

This Week's Top Articles

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Commission says trustees "alone in the dark with our money"

Graham Hand

The Financial Services Royal Commission continued its forensic examination of commissions and fees in its Round 5 hearings on superannuation this week. Senior Counsel assisting the Commission, Michael Hodge QC, said superannuation members relied on three safeguards to protect them: regulators; super fund member engagement (which is low); and super fund trustees. Said Hodge:

"What happens when we leave these trustees alone in the dark with our money?"

The trustee's function sounds simple, with a '[sole purpose test](#)' giving a primary role to ensure a super fund is maintained **solely** for the benefit of its members. As Michael Hodge asked, how is the payment of a commission in the best interests of a client and how does it meet the sole purpose test?

That's where the problems start. If a for-profit business such as Colonial First State, AMP or MLC is running a superannuation fund, it does so to make a profit, not to only serve the members. It charges fees which reduce returns to members, creating tension in the business.

In my experience working in funds management, the trustees take their responsibility seriously. They ensure the legal rights of members are upheld, but it becomes more problematic when there are tradeoffs between members' returns and company profits. Trustees are also dependent on fund managers and administrators giving them advice, which is potentially conflicted.

The wealth management industry has clung on to commissions paid to advisers by product manufacturers, and it lobbied hard for grandfathering under FOFA. Previous evidence to the Commission revealed that AMP still earns 70% of its advice revenues from commissions grandfathered in 2013. Any steps which result in commissions no longer being grandfathered can have a severe profit impact. When management wishes to change a fund but retain commissions, the trustee is in a tough position supporting the decision due to the potential benefits for clients.

Most of the Royal Commission on days one to three in Round 5 highlighted this dilemma, and even dragged into day four. Hours were spent going round in circles with two NAB/MLC executives as Michael Hodge tried to dig out definitions and answers, met commonly by "I don't recall".

NAB/MLC hangs on to the commissions

Paul Carter, an Executive General Manager in NAB's wealth division from March 2013 until February 2017, gave evidence that management believed in 2012 that a Plan Service Fee (PSF) could be charged to members without a linked adviser. The Commission argued that MLC had convinced itself, and also the trustee, that providing online tools and telephone-based advice services without a linked financial adviser, warranted charging the fee. Paul Carter admitted,

"I believe that management had that mistaken belief when they originally put the proposal to the trustee."

MLC's executives spent much of 2016 deciding whether it could keep the fees, which both Paul Carter and trustee, Nicole Smith, defended as going through "due process". Michael Hodge said management was "hopelessly conflicted" in making this decision, and should not have taken the best part of a year to decide.

As with CBA in Round 2, the Commission has now forced the retail funds to concede they cannot charge fees where an adviser was not linked to the client account and providing an advice service. NAB/MLC first acknowledged that between September 2012 and January 2017, \$35 million in PSFs were incorrectly charged to 220,460 members. NAB also announced in July 2018 that it would stop deducting a PSF from the MLC MasterKey Personal Super accounts from 30 September 2018, with 205,000 members refunded \$87 million.

That's \$120 million so far which no doubt many executives enjoyed as a boost to revenue and bonuses for many years after 2012. Indeed, a hard decision requiring due process.

Commission attempts to understand the fees

During the hearings, Michael Hodge (MH) led Paul Carter (PC) through a cornucopia of fees, including a cash account with total fees of \$893 on \$1,014 earned. The link to the section is [here](#), page P-4201, and all the transcripts are [here](#).

MH: You will see the various fees paid in relation to this investment wholly in cash. And you see the first amount is an administration fee of \$554.32? So just even if we pause on that, our understanding is that this means that for investing in cash with a return of 1.2%, you will pay on the first \$49,999 an administration fee of 1.05%?

PC: Yes

MH: And then you will see there's an adviser contribution fee debited? Now, just again so we can understand this, that adviser contribution fee is the fee that's debited on any contribution that's made in in some percentage. And that's the fee that you think is a – is actually a commission?

PC: Correct.

MH: It's not a fee at all?

PC: Correct. This is a legacy arrangement with a commission.

MH: All right. And then you see there's government levies, and the operational risk reserve cost. That's – the operational risk reserve, that is a fee that's charged – or a cost that was charged so that the trustee could build up its operational risk reserve. Is that right?

PC: I believe that is the case.

MH: And it was a mandate from APRA, I think, about requiring that there be an operational risk reserve. And then you will see there's then a Plan Service Fee which is \$186.47? And that fee of \$186.47, that's the fee that's being paid so that a financial adviser is available. Is that right?

PC: Yes.

MH: Then there's a Stronger Super implementation fee of \$65?

And later, it's even worse, as the adviser contribution fee could be as high as 5.88%.

Clients left without an adviser

Here's the exchange at the Royal Commission on 6 August 2018 which shows how some clients were left without an adviser but were still charged an adviser contribution fee, or a commission:

MH: And if we just assist the Commissioner to try to understand what some of the fees are that apply in relation to MasterKey Business Super, the first is the adviser contribution fee? And that is a fee agreed between the adviser and the employer?

PC: Yes, and the employer, yes.

MH: And there are a range of six options as to what the employer and adviser can agree is going to be that adviser contribution fee? And the highest of which is 5.88%?

PC: Yes.

MH: Now, one of the things I was hoping you could help us with is you see how there are two columns, one is Fee Percentage and the other is Commission Percentage? Can you explain why there are those two columns, one is fee and one is commission, but they have the identical amounts there?

PC: I believe one is indicating the fee that the customer pays, and then the amount then that the adviser receives, which are the same.

MH: All right. Insofar as it's a fee, can you tell the Commissioner what it's for?

PC: The adviser contribution fee is best described as a commission.

MH: And that – you're saying that because there's no agreement, as you understand it, to provide any service for it?

PC: Correct.

MH: So this is a commission then agreed between the adviser and the employer. This percentage is deducted from any contribution made, any superannuation contribution made for each employee?

PC: Yes.

MH: And this we can see is in the MLC MasterKey Business Super. But you see it says including MasterKey Personal Super. So does the adviser contribution fee carry over once an employee leaves the employment of the employer?

PC: Yes.

What happens to commissions if funds change?

At one stage, MLC wanted to transfer clients from smaller legacy funds into larger funds for efficiency and cost reasons, but they realised this might affect the commissions grandfathered under the FOFA regulations. How could commissions be legally retained? MLC executives needed to convince the trustee that paying commissions was in the best interests of clients, especially problematic since many legacy clients were not receiving financial advice.

A vital part of MLC's decision to keep paying adviser commissions was that advisers might transfer their clients out of MLC/NAB funds if commissions were removed. The obvious inference was that advisers may not be acting in the best interests of clients. Paul Carter admitted there would have been a financial impact on NAB if commissions were turned off.

