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10 years after GFC, 7 lessons for investors

Shane Oliver

The period August to October is a time for anniversaries of financial market crises – the 1929 share crash, the 1974 bear market low, the 1987 share crash, the emerging market/LTCM crisis in 1998, and of course the worst of the Global Financial Crisis in 2008. The GFC started in 2007 but it was the collapse of Lehman Brothers on 15 September 2008 and the events around it which saw it turn into a major existential crisis for the global financial system. Naturally each anniversary begs the question whether it can happen again and what are the key lessons. And so it is with the 10th anniversary of the worst of the GFC.

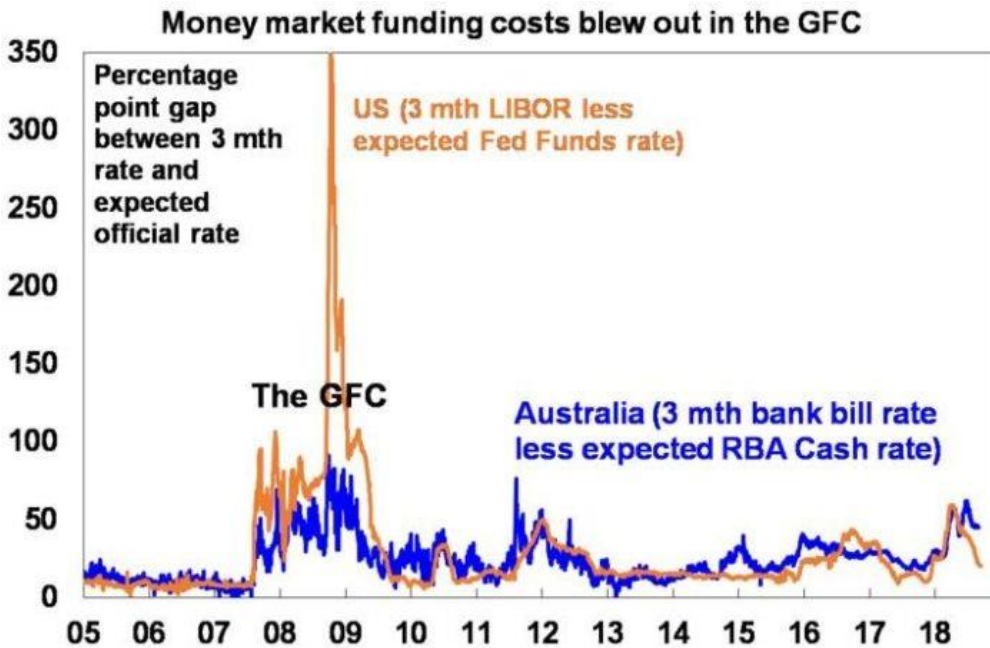
A brief history of the GFC

The GFC was the worst financial crisis since the Great Depression. It saw the freezing of lending between banks, multiple financial institutions needing to be rescued, 50% plus share market falls and the worst post-war global economic contraction. Low interest rates prior to the GFC saw too many loans made to US homebuyers that set off a housing boom that went bust when rates rose and supply surged. Specifically:

- About 40% of loans went to people with a poor ability to service them – sub-prime and low doc borrowers. And many were non-recourse loans so borrowers could just hand over the keys to the house if its value fell.
- This was encouraged by public policy aimed at boosting home ownership and ending discrimination in lending. Some extolled the 'democratisation of finance'.
- It was made possible by a huge easing in lending standards and financial innovation that packaged the sub-prime loans into securities, which were then given AAA ratings on the basis that while some loans may default the risk was offset by the diversified exposure. These securities were then leveraged, sold globally and given names like Collateralised Debt Obligations (CDOs). But after securitisation there was no 'bank manager' looking after the loans.
- Banks were sourcing an increasing amount of the money from global money markets.

This stopped in 2006 when poor affordability, an oversupply of homes and 17 Fed interest rates hikes saw US house prices slide. Sub-prime borrowers struggled to refinance loans after their initial 'teaser' rates so they

started defaulting, causing losses for investors. In August 2007, BNP froze redemptions from three funds because it couldn't value the CDOs within them, triggering a credit crunch with sharp rises in the cost of funding for banks. See the surge in short-term borrowing rates relative to official rates in the chart. A reduction in credit availability initially caused sharp falls in share markets.



Source: Bloomberg, AMP Capital

Shares rebounded but peaked around late October 2007 before falling about 55% as the credit crunch worsened, the global economy fell into recession and many banks failed with a big one being Lehman.

The crisis went global as losses magnified by gearing mounted, forcing investment banks and hedge funds to sell sound investments to meet redemptions which spread the crisis to other assets. The wide global distribution created a loss of trust resulting in a freezing of lending between banks and sky-high borrowing costs which affected confidence and economic activity.

The GFC ended in 2009 after massive monetary and fiscal stimulus along with government rescues of banks, but aftershocks continued for years with sub-par growth and low inflation into this decade. From an economic perspective the GFC highlighted that:

- **Fiscal and monetary policy work.** There is a role for government, central banks and global cooperation in putting free market economies back on track when they go into a downward spiral. While some have argued that easy money just benefitted the rich, doing nothing would have likely ended with 20% plus unemployment and worse inequality.
- **The return to normal from major financial crises can take time.** The the blow to confidence depresses lending and borrowing and hence consumer spending and investment for years afterwards. The key is to allow for this and not turn off the policy stimulus prematurely, but also to avoid thinking it is permanent as the muscle memory does eventually fade.
- **'Stuff happens'.** After each economic crisis there is a desire to make sure it never happens again, but history tells us that manias, panics and crashes are part and parcel of the process of creative destruction that has led to an exponential increase in material prosperity in capitalist countries. The trick is to ensure that the regulation of financial markets minimises the economic fallout that can occur when free markets go astray but doesn't stop the dynamism necessary for economic prosperity.

Will it happen again?

