

This Week's Top Articles

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Digital disruption and the Royal Commission

Matthew Davidson

Hip to be square ...

Recently, I walked into the San Francisco offices of payments firm Square. It's a very different scene from the typical corporate office. There are chess boards in booths, internal platforms for meetings and headphone-wearing workers staring at screens full of code. However, behind all these tech clichés, what has made Square a success is its singular focus on empowering the small business entrepreneur. Square now has the chance, with millions of users, to broaden its service offering and grow with them.

... or wedge shaped

Many successful finance disruptors create a wedge. They enter a niche of financial services with a unique mission and low-cost access to customers that allows them to scale. Then they extend the offering to something broader that could threaten the role of incumbents.

Looking across US Fintech success stories so far, many have followed this path, and the emerging backdrop in Australia is creating similar conditions, making the ground more fertile for disruptors.

Some key examples of US fintech disruptors include:

- Square, which started with pain-saving payment terminals for small business that now extend to an ecosystem of credit, cash and software services.
- UK-based Revolut, which has acquired two million customers (almost exclusively by word-of-mouth) to a prepaid currency card that offers no foreign exchange spread or fees. It is now rapidly adding further products.
- the original fintech pioneer PayPal, which accessed customers via the unique channel of eBay before becoming the trusted vehicle for internet payments for 200 million+ accounts; it continues to promise 20% growth rates.

All of these companies started narrowly, whereas those that have failed have generally had issues with the cost of customer acquisition or gone head to head with major banks.

What will force Australia's wedge?

In the US (and UK), 'payments' or 'specialised lending' have been key areas for disruption, but this hasn't happened meaningfully in Australia yet. Advancing technology and changing customer behavior supports fintech disruption, but the challenges of earning trust and acquiring new customers loom large. Australian banks have defended well, and been innovative themselves, but they could now be exposed to a different challenge.

My historical view had been that a focus on business-to-business activities and partnering with the large players would be the path to success for both Fintechs and incumbents in Australia, with large banks proving particularly resilient. But given the fragmenting effect that the ongoing Financial Services Royal Commission is likely to have on the incumbents, should we be more open minded to the little guys?

Filling the space left by risk aversion

The biggest takeaway from the Royal Commission hearings may be on governance. The impact on the mindset of boards and management towards risk aversion creates scope for disruption to have a bigger impact than otherwise. It's possible that risk aversion will create a space, or wedge, in financial services that may be filled by disruptive firms.

Risk aversion may create years of additional compliance spend and internal focus, leading to management actions that aren't consistent with defending against disruption.

We are already seeing this backdrop driving Australian banks away from any business line that is 'non-core' or places reputation at undue risk. Wealth platforms, third party originated lending, auto lending, insurance, overseas subsidiaries and high-risk lending are some of the examples.

A look into customer futures

Exiting a lot of these relationship-building products not only gives up the profit pools, but also the data insights that could unlock the types of platform-style services customers might want in the future.

The scope for financial concierge-type services (cash flow management, digital wallets, artificial intelligence driven wealth advice) as possible future product ranges for digital banking is yet to be fully explored. If banks give up many of their peripheral services and associated data, it seems likely they would be less ready to enable future digital platforms.

It could be argued Australian banks have been living in a constrained oligopoly, where protecting margins and market share has been easy. Going forward, we could see the banks fight over a narrower set of products and this arguably means a weakening in the market structure. The recent breakaway by NAB on mortgage re-pricing may be an early example.

This narrowness should make banks better at compliantly delivering core products but may create the space for new players to drive a wedge and disrupt them. Throw in the ongoing litigation and a major adjustment from responsible lending scrutiny and we could see incumbent banks relinquish their natural advantages.

Don't discount disruption for Australian banks

This leads to the question of whether Australian banks can find a digital cost reduction story to drive growth. The path to much lower digitised cost bases appears long and distant. Some US groups like Bank of America and American Express have managed to reduce nominal costs, though this was typically through traditional 'low hanging fruit' cost-cutting. Most US banks, in fact, are not seeing anything better than flat costs, and view the tech spending 'arms race' as ongoing.

Australian bank share prices currently reflect expectations of low growth, returns on equity remaining below historical levels and little benefit given to the banks for the healthy state of Australian corporates.

The Royal Commission has seen investors overreact on some factors, and if the banks can mount the perceived comeback that has been evident in some of the US banks, they might even be considered cheap at the moment. However, the bad news is that a return to the banking glory days (once the dust has settled on the Royal Commission) is likely to be compromised by meaningful disruption by non-bank players. This is in part due to the risk-averse regulatory and management response.

Now is not the time to 'discount' the impact of disruption. We see this creating a long, slow burn of subdued aggregate earnings and relatively static share prices for the banks.

Matthew Davidson is a Senior Research Analyst at [Martin Currie Australia](#), a Legg Mason affiliate. Legg Mason is a sponsor of Cuffelinks. This article is for general information only and does not consider the circumstances of any individual.

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Reverse mortgages: short-term gain, long-term pain

Robin Bowerman

Residential property has long been a major store of wealth for average Australians. The home remains the primary asset for the majority of people, and the property market – particularly in major cities – has generally been kind for those who were in the market over the past decade or so.

