

Pilar Gomez Bravo's Top Articles from the archive

- **8 ways long-term investing is rewarded** *Wilbur Li*
- **Just when my portfolio was set for the long-term** *Chris Cuffe*
- **What two investing insights would you give your 20-year-old self?** *Cuffelinks*
- **Five ways Australian super is a global outlier** *Graham Hand*
- **Are you in fixed interest for the duration?** *David Scobie*
- **How to select assets in a world of choices** *Graham Hand*

Plus:

- **2019 is time for investment caution** *Graham Hand*
- **Final monthly LIC update for 2018** *Peter Rae*
- **Predictions for ETFs in 2019** *Alex Vynokur*

Summer Series Guest, Pilar Gomez-Bravo

We certainly live in a complex and challenging investing world, especially 10 years on from the global financial crisis. We believe that given these challenges, particularly within fixed income, it is important to have a diversified approach that allows for opportunities to enhance risk-adjusted returns.

While certain financial markets have become dislocated, it's a time to be prudent and concentrate on the best opportunities. In current markets, it is important to focus on risk as a key element in assessing market or security selection. This view has guided the choices of my six favourite articles from the Cuffelinks archives.

My career in investment management has been a continuous learning experience, but I'm sure that I could have benefited from some sage words before taking the plunge. That's why I really enjoyed the [article](#): **What two investing insights would you give your 20-year-old self?** Such a diverse group of 37 industry experts providing a wide range of pertinent advice. I tell my four kids that my job is to make more money for the people who trust me to invest on their behalf, to ensure they keep that money and grow it.

I really appreciated a few articles that focused on investment patience, since we employ a long-term investment approach at MFS. All our teams focus on sustainability and not short-term advantages.

Wilbur Li's [view](#) of the rewards inherent in a **long-term investing** approach was interesting, as well as a [piece](#) by Chris Cuffe that exhibited the balance between buy-and-hold investing and being responsive to short-term trends.

It's important to have a global perspective and be mindful of your bond allocation in this world of increasing volatility and complexity. At this point in the cycle, the importance of a diverse asset allocation and owning assets that can provide some ballast to a portfolio in times of market stress is paramount. My next [pick](#) explains the **Five ways Australian super is a global outlier**. Graham Hand shows how the compulsory superannuation system has hooked the earnings and savings of millions of Australians into the stock market. He correctly asserts that investment markets follow a herd mentality and it's preferable to have an independent investment philosophy and process.

One of the things that comes up often in our discussions with clients is this fear of duration. Rates are generally rising, but we think that this generic statement underestimates the underlying complexity and opportunities of a global fixed income universe and the ability to deliver alpha and returns even though some countries are raising rates. **David Scobie's [article](#)** gives an excellent account of duration and provides much-needed education on this often-misunderstood topic.

Finally, I refer you to an [interview](#) I did with Graham Hand on **How to select assets in a world of choices**. This takes a deeper dive into the role of active management and how to create a multi-asset portfolio, among other topics.

Pilar Gomez-Bravo is Director of Fixed Income – Europe at [MFS Investment Management](#).

8 ways long-term investing is rewarded

by Wilbur Li on August 17, 2017

There is no denying that we live in a world of short-termism. From the 24-hour news cycle and daily market moves to the relentless focus on the latest set of company earnings, we are always grappling with new information flooding our way. We often overtrade as we become impatient and feel the need for action. This begs the question, does the market reward the active managers and other investors who can sit tight and invest with a long-term lens?

A report by the Thinking Ahead Institute (part of Willis Towers Watson) called '[The search for a long-term premium](#)' explores this question and offers interesting insights. The study identifies eight fundamental building blocks of long-term value creation. These factors can be categorised in two broad camps:

- Strategies that provide long-horizon return opportunities
- Strategies that lead to lower long-term costs and/or mitigate risks

Return opportunities

Active ownership
▪ Average excess return of 2.3% was generated over one year after engagements with investee companies
Liquidity provision
▪ Long-horizon investors have the potential to earn additional returns of 1% pa by providing liquidity when it is most needed
Capturing systematic mispricing
▪ Exploiting various mispricing effects in smart betas added more than 1.5% pa relative to cap weighted index in the past decades
Illiquidity premium
▪ Illiquidity risk premium is worth 0.5-2% pa -additional returns might be available to truly long-horizon investors
Thematic investing
▪ 93% of 2016 TAI New York roundtable attendees believe that it is possible to create value through investing thematically

Lower costs

Avoiding buy-high-sell-low
▪ Chasing past performance cost US pension funds 1% (over three years post manager change)
Avoiding forced sale
▪ Liquidity-driven trading in response to redemption reduced returns of open-end mutual funds by 1.5% pa
Lower transaction costs
▪ 26bps could be saved in transaction costs if UK medium-size pension funds reduce their active strategies turnover to 60%

Long-horizon return opportunities

1. Active ownership and investing in long-term oriented companies

Research by McKinsey has found that firms create value by taking a long-term approach. Investors can exploit this in two main ways. The first is that skilful investors can identify and own companies who have a genuine

long-term focus. Alternatively, investors can engage with companies they own to improve performance. The research suggests investors can expect to harvest an additional 2.3% abnormal return the following year.

A further study analyses the 183 companies CalPERS has actively engaged with between 1999 and 2012. Three years prior to the engagement, these companies underperformed the Russell 1000 Index by 38.9% on a cumulative basis. In the five years following CalPERS' engagement, on average, these firms generated cumulative returns of 12.3% above the index.

2. Liquidity provision

Long-term investors can act as providers of liquidity in times of market distress. By providing liquidity when it is most needed, investors can harvest a premium of 1% per annum. When investors require liquidity, they sell at below fair value while long-term investors can exploit this through purchasing at below fair value with cash held in reserve. Further, long-term investors who provide liquidity serve a social good as it helps stabilise markets in volatile times.

3. Capturing systematic mispricing

Exposure to smart beta strategies can help generate an additional excess return of 1.5% per annum. Rob Arnott of Research Affiliates found that all alternative weighting strategies have outperformed the cap-weighted benchmark over the long term. This may be a consequence of unintended value and small-cap tilts which are often unavoidable unless one holds a portfolio that has a positive relationship between price and portfolio weights (such as a cap weighted index).

4. Illiquidity premium

The illiquidity risk premium (IRP) estimated at between 0.5% and 2% per annum can be harvested through exposure to long-term illiquid assets. As investors invest in these illiquid assets, they demand a higher risk premium for their inability to quickly sell down their assets as needed.

5. Thematic investing

Themes are often easy to identify but the scale and rate of change is difficult to anticipate. The world is running out of oil, renewable energy can save the planet, many countries have ageing populations and technology is changing our lives. However, such investments are often neglected as they are hard to time, particularly when investing with a short-term lens. While there is no empirical evidence supporting that thematic investing generates excess return, 93% of the 2016 Institute of New York roundtable attendees believe thematic investing to be value enhancing.

6. Avoiding buying high and selling low

Investors typically sell winners and hold onto losers. As a stock performs well, we want a piece of the action, while when a stock performs poorly, we hold on and hope for a recovery. We typically end up buying high and selling low. Jason Hsu found that mutual fund investors have forgone 1.9% per year due to poor timing decisions. Short-term trading can at times be a mug's game.

Cost reduction and loss mitigation strategies

7. Avoiding forced sales

Investment funds often engage in short-term trading driven by liquidity needs. In particular, redemptions can result in 'fire sales' where managers are forced to sell assets below fair value, destroying value in the process. One study has found that liquidity-driven trading in response to mutual fund flows reduced abnormal returns in US open-ended mutual funds by 1.5% to 2% per annum. A second study found the cost to be 112 bps per annum. While closed-fund structures have limitations, forced selling can result in value destruction.