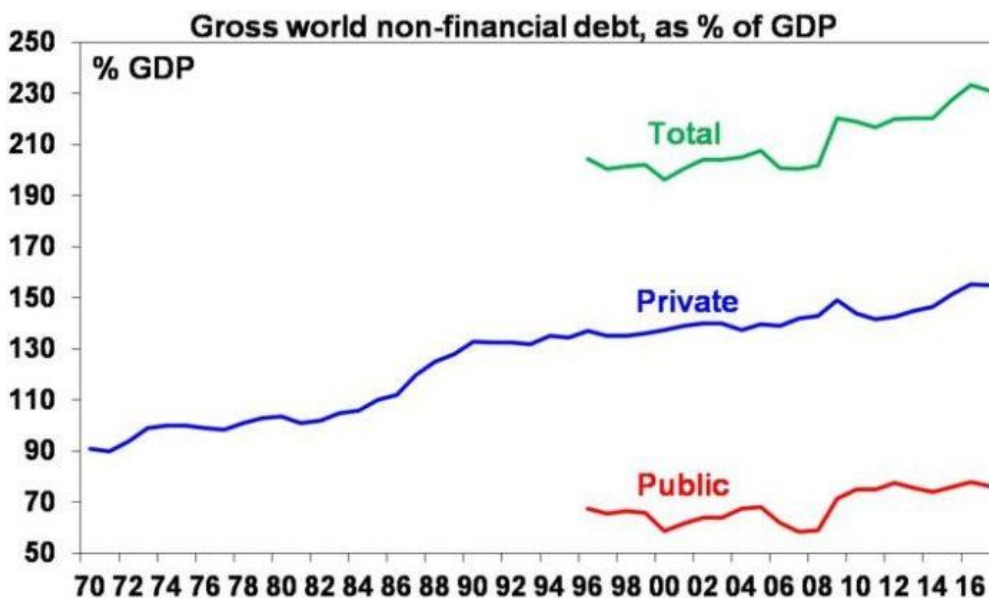
History is replete with bubbles and crashes and tells us it's inevitable that they will happen again as each generation forgets and must relearn the lessons of the past. Often the seeds for each bubble are sown in the ashes of the former. Fortunately, the post-GFC environment has seen an absence of broad-based bubbles on the scale of the tech boom or US housing/credit boom. There was a brief surge in gold and some commodity

prices early this decade but it did not become too big. Bitcoin and other cryptos blew up before sucking in enough investors to have a meaningful global impact. E-commerce stocks like Facebook and Amazon are candidates for the next bust but they have seen nowhere near the gains or infinite P/E ratios seen in the late 1990s tech boom.



Source: Thomson Reuters, Bloomberg, AMP Capital

Post GFC, global debt has grown to an all-time high relative to global GDP, but this alone does not mean another GFC is upon us. The ratio of global debt to GDP has been trending up forever, much of the growth in debt in developed countries has been in public debt and debt interest burdens are low thanks to still low interest rates. Other signs of excess like those in the GFC are not present on a widespread basis. Inflation is low, monetary policy globally remains easy, there has been no widespread overinvestment in technology or housing.



Source: IMF, Haver Analytics, BIS, Ned Davis Research, AMP Capital

Banks are required to have higher capital ratios and raise more funds from their depositors. Much of the surge in debt post the GFC has been in private emerging market debt rather than in developed countries suggesting emerging markets are at greater risk. Another economic crisis is inevitable at some point, but it will likely be different from the GFC.

Seven lessons for investors from the GFC

The key lessons for investors from the GFC are:

- 1. There is always a cycle.** Talk of a 'great moderation' was all the rage prior to the GFC but the GFC reminded us that long periods of good growth, low inflation and great returns are invariably followed by something going wrong. If returns are too good to be sustainable they probably are.
- 2. While each boom-bust cycle is different, markets are pushed to extremes.** The asset at the centre of the upswing becomes overvalued and over-loved at the top and undervalued and under-loved at the bottom, which for credit investments and shares was in first half 2009. This provides profit opportunities for patient contrarian investors.
- 3. High returns come with higher risk.** While risk may not be apparent for years, at some point when everyone is relaxed it turns up with a vengeance. Backward-looking measures of volatility are no better than attempting to drive while looking at the rear-view mirror.
- 4. Be sceptical of financial engineering or hard-to-understand products.** The biggest losses for investors in the GFC were generally in products that relied heavily on financial alchemy purporting to turn junk into AAA investments that no one understood.
- 5. Avoid too much gearing or the wrong sort.** Gearing is fine when all is well, but it magnifies losses when things reverse and can force the closure of positions at a loss. When lenders lose their confidence and refuse to roll over maturing debt or when a margin call occurs, investors are forced to sell when they should be buying.
- 6. The importance of true diversification.** While listed property trusts and hedge funds were popular alternatives to low-yielding government bonds prior to the GFC, through the crisis they ran into big trouble (in fact Australian Real Estate Investment Trusts (REITs) fell 79%), whereas government bonds were the star performers. In a crisis, correlations go to one except for true safe havens.
- 7. The importance of asset allocation.** What matters most for your investments is your asset mix – shares, bonds, cash, property, etc. Exposure to particular shares or fund managers is second order.

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at [AMP Capital](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

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'Best interests' requires walking in their shoes

Alex Denham

As financial advisers, we are subject to a 'best interests' duty whereby we must act in the best interests of our clients when providing advice. It seems obvious, doesn't it, but historically this obligation was being so overlooked by so many advisers that it has been enshrined in legislation and is overseen by ASIC.

Best interests duty is taken seriously these days, and rightly so. Our licensee has provided endless hours of compulsory training and guidance. Their regular audits of our files focus largely on this. If we get best interests wrong, we can end up in a whole world of trouble including losing our licence and in extreme cases, jail time.

The advice is up to me

I like to think that since becoming an adviser, acting in my clients' best interests is something I have always done on the advice given. The ongoing training and audits are vital to ensuring that the advice is presented and documented correctly and in accordance with the law, but the advice itself, I believe, is up to me.

In our studies, we learn about Modern Portfolio Theory, risk/return trade off and diversification – all important for building an investment portfolio that meets a client's tolerance for risk. In other words, a portfolio based on how well they can bear to lose money at any given point in time.

In our training, we are given the tools in the form of questionnaires to assess each new client's tolerance for risk and from there consider time frame and the client's goals and voila ... build an investment portfolio. Years

of brilliant minds have honed this methodology and it has been used for decades in best practice financial advice.

Not something from the textbooks

However, the longer I am an adviser, the clearer it becomes that understanding a client's 'best interests' is not something that can be learned from text books or gleaned from a complex and often misunderstood questionnaire. It comes from experience as an adviser of not only technical knowledge but also knowing how to listen to and interpret what clients are saying through words, body language, nuances and any other signals. It's about knowing the right questions to ask, recognising when there might be something they are not telling us.