But with the ageing of the population, the percentage of wealth locked up in residential property (\$500 billion in home equity is held by people over 65) is both a blessing and a challenge.

According to the last Intergenerational Report in 2015, the number of people in Australia aged between 65 and 84 is forecast to double by 2054 to around 7 million, while the number of people over 85 is expected to more than quadruple.

Home ownership and a comfortable retirement

There is no disputing that owning your own home is a foundational step on the pathway to providing for a comfortable retirement. But the problem is perfectly captured for older Australians with the expression 'asset rich, income poor'.

The challenge for many in the post-war, baby boomer generation, is that while the house value may have risen well beyond their expectations, they can't use it to pay for the groceries, house repairs or a car that needs replacing.

Downsizing has its advocates but comes with lifestyle challenges such as forming new friends and community contacts. So it is no surprise that there is considerable interest in developing a viable suite of products to release the equity locked up in the family home.

While the need is obvious, the solution less so, and products like reverse mortgages do not enjoy good reputations. A recent review by ASIC of reverse mortgage products acknowledged that a common view amongst retirees, and even among finance brokers and lenders, tends to be that equity release products take advantage of vulnerable elderly people.

That certainly accords with a personal experience of reverse mortgages courtesy of a family friend who, with her husband, took out a small (\$50,000) reverse mortgage against the equity of their mortgage-free home. It certainly helped provide some short-term cash and lifestyle enjoyment, but after the husband developed cancer and passed away, an early exit condition was triggered resulting in a massive bill that wiped out almost all their household savings and left the wife wholly dependent on the age pension to live.

The [ASIC review of the reverse mortgage market](#) came after government changes in 2012 to strengthen consumer protections, including the provision of a no negative equity guarantee. That is, the borrower cannot be required to repay more than the value of the secured property at the end of the loan.

The ASIC report found reverse mortgages were satisfying the immediate or short-term needs of borrowers, as did the case study above, and often provided for an improved standard of living while letting people 'age in place'.

Where ASIC found challenges in the market was with the long-term impacts on the borrower's asset position and, in particular, the impact of the cost of the reverse mortgage products that was only fully understood when the home needed to be sold to provide a bond for entry into an aged care facility.

That was highlighted by many of the borrowers surveyed for the ASIC report who indicated that they had not seriously considered their possible future needs.

Complexity is not well understood

Reverse mortgages are complex and expensive products for both the borrower and the product provider, and the ASIC report does a good job at explaining the short-term benefits and the long-term risks and lifestyle implications that come with it.

The ASIC study tested the impact on the remaining home equity by the age of 84 (the average age of entering into aged care) if interest rates on the loan rise and if property prices grew more slowly than expected. It showed that 63% of borrowers may end up with less equity than the average upfront cost of aged care for one person (\$380,000) by the time they reach 84.

The long-term risk for borrowers is that, because of the impact of compound interest, they may seriously compromise their future retirement lifestyle and ability to afford expenses such as aged care accommodation, medical treatment and day-to-day living expenses.

To illustrate the costs over the long-term, ASIC says the interest charges on an average loan of \$118,000 are \$100,963 over 10 years and \$180,269 over 15 years.

One of the major warnings ASIC has for borrowers is the focus on short-term objectives with “limited or no attention” being paid to their possible future needs. The review of loan files ASIC did as part of the report found:

“approximately 92% of the loan files we reviewed did not record the possible future needs of the borrower in sufficient detail and contained no evidence that the broker or lender had discussed how a loan may affect the borrower’s ability to afford future needs”.

The bottom line is that there are no silver bullets that can magically solve the ‘income in retirement’ question but a clear message from the ASIC report is that you need to carefully balance both today’s needs and your likely future requirements.

The [ASIC MoneySmart website](#) provides a comprehensive guide to the risks of reverse mortgages.

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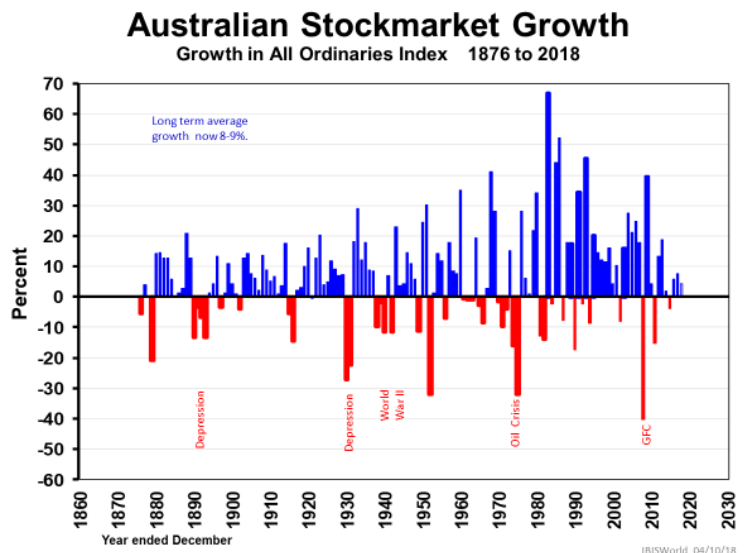
Financial assets performance over time

Phil Ruthven

Advertisements for superannuation funds usually come with an obligation to add “past performance is not a reliable guide to future returns”. This is certainly true on a year by year basis, where the pecking order of classes of assets and fund managers have some volatility. Indeed, when it comes to asset classes, it is rare for the same class to top the ladder year after year.