Michael Hodge pushed Nicole Smith on why the trustee agreed to keep paying grandfathered commissions to financial advisers. She said the issue was "heavily debated" by the trustee board, but they thought it was likely advisers would tell clients to leave MLC. If members left an MLC fund, the super product might become uncompetitive in the market, to the detriment of members. She agreed MLC management was in a conflicted position, but the trustee's role was one of "governance and oversight", not getting involved in management decisions. She told the Commission:

"I'm not going to comment on when and how an adviser acts in a member's best interest. We thought the risks called out were real ... On balance the trustee believed that grandfathering commissions was in the best interests of members."

Not much time to made the mud clearer

As Michael Hodge said during proceedings: *"All right. I hope that's clear as mud, Commissioner."*

To which an exasperated Kenneth Hayne replied: "*Better than mud, yes.*"

And given witnesses were being asked details about conversations that happened as far back as 2012, little wonder the most common response was, "I don't recall."

The Commissioner has only six weeks, until 30 September 2018, to deliver his interim report. Given how far they are behind schedule after spending three days with NAB, my bet is he'll ask for an extension to the final reporting date of February 2019.

Graham Hand is Managing Editor of Cuffelinks. There are already [hundreds of pages of transcripts this week](#), and comments are welcome on any incorrect interpretation above as much of it is "clear as mud".

Are Cuffelinks readers smarter than average?

Leisa Bell

It's a worry when a simple survey of financial literacy shows half of men and nearly two-thirds of women cannot answer correctly five simple questions. It's even worse when 13.4% are wrong on the majority of the questions, especially when we expect people to understand credit cards, buying a house and even the most complicated financial subject of all, superannuation.

Surely, Cuffelinks readers will nail these questions. The survey below will take only a minute or so to complete.

The [Household, Income and Labour Dynamics in Australia \(HILDA\) Survey](#) is a nationally representative longitudinal study of Australian households. Now in its 13th year, it collects information annually, from the same pool of people, on a wide range of aspects of life in Australia, including household and family relationships, child care, employment, education, income, expenditure, health and wellbeing, attitudes and values on a variety of subjects, and various life events and experiences.

Of particular interest to us here at Cuffelinks were the findings on financial literacy.

In his opening remarks for the section on *Financial literacy and attitudes to finances*, Roger Wilkins, Deputy Director (Research) of the HILDA Survey, says:

"Despite rising levels of income and wealth in the Australian community, the issue of financial literacy remains highly relevant, with many policy-makers in the wake of the 2008 Global Financial Crisis bemoaning the widespread lack of financial knowledge."

And:

"Financial literacy is defined by the OECD International Network on Financial Education (2011) as: 'A combination of awareness, knowledge, skill, attitude and behaviour necessary to make sound financial decisions and ultimately achieve financial wellbeing.'

"In Wave 16, the HILDA Survey included measures of basic financial literacy using an approach pioneered by Lusardi and Mitchell (2014). Five questions, respectively covering numeracy, inflation, portfolio diversification, risk versus return, and money illusion, were administered in the interview component."

Respondents were classified into three levels of financial literacy: low (two or fewer correct answers); medium (three or four correct answers); and high (all five questions answered correctly). The survey reports, 13.4% of people are in the bottom category, 44% are in the middle category and 42.5% are in the top category. There was also a significant gender divide, with men collectively scoring 4.1 out of 5 and women scoring 3.7.

We are interested in how Cuffelinks readers compare with this survey, so we have replicated the five questions in a quick quiz, linked below. We'll come back with the results next week.

<https://www.surveymonkey.com/r/6JSQXQP>

Apple at US\$1 trillion: tech titans give runaway returns to scale

Alex Pollak And Anshu Sharma

There is a well understood principle in investment known as the law of large numbers. Essentially, it says that the larger a company is, the harder it is to increase revenue growth rate, since most people already have the product or service. It's why revenue growth for big banks and retailers like Coles is almost always below 10%. Of course, this is after having got large in the first place, which is another story (about economies of scale, about which we all know).

But back to the main point. In the past few years, something very unusual has been happening to some of the biggest companies in the world, like Google (Alphabet), Amazon, Microsoft, Tencent and Alibaba. The revenue growth for these companies isn't tapering off, it is actually *accelerating*. Meaning that growth this year is higher than growth last year.

It's known as 'runaway returns to scale'. The formal definition of this is based around the concept that when output increases by more than the proportional change in inputs, there are increasing returns to scale.

Is this happening, and if so, how?

One thing that has definitely emerged in the past 20 years is the network effect. This states that arithmetical growth in users leads to geometric growth in value of the network, since each incremental user increases the number of transactions by more than just the one incremental user.

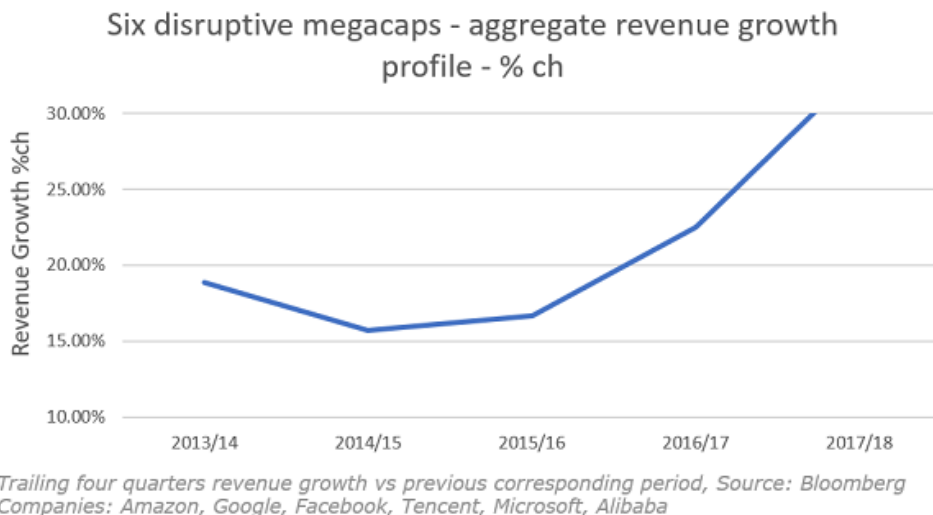
It's true that one telephone and one person cannot transact with anyone. Even two people can only do one transaction (assuming for a moment, one transaction per connection). But ten people can do 45 transactions.

There is a formula for this: $n(n - 1) \div 2$. In this case, if n is the number of users, then:

$$10 \times (10-1) \div 2 = 45 \text{ connections}$$

This is the network effect in simple terms.