Take the recent client who on the risk profiling questionnaire would tick all the boxes to be classified a 'defensive' investor, indicating a 30% allocation to growth investments such as shares and property. He is educated in financial matters, he understands the inflationary consequences of holding only cash over the long term, he understands that without exposure to growth assets, his money will lose value over time.

What the questionnaire doesn't consider is that this investor is riddled with anxiety, is a deep thinker, an avid reader of world news and a natural pessimist. Recommendations to invest a small portion of his substantial wealth – even less than the benchmarked 30% – into growth assets resulted in sleepless nights and mental anguish.

He was consumed by cognitive dissonance and his discomfort was palpable. We abandoned the recommendations and agreed to keep his money in cash. As such, he doesn't earn us much in fees, but he sleeps well at night, and that's just fine with me.

Then there's the couple who came to us already established in their SMSF. It is now invested and performing well, but the trustees both work full time in busy, time-consuming professional jobs. They have teenage children that keep them busy and they both loathe administration and paperwork. The trustee duties and obligations that come with an SMSF drive them crazy. Whoever recommended they go down the SMSF path didn't understand this aspect for a busy couple.

Not my portfolio, it's theirs

For each and every client, best interests are a matter of perspective. As an interior designer must leave his or her own tastes at the front door to envisage and interpret their client's desires, so too a financial adviser must put aside their own biases and knowledge and walk in their client's shoes.

This skill comes from experience only, and after nine years as an adviser, I'm still honing it, I don't always nail it. But I've seen it done well by very experienced advisers, and the difference it makes to a client's wellbeing can be remarkable.

I do hope The Financial Adviser Standards and Ethics Authority (FASEA) doesn't rob our industry of this vital skill.

Alex Denham is a Senior Adviser at [Focus Wealth Advisers](#). Prior to becoming an adviser, she spent 20 years in senior technical roles with several financial services companies. This article is general information and does not consider the circumstances of any individual.

The FASEA was established in April 2017 to set the education, training and ethical standards of licensed financial advisers in Australia.

Retail investors can invest like institutions

Marcus Tuck

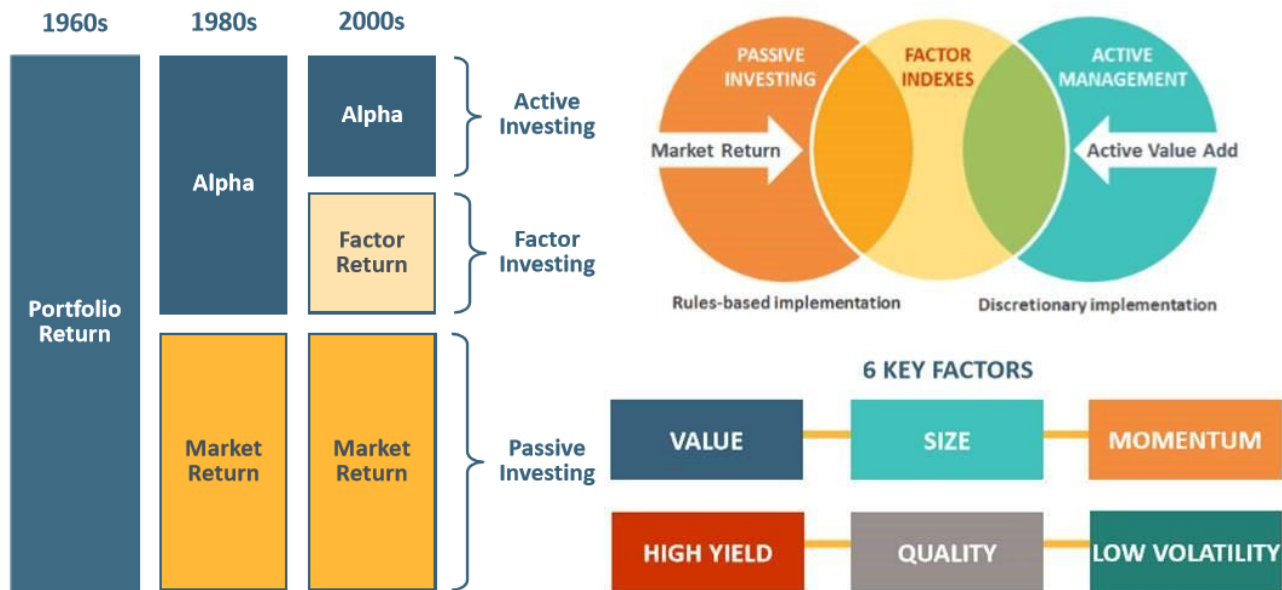
"An organization's ability to learn, and translate that learning into action rapidly, is the ultimate competitive advantage." – Jack Welch

The way big institutional investors invest money has changed over the past 50 years. In the 1960s and 1970s, investors didn't really distinguish between the sources of portfolio return, with active investing the predominant

way of managing long-term portfolios. Then in the 1980s and 1990s, finance research underpinned the adoption of passive investing as an alternative basis for implementation. That involves investors capturing market beta efficiently through low-cost index investing, with a portion (perhaps half) remaining actively managed.

In the 2000s, a third component called factor investing (or smart beta) was introduced. It lies somewhere between passive and active investing and attempts to generate alpha (i.e. returns above index) in a systematic way by exploiting factors such as value, quality, small size or low volatility.

What might be considered a 'state-of-the art' institutional approach at the moment is approximately 50% in low-cost beta and 25% each in factor-based investing and highly concentrated active portfolios (see graphic below).



Source: MSCI

Rebalancing plays a key role

Such an approach minimises the chances of underperforming a benchmark after fees, whilst still striving for alpha (outperforming the market).

When asset allocations deviate too far from strategic benchmark weights, many institutional investors choose to bring them back into line through a process of passive rebalancing, regularly trimming the weights of what has outperformed and increasing the weights of what has underperformed (i.e. selling high and buying low in a systematic way). Such an approach has typically produced better results than market strategists making big-picture tactical asset allocation (TAA) calls.

In the field of factor-based investing, many different factors have been tried. Besides producing the market-cap-weighted MSCI World index, the MSCI organisation (and others) also produces several factor-based World indexes, including an equal-weighted one. Each factor has certain advantages but invariably outperforms at certain times and underperforms at other times.