The volatility of Australian shares over the past 150 years is evident in the chart (right).

Indeed, the amplitudes of rises and falls is alarming. Of compensating solace is the fact that the All Ordinaries Accumulation Index



continues to climb, and the combination of dividends and capital gain has been rewarding to long-term investors for a long time.

So, what are our investment choices?

The main asset classes are:

- Shares (local & international)
- Property (real and trusts)
- Bonds
- Cash
- Precious metals (gold, silver, gems etc.)
- Collectables (art, stamps, vintage cars etc.)

How have these performed over time? The following charts show the returns over 20 and 10 years.

While riskier assets (shares) should always yield better returns than more passive (or defensive) assets (bonds, property, collectibles and precious metals), they don't necessarily do so. Global shares in the 20 years since 1998 were impacted by the dot-com bubble and meltdown in 2000, and the GFC in 2008. Less so Australian shares, which missed out on both crashes. Gold did much better than usual, being a panic metal these days but a perceived safe-house over this period.

There was a different story over the past 10 years.

Global shares did best, with Australian shares in third place, sandwiching listed property which has done well over both time periods. Gold resumed its normally low position, along with investment housing which consistently performs badly over long periods.

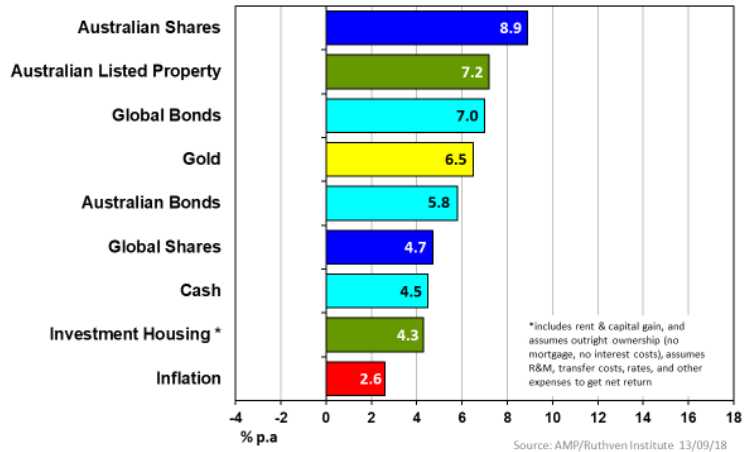
However, when we take a short period – say 5 years, as shown in the last exhibit – and combine that with some extraordinary developments, some surprises emerge.

Alarm bells are ringing

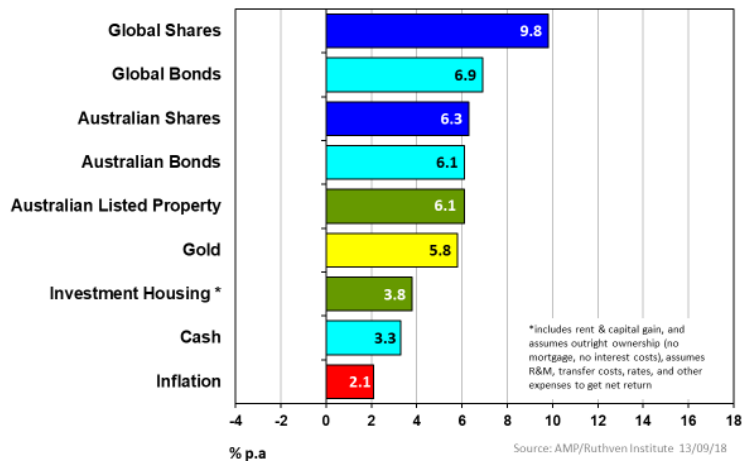
Firstly, global shares have done extraordinarily well in an environment of record-low interest rates. But with P/E ratios nudging 20:1 (with a small reversal last week, but longer term, compare to a safer 14:1) across the world, alarm bells are ringing for returns over the next five years. Ditto investment dwelling prices and returns in Australia, where bubble prices in Sydney have been experienced, accompanied by one of the highest mortgage debt to GDP ratios in the world.

All that said, it seems shares and listed property classes are the consistent best performers over long periods. Perhaps online

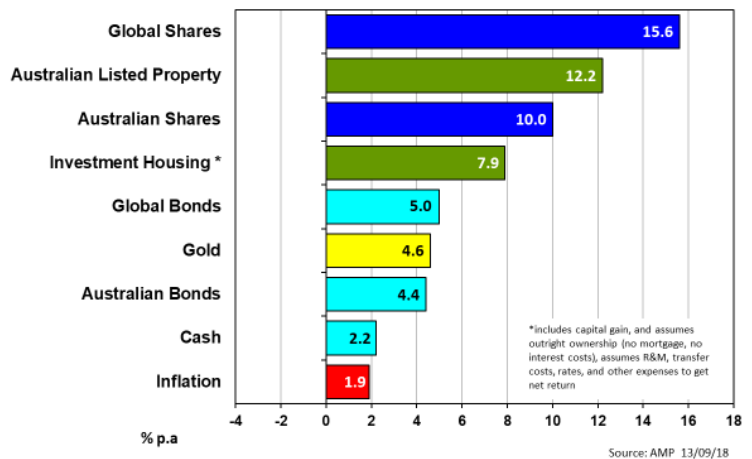
Investment Returns
20 years to June 2018



Investment Returns
10 years to June 2018



Investment Returns
5 years to June 2018



shopping could dent listed property returns in the future.

