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This Week's Top Articles

Labor franking policy will change behaviour

Deborah Ralston

Labor's plan to disallow excess franking credits to Australian shareholders with low taxable incomes is flawed on several levels. On 19 November 2018, the Parliamentary Budget Office (PBO) released some additional detail on the likely impact of the proposed policy, commenting:

"there are significant uncertainties around the baseline data and the behavioural responses of individuals, superannuation funds and companies to the proposal".

What we do know from the PBO data is that in 2014-15, more than half of the 1,132,380 individuals receiving refunds had taxable incomes below the $18,201 tax-free threshold, and 95% had taxable incomes of less than $65,000. Around half of these refunds go to people over the age of 65. With 320,000 receiving a 'pensioner's exemption' from the policy, around 812,380 individuals are still likely to be affected.

Anticipated changes by people who self-fund retirement

For older Australians, shares have often been a preferred saving vehicle. Around 70% of taxpayers over the age of 75 receive franking credits, with an average value of $6,347. These individuals take great pride in being self-funding in retirement. The PBO anticipates responses by those individuals to the policy may include shifting from Australian equities into other forms of investment, or couples may shift share ownership from the lower-income to the higher-income individual.

The impact will be felt mostly by self-funded retirees and SMSFs, while those with an institutional super account will be largely unaffected.

People who saved for retirement through an SMSF will lack the tax liabilities in pension phase to offset their franking credits and will therefore lose income unless they develop alternative strategies. Potential income loss will be significant as SMSFs tend to favour Australian equities, although the proportion invested in this way varies widely.

In 2014-15, SMSFs with balances over $1.5 million accounted for 30% of all franking credit refunds, and indeed these high balance funds have been a particular target of the Labor policy which has at times been described as a 'wealth tax'. As the intended revenue from this source is significant, the impact of the $1.6 million transfer balance cap on tax-free pension accounts introduced in 2017 may have a material effect on the potential revenue. To the extent money was transferred to the accumulation phase, trustees will have tax payable against which the franking credits can be used.

The PBO states that this has been factored into their calculations but will:

"only have a minor impact on the stated revenues as it only affects a relatively small proportion of pension-phase superannuation assets".

No official ATO statistics are available in this regard, but data from a major SMSF platform shows that total SMSF balances in pension phase dropped from 31% of the sector in March 2017 to just 14% at June 2018.

Potential changes in strategies

The strategies or behavioural responses SMSFs employ to offset any loss of income are unclear. They may:

- diversify away from Australian equities
- shift all funds from pension phase into an accumulation account and draw an occasional lump sum so that tax on earnings offsets franking credits
- roll their SMSFs or at least the Australian equities component into an APRA-regulated fund
- add younger family members to the SMSF to better utilise franking credits.

There are really no prior experiences to indicate which way most people will go.

The PBO estimates also that by 2019-20, SMSFs will have shifted around a quarter of the value of their Australian listed shares into APRA-regulated funds, although the caveat for that estimate is that it is not clear "how open SMSF trustees" would be to that strategy. Given the dominant motivation of SMSF trustees is control of their own funds, it may be more likely that they would diversify out of Australian shares but stay within their SMSF.

Equally, there has been little modelling on how companies may:

- behave given potential impacts on capital markets if there is a substantial reduction in investment in Australian shares by SMSFs and other investors
- alter dividend payment policies if the demand for franked dividends changes
- react to divest substantial banks of franking credits.

It appears the intentions of the Labor policy to contain the costs of the dividend imputation system, to improve government revenue, and to impose some kind of wealth tax are well intended from a fiscal perspective. However, the policy will impact differently on people on the same income, depending on whether they are a self-funded retiree, an age pensioner, a large super fund member or an SMSF member. SMSF members with an age pension on 28 March 2018 would also be in a different position to one who commenced their age pension on 2 April 2018.

As the PBO has said, there are many uncertainties around the baseline data and the behavioural responses. It is not clear that the policy will achieve the intended outcome of reducing the costs of dividend imputation and generating higher government revenues. Excess franking credits may simply be transferred as they move from those who can't use them to those who can. It is also unlikely to impact the wealthy who can reallocate asset portfolios, leaving older Australians with modest retirement incomes to bear the brunt.

Professor Deborah Ralston is Chairperson of the SMSF Association. Deborah has held a number of leadership positions in Australian universities and is a researcher and recognized thought leader in financial services.