The chart below shows the performance of each factor relative to the standard MSCI World benchmark. Although each one has generated alpha over the long term, there is volatility along the way.

LONG TERM PERFORMANCE VS MSCI WORLD
From Jan'76 to Jun'17



The rise of multi-factor models

What has emerged is a trend towards multi-factor models that blend the various factors, smoothing out the alpha volatility because the correlation between them is low.

MSCI has blended four factors (Value, Size, Momentum and Quality) into its MSCI World Diversified Multiple-Factor (DMF) Index. They impose additional risk controls around country and sector weights, and exposures to growth, liquidity and volatility. The end result is something that mitigates shorter-term cyclicality, while maintaining long-term potential for outperformance (see chart below).



These strategies are available to the average investor, not just to institutions. MSCI licenses their indexes to ETF providers who track them. iShares has an ETF version of the multi-factor World index mentioned above. There is an Australian-listed version, the iShares Edge MSCI World Multifactor ETF (WDMF.AXW), as well as a US-listed version (ACWF.ARC).

They also have an equivalent multi-factor ETF for Australian equities, the iShares Edge MSCI Australia Multifactor ETF (AUMF.AXW), and one for Emerging Markets equities, the iShares Edge MSCI Emerging Markets Multifactor ETF (EMGF.BZX) listed in the US. There is also an Australian-listed version called the VanEck Vectors MSCI Multifactor Emerging Markets Equity ETF (EMKT.AXW). The MSCI indexes underlying these ETFs have a demonstrated history of outperforming their respective market-cap-weighted benchmarks over the long term.

A wide range of alternatives for retail investors

Other ETF providers such as Vanguard, BetaShares and State Street also offer factor-based ETFs listed on the ASX (a list of ETFs can be found in the ASX report on [this link in Cuffelinks](#)).

Lessons learned by big institutional investors over the decades (often learned the hard way) are of relevance to the average investor. Investment solutions that were once only available to the big end of town are now available to anyone willing to learn the same lessons.

Marcus Tuck is Head of Equities Research at [Mason Stevens](#). This article is general advice only and does not take into consideration any personal objectives, financial circumstances or needs and should not be relied upon as personal advice.

Industry funds capitalise on Commission wins

Eva Scheerlinck

[Editor's note: Eva Scheerlinck is the CEO of the Australian Institute of Superannuation Trustees (AIST), the peak representative body for the profit-to-members superannuation sector. Industry funds have come through the Royal Commission largely unscathed, in complete contrast to the retail fund industry. It is a stunning success for industry funds, a traditional target of Coalition governments, and the Commission's findings will reshape the superannuation landscape forever.]

For example, the largest industry fund, AustralianSuper, reported over \$1 billion of new customer inflows in each of July and August 2018, double the same period last year. Gains were mainly transfers from retail funds. It's therefore an opportune time to hear what the CEO is thinking. This is a transcript of her introduction at the 2018 AIST Super Investment Conference in Cairns on 5 September 2018.]

It's almost unbelievable we've had to defend our outperformance over retail super funds. Our statistics have been questioned, as has our asset mix. The establishment and use of collective vehicles like IFM and ISPT have also been attacked. Decades of being on the defensive and yet continuously delivering results for our members.

But now it turns out our strongest response to our detractors has been our success. In the last four months or so, there has been a significant shift in the discourse. The Productivity Commission affirmed the profits-to-members sector's consistent outperformance and for once people listened. The message was freely accepted as fact.

Then came Round 5 of the Royal Commission's hearings into superannuation containing a 223-page report with a strong focus on fund governance. Yet there was no significant criticism of equal representation, nor the role of unions, nor employer groups. There was no mention of the need for independent directors on our boards.

[Editor's note: 'equal representation' is where the trustees of a fund come equally from employer representatives and representatives of the fund members, usually nominated by related unions.]

Instead, structural and governance issues in the retail sector were called out. Indeed, the Royal Commission proved to be a damning indictment on the retail super funds with the Commission concluding that it was open to find that eight retail funds and related parties covering almost the entire retail sector may have engaged in over 150 separate instances of misconduct. These ranged from fee gouging, charging commissions banned

under FOFA, cross-selling members into higher fee products to the snail-paced transfer of members to MySuper products to preserve both grandfathered commissions and fees-for-no-service.

The report noted that ASIC expects that compensation due to members will top \$1 billion for problems relating to fees-for-no-service alone. In sharp contrast, the Commission identified two instances of possible misconduct involving profit-to-member funds out of a total of more than 50 such funds.

So we were not surprised two weeks ago amid a leadership spill in Canberra, and a new ministry being sworn in, that the Government conceded defeat on its governance legislation requiring a third of independent directors on profit-for-member boards and an independent chair. Only this morning came the announcement that the Government is also abandoning raising the retirement age to 70. Both these policy areas have been at the heart of AIST advocacy for many years and we are relieved to see some common sense come into the discourse.

Many battles have for now been won

So many of the things we have been staunchly defending seem at least for now to have been won. We are not, however, naïve enough to think that many challenges don't lie ahead still. As everyone here would be well aware, bull markets do not last forever. While investment returns to members of profit-to-member funds have far exceeded expectations over the past year or two, this paradoxically raises the likelihood of a market downturn soon.

Another challenge for profit-to-member funds is responding to an increased focus from both the media and some super fund members on how funds are responding to ESG issues such as climate change. Increasingly, funds will need to provide more transparency around ESG investments.

Compulsory super has been around for over 25 years, and we are seeing how the unique collective approach in the profit-to-members sector is delivering value for members. Just yesterday, IFM Investors which is owned by 27 industry funds announced it was giving investors a 7.5% rebate on management fees after better-than-expected returns.

The values-based leadership at the heart of decision-making in our industry, where member outcomes are always front and centre, delivers results. But we are not complacent. The Royal Commission has signalled it will consider recommending a range of radical reforms to superannuation in its final report due next February. It has also posed some important questions.

Trustees have a special and privileged job

With regard to governance, the closing submission asks whether there are structures in the retail sector that raise inherent problems for trustees being able to meet their fiduciary obligations. AIST's answer to this is a resounding 'yes'. Being a superannuation trustee is a special and privileged job. Trustees are the stewards of other people's money. A trustee director cannot be focussed on returning profits to members when he or she is also having to return profits to shareholders or to prop up related parties. You cannot serve two masters and look after members' best interests at the same time. Retail trustees with their independent directors were unable to protect members from fee gouging and other misconduct. And the regulators have proved themselves unable to stop the bad behaviour.