However, if shares, as the riskiest active-class investment of the lot, don't stay at or close to the top, it's because the economy is in bad shape via:

- a depression
- an asset crash from excessive exuberance, or
- underperforming businesses.

Fund managers and SMSFs usually choose to be conservative by having around half their funds in active (riskier) assets while taking out insurance via other assets and cash. Just in case.

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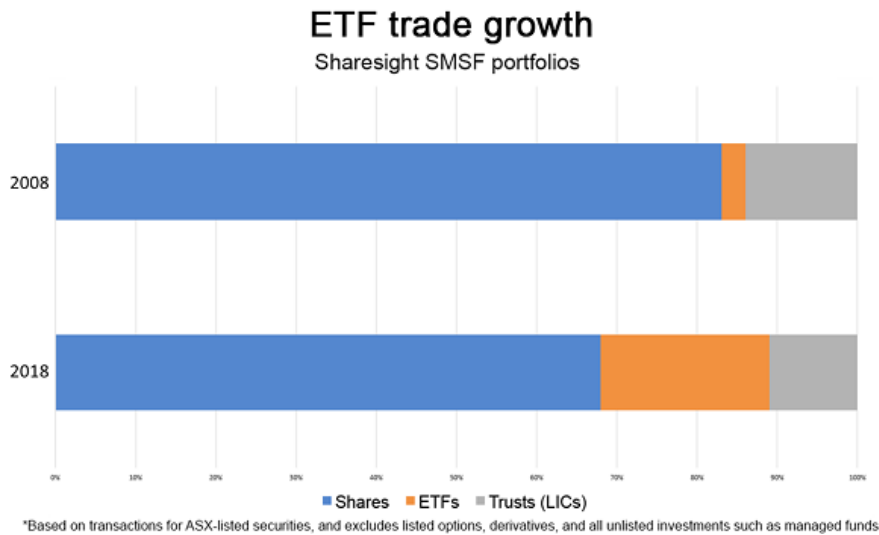
ETFs a boon, but watch the tax treatment

Doug Morris

Exchange Traded Funds (ETFs) have been a boon globally for self-directed investors, offering access to a basket of underlying investments, conveniently rolled-up into one security that trades like a stock. They're listed on public exchanges and require small minimum investments. Launched in 1993, their popularity has soared with total assets globally scraping the US\$3.5 trillion mark at the end of 2017.

Australian growth has been rapid

In fact, in 2018, 21% of investors tracking their SMSFs on Sharesight bought or sold an ETF*. This is a significant increase on just 3% in 2008.



Nowadays there's an ETF for everything: emerging markets, water scarcity, specific sectors and even cryptocurrencies. A colleague owns a cybersecurity ETF (ASX:HACK) that returned 39% in one year. I've personally owned ETFs that track commodity futures and one that shorted the real estate market.

But with this expanded investment menu of ready-access ETFs, Australian self-directed investors face complex realities. Despite all the positive aspects of ETFs, they can be a tax nightmare for Australian investors who've chosen to go off-platform or not rely on a managed service.

ETF tax in Australia

For Australian investors, ETFs create tax complications because instead of classifying them as ordinary company shares, the ATO classifies ETFs as trusts. To make things more convoluted, in 2016 the ATO changed the rules around investment trusts by creating the Attribution Managed Investment Trust (AMIT) regime.

Since the vast majority of ETFs make distributions (even those that are growth focused), investors face complex annual taxation statements. If you own an ETF and you don't know what I'm talking about, chances are your accountant or administrator is sorting it out for you.

An example of the ETF tax treatment

In our research, one purchase of Vanguard Australian Shares (ASX:VAS), which paid just four dividends throughout the year, morphed into 17 distribution and two capital gains components on the annual taxation statement. In turn these correspond to 10 items on an individual tax return, giving much complexity for just one buy.

ATTRIBUTION MANAGED INVESTMENT TRUST MEMBER ANNUAL TAX STATEMENT FOR YEAR ENDED 30 JUNE 2018

The following tax return items are valid for Australian resident individual unitholders only.

