

This Week's Top Articles

- **Deep inside Chris Cuffe's long-term portfolio** *Graham Hand*
- **4 reasons why investment performance comparisons are flawed** *Phil Graham*
- **How SMSFs can utilise franking credits under Labor** *Dr Rodney Brown*
- **Australia tops Asia-Pacific for property investment** *Adrian Harrington*
- **Sequencing risk can hit retirement outcomes** *Aaron Binsted*
- **Don't overlook the quality in consumer staples** *John O'Brien*
- **6 quick answers on appointing an enduring Power of Attorney** *Phillip Richards*

Deep inside Chris Cuffe's long-term portfolio

Graham Hand

"I should have computed the historic covariance of the asset classes and drawn an efficient frontier. Instead, I split my contributions fifty-fifty between bonds and equities."

– Nobel Laureate Harry Markowitz, father of Modern Portfolio Theory, when asked about his personal retirement account.

It is rare to look inside a private multi-sector fund managed by someone like Chris Cuffe who sees an endless stream of deals and investment managers every year. While many investors spend most of their time deciding which shares to buy, the allocation between different asset classes is far more important for long-term returns. A study by Vanguard (the second-largest asset manager in the world) of 580 balanced funds in Australia showed that 90% of the return from a portfolio comes from asset allocation between sectors. That leaves only 10% for everything else, including selection of particular shares.

What is this portfolio and its objectives?

Chris Cuffe founded Australian Philanthropic Services (APS) in 2010 to open and administer charitable fund structures known as private ancillary funds and public ancillary funds (PAFs). For details on these structured, tax-effective giving vehicles, [read here](#). APS also established its own public ancillary fund, known as the APS Foundation, to allow people with as little as \$50,000 to set up a sub-fund in a name of their choosing. The money is combined into a single charitable fund for which Chris is the Portfolio Manager.

Each year, sub-fund holders donate to charities at least 4% of the prior 30 June balance, although some give more. The fund has grown to over \$70 million in a relatively short time. The higher the investment returns generated by the fund, the more is available for charities.

The investment strategy seeks to achieve an after-fees return at least equal to CPI + 4% per annum, measured over rolling 7-year periods. Although the known minimum outflow is 4%, Chris can take a genuine long-term perspective because the donors do not redeem due to market circumstances, as they might with an open-ended managed fund holding personal assets. Liquidity is important as donors can give to charities at any time, but the portfolio does not need to be invested only in low-yielding cash or fixed interest to preserve the balance.

Chris believes that the best way to achieve the investment objective is to hold a significant portion of growth-oriented investments such as shares, with the additional benefits of franking credits. He also wants some exposure to income-oriented investments such as cash, fixed income securities and lowly-g geared property and infrastructure securities. There is tactical asset allocation when sharemarket valuations appear stretched or a better risk/return trade-off is expected away from shares.

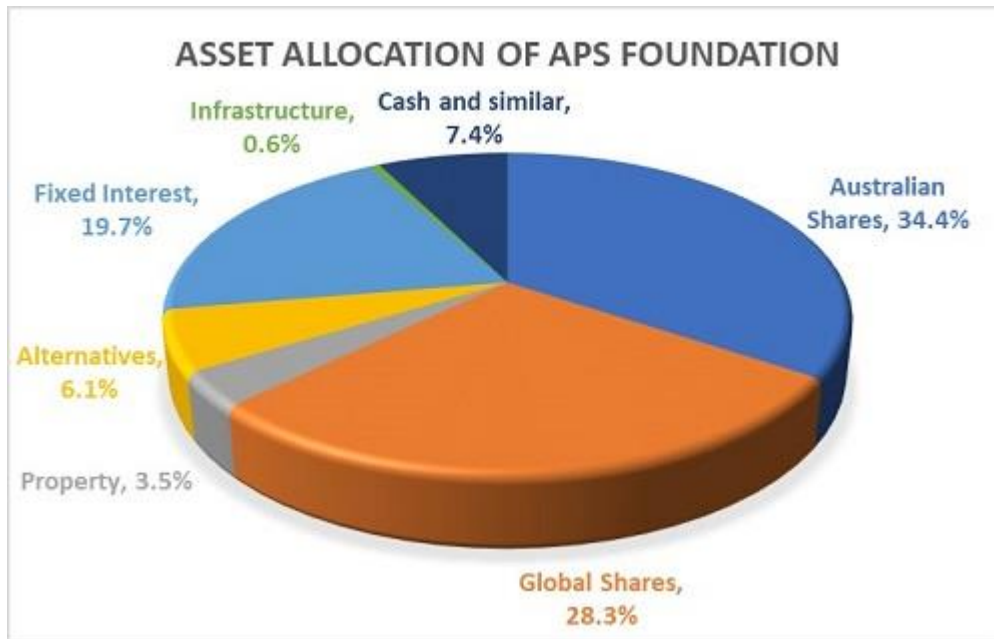
The bottom-up starting point

Unlike most multi-sector managers, Chris does not start by targeting a specific asset allocation. Instead, he builds the portfolio from the bottom up. He looks at individual investment propositions on their merits from the perspective of the return target, expected time frame to achieve the return and likelihood of capital loss, bearing in mind the return target of inflation + 4% pa. The asset allocation is more an outworking of this method and a risk check. That is, he watches the amount in each asset sector to ensure the portfolio does not become too concentrated in one asset class.

He pays little regard to the so-called 'growth/defensive' split because he believes such categorisation is too vague. It implies precision when the world of investments is imprecise. He prefers the 'growth/income' distinction, which refers to where the majority of return is expected to come from.

For a previous article by Chris on the difficulties of Tactical Asset Allocation, [see here](#).

Investments held at 30 June 2018



The broad investment ranges allow 25% to 75% in either growth-oriented or income-oriented.

Growth-oriented investments (72.3%)

Australian shares (34.4%):

- Unlisted managed funds/IMAs (31.6%) – Aberdeen Australian Small Companies Fund, Auscap Long Short Australian Equities Fund, DS Capital Growth Fund, EGP Concentrated Value Fund, The Level 18 Fund, Pengana Australian Equities Fund, TDM Asset Management IMA, The Wattle Fund, LHC Capital Australia High Conviction Fund, Wentworth Williamson Fund, Third Link Growth Fund
- Shares directly held (2.8%) –comprising 5 securities listed on the Australian securities exchange

International equities (28.3%):

- Listed investment companies (6.2%) – Future Generation Global Investment Company, Magellan Global Trust, VGI Partners Global Investment

- Unlisted managed funds/IMAs (17.3%) – Antipodes Global Fund (Long Only), Magellan Global Fund, Paradise Global Small Mid Cap Fund, TDM Asset Management IMA, VGI Partners Master Fund
- Shares directly held (4.7%) – comprising 7 securities listed on various international markets

Property (3.5%):

- Unlisted property trusts – Portgate Estate (Port of Brisbane – industrial property), IIG TAC Property Trust (60 Brougham Street Geelong – commercial property), Quintessential 036 Trust (39 Brisbane Avenue, Barton, ACT – commercial property), IIG K5 Property Trust (25 King, Brisbane Showground – commercial property), Terra Australia Partners III Fund, Folkstone Sydney Airport Hotel Fund

Alternative assets (6.1%):

