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Reputations hit hard at the Royal Commission

Graham Hand and Vinay Kolhatkar

Round 5 of the Financial Services Royal Commission commenced on 6 August 2018 for two weeks with a focus on superannuation. The objectives of this round are summarised [here](#). We are presenting these highlights as direct dialogue to allow readers to make their own judgments.

Among the many witnesses who gave evidence, we have selected examples to illustrate important points, from NAB/MLC, AustralianSuper, IOOF, Hostplus, Colonial First State, ANZ and APRA. Senior Counsel Assisting the Commission was Michael Hodge (MH).

Highlights of week one

NAB/MLC

Paul Carter (PC), Executive General Manager within NAB's Wealth Division was interrogated with respect to payment of fees for services not rendered.

MH: ... it can be agreed that an amount will be debited on a regular basis from the employee's superannuation balance in order to pay the adviser for personal advice?

PC: Yes.

MH: And that's what is referred to as an adviser service fee (ASF)?

PC: Yes.

MH: Okay. And if we just pause on that for a moment. Whilst you were the Executive General Manager for the superannuation business, was there a programme for actively monitoring the provision of advice in exchange for the ASF to members of the NAB super funds?

PC: Not to the extent it was required.

MH: And in the way of these things, they would be paid the same amount and the member would be charged the same amount whether they actually provided the service or were just available to provide the service?

PC: Yes.

Carter was also queried about why consumers were not advised of their ability to dial down adviser fees by simply electing to do so.

MH: Okay. And on the basis that the adviser was available to provide the service, MLC would keep deducting the 0.44% from the member's MKPS product. Is that right?

PC: Yes.

MH: I understand they could call up and say, "I don't want to pay a fee any more", but if they don't do that, then originally MLC and later NULIS will keep paying the money over to the adviser?

PC: Correct.

MH: But there's no requirement that there be an agreement between the adviser and the member in order for that to occur?

PC: Correct.

MH: And how is it, without that sort of agreement that MLC or NULIS could be satisfied that the payment of the fee was in the best interests of the member?

By day two, Hodge was not mincing his words.

MH: Can I put this to you very bluntly, and we will go through the documents. What you did was to systematically look for any way to avoid having to refund all of the money to customers?

PC: I disagree.

MH: And that is why there is this idea [which Hodge revealed through the documents] that somehow you will find some other service that can be said to have been provided in exchange for the money?

PC: I disagree.

An exasperated Hodge kept at it.

MH: Do you recall that from May you were engaged in the exercise of trying to figure out how NAB could keep the money, rather than refund it?

Carter never admitted to deliberate wrongdoing except the failure to do the right thing.

MH: Did you ever think to yourself, "This is the wrong way to think about the situation, to be trying to identify services that we can say justify keeping the plan service fees"?

PC: No.

When Hodge questioned Nicole Smith (NS), a director of NULIS (NAB's superannuation trustee) from 1 October 2009 to 30 June 2018, the leading questions came a lot earlier.

MH: You know, don't you, about the resistance that NULIS, through the Wealth division, has put up to remediation in various respects?

NS: I would not say that NULIS has ever put up resistance to remediation.

MH: And can I suggest to you that the reason that the trustee did not do that was because it simply could not manage the conflict of interests that exist within – as between the NAB Wealth business and the trustee?

NS: No. I wouldn't agree that that is the reason.

MH: As you know, commission-based remuneration structures are opaque, lack any corresponding customer service obligation and are not generally understood by customers. Is that a view you share?

NS: I think that's a fair assessment.

AustralianSuper

Issues relating to the use of member funds for marketing were addressed when Ian Silk (IS), CEO AustralianSuper, took the stand.

MH: And what's the logic behind saying there's a free newspaper – free online newspaper that's being distributed to members and that will, therefore, lead to members staying with the fund?

IS: So we have – in terms of a strategy to retain as many members as possible, we have a multi-pronged approach, more than a dozen particular activities that are directed to that objective, and each of them are directed to achieving one of two, preferably both, objectives.

MH: Does AustralianSuper have a view as to whether it can use the fees that it collects to push a policy position in relation to superannuation?

IS: Absolutely. We believe we can use member fees to advocate for policies that we believe are to the benefit of the fund's members.

MH: Why isn't it the case that AustralianSuper couldn't say, "Well, we're not going to spend \$2 million acquiring The New Daily, and instead we're going to lower the administration fee."

MH: Was [it] originally intended to be a voice also in favour of industry funds?

IS: Where the facts warrant that, and we say in most cases the facts do warrant that.

*MH: How does that fit with **editorial independence**?*

Ian Silk defended the ['fox and the henhouse' advertisement](#) paid for using member funds.

IS: The proposal was to essentially strip superannuation from the industrial system and allow employers the unfettered right to choose the default fund that would apply at their workplace, and in doing so, create the likelihood, based on research that had been undertaken, that retail wealth management organisations, in particular the banks, would seek to leverage their business relationship with employers with a view to influencing them to choose, in the case of the banks, a bank-owned fund as the default fund to apply to the workplace.

MH: But the legislative change would be to remove a provision for superannuation from industrial awards and enterprise agreements?

IS: Correct.

IOOF

Chris Kelaher (CK), Managing Director of IOOF, was examined about the dual structure (wherein the trustee and the manager of the fund are the same entity).

MH: And APRA has been insisting that – or has said that its minimum requirements are now that the dual structure, that is, that IIML is both the registered entity for the responsible entity for the managed investment schemes and also the RSE licensee be dissolved?

CK: Yes, that's their aspiration, yes.

Kelaher failed to adequately defend why, when over-distribution occurred to the detriment of members, new members were not compensated promptly, neither were all members informed promptly.

MH: And the issue that that is getting at is that the problem with what Questor was doing by reducing the distribution was that new members who were joining the CMT were being detrimentally affected?

CK: Yes.

MH: And they were not receiving what they were contractually entitled to receive?

CK: Yes.

MH: What this paper is explicitly recording is that it was intended to wait until the end of the three-year period of under-distributing before doing the assessment of the impact on members and proposed compensation. Do you agree?

CK: No.

MH: Did it concern you that it was only because of a whistleblower notification that IOOF was now going to take steps to bring forward undertaking this assessment of compensation and the effect on members?

CK: I don't accept that it was the whistleblower that triggered the action.

By the end of the week, the Commission had covered many of its objectives despite the extended time spent with NAB and NULIS on trustee duties.

Highlights of week two

MLC/NAB

On the first day of the second week, the Commission asked Andrew Hagger (AH), Chief Customer Officer, Consumer Banking and Wealth, to return to give evidence. In total, NAB would give 20 hours of evidence over five days, versus the second-placed CBA at 6 hours.

MH: What I want to suggest to you is this: there is no reason why the trustee would want to do anything other than fully remediate its members?

AH: I don't necessarily – well, I don't agree with that proposition.

MH: What reason can you think of for why the trustee, acting in the best interests of its members, would not want to fully remediate them?

AH: Well, the trustee has a duty to work through what the appropriate remediation methodology is. Otherwise, if you took what you just said to its extreme conclusion, the trustee would never take any money from – accept any money from members. Or any money it ever received, it would give back.