PART A – SUMMARY OF 2018 TAX RETURN (SUPPLEMENTARY SECTION) ITEMS			
Item	Tax Return Label	Amount	
Share of net income from trusts, less net capital gains, foreign income and franked distributions	13U	\$3,606.42	
Other deductions relating to non-primary production income	13Y	\$0.00	
Franked distributions from trusts	13C	\$22,870.71	
Share of franking credits from franked dividends	13Q	\$7,069.35	
Share of credit for TFN amounts withheld	13R	\$0.00	
Share of credit for foreign resident withholding amounts	13A	\$0.00	
Share of credit for tax paid by trustee	13S	\$0.00	
Net capital gain	18A	\$1,568.43	
Total current year capital gains	18H	\$3,135.48	
Assessable foreign source income	20E	\$463.54	
Australian franking credits from a New Zealand company	20F	\$0.00	
Other net foreign source income	20M	\$463.54	
Foreign income tax offset	20O	\$15.64	
PART B – COMPONENTS OF ATTRIBUTION			
Item	Cash Distribution	Tax Paid/Offsets	Attribution
Australian Income			
Unfranked distributions	\$578.07		\$768.23
Unfranked CFI distributions	\$1,860.53		\$1,345.41
Interest - subject to non resident WHT	\$506.11		\$411.34
Interest - not subject to non resident WHT	\$0.00		\$0.00
Other income	\$1,567.15		\$1,083.44
Non primary production income	\$4,561.86		\$3,606.42
Franked distributions	\$15,453.56	\$7,069.35	\$22,870.71
Capital Gains			
Discounted capital gains TAP	\$150.91		\$75.18
Discounted capital gains NTAP	\$1,238.63		\$1,491.87
Capital gains – other method TAP	\$0.00		\$0.00
Capital gains – other method NTAP	\$2.78		\$1.38
Net capital gain	\$1,392.32		\$1,568.43
AMIT CGT gross up amount			\$1,567.05
Other capital gains distribution	\$1,238.63		
Total current year capital gains	\$2,630.95		\$3,135.48
Foreign Income			
Assessable foreign source income	\$407.01	\$15.64	\$463.54
Other Non-assessable Amounts			
Non-assessable non-exempt amount	\$0.00		\$0.00
Net exempt income	\$0.00		
Other non-attributable amounts	\$0.00		
Gross Amount	\$23,053.38		\$30,076.15
AMIT cost base net amount – excess (Reduce cost base)			\$62.21
AMIT cost base net amount – shortfall (Increase cost base)			\$0.00
Less TFN amounts withheld	\$0.00		
Less non-resident withholding tax			
- interest / dividend amounts withheld	\$0.00		
- Fund payment amounts withheld	\$0.00		
Less other expenses	\$0.00		
Net Cash Distribution	\$23,053.38		

Source: VAS annual tax statement.

Why does this happen? VAS invests *mostly* in ASX shares, whose companies in turn pay dividends, are subject to *franking credits* and undergo corporate actions. This creates different tax implications. VAS also invests in unlisted securities, derivatives and overseas companies each with their own tax nuances.

When a fund manager runs a large portfolio, they leave room at the margins for inflows, outflows, rebalancing and hedging. It's impossible for a portfolio manager to be 100% exposed to their core mandate at all times. Portfolios change daily, which means the underlying components of each distribution will be different quarter to quarter as corporate actions occur, or the portfolio turns over. This activity affects your annual tax situation.

As time goes by, you receive VAS distributions in cash (usually quarterly or half yearly), along with a simple statement from the registry showing the net payment. At the end of the year, the registry will send you a final statement.

These final statements contain all of the component and subcomponent information and are far more detailed than what you received during the year. This information can *retroactively modify your cost base and taxable dividend income*, making your tax lodgement difficult. It runs the risk that investors will pay more tax than they need to.

How Fintech is easing the ETF tax problem

Fintechs like Sharesight have created the expectation for real-time investment information. Once-per-year investment statements are no longer good enough for investors seeking accurate performance data about their hard-earned investment portfolios.

Case in point: in order to provide accurate performance and tax reporting for our clients, we sought to improve the depth and accuracy of ETFs' distribution data for our self-directed clients and partners.

We knew this would be a big undertaking, but it proved more difficult than anticipated. After beginning our journey, we realised there was a lack of information and no clear rules available to investors. No one at the ASX, the ETF providers, professional firms, or even the share registries held the answer — but all recognised the problem.

Ideally, we thought we'd license the detailed distribution data from the registries or ETF managers on an ongoing basis. This proved impossible because they don't calculate the data as the tax year progresses. It's just one opaque process at year-end.

Fortunately, Computershare came to the party and agreed to provide us with the detailed information for some of the most popular ETFs as soon as the financial year ended. We use this data as a basis for calculating the distribution components for the 2017 and 2018 Australian financial years.

Unfortunately, not all the registries were able to provide data for their ETFs. We have no idea how it can be that a registry can send personalised taxation statements out to millions of Australians but not be able to provide even notional data to software companies like Sharesight. In some cases, we did receive sample data, but not always in a useable format.

After months of hard work, tracking down the right people at Computershare, and even buying ETFs ourselves in a Sharesight company account just to get the statements, we managed to build a solution that simplifies ETF tax administration for self-directed investors. After months of research we could not find clear answers from the industry, so we believe our feature hits the mark in terms of both accuracy and usability. Hopefully, it will push the industry towards better reporting standards.

ETFs remain terrific investment options

ETFs have helped democratise investing. I use them myself for long- and short-term investing and we support other fintechs who use them as building blocks for their clients' portfolios. However, it seems that the zest to market new 'easy' ETF investment products wasn't matched by an ease in tax administration.

The reality is that all investments have a tax implication of some kind. For example, ASX-listed stocks are vulnerable to future franking credit decisions. Tax complexity is just a new piece of the puzzle investors must keep in mind when building and administering their portfolios.