Therefore, AIST believes there is no place for retail funds in MySuper where members in a compulsory super system have the right to expect the highest level of protection. We will be advocating this position to the Commission, to the regulators and to the Parliament. There exists now a real opportunity for us to capitalise on our outperformance, our governance structure that puts members first and to take our market lead to a whole new level.

Eva Scheerlinck is the CEO of the [Australian Institute of Superannuation Trustees](#) (AIST). Graham Hand, Managing Editor of Cuffelinks, chaired a session at the 2018 AIST Conference.

Why has the Value investing style struggled?

Reece Birtles

We have witnessed strong world earnings-per-share (EPS) growth since June 2016, extending the post-GFC run to nearly 10 years of expansion. Given the persistence of the economic cycle, 'Momentum' strategy performance has been exceptionally strong. A Momentum strategy seeks to invest in the continuance of an existing market trend, such as upward-rising prices.

The strength of Momentum has also driven unprecedented underperformance of 'Value'-based strategies globally for the last few years. Unlike Momentum, Value-based strategies invest in undervalued companies trading at less than their estimated intrinsic value. The following chart shows how Value has suffered relative to the market in the last five years, whereas historically it has outperformed.

Source: Martin Currie Australia, Factset; as at 30 June 2018. Returns in US\$.

MSCI Value vs. MSCI World:
Rolling 10-year annualised return differential

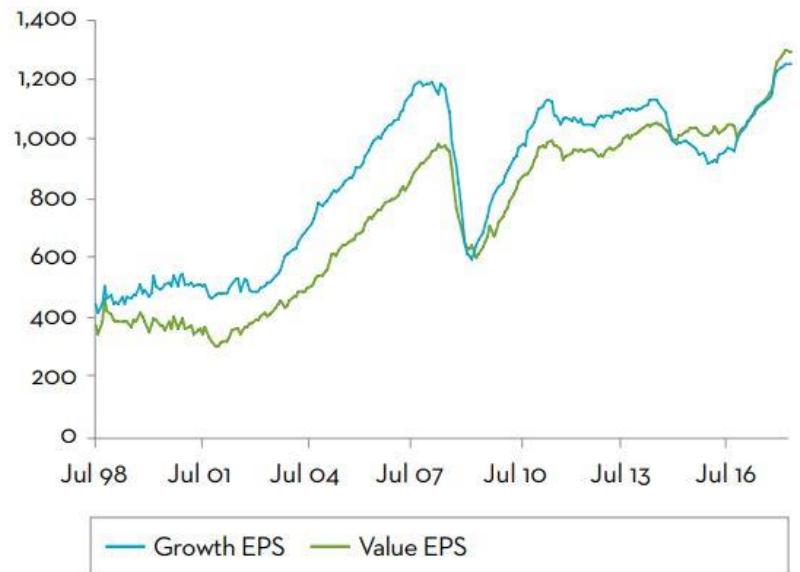


EPS growth not the problem

We had originally surmised that the main reason traditional Value indices had performed poorly was that Value stocks have not shown great earnings growth compared with 'Growth' or FANG (Facebook, Amazon, Netflix and Google's parent Alphabet) stocks. However, we were surprised to find that in the global market, since June 2016, earnings growth of Value (+14.8% p.a.) has in fact been stronger than that of Growth (+12.5% p.a.).

Source: Martin Currie Australia, Factset; as at 30 June 2018.

MSCI World EPS by style



Is now the time for Value to recover?

The recent strong returns of Growth strategies appear to have come not from earnings growth, but from a price-to-earnings (P/E) re-rating (18.7x to 20x) versus a de-rating of Value (from 14.3x to 13.1x), as shown in the chart below. The blue Growth line has recently risen while the green Value line has fallen.

MSCI World P/E by style



Source: Martin Currie Australia, Factset; as at 30 June 2018.

So, it looks like Value stocks have been beaten up, despite their better EPS growth. Now may be the time to look for Value opportunities.

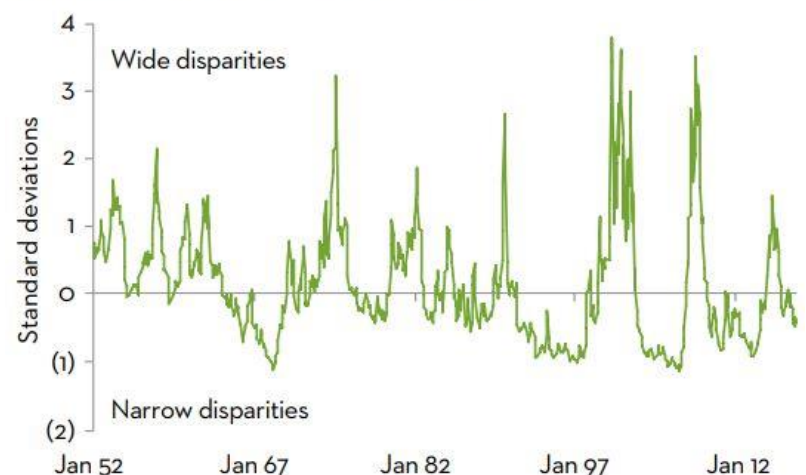
Is the growing valuation gap all it seems?

By some measures, there is evidence of a growing valuation spread – the gap between the cheapest and average-priced stocks in the market. Wide valuation spreads have historically preceded strong performance for Value strategies.

Most traditional Value indices (such as MSCI Value) are predominantly based on relatively naïve measures such as P/E or price to book (P/B). The divergence in P/E across investment styles has caused the valuation spread based on this measure to widen significantly. Dispersions of P/B, another common indicator of valuation opportunity, have also widened notably for the Australian market.

However, a note of caution: other measures, which use current earnings/cash flow-based metrics and rely less on a mean reversion assumption, are still showing far narrower dispersions. This is well described by the valuation analysis of Empirical Research Partners on the US market which uses cash flow methods. Their analysis in the next chart shows a much lower valuation spread, and as such, less Value opportunities available in the market than shown by P/E or P/B measures.

US valuation spreads: expected return of the top quintile compared to the average



Source: Empirical Research Partners Analysis, National Bureau of Economic Research; as at 31 May 2018.