8. Lower transaction costs

Willis Towers Watson's 'UK Food Chain' study estimates the size of each component of fund expenses based on a medium-sized UK pension fund. Transaction costs account for 44 bps, or almost half of all fund expenses, as shown below.

Components of fund expenses

In addition, figure 3 shows that reduced turnover levels can substantially reduce transaction costs, significantly improving investment outcomes.

How reduced turnover leads to lower transaction costs

Note it is not appropriate to sum the return potential of the eight building blocks, which would yield an incremental return of approximately 10%, as these factors are correlated.

A snapshot of additional incremental returns

Bringing together all eight factors, the table below presents potential benefits for a large asset owner investing with a long-horizon approach. The Thinking Ahead Institute observes this investment approach yields a potential incremental return of 1.5% per annum over the long run.

To put this into perspective, a \$50,000 portfolio invested for 20 years returning 6.5% per annum would net a healthy \$176,000. However, a return of 8% per annum would turn \$50,000 into a whopping \$233,000. What a difference a few percentage points can make in the world of compounding.

There is a strong belief that a long-term premium exists. The challenge, of course, is to harvest it.

Figure 3 – Components of fund expenses

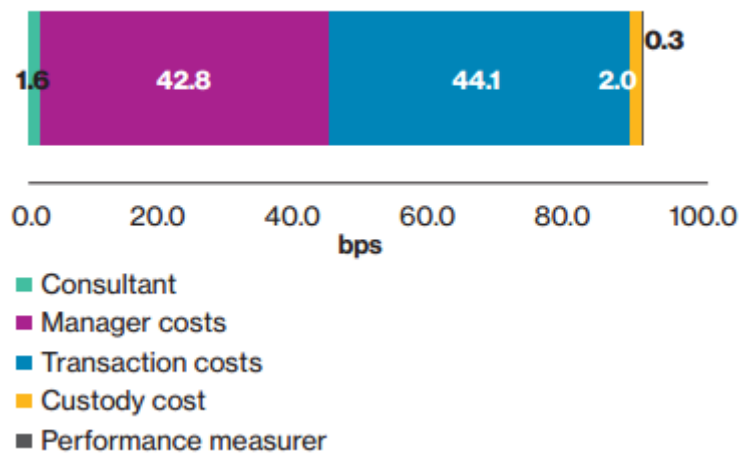
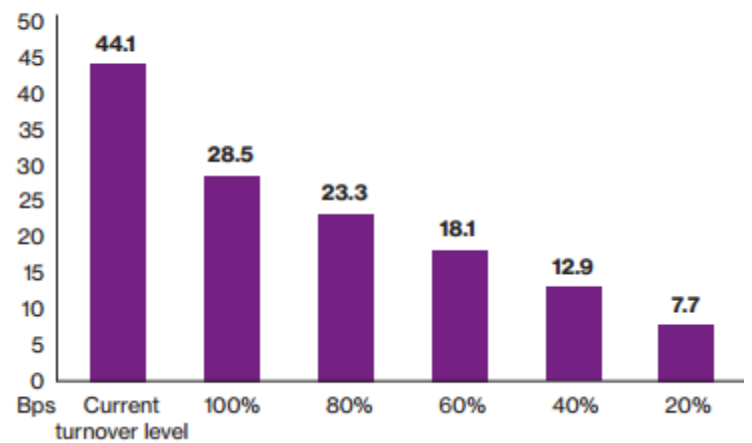


Figure 4 – How reduced turnover leads to lower transaction costs³



Actions	Incremental annual governance costs	Return gain at the fund level
Reduce turnover for all active mandates	Small	20bps pa
Avoid chasing past performance when hiring managers	Medium	15bps pa
Move 20% of the total portfolio from open-ended funds to a more fit-for-purpose structure to avoid being forced sellers	Small	15bps pa (20%*75bps)
Move 40% of total passive exposure (20% of total AuM) to smart beta	Medium	15bps pa (20%*75bps)
Set aside 5% allocation to cash to exploit forced selling	High	25bps pa* (net of opportunity cost)
Become active owners for 30% of the equity holding (18% of total AuM)	High	41bps pa (2.3%*18%)
Invest 10% in illiquid assets	High	20bps pa (2%*10%)
Allocate 5% of total portfolio to thematic exposures	High	10bps pa**
Total	Say 8bps pa (\$80m)	161bps pa
	Total net benefit	-1.5% pa

Wilbur Li has worked at Yarra Capital Management (fixed income), PwC (debt and fixed income) and Unisuper (global equities).

Just when my portfolio was set for the long term ...

by Chris Cuffe on July 25, 2014

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."
– Warren Buffett

Imagine two portfolio managers, Jack and John, who are both responsible for Australian equity portfolios for large funds management businesses. They both have offices overlooking Sydney Harbour, and are supported by large teams of analysts. John manages three billion, Jack about four billion. For 20 years, both have arrived in the office by 7:30 am to prepare for the first meeting of the day, having already read their emails and checked Bloomberg and Reuters at home. They are well known in the market and are often interviewed on television to give their market views.

They are both Masters of the Universe, and to the casual observer, they seem to be doing the same job. But they have completely different styles.

John markets himself as index agnostic, and he is not active in terms of portfolio turnover. He prefers to hold a relatively concentrated portfolio of less than 25 stocks, backing his judgement and not owning a bit of everything. For the majority of the time, he is happy with the way his portfolio is set, he has a good understanding of the investee companies' long term prospects, and there's usually little which suggests to him that he needs to change his portfolio. On most days he does not do a single trade, although it has taken him the best part of 20 years to learn this discipline. His portfolio turnover is only 15% annually. In the last decade, he has beaten the index by 3% per annum, making him a top quartile manager. As a younger man, he found he was often trading just to look busy, and it was only when he had nothing to prove that he felt confident doing nothing. In fact, he now has time to spend some mornings with his wife, and he tries to amaze her and leave early to cook dinner.

Jack's portfolio includes 70 of the ASX100, with most large companies close to their index weight. He is continually rebalancing back to index, selling companies which have risen and buying companies which have fallen. He has also delivered good results over the last decade, about 2% over the index. He finds outperformance, or alpha, through intimate relationships with the major brokers in town. They tell him whenever they hear anything, and he quickly buys or sells a stock before the story is on the street. He often reverses his trade a few hours later. He rarely claims to have any great insights into a company's long term prospects, but he just stays a step ahead of the market. His portfolio turnover is over 200% a year. He stays close to the screens and phones all day, and demands any broker with news contact him first or face a black ban. He pays handsome brokerage, with the large firms earning \$5 million a year from him. He does not know or care how long he has held any individual stock. He's never home early.

How do you manage your portfolio?

Who do you want to manage your money? If you are a direct investor, where do you stand on active trading? Both Jack and John have their strengths and weaknesses, and in my career, I have worked with both types and they've done well. In reality, most investors are somewhere between these two extremes, with elements of 'buy and hold' and 'trade opportunistically'.

Personally, for my own investing, I'm more in John's camp of 'buy and hold'. In fact, I find it much easier to recommend changes to other people's portfolios than my own. Maybe I'm less emotive when it comes to other people's money and can see other opportunities, but some of the benefits of John's approach include:

- More likely to detach himself from market emotion and not be spooked by short term movements in share prices
- Low turnover means lower costs and he takes advantage of the capital gains tax (CGT) discount on shares held for longer than 12 months
- Smaller portfolio may mean a more intimate knowledge of the investments.

But it's not all plain sailing. A 'buy and hold' strategy may ignore how poorly some sectors and stocks can perform over time, and fails to recognise the need to change at certain points of inflexion. Few if any businesses are immune from challenging conditions. Just ask the executives and investors in companies like Kodak, destroyed by digital processing, or Blockbuster, impaired by online movie downloading.

It's easy to think BHP must have been a good long-term investment, but as [Ashley Owen wrote in Cuffelinks on 24 October 2013](#), its share price in real terms has moved little over 125 years.