Doug Morris is the CEO of [Sharesight](#), an investment portfolio tracker that provides reliable tax and performance reporting to self-directed investors and financial professionals. Sharesight is an alliance partner of Cuffelinks.

Important Disclaimer. We do not provide tax or investment advice. The buying of shares can be complex and varies per individual. You should seek tax and investment advice specific to your situation before acting on any of the information in this article.

The value of disruptors is different

Alex Pollak

Contrary to commentary found in Cuffelinks recently, investors are not naive when they buy shares in 'expensive' major global businesses that are using the latest tools to win customers. Those investors have chosen these companies, which now fall into the category of disruptors, because they have outgrown and are continuing to outgrow their nearest competitors. Investors have to pay up (in a valuation sense) to access them.

It's not simply a power train

Earlier this month, Porsche (effectively a division of Volkswagen) announced that it will no longer produce the diesel engine in its popular Cayenne and Macan four-wheel drive vehicles. Investors who had bet that the 2015 VW diesel scandal would just 'blow over' were wrong, with Volkswagen off 40% since the cheating was revealed. Exhibiting the same share price trajectory is Daimler Benz, down 30% in three years to €57 per share. It wasn't caught cheating (and you should unpick that phrase very carefully) but will probably also phase out the diesel over time.

If we were simply considering two companies together, in stasis, making the same electric cars, then maybe the valuation comparison would be closer. But the history of these two competitors, and their existing structures, means that their journeys will be different, and so will their share prices.

So while it may be tempting to simply view the car makers as moving from one power train (internal combustion engine, whether diesel or petrol) to battery or hybrid, it isn't that simple. Well-established fossil fuel engine companies have extensive supply chains which produce tens of thousands of components, which means that any car maker will have to manage the costs in that process in tandem with the costs in the new process.

Like all manufacturing, how all these parts come together often isn't just a matter of contract, it's also about the hundreds of other things that need to come together to get the job done, some of which come with complex arrangements.

New technologies blow all this away – disrupt it, in fact – breaking down the industries just as they eat in to sales, creating new pockets of wealth all along the way.

If it were just as easy as adding on a business, Daimler and VW and BMW would not have fallen in the wake of the diesel problem. They would have rallied in anticipation of the new electric cars they would produce. But the real way it works is that existing managements, boards and shareholders don't get paid for the value they create through disruption but are still penalised for the coming re-engineering that will be forced upon them.

Other industries are the same

It's the same with Woolworths and Coles. These companies are optimised for sales in shopping centres controlled by Westfield and the like. A significant move online simply cannibalises their existing store sales without reducing the fixed costs of those stores. At the same time, creating an online fulfilment channel can be very expensive. The combination of lower throughput in the physical store and higher costs for online is a drop in profit.

Another example: Foxtel and free-to-air networks are struggling to make their existing one-to-many broadcast television models work, in part because Netflix and others have taught viewers to expect that their favourite content should be available any time, including with a fast forward or pause button. Foxtel can't offer this with the same economics as its regular pay tv service – it hurts the advertising and subscription funded business model, which is based around as many people watching the programme at the same time as possible.

Globally, Walmart, the car companies, AT&T, and Procter and Gamble are affected. In Australia, it's Telstra, Fairfax, Coles, Myer, etc. By the way, this is the reason that Murdoch sold out of content creation in the US and UK.

And banking? What will the banks do with their heavy management structures built to corral people during different credit cycles at a time when the world's understanding of money is that it is truly a digital commodity? How many operatives does it take for a consumer to send money over a mobile phone?

Then we come to Tesla, the subject of a [recent commentary on Cuffelinks](#). The company is capitalised at US\$50 billion, 10%-20% below Daimler and VW. But Tesla doesn't have tens of billions of dollars of capital tied up in obsolete plant or sales channels geared to that plant.

Of course, we know that the market has discounted the value of Daimler, so that its enterprise value is just twice its EBITDA. So in theory, the share price of the company already reflects the current situation. Maybe. But whether Tesla is expensive because it is valued at more than Daimler is not something that can be divined by cherry-picking a few statistics, such as the number of cars produced per dollars of capitalisation.

Meanwhile, Tesla has just produced 80,142 cars in the quarter to 30 September 2018, implying an annual run rate of over 300,000 cars. It will probably produce a million cars by 2022 at US\$60,000 per car. Is the market

ready for a company which is generating US\$60 billion in annual sales, with gross margins in the high teens? Maybe not.

In a perfect world, we could all just buy companies on low multiples and sell them as they went up. But the world is not perfect, and investors must operate according to the circumstances. Wishing the investment problem would go away, and making negative return in the process, isn't a preferred option.

Alex Pollak is Chief Executive, CIO and Founder of [Loftus Peak](#). This article is for general information only and does not consider the circumstances of any individual.