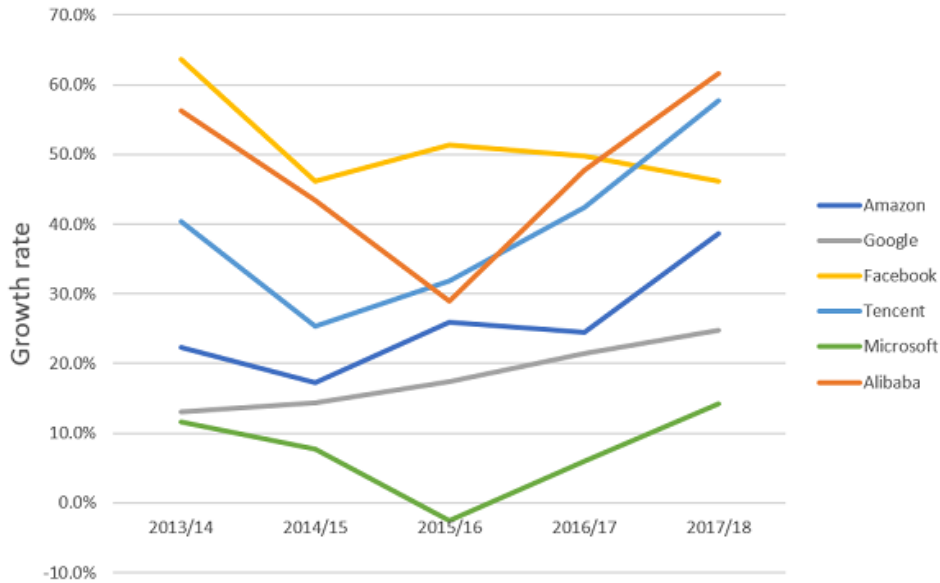
So it is that growth rates for some of the largest companies in the world, as measured by revenue, are increasing, as shown below:



The chart above shows revenue growth in aggregate for six of the world's largest companies: Amazon, Google, Facebook, Tencent, Microsoft, Alibaba. It shows revenue growth accelerating in the past few years, not slowing down as could be expected from the law of large numbers. So perhaps these are examples of runaway returns to scale? (There is some further explanation needed for Microsoft and Apple, which will we get to.)

The connection between these companies is their use of software to connect users arithmetically, in the process increasing transactions, and the value of their networks, geometrically. Alibaba and Tencent connect more people in China than any other network, so have the largest dollar value of transactions. Same with Amazon in the US. For clarity, we have broken out the revenue growth of the individual companies in question.

Runaway returns to scale?

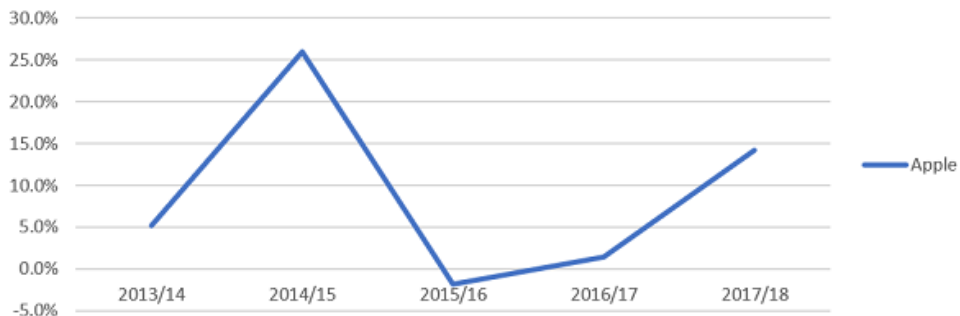


Trailing four quarters revenue growth vs previous corresponding period, Source: Bloomberg

Microsoft works slightly differently, but is still showing big returns to scale. The company’s major products, enterprise software and Windows, are the largest corporate operating system in the world. The company is shifting from the provision of these products within individual companies to providing them as a service in its datacentres, effectively moving every on-premise data centre to Microsoft’s own datacentres, and providing the product (IT) as a service. We are not certain whether this is part of a network effect or simply a one-time business migration. The acquisition of LinkedIn a few years ago suggests that Microsoft is trying to turn itself into a network company. But in any case, it is showing runaway returns to scale as it moves whole industries to the datacentre.

As a separate case, we should consider Apple. It hasn’t primarily been a network company. It sells phones, which are hardware, and are interoperable with all other brands of phones, and most all other networks, so while it is a beneficiary of the network effect, it is not driven by it. Its product set is expanding, in turn attempting to lock users to its ecosystem to ensure seamless operability, which is driving sales, though previous quarters’ growth don’t point to runaway returns. And its expansion into networked services like the app store, music, entertainment etc. can be classed as a network, (though it has been the company’s choice to pursue this more slowly because of privacy issues) but it is much smaller though faster-growing than the hardware business.

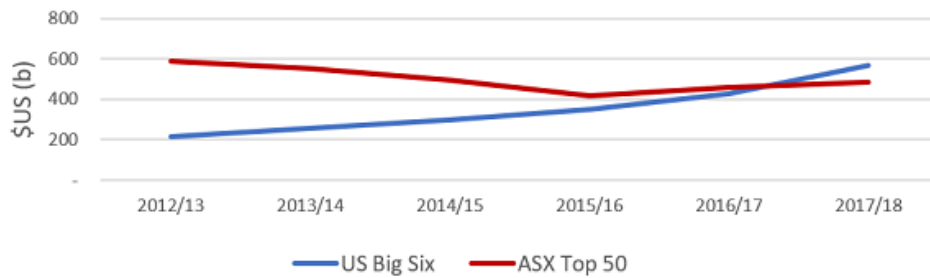
Apple's four quarters revenue growth vs previous corresponding period



Trailing four quarters revenue growth vs previous corresponding period, Source: Bloomberg

Just how big are the big six? They are now bigger in revenue than the ASX top 50, once the currency conversion is considered. And growing faster.

US Big Six* aggregate revenue (TTM) vs ASX Top 50
(as of 8 August 2018)



*Big Six includes Amazon, Google, Facebook, Tencent, Microsoft, Alibaba

Source: Bloomberg

Does size bring problems?

What happens when companies become so large that they create problems for lesser competitors? Eventually, they get broken up, like AT&T or Standard Oil, into a group of smaller businesses. And of course, as Thomas Piketty noted in his excellent book *Capital in the Twenty-First Century*, every so often a major global calamity comes along, like say a World War or even two), at which point everything is blown up, quite literally, and everyone starts again from a more or less zero base.

The first is preferable to the second. And it should be noted, in the case of the Standard Oil break-up, the sum of the parts wound up being much greater than the whole.