"BHP shares peaked at £413 in February 1888 at the top of the late 1880s/early 1890s silver and lead mining boom. That's \$34.70 in today's dollars in real terms after CPI inflation and after accounting for all of the splits and changes in capital structure over the years. People who bought BHP shares at the top of the 1888 mining boom had to wait 75 years for the share price to recover in real terms after inflation. BHP is still only \$36 today as I write this in October 2013, some 125 years later!"

Why do I resist over-trading?

No doubt there were good trading opportunities in BHP along the way, so what other reasons cause me to resist over-trading?

- transaction costs
- the paperwork (which I dread)
- taxation leakage (if I have made a profit)
- loss aversion (if I am carrying an unrealised loss then, rightly or wrongly, I often just want to 'stay in there' to prove it will come good)
- not wanting to become a 'trader' where gains are taxed on income account rather than capital account (although this is a fuzzy piece of tax law)
- not having carry forward losses that gains could be offset against
- the reported experience of traders, who often seem to lose money by being too flighty in their positions and opinions.

I believe taxation leakage is one of the more important considerations when selling a stock. A portfolio manager may be happier to actively trade on behalf of a tax exempt fund (though always watching the 45-day rule to avoid losing franking credits) but should be more hesitant about realising a gain where they are a taxpayer (whether 15%, 30% or 45%). The time value of money paid to the ATO becomes an important calculation.

On the other hand, some experienced fund managers believe tax is a secondary issue, and sell decisions should always be made on investment principles. I understand this view, but I'm not impressed if a portfolio manager generates a capital gain by selling a share after owning it for 11 months and three weeks (and losing the lower CGT concessional rate).

There's no right answer

Investment is more art than science, and I find these trade-offs a real dilemma in practice. Sometimes I think I have *finally* got my portfolio 'set' and then something happens that makes me feel I should change it (yet again!) but deep down this is an uncomfortable move.

I've often thought we need a formula that takes into account our tax rate, our concessional CGT rate, transaction costs, the value of carried forward losses, an estimated valuation on the stock versus its market price (an inexact task at the best of times), etc etc ... and, hey presto, the formula would spit out whether selling is a good strategy. And by the way, this issue applies equally to changing asset allocation as it does to changing securities within a specific asset class.

I personally manage an investment portfolio for a not-for-profit, tax exempt organisation that has nil brokerage fees thanks to the generosity of a community-minded stockbroker. I find myself regularly adjusting the portfolio both in terms of security selection and asset allocation (between Aussie shares, international shares, property, infrastructure and various fixed income securities). I find this rewarding (the portfolio performance has been very good, even if I do say so myself!), but at the same time challenging and somewhat tiring, like I am on a never-ending marathon.

But when it comes to my own personal affairs where I am definitely a taxpayer, until someone gives me a black box to work through the myriad of variables, I am much more of a 'buy and hold' investor, unless I need to sell for cash flow reasons. That said, there have been many times where I have kicked myself for not reducing exposure to particular stocks or asset classes when it looked obvious they were stretched in value.

Chris Cuffe is co-founder of Cuffelinks; Portfolio Manager of the charitable trust, Third Link Growth Fund; Chairman of Unisuper and Chairman of Australian Philanthropic Services. The views expressed are his own and they are not personal financial advice.

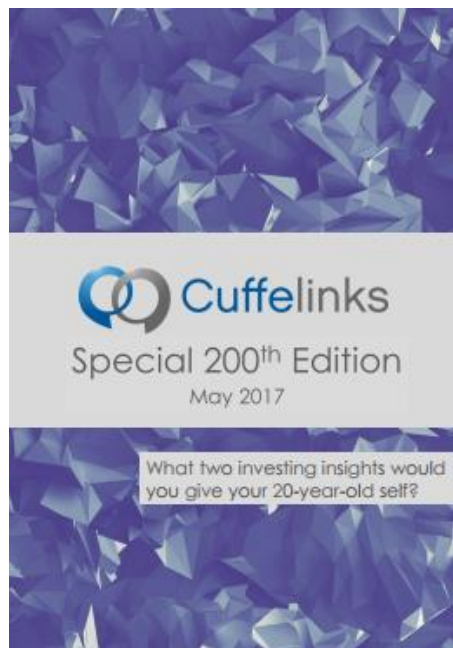
What two investing insights would you give your 20-year-old self?

by Cuffelinks on May 4, 2017

To mark our 200th edition, we asked investors and market experts for the top two investing insights they would give to their 20-year-old selves if they could go back in time.

Contributors: Hamish Douglass, John Pearce, Alex Denham, Shane Oliver, Chris Stott, Roger Montgomery, Andrea Slattery, Rob Prugue, Warren Bird, Jeremy Cooper, Monica Rule, Karl Siegling, Rodney Comegys, Geoff Wilson, Judith Fox, John O'Connell, Noel Whittaker, Don Stammer, Olivia Long, Alex Vynokur, Jonathan Rochford, Phillip Ruthven, Besa Deda, Peter Thornhill, Hugh Dive, Graeme Colley, Rachel Lane, Greg Paramor AO, Paul Moore, Crispin Murray, Jo Heighway, Bryce Doherty, David Bell, Ashley Owen, Leisa Bell, Graham Hand, and Chris Cuffe.

Due to the length of this piece, please read from the [website](#), or download the [eBook](#):



Five ways Australian super is a global outlier

by Graham Hand on February 7, 2018

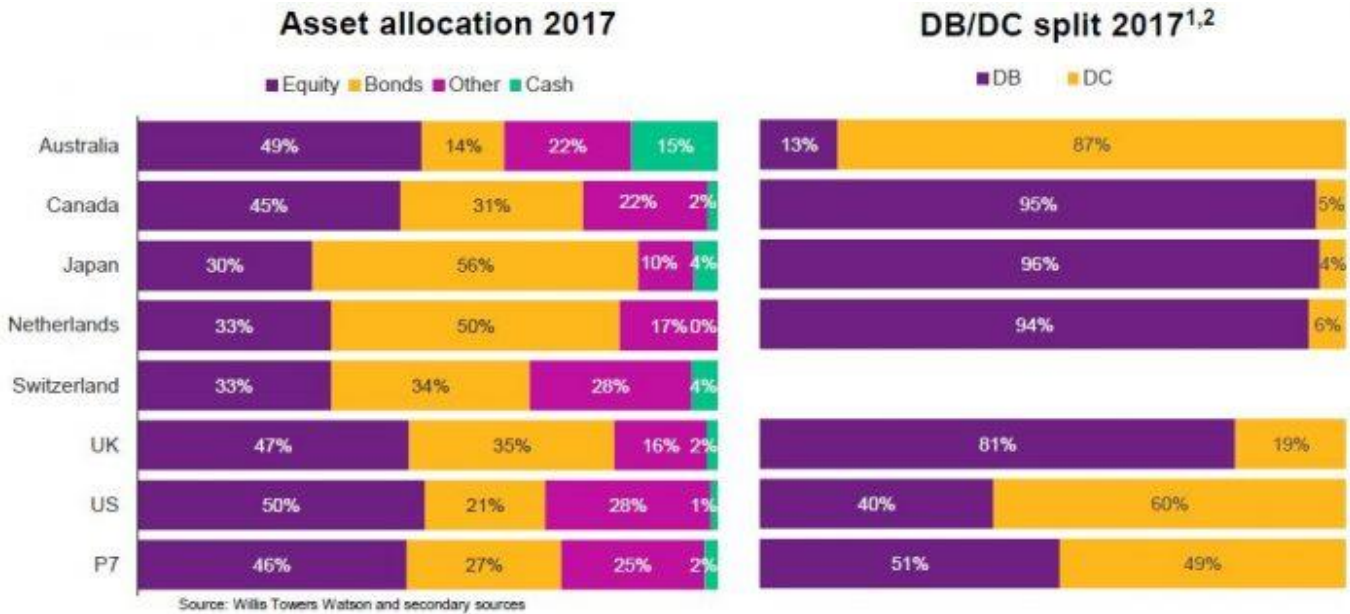
The most obvious expectation is that Australian superannuation should have a similar asset allocation as the retirement money in other developed countries. Major asset managers are global, consultants advising big super funds are global businesses, finance executives study the same markets and theories, and investment markets follow a herd mentality. Surprisingly, the differences are stark.