The changing landscape of US large and mid caps

Nick Paul

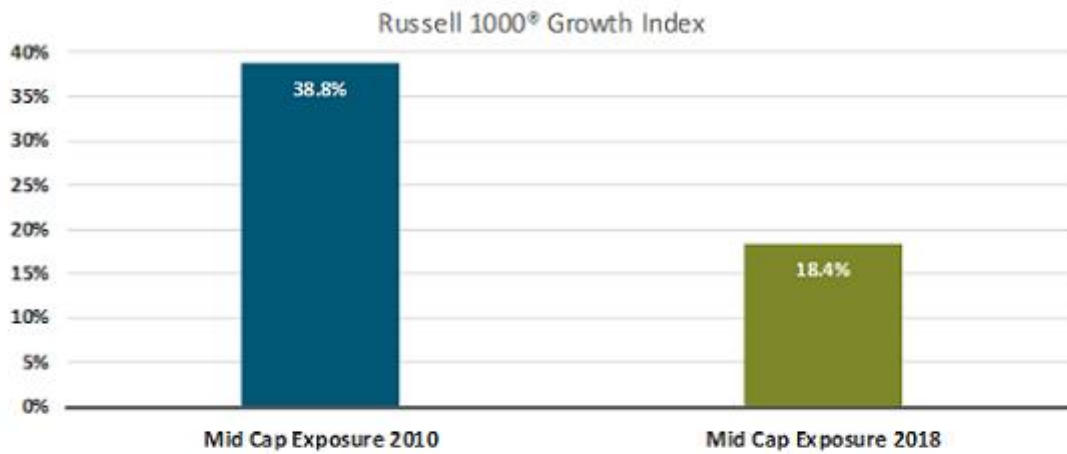
Historically, an allocation to the US large cap growth category of the equity asset class, as represented by the Russell 1000® Growth Index, has presented investors with a reasonable opportunity to gain exposure to mid cap stocks. For this analysis, we define US mid caps as companies with a market capitalisation between \$2 billion and \$25 billion¹. The advantage of this inefficiency within the asset class is that it may help to diversify a portfolio, at least from a market capitalisation standpoint. However, due primarily to the strong performance of a handful of technology stocks (and their ensuing increase in market capitalisation) within the Russell 1000® Growth Index, today's large-cap growth investor may be less able to gain mid cap exposure through the traditional large cap growth allocation (as shown in Exhibit 1).



The increasing dominance of large caps

In our view, the dominance of the most influential large cap stocks can be better appreciated when viewed from the perspective of market-capitalisation buckets, as illustrated in Exhibit 2. Exposure to mid cap stocks in the Russell 1000® Growth Index has declined from 39% of that index in 2010 to just 14% as of 31 August 2018. Also worth noting is where this percentage change was reallocated. We have observed a significant increase in stocks with a market capitalisation greater than \$300 billion in the index.

Exhibit 2: There is less mid-cap exposure within the large-cap growth universe than there was eight years ago



Market cap breakdown of the Russell 1000® Growth Index

Assets (in millions)	1/31/10	8/31/18	Change	Market cap categorization
\$0,000 - \$2,000	1.4%	1.4%	0%	Small Cap
\$2,000 - \$5,000	10.3%	1.0%	-90%	
\$5,000 - \$10,000	11.3%	5.4%	-52%	Mid Cap
\$10,000 - \$20,000	12.2%	9.6%	-21%	
\$20,000 - \$25,000	5.0%	2.4%	-52%	
\$25,000 - \$50,000	16.4%	13.4%	-19%	Large Cap
\$50,000 - \$75,000	6.5%	9.2%	43%	
\$75,000 - \$100,000	5.7%	4.7%	-17%	
\$100,000 - \$150,000	12.5%	11.7%	-6%	
\$150,000 - \$200,000	11.0%	6.7%	-40%	
\$200,000 - \$250,000	6.3%	3.1%	-51%	
\$250,000 - \$300,000	0.0%	1.9%	+1.9	
Greater than \$300,000	1.5%	30.9%	1919%	Mega Cap

Source: FactSet, as of 8/31/18.

This one-dimensional shift in the market cap exposures has added an additional layer of concentration risk where over 30% of the Russell 1000® Growth Index is focused on those companies with a market valuation of over \$300 billion.

Exhibit 3 puts it in perspective. In 2010, Facebook was not even a publicly traded company (IPO: May 2012), but it's currently the sixth-largest company in the index, behind only Apple, Alphabet, Amazon, Microsoft and Berkshire Hathaway.

Exhibit 3: Mega-cap tech driving the shift in the Russell 1000® Growth Index



Source: FactSet, as of 8/31/18.

Dedicated allocation to mid caps

While the market caps for the largest growth companies have accelerated dramatically since mid-2016, outpacing mid caps, how this trend is likely to progress is uncertain. However, an allocation to large cap growth today provides far less exposure to companies further down the capitalisation spectrum. A dedicated allocation to mid cap growth may prove a key component of a comprehensive asset allocation framework moving forward.

In any market environment, we strongly believe that investors should stay diversified across a variety of asset classes. By constructing your portfolio with the awareness of how these weights shift over time, you can help ensure that your portfolio is properly diversified and that your financial strategy supports your long-term goals, time horizon and tolerance for risk. Diversification does not guarantee a profit or protect against loss.

Nick Paul is Institutional Equity Portfolio Manager at [MFS Investment Management](#), a sponsor of Cuffelinks. The views expressed in this commentary are those of the author and are subject to change at any time. These views should not be relied upon as investment advice, as securities recommendations, or as an indication of trading intent on behalf of any investment product.

For more articles and papers from MFS Investment Management, please [click here](#).

