, as good companies are

Chart 3: Sector distribution – large, mid cap and small cap indices



Source: Factset at 31 May 2018.

rewarded on their merit, rather than the prevailing market sentiment.

A hive of activity

The mid-caps space is rich with corporate activity, which can provide investors with additional opportunities. Mid-cap companies are typically in a growth phase, funded by reinvesting their excess cash or through acquisitions. Given their larger size and generally stronger balance sheets than small companies, mid-caps have ready access to debt markets and funding which they can use to grow their business and expand into new markets. Recent acquisitions in the mid-caps space include Magellan's purchase of Airlie Funds Management, Carsales' purchase of South Korean company SK Encar, and Flight Centre's purchase of Executive Travel Group.

Given their existing profitability and potential for growth, mid-cap companies are also often the subject of takeover offers from large companies or private equity, which typically results in strong share price appreciation.

Mid-cap companies are commonly well positioned for further growth. They typically have strong management teams, a successful business strategy, strong cash flow, a competitive advantage, access to debt markets and, perhaps most importantly, the hunger and capacity to grow.

A natural extension of small caps

Around two-thirds of companies in today's S&P/ASX Mid-Cap 50 Index have graduated from the S&P/ASX Small Ordinaries index within the past seven years. This means an established small cap manager would typically have already researched or owned around 33 out of 50 mid-cap stocks. This makes small cap managers ideally placed to manage a mid-cap portfolio.

Traditional small cap managers necessarily have a deep understanding of companies in their universe, given the heightened risk and volatility of fledgling companies. Experienced managers are likely to personally know senior management, often from the time of listing. They will have a deep understanding of the business and the journey it's taken. They may have participated in capital management initiatives, been a cornerstone investor, or helped to guide the business strategy.

This in-depth company knowledge gives small cap managers an information edge in the mid-cap universe and allows them to drive significant alpha, especially as mid-cap companies are generally less well researched and understood by the sell-side and buy-side. This lack of information, or an inconsistent interpretation of information among investors, can create mispriced investment opportunities that can be identified and exploited by professional mid-cap investment managers.

Managers with the resources to complete independent and thorough analysis of small and medium sized companies are able to generate favourable long-term returns for investors. The bottom-up stock selection process of small caps is also ideally suited to mid-cap portfolio construction, although many small cap managers lack the scale, resources and infrastructure to successfully also operate a mid-cap fund.

Dawn Kanelleas is Senior Portfolio Manager, Australian Equities Small Companies, at [Colonial First State Global Asset Management](#), a sponsor of Cuffelinks. For more articles and papers from CFSGAM, please [click here](#). This article is for educational purposes and is not a substitute for tailored financial advice.

The importance of corporate culture in investing

Ben Rundle

Environmental, Social and Governance (ESG) investing has been in a structural growth phase for some years now. A [report](#) by the Responsible Investment Association Australasia (RIAA) notes that 81% of the largest super funds have now embedded a formal commitment to responsible investment, up from 70% in 2016. [Additional research](#) conducted by the RIAA found that funds which are implementing core responsible investment strategies are outperforming equivalent Australian and international share funds and multi-sector growth funds over most time horizons.

The corporate culture advantage

Core to ESG is governance. Corporate governance upheld by a robust company culture can help organisations thrive and can become a powerful differentiator. We recently wrote about how focussed on culture the [CEOs at Berkshire Hathaway](#) are. The more we look, the more we see companies taking market share and outpacing their competition by placing focus here. A great culture may contribute to outperformance or a generation of long-term shareholder value via attracting and retaining the best staff or improving brand and reputation, whereas poor culture can be costly to a business.

Corporate culture is clearly taken seriously by the world's leading businesses. A 2018 study published in the Harvard Business Review '[The Leader's Guide to Corporate Culture](#)' references several high-profile CEOs and their approach to culture, two of our favourite quotes being:

"Most of the greatest companies in the world also have great purposes ... Having a deeper, more transcendent purpose is highly energizing for all of the various interdependent stakeholders."—John Mackey, founder and CEO, Whole Foods

"It is incredibly important to be open and accessible and treat people fairly and look them in the eye and tell them what is on your mind."—Bob Iger, CEO Disney

In [a recent interview](#), one of the most successful traders in the world, Paul Tudor-Jones, made the following comments on company culture:

"If you have a motivated workforce that you pay and treat well, you produce a high quality and low-cost product that has some benefit, and you treat your customers throughout with respect, this is a winning formula and these companies are outperforming those that don't. It's a win-win, go look at the companies that are doing it, they're outperforming everyone else."

The drivers of socially responsible investing

Mr Jones has gone a step further in redefining the definition of socially responsible investing, believing that capitalism may need modernising. He polled the American public on their definition of 'just' behaviour. The poll took 200 socially responsible metrics and combined them into 39, and then aggregated those into seven drivers. Those seven drivers in order of importance are:

1. How do you pay and treat workers?
2. How do you treat your customers, do you respect them individually, their privacy?
3. Do you make high quality, low cost, socially beneficial products?
4. Environment sustainability
5. Community awareness
6. Domestic job creation
7. Do you serve your shareholders?

Using these seven socially responsible metrics, Mr Jones then created an index based on the 1,000 largest US companies and applied these criteria. Assessing the companies which performed best or in the top half of each sector, he found the following from this group:

- These companies on average created 20% more jobs
- These companies pay over 70% less in fines
- They donate 2.4 times more to the local community and charities
- And arguably the most important point for investors, these companies had on average 7% higher return on equity (ROE) than the companies in the bottom half of each sector.

Mr Jones presents a strong case for including these questions as part of the investment process or when including a new position in a portfolio.

We agree, and given the significant potential benefit to long-term shareholder returns, these considerations should be of growing importance for all investors.

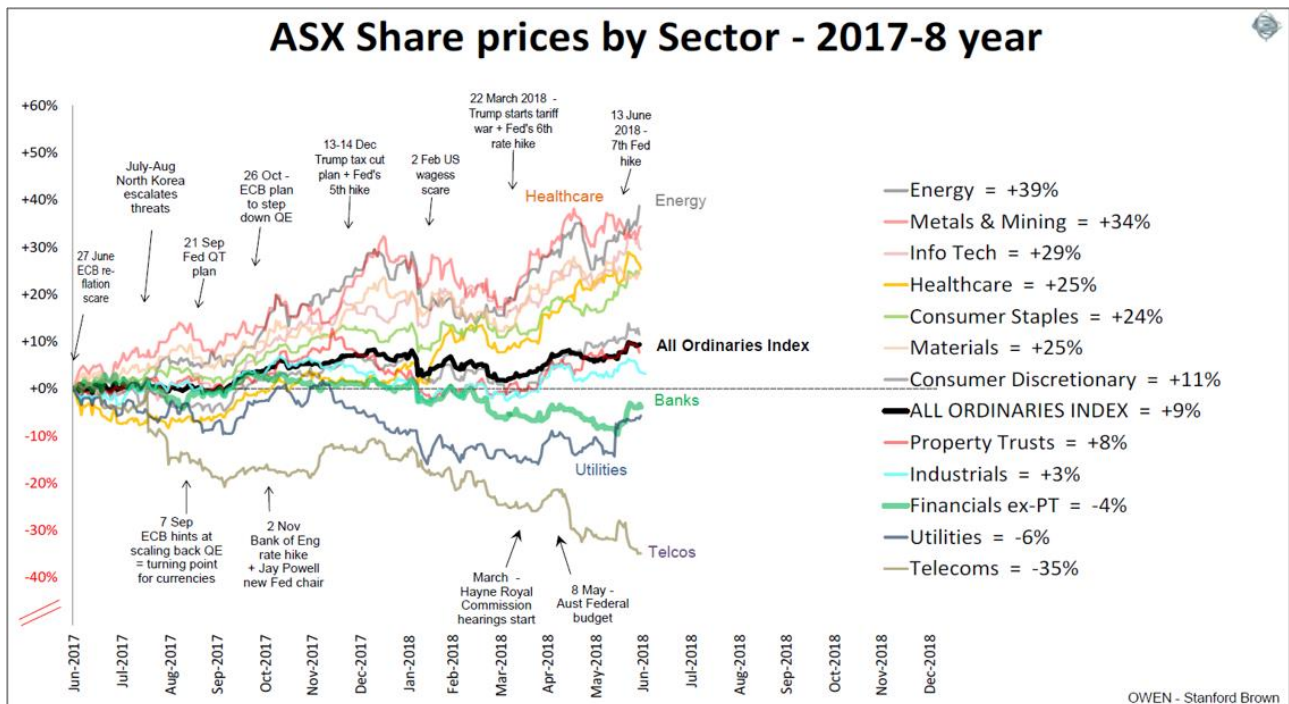
Ben Rundle is a Portfolio Manager at [NAOS Asset Management](#). This material is provided for general information purposes only and must not be construed as investment advice. It does not take into account the investment objectives, financial situation or needs of any particular investor. Before making an investment decision, investors should consider obtaining professional investment advice that is tailored to their specific circumstances.

