

This Week's Top Articles

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Where did SMSFs come from, and where are they going?

by PJ Keating on February 14, 2013

When we laid the foundations for the current superannuation system in the 1991 Budget, I never expected Self Managed Super Funds (SMSFs) to become the largest segment of super. They were almost an afterthought added to the legislation as a replacement for defined benefit schemes.

This is the second article which draws on my talk to ASFA in November 2012, and it examines why SMSFs have become so popular.

In 1992, my Government introduced the Superannuation Guarantee Charge (SGC), with major extensions in coverage for working Australians who previously had no easy access to super. It came from the sea change in the economy and society produced by the co-operative political model adopted in 1983, with a productivity basis for improvements in living standards, and superannuation as a form of distribution of those improved living standards. The co-operative model induced and produced a massive increment to real wealth.

Employer contributions to superannuation rose from 4% of salaries in 1992-93 to 9% by 2002-2003. I wanted to reduce the future reliance on the age pension, and over time, give ordinary people a better retirement. Back in the 1980s, only wealthy people were in the stock market, but I felt mums and dads should be able to share in the bounty of the wealth of the nation. Owning a home was fine but they needed more. And through superannuation funds, everyone is now in it, and it's been good for both investors and the nation. We have created a \$1.5 trillion pool of capital, and many super members have accumulated significant balances which they want to manage themselves.

It was not generally so initially. In 1992, employers mainly made the decision about which fund an employee's super contributions would be invested in, usually a so-called default fund. This approach was intended to keep the system simple, affordable and understandable. Each year, the employee would see the contributions and the gradually-building balance, without the employee having to take any action. It also kept the accumulations out of the hands of government bureaucracy.

The wealth would address the growing economic problem of an ageing workforce, and realign the mix between capital and labour through labour contribution to real capital growth. Very few countries have developed an adequate retirement income system with no 'false promise' in such a universal way, leaving the age pension – an income and asset tested pension – as an anti-destitution payment, which ceases when the recipient dies.

So the SGC was not introduced as a welfare measure to supplement the incomes of the low paid. It was principally designed for Middle Australia, those earning \$65,000 to \$130,000 a year, or one to two times average weekly ordinary time earnings (AWOTE). This is not to say that those on 50% or 75% of AWOTE should not benefit equitably from the superannuation provisions. They should. But for Middle Australia, the SGC and salary sacrifice was and is the way forward.

At an SGC of 12% and tax arrangements as now, someone on one to two times AWOTE plus adequate salary sacrifice limits should be able to secure a replacement rate in retirement income of around 70% over a 35 year working life.

That was the basic design, and achieving those targets did not require a lot of risk-taking in the investments. If compound annual returns reflected nominal GDP plus say 1%, the system would be doing well. Indeed, the Treasury forecast of system assets growing from \$1.4 trillion today to \$8.6 trillion in 2040 represents a compound annual growth rate of around 6.7%.

I mention this to provide context commentary on the rapid growth of SMSFs. As a general statement, I believe people's expectations as to rates of fund returns are too high. The Australian superannuation system is both large in world terms and large in absolute terms. Not only is it forecast to grow to \$8.6 trillion by 2040, but currently, the system stands at over 100% of GDP and will mature nearer to 200% of GDP. It is simply too large in aggregate to consistently return high single or double digit returns.

I am certain expectations as to returns and the search for yield have done two things:

- managers have adopted a higher risk profile in portfolios, and
- lower returns than expected have soured expectations, encouraging more people to take the initiative and manage their own assets, including taking on the trustee role when setting up an SMSF.

Returns on APRA-regulated funds averaged 3.8% over the 10 years to 2011, notwithstanding volatility from the unprecedented growth in equities and investment markets between 2002 and 2008, juxtaposed against the impact of the GFC. Over the same period the average cash rate was 5.2% and the average GDP growth 3.1%.

These results indicate that significant risk was taken by superannuation managers to secure returns in line with the relatively risk-free government cash rate. Importantly, these risks were taken on by managers who had limited direct exposure to losses – losses ultimately borne by superannuation beneficiaries. However, if the funds did return a significant amount, those same fund managers are often entitled to performance fees! And these fees are generally calibrated to annual returns rather than long term returns required to fund a retirement income.

I believe returns expectations are inflated and those expectations lead to incentives to drive higher fees for managers, but at much higher risks, as was the case between 2002 and 2011. We only have to look at asset allocations. At December 2011, total Australian super assets were weighted:

- 50% to equities
- 18% to fixed income
- 24% to cash and term deposits
- and the rest across other asset classes including property.