Willis Towers Watson's not-for-profit initiative, The Thinking Ahead Institute, has issued its '*Global pension assets study 2018*' based on 22 pension markets with assets of USD41 trillion, showing Australia has been the fastest grower over the last 20 years, up 12.1% per annum. This is driven by mandated contributions and dominance of defined contribution schemes. Note that although the study refers to 'pensions', in Australia's case, it includes the entire balance in superannuation funds (pre and post retirement).

What's most notable is how Australia is an outlier in many important ways, including:

1. The **highest allocation to equities** at around 50% (same as the US) of the 22 countries, with Switzerland and Netherlands as low as 33% and Japan 30%. What do the Gnomes of Zurich know that we don't?

Asset allocation and DB/DC split in 2017 by country



Equity markets are usually more volatile and subject to larger drawdowns than bonds, leaving Australian savings more exposed to the vagaries of the market. Countering this worry is the fact that shares offer better long-term returns, and with increasing longevity, pensions need to last 30 to 40 years, not the 10 to 20 years of the past. Australia also has relatively high dividend yields and the benefits of franking credits.

(The Australian data uses the ATO's reports on asset allocations, which have shortcomings as [documented here](#), especially in not recognising SMSF exposure to global equities).

The concern about capital protection is one reason why many MySuper funds are 'target date' or 'lifecycle' funds, where the defensive or bond allocation increases with age.

There is also an issue with sequencing risk, where the market falls heavily shortly before retirement, when pension balances are at their highest, about to face withdrawals to fund a retirement, and with little ability to top up.

For example, on 18 January 2016, the Chairman of the Future Fund and former Treasurer, Peter Costello, wrote in the Herald-Sun about the risk of investing too much superannuation money into shares, including:

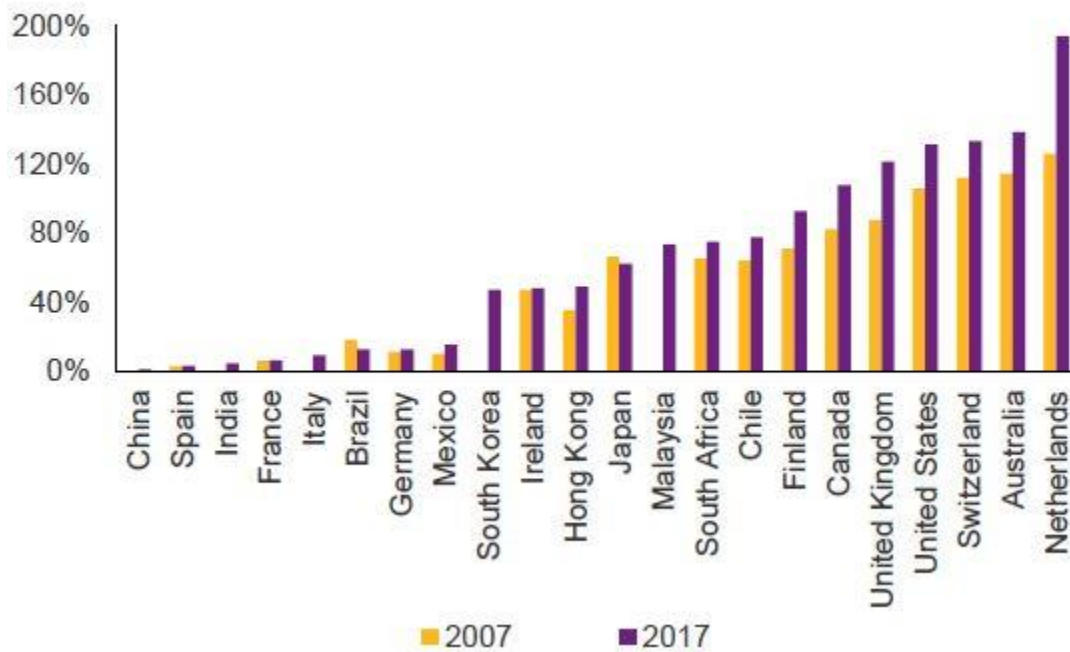
"The compulsory superannuation system has hooked the earnings and savings of millions of Australians into the stock market. I don't think it was a conscious decision. It started off small and now it has grown big. Stocks are at the riskier end of the investment universe. Government policy has directly hooked the wealth of individual citizens to rises and falls in share prices."

"Our stock market is still 30% below its level of eight years ago. There's a lot of lost years for people to make up and a lot of lost wealth. You can see why people prefer to put their voluntary savings in less volatile assets like residential housing. They're more careful with their money than the Government is."

2. The **highest allocation to cash**, at a heady 15%, when cash rates are negative in real terms, in contrast to The Netherlands at nil and a global average of only 2%. Do Australian investors use their 'risk budget' on equities and compensate by holding lots of cash? There is probably a distortion that explains some of the difference: the Australian numbers include SMSFs, a uniquely Australian vehicle which comprises one-third of all superannuation balances. SMSF trustees are individuals, notoriously conservative and protecting their own capital with cash and term deposits. The Australian number is being compared with predominantly institutional investors in other countries.
3. The **lowest allocation to bonds** at only 14%, versus the global industry average of 27% and a country like The Netherlands as high as 50%. Some of these countries have negative interest rates on their government bonds, although they have a far more active non-government market than Australia. And note previous comment about SMSF allocations.

4. The **highest proportion of assets in defined contribution schemes** (where the amount invested is defined) rather than defined benefits (where the final benefits of the scheme are defined). Defined contributions require the investor to decide how money will be invested (although most are in defaults and do not make an explicit decision on how the money is managed). It is the investor who takes the full risk of the outcome, rather than receiving the protection of a pension with the risk borne by an institution. Australia has only 13% of assets in defined benefits versus over 94% in Canada, Japan and The Netherlands, as shown above.
5. Australia's system is second only to The Netherlands in the **ratio of pension assets to GDP**, showing the maturity of our compulsory superannuation system relative to the size of our economy. Pension assets now stand at 138% of GDP. This looks like it's up from 114% in 2007, but the 2017 data includes SMSFs.

Pension assets as % of GDP



Other comments by the Thinking Ahead Institute include:

- Global institutional pension fund assets in the 22 major markets reached USD41 trillion at year end 2017, increasing USD5 trillion over the year.
- With DC models in the ascendancy, it is important that governance issues and the shift in risk on to the end-saver are closely monitored.
- Reduced home bias for equities in the last 20 years, falling to 41% in 2017 from 69% in 1998. Private assets rose from as little as 4% of allocations in 1997 to around 20% today, showing a sophistication of strategies in allowing funds to go beyond traditional means of diversification.

Graham Hand is Managing Editor of Cuffelinks. The [Thinking Ahead Institute](#) is a global not-for-profit member organisation whose aim is to influence change in the investment world for the benefit of savers. The Institute is an outgrowth of [Willis Towers Watson Investments'](#) Thinking Ahead Group. The full study is [linked here](#).

Are you in fixed interest for the duration?