Watch the one rule that applies to all assets

Roger Montgomery

Many readers understand the inverse relationship between bond prices and bond interest rates. Bonds usually carry a fixed coupon payment that reflects interest rates at the time of issue, and the promise to pay the principal back at maturity. Once bonds start trading in the secondary market, the price of the bond can change with the yield – remember the coupon payments are fixed – moving in the opposite direction to the price.

Investors overlook that the relationship between interest rates and values applies to all income-producing assets.

Think of a rental investment property with a stable tenant who pays the same rent every week for decades. The income from the property stays the same so the payment of a higher price for the property results in a lower yield and the payment of a lower price for the property results in a higher yield.

I have deliberately introduced property as an example to help explain that it is not only bonds that share an inverse relationship with interest rates. And that's important to keep in mind when one considers the structural change in the stance of central banks around the world, which we will come to in a moment.

The higher the price, the lower the return

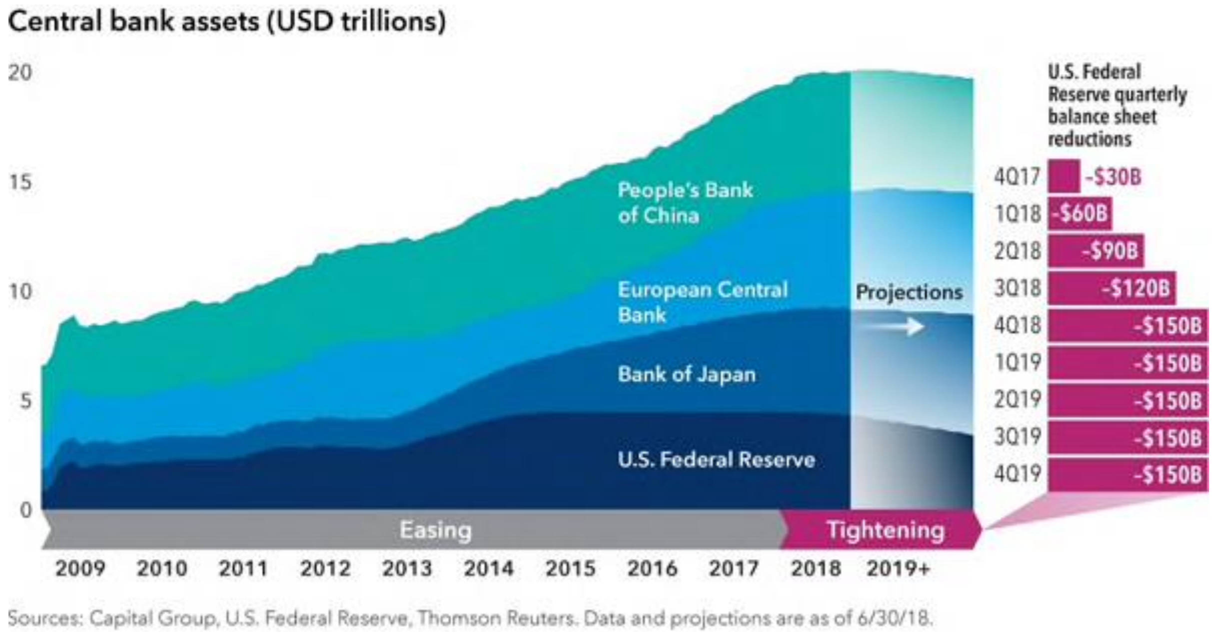
An unforgettable investing rule is the higher the price you pay, the lower your returns. If, for example, a non-dividend-paying company's shares trade at $40 each in November 2029 – say 10 years from now – then paying $10 for them today will deliver 14.86% compounded annual return. But at $21 for those shares today, the return drops to 6.6%.

Flipping this, if a business generates $40 of cash flow in January 2029, what is that future $40 worth today? The answer depends on the rate used to 'discount' that future cash flow back to today. If we demand a 15% return on our investment over the next 10 years, the value of that future $40 is worth $9.89 today. If we are satisfied with a 6.6% annual return on our money, then that future $40 is worth $21 today.

By lowering the rate of investment return from 15% to 6.6%, we increase the present value of a future cash flow from $9.89 to $21. In other words, when interest rates (required returns) fall, the value of an asset rises. The reverse is also true. In the example above, if interest rates rise from 6.6% to 15%, the value of that future $40 falls from $21 to $9.89.