While Empirical Research Partners has a comprehensive quantitative valuation model, we believe all these measures miss a layer of fundamental insight required to truly understand the level of opportunity.

A deeper search for value

We conduct fundamental, forward-looking risk-adjusted analysis on the broad Australian market considering cashflow, quality, growth, cyclicality, and environmental, social and governance (ESG) risks. Our ongoing analysis reveals that immediately following the GFC, these Value spreads were much wider generally and also relative to each other. This was due to greater uncertainty about world growth drivers.

However, since 2009, these spreads narrowed significantly, and in February 2017 reached their lowest post-GFC levels. It is only recently that the spread for cheapest stocks has begun to really look cheap again.

Despite the better outcomes that P/E and P/B measures indicate, and the lower opportunities shown by quant measures, our analysis suggests valuation spreads have widened, but only at the extremes.

So, if Value spreads by our measures are in fact generally still low – and only in certain pockets – is the Value approach to investing compromised? In a word, **no**.

We believe the combination of a collective analysis of the market environment and a multi-lensed investment process (**valuation, quality, direction** and **sustainable dividend**) means it is still possible to assess the potential reward versus risk on offer of individual stocks, broad factors and the overall market regardless of the prevailing conditions.

This type of investment approach won't deliver the same outcomes at all points in the cycle, but it certainly has helped us to navigate the choppy conditions we have seen for Value investors over the last three years.

Reece Birtles is Chief Investment Officer at [Martin Currie Australia](#), a Legg Mason affiliate. Legg Mason is a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any individual.

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There's more to bonds than buy and hold

Gopi Karunakaran

In fixed income investing, there are two conventional sources of return that investors are familiar with: collecting interest payments from bonds (i.e. income) and correctly predicting the direction of rates, which delivers capital gains or losses (i.e. duration exposure). The expected returns from both these sources are heavily challenged by the current low levels of interest rates and credit spreads, as well as uncertainty about their future direction.

But what if there was another source of returns that could help restore balance to fixed income portfolios? At Ardea, we believe that source of return is relative value fixed income investing.

Relative value strategies can deliver positive returns from fixed income, irrespective of the current level or future direction of rates and credit spreads. Conventional approaches tend to miss these opportunities. Conventional return sources are challenged at the moment and simply holding government bonds is no longer a reliably defensive strategy.

Conventional fixed income return sources are challenged

For investors seeking a defensive investment, fixed income has traditionally been the asset of choice. The debt markets, by offering a senior claim above equities on the assets of a company or government can provide a safer option for investors' capital. In addition, bonds can provide a stable stream of income as bond issuers are contractually obliged to make regular interest payments, unlike equity dividends, which can be cut at any time.

However, three challenges currently face those reliant on fixed income to provide reliably defensive returns.

The **first** is that low interest rates have eroded the yield cushion in fixed income. We can think of the income from a bond as a 'yield cushion' because that stream of income (or yield) helps cushion investors' capital against losses if rates rise. When rates are low, the yield cushion is thin, giving little protection against potential capital losses.

For example, as bond yields rose in late 2016 and early 2017, 10-year Australian government bonds incurred a capital loss of around 10% over 6 months, compared to interest income of just 1.13% over the same period.

Hardly what you expect from a 'defensive' investment. Add to this, the fact that central banks around the world are signalling a shift away from the extreme stimulus that has kept rates suppressed since the 2008 financial crisis. Investors are now left with less return for more risk.

The **second** is that bonds are not as reliable a risk diversifier as commonly assumed. An allocation to bonds is supposed to provide a buffer when equity markets fall, as bond yields should decline and thus bond prices rise.

The starting point of bond yields is already close to zero. In addition, while this bond-equity correlation has held in recent history, a longer perspective shows that it's actually quite unstable. It is sensitive to shifting interest rate and inflation paradigms, just like the one we're currently seeing in the US.

The **third** is that 'credit creep' in fixed income portfolios has further compromised the defensiveness of fixed income portfolios. The 'reach for yield' means larger allocations to higher yielding credit assets, with more risk in the form of defaults, credit spread volatility and illiquidity.

'Credit tourists' accepting these risks

In the desperation for yield, defensive portfolios that wouldn't normally take these types of credit-related risks have been forced to become 'credit tourists'.

In benign markets, credit assets tend to perform independently of equities (i.e. they have low correlation to equities). But in times of market stress, say during a recession, they often become highly correlated and incur capital losses as equities fall, just when the defensiveness of fixed income is most needed. This risk has been masked by the current bull market, resulting in a build-up of hidden equity 'beta' in fixed income.

Particularly concerning is the growing evidence of late cycle credit risks. Corporate borrowers are taking advantage of cheap debt and weakening creditor protection in bond and loan terms. The extreme 'reach for yield' behaviour includes a BBB-rated European company issuing a bond with a negative yield. That's right, a company with real default risk being paid to borrow money! This is the kind of behaviour you might see towards the end of a party. Seems like a good idea at the time, but the next morning not so much. This topic is discussed in Ardea's publication: "Corporate bonds – More Risk for Less Return", available [here](#).

What's the alternative and why does it exist?

Conventional fixed income approaches focus on how much yield can be earned from buying and holding a bond. In contrast, a relative value approach specifically identifies whether that bond is mispriced relative to other related securities with similar risk characteristics and therefore has potential for its price to rise or fall. A profit can then be monetised when the relative mispricing corrects, and capital can be recycled into the next opportunity.