- Unlisted managed funds/IMAs (4.0%) – Atrium Real Assets Fund, TDM Asset Management IMA, Champ IV Trust A, Armitage Private Equity Fund
- Unlisted shares directly held (0.6%) – Tellus Holdings
- Listed investment companies (1.5%) – Global Value Fund

Income-oriented investments (27.7%)

Infrastructure assets with low gearing/development (0.6%):

- Managed fund (0.2%) – Magellan Infrastructure Fund (hedged)
- Listed investment company (0.4%) – Argo Global Listed Infrastructure

Fixed interest (19.7%):

- Unlisted managed funds/IMAs (17.0%) – Morgan Stanley IMA, MINT Partners IMA, PIMCO GIS Income Fund, Lannock Sophisticated Investor No. 1 Unit Trust, Elstree Enhanced Income Fund, CLR Portfolio Note, Western Asset Macro Opportunity Bond Fund, Invesco Zodiac US Senior Loan Fund
- Directly held (2.7%) – comprising 3 fixed interest securities

Cash, franking credits receivable and other receivables (7.4%)

Some features which are notably different to, say, the average SMSF or personal portfolio, include:

1. The outsourcing of share selection to external fund managers. Chris believes it is possible to identify talented managers who deliver excess returns over the long term. He is not concerned if a fund manager underperforms an index over a one-, two- or three-year period. He judges managers over rolling five-year periods. Chris has decades of experience and market contacts to draw on, and not all these managers are available to retail investors.

Although many of the managers have agreed to rebate their fees (both management and performance), Chris is willing to invest in some funds or securities where fees are not waived. He will pay fees if the after-fees return is expected to be attractive from investing with one of the limited number of managers who can consistently provide attractive after-fees returns.

2. The international equity allocation at over 28% is significantly higher than the average SMSF and most Australian balanced funds, based on Chris recognising the global opportunities in sectors not available in Australia.
3. Fixed interest funds are used for income and capital protection, often taking advantage of higher-yielding sectors beyond traditional government and corporate bonds. He is a fan of the private debt markets (for example, loans to businesses starved of traditional bank borrowings) because returns are seen as disproportionately high compared to the risk of capital loss.
4. He does not regard volatility in the value of a security or fund as a measure of 'risk', instead viewing risk as the possibility of permanent capital loss.
5. He has little regard for how competitor funds invest and is not a fan of 'following the Joneses'.

6. Asset allocation close to the maximum for growth-oriented assets is possible with the long-term thinking, which gives flexibility to take more risk than a portfolio subject to outflow if short-term performance is poor.

Performance

Although few, if any, of the donors watch the investment performance in the way they might with their personal portfolio, and short-term performance is almost irrelevant to Chris, it’s interesting to see how the fund has performed relative to its target and indexes. With a since-inception (1 July 2012) return of 12.9% pa against inflation of 2.1%, it’s clearly meeting its objective and helping build the amount available for charities. Holders of sub-funds can see their balance at any time and know how much they have to give that year.

| | Six months | One year | Two years | Three years | Since inception |
|--|------------|----------|-----------|-------------|-----------------|
| Australian Philanthropic Services Foundation | 5.9% | 9.4% | 8.2% pa | 9.3% pa | 12.9% pa |
| Australian shares (S&P/ASX300 Accumulation Index) | 8.6% | 11.9% | 11.9% pa | 8.8% pa | 12.2% pa |
| International shares – currency unhedged (MSCI World ex-AUS Unhedged AUD Total Return) | 8.5% | 13.4% | 10.6% pa | 11.0% pa | 18.2% pa |
| Australian cash (Bloomberg AusBond Bank Bills Index) | 0.9% | 1.7% | 1.9% pa | 2.1% pa | 2.5% pa |
| Australian inflation (ABS All Groups CPI index) | 1.3% | 1.9% | 1.7% pa | 1.7% pa | 2.0% pa |

APS manages all aspects of the APS Foundation (including administration, compliance, arranging investment management, and facilitating the yearly audit) for a fee of 1% pa. Chris provides his services to APS pro bono, as do most of the external fund managers. Some may earn fees but are still used where an attractive post-fee return is expected.

For further information on charitable giving using Public or Private Ancillary Funds, contact APS at foundation@australianphilanthropicservices.com.au.

Graham Hand is Managing Editor of Cuffelinks. Chris Cuffe is a Co-Founder of Cuffelinks; Portfolio Manager of the charitable trust, Third Link Growth Fund; Chairman of Australian Philanthropic Services (APS); Chairman of Hearts and Minds Limited (all in a pro bono capacity) and Non-Executive Director of various companies. The views expressed are not personal financial advice and do not consider the circumstances of any individual.

4 reasons why investment performance comparisons are flawed

Phil Graham

Over the course of 2018, the focus on peer relative comparison of superannuation fund investment returns has increased, fuelled by the usual end of financial year comparisons, and this year compounded by the Productivity Commission and Royal Commission reviews.

While it is right for fund returns to come under close scrutiny – after all, the impact of a lower return on a member’s balance over the long term is significant – there are many aspects of these comparisons that are deeply flawed.

1. Excessive focus on the short term

Anyone who builds a multi-sector investment portfolio knows that they are designed to deliver over the long term. The focus should be on five years or more for most ‘growth’ or ‘balanced’ funds in the performance surveys, and even better seven or 10 years. The media and the survey providers grab on one year is largely meaningless.

2. Ignorance of investment objectives

The stated investment objective of most balanced superannuation funds is usually as a CPI plus return over a specified time frame. For example, a 75% growth asset fund would typically have an objective of CPI + 3.5% over five years.

It was notable that during the Royal Commission hearings, the focus was almost exclusively on peer relative performance measures rather than performance against the investment objective. The Commission examined which funds had outperformed others, and more often than not industry funds versus retail funds. Yet even the bottom quartile fund in the SuperRatings survey has delivered 7.8% pa over five years and 5.7% pa over 10 years to June 2018 (the latter is lower as it still includes the impact of the GFC on returns), against an investment objective of around 5.5% (based on CPI + 3.5%). The fact that almost all funds would have achieved their stated investment objective, even including the GFC period, has been completely ignored. These funds have achieved what they had promised to deliver to members over the long term.