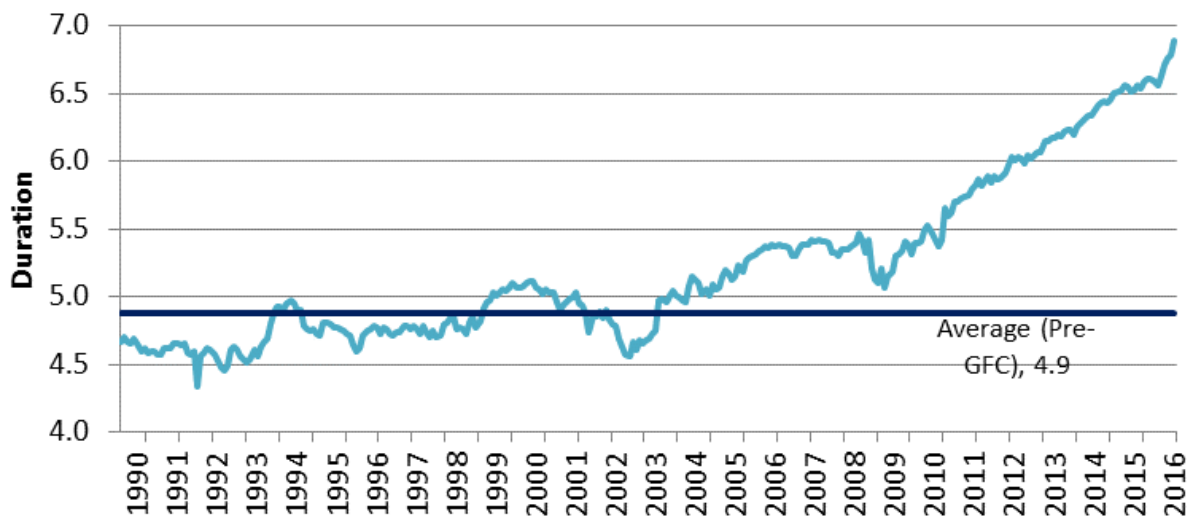
David Scobie

The most commonly followed global bond benchmark, the Barclays Global Aggregate Index, is poised to reach seven years – not in age (it has been around a lot longer than that) but in duration, being in simple terms the index’s average weighted term to maturity. Why should we care about such a milestone? The answer lies in how the index’s duration has tracked over time and how that affects investment returns, particularly in the current context of historically low (in some cases negative) interest rates.

Know your duration

Duration is important to investors as it indicates the sensitivity of bond exposure to changes in interest rates. All else being equal, bonds with higher durations have greater price volatility than bonds with lower durations. The longer the duration, the greater the price will fall for a given rise in interest rates, and vice versa.

The chart below shows the duration history of the Barclays Global Aggregate Index.



The duration of the Barclays index has progressively lengthened, like many conventional fixed interest benchmarks, particularly over the past decade. Currently sitting at 6.9 years, this compares to 5.5 years in 2010 and an average of 4.9 years prior to the Global Financial Crisis (1990-2008). One of the drivers is the increase in longer-dated issuance by both governments and companies – who themselves have diminished in credit quality on average – to lock-in the alluring borrowing rates on offer.

The consequence for investors is that, by being in a fund which closely or broadly tracks the Index, the interest rate risk exposure has increased markedly over time. And it has happened without an investor necessarily making any active decision.

A related issue is that the yield on the Barclays Index is now just under 1.2% compared to, say, 4.3% a decade ago. Investors are receiving lower compensation per unit of interest rate risk for their investment. At the same time, the positive return ‘carry’ from hedging to local currency has fallen in recent times, alongside the Reserve Bank’s opposite monetary policy path to that of the US Federal Reserve. Hence the buffer to help insulate a fund’s overall return from any downward movement in the capital price of bonds has diminished.

So is this a comfortable state of affairs for investors? That depends on your outlook for global interest rates. If you believe yields will rise in the short-medium term (particularly at a relatively brisk pace), then that could have an adverse effect on portfolio returns. Even if you hold no view you should be aware that, by default, indexes have been changing the risk characteristics of your portfolio.

We need not jump to the conclusion that additional duration is a bad thing. Global economic weakness and low inflation over recent years have pulled yields downward, thereby generating solid returns for bond holders, and high quality credit exposure is typically a useful safe haven for investors during times of market stress. However, when it comes to duration, the relevant question is ‘how much is too much?’. There is no sign of an

end to higher duration trend in conventional benchmarks. One might wonder where it will end, and moreover, what the rationale may be for an investor to passively follow.

Forewarned is forearmed

Most portfolios would do well to retain material exposure to the diversification and liquidity benefits of fixed interest. At the same time, however, some regard for 'duration creep' in bond indexes is warranted. This may be addressed via asset allocation decisions, or in some cases we have worked with clients to consider alternative benchmarks or partially using more absolute return-oriented solutions.

The lower-for-longer interest rate theme continues to dominate markets, but this theme is notably embedded in current equities pricing and other risk assets as well as fixed interest. Strong exposure to duration has been a tailwind to portfolio returns for an extended period, but under some economic scenarios it could be a less-than-welcome attribute.

David Scobie is a Principal in Mercer's Investments business, based in Auckland. He advises institutional clients on their investment policies and structures. He is also involved in evaluating fund managers, linking in with Mercer's research capability in Australia and globally.

This article does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances.

How to select assets in a world of choices

Graham Hand

Pilar Gomez-Bravo, CFA, is the Director of Fixed Income for Europe at MFS Investment Management. Pilar also has fixed income portfolio management responsibilities, having joined the firm in 2013. Prior to this, she was Managing Director at Imperial Capital and Head of Research and Portfolio Manager at Negentropy Capital within Matrix Asset Management. This discussion took place in Sydney on 15 May 2018.

GH: What's the first thing you check in the markets when you wake up each morning?

PGB: I manage global multi-sector portfolios, so there's a lot to cover. I check what interest rates have done overnight, what equity markets or equity futures are doing, movements in credit indices and key asset class relationships, plus the top news headlines. We construct portfolios from the top down but driven by bottom up research. We concentrate exposures on our high convictions, and we have to size exposures appropriately. We are running large issuer exposures and I check any developments that could impact them.

GH: When 10-year US Treasuries yielded 1% or less, how did you manage that and what do you think now is the argument for 10-year US Treasuries at 3%? Even with this higher rate, is there an investment case?

PGB: We have become a little immune to Quantitative Easing after 10 years of central bank intervention, but this level of liquidity injection was quite a shocking thing to do. It was an experiment and maybe there are not enough people around to remember what it was like to have central bank policy that didn't use such extraordinary measures.

The reason we had 1% rates in the US was because there were fears of deflation after the extremes of the global financial crisis, and uncertainty about how the financial system would recover. Australian banks didn't have the same degree of failure as elsewhere, but there was a lot of soul searching in markets that led to severe deflation fears in Europe and the US.

The central bank manipulation encouraged consumers and companies to spend money to recover from the shock. And that worked and now we are in a different period where we are seeing signs of inflation instead, but still not sufficiently high to worry people too much. There's a little bit of wages growth pressure in the US but nothing that indicates a sudden different paradigm of inflation.

Demographics, technology and debt will limit inflation rises

And in the back of investors' minds is the large structural headwinds against yields going higher such as demographics, the deflationary nature of technology and the amount of debt in the world. If they raise rates quickly, will consumers and companies be able to manage that increased debt load? There's also heightened sensitivity in the G20 about currency wars. So we should continue a gradual progress to higher global yields but at a pace that should be able to generate a long-term total return from fixed income.

GH: As in the US, in Australia we've seen a movement in what we call MySuper towards lifecycle (or target date) funds. What do you think of lifecycle funds and the merits of putting more into bonds as people get older?

PGB: Well, 20 years ago I took the CFA and back then we were already talking about the appropriate level of risk for different age cohorts. There's economic theory that says as people age, they have different risk return profiles. And it also shifts as people become spenders and stop earning. People are living longer and so the nature of the products they need should shift. On top of that, shocks like the financial crisis linger in the mentality of investors for a long time. Investors are reluctant to potentially lose all of their savings and they look to own some lower risk assets to protect capital by holding fixed income.