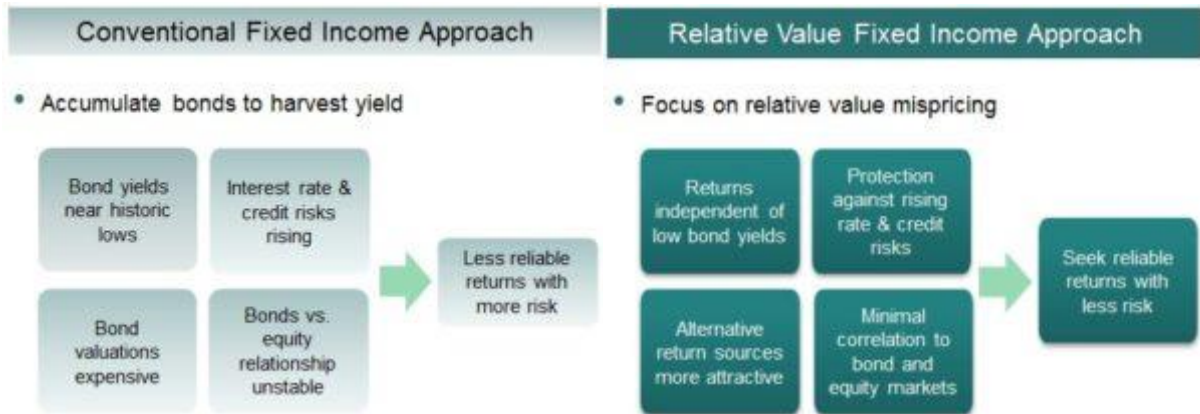
Fixed income markets have a vast range of liquid bonds and derivatives giving diverse opportunities to exploit. Rotating through many modestly sized and uncorrelated relative value positions can deliver more stable returns with lower risk than portfolios with large concentrated bets on market direction. Positions can be isolated from unwanted market risks by using risk management tools such as derivatives, meaning relative value portfolios can seek returns independent of the current level and future direction of interest rates.

Fixed income markets are inefficient. Underlying structural factors such as regulation, investor mandate restrictions, market segmentation and varying investor objectives have always existed in fixed income. These forces give rise to buying and selling flows that are non-economic in nature (i.e. they're not focused on maximising profit). Examples include banks managing their balance sheets, insurance companies hedging liabilities, passive investors tracking benchmarks and central banks pursuing policy objectives. These drivers of market inefficiency are structural in nature and persistent through time and across market cycles. The reliable source of returns allows for a repeatable investment process.

What can relative value do for you?

A relative value approach does not rely on accumulating bonds to harvest yield or trying to predict market direction or reaching for yield in credit and is therefore not vulnerable to those challenges. It can include specific strategies to protect against extreme negative scenarios, for example, by using interest rate options that profit from rising volatility. The end result is the potential for stable returns exceeding cash or inflation.

The opportunities provide compelling diversification benefits when used alongside traditional government bond, credit or equity investments, as indicated in the diagram below.



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Is this your biggest retirement worry?

Ben Hocking

Are you ready for retirement? Are you confident your money will last?

Over the past 18 years, retirement website YourLifeChoices has surveyed its membership on all aspects of retirement and retirement affordability. Many things have changed in that time, but the one constant is the fear of running out of money.

The uppermost concerns of retirees

According to YourLifeChoices' recent *Retirement Income and Financial Literacy Survey*, which garnered more than 5,000 responses, 48% of respondents were concerned that their savings will not last in retirement. Add in the indisputable evidence that we are living longer and that fear is magnified.

When we asked our members about the single greatest challenge to living within their current income, 35% cited the costs of health insurance and healthcare. And the latest cost-of-living increases in the June 2018 quarter showed no respite, with health costs up 1.9% compared to the March quarter and 3.4% compared to the June quarter in 2017.

A Monash University-CSIRO [report](#) in 2016 estimated that as a result of an ageing population, health expenditure per person will rise from \$7,439 in 2015 to \$9,594 in 2035, an increase in total expenditure from \$166 billion to \$320 billion or an average annual growth of 3.33%.

Personal health costs are an issue for many retirees. In the financial literacy survey, 71% of respondents said they had private health insurance. However, the increasing cost of private cover means that some are struggling to maintain their policies. Health costs are closely followed by housing costs, with 28% citing this retirement expense as one of their greatest challenges. The ongoing debate about lifting the superannuation preservation age is also a major concern for those approaching retirement.

DIY or trust an adviser?

Currently, Australians are able to access their super as early as 55 (subject to certain conditions of release) for anyone born before 1 July 1960, progressively extending to 60 for those born on or after 1 July 1964. There are, however, moves afoot to increase the preservation age in an attempt to keep people in the workforce for longer.

Lack of action could be one of the biggest mistakes older Australians make when they start planning their transition from full-time work, as 52% of survey respondents said they were either confident or very confident about their long-term future finances. Could self-confidence – and perhaps a distrust of the financial services sector given the events that prompted the Financial Services Royal Commission and the subsequent revelations – mean that they are missing out on maximising income and savings? Could it sometimes be a case of not knowing what you don't know?

The Australian Securities and Investment Commission (ASIC) says:

"Advisers mostly add value by helping you sort out your financial goals and working with you to develop a plan to achieve them over time. Most importantly, working with an adviser will help you turn thought into action, especially if you tend to put things off."

Joe Stephan, director at Stephan Independent Advisory, says that clients often remark they are not aware certain strategies exist. He said financial planners regularly reviewed plans to adjust the impact that outside forces (legislative and market changes) could have on them. He says:

"If you choose to manage your own affairs, how much time will you spend reviewing all aspects of your strategies? How accurate, non-conflicted or detailed would your reviews be? How effective and confident will you really be with your own review?"

The nest egg we need

While our survey also shows that most of our members wished they had saved more, many feel that the ability to fund themselves in retirement was denied to them by external factors over which they had no control: health, fragmented work history, lack of income due to caring for others, work in low-paid industries and other such factors associated with life-course disadvantages. YourLifeChoices' estimates of annual expenditure after the June 2018 quarter cost-of-living increases are \$74,813 for 'affluent couples' (privately funded retirees who own their home). Depending on the assumed investment earnings, a significant seven-figure amount is required in savings to produce this amount of income. For example, \$1.5 million earning 5% is needed to produce \$75,000 a year, which requires some risk-taking in shares or property as bank deposit rates are only 2.5%.

Those close to retirement can still improve their financial situation and maximise their super benefits by:

- increasing the amount they contribute
- consolidating their super if in more than one fund
- reviewing the options and ways in which their super is invested

Pre-retirees can also consider investment options outside super to assess whether they are in the most tax-effective environment.

Ben Hocking is a writer with [YourLifeChoices](#), Australia's leading retirement website for over-55s. It delivers independent information and resources to 250,000 members across Australia. This article is general information and does not consider the circumstances of any individual.

Which microcap funds outperformed in FY18?

Mark Tobin

The 2017-2018 financial year was strong for both microcap and small caps indexes. Once again, microcaps significantly outperformed large caps. The S&P/ASX All Ordinaries Accumulation Index returned 13.7% for FY18, a healthy return. In contrast, the S&P/ASX Emerging Companies Index posted a stellar return of 23.2% for FY18, leading to an outperformance of 9.5% for microcaps over large caps in the Australian market.