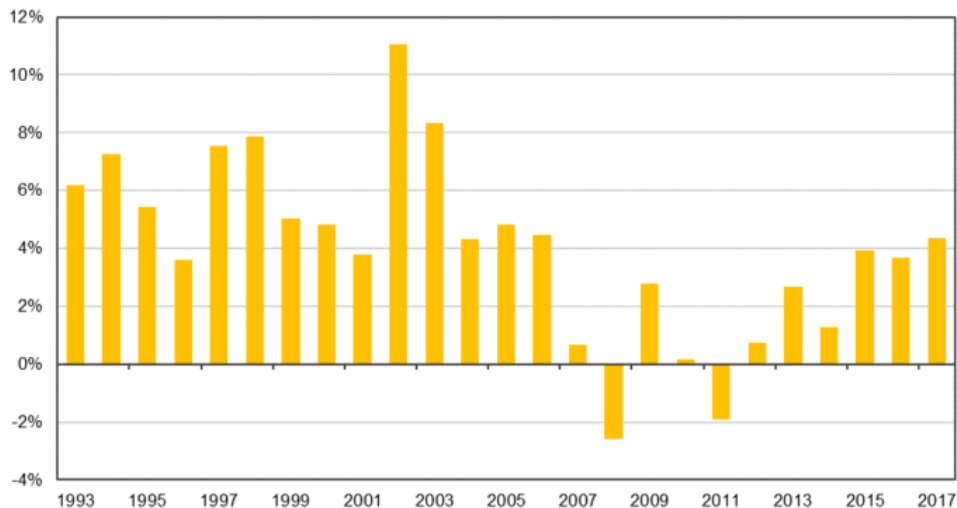
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Will the Royal Commission end our debt obsession?

Tim Carleton

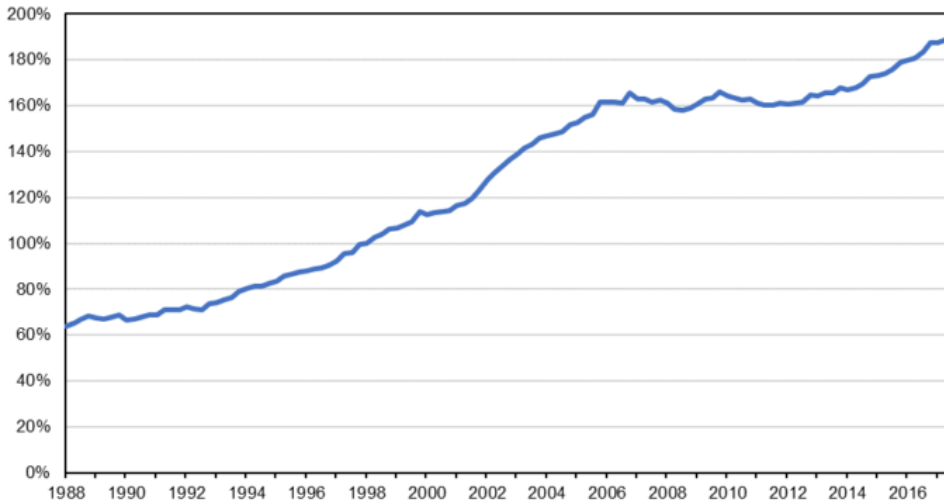
Australians appear to be addicted to leverage, and most specifically, housing leverage. In 23 of the last 25 years, Australian household leverage has increased. That is, the average household has borrowed more money for the same dollar of income. The debt to income ratio has continued to rise, with only occasional pauses. Will this continue into perpetuity? We are reminded of a famous German proverb, "Trees don't grow to the sky."

Change in Household Leverage (Household Debt to Income Ratio)



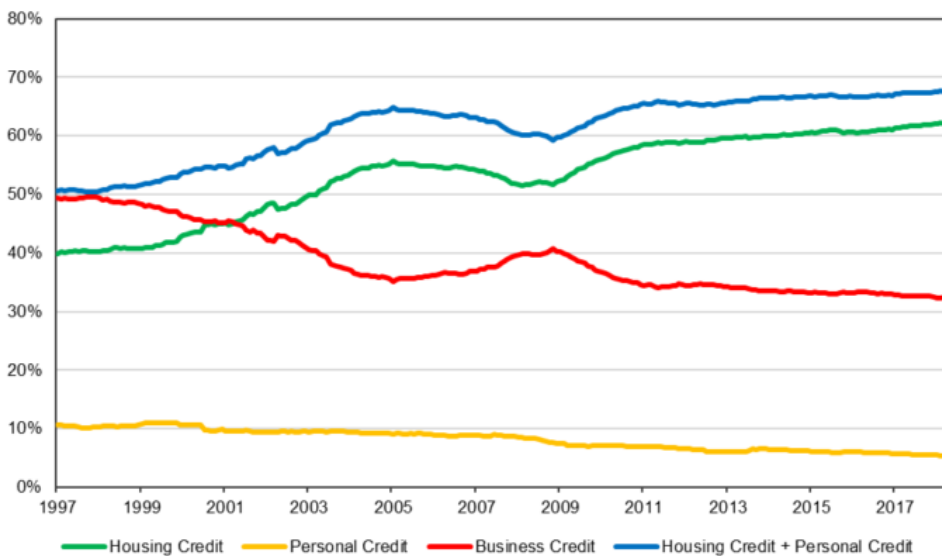
Source: Reserve Bank of Australia, Auscap

Household Debt As A Percentage Of Disposable Income



Household debt as a percentage of disposable income now exceeds 190%.

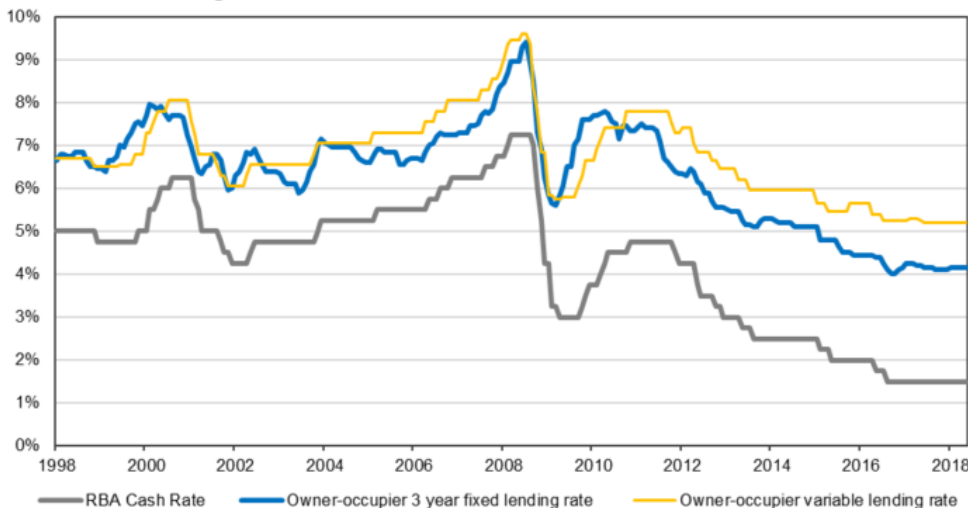
Private Sector Credit - Percentage of Total



Housing credit is now over 62% of total private sector credit.

Source: Reserve Bank of Australia, Auscap

Australian Borrowing Costs



Part of the equation has been falling borrowing costs. As interest rates fall, households can afford to borrow more money with the same dollar of income. Whether this is a sensible strategy is a question for debate. In recent years, APRA has started to insist that lenders use a minimum borrower interest rate assumption of 7% to assess a borrower's capacity. This is recognising that interest rates are unlikely to stay low forever, and that housing loans are typically written

over a 25 or 30 year period. Ensuring that households can afford their loans under a higher interest rate scenario is logical and sensible.