There is an increased variety of assets to invest in today than there were 20 or 30 years ago, so that gives more richness to the allocation decision for investors. For example, more ways to invest in real estate, a more targeted approach for individuals by using ETFs, or even shorting the market to take a negative view. All of that is relatively new which gives more ways to discuss the risk return profile.

Equity managers argue they can deliver income

A major development when yields went so low was that generically equity managers could go to clients and say they would be the providers of income and investors could forget about bonds. On this basis, the discussions from equity managers with company management led to dividend increases, and that's distorted the behaviour of companies around the world towards higher dividends, share buybacks and less investment. So perversely, central bank policy has led to lower levels of investment worldwide as companies have chosen to do share buybacks and dividends to appease their new shareholders with a promise of income. Hopefully, we'll see a gradual shift back to investing in the company as policy normalises and global growth stabilises.

Finally, now we can go back to saying that with bond rates rising, especially in the front end in the US, we have an asset that gives a yield and that is good for investors looking for safe assets.

GH: Can we discuss the move to passive investing in a bond context. Would you support the view that for non-government bonds, the case for passive investing is probably the weakest of any asset class? Is there evidence that retail investors understand why it's a weak argument?

PGB: There are a couple of reasons why it's more dangerous to follow passive investing in credit markets. One is that benchmarks are dominated by companies where the more debt they have, the bigger weighting in the index. Two, liquidity matters in credit and you may not be able to get out when you want to. That leads to another discussion around ETFs and derivatives. Credit markets become illiquid in periods of stress.

And three, in credit markets you have an asymmetry of risk and return. You have no upside and you have all the downside. So paying attention to potential blow-ups becomes increasingly important as the economy reaches the end of the cycle. A keen awareness of risk-adjusted returns is needed because you don't recover from a credit default.

The role of active management

People have forgotten about the value of active management. First, yields are low at the moment so any fees paid are painful. Second, with low volatility and low dispersion, it's difficult to generate alpha without adding leverage or taking concentrated risk, but with an asymmetric asset class and increases in volatility, the value of active becomes apparent. We tell clients when looking at active asset managers, ask them to show their excess performance in different periods of volatility. Obviously, you want to see performance through the cycle, but you should expect higher excess returns in periods of heightened volatility.

GH: With your own portfolios, how much of the extra returns you generate comes from off-market transactions? For example, where a company wants \$500 million quickly and they ring you up and offer say 100bp over the market.

PGB: Our strategies have two characteristics for portfolio construction: liquidity and diversification. We don't hold a lot of illiquid positions and for those exposures we need to be paid more because you lock yourself in. In the hunt for yield, there are three main ways to add yield. One is duration, which nobody wants. Two is credit risk, so we've seen huge inflows into credit and emerging markets. And third is illiquidity. There may be better opportunities at times of stress to consider more of these off-the-run illiquid positions.

GH: What do you think about the big spread contraction in the high yield corporate sector? Is there adequate reward for risk there now?

PGB: At the individual level in some cases, yes, but at the lower quality parts of the high-yield market (rated CCC), you are not getting paid enough for the traditional experience of losses. Despite the stresses seen in equity markets, the CCCs have outperformed. They have lower rate sensitivity, when the fear in the fixed income markets has been that the Fed might make a policy mistake. There's also a lot of energy companies in there that have been supported by rising oil prices. In general, we believe that high yield as an asset class is expensive.

GH: It's difficult to make statements about correlations between asset classes in advance of a stress event. We saw during the GFC correlations rose so that when you thought there was protection in your portfolio, it didn't help much. Can you give guidance on what you think about future correlations? Is there anywhere safe to hide?

PGB: You are always looking for uncorrelated returns and good sources of alpha in multi-sector portfolios. The first choice is between duration and spread and the right combination, and that decision depends on what paradigm you think you are living in. For a long time back to the 90s, the paradigm was 'risk on, risk off'. But since the GFC, the new paradigm is 'Goldilocks/QE' and 'taper tantrum', where yields and credit perform in the same direction. I think as monetary policy normalises, we will revert to the 'risk on, risk off' relationships. It provides more of a diversifier against risky assets or spread assets. The reality is that in periods of stress, bank correlations move to 1.0, even though fundamentals have significantly improved since the GFC. When fear strikes in the markets, all banks underperform.

How to create a multi-asset portfolio

GH: What's your high level process for creating a portfolio?

PGB: We are really mindful of risk management at every step of the investment process. First, decide how much risk you want to take, your risk budget. Then you have to do your allocation correctly. How many uncorrelated sources of alpha can you put in. Then you need portfolio construction where you match risk allocation with idea generation. What bonds do you actually want to buy that get you to that risk allocation? Finally, monitor the risks so that under any scenario, you don't get surprised by unwanted sources of risk. So that's still the basics.

GH: You probably know we had our Federal Budget recently. Conditions are better than expected with a possibility of moving into surplus next year. Now there's a debate on whether we should spend more, tax less or repay debt. What's your view on governments repaying debt to give more security for the good times, especially for the US where trillions in debt don't seem to matter?

PGB: At a basic view, whether you are a corporate or a government, you need to be countercyclical in your finances. You need to build cushions in the good times for when the bad times come, so you can then spend the money and keep growing.

There's too much debt in the world. The IMF forecasts that most countries will significantly reduce their debt-to-GDP ratios between 2018 and 2023, but the US will continue to increase. All the efforts of countries like Germany and Australia will be completely offset by the US as it's such a huge part of global GDP. The US has fiscal stimulus at a time of almost full employment when that extra stimulus is not necessary. So when times get rough, how much more can be borrowed?

Graham Hand is Managing Editor of Cuffelinks. Pilar Gomez-Bravo, CFA is the Director of Fixed Income for Europe and Fixed Income Portfolio Manager at [MFS Investment Management](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

2019 is time for investment caution

Graham Hand

In the six years I have been writing the weekly introductions in our newsletter, I have been reluctant to make macro forecasts. There are so many factors at play that predictions become an unsatisfactory 'on the other hand' exercise. Sound reasoning can be overtaken by a late-night tweet from an egotistical and unpredictable leader.

Former Leader of the Federal Opposition and prominent economist (and one of my tutors at university in 1983!), John Hewson, told an EY client function at the end of November 2018:

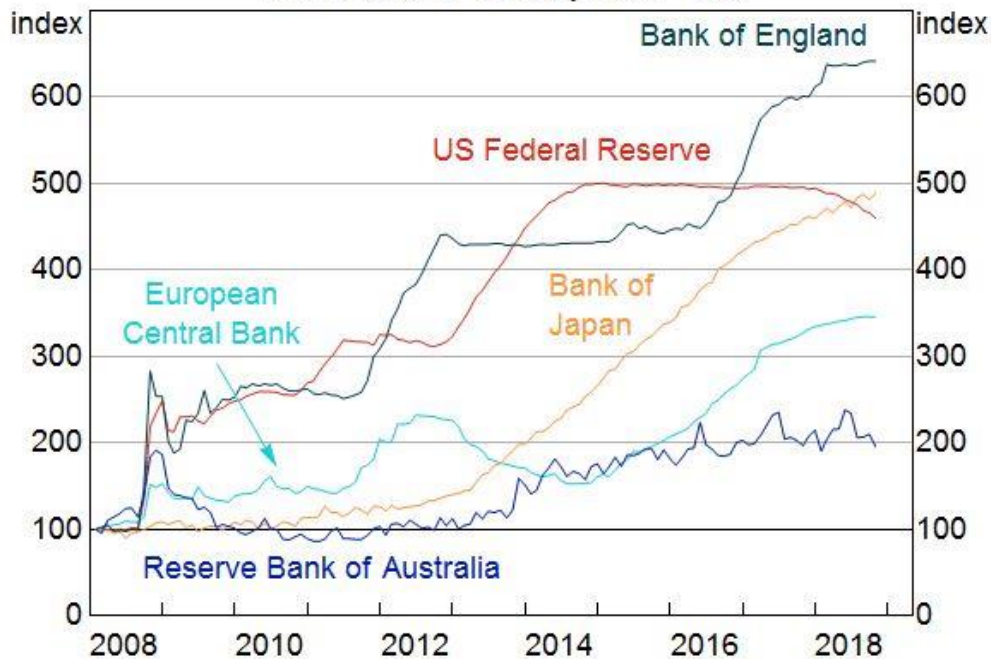
"Today, it's harder to predict how things will unfold in the world than at any time in the last 40+ years. It is a riskier environment than I can ever remember. A lot of the relationships economists took for granted no longer seem to apply."