By contrast, the average weighting of OECD country pension assets was:

- 18% to equities
- 55% to fixed income
- 11% to cash and term deposits
- and the rest to other asset classes including property.

So, Australia is 2.5 times more heavily weighted into equities and relatively underweight in other asset classes. We are disproportionately weighted into the most volatile and unstable asset class.

The question is – how does this weighting work to deliver the key objective of the system? 60% of total superannuation assets are held by investors over the age of 50. A large proportion of these assets should be moving towards less risky, more stable asset classes, protecting capital ahead of the retirement phase. When we reach the point where outflows are increasingly matching inflows, the weighting to equities needs to be rectified. As the system matures, a real capital adequacy risk may start to develop, which will need to be seriously monitored by the government.

SMSFs currently represent almost 32% of system assets, a pool of \$475 billion, and growing strongly. As I said earlier, generally this group has unrealistic expectations as to how much is a good return. Single digit returns sour their enthusiasm for managed funds. They think they can do better themselves. Some sophisticated investors probably can, but how many self managers have the required level of investment expertise? And by investment expertise, I do not mean falling prey to financial advisers. Notwithstanding the costs of setting up a SMSF, you need something like \$600,000 of assets to make the decision to self manage a better relative fee proposition to management by larger managed funds.

But the main issue gets back to investment skills. How many SMSF investors are competent in matters of asset allocation and general investment savvy? This becomes a real problem for the SMSF system and its deliverability as it occupies an increasingly higher proportion of overall system assets.

For systemic prudential reasons, investment in stable asset classes, such as government bonds or higher rated corporate bonds, could be desirable for SMSFs. That is, perhaps some form of minimum investment will be required which is mandated to mitigate downside risks. As the system reaches the tipping point, where inflows are increasingly being matched by outflows, it will need to be monitored for capital adequacy risk.

Hon Paul Keating was Treasurer of Australia between 1983 and 1991 and Prime Minister between 1991 and 1996.

Three things I've learned from Warren Buffett

by Bill Gates on September 5, 2013

I'm looking forward to sharing posts from time to time about things I've learned in my career at [Microsoft](#) and the [Gates Foundation](#) (I also post frequently on [my blog](#).)

Last month, I went to Omaha for the annual [Berkshire Hathaway](#) shareholders meeting. It's always a lot of fun, and not just because of the ping-pong matches and the newspaper-throwing contest I have with Warren Buffett. It's also fun because I get to learn from Warren and gain insight into how he thinks.

Here are three things I've learned from Warren over the years:

1. It's not just about investing

The first thing people learn from Warren, of course, is how to think about investing. That's natural, given his amazing track record. Unfortunately, that's where a lot of people stop, and they miss out on the fact that he has a whole framework for business thinking that is very powerful. For example, he talks about looking for a company's moat—its competitive advantage—and whether the moat is shrinking or growing. He says a shareholder has to act as if he owns the entire business, looking at the future profit stream and deciding what it's worth. And you have to be willing to ignore the market rather than follow it, because you want to take advantage of the market's mistakes—the companies that have been underpriced.

I have to admit, when I first met Warren, the fact that he had this framework was a real surprise to me. I met him at a dinner my mother had put together. On my way there, I thought, "Why would I want to meet this guy who picks stocks?" I thought he just used various market-related things—like volume, or how the price had changed over time—to make his decisions. But when we started talking that day, he didn't ask me about any of those things. Instead he started asking big questions about the fundamentals of our business. "Why can't IBM do what Microsoft does? Why has Microsoft been so profitable?" That's when I realized he thought about business in a much more profound way than I'd given him credit for.

2. Use your platform

A lot of business leaders write letters to their shareholders, but Warren is justly famous for his. Partly that's because his natural good humor shines through. Partly it's because people think it will help them invest better (and they're right). But it's also because he's been willing to speak frankly and criticize things like stock options and financial derivatives. He's not afraid to take positions, like his stand on raising taxes on the rich, that run counter to his self-interest. Warren inspired me to start writing [my own annual letter](#) about the foundation's work. I still have a ways to go before mine is as good as Warren's, but it's been helpful to sit down once a year and explain the results we're seeing, both good and bad.

3. Know how valuable your time is

No matter how much money you have, you can't buy more time. There are only 24 hours in everyone's day. Warren has a keen sense of this. He doesn't let his calendar get filled up with useless meetings. On the other hand, he's very generous with his time for the people he trusts. He gives his close advisers at Berkshire his phone number, and they can just call him up and he'll answer the phone.