MH: Mr Hagger, in this case, the issue was, on its face, quite simple, wasn't it? Let me put these things to you?

AH: It certainly was not simple, Mr Hodge.

MH: You didn't make it simple. Let's deal with why that was?

AH: No. No, it's not anything to do with me, Mr Hodge. It was not a simple matter.

And on it went for hours, with Michael Hodge trying to prove NAB had delayed telling ASIC the correct remediation amount, while Andrew Hagger argued he had been open with ASIC.

Hostplus

David Elia (DE) is CEO of Hostplus, and he started by advising that his super fund has about 1.1 million members with an average balance of about \$30,000. But then we heard some of the reality of engagement and excess super fund policies when members come from hospitality and tourism.

MH: Okay. And so we see there that as at 30 June 2017, 469,659 member accounts had balances that were \$6000 or less? And that figure represents around half of the total as at that time, roughly half?

DE: At that time, yes, just under 50% of the membership. That is correct.

MH: Thank you, Mr Elia. And the second table on page 6, that shows the number of accounts that are deemed inactive?

DE: Yes. So inactive as defined within the context of a member hasn't received a contribution over a 12-month period.

MH: And we see there that 296,898 accounts are inactive. That's at the end of June last year?

That's three-quarters of members either inactive or with balances less than \$6,000. No wonder there's an engagement and education problem in superannuation. Hostplus also has high turnover:

DE: We had approximately 200,000 new members join the fund over the course of the financial year ending 30 June 2018. For the financial year ending 30 June 2017, we had approximately 180,000 new members. But we then on average lose about 100,000 members, 80 to 100,000 members per year. So on balance, the growth of the fund has largely been net about 100,000, year on year.

Colonial First State

Superannuation funds have been required by law (Section 29WA of the SIS Act) to direct default contributions (where the employee has not made an investment selection) into a complying MySuper product since 1 January

2014. Colonial First State's Linda Elkins (LE) was asked by Michael Hodge why CFS had been in breach of this requirement.

MH: And you know, and were aware at the time, that under the amendments that had been made to the legislation to introduce MySuper, there was a requirement that all new default contributions be paid into a MySuper product?

LE: Yes.

MH: And it was a strict liability offence not to do so?

LE: Yes.

MH: Now, in the lead-up to 1 January 2014, APRA had written to all of the RSE licensees? ... And then a few months after 1 January 2014, Colonial First State gave notice of a breach to APRA?

LE: Yes.

MH: And the breach was that in respect of, at that time, approximately 13,000 members of FirstChoice Personal Super, they had made a default contribution into the fund since 1 January 2014 and it had not been paid into the MySuper product?

LE: That's right.

MH: Do you know how it could be that a trustee as large and sophisticated as Colonial First State had not identified, before 1 January 2014, which members were choice members and which members were default members?

LE: I think just the complexity at the time.

According to Michael Hodge, CFS subsequently addressed the breach problem by asking members to make an investment nomination, so CFS would no longer be required to place them in a MySuper account. Call centre operators were required to tell customers: "There has been a recent change to legislation which requires us to confirm the investment options into which you would like your superannuation contributions paid." However, this was incorrect, as CFS could have placed them in a lower cost MySuper account.

MH: But it achieves the purpose that Colonial was setting out to achieve?

LE: Colonial was wanting to – Colonial had a view that these were choice – that these people had made a choice, and were seeking to get the investment confirmation from them.

MH: Well, they had never made a choice as to investment options, had they? ... Do we agree that in no sense is choosing a fund the same thing as making a choice of investment product to invest in some specific investment option rather than the default product?

LE: I agree with that. At the time, that was the source of our contention, I guess, but yes, that is correct.

MH: But the contention by this point is done. You have given a notification of breach to APRA?

LE: Yes, but we were still of the view, as we expressed to APRA, that these people – we wanted to confirm whether these people wanted the investment selection.

MH: I'm not sure I understand that. You wanted to confirm with APRA whether they wanted the investment selection?

LE: We had confirmed with APRA that we would be calling these people to confirm the investment selection.

MH: Yes. I understand you sent this script to APRA?

LE: Yes. To APRA, yes.

MH: And APRA didn't contact you and say, "This is obviously misleading, don't do it"?

LE: Well, no.

MH: And advantage to Colonial of using a script like this, is that if it leads the member to make the investment choice, then you don't have to pay new contributions into a MySuper product?

LE: They can stay where they are.

MH: They – and, again, just to be precise about this, in relation to new contributions, you don't have to pay them into the MySuper product?

LE: That's right.

By Friday, Michael Hodge was using this example in his grilling of the regulator, APRA, and asking why it did not take legal action for this breach of 29WA.

MH: And the issue, as we understand it, is that Colonial between 1 January 2014 and mid-April 2014 contravened 29WA at least 15,000 times?

ANZ

ANZ Bank was criticised by the Commission for the methods it used to sell superannuation products through branches. ANZ admitted that customers could end up worse off if they switched their retirement savings into the bank's product, and ANZ knew it was a risky to use bank tellers. The Head of Superannuation, Mark Pankhurst (MP) gave evidence:

MH: So it will – the bank – the employee at the bank will go through these three steps, identify various banking products that the customer might be interested in, and then say, "Now that we've completed the A to Z review, would you like me to provide you with some general information on ANZ Smart Choice Super which is designed to be a simple low cost way for customers to manage their superannuation."?

MP: That is correct.

MH: But having done this A to Z review of the customer, ANZ staff then relied on their ability to sell the product under general advice rules by saying: "Please note, I can only provide general advice on this product so you need to consider if it's right for you."? ... And this process was regarded by ANZ as being the provision of general advice only and not personal financial advice?

MP: That is correct.

MH: What does advice mean, though, in this context?

MP: In this situation, it's really just talking about a product, and its features. And what it costs and how it works, really.

MH: Do you think it's misleading to even call it advice?

MP: My personal view is it's challenging – it's a challenging topic because you're trying to just give information and you're needing to do it within a legal framework. And so the general advice rules is what you're trying to play within and trying to make sure that you're not misleading the customer, you're not giving them anything that's advice, you're just simply telling them this is what the product does and that's effectively what it is. I think that's the intention here was simply to just make people aware of what the product did.

MH: It must be a bit more than though, isn't it, it's not just telling people about the product. ANZ wants people to take the product up?

MP: That's correct, yes.

ASIC has stopped both ANZ and CBA from distributing super products through bank branches because these financial health checks make customers believe they are receiving financial advice.

The final day for superannuation

On Friday 17 August 2018, 10 days of superannuation hearings came to an end with the two main regulators, APRA and ASIC, giving evidence.

Michael Hodge's main criticism of APRA was that it had not taken firmer action against breaches of law. For example, he quizzed Deputy Chair, Helen Rowell (HR), on why APRA had not commenced any court cases or imposed enforceable undertakings for the past decade.

MH: Would it [APRA] ever commence litigation?

HR: That is a potential action that we could take if we could not otherwise get the outcomes that we're seeking to achieve through getting changes to practice, or even negotiating an enforceable undertaking, for example.

MH: You know one of the criticisms that has been made by the Productivity Commission in its draft report of APRA is that the behind closed doors nature of its activities is not effective for achieving what I will call general deterrence?