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Winners and losers in sharemarkets, 2017/18

Ashley Owen

The broad Australian share market posted total returns (including dividends) of 14% for the 2017-2018 year. This was the sixth straight financial year of positive total returns (although the 2015-2016 year was line ball following the commodities price collapse). Here is a chart of the main sector price indexes over past 12 months.



Winners and losers by sector

The sectors that dragged down returns were the banks, telecommunications and utilities. They account for nearly half of the total market value. The main culprits were the banks ('Financials ex-property trust' sector above). All of the big dinosaur banks were down heavily with CBA the worst, down 12%. Macquarie, which is more of an asset manager than a bank, is the only local 'bank' with any global or even regional potential and was up a strong 40%. AMP was down another 30% for the year and is now more than 80% below its listing price 19 years ago.

Telstra fell another 39% over the year as it cut dividends and faces more cuts in coming years. Its share price is now 70% below its dot-com peak 19 years ago. Both AMP and Telstra were sleepy old institutions prior to their stock market listings but both were crippled by disastrous spending sprees undertaken by their imported American CEOs in their early years as listed companies. They have both been plagued by poor management distracted by cleaning up the messes of the past. Unfortunately, hundreds of thousands of retail investors were caught up in the hype drummed up for their listings in the late 1990s boom and many are still clinging grimly to their shares today.

Most other sectors of the market had a great year. Resources were the best, benefiting from rising commodities prices and finally a weaker Australian dollar. Miners were up strongly virtually across the board, led by BHP and RIO (up 45% and 32% respectively). Fortescue was the only major exception. In the Energy sector, all of the major oil, gas and coal stocks were up strongly on higher oil prices.

The Tech sector also rode the global tech boom. Computershare was up 30%, Carsales and REA both up 30+%. Healthcare stocks were aided by global healthcare strength, with CSL, Cochlear, Fisher & Paykel Health and especially Sirtex up strongly.

Although the overall Australian share market is not overpriced on a variety of valuation measures, our outlook for returns is rather subdued. The banks are facing a housing and construction slowdown, rising compliance costs, and management severely distracted by the fallout from the Financial Services Royal Commission. Falling housing prices, credit restrictions and rising mortgage interest rates risk hurting local demand for products and services, while exporters face lower global demand if the trade war escalates

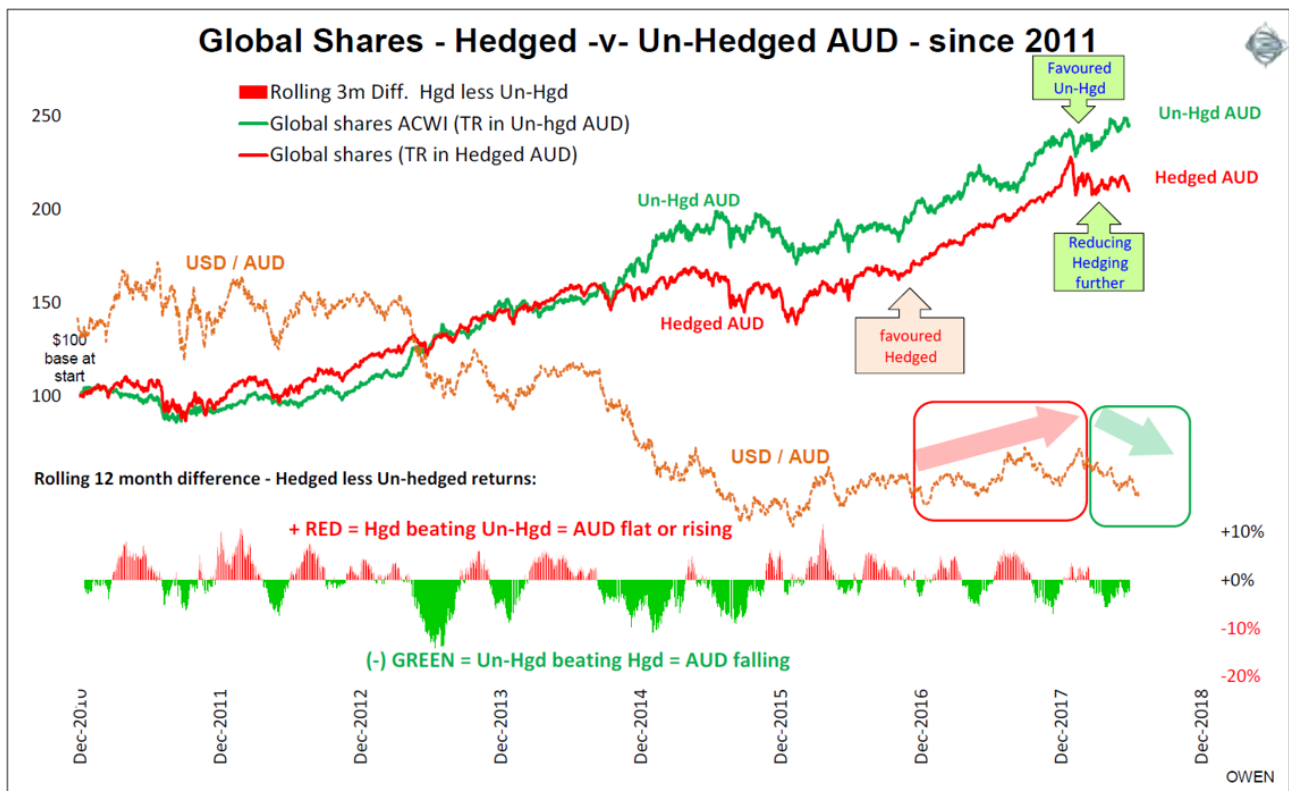
Impact of a falling Aussie dollar on global equities

One of the big impacts on investment portfolios this year has been the Australian dollar, and how much of the currency risk in international share holdings was 'hedged' or 'unhedged'.