Although Warren makes a point of meeting with dozens of university classes every year, not many people get to ask him for advice on a regular basis. I feel very lucky in that regard: The dialogue has been invaluable to me, and not only at Microsoft. When Melinda and I started our foundation, I turned to him for advice. We talked a lot about the idea that philanthropy could be just as impactful in its own way as software had been. It turns out that Warren's brilliant way of looking at the world is just as useful in attacking poverty and disease as it is in building a business. He's one of a kind.

[Bill Gates](#) is the founder of Microsoft and Co-chair, Bill & Melinda Gates Foundation. He posted these thoughts on LinkedIn.

Should we exclude companies purely on ethical grounds?

by Adam Tindall on March 23, 2017

Fund managers used to be discouraged, or even prohibited, from taking ethical issues into account when making investment decisions on behalf of their clients. It was widely agreed that investment managers should not let consideration of ethical criteria distract them from choosing investments that maximise financial returns for their clients unless, of course, the client had specifically mandated ethical investment. Asset owners, so people said, were best placed to take action on ethical grounds.

But times have changed and society has changed with them. Fund managers have also had to keep up because we increasingly felt we didn't want to deliver investment returns to customers irrespective of the cost to society.

How do trustees, managers and investors discharge their duties?

At the heart of this issue lies questions about how investors best discharge their duties. What actions are acceptable in the pursuit of returns? Can investors, or indeed should they, dismiss 'immoral' activities relying instead on governments to intervene via regulation? Is it sufficient for investors to say they tried to engage with a company to improve the nature of a product offering or on their corporate risk management strategy?

As recent campaigns on a range of issues have demonstrated, investors are increasingly being asked to justify their actions. This has raised questions about the role of ethics in investing and whether it is defensible for investors to support an activity that, while commercially convenient, viable and legal, is inherently wrong (i.e. something that is bound to have an adverse impact on stakeholders).

Ethical dilemmas by their very nature are not straight forward. The question of 'whose ethics' is sometimes used as a reason not to articulate and implement an ethical position. Certainly, criticism by others of a particular ethical position may make it tempting to choose the path of least resistance and avoid any explicit consideration of ethics.

Integrating environmental, social and governance (ESG) issues into our investment decisions and in the discussions we have with the entities in which we invest is entirely consistent with the objective of delivering

appropriate risk-adjusted returns over the long term. This approach was formalised when AMP Capital became a signatory to the UN Principles for Responsible Investment (UNPRI) in 2007 and further reinforced in 2012 with the public statement of our ESG and Responsible Investment Philosophy.

Deciding to exclude certain companies

In 2012, we did not seek to exclude specific companies, asset types or industry sectors from our investable universe on wholly moral or ethical grounds, but this position was recently revisited. We concluded that we had a responsibility, as an investment manager, for what we choose to do, or not do, and how we invest. And that, under rare or extreme circumstances, it may be appropriate to exclude investments in a particular company or sector for purely ethical reasons. The decision was also reflective of the changing attitudes of our clients, who increasingly do not want to be invested in harmful products.

Subsequently, we added an ethical framework and decision-making process that, under exceptional circumstances, would lead to the exclusion of certain investments from a portfolio based on ethical grounds. Working with ethicist Dr Simon Longstaff of The Ethics Centre, we developed a principles-based framework that provided a consistent basis for considering a range of potential ethical issues, not only now but well into the future.

The three concepts that underpin the ethical framework are:

1. The degree of harm caused
2. The denial of humanity
3. The principle of double effect.

[Editor's note: the principle or rule of double effect concerns the ability to act when a legitimate aim (in this case, removing a company based on ESG guidelines) may cause an effect one would normally be obliged to avoid (eg, reducing the size of the investable universe)].

The result is that we will no longer invest in manufacturers of tobacco and companies involved in manufacture of cluster munitions, land mines, and chemical and biological weapons. We have now started the process to divest of these companies from across our entire portfolio. The divestment of tobacco manufacturers will be the largest to date in Australia.

It's important to note we are only excluding certain companies or sectors by exception. We still firmly believe in company engagement in order to effect meaningful change. In the case of tobacco, cluster munitions, landmines, biological and chemical weapons manufacturers, however, no engagement can override the inherent dangers involved with their products.

Crucially for investors, this decision still means we can meet our fiduciary obligations to them and our obligations to be a responsible fund manager, delivering strong investment returns that continue to meet their objectives. Our analysis has found that our funds can continue to be managed effectively under this new framework without compromising investment objectives.

In looking after our clients' funds, we consider it prudent that we articulate the principles by which we discharge this responsibility. Introducing a new ethical framework is the right thing to do by our investors and it is consistent with our long-term focus on responsible investing, which provides greater insights into the potential risks and opportunities that may impact the value, performance and reputation of companies we invest in.