HR: That is an observation that has been made.

MH: And that's an observation that APRA disagrees with?

HR: We do disagree with that observation.

MH: Do you agree that the characterisation of your activities as behind closed doors?

HR: No.

MH: And do you agree with this proposition: that what APRA does publicly does not identify specific conduct of specific entities?

HR: In general, that would be the case. The exception would be, for example, enforceable undertakings which would ultimately become public – which do ultimately become public.

MH: Yes, but in the case of superannuation, no corporate trustee has been required to give an enforceable undertaking, at least in the last 10 years?

The transcript of the final day can be found [here](#), which includes a brief summary from Michael Hodge over the last few pages on what the Commissioner has learned on superannuation. For example:

"Members of superannuation funds, like most beneficiaries, are vulnerable, and in respect of superannuation, many are disengaged and disadvantaged by a lack of financial literacy. They are readily able to be taken advantage of. And the evidence, you may conclude, Commissioner, suggests that this has occurred in some cases. In most industries, the forces of competition can be relied upon to minimise improper conduct and effective regulation can be expected to address breaches of the law when breaches occur. However, for superannuation, the disengagement of members, amongst other things, may limit the effectiveness of competition."

We can expect superannuation to feature prominently when Commissioner Hayne hands down his Interim Report by 30 September 2018.

Graham Hand is Managing Editor of Cuffelinks and Vinay Kolhatkar is Assistant Editor. The superannuation evidence contains hundreds of pages and the above is only some examples, and if any are taken out of context, that is not intentional but in the interests of brevity.

Investing versus chance and beating the odds

Miles Staude

We know that humans have been infatuated with gambling throughout history. Some of the earliest games of chance were forms of a dice game that used the squarish knucklebone of hoofed animals. Gambling was a constant fixture in the lives of both the ancient Greeks and the Romans. Pontius Pilate's soldiers cast lots for the robe of Christ as he suffered on the cross. In Greek mythology, three brothers rolled dice to decide how to divide the universe. Zeus won the heavens, Poseidon the seas, while Hades, the loser, was sent to hell as master of the underworld.

Our obsession with besting chance has not changed since ancient times. The total known sum of global gambling losses was estimated at US\$400 billion in 2017, equivalent to roughly one third of Australia's annual GDP. Undoubtedly, the actual amount is far higher since Americans are estimated to wager US\$150 billion a year on illegal sports betting alone. In Australia, gambling is almost the national pastime. Australians are the biggest gamblers in the world, losing on average \$990 per resident adult in 2016, 40% more than runner-up Singapore.

Separating investing from chance

Gambling is part of the human experience, but what separates a random game of chance from the supposedly more highbrow venture of investing? Indeed, the inexorable rise of the passive investment industry is based on the uncomfortable truth that few professional investors outperform the market over long periods.

In the age of Exchange Traded Funds (ETFs) and efficient financial markets, generating investment returns is in fact relatively easy. Over long enough periods, most asset classes generate positive investment returns. Given this, the skill of investing can hardly be thought of as the act of generating positive returns. This is especially the case during periods like the present 9-year equity bull market. Instead, what should separate investing from a random toss of a coin is the skilful assessment, management and bearing of financial risk. The real art of investing should be in generating better returns than what the pre-investment odds would have forecast.

Yet, investment risk remains one of the least talked about aspects of investing. Most investors know what their portfolio returned last year but ask that same investor how much risk they bore to generate those returns and too often, the response is a blank stare.

Given the fundamental principle of investing is 'risk versus reward', it is unnerving how little time is spent contemplating risk.

How do we measure risk?

One of the challenges that a wider appreciation of 'risk' confronts is that of accounting for the vast range of possible outcomes within financial markets. Most financial risk management becomes a mathematical exercise in quantifying risk based on historical events. This exercise often polarises people. For some, the mathematics provides the only quantifying tools we have to compare the historical 'riskiness' of different investment returns.

However, calculating the probability of known historical events only tells us one thing: the probability of events that happened in the past. We cannot quantify the risks that may appear in the future and just as importantly, we cannot quantify the risks that did not appear in the past. Landing safely after skydiving without a reserve parachute does not prove that you will never need one.

Such arguments do not mean that evaluating risk is a futile exercise. Rather, understanding and managing investment risk is both a quantitative exercise and a subjective exercise of skill. The best investors use the framework that quantitative risk management provides to find opportunities that deliver better outcomes than random chance alone.

The risk and return trade-off

Unfortunately, the mathematics involved in quantifying risk is less straightforward than the mathematics used when calculating returns. If you bought a stock at \$1 per share and it goes to \$1.50 per share, calculating the investment return is a straightforward exercise. Few of us however, can calculate a standard deviation of returns figure in our head. Too often this means that investors overlook the importance of thinking about risk.

This is a great mistake. All the shortcomings that apply to quantifying risk apply in equal measure to quantifying returns. The first metric we all look at when assessing an investment proposition is what historical returns have been. A skilled investor is one who can form the same sorts of subjective assessments about risk.

The workhorse in most risk measurement exercises is the concept of volatility. In simple terms, the more volatile an investment is – the greater it moves up and down over time – the riskier it is as a proposition. In statistical terms, volatility is a measure of the dispersion of returns around a mean (a standard deviation). Fortunately, it is not necessary to understand statistical mathematics to be able to usefully apply this concept to your investing. Over the long-term, the volatility of global share markets has been 15%. In contrast, the volatility of global bond markets (a much less risky investment class) has been 6%. Long-run average annual returns for global shares have been 5.3%, while for global bonds they have been 3.9%.

Without needing to understand how volatility is calculated, with this information we are now able to put rigour into the idea that investing is a trade-off between risk and reward. The more volatile (risky) an investment is, the greater the returns needed to compensate for taking extra risk.

Taking these concepts to their natural conclusion is the Sharpe Ratio, which is the most widely used metric of risk vs. reward in finance. It gives us a simple way of fairly comparing different investment propositions. It effectively shows the ratio of returns divided by their risk (volatility), with a higher ratio indicating better risk-adjusted returns than a lower ratio (a fuller summary of how the Sharpe Ratio works can be found [here](#)). Using

the above example, the Sharpe Ratios for global share and bond returns are 0.23 and 0.38 respectively, showing that global bonds have delivered better risk-adjusted returns than share markets have.

For Australian investors, a worthwhile data point is that the long-term Sharpe Ratio of the S&P/ASX200 is 0.34.

Conquering luck

The bull market of the past few years has generated returns far greater than the historical long-run average share market return. Hanging over this is one of the most powerful forces in finance, the notion of the return to the mean. Recent double-digit annual returns are not likely to be sustainable in the long run. It is increasingly important for investors to distinguish between the quality of returns rather than only the absolute return numbers.

Many investors today would benefit greatly from a deeper understanding of the concepts of investment risk. In a rising market, an ability to beat random chance is easily overlooked. Yet ultimately, over the long run, the test of an investor is whether they managed to generate returns greater than the risks they took, not whether they made money in a bull market.

Miles Staude of Staude Capital Limited in London is the Portfolio Manager at the [Global Value Fund](#) (ASX: GVF). This article is the opinion of the writer and does not consider the circumstances of any individual.