Some global share funds have the currency risk 'hedged' (like the Exchange Traded Fund 'VGAD' and the Magellan Infrastructure Fund) while others leave the currency risk 'unhedged' (like the ETF 'VGS' and the MFS Global Fund). The decision on how much hedging to use can make a big difference to portfolio returns.

In the chart below, the red line shows returns in Australian dollars from global shares when the currency risk is hedged, and the green line shows returns when the currency is unhedged.

Hedged returns do better when the Aussie dollar is rising or flat (usually in booms), and unhedged returns do better when the Aussie dollar is falling (usually in busts). The lower section shows the relative returns between hedged and unhedged – positive red bars when hedged returns are beating unhedged (AUD rising or flat) and negative green bars when unhedged is winning (AUD falling). The orange dotted line running through the middle of the chart shows the US Dollar / Aussie dollar exchange rate.



This calendar year, the US dollar has risen and Aussie dollar has fallen. Hedged returns (red) have been flat as global shares have stalled, but unhedged returns (green) have continued to rise. It shows how performance of

global shares for unhedged Australian investors can be affected as much by the currency as the underlying funds, companies or markets.

Ashley Owen is Chief Investment Officer at advisory firm [Stanford Brown](#) and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

Finding opportunities in listed global funds

Peter Rae

Much has been written about the fact that Australian retail investors' portfolios are heavily weighted to Australian equities, despite the domestic market representing a small proportion of global equity markets. It is not difficult to understand the reasons for this home bias given the benefits of the dividend franking system in Australia, the difficulties of direct investing in foreign markets and currency risks associated with offshore investing. The universe of global equity investment opportunities is vast, but researching and selecting the right shares to invest in is a challenging task for the average investor.

Plenty of ETFs and LICs on the ASX

There are numerous indirect options for Australian investors to gain international exposure, in both managed and passive form. Many Exchange Traded Funds (ETFs) offer global exposures, usually as 'passive' investments designed to track the performance of a certain index. There are also a large number of unlisted global managed funds.

For investors looking for actively-managed international equity exposure with the benefits of ASX market liquidity, there are an increasing number of listed investment companies (LIC), listed investment trusts (LIT) and active ETF options. Our tables (annexed at the end, or see the [full monthly report](#)) list the 27 LICs and LITs which invest solely in international equities (excludes those with blended portfolios of Australian and international shares), and the 18 active ETFs with international share strategies. We do not cover or provide ratings for any of these Active ETFs, so our data is for information only.

In our tables we split the 27 international-focused LICs and LITs into different categories according to their investment strategies. There are 13 LICs/LITs that have diversified global portfolios, five with emerging markets exposure and seven with specialist strategies. There are also two Watermark absolute return funds that are predominantly invested in global equities.

The majority of the international LICs/LITs are trading at discounts to pre-tax NTA and at the end of May 2018 the average discount was 7.4%. Platinum Capital (ASX:PMC) was the only LIC trading at a significant premium of 14.0%. It is unclear why so many of the international LICs/LITs are trading at discounts and, in our view, this provides a good opportunity for investors add international exposure to their portfolios.

Recommendations on nine LICs/LICs

IIR covers nine of the 27 international LICs/LITs at present with more to come. The table below lists these nine entities showing premiums and discounts at the end of May. We have also added WAM Global, which listed at the end of June.

International LICs & LITs*

ASX Code	Entity	Focus	Market Cap \$m	Prem/Disc %	Prem/Disc (Diluted) %	IIR Rating
VGI	VGI Partners Global Inv.	Diversified	600.1	2.8	2.8	Recommended Plus
FGG	Future Sen. Global Inv.	Diversified	389.4	0.4	0.4	Recommended Plus
EDG	Evans & Partners Global Disruption	Specialist (Disruption)	253.4	0.0	0.0	Recommended
MGG	Magellan Global Trust	Diversified (Large Cap)	1626.1	-4.0	-4.0	Recommended Plus
GFL	Global Masters Fund	Specialist (Berkshire Hathaway)	22.1	-5.0	-5.0	Recommended Plus
APL	Antipodes Global Inv. Co.	Diversified	433.4	-5.9	-1.6	Recommended
PIA	Pengana International Equities	Diversified (Mid/small cap)	279.6	-7.2	-5.9	Recommended
EBI	Ellerston Global Investments	Diversified (Mid/small cap)	115.6	-8.7	-8.7	Recommended
WGG	WCM Global Growth	Diversified	92.6	-13.0	-10.6	Recommended Plus
WGB	WAM Global	Diversified (Mid/small cap)	496.0	n.a.	n.a.	Recommended

*Covered by IIR. Data as at 31 May 2018.

Click to enlarge

For those LICs/LITs with options on issue we have calculated an options-diluted premium or discount. There are only two LICs/LITs trading at small premiums. We view all the LICs/LITs on the list as suitable investments at current prices, although those at larger discounts represent better value. In our May 2018 LMI Monthly Update we wrote about WCM Global Growth (**ASX:WQG**) (formerly Contango Global Growth) which we believe represents good value at a 10.6% discount to option diluted pre-tax NTA (The discount has narrowed since the end of May).

For investors looking for a well-diversified portfolio of international equities, it is hard to go past Future Generation Global Investment Company (ASX:FGG), a fund of funds LIC. It invests in a portfolio of 15 funds managed by Australian fund managers who forgo management fees so that the LIC can make a 1% annual donation to charities. The charity donation is less than the fees that the managers would normally charge, with the difference being to benefit of investors in FGG. The managers also forgo performance fees, also to the benefit of investors in FGG. The portfolio is well-spread across geographic regions and has a mix of large, mid and small cap exposures. FGG shares were trading close to pre-tax NTA at the end of May.

Magellan Global Trust (ASX:MGG) is the largest of the global listed managed investments. It primarily invests in large international companies and has a high weighting in US technology companies. Pengana International Equities (ASX:PIA), Ellerston Global Investments (ASX:EGI) and the newly listed WAM Global (ASX:WGB) all invest in mid and small-cap shares, providing a point of differentiation. PIA also offers the benefit of a high, fully franked dividend yield.

This article provides a brief overview of the international focussed LMIs that we cover. For more details we encourage investors to read the individual two-page profiles in our recently published Listed Managed Investments Quarterly Review ([attached here](#)).

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

Active ETFs with International share and security strategies

Pricing & Rating

All data as at 31 May 2018	ASX Code	Market Cap (\$M)	Last Price (\$)	Dividend Yield	NAV (\$)	Management Fee	IIR Rating
International Share/Security Strategies							
AMP Capital Global Infrastructure Securities Fund (Unhedged)	GLIN	21.4	2.44	2.4%	na	0.95	Not Rated
AMP Capital Global Property Securities Fund (Unhedged)	RENT	14.3	2.44	1.5%	na	0.99	Not Rated
BetaShares US Equities Strong Bear Currency Hedged	BBUS	56.2	5.06	0.0%	na	1.38	Not Rated
BetaShares Geared U.S. Equity Fund - Currency Hedged	GGUS	15.4	11.83	0.8%	na	0.74	Not Rated
Betashares Managed Risk Global Share Fund	WRLD	28.5	11.83	1.0%	na	0.39	Not Rated
BetaShares S&P 500 Yield Maximiser Fund	UMAX	92.4	18.68	4.2%	na	0.59	Not Rated
BetaShares Legg Mason Equity Income Fund (Managed Fund)	EINC	10.6	8.07	0.0%	na	0.85	Not Rated
K2 Global Equities Fund	KII	16.8	2.69	0.0%	2.72	2.05	Not Rated
Magellan Global Equities Fund	MGE	1,045.9	3.14	1.6%	3.15	1.35	Not Rated
Magellan Global Equities Fund (Currency Hedged)	MHG	68.4	3.11	1.6%	3.10	1.35	Not Rated
Montgomery Global Equities Fund	MOGL	78.8	3.55	0.0%	3.56	1.32	Not Rated
Platinum International Fund	PDX	223.6	5.55	0.0%	na	1.76	Not Rated
Platinum Asia Fund	PAXX	106.8	5.71	0.0%	na	1.58	Not Rated
Schroders Real Return Fund (Managed Fund)	GROW	46.7	3.64	2.6%	na	0.90	Not Rated
AMP Capital Dynamic Markets Fund (Hedge Fund)	DMKT	29.0	2.68	4.8%	na	0.48	Not Rated
Magellan Infrastructure Fund (Currency Hedged) (Managed Fund)	MICH	174.3	2.76	2.7%	2.74	0.95	Not Rated
Vanguard Global Value Equity Active ETF	VVLU	4.7	51.96	0.0%	na	0.28	Not Rated
Vanguard Global Min Volatility Active ETF	VMIN	2.0	51.21	0.0%	na	0.28	Not Rated