Adam Tindall is Chief Executive Officer at [AMP Capital](#), a sponsor of Cuffelinks.

Give me the long-term predictability of shares, at any age

by Peter Thornhill on February 28, 2018

As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates.

It is a terrible mistake for investors with long-term horizons – among them, pension funds, college endowments and savings-minded individuals – to measure their investment “risk” by their portfolio’s ratio of bonds to stocks. Often, high-grade bonds in an investment portfolio increase its risk.”

Warren Buffett, 2017 letter to Berkshire Hathaway shareholders, published 24 February 2018.

I noticed with sadness that an [article promoting ‘life cycle’ investing](#) was published in Cuffelinks last week, pushing this asset allocation technique as a sensible retirement alternative.

In 2015 Glenn Stevens, the then Reserve Bank Governor, pointed out the huge cost required today to produce a reasonable level of income and, more importantly, generate a sustainable income for longer retirements.

“In a low interest rate world, the problems of providing retirement incomes will become ever more prominent. The very low level of yields on fixed income assets means that it is very expensive today to purchase a secure stream of future income, which is what someone who is retiring is usually seeking. And there are more of such people, living longer.

The retiree can of course respond to this by holding more of her portfolio in dividend-paying stocks – accepting more risk. She may hope for a dividend stream that is fairly stable from year to year but that tends to grow over time.”

Glenn Stevens, ‘[The Long Run](#)’, address to the Australian Business Economists, 24 November 2015

Put simply, from the heady days of the late 80’s/early 90’s where a \$1 million dollar bank deposit would have produced around \$140,000 income a year, on this same amount we have seen the income fall to around \$30,000 in 2018. I refer to this as the ‘cash crash’. If the sharemarket fell by 80%, can you imagine the outcry?

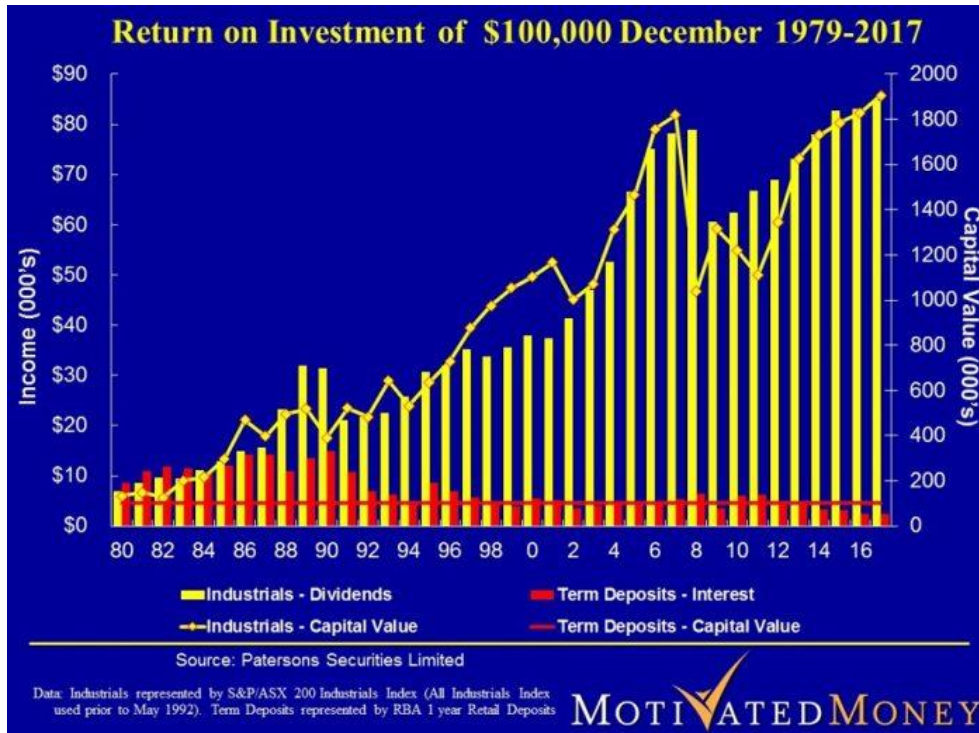
Challenging the definition of ‘risk’

Investing is about survival and we are living a lot longer in retirement than most people imagine or plan for. The greatest danger is locking into artificially low rates of return for long periods, such as with bonds, term deposits or annuities. I am reminded of the Law of Unintended Consequence when seeking the ‘security’ of cash instruments.

Stevens also reinforced my theme when talking about people facing retirement today when he said; *“They have to accept a lot more risk to generate the expected flow of future income they want”*. I accept that he is using the traditional measure of risk and is referring to the volatility of capital. I, however, will not accept that volatility of capital is a satisfactory measure of risk provided one is a long-term ‘investor’.