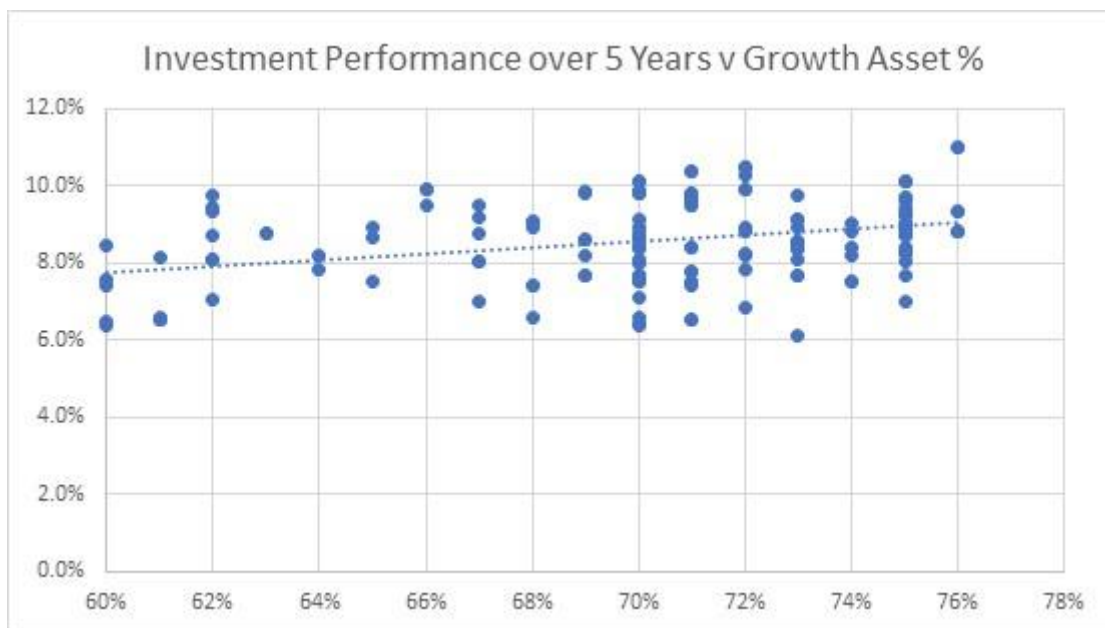
3. Major differences in asset allocation within same category

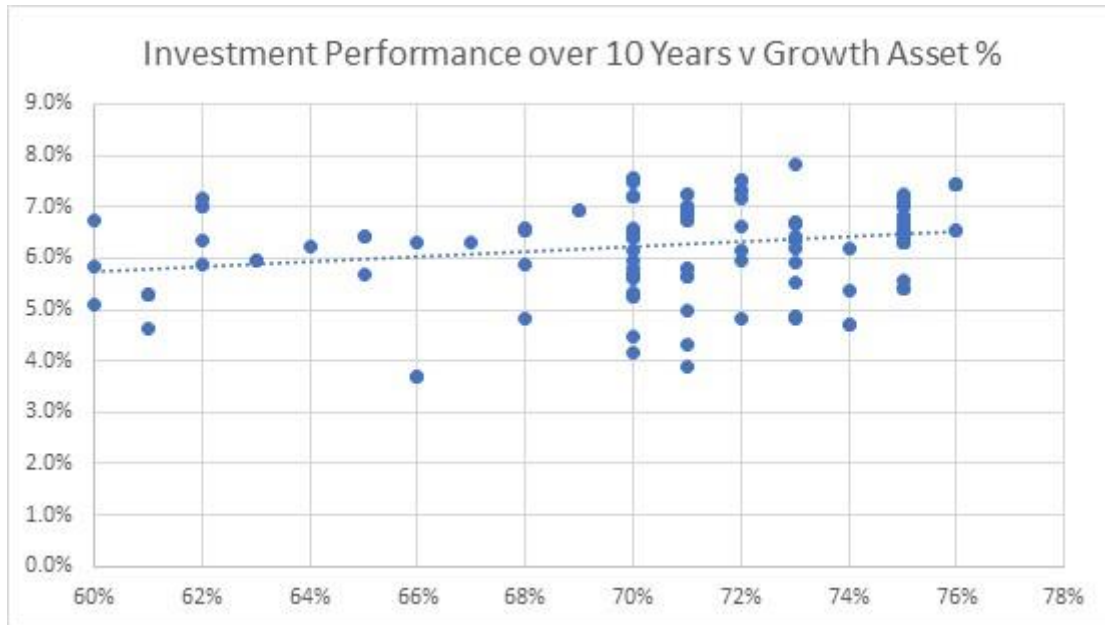
For reasons of practicality, comparison surveys include funds with a wide range of growth-defensive mixes in each bracket. For example, for the most-watched growth-oriented survey categories, SuperRatings covers 60-76% growth assets, while Chant West has a range of 61-80%. This is a very wide range. During rising equity markets, a fund with 60-70% growth assets will of course perform worse than funds in the 70-80% range.

A trend line of fund returns against growth asset levels suggests that a 10% increase in growth assets (from 65% to 75%) produced a 1% higher return over five years, and a 0.5% higher return over 10 years. This is enough to move a fund from 1st quartile to 3rd quartile over both time periods, a massive difference in performance ranking.

In this age of quantitative analysis, survey providers should provide a regression fit showing the best fit line for the results, which then allows a comparison of an individual fund's performance at the comparable growth asset allocation, as shown in the chart below. Funds could then be compared against what they should have been expected to return. A fund above the trend line has outperformed at its level of growth assets, and equivalently for those funds below the trend. This would then focus attention on funds relative to their own growth asset positioning.

After all, a fund with 76% growth assets could make bad decisions and underperform relative to what it should achieve, just as a fund with 65% growth assets can. The higher equity exposure should not disguise the real result.





A resultant impact of the focus on peer relative performance is that funds have started to push themselves towards the top end of the survey brackets, so there is a cluster of funds with growth asset allocations towards the top end of the bracket (as can be seen in the above charts, for the SuperRatings survey).

Of course, targeting higher return also comes with higher risk. This is not necessarily driven by what is the best investment structure for their members, but by the desire to outperform competitors.

4. The growth versus defensive asset definition game

The assessment is made even more cloudy because there is no industry-wide standard for defining growth and defensive assets. While some assets are easily defined as 100% growth (listed equities, private equity) or 100% defensive (cash, sovereign and investment grade corporate bonds, inflation-linked bonds), there are many assets that exhibit both growth and defensive qualities, such as unlisted property and infrastructure assets, high yield bonds, alternatives.

Rather than having a standard accepted definition, funds are allowed to make their own choice. Inevitably, some funds have been aggressive in saying some growth assets are defensive, allowing them to load up on other growth assets to the point where they should not be in the survey bracket they are allocated.

Guidance for allocating between growth and defensive

Applying some simple metrics such as the ones below would provide guidance for how to allocate assets on the growth-defensive range, especially for unlisted assets:

- **Volatility** (standard deviation) of the asset class (higher volatility = higher growth allocation)
- **Correlation** of the asset class returns with listed equities (higher correlation = higher growth allocation)
- The largest historical **drawdown** of the asset class over the last 30 years (bigger drawdown = higher growth allocation)
- The breakdown of the asset class return into its **capital and income components** (greater % in capital return = higher growth allocation, and vice versa) and
- The level of **leverage** of underlying investments within a fund (higher leverage = higher growth allocation).

Rightly or wrongly, survey providers have argued it is not their role to dictate to funds on this question. While that in itself is debateable – some leadership on this issue would actually be in their interests – what is needed is an industry-wide agreement (preferably sponsored by an industry body) on some parameters to decide the correct growth-defensive allocation.

As some unlisted property and infrastructure funds include a variety of types of assets, this could include requiring investment managers to provide an assessment of growth-defensive qualities of their own funds. For example, an unlisted property manager could assess each property on its capital and income components, historical volatility and the like, and conclude its fund on average should be classified as 50% growth and 50%

defensive. A superannuation fund would then use these metrics to calculate a fund-wide breakdown of its product (as the sum product of the asset allocation and the growth % allocation).

While it may be too much to expect the media to focus on long-term returns (both absolute and relative to peers) and performance against investment objectives, these relatively easy measures would markedly improve peer relative performance comparisons, and provide a more like-with-like comparison of fund returns. It would also remove the gaming currently prevalent in the system, and focus attention on the real story – generating a return net of fees and taxes that will meet the retirement needs of members.