A-REITS are looking at M&A activity again

Winston Sammat

The 2018 financial year, like the previous few years, turned out to be a security picker's market in the listed property, or A-REIT, sector. Performance varied across the 31 stocks in the S&P/ASX300 A-REIT Index, ranging from Propertylink at up 34.4% to Stockland Group at down 3.6%.

Even within sectors, the performance variation was wide. Among the retail A-REITs, SCA Property Group took line honors with a total return of 18.4% while Aventus, the specialist large format retail centre owner, underperformed with a total return of just 4.7%. It was a similar story in the office A-REITs, GDI Property Group returned 33.8% while Dexus returned just 7.5%. Among the diversified A-REITs, Abacus returned 25.5% and Stockland negative 3.6%.

Overall, the S&P/ASX 300 A-REIT Accumulation Index finished FY18 on a high, returning 13.2%, in line with the broader equities market, with the last three months delivering a strong return of 9.8%. The strength in the A-REIT sector coincided with rising concerns of an escalation in a trade war between United States and China, political tensions in Europe, a pullback in US bond yields and the flattening of the Australian yield curve.

Office and industrial up, residential steady

In the current reporting season, valuations are up and earnings guidance ranges have narrowed towards the upper end supported by solid rental growth across most office and industrial markets. Notwithstanding the broader markets concern about the weakening residential sector, strong settlements were recorded across the Stockland, Mirvac and Ingenia residential portfolios.

Darren Steinberg, CEO of Dexus, was on the money when he recently said:

"It is pleasing to see higher market rents being reflected in our latest round of valuations across many of our assets. In addition, valuers have taken into account recent transactions where there has been no softening in the underlying investment demand for good quality office and industrial properties which continue to attract a variety of domestic and offshore buyers."

Looking ahead, we expect corporate activity to remain elevated reflecting many of the A-REITs inability to acquire assets in the direct market at reasonable prices. Finding bargains is next to impossible at this point in the cycle, and to grow, A-REITs are now looking to M&A. And we've seen this play before. Back in 1999-2000 and again in 2006-2007, M&A became defining factors in a relative hot property market.

Also, the lower Australian dollar is making the valuations of A-REITs increasingly attractive to foreign acquirers (note the Unibail-Rodamco acquisition of Westfield Group, Blackstone's bid for Investa Office Fund and Brookfield and Hometown's fight for Gateway Lifestyle).

A-REITs trading at the smallest premiums or discounts to NTA will be most prone to being merged or taken private.

Overall, we expect the A-REIT sector to deliver relatively attractive returns given the continued low domestic interest rate environment. The two wildcards are the impact of more M&A activity and A-REITs, like interest rate sensitive sectors, being susceptible in the short term, to any major sell-off in global bond markets.

A-REITS owned by asset allocators

Unfortunately, short-term volatility is now a permanent feature of the A-REIT market. With more of the A-REITs being owned by general equity funds, hedge funds and global investors, the sector is more susceptible to the gyrations of these investors, who move in and out of the sector, at a whim. In January and February 2018, the A-REIT sector returned negative 3.2% and negative 3.3% respectively, as concerns about rising global inflation pushed global bond yields higher. Fast forward to May and June, as concerns about rising bond yields abated, the A-REIT sector rallied, with returns of 3.0% in May and 2.3% in June.

In such an environment, as an active manager that doesn't follow the weighting of each A-REIT security in the Index, we favour those stocks with exposure to the social infrastructure and specialised property sub-sectors, selected real estate developers and managers that have growing funds management platforms. We also like securities with quality management and relatively attractive yields that have the ability to actively manage their portfolios to drive income growth. Not all A-REITs will perform the same.

Winston Sammat is the Managing Director of the [Folkestone Maxim A-REIT Securities Fund](#). Folkestone is a sponsor of Cuffelinks. For more articles and papers from Folkestone, please click [here](#).

ETFs: survival of the fittest

Dugald Higgins

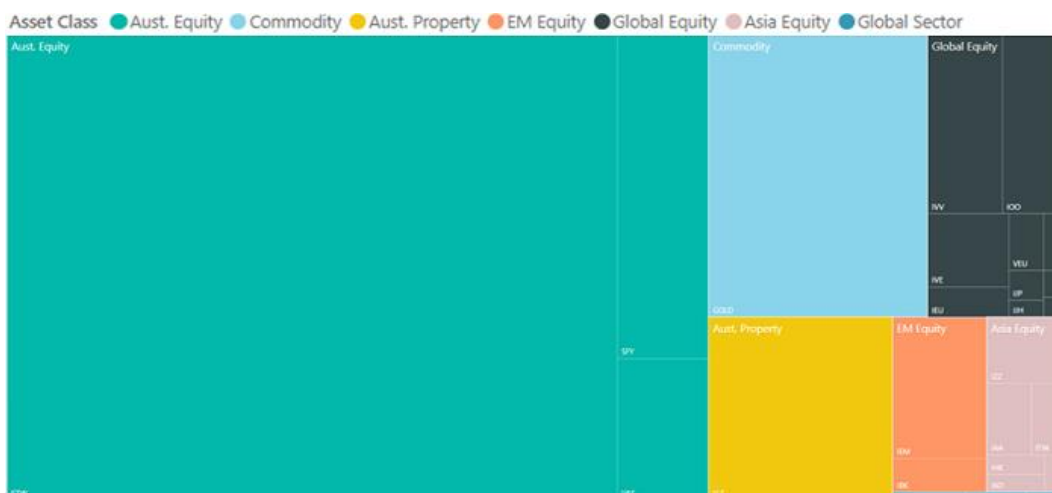
The growth of Exchange Traded Funds (ETFs) has been one of the greatest global investment success stories of the past decade. In Australia, the increase in appetite for ETFs is reflected in the surge of listings with 179 ETFs available in 2018, up from 30 in 2010. However, little attention has been paid to the risks in some ETFs for investors.

While ETFs provide easy access to market segments and low-cost asset allocation tools showcasing a wide range of strategies, Zenith believes investors need to pay attention to potential red flags on the longevity of individual ETFs before investing.