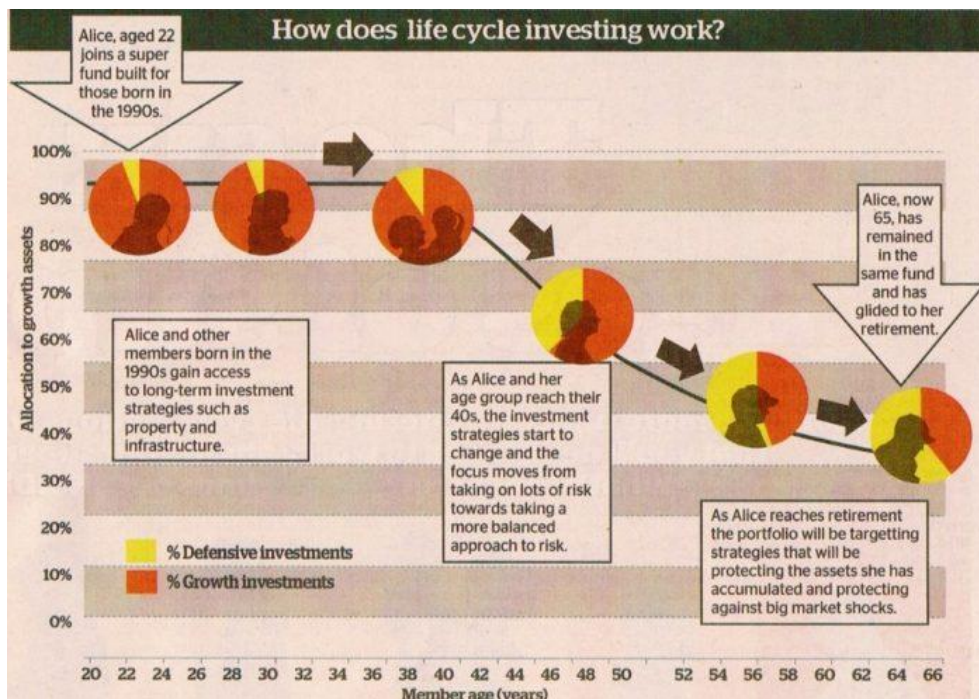
On the basis that a picture is worth a thousand words, the ‘mothership’ (as I call it) chart below, comparing cash deposits with industrial shares over 37 years, hopefully speaks for itself. This example shows \$100,000 invested in both industrial shares and term deposits in 1979, with all income from both investments spent and not reinvested. After receiving interest payments every year, a term deposit is still \$100,000 after 37 years whilst shares, in addition to the income received, are now worth \$1.9 million. I must add, as with the interest, no dividends have been reinvested during this period.

This is why I prefer the safety and security of the sharemarket to risky assets like term deposits. I can live with short-term volatility over 40 years. It is my friend during accumulation phase as I inevitably buy more when the market is cheap and less when it is expensive. In retirement, I want income and for me, the volatility in the value becomes a non-issue.



The life cycle investing argument

In the same vein as the Cuffelinks article on life cycle investing, an article titled, 'Your super can grow old gracefully' in the Sydney Morning Herald in 2015 caught my eye. The chart below from the article explains graphically how an investor can automatically be transitioned from 'risky' growth assets into more conservative investments as they approach and then enter retirement. It is posited as a sensible and conservative approach.



Source: Sydney Morning Herald, 5 March 2015

Proponents of this strategy explain that this will ensure the security of your financial future. Thankfully, the authors of the article raised legitimate concerns but what annoys me about this simplistic approach is that it intimates an 'account value' without splitting it into the two components of capital and income.

It should be clear from the two charts above that theirs is the antithesis of mine. According to the second chart, as one grows older, investments will be shifted away from the yellow in my chart and more into the red so that by the time retirement comes, having invested for 40 or so years, the retirement future is now jeopardised. In addition, the entire account balance in the life cycle fund will be substantially less than mine as 'they' will have been selling shareholdings over the years and switching to cash.

To give you a sense of the compounding effect during the accumulation phase of life, if I had reinvested the interest and the dividends, the account balances would be **\$1.3 million for cash** and **\$12 million for shares** over the 37 years. Let's take it a step further. You are now about to retire, and the account balances above can be used to produce an income. So, looking at the chart above, in retirement, your starting point for cash remains the \$1.3 million whilst your starting point for shares will be \$12 million.