Phil Graham is an independent investment committee member. Until recently he was Deputy Chief Investment Officer with Mercer.

How SMSFs can utilise franking credits under Labor

Dr Rodney Brown

Recent events in the political landscape point to an increased likelihood of a Labor Party election victory in 2019, making the implementation of its proposed changes to franking more likely. Much has been written on this proposed policy change including its impact on SMSF pensioners, its unfairness, its potential impact on equity markets and the perception that an underlying motive is to move people out of SMSFs and into industry funds.

However, in all the heated discussion, one key advantage of SMSFs has been largely overlooked: *control*. Some SMSF trustees will still be able to exploit this feature of SMSFs to minimise or remove the financial impact of the franking change while at the same time undertaking strategic estate planning, the fruits of which they will enjoy *while still alive*.

The benefit of control

Most people set up SMSFs because they want to exercise control over key aspects of the fund including its membership, investments, timing of investment sales to maximise tax outcomes, general administration and estate planning. Our students at the University of NSW are taught this early in our SMSF course to demonstrate why people decide to take responsibility for their retirement.

However, the current franking discourse has lost sight of this major SMSF benefit. This article expands the discussion on one strategy available to SMSF trustees (mentioned in Matthew Collins' [article in Cuffelinks](#)).

Adding adult children in accumulation mode to an SMSF in pension mode

The addition to an SMSF of younger family members who are still in accumulation mode and making taxable superannuation contributions will lead to an increase in the fund's taxable income. The SMSF is a single taxable entity. Trustees can utilise the combined taxable income of both the pension and accumulation components. This can soak up some, if not all, of the franking credits otherwise lost from 1 July 2019 under Labor's proposal.

The table below sets out the potential franking credits lost assuming a two-member SMSF in full pension phase, a dividend yield of 5% and an asset allocation of 29.2% to listed Australian shares as per the latest ATO statistics (assume these shares are fully-franked dividend paying).

| Scenario | 1 | 2 | 3 | 4 | 5 |
|---|-----------|-----------|-------------|-------------|-------------|
| Fund balance | \$500,000 | \$750,000 | \$1,000,000 | \$1,250,000 | \$1,500,000 |
| Of which, Australian listed shares | \$145,929 | \$218,893 | \$291,858 | \$364,822 | \$437,787 |
| Dividends received | \$7,296 | \$10,945 | \$14,593 | \$18,241 | \$21,889 |
| Franking credits | \$3,127 | \$4,691 | \$6,254 | \$7,818 | \$9,381 |
| Total taxable income required to soak up all franking credits | \$20,847 | \$31,270 | \$41,694 | \$52,117 | \$62,541 |

This stylised example shows the taxable income required to fully utilise all franking credits.

Where does the taxable income come from?

The increase would come from concessional contributions made by adult children added to the SMSF along with investment earnings on any existing accumulation balance rolled over. Given adult children in their 40s have been receiving superannuation contributions for 25 years (since 1992 albeit at lower rates than the current rate) the balances rolled into the SMSF may be significant. The full amount of the concessional contribution is classified as assessable income to the SMSF.

Assuming one child joins the SMSF and rolls over an existing balance of \$150,000 and makes maximum annual concessional contributions of \$25,000, the SMSF's taxable income would increase by \$32,500 ($\$25,000 + [\$150,000 \times 5\%]$). This would result in all franking credits being used in scenarios 1 and 2 above. Based on investment earnings of 5%, every additional \$50,000 of accumulation funds rolled into the SMSF would increase taxable income by \$2,500. Compounded over a decade or two (a feasible result given current longevity expectations), the financial result is material.

The outcome becomes more favourable if two or more children join the fund (up to four children could join the fund if the current proposal to increase the limit of SMSF members from four to six commences in 2019). While ATO statistics point to a slight fall in four- and three-member SMSFs in recent years, the increased scope for strategic planning emanating from the proposed change may reverse this trend.

Benefits of the strategy

The addition of children to an SMSF who are still in accumulation mode can be an effective strategy for several reasons:

First, existing SMSF pension members will not want to 'lose' money after 1 July 2019, and increasing the fund's taxable income partially or fully retains the benefit of franking. In effect, the SMSF is achieving the same result as an industry or retail fund which will not lose the ability to use franking credits.

Second, by utilising their parent's franking credits, children can tax-efficiently increase their retirement savings. This could occur at a time when they are dealing with significant financial commitments like mortgages and school fees thus providing a welcome financial boost.

Third, and perhaps the most overlooked reason, is that the proposed change provides an opportunity for SMSF pensioners to implement an estate planning strategy that takes effect *while they are still alive*. Effectively, SMSF pensioners will be able to legally and tax-efficiently pass on some of their estate to their children by reducing the tax liability on their children's super contributions and earnings. Again, the compounding effect over many years may be significant. Furthermore, rather than the usual scenario of their estate being transferred to their beneficiaries *after* their death, parents will be able to enjoy their retirement years in the knowledge that their children are simultaneously reaping the benefit of their SMSF structure instead of losing some of their retirement benefit to a legislative change.

Potential drawbacks of the strategy

Of course, all strategies come with risks and potential problems.

First, in return for joining the SMSF, children would have to take on the associated trustee responsibilities, although this may lead to greater engagement with their superannuation.

Second, family life can be complex. Marriage breakdowns, estranged children or family in-fighting are common and may prove too much of an impediment to this strategy. No doubt, some people will understandably not want to go anywhere near mixing finances with family life.

Third is the issue of fairness. More of the benefit of franking credits otherwise forfeited would accrue to the children with greater existing accumulation balances or making larger concessional contributions because the franking credits are applied proportionately (i.e. they save the greatest amount of tax). However, this could encourage children to make greater contributions.

Fourth, a risk for children joining the SMSF is that investment returns may be less than those earned in their existing retail or industry fund, or they may sacrifice favourable insurance arrangements.

Such impediments are not insurmountable and may even be a catalyst to 'professionalise' the SMSF and take a more holistic, whole-of-family approach, to financial planning. Against the backdrop of the ongoing Royal

Commission and other changes occurring in the financial advice industry, Labor's proposed change represents an opportunity for SMSF trustees and their advisers to consider a more forward-thinking approach. Of course, the policy proposal is facing considerable public opposition, and its final form or timing are unknown at this stage.

Dr Rodney Brown is a Lecturer in Taxation and Business Law at the [University of NSW Business School](#), including the Master of Tax and Financial Planning course. He completed his PhD at the London School of Economics after working as a financial planner in Sydney. This article is general information based on a current understanding of tax law and Labor's proposal, and it does not consider the circumstances of any individual.

Australia tops Asia-Pacific for property investment

Adrian Harrington

Melbourne and Sydney have placed first and third as the most popular destinations to invest in commercial property in the Asia-Pacific region in 2019.

Australia's strong underlying economic growth combined with high yields relative to other Asia-Pacific markets, good prospects for rental growth and market transparency are driving continued domestic and global investor interest in the Melbourne and Sydney commercial property markets according to the latest results from the ULI/PwC 2019 industry survey^[1].