LICs & LITs which invest solely in international equities

Pricing & Recommendations – International Shares & Specialist Focus

All data as at 31 May 2018	ASX Code	Market Cap (\$M) *	Last Price (\$)	Dividend Yield	Pre-Tax NTA (\$)**	Pre-tax NTA Prem/Disc (\$)	3 Year Avg Prem/Disc	M'ment	M'ment Fee	IRR Rating
International Shares - Diversified										
Magellan Global Trust	MGG	1,626.1	1.55	1.9%	1.61	-4.0%	0.0%	External	1.35	Recommended +
MFF Capital Investments	MFF	1,347.1	2.49	1.0%	2.68	-7.0%	-10.9%	External	0.42	Not Rated
VGI Partners Global Investments Limited	VGI	600.1	2.18	0.0%	2.12	2.8%	4.1%	External	1.50	Recommended +
Platinum Capital	PMC	580.4	2.03	4.9%	1.78	14.0%	8.4%	External	1.10	Not Rated
PM Capital Global Opportunities Fund	PGF	442.1	1.26	2.9%	1.37	-8.3%	-12.6%	External	1.00	Not Rated
Antipodes Global Investment Company Ltd	APL	433.4	1.18	0.0%	1.25	-5.9%	-1.6%	External	1.10	Recommended
Future Generation Global Investment Company	FGG	389.4	1.32	0.8%	1.31	0.4%	-0.5%	External	0.00	Recommended-
Templeton Global Growth	TGG	311.1	1.39	3.2%	1.54	-9.7%	-10.5%	External	1.00	Not Rated
Pengana International Equities Limited	PIA	279.6	1.13	6.2%	1.22	-7.2%	-8.0%	External	1.50	Recommended
Ellerston Global Investments	EGI	115.6	1.06	3.8%	1.16	-8.7%	-8.7%	External	0.75	Recommended
WCM Global Growth Limited	WOG	92.8	1.02	0.0%	1.18	-13.8%	-6.4%	External	1.25	Recommended +
Morphic Ethical Equities Fund	MEC	46.8	1.03	0.0%	1.17	-11.8%	-3.5%	External	1.25	Not Rated
Fat Prophets Global Contrarian Fund	FPC	44.5	0.99	0.0%	1.16	-14.8%	-3.2%	External	1.25	Not Rated
International Shares - Emerging Markets										
Platinum Asia Investments	PAI	460.8	1.28	3.9%	1.24	3.2%	-1.1%	External	1.10	Not Rated
Emerging Markets Masters Fund	EMF	189.2	1.98	3.0%	2.05	-3.4%	2.1%	External	1.10	Ceased Coverage
Evans & Partners Asia Fund	EAF	159.0	1.22	0.0%	1.27	-3.9%	-3.9%	External	1.00	Ceased Coverage
Ellerston Asian Investments	EAI	119.3	1.10	0.0%	1.17	-6.3%	-9.5%	External	0.95	Not Rated
PM Capital Asian Opportunities Fund	PAF	71.0	1.26	4.0%	1.28	-1.6%	-11.1%	External	1.00	Not Rated
International - Specialist										
Argo Global Listed Infrastructure	ALI	260.7	1.77	2.1%	2.11	-16.1%	-10.3%	External	1.20	Not Rated
Evans & Partners Global Disruption Fund	EGD	253.4	2.04	0.0%	2.04	0.0%	5.3%	External	1.28	Recommended
Global Value Fund	GVF	159.0	1.08	5.8%	1.08	-0.1%	-3.1%	External	1.50	Not Rated
Zeta Resources	ZER	75.4	0.38	0.0%	0.54	-29.3%	-14.7%	External	0.50	Not Rated
Global Masters Fund	GFL	22.1	2.06	0.0%	2.17	-5.0%	-7.6%	Internal	0.00	Recommended-
Fat Prophets Global Property Fund	FPP	16.2	1.07	0.0%	1.08	-1.2%	3.3%	External	1.00	Not Rated
Aurora Global Income Trust	AIB	2.3	0.32	16.1%	0.46	-30.9%	-3.7%	External	1.33	Not Rated
Absolute Return Funds										
Watermark Global Leaders Fund Limited	WGF	75.6	0.92	0.0%	1.10	-16.8%	-10.3%	External	1.20	Not Rated
Watermark Market Neutral Fund	WMK	72.7	0.83	4.2%	0.96	-13.5%	-5.1%	External	1.00	Not Rated

Time to build a super system fit for retirement

Jeremy Cooper

When the modern super system was introduced under former Prime Minister Paul Keating, it wasn't designed for a mass market of people reaching the age of 80, but that's exactly with what it has to deal with today.

The system Keating conceived was for a life expectancy around 75, where retirement could commence at 55. Today's retirees are now typically living into their late 80s, more than nine years longer than they did in the 1990s. A 65-year-old woman today can expect to live to 89 years on average, with a one-in-five chance of living to 98. Australians have added about four months of longevity every year since the start of the superannuation guarantee in 1992. That greater longevity means we need to rethink how super is delivered.

Is super doing its accumulation job?

By 2030, our national super savings will double in size from the current \$2.6 trillion to around \$5 trillion. Over that period, something in the order of \$1.3 trillion of super savings will move into the retirement phase. This is in addition to the \$760 billion that is already there.

Super is also moving from merely supplementing the age pension to substituting it for an increasing proportion of retirees. The evidence is already in. At June 2017, only 42% of the over-65 age cohort were getting a full age pension, with a further 28% on a part age pension.

Put another way, 58% of today's retirees have sufficient means to reduce, or eliminate, their entitlement to government income support. Growing super balances play a material part in this story.

Super is doing the first part of its job; it is allowing people to accumulate assets for retirement. Our system is more mature than most people think. Average member balances in retirement are now exceeding \$250,000. Typical household super wealth at retirement is in the \$350,000-\$500,000 range and increasing.

The pension-phase drawdown task of super

However, there is no structure to the drawdown phase of superannuation. Flexibility is prioritised at the expense of risk management, income certainty, and sustainability.