The thought of this life cycle model being applied to our adult children strikes fear into my heart. If 'Alice' had stayed in the yellow, as per my chart, for all of her working lifetime, her eventual retirement pot would have been substantially greater than the outcome as proposed in the shifting asset allocation of the second chart. She, like my wife and I, would have no need for cash as a buffer to smother the volatility. The opportunity cost of the life cycle strategy will be huge. It's the opportunity cost that no one talks about and the largely irrelevant volatility. When one hits retirement, one simply stops the reinvestment and turns on the dividend stream from a substantial asset base as a pension.

Why sell off the best compounding asset?

Commentators are always banging on about compounding, the '8th wonder of the world'. So why do the supporters of life cycle investing undervalue it in the latter stages of the accumulation phase of our lives? They are going to guarantee that as you progress through your working life, the strongest compounding (income-producing) asset will be sold off to buy something that will produce the lowest income stream.

The irony is that we are only now beginning to recognise the longevity risk, and retirements stretching out to equal our working lifespan. With most of your retirement fund in 'defensive' investments for 30-40 years, the experience of the last 37 years, as displayed in my 'mothership' slide, being applied to your retirement years should hopefully ring warning bells.

There is nothing conservative or defensive about term deposits or bonds, in fact, quite the opposite. In the longevity stakes they rank as the riskiest asset you can hold. Why must we cling to the outdated concept promulgated as 'modern portfolio theory' from the 1940's? Volatility does not measure risk, it merely indicates the high level of liquidity.

Personally, I refuse to expose my family to these risky deposits, preferring instead the boring predictability of shares.

Peter Thornhill is a financial commentator, public speaker and Principal of [Motivated Money](#). This article is general in nature and does not constitute or convey specific or professional advice. Formal financial advice should be sought before acting in any of the areas discussed. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon.

Learning from my investment mistake

by David Bell on February 18, 2016

I recently made what I consider to be an investment mistake in my personal portfolio. Strangely, it doesn't look like a mistake on paper, but you only become a better investor by admitting and learning from your errors. Whether a work or a personal investment, a post-mortem is an important process to go through whether the investment was successful or not.

I will share my broad reflections of this experience with you. For confidentiality reasons, I cannot provide all of the details but I don't think that stops me giving some useful insights.

For personal background context, you should know that I work in wealth management, study and have a young family. I love my work and have had a history of prioritising my work and my study above my personal

finances. I have a lifelong trail of personal operational slippages which have cost me through the years, for example, not claiming refunds on expenses and not completing paperwork to accept free staff share offers at previous companies. At least things now align better as my super is invested in the fund that I manage at Mine Wealth + Wellbeing.

A little while ago, I made a private equity-style investment. For much of the time I was invested, I felt uncomfortable with the exposure. Recently it was restructured and I was fully paid out, both principal and interest. Overall, if you just looked at my outcome (low double digit annualised returns) you would say that it was a good investment. But deep down I know I made some fundamental mistakes.

What were my mistakes?

The first, and largest, mistake was the time I spent undertaking due diligence. Due to time constraints, I put in what I thought was a sufficient amount of time, but on reflection I should have put in a lot more. How much time is the right amount? The answer to this question is not known at the start of the due diligence process; rather a point is reached where you feel confident you have an appropriate amount of insight. Allocating time for due diligence is especially important in the case of illiquid investments where there is no opportunity to capitalise on subsequent learnings (unlike listed stocks for example when you can change your mind and exit the position with little cost). Different types of investments require different levels of due diligence. In the case of a private investment a large amount of time should be dedicated to the business model, competition, financial analysis and the structure of the transaction.

The related mistakes were broadly flow-on effects from the first mistake. When you are time poor you do less primary research (your own independent research) and take shortcuts such as relying on the information presented to you and taking confidence from the quality of the co-investors. These are examples of shortcuts that work well often but not always.

It's also important to reflect on what went well. I was involved in the structuring of the original investment and overall this was well-designed in the sense that it provided lots of protection for investors. Also by investing alongside some high quality investors it did prove that they were able to have some positive influence on the final outcome as the investment wavered (and it did get hairy: at one point, interest payments were missed).

Lessons for other investors

A post-mortem is a valuable process for all investors. It allows you to reflect on what went right and wrong and to consider improvements to your investment process. If you are reflecting as a group (for instance, we do this at Mine Wealth + Wellbeing) there can be moments where people may feel defensive but if the session is run positively then a lot of good can come from it.