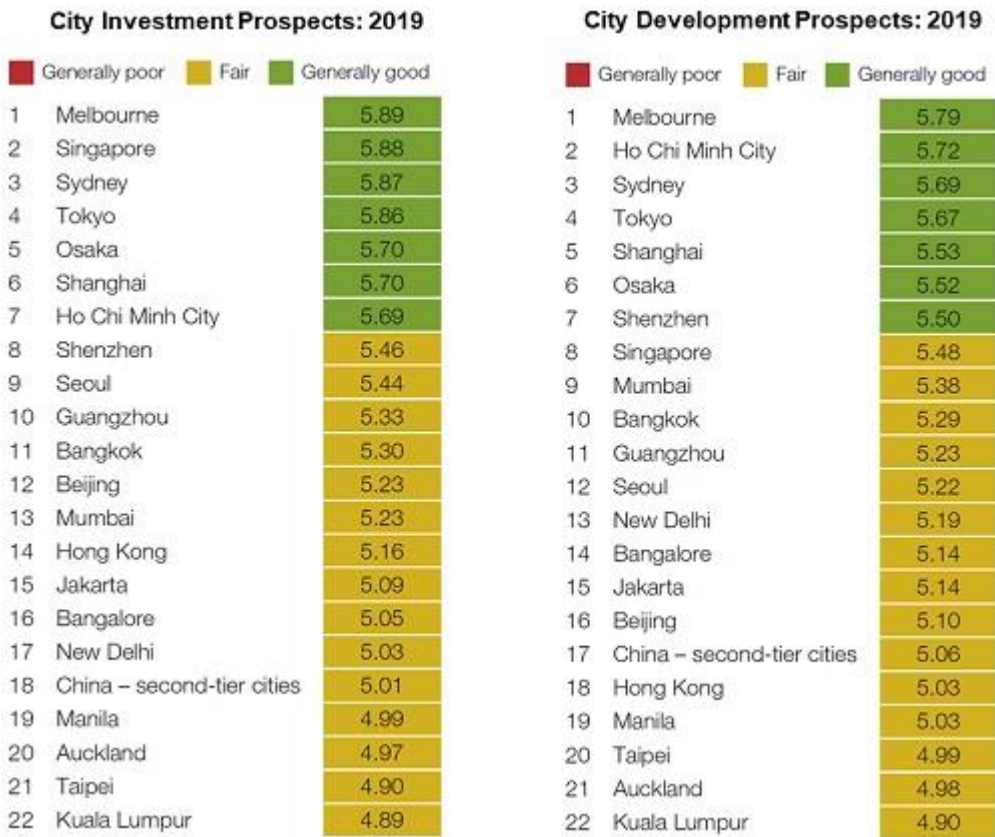
Relative yields are important

Although yields in Australia are close to record lows (circa 4.75% – 5.0% for high quality office and retail, and 5.5% for high quality industrial), they remain higher than those in other Asia-Pacific gateways. Hong Kong and Tokyo yields are now below 3.0% while Shanghai yields hover just above 3.0% and Singapore yields are circa 3.5%.

Melbourne has overtaken Sydney as the best prospect in the Asia-Pacific region for both investment and development (see Figure 1), with Sydney slipping from No. 1 to No. 3 this year. The top four markets for investment in 2019 are:

- Melbourne (first in investment, first in development) – Melbourne offers a constrained office supply pipeline, a good yield spread over the cost of debt and sovereign bonds, a deep, liquid, core market and good prospects for rental growth
- Singapore (second in investment, eighth in development) – an improvement in Singapore's office market has caused the city to take second spot as it rebounds from cyclical lows
- Sydney (third in investment, third in development) – Sydney offers the same reasons as Melbourne, and is a favourite of global investors due to relatively high returns and as a safe-haven play. Competition for assets has helped sustain pricing, while low vacancies and growing demand for space suggest rents will continue to rise.
- Tokyo (fourth in investment, fourth in development) – Tokyo's move to fourth is somewhat surprising after last year's drop. This reflects cheap finance, attractive leverage, a good spread over other interest rates and a large stock of investment-grade assets.

Figure 1: City investment and development prospects: 2019

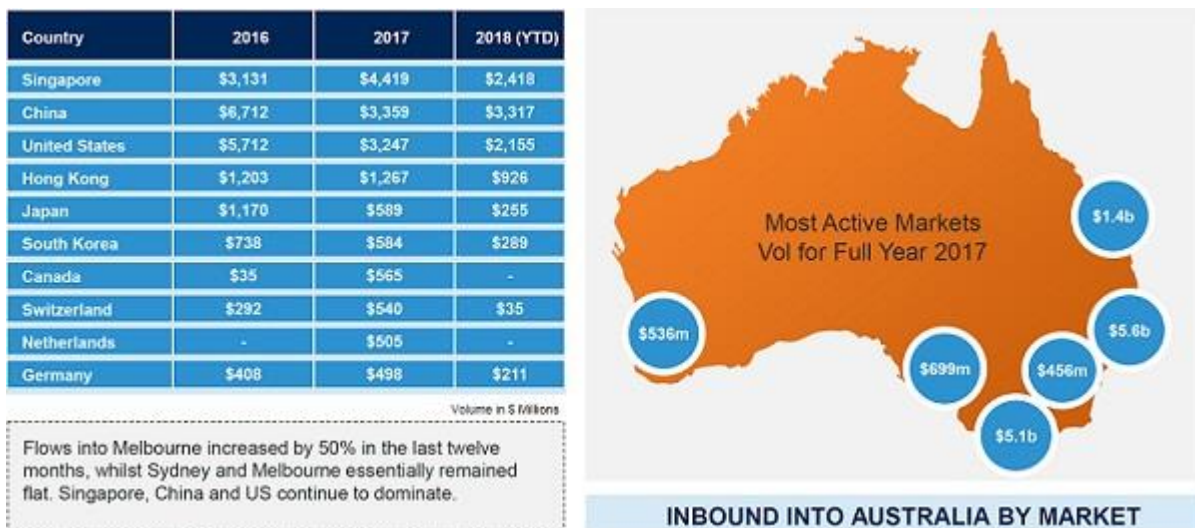


Source: ULI/PwC

With abundant capital seeking a home in the Asia-Pacific region, it’s not surprising that Australia continues to be a beneficiary of cross-border money flows. Most of the capital being deployed into Australia is coming from both high net worth families and Asian-based funds domiciled in Singapore and Hong Kong, US real estate equity funds and insurance companies, and the Chinese (see Figure 2).

Despite restrictions on Chinese capital flows, more than \$3 billion of Australian assets have been acquired in the first nine months of 2018. This is well down on the \$6.7 billion invested in 2016 but is set to pass the \$3.4 billion invested in 2017. Recent Chinese investing has largely been driven by corporates and high net worth private investors who have capital reserves outside of China.

Figure 2: Capital flows into Australia: 2016 – 2018



2018 YTD – as at 30 September 2018. Source: Perpetual/Real Capital Analytics

Logistics tops shopping list of sectors

Logistics topped the list in the ULI/PwC survey as the most preferred property sector to invest across the Asia-Pacific region in 2019. For most institutional investors, industrial remains a small component of their investment portfolios, well behind office and retail. This is changing as investors re-rate industrial and some are now seeing it as the retail of the future in their portfolios.