My investing philosophy is to construct portfolios based on risk appetite and goals, which enables you to sleep comfortably and not panic if the stock market falls. Tactical asset allocation based on market expectations can lead to constant portfolio switching at the wrong time with higher costs.

Contrary to my instincts to minimise tampering, this is a time for greater caution in portfolios. Central banks have spent the best part of a decade stimulating economies and expanding their balance sheets, including buying US\$18 trillion of government bonds in QE. This money found its way into other asset classes and inflated prices. A major deceleration is now underway, with their balance sheets flat or falling. The US Fed wants to raise rates further, corporate credit spreads are widening and geopolitical risks are high.

Central Bank Balance Sheets

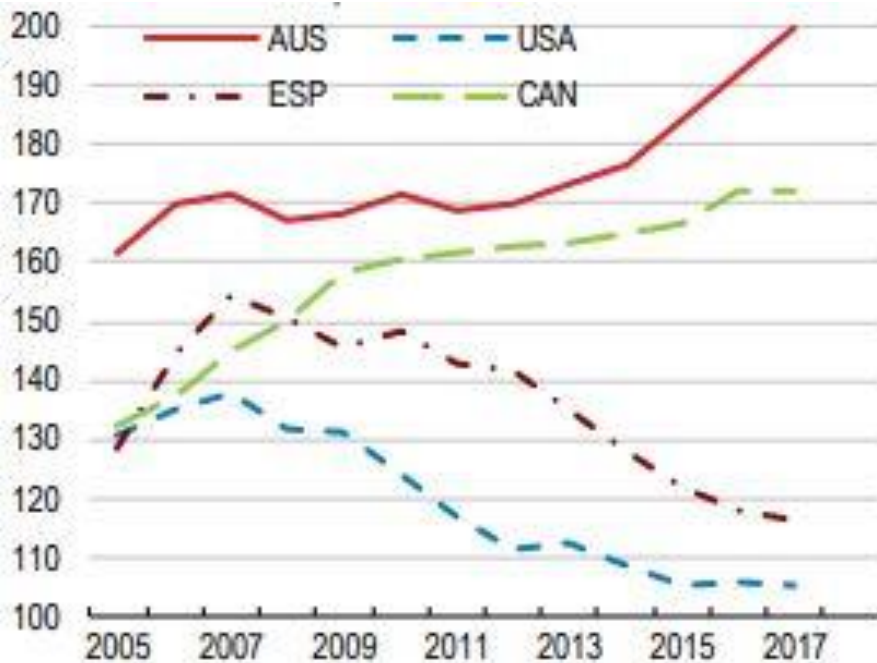
Total assets; 31 January 2008 = 100



Sources: Central banks; RBA; Refinitiv

In Australia, risks are heightened by the **Royal Commission**-induced crackdown on business and residential property lending, especially for investing. Anecdotal evidence from mortgage brokers writing to Cuffelinks suggests it's worse than yet seen in official data. The **OECD** issued a report this week showing Australian household debt rising rapidly, even at a time of record low interest rates. Falling property prices and the transition from interest-only loans will contract the local economy, and any increase in unemployment will make high household debt levels problematic.

Household debt as a % of net household disposable income



Source: OECD Economic Survey of Australia 2018.

There has been much debate about [last week's speech](#) by Guy Debelle, Deputy Governor of the Reserve Bank. The controversial statement was this:

"The Reserve Bank has repeatedly said that our expectation is that the next move in monetary policy is more likely up than down, though it is some way off. Should that turn out not to be the case, there is scope for further reductions in the policy rate. It is the level of interest rates that matters and they can still move lower ... QE is a policy option in Australia, should it be required."

Are the possibility of Australian QE and rate falls a warning? The summer holidays is a time to think about portfolio risk, and three articles examine the market outlook.

- Bill Evans describes the [domestic slowdown](#) and higher US rates
- Lee Mickelbrough and Jay Sivapalan look at [prospects for Australian equities and bonds](#)
- In the White Paper section, Shane Oliver checks 2019 prospects.

Graham Hand is Managing Editor of Cuffelinks.

Final monthly LIC update for 2018

Peter Rae

It has been a big year for Listed Investment Companies (LICs) and Exchange Traded Funds (ETFs), both finishing 2018 with about \$40 billion on issue and vying for top spot on the ASX.

The full December 2018 update from IIR is in the [Education Centre](#).

Initiating coverage of Templeton Global Growth

We have initiated coverage of Templeton Global Growth (ASX:TGG) a listed investment company that provides exposure to a long only portfolio of global shares. TGG has been listed since 1987 and has historically held a portfolio of more than 100 stocks, although this is in the process of being reduced to 40-60 securities. Stocks are selected based on Sir John Templeton's value investment philosophy. TGG's fees are low compared with peers with a 1.0% management fee and no performance fee, although the portfolio and share price have

underperformed over the LIC's history. TGG may suit investors looking for a value-driven diversified portfolio of global shares. It pays annual dividends which have been fully franked with the exception of FY2015 and FY2016 dividends.

Whilst TGG has paid dividends most years, historically there has been a degree of volatility in the dividend amounts. However, dividends have been steadily increasing since FY12. We initiated on TGG with a 'Recommended' rating. At the end of October 2018 the shares were trading at a 10.7% discount to pre-tax NTA.

Century Australia to Merge with WAM Leaders

Century Australia (ASX:CYA) is set to merge with WAM Leaders (ASX:WLE) following the execution of a Scheme Implementation Agreement between the two listed investment companies. Under the agreement, WLE will acquire 100% of CYA via a share exchange based on the pre-tax net tangible assets of the respective entities. The scheme of arrangement is subject to approval by CYA shareholders with a meeting expected to be held in late January. Wilson Asset Management is the investment manager for both WLE and CYA. In April 2017 CYA shareholders voted to change the management from Perennial Value Management to Wilson Asset Management.

We think it makes sense for CYA, which has a market cap of just under \$100m, to merge with the larger WLE. The combined market cap of the merged company will be close to \$900m and CYA shareholders will benefit from the greater market liquidity of the larger LIC. Investors will also benefit from a reduction in the management expense ratio with the removal of duplicated expenses and remaining expenses spread over a larger asset base. Both LICs currently have similar investment strategies, investing in large cap Australian shares, so there will be no major changes to the management of the portfolio. Investors in CYA will continue to hold shares in an Australian large cap focused LIC managed by Wilson Asset Management.

We do not cover CYA and make no recommendations as to the merger proposal. However, we think basing the consideration for the merger on the pre-tax NTA of the respective entities is reasonable but note that CYA's post tax NTA is higher than pre-tax NTA given a net deferred tax asset of 5.3 cents per CYA share. This means WLE shareholders will receive the benefit of these tax losses if they are realised in subsequent years.