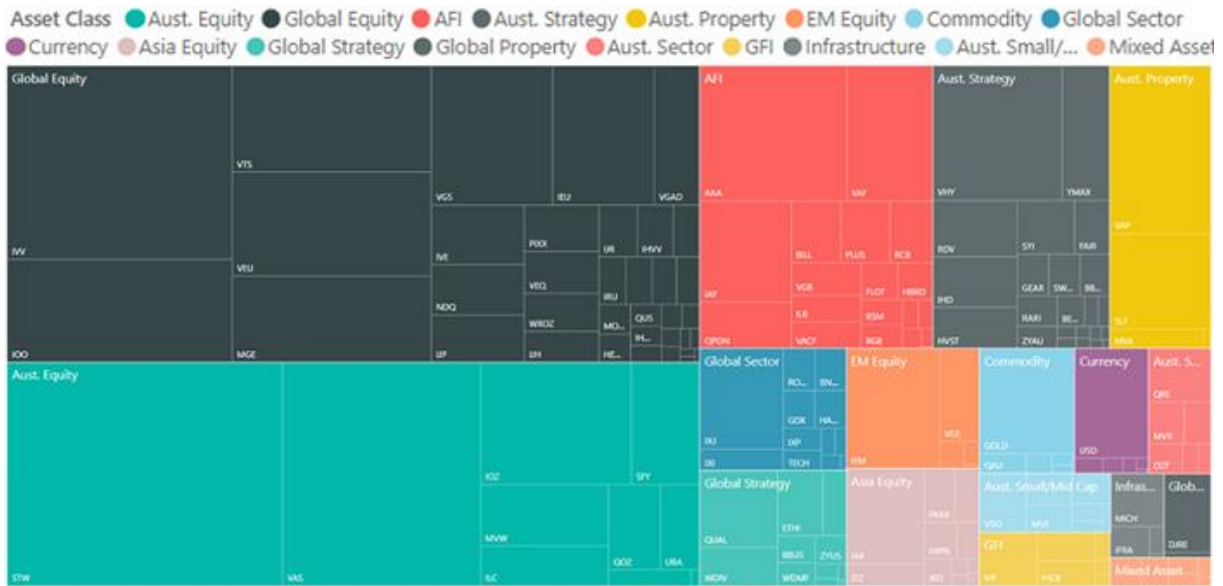
Growth and diversification

Industry competition has developed rapidly. The following charts show how the market has expanded since 2011, with a material increase in the number of ETFs and range of market segments (depicted according to size).

June 2011

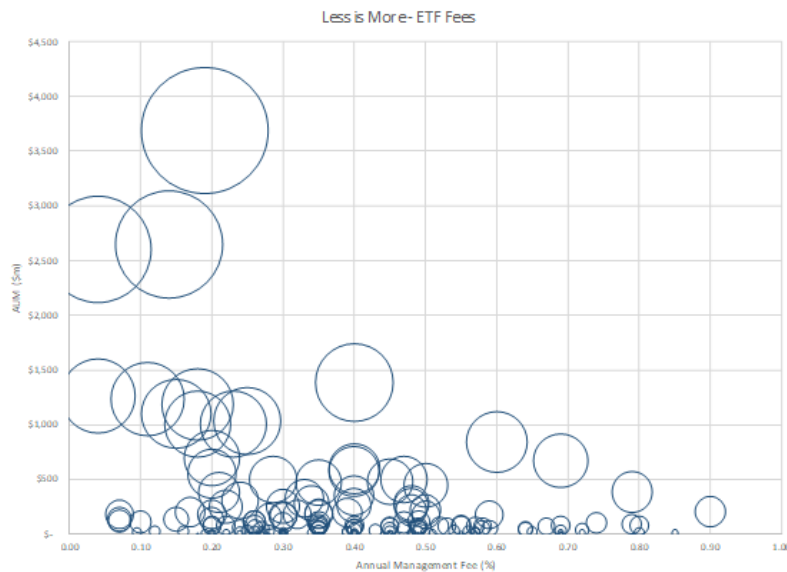


June 2018



Expanded availability of options is broadly a positive. However, this shouldn't mask the risks associated with some ETFs that struggle to gain acceptance and achieve scale.

Investors are becoming increasingly sensitive to costs. Trends both locally and globally show that ETFs which act as low cost, core building blocks gain the greatest traction. The following chart shows all ETFs on the ASX measured by size and annual management fees (ex 'Active' products). Data points are unlabelled as this is less about 'who's winning' than the broader themes.



There is clearly a relationship between fees and Asset Under Management (AUM). Over time, as ETFs reduce fees, they typically accelerate AUM. Leaders across the asset classes are generally first quartile for cost competitiveness, although there are some newer, cheaper ETFs which have not had time to build scale.

Achieving scale

Common denominators in ETFs which achieve material scale are:

- Competitive fees relative to peers
- Core market exposures
- Relative attractiveness of a strategy within a peer group
- First mover advantage
- Issuer business model, including scale, product diversity and marketing effectiveness.

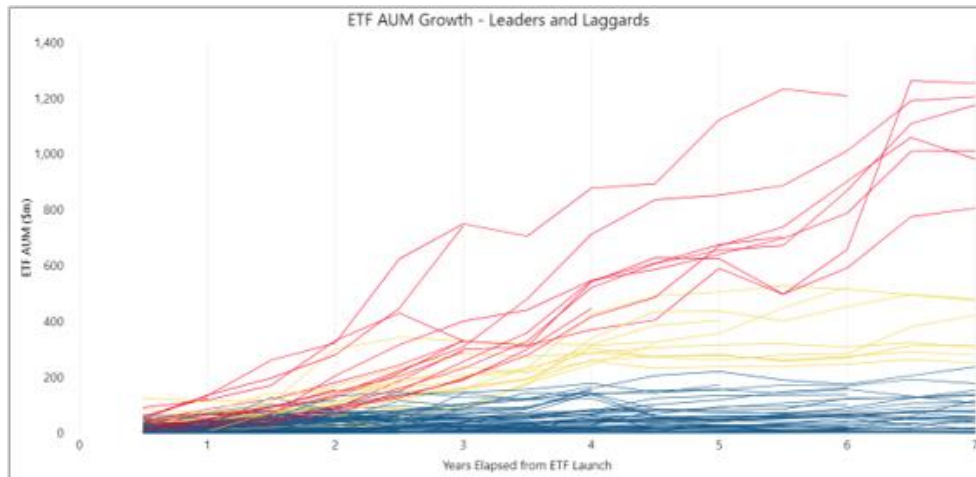
While strong performance can drive short term growth, it typically lacks persistence as a factor.

As AUM rises, management can potentially reduce expense ratios as efficiencies increase. This can promote a positive feedback loop, where an ETF gains AUM, increases efficiency, lowers costs and gains yet more AUM. Cost competitiveness between products means investors reap the rewards as expense ratios fall.

While core ETFs have benefitted, the same cannot always be said for some niche products. ETF's key attraction is the ability to bring asset allocation tools within reach of the average investor.

But specialisation can have drawbacks. The pool of investors to which specialised ETFs appeal may be shallower, and while fees tend to be higher, lack of scale can limit issuer profits. While their investment premise can be valid, a specialised ETF has a higher business-viability threshold.

The following chart shows growth in market capitalisation for individual ETFs, measured in six-monthly intervals for the first seven years from listing.



There is a recognisable separation between 'leaders' and 'laggards'. Occupying the middle ground are the 'moderates', those ETFs although successful, have failed to attain the momentum of the leaders.

Leaders are typically distinguished by cost effectiveness and core exposures. Obviously, cost is not the only thing that matters, however, it is clearly a dominant factor in investor preference.

The laggards face the risk that they fail to benefit from increased efficiencies enabled by growth, which in turn can result in stagnation and in some cases, delisting. We believe that there is a danger zone for ETFs failing to exceed \$100 million in their first three to five years of operation.