The rule applies to all assets

As interest rates rise, asset values fall. It applies to all income-producing assets – businesses, shares, property, bonds. And as the value of income-producing assets fall, banks are less inclined to lend, which reduces liquidity and the money available to speculate on non-income-producing assets such as art, wine, cars and low digit number plates.



The chart above follows the rapid growth in central bank balance sheets since 2009 when they collectively commenced the greatest monetary experiment of our time. They paid cash to banks and investors for their bonds and pushed bond prices up and yields down.

The hitherto 'building up' of central bank balance sheets has now gone into reverse as the US Fed starts reducing its balance sheet by allowing bonds to mature, and through the cessation of purchasing any more. Meanwhile, the Bank of Japan (BoJ) and the European Central Bank (ECB) have entered Quantitative Tapering by reducing their purchases initially, followed by presumably ceasing altogether.

What happens when you remove from the bond market the biggest constant buyers of bonds in the last 10 years? Bond prices stop going up and start falling and bond yields stop going down and start rising.

In addition to the biggest buyers being removed, a new seller has emerged in the form of the US Treasury issuing bonds to fund Donald Trump's fiscal deficits. Remember all those tax cuts? The hole left in the budget from the reduction in tax revenue needs to be plugged with borrowings and that means an increase in the supply of bonds.

Why 2018 was a transition year

Take out the biggest bond buyer and introduce a new large seller and bond prices go down and yields go up. The difference this time around is that it appears to be structural rather than cyclical and the quantum of the change may yet overwhelm other typical influences on bonds.

It makes 2018 a transition year. Although US 10-year bond rates have been rising for more than two years – from a low of 1.36% in 2016 to more than 3.2% late last year – the stock market only seemed to react last year. As is often the case when rates start rising, the markets were initially buoyed by the economic growth that typically accompanies rising rates.

Eventually, the exuberance about inchoate economic growth gives way to concerns about the effect on asset values from rising rates. At that juncture, Price/Earnings ratios are generally extended thanks to the prior exuberance.

Consequently (and especially if rates keep rising), those investors who paid record prices for everything from property to collectibles may now experience poor returns. The only question is whether those lower returns are accompanied by higher volatility to.

Switch from corporate to government bonds

The higher yields on government bonds are starting to look more attractive. Consequently, investors who were overweight corporate bonds are selling those bonds, pushing their yields higher too. You can see this in the market value of Corporate Bond ETFs such as the iShares IBoxx US Dollar Investment Grade Corporate Bond Fund (NYSEARCA:LQD), which has fallen from over US$116.00 to US$111.00 since August 2018. Yes, bond ETF prices can fall and are not as defensive an asset as many think.

The switch from US corporate bonds to US Treasuries is occurring at a time when a record 47% of all US corporate bonds are rated the lowest BBB investment grade, and 14% of S&P1500 companies are considered 'zombie' companies unable to pay their interest from earnings before interest and tax. I would not be surprised, as interest rates on these bonds rise, that the high levels of leverage results in a significant number of downgrades to these BBB bonds by the ratings agencies.

Perhaps even more worrying, a credit market record level of CCC-rated high yield (previously called 'junk') debt is due to be refinanced in 2019 and 2020.

It all suggests more volatility. For investors who remember the rule about higher prices and lower returns, they may already have a stash of cash ready to take advantage of opportunities.

Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is general information and does not consider the circumstances of any individual.

Vale Jack Bogle

Robin Bowerman

Investors all around the world lost a friend and passionate advocate this month with the passing of John C. (Jack) Bogle.

The founder of Vanguard Group was a colossus both within and outside the investment industry. A strong believer in pooled investment vehicles like US mutual funds (managed funds to Australian investors), he was a strident and life-long critic of deceptive industry marketing practices and high costs.

It is impossible to overstate the legacy of Jack Bogle. His pioneering work – for which he was publicly derided as 'un-American' – has put billions of dollars back into the pockets of investors. Australian investors benefited directly when his long-time assistant Jeremy Duffield returned home to setup Vanguard Australia in 1996 – the first country outside the US to experience the 'Vanguard effect' as the group began to expand internationally. Bogle visited Australia in 1998 to speak at investor seminars in Melbourne and Sydney and explain the power of index investing as only he could.

It was a privilege at the time to share the stage with him – in my former guise as a financial journalist – because back then indexing was something of an oddity in the Australian market. The passion and compelling logic built on what he called "the relentless rules of humble arithmetic" left an indelible impression. As did his passion to give individual investors a "fair shake" by keeping fees at rock-bottom levels because "the miracle of compounding returns is overwhelmed by the tyranny of compounding costs".