The reflections I make are largely for personal investors, and particularly those who have an SMSF:

- As much as investing is interesting, do you have the skill to select your own investments? What is your personal investment edge that justifies selecting your own investments rather than relying on professional fund managers or using passive investments?
- If you believe you have the skill, do you have the time to appropriately assess investment opportunities and conduct ongoing monitoring on each of your investments? In my case I believe I have the skill but time was the issue.
- Are there investments that you are considering because they sound interesting and would be a great conversation starter? If yes, do you have the skill and time to appropriately assess and monitor these opportunities? Sometimes these skills need to be even more specialised. Strategies like hedge funds and private equity sound exciting but they can be much more complex to assess.
- If you are considering private (illiquid) investments, then the issues raised about skill and time are even more important: you cannot easily reverse your decision once it is made.

Following on from my self-reflection I changed the way I invest my personal portfolio. I acknowledge that I don't have enough time to undertake due diligence and conduct ongoing monitoring on a range of investments. Indeed, my personal investment process is well below the investment process I apply at work. I came to the view that this makes investing in private, illiquid investments a bad match for me at this stage of my life. So now I invest in liquid assets through managers that I know very well and trust. As my personal situation changes then the scope of my personal portfolio management activities may also change.

Being honest with yourself is an important starting point when designing and evolving your personal investing strategy. How well does your current strategy line up against your skills and time availability?

David Bell is Chief Investment Officer at [Mine Wealth + Wellbeing](#). He is working towards a PhD at University of New South Wales.

Why would you invest in junk?

by Warren Bird on July 17, 2014

The Australian bond market made history this year. For the first time a company whose credit rating is below 'investment grade' – often colloquially called 'junk' – successfully raised funds by selling Australian dollar bonds publicly in the institutional market. The company issued \$300 million of 7 year bonds in May 2014, then returned to raise another \$400 million in June through an 8 year issue.

Many readers might be wondering why anyone would invest in 'junk'. In this case there are some unique reasons, but the issuing success of this company provides an opportunity to explore the investment case for high yield bonds.

The issuer and the yield

One of the reasons for the success of these deals is the familiarity of the company to investors. After all, Qantas is a household name! Not only is Qantas the 'national carrier', but it's listed on the ASX and held in many share portfolios. Further, Qantas has been an issuer in the bond market before, so its credit fundamentals are well known to fund managers.

In fact, credit analysts looked at the airline relatively recently. In April and May of 2013, Qantas raised \$250 million through a bond maturing in 2020. At that time the company was rated BBB, which is investment grade, but after well-publicised problems late in the year, Standard & Poor's cut the rating to BB+ in December 2013. Moody's followed suit in January 2014.

A sub-investment grade rated company that was not so familiar would almost certainly not have been as successful in raising funds. However, local investors seem to have formed a view that Qantas' cash reserves, plus the fact that it has strategic options for dealing with its financial problems, make it a relatively 'safe' play outside the usual AAA to BBB credit range.

Of course, investors have only done this because Qantas paid a high yield. The 8 year deal done in May 2014 paid investors 7.96%, at a premium over the Government bond rate of just over 4.0%. The range of yields on other similar maturity bonds in the market at the time was more like 4.25 – 5.25%.

Risk and return

High yields are precisely the point to investing in the sub-investment grade space. High yields compensate investors for higher risk.

Mostly, this is a higher risk of default. Based on historical outcomes, bonds rated in the BB range are about ten times more likely to default at some point over the next ten years than the average investment grade securities (A to BBB ratings). [See here](#) for a more detailed discussion of credit risk and the meaning of high yield risk. There is also a liquidity premium to high yield securities compared with investment grade bonds.

However, the high yield market usually overpays for these risks and thus delivers very competitive return outcomes, against both shares and bonds (this analysis uses the Bank of America Merrill Lynch BB/B index hedged to A\$ to June 2014. That is, the comparison is not based on a handful of domestic bonds, but the well-established US market). Over the long run of 25 years, high yield has returned 11% per annum, compared with 9.5% for Australian shares and 8.8% for Australian bonds. It has done this with 8% pa volatility, which is more than bonds (4%), but much lower risk than shares (17%).

Over the medium term of five years, high yield also compares very favourably. The return from June 2009 to 2014 was 15.9% pa. Volatility was 14%, which is higher than over the long run. Bonds have delivered 6.9% pa, but at lower than long run volatility (3%), while shares have returned 11.2% pa at about the same as their long run volatility.

The medium term comparison is fascinating. The five years to June 2014 commences just after the bottom of the GFC-induced blow-out in credit spreads and fall in share prices. Of course, the sharemarket has rebounded nicely since the GFC, but few would investors would realise that high yield bonds over the same period have provided almost 5% per year better return than shares.

So why is it called 'junk'?