Pinnacle terminates arrangements with Blue Sky

Pinnacle Investment Management and its subsidiary Alterium Investment Management have withdrawn the proposal for Alterium to be appointed the investment manager for Blue Sky Alternative Access Fund (ASX:BAF). Pinnacle said it considered Blue Sky Alternatives Investments (the BAF manager) willingness to enter into discussions with a competing party (Wilson Asset Management) was inconsistent with the co-operative basis on which Pinnacle agreed to proceed with the proposal. This leaves Wilson Asset Management as the only other party in discussions regarding the management of BAF.

In a letter to the BAF Board (which has been reconstituted following resignations, removal of two directors at the AGM and the appointment of two new directors) Wilson Asset Management reconfirmed its offer to take over the management of BAF and announced Adrian Siew, an experienced manager with private equity and alternatives experience, would oversee the management of the portfolio and Andy Smith, another experienced alternatives asset manager would be appointed to the investment committee. Under the proposal Geoff Wilson and Andrew Siew would be appointed to the BAF Board.

Shareholders in BAF have experienced a tumultuous time and despite a rally over the past few months, the shares are still trading at a sizable discount to pre-tax NTA. At present, the Wilson Asset Management proposal seems to be the only offer that might see a return to stability for BAF shareholders.

Regal planning to launch its first LIC in 2019

Hedge funds manager, Regal Funds Management, is planning to launch a new listed investment company in early 2019. There are suggestions the Manager may look to raise up to \$500m in a fund that combines a number of its existing strategies including its Long Short Australian Equity Fund. Regal joins Pengana Capital Group which is also lining up an offer for early 2019 with plans to raise up to \$1,250bn for a Private Equity Trust. We will provide more details on these planned offers as they come closer to launch in the new year.

Spotlight on Whitefield

Founded in 1923, Whitefield (ASX:WHF) is one of the oldest listed investment companies on the ASX. It offers investors exposure to an actively managed, well-diversified portfolio of Australian industrial equities. The

portfolio is managed by White Funds Management which has a small investment team with considerable equities experience. While the portfolio is well diversified, the top 10 stocks account for 48.8% of the portfolio, slightly higher than the benchmark index. There is a high weighting to the Financials sector with the four major banks being four of the top five investments.

WHF recently adjusted its objective from a longer-term outperformance objective to a medium-term objective. The company is now seeking to generate portfolio returns (before fees and taxes) that outperform the benchmark index (S&P/ASX 200 Industrials Accumulation Index) over rolling five-year periods. The change was made to account for the evolution of the investment strategy with the introduction of quantitative techniques allowing for a shorter-term outlook. After fees and taxes paid, and including dividends, WHF has delivered an average portfolio return of 8.7% p.a. over the past ten years, 0.7% below the S&P/ASX 200 Industrials index.

WHF seeks to provide investors with a cost-effective investment that delivers long-term capital growth and a reliable and growing dividend stream. The management fee at 0.25% p.a. and total management expense ratio under 0.40% are low for an externally managed LIC. Total full year dividends were held flat at 17 cents per share, fully franked, from FY2009 to FY2017 but have since been increasing. Following the partial conversion of its Convertible Resetable Preference Shares (CPRS) and rate reset on the remaining CPRS (to a lower rate) WHF expects to be able to support a higher level of dividends. A fully franked interim dividend of 9.75 cents per share was paid for 1H2019 and the company expects to pay a final dividend of at least 10 cps in June 2019. This equates to an attractive fully franked dividend yield of at least 4.7% based on the current share price.

WHF shares have historically traded at a discount to pre-tax NTA and at 31 October were trading at a discount of 5.5% compared to a three-year average discount of 8.0%. Given the improved dividends we think this is an attractive entry point for investors looking for exposure to a diversified, well-managed portfolio of Australian industrial equities. Investors should be aware that the discount may change on a daily basis in line with market movements. We also note that the CPRS conversion and recent share purchase plan issue may have impacted the pre-tax NTA.

Peter Rae is Supervisory Analyst at [Independent Investment Research](#). This article is general information and does not consider the circumstances of any individual.

Predictions for ETFs in 2019

Alex Vynokur

Australia's ETF industry is predicted to continue its rapid growth trajectory in 2019, driven by investor demand, product innovation and the evolving requirements of advice models used by financial planners.

This year to November, the Australian ETF industry continued its growth trajectory, [finishing the month at \\$41.1 billion](#), up from \$35.5 billion as at 30 November 2017 and in line with BetaShares' 2018 predictions made in late 2017. More investors appear to be recognising the benefits of ETFs, including the ability to diversify portfolios, lower costs and access opportunities in international sectors which have historically been hard for Australians to access.

For the upcoming year, we're highlighting ETF model portfolios, increased allocations to fixed income ETFs and global growth thematics as themes.

Prediction one: Adoption of ETF model portfolios

Adoption of ETF model portfolios is predicted to increase, as advisers seek to create efficiencies in their businesses and lower costs for clients, and as more ETF strategists, investment consultants, portfolio construction specialists and robo advisers enter the market.

2018 has seen a strong rise in the number of advisers and investors seeking to implement expert portfolios via models, and we ourselves have seen significant growth in advisers using our ETF Model Portfolio service offered to them. This demand is primarily coming from groups who are seeking to use such services to offer efficient and cost-effective access to diversified investment portfolios, at much lower costs for clients than had been previously available.

It is becoming increasingly understood in the Australian market that the combination of low-cost index building blocks and active asset allocation can result in a compelling investment solution that delivers value for both the end client and the adviser, and so we predict this theme to grow strongly.

Prediction two: Fixed income exchange traded products growing in popularity

Last year our second prediction was for greater innovation in fixed income exchange traded products and there is no doubt that prediction has come true, with a number of innovative solutions offered to the market in 2019.

We believe the adoption of ASX-traded fixed income funds will rise significantly in 2019, both due to increased product choice but also signalling changing sentiment from investors looking to position portfolios more defensively.

Australian investors typically hold an underweight exposure to fixed income, although, with growing market volatility, investors are starting to increase allocations to fixed income as a defensive shield for their portfolios. We've already seen this start to happen with the Fixed Income category continuing to be amongst the top 3 for asset flows each month.

In addition, the growing number of Australians reaching retirement age means that defensive asset classes such as fixed income will likely continue to benefit from increased allocations.

Product innovation is also predicted to continue, after this year's significant growth in existing bond solutions including our [Australian Bank Senior Floating Rate Bond ETF \(QPON\)](#) and our [Australian Investment Grade Corporate Bond ETF \(CRED\)](#) which, combined, currently sit with over \$450M in assets.

We also saw the recent launch of Australia's first fixed income Active ETF, the [BetaShares Legg Mason Australian Bond Fund \(managed fund\) \(BNDS\)](#), which offers investors access to an actively managed bonds portfolio via the ASX.

Fixed income has long been an overlooked allocation, primarily due to access issues. ETFs are reducing barriers to adoption across a variety of different asset classes, including fixed income.

Prediction three: Thematic investing will continue to grow

A record number of thematic ETFs were launched during 2018 and have experienced strong take-up to date. This trend is predicted to continue into 2019.

We continue to see strong demand for funds offering access to a range of global growth themes, including [global cybersecurity \(HACK\)](#), [global healthcare \(DRUG\)](#) and [global robotics and artificial intelligence \(RBTZ\)](#).

At the same time, the bellwether [Nasdaq 100 ETF, NDQ](#), has seen a record year of inflows in 2018. Indeed together, the technology range has combined assets of over half a billion dollars as at 30 November.

In terms of a newer exposure that is quickly gaining popularity, more recently, valuations in the Asian technology sector have become more attractive. This has underpinned a strong period of growth in the adoption of the [Asian Technology Tigers ETF \(ASX: ASIA\)](#), which allows investors to access a portfolio of the largest Asian tech companies in a single trade.

Overall, Australia's ETF industry is headed into another strong year for growth

We predict the ETF industry will end 2019 at \$55-60 billion versus \$41 billion as at November 2018.

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