Will greater recognition of expenses be the straw that breaks the camel’s back?

The Financial Services Royal Commission appears to have uncovered another reason explaining why and how leverage has been ballooning. The availability of credit has been growing partly due to the widespread understating of household expenses and a corresponding lack of due diligence by lenders to investigate the facts. The Household Expenditure Measure (HEM), an index designed to put a floor on claims of low living expenses, was relied on by many loan applicants and lenders as the estimate for actual annual non-housing related living expenses. When applied, this index has been an unrealistically low approximation for the majority of households.

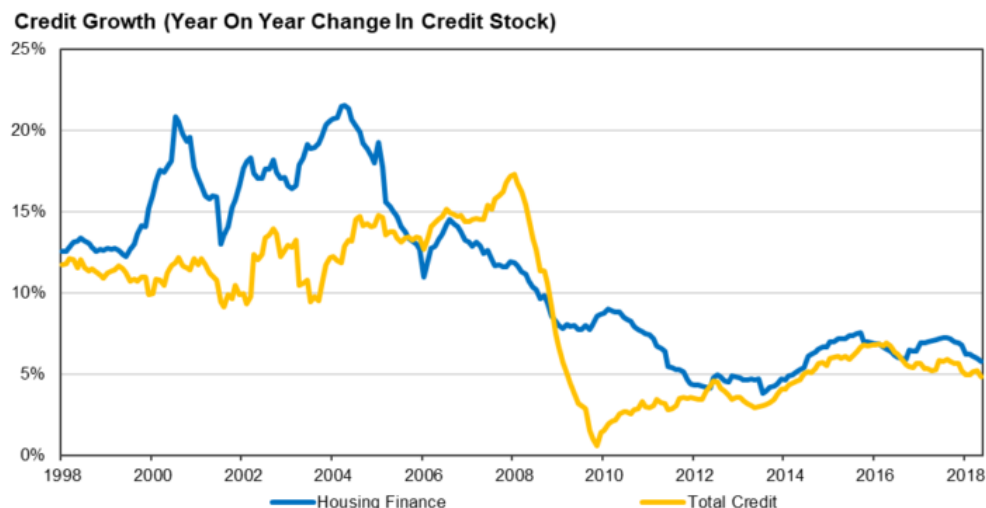
We suspect ensuring appropriate household expenditure due diligence by lenders will be an outcome of the Royal Commission. As Wayne Byers, Chairman of APRA, stated in a speech to the Australian Business Economists,

“Under ASIC’s responsible lending obligations, banks are required to make reasonable inquiries into borrowers’ living expenses, and APRA’s own prudential practice guide is clear that benchmarks shouldn’t be relied on to proxy expenses. Benchmarks can be helpful in providing a prudent floor where borrower declared expenses appear low, but should not be a replacement for making reasonable inquiries.”

The major banks appear to have already adopted more stringent measures. Formal due diligence on bank account and credit card statements could be an outcome. Positive comprehensive credit reporting will undoubtedly give lenders a greater ability to assess a borrower’s financial position.

How this affects leverage ratios and the creation of household credit is unclear. Household leverage ratios may be peaking. This is significant, because increasing leverage has clearly been a partial driver of house price growth over recent years. Credit contraction would reduce property price growth. The outcome of the Royal Commission, APRA’s multi-year focus on ensuring prudent lending standards and the banks’ adoption of more rigid standards is not yet clear in the data. As Wayne Byers commented “the changes in lending practices to date do not seem to have had an obvious impact on housing credit flows in aggregate”. But perhaps this is no surprise. Living expenses featured in the Royal Commission in March 2018. Our enquiries with a number of lenders suggest that living expenses came into greater focus around this time. So, will a sustained focus on living expenses be the straw that breaks the camel’s back?

Mixed reporting of credit growth

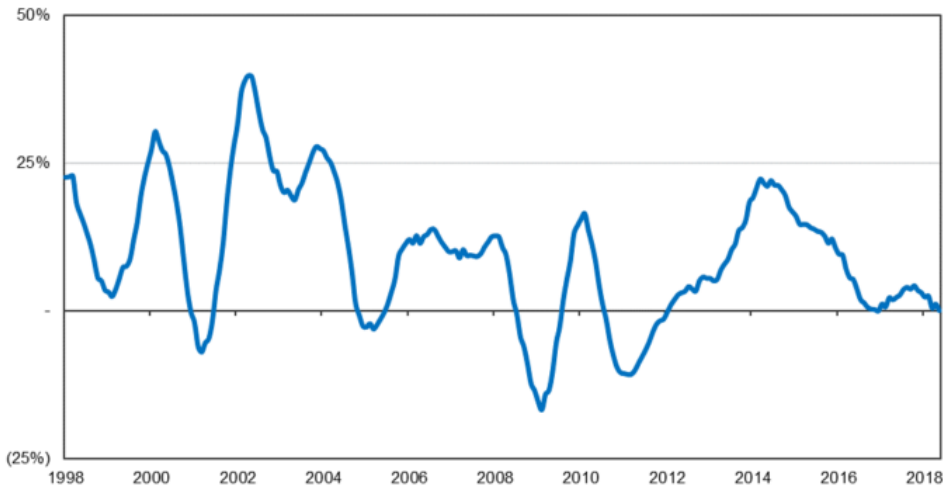


The size of domestic credit in aggregate relates to the stock of total credit in an economy. It is last year’s aggregate credit plus new credit created less any credit extinguished.

Source: Reserve Bank of Australia, Auscap

It is our view that this is a lagging indicator for what is happening in the economy, which operates more on the flow of credit. That is, how much new credit is being created this year versus how much was created last year. The largest component of credit is housing-related credit.

Housing Credit Flow Growth (Year On Year Change In Credit Flow)



The most recent May 2018 data point suggests new housing credit growth is weak, coming in at just +0.08% on an annualised basis. The actual exchange of properties that has led to this data most likely occurred six to eight weeks prior. This data potentially predates any changes made by lenders following the focus on household expense verification.

Source: Reserve Bank of Australia, Auscap

We suspect there are other leading indicators, such as auction clearance rates. It would be understandable that vendors have price expectations based on comparable sales made six to twelve months ago. But if a borrower's capacity has been reduced, there might be a noticeable gap between a buyer's ability to pay and a vendor's expectation on price. Clearance rates around the country have recently fallen significantly.

Weekly Australian Auction Clearance Rate, Combined Capital Cities



If lower clearance rates and listing volumes are symptomatic of falling housing credit growth, this should become apparent in the data over the coming months. The level of housing credit growth has important implications for the domestic economy. Has Australia become overly reliant on the creation of housing credit and increased household

leverage to fuel economic growth? Only time will tell, but it might provide both long and short opportunities in the near term.