Standout manager performances

Standout performances from active managers for the year came from microcap vehicles managed by Perennial, Eley Griffiths and Acorn with FY18 returns of 50.2%, 41.9% and 30.6% respectively, all easily outpacing the

index and their own selected benchmarks. Given these results are net of all fees it makes them even more impressive as the index has no fees in its performance measure.

However, as always there are the managers which lagged both the index and their peers for FY18. Managers who struggled in FY18 were 8IP, Microequities and DMX who all delivered low single-digit returns. Now, my usual caveat applies, that no investor should judge a manager on a single year's performance no matter how positive or negative the performance was. Microcap manager returns vary significantly year-to-year, as shown in the table below.

The tables give the 1, 3, 5 and 10-year returns for fund managers who have such track records. This gives investors some perspective on the longer-term performance record of all managers. It also shows returns for the indexes over similar timeframes.

MicroCap Managed Funds	1Y	3Y	5Y	10Y
Ausbil Microcap Fund	34.1%	18.8%	23.7%	N/A
Australian Ethical Emerging Companies Retail	13.1%	13.8%	N/A	N/A
Pendal Microcap Opportunities Fund	19.8%	18.4%	21.5%	17.3%
Cromwell Phoenix Opportunities Fund	18.4%	21.9%	N/A	N/A
Cyan C3G Fund	0.2%	23.8%	N/A	N/A
DMX Capital Partners Ltd	4.0%	17.6%	N/A	N/A
Eley Griffiths Group Emerging Companies Fund	41.9%	N/A	N/A	N/A
Microequities Deep Value	3.5%	16.8%	17.3%	N/A
Microequities High Income Value	3.1%	12.5%	11.1%	N/A
NovaPort Wholesale Microcap Fund	23.0%	15.2%	13.7%	10.9%
OC Micro-Cap Fund	31.5%	18.4%	24.0%	16.9%
Peak Opportunities Fund	N/A	N/A	N/A	N/A
Perennial Value Microcap Opportunities	50.2%	N/A	N/A	N/A
Perpetual Pure Microcap Fund	7.4%	21.5%	N/A	N/A
Prime Value Emerging Opportunities Fund	19.0%	N/A	N/A	n/A
Spheria Australian Microcap Fund	16.2%	N/A	N/A	N/A
Terra Capital Ethical Emerging Companies Fund	-6.4%	N/A	N/A	N/A
UBS Microcap Fund	20.9%	16.9%	N/A	N/A
MicroCap LICs	1Y	3Y	5Y	10Y
8IP Emerging Companies	1.9%	N/A	N/A	N/A
Acorn Capital Investment Fund	30.6%	18.5%	N/A	N/A
Forager Australian Share Fund	6.5%	16.3%	15.8%	N/A
Glennon Small Companies	27.6%	N/A	N/A	N/A
Monash Absolute Investment Company	12.6%	N/A	N/A	N/A
NAOS Emerging Opportunities	7.1%	14.5%	14.9%	N/A
NAOS Small Cap Opportunties	N/A	N/A	N/A	N/A
Spheria Emerging Companies	N/A	N/A	N/A	N/A
WAM Microcap	28.9%	N/A	N/A	N/A
Index Performance	1Y	3Y	5Y	10Y
ASX Emerging Companies Accum Index	23.2%	15.8%	11.5%	0.3%
ASX Small Ords Accum Index	24.3%	15.0%	11.6%	2.6%
ASX All Ords Accum Index	13.7%	9.5%	10.3%	6.2%
ASX 300 Accum Index	13.2%	9.1%	10.0%	6.3%
ASX 200 Accum Index	13.0%	9.0%	10.0%	6.4%

	% Return	No. Funds
Average Perf 3 Year All Managers	17.7%	15
Average Perf 5 Year All Managers	17.8%	8
Average Perf 10 Year All Managers	15.1%	3
Comparison Emerging Companies Accum Index	% Return	% Of Funds
Outperformance vs EM 3 Year	1.8%	73%
Outperformance vs EM 5 Year	6.3%	88%
Outperformance vs EM 10 Year	14.7%	100%
Comparison Small Ordinaries Accum Index	% Return	% Of Funds
Outperformance vs SO 3 Year	2.7%	80%
Outperformance vs SO 5 Year	6.2%	88%
Outperformance vs SO 10 Year	12.5%	100%
Comparison All Ordinaries Accum Index	% Return	% Of Funds
Outperformance vs AO 3 Year	8.2%	100%
Outperformance vs AO 5 Year	7.5%	100%
Outperformance vs AO 10 Year	8.9%	100%

Microcap outperformance versus large caps and ETFs

Over a medium-term time horizon or longer, active microcap managers usually have an excellent track record of delivering alpha (performance above the index) to their investors as can be seen from the data. In addition, they have delivered superior returns versus mainstream index funds and ETFs.

This is continuing evidence that active microcap managers can provide attractive relative and absolute returns to investors. The data also suggests that despite an increase in the number of microcap-focused vehicles that have come to the market in the last three years, microcap managers as a group have been able to provide continued strong performance.

Standout performers over a medium-term 3-year horizon continue to be Cyan, Perpetual and Cromwell, all posting annualised returns in excess of 20%.

The curious case of the microcap benchmark

One of the most curious things about looking at the universe of microcaps managers is the disproportionate use of the S&P/ASX Small Ordinaries Accumulation Index as the benchmark for the funds and performance fee calculations. No fewer than 15 of the 28 vehicles in our universe use this index as its benchmark.

Now some of the funds in our universe could be classed as small cap funds as they straddle the line in terms of the market caps of their holdings. This makes classification a bit of a grey area. However, if we take the Perpetual Pure Microcap Fund, for example, you would think that it would use the S&P/ASX Emerging Companies Index as its benchmark given the name of the fund and its investment strategy and mandate? Yet, it uses the S&P/ASX Small Ordinaries Accumulation Index for its benchmark.

Indeed, just two funds in our universe use the S&P/ASX Emerging Companies Index as their benchmark. Now, I am not saying one benchmark is better than the other but it is curious that so many funds use a benchmark which in name at least is perhaps not the most relevant or appropriate for the fund's strategy and mandate. This is perhaps something investors current or prospective can query with the relevant managers to get a better understanding as to why one was selected over the other.

Mark Tobin is a Senior Analyst at [Independent Investment Research](#).

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