That's what a current Treasury position paper on a Retirement Income Covenant sets out to address. The position paper outlines two principles to be included in a retirement income covenant in the *Superannuation Industry (Supervision) Act 1993* (SIS Act) that will require trustees to:

- Assist members to meet their retirement income objectives throughout retirement by developing a retirement income strategy for members. This will plug a significant gap in the SIS Act. Retiring members currently do not have the benefit of such a provision and neither do fund trustees.
- Assist members to meet their retirement income objectives by providing guidance to help members understand and make choices about the retirement income products being offered by the fund.

The retirement income covenant is designed to fit into the SIS Act next to covenants that are similar in style and intent, such as the investment and insurance covenants. It has the potential to send a strong normative signal about what is expected of trustees in the retirement phase.

The retirement income covenant would be an important part of the structure for a retirement income framework. It's a top priority reform for six reasons:

1. About 700 Australians are retiring every day, more than 85% of whom have a need for reliable income for life, but less than half of them are entitled to the full age pension.
2. The industry standard is that accumulation-style products are presented to retirees as retirement income streams. This is effectively our current default retirement product.
3. Diversification is the only risk mitigant applied to most retirement income streams, with all other risks currently borne by retirees who are consequently self-insuring, living too frugally and leaving 'unintended bequests' to the next generation.
4. Over \$760 billion is already in the retirement phase, but the industry is substantially under-prepared for this.
5. There is very limited governance currently dedicated to retirees and retirement income.
6. Risk pooling and insurance are widely used in the accumulation phase but are not routinely used in the retirement phase to reduce the risk of running out of money in retirement.

The Treasury position paper argues it is preferable for superannuation fund trustees to have an obligation, rather than an option, to offer a Comprehensive Income Product for Retirement (CIPR) because providing appropriate income streams to retirees is fundamental to the purpose of super. It might also overcome inertia and ensure quick progress in delivering better outcomes for retirees. It will also ensure that all retirees, regardless of their fund, are provided the same opportunity and range of choices. The proposed requirement in Treasury's paper that all large APRA-regulated funds (other than eligible retirement funds [ERFs] and defined benefit [DB] lifetime pension funds) must offer CIPRs is the right policy setting.

Member choice on CIPRs

Importantly, of course, there is no compulsion on the part of the member. The decision (and consent) of the member is a key part of the proposal. It follows from this that a CIPR will not be a default. Retirees will have a clear and simple choice of whether they want to take up a CIPR or not. CIPRs will provide a wider range of

choices for retirees than the currently have. Just as is the case now with account-based pensions, some retirees will choose a CIPR without advice and some will do so with advice.

The notion that trustees should have a duty, via the proposed covenant, to assist members with their retirement income objectives through guidance about their choices makes sense. Regardless of the account balance threshold below which a CIPR need not be offered to a member, all members should benefit from the engagement aspects of the covenant. Leading funds are already engaging with members about retirement income and the covenant will ensure that it becomes a core activity of all funds.

It's important to note that CIPRs will not affect a large part of the system. CIPRs will not affect members in accumulation, not apply to SMSFs, and only apply to retiring members who choose one. Even then, many CIPRs will still comprise around 75-80% in account-based pensions, which is the current pension default.

Pooled lifetime products

The pooled lifetime component of superannuation envisaged under the Treasury position paper would initially only represent a very small proportion of the overall system and even a modest proportion of the retirement phase. We have estimated that if all retired members opted for a CIPR with a 20% allocation to a pooled lifetime product in the first year of the new regime, this would amount to around \$40 billion allocated to a pooled lifetime income product.

It will not be a disruptive or revolutionary change, but a necessary enhancement for a system with around \$1.3 trillion heading towards the retirement phase by 2030.

While other regulatory measures needed to implement the retirement income framework will follow, setting appropriate governance standards that place emphasis on the needs of members in retirement is a critical first step.

Challenger has provided a submission on the May 2018 Treasury position paper on the retirement income framework. This outlines the proposed principles for the retirement income covenant. We support the direction of the paper and believe now is the right time to drive this reform forward. [Read the full submission here.](#)

Jeremy Cooper is Chairman, Retirement Income, at [Challenger](#), a sponsor of Cuffelinks. For more articles and papers from Challenger, please [click here](#).

In Australia, who's got the money?

Phil Ruthven

[Editor's introduction. In The Sydney Morning Herald on 29 June 2018, columnist and advertising executive Howard Mitchell described how he first met "the brilliant Phil Ruthven" when their businesses were both starting out. "Forty-two years later, his company, Ibis World, has a staff of 450 providing astute forecasts to business and government. Phil's forecasts about our rapidly changing world have been a key part of my business planning for decades."

The recent taxation bills in Federal Parliament generated the usual heated arguments from the benches. The legislation was in no way 'reform' as some claimed, since it only dealt with personal and business income tax, and the GST was left untouched. Many other indirect taxes, such as payroll tax and stamp duties, were also unchanged recently at the state level.

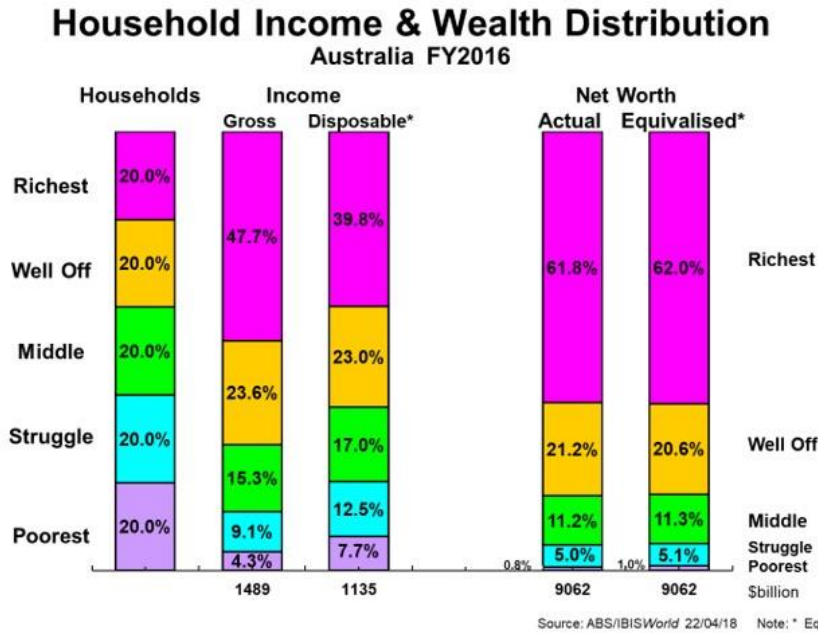
Income taxes versus spending taxes

The broad principle of wealth creation by going easier on taxing incomes and going harder on taxing spending has been ignored yet again. The current ratio of income taxes to spending taxes (such as GST, customs, excise and stamp duties) is over 2.5:1 in favour of income taxes on wealth creation. Hardly a recipe for higher savings and investment as a share of GDP.

So-called class warfare has become the order of the day. Is there substance to the claim that the rich are getting richer and the poor, poorer? Not quite, allowing for the changes in household structures and age groups. More on this shortly.