Tim Carleton is Principal and Portfolio Manager at [Auscap Asset Management](#), a boutique Australian equities-focussed long/short investment manager. This article contains information that is general in nature. It does not take into account the objectives, financial situation or needs of any particular person.

Golden rules for considering tax in investing

Damien Klassen

Fairfax newspapers have been running a series of articles (see [here](#) and [here](#)) on the collapse of Great Southern and the hardships it has caused, a timely reminder of the perils of mixing debt, investment and tax breaks. Almost every case consists of investors borrowing to invest on the advice of a trusted professional, usually in search of a tax break. When the investment went bad, the investors were left with huge debts that many are still struggling to pay off. From the Fairfax articles:

"Great Southern's plunge into administration and infamy laid bare toxic conflicts within the accounting and financial advice professions, led to a series of explosive parliamentary hearings and, eventually, added to

momentum for the royal commission now underway. The commission has shone a spotlight on aggressive, unethical and potentially illegal behaviour by financial institutions in Australia but will not consider Great Southern ...

A Fairfax Media investigation has examined the stories of dozens of such investors, who say they were misinformed about the risks of investing in Great Southern by financial advisors who incorrectly told them the loans were non-recourse, which means if debt was called in, Great Southern was on the hook, not the investors."

It's a timely reminder for anyone with property in an SMSF. My prediction is that we are two to three years away from replaying similar stories on properties in SMSFs that were bought from spruikers at free seminars and leveraged as much as possible.

These rules are designed to minimise the chasing of tax breaks and people becoming another statistic:

Rule 1: Choose your investment first without regard for tax

Forget about tax. Work out whether the investment is good or bad before you even think about tax. If you can't justify an investment without incorporating some sort of tax benefit then you probably shouldn't be investing. You might like an investment on pre-tax returns and then reject it after considering the post-tax returns, but you should never do the opposite.

Rule 2: Get your structure right

It is sensible to invest using a tax-efficient structure, but you need to consider not only the financial cost but the time cost and the potential for additional liabilities or responsibilities.

Choosing between investing in your own name, a company, a trust or an SMSF is sensible. But, if you need to create a special structure to save yourself a few dollars in tax then consider:

- How much will you pay in accountancy or legal fees? I'm not saying don't listen to your accountant, but you should do the numbers yourself. If the structure results in a \$3,000 tax saving but a \$2,500 accountancy bill, then your accountant will probably think it's a good idea. You need to work out if \$500 will be worth the extra time and the potential liabilities.
- How much extra work every year will you need to do? If you hate doing one tax return then why are you signing up to add company or SMSF tax returns to your annual list of chores?
- If the tax rules change, how much will you be out of pocket? For example, spending \$5,000 upfront on a fancy structure to save \$2,000 per year might leave you considerably out of pocket if the rules change.
- Are you taking on additional liabilities and responsibilities? For example, becoming a director has additional legal ramifications. Your structure might affect how you will be treated legally if things go badly.

Rule 3. Debt is dangerous

Debt can make a good asset great. But, debt can never make a bad asset good, and it can make an average asset bad.

If your investment loses money, debt will never make the situation better. An asset that only returned say 2% might be disappointing if you invested in it without debt, but the investment is not disastrous. An asset that returned 2% funded by debt costing 10% might be disastrous.

I am wary of using debt to invest in any volatile asset. Never use debt to get yourself a tax break. If you are taking out a margin loan then make sure you can meet the margin calls if the stock market falls.

A common example might be borrowing against an investment asset (usually tax deductible) and using that money to say reduce your home loan (not tax deductible). First, this is playing with fire from a tax perspective (it may fall foul of Part IVa of the tax code) and second, check the interest rates. In many cases, higher interest rates mean that the benefit is negligible. And definitely don't increase the amount you invest to access a bigger tax break. Often the equation is:

- investment goes well, save a few hundred dollars or so in tax
- investment goes badly, financial ruin
- plus potential to fall on the wrong side of the ATO.

Rule 4. Never invest in an asset where the sales pitch has a major focus on tax breaks

Go back to rule number one.

Rule 5. Don't let tax affect your decision when to sell

There are timing benefits in when you might take a capital gain or a capital loss. But I'm much more comfortable selling an asset earlier than holding onto a poor investment hoping that it doesn't fall further while I wait for some tax advantage. That is, don't hold onto a poor investment that might get worse just because you are hoping there will be a tax benefit.

Damien Klassen is the Head of Investments for [Nucleus Wealth](#). This article is general information and does not consider the circumstances of any individual.

Five tips for better startup investing

Jaren Nichols

While angel investing groups have been around for decades, it has become easier in recent years to connect angel investors directly to entrepreneurs using online platforms. As a result, there is less interference, fewer restrictions and bigger opportunities. While many angel investors boast great success stories, there are also lots of ways to lose money.

There are some important steps to making good startup investments. Many angel investors never consider that *they* play a role in the outcome of their investment. At my company ZipBooks, our initial outside funding was led by a venture capital (VC) firm, but we consciously included angels based on the value they would bring. I've seen the process up-close, so I have some ideas about what works and what doesn't, what's helpful and what isn't.

Here are my five top tips for angel investors, because when investors and entrepreneurs work together, the chance of success is so much greater.

1. Look for companies that know how to pivot when it's time

Pivoting, or changing course in order to take advantage of a better, previously unseen or ignored possibility, is a huge benefit that startups have over big corporations. Smaller businesses are more agile and can pivot with a lot less risk, with upside for reward. Angel investors need to look for businesses that either already have a great track record of being able to pivot, or for businesses with the opportunity to do so right now.

By bringing in a fresh perspective, you may help direct a course down the most-likely path for success. Imagine if you were an investor in Twitter or Slack before they [made their big pivot](#) – where would you be today? ZipBooks started with free software before pivoting to a premium model with additional services to drive more revenue per customer. You should only invest in a company that is open-minded enough to consider a pivot. A company too set in its ways may not be the best place to guarantee a return on your money.

2. Be diligent in your due diligence, but within reason

While it's easy to understand you want all of the information you can get your hands on to make a smart investment, there's a point in the due diligence process where you can go too far. Although entrepreneurs should be happy to answer questions, pulling at every thread and guessing what might happen will deteriorate the relationship you are trying to build.

3. Take a cue from Shark Tank and invest in people

The Shark Tank programme often features a business that is so-so but they still get a great deal. You've also probably seen a great business, one with all the right numbers and a super smart strategy, totally tank. Why? Because savvy investors recognize the power of people. When a person has conviction and determination, when they have a story that makes you listen, when they wake something up in your gut that tells you to trust them – you probably should. People are what make or break businesses. And, when you have a feeling that the person behind a company is someone that is going to succeed, it often turns out that way. Nothing is

guaranteed when it comes to investing, but in startups, you can guarantee that if the people aren't right, neither is the investment.