Negative attributes inhibiting ETFs from achieving scale reflect success factors:

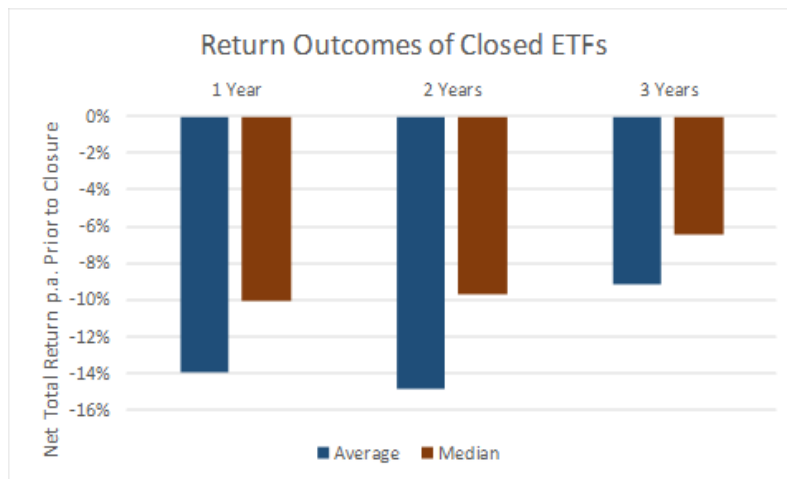
- Uncompetitive fees relative to peers
- Highly specialised exposures
- Complex investment thesis
- Issuer businesses lacking scale, product diversity and marketing effectiveness.

Since 2010, 17 ETFs have been delisted, mainly due to increased competition and poor performance which have contributed to lack of investor take-up. While only equating to approximately 1% per annum (by number), Zenith believes the rate of terminations will increase. By comparison, in the more mature market of the US, ETF delistings have averaged approximately 7% per annum over the last decade.

Consequences of a delisting

Small scale and poor market performance over a multi-year period can be leading indicators for delisting. Closure of a product has two main primary effects on advisers and their clients.

First, there is a potential sequencing issue. Delistings sometimes occur after prolonged negative performance. Over two-thirds of all delisted ETFs delivered negative total returns over one, two and three years prior to their delisting date. The following chart shows the median and average per annum net return across these ETFs prior to delisting.



On delisting, investors are generally forced to exit and therefore crystallise a tax event. Naturally, there is the risk that for some, the timing can be far from ideal. The delisting of an ETF removes investor choice as to whether or not to maintain market exposure.

Second, the process of changing an exposure can be time-consuming for both advisers and clients. Depending on the arrangement, there may need to be discussions and a Record of Advice or new Statement of Advice issued. There may also be implications around sourcing a suitable replacement, particularly for more specialised ETFs.

Of course, not all small-scale ETFs risk closure and other factors may provide ongoing support at the issuer level. Some issuers will maintain certain niche ETFs for strategic reasons, as the ETF is part of a broad product offering from a stable business.

Obviously, terminations are not limited to ETFs and are also common in managed funds. However, Zenith believes that strong growth in issuance increases product competition. As a result, we believe that more products will be rationalised in the future, and investors should consider the implications of an ETF's lifecycle and the quality of the issuer, not just the investment merit.

Dugald Higgins is Head of Property and Listed Strategies at [Zenith Investment Partners](#). This article is general information and does not consider the circumstances of any individual.

Lucy Brogden on the link between mental and financial health

Jeannene O'Day

How can financial institutions care for customers in a way that goes beyond the balance sheet?

If you were to ask financial services executives what role the sector plays in our society, some might talk about its impact on the economy. Financial planners or superannuation executives might talk about how the sector contributes to retirement incomes and outcomes. A portfolio manager might point out how the sector efficiently allocates capital to the highest returning or prospective sectors. Australia's National Mental Health Commissioner, Lucy Brogden, offers another perspective:

"There is no doubt that a connection exists between mental health and financial wellbeing."

Rethinking risk: why we need to consider the social impact

This is why, Lucy Brogden suggests, it may be time for a rethink of how the industry looks at the way they interact with their clients:

"With industry practices in the spotlight, it's clear that while something might look good in the spreadsheet, when you consider all of the possible social impacts is it good risk management to put clients in a situation which has the potential to cause financial stress?"

Indeed, the impact of financial stress on Australians was highlighted in a 2015 survey by the Australian Psychological Society which found that financial issues are rated as the top cause of stress, with 35% of Australians reporting having a significant level of distress.

Women: three pay cheques away from homelessness

In Australia, women are for the most part among the most disadvantaged when it comes to financial stress. Lucy states:

"A study by Women in Super and the Sydney Women's Fund found that only 15% of women living in Sydney earned in excess of \$100,000 and 48% earned less than \$34,000. While some of this is can be explained by women not being the primary earner, we know that divorce rates mean that women are the most impacted financially when there is a separation. Most women are a mere three pay cheques away from homelessness and women over 55 are the fastest growing cohort of homeless. This is why it's so important for us to help women develop a sense of financial independence."

The challenge, Lucy explains, is that while working women can experience workplace stress from gender discrimination and pregnancy, men are more likely to feel the burden of being the main bread winner. Women, however are more likely to seek help than men.

KYC: Why stress points matter

Getting the best advice for clients is about instilling a culture that takes a deeper approach to traditional 'know your client' policies:

"We need to ask, what does 'know your client' really mean? You could argue that having better insight into a client's mental wellbeing is good risk management. It makes good business sense to go a bit deeper into the human aspect of the advice we are offering clients. But many financial planners and advisors aren't trained to have that conversation."

Making sure disclosure helps not harms

The challenge, however is where do you draw the line and how do you ensure clients are not disadvantaged by disclosing some of the challenges they are facing?

"Although there is a business imperative to know more about the client, at the same time we don't want to disadvantage those clients who are transparent about the issues they are dealing with. For example, we know that the minute a client seeks a mental health plan this action is notifiable under most insurance policies and can impact on a policy-holder's ability to make a claim."

Industry collaboration: finding a TPD middle ground

The good news is, unlike 10 years ago, the industry is now looking at ways to collaborate with the Mental Health Commission to tackle some of these issues:

"We have been trying to work with insurers to design products that offer a solution to mental illness claims which sits somewhere between no payment and TPD (Total and Permanent Disability). At the end of the day, neither the insurer nor the claimant really wants a TPD outcome – and we also know from a mental health perspective, getting people through recovery and back to work delivers the best outcome in most cases for patients. So there has to be a middle ground and we are working on that with the insurance industry."

Bank regulation: Aspirational target or baseline?

It seems the banks are also stepping up on this front, Lucy adds:

"Most of the major banks are also looking at this and it makes sense when you consider the impact mortgage stress has at both a business and societal level. In banking and finance we need to ask the question, is regulation an aspirational target or the baseline? How can we help financial institutions link values to the way we care for customers in a way that goes beyond the balance sheet? Intuitively it would seem that the ability to identify client problems early will help these institutions better monitor and manage risks."

Finding peace of mind in retirement

While for many the aim of super in retirement is to minimise financial stress, increasingly we are realising that with longer life expectancy, compulsory superannuation is insufficient to ensure a vast proportion of the Australian population have the financial peace of mind they had planned in retirement.

"Here the conversation needs to be about models of tenancy and home ownership that can provide the certainty that retirees will have a roof over their heads."