Wealth and income inequality in Australia

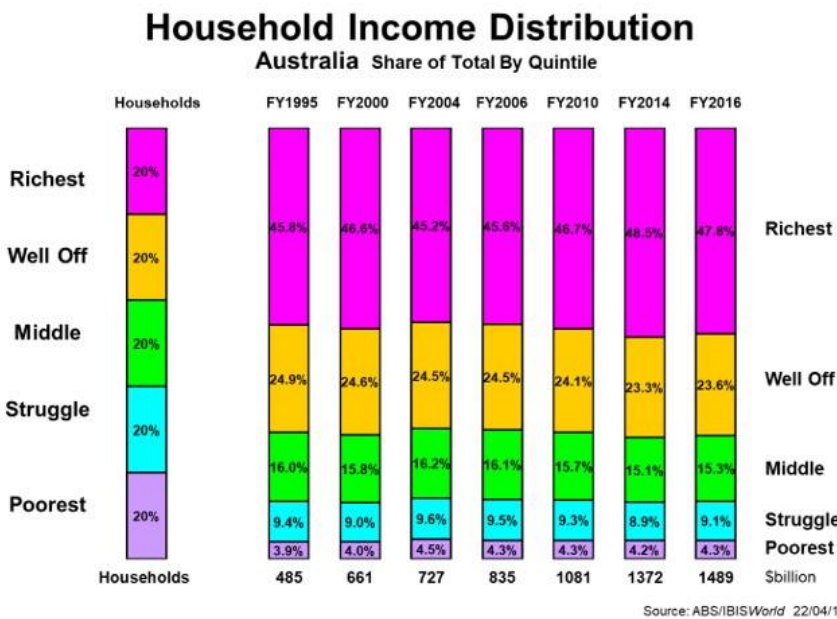
The first chart shows the latest ABS data (FY16) on income and wealth distribution as it applies to quintiles (each one fifth of all households).



Yes, the richest and well-off 40% of all households enjoyed 71% of gross incomes and had 83% of the wealth (net worth). But they paid 87% of all income taxes, and the remaining 60% of all households paid 13% of all income taxes. This diluted the disposable income shares of the affluent 40% from 71% to 63%, and lifted the struggle and poorest 40% of households from 13.4% of gross incomes to over 20%.

So, are the poor getting poorer?

Interestingly, no. The next chart shows the changing distribution of gross incomes over the past 20 years. The Struggle and Poorest sectors have kept the same share, virtually unchanged. In disposable income terms, their higher share has also remained constant. If anything, there has been a slight dilution of the middle-income sector, but hardly anything to write home about.



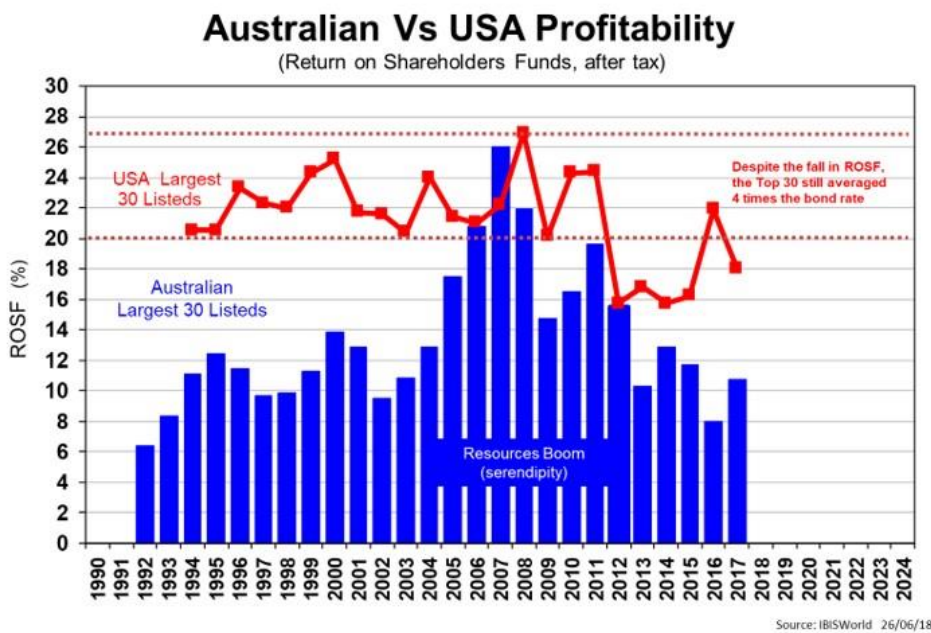
Then again, we need to be careful with terms such as 'struggle' and 'poor'. Lest we think of strugglers as being big families with one income, or the poor as elderly pensioners, it isn't that simple. Among the so-called poor in both income and wealth measures, there are many students at universities with minimal incomes who have not yet had the time to accumulate assets.

Holding up the 'middle' quintile's share are growing numbers of retired baby-boomers, who have had much more opportunity in salaries and wealth accumulation than older generations that experienced the Great Depression of the 1930s and World War II. This is giving them a better lifestyle via their investments. The eventual retirement of the Gen Xers (37-52 years-of-age today) will amplify this trend even more so, given their near-entire working lifetime with superannuation savings. They are more financially savvy too.

The recent tax changes have been about addressing bracket-creep and lowering corporate taxes, in line with overseas trends. The bracket creep issue has not been as great as in the past because of very low inflation and slow-growing incomes, the result of an under-performing economy over the past 10 years.

Are our corporates doing well by global standards?

Some argue that the corporate tax case was not strong considering how poorly our top corporations perform compared with our US cousins, as the final chart shows. Our profitability is half theirs.



If our big end of town wanted to make better net profits, then becoming more profitable by global standards would be better than just paying slightly less income taxes.

It seems genuine taxation reform is on the too-hard list along with other overdue reforms to the labour market, energy market, parliament (lack of the democratic-election principle with the unrepresentative Senate and its obstructionist power), and the Budget (balancing the books).

But compared with other western nations, we are still doing better, and we can preserve the moniker of *the lucky country*. Phew.

Phil Ruthven is Founder of [IBISWorld](http://IBISWorld.com) and is recognised as one of Australia's foremost business strategists and futurists.

Going global? Don't break the 'Golden Rule'

Warryn Robertson

With a backdrop of the Financial Services Royal Commission and a cooling property market, Australian investors are understandably looking to diversify from the bank-dominated ASX/S&P 200 Index.

Yet risks also abound offshore with interest rates rising after years of low real rates, inflation is inching higher and equities appear more expensive after a strong decade-long run.

So how does an investor navigate this environment?

While equity valuations are stretched, they are more attractive investments than fixed income securities and direct (unlisted) investments such as property and infrastructure. These asset classes could face even greater risks in an interest rate tightening environment.

There are, however, segments of the equity market that are trading at extreme valuations and that is where the greatest risk lies.

The Golden Rule

Why do we think these valuations are extreme and not just the 'new normal' as some commentators have said? A problem is that the market is pricing in low rates into perpetuity, while also maintaining heroic growth assumptions. This represents a theoretical mismatch. Why so?

Any company valuation essentially has two parts:

1. Earnings or cash flows (the numerator)
2. The multiple or discount rate, usually P/E (the denominator)

This is the basis for what we refer to as the 'Golden Rule' of equity investing. The Golden Rule is: *In the long run, nominal GDP growth should correlate with nominal long-term interest rates.* In other words, in the long run, there must be a link between the numerator (earnings growth or cash flow) and the denominator (the multiple or discount rate).