4. Be involved, but keep your hands off the wheel

As much as I'm sure you love the idea of being the biggest asset to the business, most companies don't really need all that much help. Lack of capital, which is where angel investors like you come in, is typically the biggest barrier entrepreneurs need help overcoming. So, while you can offer sage advice and unique perspective, don't become involved in everything that's going on inside the business. If you've made a smart investment, the company really isn't going to need much of your help.

5. Don't count on one investment being enough

In order to maximize your investment return, you need to [take a diverse approach](#) to angel investing. The most successful angel investors have a portfolio of businesses in case one of the investments turns out to be a dud. While there are always stories of one-and-done successes, the chances are as likely as overnight success or an entrepreneur's first business being the only one he'll ever need. If you want to ensure you're being a smart angel investor, spread your funds around. This means that if you don't have enough money to invest as an angel in a few different businesses, it might not be the right time now.

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When good defensive investments go bad

Campbell Dawson

The 2017/2018 financial year was a bumper time for many fund managers, but something else jumped out at us when reviewing performance figures. When the worst equity manager returns 5%, you know it has been a near-perfect year. It's the same in all classes with balanced super funds doing 10%+ and small cap funds returning between 10% and 35%.

But what really stands out is the best-performing Australian equity managers (Bennelong, Platypus and Colonial First State) achieved between 23% and 26%. In our experience, widespread 20% returns usually signal the 'start of the end or the end of the start'. It's not quite 2006 and 2007 when the median super fund returned 14% p.a. or 1987 when some equity funds hit 50% returns, but we're reaching the stage where markets are in that swampy area between complacency and hubris. When things go pear shaped, everyone will say that it was oh so obvious.

Great year(s) fellas!

Manias affect all investors to some extent, so it's unfair to point out individual examples, but the 2007 – 2010 period produced some wonderful examples of what happens at the end of complacency. MTAA was a large industry superannuation fund which had made a more extreme asset allocation than its peers. It was heavily weighted to alternative assets such as private equity and infrastructure. The fund was only 4% invested in traditional defensive assets. Everything else was either 'growth' or 'alternative' with 45% of the portfolio in illiquid assets (alternatives, PE, property etc.) with a large derivative overlay. It was working well too. By 2007, the fund had returned 17% p.a. for the previous four years. Maybe the investment team thought illiquid and alternative assets were safe, or maybe they thought it would never end. We remember contacting them (or their advisers) and were told politely that they only invested in assets that generated returns greater than 10%.

It didn't work out for long though. The Fund generated a -23% return in FY2009 (and it was worse intra-year) and it took five years to generate returns higher than the low single digits, by which time equity markets had generated 20%+ gains. The investment return for the decade to 30 June 2017 was a meagre 2.4% p.a.

When good assets go bad

You would have expected the 'true' growth assets like equities to get shredded by the GFC, but they recovered quite quickly. What really killed MTAA was the exposure to alternative assets which were, or still are,

considered 'safe' investments. The table shows the capital gains and losses (in \$ million) attributable to the alternative asset classes for each year.

	2007	2008	2009	2010	2011
Enhanced cash	1	-28	-74	47	10
AUD Property	150	22	-85	2	-82
OS Property	-1	-11	-135	-15	19
AUD Infrastructure	99	14	-110	146	22
OS Infrastructure	-4	-67	-163	-234	-104
AUD Private Equity	-9	-26	-31	1	-12
OS Private Equity	65	-46	-112	-78	-58
Derivatives	73	250	-598	109	224

Source: MTAA Annual Reports.

There were a couple of pertinent points:

- The divergence between the domestic and international versions of the same asset classes is enormous. Australian infrastructure bounced quickly (which is what you would expect as interest rates fell), but international infrastructure was still generating losses almost five years later. Similarly with property. While the Australian version was fine, international property was double digit negative.
- Given the point above, it's interesting to speculate on why Australian 'alternative' assets in the post-GFC period did so well. Maybe they are genuinely low risk, maybe they were saved by the lack of a real recession or continued cash inflows into the sectors meant that prices never fell. We'll find out the real reason some time in the next decade when markets falter.

The biggest saviour

The only reason MTAA did not end up a total rout was that the fund maintained its cash inflows. This was a combination of the super guarantee cashflows which are virtually impossible to turn off, and super fund reporting, which is well after the event. For most super fund members, the reporting comprises a colourful brochure once a year and which most recipients either don't understand or throw in the bin. Few people withdrew their money from MTAA, which meant that the capital losses in 2008, 2009 and 2010 were spread out on a wider denominator and the 22% loss was much smaller than it otherwise might have been if their liabilities were more liquid.

Investment drivers

Investments are driven by factors which will determine their ultimate return outcomes and how messy the path is. For example, investment-grade bond returns are driven by duration and how likely an investment-grade company will default (not very often). The path is also influenced by sentiment. So, the ultimate returns of investment-grade bonds are stable and the path variability is driven by the duration.

Alternatively, equity and infrastructure value is driven by the economy and management and wars and politics and demographics, etc. Sentiment and risk aversion drives the path, and because they are very long duration, both the ultimate value and messiness of the path are highly variable and unknown. The example in the MTAA case is the offshore infrastructure which lost money for at least five years.

The implications for hybrids

We believe hybrids are closer to investment grade bonds with respect to ultimate returns, but they have other factors of not only default risk but near-death experiences with the issuer that will affect return outcomes. Their path is also affected by sentiment, but because of their shorter duration, they are far less volatile than equities. Which is why in the past 20 years, hybrids have had bad years, but they have tended to only last one year.

The other read is that investors should demand big premiums for illiquid investments, but they don't receive premiums except in the immediate aftermath of a crisis. They then get hit by the next crisis and either scratch their heads or complain. It's a non-trivial outcome as can be seen by the MTAA post-decade return of 2.5% p.a. driven by their exposure to illiquid assets at the wrong time of the cycle. Hybrids were more liquid than Australian corporate bonds in the last liquidity crisis and arguably more liquid than high yield bonds are now.

Campbell Dawson is Executive Director at [Elstree Investment Management Limited](#). This article is general information and does not consider the circumstances of any individual investor.

Five financial stages in everyone's life

Don Ezra

We go through stages in our lives. Sometimes it's useful to look at how our psychology changes as we move from one stage to another. This article describes five financial stages, looking at minimum, successful and exceptional standards.

I don't have numerical benchmarks for you. Individual circumstances vary too much for standardised benchmarks. It doesn't matter whether you're ahead or behind anyone else, let alone some fictitious benchmark person.

Instead, I'll give you three very rough action criteria at each stage. One will be the minimum, one will represent success, and one will be exceptional. As you get nearer retirement, the criteria stay the same, but their interpretation changes. What was exceptional in the previous stage now simply represents success, and what represented success now becomes the minimum. Don't take them as rigid guidelines, they're meant as hints to you.

And don't take the dates mentioned in defining the stages too rigidly either. Again, they're hints. We're all different.