Lucy reminds us that relevancy is the ultimate test of social license and that financial stress is a pain point that innovation will eventually address. *"The ability to help solve a problem, to fill a need is the ultimate test of the sector."*

Jeannene O'Day is a Business Development Manager at [Colonial First State Global Asset Management](#), a sponsor of Cuffelinks. For more articles and papers from CFSGAM, please [click here](#).

Over the top: exceeding the concessional cap

Graeme Colley

Last year's super reforms have certainly changed things if you want to make concessional contributions to super, with tax deductions being available to more people including employees.

The concessional contribution cap of \$25,000 applies to any super contributions made for you, or that you claim as a tax deduction. It includes salary sacrifice, superannuation guarantee and any of your pre-tax salary package that is paid to super.

If you have just one source of income then the calculation should be relatively simple, but if you have several jobs or belong to more than one super fund, then monitoring your concessional contributions can be a little more tricky. And if you do go over the cap there are tax ramifications.

What is happening with Jane?

Jane earned a salary of \$100,000 last financial year. Her employer paid 9.5% of her salary as compulsory super, totalling \$9,500 for the year and remitted at the end of each month. Also, each year she salary sacrificed up to the \$25,000 cap, or \$15,480 paid as a monthly amount of \$1,290 and at the same time her compulsory contributions were made.

During the year, Jane did some part-time work in a friend's business, with \$1,000 paid in superannuation. Jane's total concessional contributions were \$25,980, which exceeded the \$25,000 cap.

She exceeded the cap, what happens next?

Once the ATO has all the information about Jane's superannuation, it will send her a determination detailing the amount and the charge that applies for the excess. The charge is calculated from the beginning of the financial year in which the excess arose up to the time of her income tax assessment. The ATO will amend Jane's tax assessment to include the excess, which is taxed at her personal rate less a 15% tax offset to take account of the tax already paid on the contribution by the super fund.

Once Jane receives the determination from the ATO she will have 60 days to make one of two choices:

1. She can make an irrevocable election for one of her super funds to release 85% of the excess contributions to the ATO within 21 days of her election. This should provide enough to pay the amended income tax assessment. Anything left over will be applied against any of her other tax liabilities, then any remainder will be refunded to Jane.
2. She can pay the penalty tax and leave the excess in super which will also be counted against her non-concessional contributions cap for the financial year in which the excess arose.

Government measures to help

The 2018 Federal Budget provided help for those at risk of breaching the cap but only where the person has a number of employers required to make superannuation guarantee contributions. Where compulsory contributions across all employers are expected to exceed the cap, an election can be made to absent one or more of those employers from paying super. This will help high income earners on more than \$263,157 (and who have multiple employers).

However, individuals like Jane will be unlikely to access this measure, as part of her concessional contributions comprised salary sacrifice. But for an unexpected situation like Jane's, the excess plus penalty charge will

apply. She will need to decide whether to leave the excess in the fund and be counted against her non-concessional cap, or whether to withdraw it.

Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at [SuperConcepts](#), a sponsor of Cuffelinks. This article is general information and does not consider any individual's investment objectives. For more articles and papers from SuperConcepts, please [click here](#).

The Thorny Birds of McCullough's estate

Donal Griffin

"From the outside, Australian novelist Colleen McCullough's home on Norfolk Island is prim and picket-fence perfect, a long tree-lined driveway leading to a white two-storey colonial house in a leafy garden. Inside, it's a different story ..." Extract from an [article in Traveller.com.au](#).

Colleen McCullough (or 'Col' as the court case found she was called) famously wrote *The Thorn Birds*, a huge hit in the 1980s and later made into a television show. Growing up in Ireland, I remember the whole country being shocked at this tale of a woman having a relationship with a priest. Shocked but we had to watch!

Not quite the quiet life

Ms McCullough moved to Norfolk Island, perhaps for privacy or a quiet life. However, that peace did not follow her passing as recent proceedings in the NSW Supreme Court publicly analysed aspects of her family and health in a dispute about her estate. The [decision in this dispute](#) was recently handed down by the Court.

The famous author would perhaps have been pleased to write such a great story, with her estate dispute finding a broad audience but she would not have relished being the main character.

The parties giving evidence seemed caught up in the drama of a wealthy famous woman. There were reports of her husband Ric being in "a murderous mood" and evidence that Ms McCullough herself could be "cranky and impatient ... and difficult and demanding".

The Court admitted that it did not get to the bottom of what exactly happened and that certain things were a mystery. The Judge too seemed inspired by literature and explained his difficult position, "If the track of the truth in this matter is to be found, it is narrow and poorly lit."

Testamentary documents had been prepared by the deceased's friend, Ms Coleman, who was a lawyer and also by her husband's lawyer.

The Court was doubtful about much of the evidence that led to a will being produced which failed to include a suspicious page that purported to distribute the entire estate to a foundation in Oklahoma. "F@#k Oklahoma", the late author allegedly shouted at one point. We were invited to believe that this meant she did not want the foundation to be the main beneficiary of her will. The Foundation issued proceedings.

On Ms Coleman's evidence, Ms McCullough initialled the page of the Oklahoma Will bequeathing her estate to the Foundation, but neither of the two witnesses initialled or signed that page nor the page setting out executor powers.

The courtroom drama

The Judge set out some fairly extensive segments of the cross-examination of Ms Coleman relating to her discussions with Col and Ric because of their importance to the critical issues in this case and to Ms Coleman's credibility: "*Listen, let's leave the mind reading to one side. She has told you, 'Give him what he wants.' One, two, three, four, five words - all one syllable. Not hard to understand, are they?"*

The Court found that Ms Coleman admitted to a course of conduct that is entirely inconsistent with what is required of a practising solicitor, namely:

- Asking a person (Mr Quintal) to add his initials to a document as a witness when he had not seen the person whose signature he was purporting to witness sign that document, and
- Providing a document purporting to be the will of her client to the husband of her client in order to deceive him into believing that his wife had made a will in his favour.

There was evidence which points to significant involvement of a carer named Ms Wright. She called the police and told them that Col feared for her safety. She most likely organised a medical certificate from a Dr Metcalfe, and Ms Wright was in a relationship with Dr Metcalfe at the time!

The judgment is clear and we think it is helpful to quote directly from it – while legal issues may be complex, a consideration of people’s behaviour is, well, interesting.

The judgement

The Court said: *"In other circumstances, the evidence of a nurse or carer with no benefit to be obtained by either of two (or three) contested wills would be important evidence in assessing where the truth lies. I am, however, not able to accept Ms Wright as a truthful non-partisan witness whose evidence can be accepted without corroboration. Ms Jackson is another carer whose evidence cannot be safely relied on without independent corroboration, although for different reasons".*

The Judge concluded: *"The matters referred to [above] lead me to conclude that, whatever the imperfections in their marriage ... the situation by October 2014 ... was not so acrimonious as to necessarily preclude as a possibility that Col would decide to reinstate Ric, her husband of more than 30 years, as the sole beneficiary of her estate."*

"It is not unheard of that a relative or close friend of a married person holds strong views about the spouse’s unsuitability and the viability of the marriage which views, even if made known, are not accepted or acted upon by the married person."

The Court found the will leaving the entire estate to husband Ric was valid.