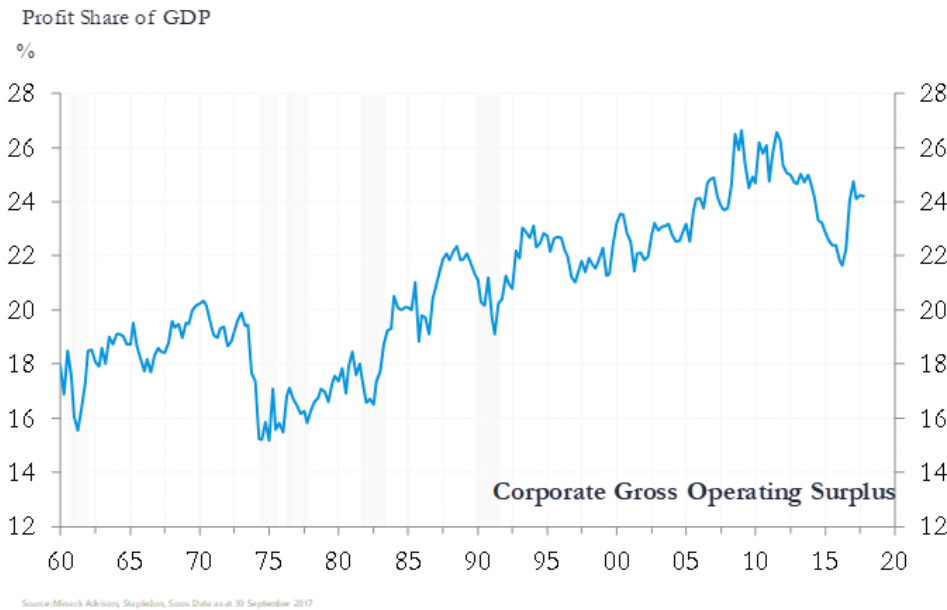
In times of heady investment markets, like today, we often see investors break this Golden Rule and build heroic growth assumptions without applying higher interest rates. In our view, there are only two alternatives: either growth will be higher and rates will rise, resulting in a higher discount rate and lower valuations; or growth will be structurally lower and earnings will come down.

The earnings side of the equation

The expansion in price to earnings ratios (P/Es) and other metrics in certain areas of the market is not what concerns us the most. We are also concerned about the risk of inflated earnings of some companies, or the 'E side' of the equation.

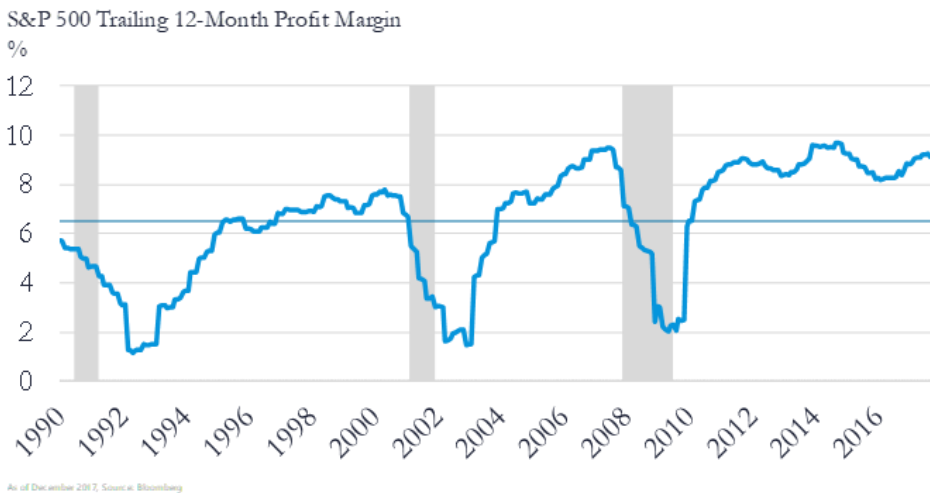
Profits as a percentage of the economy are now high by historical standards (Exhibit 1).

Exhibit 1 – Profit share of GDP



Corporate profit margins are expanding and are well above long-term averages (Exhibit 2). In our view, for most companies this margin growth is unsustainable in the long term. Ultimately, we believe profit margins over the long term will decline, either through slower sales growth (associated with lower GDP) or higher input costs (wages and cost of funding via higher interest rates). We believe this has the potential to dramatically impact some companies, particularly those with both high margins and a high P/E multiples.

Exhibit 2 – Corporate profit margins rising

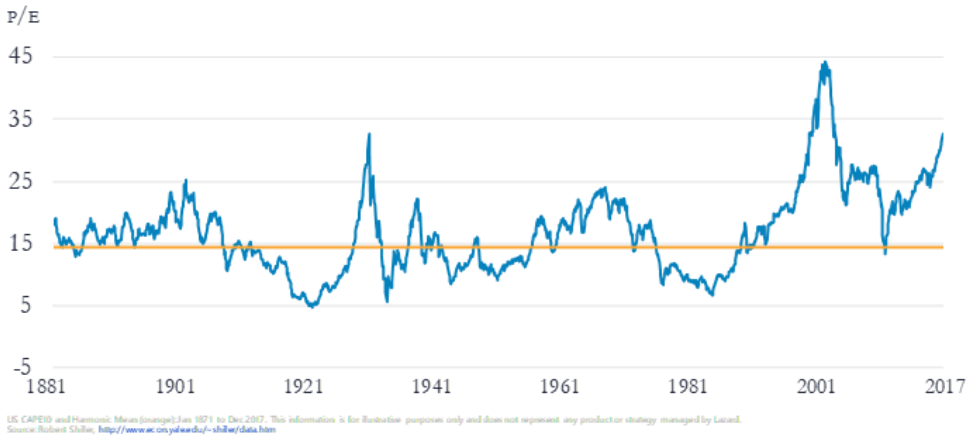


A better guide is the Shiller P/E

To put market valuations in an historical context, we think the Shiller P/E acts as the best guide. Standard P/E uses the ratio of an index over the trailing 12-month earnings of its constituent companies. During economic expansions or bull markets, companies can have inflated profit margins and earnings and the P/E falls as a result.

The Shiller P/E eliminates fluctuations caused by the change in profit margins during different business cycles. Currently, the Shiller P/E is at a level only reached three times in history, the others being in 1929 and in 2000 (Exhibit 3).

Exhibit 3 – US 10-year cycle-adjusted P/E



What to avoid

We primarily see two main risks for investors:

1. Companies with unsustainably high margins

We are concerned about some companies' rapidly rising profit margins, which lead to expanded earnings, and the hefty multiples paid for their stocks. It is dangerous to assume these companies can maintain such profitability into the future and an investor needs to understand how sustainable the current level of profitability is.

This sustainability is particularly important should the economy soften. The ability to generate stable margins is actually quite rare, particularly in times of economic dislocation.

2. Expensive defensives

The prolonged low-interest rate environment has driven investors to seek out bond proxies: companies that have a combination of relatively attractive dividend yields and stable earnings. Consumer staples companies are the classic case, as are other traditional safe havens such as North American utilities and global REITs.

In consumer staples, the growth rates required to justify current share prices are substantial, which contradicts the sluggish revenue growth most of these companies are actually experiencing today. We believe either rates will rise, making these stocks less appealing, or growth rates will disappoint, bringing multiples down.

Where to go?

As the investment environment normalises, investors must adapt their portfolios to achieve their return target. Generating an adequate return from global equities will not be as easy as in the past. Now investors need to:

- Focus on the right companies, such as higher quality names with more predictable earnings.
- Focus on valuation, and invest in the right companies but only at the right prices.
- Diversify sensibly, not naively. A widely diversified portfolio perversely may be more risky than a concentrated portfolio given the overall level of risk in equity benchmarks.
- Expect currency exposure to play a major role in the performance process.

We expect a greater spread between the small number of winners and the larger number of losers. Risk should be defined as the probability of a permanent loss of capital, and, in the environment we face today, that risk is coming into sharper focus.