Given risk and return outcomes, it is unfair to call the asset class 'junk'. That term came into being nearly 100 years ago when the high yield market was comprised entirely of companies who had previously been rated more highly, but which had encountered financial difficulties and become more risky as a result. These 'fallen angels' did not deliberately run their businesses to be BB or B credit rated, and issuing bonds with such ratings was problematic. They became, in the eyes of investors who had previously bought their debt, 'junk'. Some would say that Qantas is a perfect example of such a fallen angel.

However, the modern high yield market is different. Since the 1980's it has become a means by which particular kinds of businesses have been able to tap the capital markets for funding that might not have otherwise been available. Some people argue that the high yield market democratised capital markets, because banks, insurance companies and pension funds had previously spurned such issuers unfairly.

Therefore, nowadays the high yield market is mainly populated by companies who deliberately run their businesses as BB or B rated. They either have reasonably stable earnings but operate with high leverage ratios, or they have more conservative leverage in a highly volatile industry. They operate in industries not typically found in the investment grade space, and thus offer a more diverse universe of credits. The US market comprises around 1,500 sub-investment grade issuers and is valued at US\$1.3 trillion.

Manage the risk properly

That said, each individual high yield bond does carry a relatively high risk of default. The only effective way to manage a credit risk portfolio is through continuous credit research and [an appropriate level of diversification](#). The higher the credit risk of individual investments, the smaller the exposures to each company should be and the larger the number of individual holdings required. In high yield, we're talking at least 50-100 holdings, if not more. Further, these should be spread across as many industries as possible in order to make sure you don't have a concentration of risks.

Investors need to be cautioned against simply buying some Qantas bonds, along with a handful of the other high yield bonds that are available to retail investors in Australia, and believing that they have a healthy portfolio. The concentration of holdings makes that approach highly risky.

This is a space where managed funds or ETF's really come into their own as an efficient way of getting the diversity that is needed.

Many investors are unnecessarily put off by the colloquialism 'junk' and don't appreciate the case that exists for high yield bonds to be included in their portfolio. A well-managed portfolio of 'junk bonds' is not a junk portfolio. It can be a high-returning, moderate risk asset class.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

A right royal collection from the Commission

Graham Hand

In financial markets, 2018 was the year of the Royal Commission. Broadcast live, the hearings became compelling viewing for both market participants and the public, and the worst revelations dominated the news cycle. The Final Report is due on 2 February 2019, and the market awaits with great anticipation.

Banks and large wealth managers are big and ugly and fair game, but like the Westminster political system, they look bad until the alternatives are considered. Do we want to close the loan choices offered by mortgage

brokers? Do we want banks to stop offering financial advice to their customers, and instead send them around the corner to an 'independent' adviser? Do we want the banks to reduce lending to small businesses, pushing activity to second-tier and shadow lenders with less regulation and capital. The Commission must note: **Be Careful What You Wish For.**

Consider what appears on the surface the worst of the behaviours: charging financial advice fees to dead people. How can a dead person receive advice? But financial advisers often have a lot of work to do handling matters for a client's estate. Are they not supposed to be paid for that? Aren't the very people in the legal profession who accuse banks of charging scurrilous fees also the people who act for dead clients and charge handsomely for their services? Do accountants turn off the meter when handling the final financial accounts for a dead person? Someone has to manage the affairs of the estate, and many service providers 'charge fees to dead people'.

In the Cuffelinks editorials, we covered the Royal Commission throughout the year, and we have collected the major events into [this summary](#), from most recent backwards in time.

Free ebook: Firstlinks, the 2018 highlights

Cuffelinks

During the course of the year, it is not possible to read everything that comes across your desk, which is why Cuffelinks summarises highlight articles in an end of year review each year.

The six previous free ebooks from prior years are in [this folder](#).

The Cuffelinks team has selected 10 highlights from the hundreds of articles published in 2018. This ebook, [Firstlinks](#), contains original content first published in Cuffelinks, including many of our most popular.

Our sixth year of publishing in 2018 was tumultuous for financial services. The Royal Commission provided a deep well of revealing and often unbelievable content, and the [editorials from Cuffelinks are collected in another article](#) as a summary of what the industry needs to address.

Many of our articles are viewed over 10,000 times, including this year, the [Budget Special](#) direct from the Canberra lockup and Garry Mackrell's [insider view of the changes at CBA](#). The survey in our Special Edition on the book '[Factfulness](#)' was completed almost 5,000 times.

The coming year of 2019 promises to be tough for financial services and investing. The Royal Commission report in February will set the ground rules for future regulatory and behaviour changes, while rising US rates will temper enthusiasm for risk assets. Cuffelinks will continue to deliver insights to help navigate these changes.

Click on the cover page image to download the ebook, or [here](#).



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