The Court had a lot to say about the lawyers: *"The need for this litigation has been caused by Ms Coleman and for two reasons. The first is that she failed to prepare a fresh will in the usual fashion and instead decided that she could substitute one dispositive page for another. The second is that she propounded a version of events by which she sought to justify [her actions]"*.

Perhaps because of the way the case was run, he ordered that each party should bear his or her own costs.

"It could happen to a bishop"

The Foundation lost, Ric won, and many reputations were damaged. The drama of a life of ups and downs can get concentrated and messy at the end. It is human nature to want to have a final say. In Ireland, we say: "It could happen to a Bishop"!

The courts take no pleasure in managing such disputes and sometimes the only winners are the lawyers. We work with clients to avoid going to court but sometimes it is inevitable and we will fight for them in court if necessary so that their wishes are honoured.

Col explained to Ric that movie rights do not necessarily turn into movies. We wonder who will make the movie of this story!

Donal Griffin is a Principal of [Legacy Law](#), a legal firm specialising in protecting family assets. The firm is not licensed to give financial advice. This article does not consider any individual circumstances and Cuffelinks does not know the merits or otherwise of the case.

Personal reflections on the history of CFS

Warren Bird

*Editor’s note: On 22 August 1988, an accountant named Chris Cuffe joined First State Fund Managers (FSFM) at the age of 28, shortly after it had commenced managing **\$300 million** of internal State Bank deposit funds and staff super. He was CEO within 18 months and by the time he left 14 years later, it had become Colonial First State and it was managing over **\$70 billion**. This week marks the 30 year anniversary of that joining date. After Chris left in 2002, Colonial First State was split into its funds management side and platform/retail distribution side. Going full circle, the Commonwealth Bank plans to put these businesses back together in the float of Colonial First State next year.*

In this article I provide some personal reflections on my time working for one of Australia's funds management success stories.

Over 20 years ago, I became Head of Fixed Interest at a small investment firm that many people thought was about to be gobbled up by another. The FSFM business had been assigned zero value in the acquisition of the State Bank of NSW by the Colonial Mutual Group a couple of years earlier. Colonial at the time expected that all funds management activities would be taken up by its Melbourne-based Colonial Investment Management.

Was I crazy to join this tiny business?

Nevertheless, I left a senior role at the firm that was at the time widely regarded as the best fixed income house in Australia to join this little business that had about \$1 billion in cash and \$28 million (sic – million, not billion) in its bond fund. While some in the industry who knew FSFM well were encouraging about my move, many thought I was crazy.

FSFM had commenced in 1988 as mostly a cash and fixed income investor, to manage the approved deposit funds of employees and ex-employees of the State Bank of NSW. With interest rates well into double digits at the time, the vast majority was in cash.

However, FSFM's equity business grew rapidly with Greg Perry at the helm. With all due respect to the many other fine equity managers I've worked or invested with since, Greg is the best stock picker I've known. Through the mid-1990s his ability was widely recognised by the independent financial planning community. By the time I joined at the start of 1997, the equity funds had become the growth engine of the business, which had just surpassed a total of \$3 billion under management [Managing *Editor's note: I remember the \$1 billion party in 1991, when I was Deputy Treasurer at State Bank of NSW and FSFM was an almost inconsequential section in Treasury*].

Growth had been so rapid that a large proportion of the staff were contractors, brought in to manage investor applications. Strategic discussions at the time had a base case that the coming year would be "a year of consolidation". However, that year didn't come. The business kept growing – rapidly.

Fixed income was part of that, with our funds under management reaching \$60 billion around 10 years later. The Colonial Melbourne business that had been expected to take over FSFM was itself taken over in May 1998 and the name of Colonial's funds management arm instead became Colonial First State (CFS).

What were the reasons for CFS's success? Certainly, we benefitted from the fortuitous timing of being set up just as the rapid growth in Australia's superannuation industry was getting underway, but there was a lot more to it than that.

Strategic team building

By 1996, Chris Cuffe knew that, if FSFM was to enjoy sustainable success, it needed to have more than a great equities team. Balanced funds were still popular in superannuation at the time. These funds invest across asset classes with the same manager. So Chris began hiring managers to head up other asset classes. Sandy Calder was hired for listed property, Dave Whitten for global resources and I was brought in to the fixed income piece of the equation. There were some setbacks, especially in global shares, where the guy that had been hired to establish those funds went back to his previous employer the day they were due to launch, just before Christmas in 1996. But overall, the team Chris put together was effective and coherent, embracing complementary investment styles that could be blended well.

Strong performance

We delivered strong fund performance, which has to be a key plank for any business. Greg and his team delivered superb results in the equity funds from around 1994 onwards, in both large and small cap portfolios. Other asset classes then kicked in. In my first year heading up the fixed income team (1997) we had the best performing Australian Bond Fund, and listed property and global resources also did well.

End-to-end business

The industry was changing rapidly in the later years of the 20th century and CFS was able to change with it thanks to the leadership team having control of all aspects of the business. This included IT, which was a flexible and creative team led by a business-savvy guru, Derek Ngoh, who kept us ahead of the game. One of the drawbacks of becoming owned by the CBA a few years later was the loss of this end-to-end capability and the enforcement of 'shared services' on many parts of the business.

An excellent culture

At CFS we lived and breathed a positive, high performance culture. This came from the top, with the way Chris dealt with his team, modelling how all leaders within the firm were to deal with theirs. Good cultures empower their staff and equip them to do their jobs to the best of their ability. I have not personally felt as empowered to run the funds and make decisions as I was during the earlier years at CFS.

Focused customer base and quality service

During its rapid growth period, CFS focussed exclusively on servicing independent financial planners. We had no ambition to deal directly with retail investors or to have in-house advisers, seeing the independent planners as the experts in looking after the end-investor's needs. To this target market we provided high quality, personalised service. I fondly remember walk-throughs, when Rob Adams or one of his team would bring around a group of advisers to show them the investment teams at work.

What they saw was the culture being lived out. They picked up a positive vibe from all of the teams, often remarking that they could see people working at CFS who were energised and clearly enjoying one another's company.

As a result of all of these factors, the CFS brand became very strong. Also, by early 1998 Colonial's CEO Peter Smedley became convinced that Chris knew how to run a business and deliver results. So Smedley ditched the plans for the Melbourne funds management business to be the driver of a combined entity and instead the First State team dominated the in-house merger.

CFS then took over the Australian operations of Legal and General (June 1998) and Prudential (August 1998) in quick succession as Smedley (nicknamed 'Pac Man' at this time) built Colonial into a diversified financial services company. That in turn made the business a takeover prospect, an opportunity the CBA grabbed in 2000, in what was then the largest corporate takeover in Australian history.

That created another situation where the CFS team was in competition with the new owner's in-house fund manager. That turned out quite differently. Suffice to say for now that my team merged with the Commonwealth Investment Management fixed income and credit team in 2003, and we enjoyed some great success over the next few years with Tony Fitzgerald's team.

I've been gone from CFS for five years. I often think back on those exciting times when I joined Chris and Greg and the rest of the team with a dream of becoming the biggest and the best. Some dreams do come true.

Warren Bird is Executive Director of [Uniting Financial Services](#), a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee.

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