Demand for industrial space is being driven by businesses looking for greater efficiency through the optimisation of their supply chains and warehouse footprints. There is a rise of e-commerce logistic players wanting large, state of the art distribution centres located at major transport hubs. More recently, demand has also spread to last-mile delivery hubs, which provide smaller fulfillment facilities strategically located nearer to, or in, city centres allowing retailers and third-party logistics providers (3PLs) to offer next day, or even inter-day (two hour) delivery.

Investors have responded by driving down industrial yields to enter the sector. The yield spread between industrial and both office and retail property has compressed more over recent years than in previous cycles. According to JLL, prime Sydney industrial yields currently average 5.38%, just 0.63% higher than prime Sydney CBD office yields at 4.75% and 0.56% higher than prime retail yields at 4.82%.

Focus on income in future

2019 is set to be a pivotal year for Australian commercial property. If the ULI/PwC survey is any guide, Australia will remain an attractive destination for foreign capital. Competition for assets will remain high, with the office and industrial sectors being particularly attractive. Yet at this point in the cycle, after eight plus years of yield compression and strong capital growth, income is set to become the main driver of investment returns. Investors will be well served seeking quality assets with long-term leases underpinned by strong tenant covenants. It is these assets that will provide the best protection against any turbulence stemming from disruptions in the broader capital markets.

Adrian Harrington is Head of Capital & Product Development at [Charter Hall](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

For more articles and papers from Charter Hall (and previously, Folkestone), please click [here](#).

[1] *The ULI/PwC 2019 Emerging Trends in Real Estate Asia Pacific Report is based on the opinions of 350 real estate professionals, including investors, developers, and lenders who were surveyed on the prospects for both property investment and development markets and property finance and capital markets in the Asia-Pacific region.*

Sequencing risk can hit retirement outcomes

Aaron Binsted

It has been an extraordinarily good period for retirees in recent years, with the stock market recording one of the longest bull markets in history. But bull markets typically end with a bear market, and while no-one knows for sure when that may occur, retirees should be preparing for a change in sentiment.

October 2018 was a bruising month for equity markets, and we think volatile markets are here to stay. While all investors understand that market volatility can affect the value of their retirement savings, many do not realise there is another type of risk lurking in the shadows that could be of greater concern for those nearing retirement. It is called sequencing risk.

The sequence, or order in which your investment returns occur, can have a dramatic impact on the health of your retirement savings. Retirees therefore need to look at strategies that can help them during this vulnerable period.

What is sequencing risk?

A portfolio is exposed to sequencing risk if there are contributions coming into a portfolio, or if withdrawals are coming out of the portfolio to fund retirement. A portfolio with no contributions or withdrawals has no sequencing risk because with multiplication, changing the order of numbers has no impact on the result.

The example below shows two investors, A and B, who both start out with an investment of \$350,000. Both investors achieve an average rate of return of 5% per annum over the 11-year period.

Investor A's portfolio experiences negative returns in the early years of his retirement. Investor B's portfolio experiences the negative returns later on, exactly reversing the annual timing of the same returns. As neither investor is making withdrawals from their portfolio, at the end of the final year both investors have an identical balance of \$549,512.

No sequencing risk

| Year | Investor A's Portfolio | Return Pattern | Investor B's Portfolio | Return Pattern | Withdrawal | Difference between 2 portfolios |
|------|------------------------|----------------|------------------------|----------------|------------|---------------------------------|
| | \$350,000 | | \$350,000 | | | \$0 |
| 1 | \$360,500 | 3% | \$399,000 | 14% | \$0 | \$38,500 |
| 2 | \$270,375 | -25% | \$446,880 | 12% | \$0 | \$176,505 |
| 3 | \$243,338 | -10% | \$460,286 | 3% | \$0 | \$216,949 |
| 4 | \$253,071 | 4% | \$483,301 | 5% | \$0 | \$230,230 |
| 5 | \$283,440 | 12% | \$579,961 | 20% | \$0 | \$296,521 |
| 6 | \$331,624 | 17% | \$678,554 | 17% | \$0 | \$346,930 |
| 7 | \$397,949 | 20% | \$759,981 | 12% | \$0 | \$362,032 |
| 8 | \$417,847 | 5% | \$790,380 | 4% | \$0 | \$372,533 |
| 9 | \$430,382 | 3% | \$711,342 | -10% | \$0 | \$280,960 |
| 10 | \$482,028 | 12% | \$533,506 | -25% | \$0 | \$51,479 |
| 11 | \$549,512 | 14% | \$549,512 | 3% | \$0 | \$0 |
| | Average | 5% | | 5% | | |

This example is for illustrative purposes only.

A tale of two investors

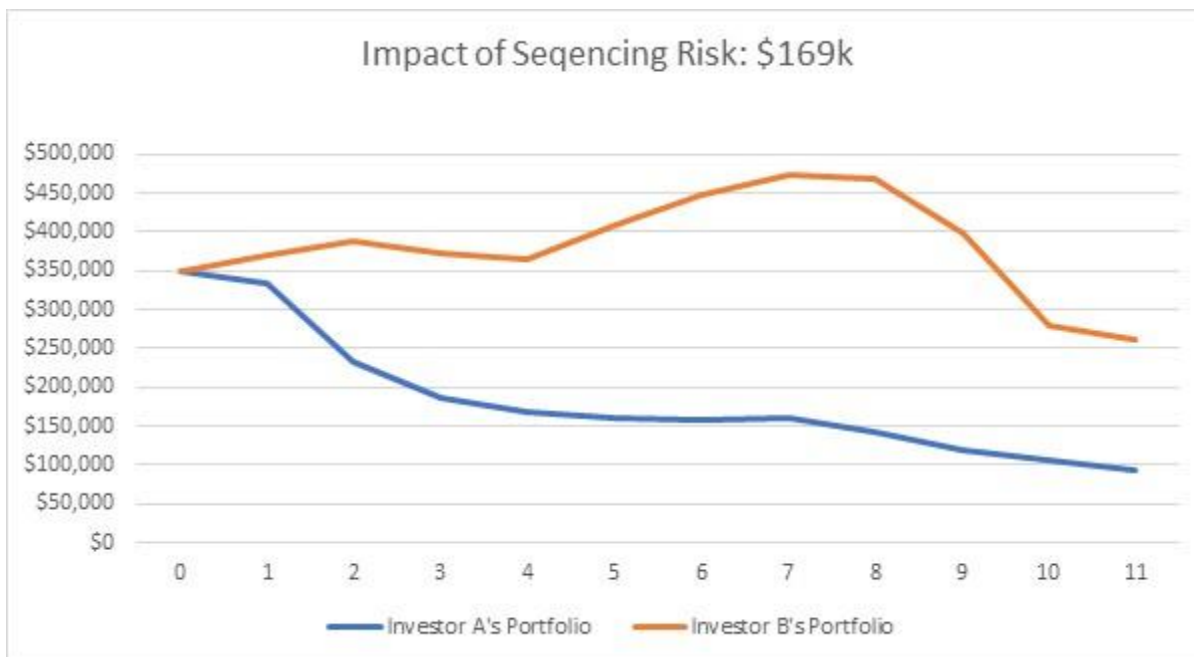
The concept of sequencing risk could kick in during that phase when an investor moves from the accumulation stage (saving for retirement) to the decumulation stage (living off retirement savings).