Warryn Robertson is a Portfolio Manager and Analyst at [Lazard Asset Management](#). This article is general information and does not consider the circumstances of any investor.

Will the Royal Commission ban all incentives? Not quite

Graham Hand

The Financial Services Royal Commission continued its Round 4 hearings in Darwin this week, with a focus on the rural sector, especially agricultural lending. It followed a now-familiar pattern. Case studies were identified by the Commission, usually self-reported by banks as part of the discovery process, and aggrieved bank customers appeared as witnesses unloading about their mistreatment. Then a middle-ranking bank executive apologised for poor behaviour under intense questioning.

Banks are defending their positions poorly

The banks are a big target and the Royal Commission has plenty of arrows in its quiver. There is no doubt much bank behaviour identified has been inappropriate. It's also true the Commissioner has to push hard to meet his deadlines. As the Chief Executive Partner of King & Wood Mallesons (KWM is doing the AMP work), Berkeley Cox, told *The Australian Financial Review*:

"The Commission has got a timetable and for the Commissioner to meet that timetable – given the terms of reference – there's a lot of work. It's a difficult task for the Commissioner. It's a difficult task for the AGs [the Attorney-General's Department]. It's a difficult task for the clients, so it's a difficult task for us. That's the way it is."

Another unidentified lawyer to the AFR said that *"Somebody is going to die"* due to the intense legal workload involved in 18-hour days, seven days a week.

A surprising aspect of the interviews is that the bank executives are defending their policies so poorly, or not at all. The Counsels assisting the Commission have a powerful position, but the bank executives are experienced professionals on large salaries. Many of them appear like deers caught in car headlights. The policies represent the way the banks offer their products and services. Across a wide range of products, such as mortgage lending, financial advice, funds management and farm loans, the bank policies were developed and agreed after considerable debate and research across the business. Yet there is relatively little explaining and defending the products, and nobody is willing to tell the ultimate truth: *"We do it this way to make more money."*

Incentives are an important part of businesses

Almost every major business has bonus incentive schemes for staff. They are a valuable way of rewarding effort, and they have been a fundamental part of KPIs for decades. Of course, they must be structured properly with risk and reward, and not provide the wrong incentives. The Royal Commission is rightly drilling into when incentives cause the wrong behaviours, such as falsifying documents to increase loan sizes, or giving advice that generates the maximum commissions.

But the continuous line of questioning from the Commission over the months seems to target all incentives as unacceptable. The crucial point is to design them correctly, not ban them.

So it was refreshing this week to hear Bradley James (BJ), Rabobank's Regional Manager, Southern Queensland and Northern NSW, firmly defend his bank's policy and not duck the issue under examination from the intimidating QC and Commission Counsel, Rowena Orr (RO). Ms Orr had earlier interviewed an aggrieved Rabobank client, Mrs Bauer, with leading questions such as *"What is the non-financial impact of all this?"* and *"How do you feel about your experience with Rabobank"*. Mr James was in the room listening to the fierce criticisms of his bank and he could easily have cowered under interrogation.

RO: Does Rabobank still set KPIs for its bank managers that have lending targets?

BJ: Yes, we do.

RO: And why do you do that?

BJ: To enable us to grow our business through increased lending.

RO: Do you see any difficulties with that from a customer perspective, Mr James?

BJ: Absolutely not.

RO: No difficulties?

BJ: None whatsoever.

RO: Do you see any difficulties having heard the evidence of Mrs Brauer about her experience?

BJ: I do understand the difficulties that Mr and Mrs Brauer experienced as a result of how those actions may have come about, but in terms of us having objectives for managers to lend to increase the business, I have absolutely no problems with that whatsoever.

RO: So does Rabobank take some responsibility for creating a system that incentivises its bank managers to go out and sell as much volume of loans as they can so that they can meet their KPIs?

BJ: If it was unqualified, I would have a problem but it's not unqualified.

RO: In what way is it qualified, Mr James?

BJ: We have a requirement for our managers to lend sustainably in terms of the risk in those KPIs as well.

RO: Mr James, what's the consequence of meeting your KPIs?

BJ: The consequence of meeting them? So we have – at that stage we had a – what I would refer to and the bank refers to as a discretionary bonus system. In line with a review of salary, what we refer to as TEC (Total Employment Cost), and that alignment of that salary is in terms also of the performance of a staff member, not just a manager.

RO: So if you met your KPIs you were eligible for a bonus?

BJ: That's correct.

RO: And if you didn't meet these lending targets, you wouldn't be eligible for your bonus?

BJ: If you didn't – well, no, it's not just the lending targets. So if you met the lending targets and you didn't meet the risk aspect of it, you may not achieve a lending target. Because it's – it's assessed as a total contribution.

RO: But one element that you had to satisfy was meeting your lending targets. Is that right?

BJ: Yes, that's correct.

RO: If you didn't meet your lending targets, it didn't matter about the rest of it, you wouldn't be eligible for a bonus?

BJ: No, that's not correct.

RO: Okay. Could you explain that?

BJ: Because it's discretionary, we look at the seasonal conditions that may exist at the time. So in any given year we've had managers that have achieved a bonus who haven't met their lending targets because of circumstances beyond their control. It is rare that we would pay – and in my personal experience would not pay a bonus to a manager who has achieved those lending targets but did not achieve the risk targets.

Good to see a bank executive stand up for a policy he believes in.

(For further context, see <https://financialservices.royalcommission.gov.au/public-hearings/Documents/transcripts-2018/transcript-27-june-2018.pdf>)

A typical tough day at the Royal Commission

Here is another insightful exchange between the Commission and Charles Scerri (CS), QC for BankWest and CBA at the end of an intense day.

CS: Commissioner, can I respectfully ask how much extra time we need? The difficulty is that Ms Taylor comes from Perth. She has a young family. She has been involved in this for weeks now. And if it's possible to finish tonight, we would very much appreciate it. We have been told several times that it's expected that she would finish tonight.

COMMISSIONER: I'm surprised by that, Mr Scerri, but there we are. What do you say, Ms Orr?

RO: *I think I've got up to an hour, Commissioner.*

COMMISSIONER: *Well, I'm not sitting that long.*

CS: *No, I understand.*

COMMISSIONER: *Mr Scerri. It's not fair to the witness.*

CS: *No. I was really trying to clarify whether it was 10 minutes or an hour or two hours.*

COMMISSIONER: *Yes.*

CS: *Some of the estimates have been pretty inaccurate, I should say, with respect, sir.*

COMMISSIONER: *Mr Scerri, do you want to think about that statement again?*

CS: *Yes. It is the fact, sir, that witnesses have cooperated to extraordinary extents, and the estimates of when they will be required and where has changed a lot.*

COMMISSIONER: *I have noted what you've said, Mr Scerri. It may surprise you then to know that very careful attention is given to trying as best we can to minimise disruption. Now, do we always succeed? No, we don't. I accept that. I know we don't always succeed. But we do try.*

And then the Commission adjourned for the evening. There's no doubt it's tough in that room, but it would be good to see a few more of the bank executives who actually designed and approved the policies at Executive Committee level come in and explain the bank's culture and decisions.

But rewards and incentives are appropriate for some

While the Commission zeros in on any incentives in financial services, there's one group of people for which they are entirely appropriate. Going back to Mr Cox of law firm, KWM, he said his firm is rotating staff and working on their wellbeing, including "very deliberate reward and recognition – financial and soft benefits". Of course, why not give incentives and rewards for a job well done.

Graham Hand is Managing Editor of Cuffelinks.

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