Endnotes

¹ Companies with a market capitalization between \$2 billion and \$25 billion account for 80% of the constituents in the Russell Midcap® Growth Index, as of 8/31/18.

The **Russell 1000 Growth Index**® measures US large-cap growth stocks.

The **Russell Midcap Growth Index**® measures U.S. mid-cap growth stocks. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

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Investing with Hearts and Minds

Chris Cuffe

It's not often that an opportunity presents itself where you can both make money and contribute to a good cause. A new listed investment company (LIC), Hearts and Minds Investment Limited (Hearts and Minds), of which I am Chairman, is one such opportunity.

[Hearts and Minds](#) is seeking to raise up to \$500 million and list on the ASX in November (ASX:HM1). There are many LICs on the market, but what makes Hearts and Minds different from most is that it has a charitable goal.

Of course, an objective of Hearts and Minds is to make money for investors, but Hearts and Minds will forego any investment fees and instead make donations to designated medical research charities every six months. Also, the Hearts and Minds Board and Investment Committee members have waived rights to be paid director and committee fees. The lead arranger and brokers for the Offer have waived broker management fees.

The donation amount for each six-month period will be equal to 1.5% per annum of the average monthly NTA (net tangible assets) for the previous half-year. If the portfolio increases in value, the donation amount will increase.

Investment in medical research is critical, and this field has historically provided instances of strong returns. For every dollar invested in medical research, it is estimated that an average of \$2.17 in health benefits is returned.

High-conviction picks in a concentrated portfolio

Aside from the charitable goal, the Hearts and Minds LIC is aimed at investors seeking exposure to a high-conviction portfolio of global equities.

The portfolio will be concentrated, with only about 25 stocks. Hearts and Minds will take long-only positions on Australian and international listed securities based on the highest conviction ideas from two groups of fund managers:

- 40% of the portfolio will be held in about 10 securities based on the recommendations of fund managers who present at the yearly Sohn Hearts and Minds Investment Conference.
- 60% of the portfolio will be held in about 15 securities based on the quarterly recommendations of five leading fund managers: Caledonia, Cooper Investors, Magellan, Paradise Investment Management and Regal Funds Management.

Hearts and Minds has been established following the [Sohn Hearts and Minds Investment Conference](#), which is in its third year now. At this Conference, industry professionals share their expertise and provide their best investment ideas. It sells tickets and the proceeds go to medical research. It has raised \$8 million to date.

The Hearts and Minds IPO thus provides shareholders with an opportunity to benefit from the expertise of each fund manager, some of whom are not readily accessible to retail investors.

Investors will also benefit from having a portfolio that is not concentrated on the philosophy or investment thesis of just one fund manager.

Initially, the designated charities are: Victor Chang Cardiac Research Institute; Black Dog Institute; The Brain and Mind Centre, Sydney University; Charlie Teo Foundation; The Children's Hospital at Westmead; Florey Institute of Neuroscience & Mental Health; Centre of Human Psychopharmacology, Swinburne University; Multiple Sclerosis Research Australia; Orygen; and Royal Prince Alfred Hospital, Research.

Strong momentum with more than \$225 million in commitments

Hearts and Minds has already attracted strong support with numerous cornerstone family investors having already committed more than \$185 million. Members of the Board and the Investment Committee and their associates are committing more than \$40 million to the Offer. Hearts and Minds will not accept oversubscriptions.

The Board has a strong mix of business, social enterprise and philanthropic experience. It includes Ariadne Australia director Dr Gary Weiss, Wilson Asset Management founder Geoff Wilson. UBS Australia CEO Matthew Grounds is a proposed director.

The Board of Hearts and Minds has appointed Rory Lucas as the CEO. Rory has worked in the Australian and global equity markets for nearly 30 years. Rory's specialty is in trade execution, portfolio construction and risk management. His previous roles include managing funds at Rothschild Australia Asset Management, a senior equity facilitation role at UBS, and trading and execution roles at the Commonwealth Bank of Australia.

The IPO opens on Monday 15 October 2018 and is expected to close on 6 November 2018. Shares in Hearts and Minds are expected to start trading on the ASX on 21 November under the code HM1.

This is an investment supported by some of the best and brightest fund managers and investors in the nation, with a genuinely worthwhile philanthropic goal.

I encourage you to read the [Prospectus](#). Applications under the general Offer can be made by completing the application form attached to the Prospectus or online through the application form accompanying the electronic Prospectus. Applicants under the broker firm offer should contact their broker for application details. The Lead Arrangers for the Offer are CommSec, NAB and Crestone. Brokers include Bell Potter, Evans Dixon, JB Were, On-Market Book Builds, Ord Minnett, Paterson, Shaw and Partners, Taylor Collison and Wilsons.

Watch [the video](#) of my introduction to the Hearts and Minds Investments Limited Offer, including some of the medical work that will benefit.



Chris Cuffe is Chairman of [Hearts and Minds Investment Limited](#) and Founder and Portfolio Manager of [Third Link Growth Fund](#). He is also a Co-founder of Cuffelinks. This information provided is general and does not constitute personal financial, tax or legal advice. Any participation in the Offer is subject to disclaimers in the Prospectus.

View Chris Cuffe's appearance on ABC's *The Business* program [here](#).

Download Independent Investment Research's IPO Research Report on HM1 [here](#).

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