Negative investment returns early in retirement can be problematic for retirees. If an investor experiences a higher proportion of negative returns in the early years of their retirement, it will have a long-lasting negative effect on their retirement savings. This will reduce the amount of income they can withdraw over their retirement years.

Here we apply the same example above, but this time, Investor A and Investor B are withdrawing \$25,000 per year to fund their retirement. They both have identical starting super balances of \$350,000. They both have an average return of 5% p.a. over the 11-year period. However, in this case, Investor A's retirement balance is \$169,475 lower than Investor B's retirement balance. This is the impact of sequencing risk.

The impact of sequencing risk

| Year | Investor A's Portfolio | Return Pattern | Investor B's Portfolio | Return Pattern | Withdrawal | Difference between 2 portfolios |
|------|------------------------|----------------|------------------------|----------------|------------|---------------------------------|
| 0 | \$350,000 | | \$350,000 | | | \$0 |
| 1 | \$334,750 | 3% | \$370,500 | 14% | \$25,000 | \$35,750 |
| 2 | \$232,313 | -25% | \$386,960 | 12% | \$25,000 | \$154,648 |
| 3 | \$186,581 | -10% | \$372,819 | 3% | \$25,000 | \$186,238 |
| 4 | \$168,045 | 4% | \$365,210 | 5% | \$25,000 | \$197,165 |
| 5 | \$160,210 | 12% | \$408,252 | 20% | \$25,000 | \$248,042 |
| 6 | \$158,196 | 17% | \$448,404 | 17% | \$25,000 | \$290,209 |
| 7 | \$159,835 | 20% | \$474,213 | 12% | \$25,000 | \$314,378 |
| 8 | \$141,576 | 5% | \$467,182 | 4% | \$25,000 | \$325,605 |
| 9 | \$120,074 | 3% | \$397,963 | -10% | \$25,000 | \$277,890 |
| 10 | \$106,482 | 12% | \$279,723 | -25% | \$25,000 | \$173,240 |
| 11 | \$92,890 | 14% | \$262,364 | 3% | \$25,000 | \$169,474 |
| | Average | 5% | | 5% | | |



This example is for illustrative purposes only.

While Investor B's portfolio balance grows in the early years of her retirement, for Investor A, negative returns just after retirement have a devastating effect. This is because he is withdrawing funds as his portfolio is losing value and is therefore holding fewer shares that could benefit from positive returns down the track.

How to reduce sequencing risk when it matters most

The timing of share market falls can dramatically impact the length of time a retiree's capital will last. The good news is that there are ways to structure an SMSF or retirees' assets to limit the risk of a poor sequence of returns impacting on retirement goals. These include diversification into uncorrelated asset classes and holding cash to reduce withdrawals from an equity allocation during heavy market falls.

Another strategy is to set aside a portion of retirement savings in an investment that is not as impacted as much by market or index returns, such as a defensive equity solution. It should reduce vulnerability to an early retirement stock market decline that causes the most harm to retirees. If a retiree is at a point where their retirement savings meet their needs and objectives, they should consider dialing down the risk of their investments.

Investors who are exposed to sequencing risk in early retirement may need to work longer or reduce their living standards, so having an effective plan to manage this risk is essential.

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

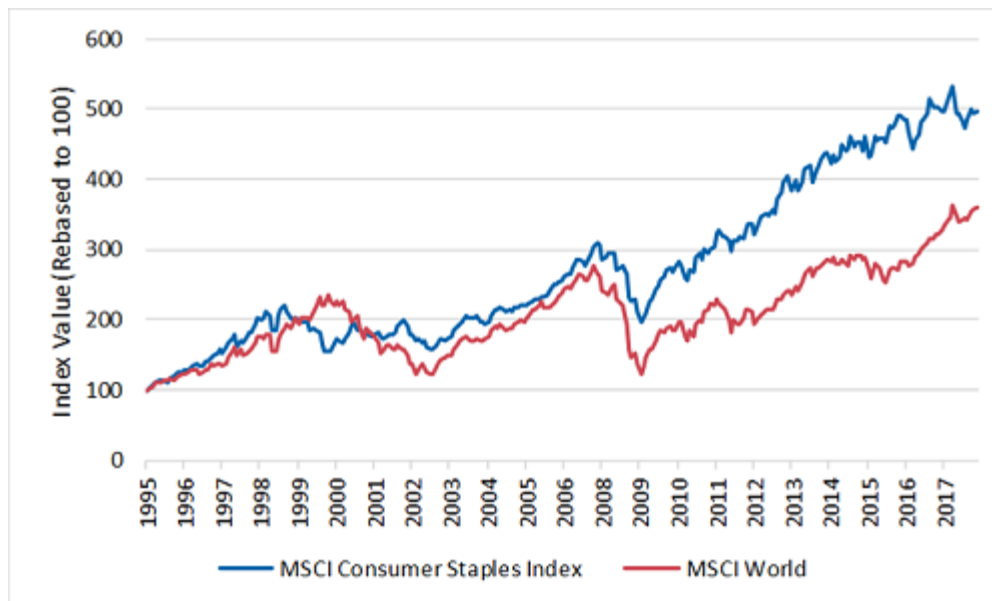
Don't overlook the quality in consumer staples

John O'Brien

Although they have commanded little attention recently, consumer staples companies such as food and beverage groups are a core part of global equity portfolios. These companies have underperformed perceived growth sectors such as information technology and health care, but they are generally considered quality companies whose share prices have lower volatility than more cyclical companies. For many of these companies, the characteristics that cause them to be considered quality companies are the same ones that enable them to score well on standard ethical investing criteria.

After a period of investor attention in the five years following the 2008-2009 financial crisis, consumer staples companies have fallen off the radar of many investors. Their performance, particularly in the past 12 months, has been sluggish, as shown in the chart below. Most global equity investors – particularly those focused on future earnings growth – have turned to companies in the information technology, healthcare, and consumer discretionary sectors, which collectively appear to be signalling the likely sources of economic focus in decades to come.

MSCI Consumer Staples versus MSCI World, 1995-2018



Source: Bloomberg, Whitehelm Advisers

But consumer staples companies have not gone away. From an economic perspective, most are as large as ever, and the products they provide are for the most part still considered essential.

Consumer staples defined

There are two definitions of consumer staples. The first is essential products, such as food, beverages, and household items. That is a relatively broad definition. The second, however, is goods or services that people are unable or unwilling to cut out of their budgets regardless of their financial situation. This textbook definition of inelastic demand is the one that investors pay most attention to. Consumer staples sell in all economic conditions.

Virtually all global consumer staples companies have consistent year-over-year net profits and dividends, and as shown below, they also have other characteristics associated with quality companies: relatively high operating margins, low debt and a low cost of capital.

Financial summary for selected consumer staples food groups

| Financial Measure | Nestle | Mondelez | KraftHeinz | Kellogg |
|-------------------------------------|----------------|----------------|----------------|----------------|
| Annual Revenues | US\$90 billion | US\$26 billion | US\$27 billion | US\$13 billion |
| Operating Profit Margin | 16% | 16.5% | 29% | 16.5% |
| Revenue Growth (3-year average) | 0.7% | -9% | -1% | -4% |
| Trailing Price/Earnings | 31.0x | 21.5x | 6.6x | 14.5x |
| Intangibles/Goodwill as % of Assets | 80% | 80% | 70% | 80% |

Source: Company financial statements

The beverage group of consumer staples companies – alcoholic and non-alcoholic – shares many of the same characteristics of consumer staples food groups: stable earnings, generous profit margins (even after government taxes), low debt, and high intangible assets.