Stage 1: The family and career years (more than 20 years before planned retirement)

The start of your paid working career is a natural starting point for looking at retirement finances. It's hardly a priority, though. Typical priorities at this stage relate to family and career. From a personal perspective, you'll want to establish a residential pattern, whether renting or purchasing, keep fit, enjoy life involving leisure, family and friends.

Nevertheless, minimum retirement-related action steps in this phase are to start saving via compulsory super and register for some form of default investment glide path, if there is one. (I explained about glide paths in an [earlier article](#).) In other words, start early.

Success at this stage involves making additional voluntary contributions and increasing those contributions every time your pay increases.

This isn't easy. You have so many other financial priorities. And you may be saving indirectly for retirement anyway, via paying down a mortgage, which is another form of increasing your assets.

What's exceptional? Getting into a post-retirement income mindset by doing funded ratio calculations, and understanding social security and superannuation rules. In the early years of work, it's completely natural to think solely in terms of accumulating wealth towards retirement. Changing from a wealth mindset to an income mindset typically comes much later.

Stage 2: Consolidating the financial base (5 to 20 years before planned retirement)

Now you're in the peak earnings phase of your career, and this is when you make the financial transition from paying off debts to accumulating wealth, although your children's education may make a big claim on your resources. The thing is, if it isn't now, it may be never.

Your social life is still important, as is keeping fit. If you have time, this is when you are valuable as a mentor to young people, because of the experience you have gained.

Being already in compulsory super, increases in your additional voluntary contributions as your pay increases are now the minimum requirements if you want the gift of a financially independent retirement.

Success? Getting into an income mindset is the only way to identify what you need to do between now and your planned retirement date. Included in what you need to do is a consideration of when you'll move away from the default investment glide path and customise one for yourself.

Exceptional? That's when you're in control of an integrated plan for paying off debt (mortgage and credit cards), financing your children's education and saving toward retirement.

Stage 3: Reaching maturity (five years approaching retirement)

Now it's not just a financial priority, it becomes a life priority to establish a plan for graduating from full-time work. There are two parts to the plan, financial and psychological, identifying the lifestyle you're going to, not just the lifestyle you're going from.

Social activities and keeping fit are important. Start to identify the experiences that satisfy you and make you happy, and explore ways to give something back to society.

At this stage, the income mindset and maximising retirement contributions are the minimum financial requirement. It's also time to understand investment risk and set forth on your investment path to retirement, including a customised glide path. You should know exactly how you relate to the age pension.

Success? The mortgage and credit card debt are gone, your children's education is paid for and you are on target for your retirement financial goal without having to increase contributions. You're starting to understand longevity, for both you and your partner. And you're considering what to do about post-retirement healthcare and long-term care.

What's exceptional? You're ready to start considering your legacy to your children, or even starting to make it available to them in small amounts now. You're making arrangements for a part-time career. You're searching for, or may have found, a financial adviser.

Stage 4: Transition (the first three years of getting into a retirement lifestyle)

Now the priority is to make the transition from full-time work happily, remembering that it's psychologically a new world, and even if you thought you knew what you'd enjoy doing, reality is often different. This is normal, not something to be surprised by or disappointed about.

Expand the scope of those social activities that create shared experiences, because typically those are the ones that make you happiest. Experiment with many activities and be honest about what really does satisfy you and make you happy.

The minimum toward retirement finances is now to understand the pattern you have chosen (whether an annuity or regular drawdowns) for your income. Make a decision about long-term care. Find a financial professional. Reassess your financial position (including your [personal funded ratio](#)) annually, with your spending pattern starting to establish itself. Make a decision about how you'll deal with longevity risk.

Yes, all of that is the minimum. If not now, when? After all, you're now already retired, at least partially. Success comes from everything now being on track, with your legacy plans established.

Exceptional? The psychological adjustment is complete, for both you and your partner.

Stage 5: Planning to downsize your lifestyle (around age 75 or a little later)

Downsizing your lifestyle is a typical phase, and it occurs naturally. Getting your financial affairs to match your downsized lifestyle needs to be done consciously. All financial aspects should now be routine and low risk, because that defines your lifestyle too.

I have no criteria for you at this stage. I simply wish you much happiness!

Don Ezra has an extensive background in investing and consulting and is also a widely-published author. His current writing project, blog posts at www.donezra.com, is focused on helping people prepare for a happy, financially secure life after they finish full-time work.

Lessons from the endgame for Toys 'R' Us

Alex Wu

After failing to secure a buyer, Toys 'R' Us (Australia) Pty Ltd has closed its 44 toy and baby goods stores, affecting approximately 700 employees. The closure has come as no surprise following the parent company, Toys 'R' Us Inc., filing for bankruptcy. The company's online store was shut down in June 2018 and the retail stores closed on 5 August, after an inventory clearance sale.

Inability to adapt to change

The demise of Toys 'R' Us can be attributed to the company's inability to adapt to changes in the Toy and Game Retailing industry. Industry operators have faced intense competition from online retail giants over the past five years. Amazon has dominated the US online toy sales market earning double the Toys 'R' Us' revenue in 2016. Toys 'R' Us Inc. outsourced its online business to Amazon in 2000. While Amazon grew rapidly, Toys 'R' Us never managed to catch up with the online trend. After Toys 'R' Us was acquired by private equity firms in 2005, the company accumulated significant debt and consequently lacked the resources to invest in building robust online infrastructure.

The Australian Toy and Game Retailing industry has struggled in recent years, with revenue only increasing at an annualised 1.4% over the five years through 2017-18. However, Australia Post's Inside Australian Online Shopping report shows that online game and toy sales have increased strongly, including a rise of 19.2% in 2017. Toys 'R' Us' offline operations have also been challenged over the past five years. Department stores represent a significant source of competition for operators in the Toy and Game Retailing industry. Department stores such as Kmart and Big W offer a wide range of products at lower price points, due to their strong bargaining power and economies of scale. Being a specialised retail chain has limited Toys 'R' Us' potential sales.

When one door closes, another opens

However, the exit of Toys 'R' Us represents a significant opportunity for Associated Retailers Limited, the owner of Toyworld, which is the major competitor of Toys 'R' Us in Australia. Toyworld has adopted the same traditional strategy as Toys 'R' Us, which focuses on bricks-and-mortar stores. There are currently over 120 Toyworld stores across Australia. Many parents are expected to turn to Toyworld's retail chain.

Associated Retailers Limited's revenue in the Toy and Game Retailing industry has declined in recent years, from a peak of \$230 million in 2014-15 to an estimated \$190 million in 2017-18. Intense competition from online operators and department stores has affected the company's performance. These challenges are expected to continue for the overall industry in the current year, with industry revenue anticipated to decline by 0.5%. However, the exit of Toys 'R' Us represents a significant opportunity for Associated Retailers Limited, if the company can avoid the same challenges that led to the closure of their main competitor.

Alex Wu is a writer for [IBISWorld's Media Centre](#).

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