Financial summary for selected consumer staples beverage groups

| Financial Measure | Coca-Cola | Heineken | Diageo | ABInBev |
|-------------------------------------|----------------|----------------|----------------|----------------|
| Annual Revenues | US\$35 billion | US\$22 billion | US\$12 billion | US\$56 billion |
| Operating Profit Margin | 30% | 14% | 31% | 32% |
| Revenue Growth (3-year average) | -8% | 4% | 4% | 7% |
| Trailing Price/Earnings | 85x | 21.9x | 21.6x | 18.5x |
| Intangibles/Goodwill as % of Assets | 19% | 43% | 42% | 76% |

Source: Company financial statements

Australian consumer staples companies are different, however. The long, inexorable march toward convenience-oriented food over the past 70 years did not develop as fully as in other developed countries, particularly North America and northern Europe. This is reflected clearly in the consumer staples segment of Australian stocks within the ASX200. The main constituents of the index are large integrated grocery chains and specific health and nutrition companies, including vitamin and infant health companies.

On the surface, it might be considered unfortunate that whole other sectors of the Australian food-producing economy are essentially uninvestable to listed equity investors, but perhaps it is a blessing in disguise, since many of these businesses are highly cyclical in nature, whereas consumer staples companies are generally very stable.

Threats to food and beverage consumer staples companies

A company like a consumer staples food or beverage producer may be attractive to investors because of its stable revenues and relatively high operating profit margins. Such a company may also be attractive from an ethical investing perspective because of its focus on providing essential products without harmful effects. Just as consumer preferences and collective beliefs change over time, however, so does the financial landscape in which these companies operate. A company that has comfortable profit margins, stable earnings, low debt, and

a low cost of capital, with diverse brands and a focus on adhering to ethical standards may grow too comfortable. For an activist investor, a consumer staples company could have *higher* operating profit, higher debt, and more dynamic management. The very things that have made it a quality company are on the way to making it a mediocre company, and one vulnerable to outside shareholder action. This action may come either through activist investing – agitating for change from the outside, typically through board representation – or alternatively from a takeover of the company’s management, and an accompanying efficiency drive. That is essentially what 3G, a consumer food and beverages group originally based in Brazil, has done sequentially with the world’s largest beer company, Anheuser Busch InBev, and with KraftHeinz, the US food products company.

A second financial threat to the consumer staples group is consumer preferences themselves. This has manifested itself in static or falling revenues. While the low growth and low inflation environment of many developed world countries since the 2008-2009 financial crisis does not make this particularly surprising, a number of consumer food groups are experiencing declining revenues, or revenues that would be declining if not for growth in developing country sales. In most cases, however, consumer staples company sales are declining not only due to low economic growth, but also due to consumer preferences that do not match what the companies are producing.

In response, only a minority of large consumer staples companies have taken the 3G approach of attempting to make operations significantly more efficient, however. The first response of consumer staples companies to falling sales has instead been to acquire smaller companies. For the most part, however, these absorptions have only stopped revenues from falling further, rather than increasing them. A minority of companies have continued to focus on increasing sales organically, rather than through continued acquisitions. A common theme has been a focus not on reducing costs, but on increasing sales through reinvestment in brands, employees and research. Whether doing so can be considered more advisable, however, is an open question.

Australian institutional investors collectively own a large amount of consumer staples companies both inside and outside Australia and will likely own more in the future. Even today, a single Australian investor is one of the largest shareholders in several global consumer staples food groups. As their collective influence grows, Australian investors might consider teaching the rest of the world the lessons that they have learned about how companies can balance the competing concerns of investor, consumer and shareholder objectives.

John O’Brien is a Principal Adviser at [Whitehelm Capital](#). This article is for general information purposes only and does not consider the circumstances of any investor.

6 quick answers on appointing an enduring Power of Attorney

Phillip Richards

There may be times when, perhaps due to family illness or incapacity or if someone is working abroad, someone else needs to hold an enduring power of attorney (POA) over a person’s financial and legal affairs.

A POA is essentially a document that will legally appoint someone to act on another’s behalf. This arrangement can be useful as people age and struggle to manage their financial affairs, particularly if they start to lose their mental capacity.

What is mental capacity?

To be mentally capable is to be able to fully understand any decisions that need to be made, which includes the reason you are making a decision and the outcome of that decision. It also means having the ability to communicate or to make decisions at the time they need to be made. This may include the sale of property or shares in order to pay for medical bills, or aftercare service in case of illness.

What are the differences between general and enduring POA?

A general POA gives another person control of your financial matters but only for a certain period of time such as an extended overseas visit or stay in hospital. If during this time you become incapacitated, then the general POA documentation becomes invalid.

On the other hand, an enduring POA gives someone such as a financial adviser control of your financial matters for an indefinite period if you are not able to make the right decisions due to mental or physical incapacity. Therefore, if there were changes, for example, to government policy that affected your superannuation and you had not nominated a POA with relevant financial wealth management expertise to manage your affairs, then it could affect your savings, income and potentially your wellbeing.

Who can be nominated as a POA?

The person appointed must be over 18 years-of-age and should not have an interest or stake in the financial affairs of the individual who appoints them. Having a family member is difficult as there may be a conflict of interest when it comes to financial matters. It needs to be someone in whom you have total trust and confidence, and also someone who is financially literate.

If you choose a close friend to undertake this role, it will be important they meet with your financial adviser to ensure they have a full understanding of the state of your financial affairs in case they take over decisions on your behalf.

What financial decisions can a POA make?

Enduring POA for financial matters allows the attorney to make decisions that are related to financial or property matters. This could include day-to-day decisions regarding personal finances and investment portfolios, payment of bills, management of property or completion of tax returns. This is why it is important they understand your financial needs, now and in the future.

Who can draw up enduring POA documentation?

It is always best to ask a solicitor to complete any form of legal documentation. There have been cases highlighted by Alzheimer's Australia in which enduring POA agreements were used to the detriment of vulnerable adults.

Financial institutions are also looking carefully at POA agreements and will usually require some form of validation, so avoid the DIY POA kits from the internet.

Should the attorney receive payment for this role?

Expenses incurred by those acting as an enduring POA or other fees can be agreed, and you can authorise the attorney to pay themselves a reasonable amount for undertaking this role. Again, bearing in mind if there could be questions or disputes raised at a later date by family members, the attorney must keep records and account for all they spend.

It may be worthwhile appointing a professional organisation or individual to act on your behalf. This will likely incur fees but may cause less hassles in the long run.

Whether you are planning ahead for yourself or managing the affairs of elderly parents or relatives, it is always best to talk to a financial adviser and share any concerns. We have seen many instances of complications when clients have not appointed a POA prior to their circumstances changing.

Phillip Richards is the Director and Financial Adviser at [Endorphin Wealth Management](#). This article is general information and does not consider the circumstances of any individual.

Disclaimer

This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.

For complete details of this Disclaimer, see <http://cuffelinks.com.au/terms-and-conditions>. All readers of this Newsletter are subject to these Terms and Conditions.