Over his 60-year career Bogle wrote 12 books – his last book *Stay the Course: The story of Vanguard and the Index Revolution* was published late last year. He also published numerous technical and opinion articles in the financial and mainstream media. Which is good news for investor's both today and tomorrow who want to learn how to invest using fundamentally simple concepts like low costs and owning the whole market forever.

The Little Book of Common Sense Investing is a great distillation of everything Bogle held true, while for the more technically minded the longer form *Common Sense on Mutual Funds* will reward the time invested.

The genius of Jack Bogle was his unique ability to cut through the complexity – both real and artificial – that clouds the investment industry and focus on giving individual investors the best chance of success.

See also:
Vanguard mourns passing of founder John C. Bogle
A look back at the life of Vanguard's founder (video)

Robin Bowerman is Principal and Head of Corporate Affairs at Vanguard Australia, a sponsor of Cuffelinks.

For more articles and papers from Vanguard Investments Australia, please click here.

6 stark superannuation policy differences

Adam Shultz

A federal election will be held by May 2019 with the Australian Labor Party (Labor) well ahead in the opinion polls. A change in government may result in amendments to superannuation laws after this financial year. To its credit, Labor has released a plethora of policies relating to financial services, including superannuation, negative gearing and capital gains tax. This allows voters ample time to consider the policies prior to casting their ballots.

What is Labor proposing for superannuation?

1. Non-concessional (after tax) contributions (NCCs)

Labor will reduce the annual non-concessional contribution cap to $75,000 from the current $100,000. Further, at present, a person can utilise the 'bring-forward' rule if they are under 65 years of age and make three years of non-concessional contributions in one year. For example, a person nearing retirement may want to sell an investment property. This person can theoretically contribute $300,000 (after tax), or $600,000 for a couple, into their superannuation.

Under a future Labor Government, the 'bring-forward' rule will allow a one-off (after-tax) contribution of $225,000 for an individual, or up to $450,000 for a couple.

The above only applies for people who have less than the Total Superannuation Balance cap of $1.6 million per person.

2. Tax deductions for personal superannuation contributions

Labor will abolish the tax deductibility for personal superannuation contributions.

At present, in order to claim a tax deduction for a personal superannuation contribution, a person's total concessional contributions, including an employers' compulsory superannuation guarantee contributions (currently 9.5%) must not exceed the annual $25,000 concessional cap.

The person must also provide a valid notice of intent to their superannuation fund and it must be acknowledged (in writing) by the fund.

For example, a person earning $90,000 will receive ($90,000 x 0.095) $8,550 from their employer as a superannuation guarantee contribution. Theoretically the person could contribute a personal after-tax contribution up to a further ($25,000 – $8,550) $16,450 and receive a tax deduction for it.

3. Catch-up concessional (before tax) measure

The Government introduced a scheme on 1 July 2018 that allows people with total superannuation balances below $500,000 to make catch-up concessional contributions. Labor has indicated that it will abolish this in order to tighten up concessions to the wealthy.

At present, any unused portion of the annual concessional cap of $25,000 can be carried forward for up to five years. Using the example above, a person earning $90,000 per annum would have an unused portion of $16,450 if no personal contributions were made. If this same person went on parental leave the following year (year 2) or left the workforce for a 12-month period, they could theoretically contribute ($16,450 + $25,000) $41,450 upon their return into their superannuation account.

4. High-income super contribution threshold

Labor will lower the high-income superannuation contribution threshold to $200,000 from the current $250,000. Exceeding the $200,000 threshold will trigger an additional 15% tax (or 30% total rate) imposed on amounts over the threshold and up to the total amount of concessional contributions that must not exceed the cap of $25,000.

Labor has indicated that this will impact less than 4% of taxpayers.

5. Phase out the $450 superannuation guarantee threshold

Labor will phase out the requirement for employees to earn more than $450 per month before employers are required to make superannuation contributions on their behalf. This will benefit those who work part-time, are in casual employment or work multiple low-paid jobs. The threshold will be reduced in $100 increments from 2020 and will cease to exist by 2024.

6. Superannuation guarantee (SG) to be paid on the Federal Government's paid parental leave

Labor will legislate to pay the superannuation guarantee on the Federal Government's paid parental leave scheme. At present, the paid parental leave scheme provides $719.35 per week for 18 weeks to those women who meet a work test and earn less than $150,000 per year. However, no superannuation contribution is currently paid on this leave.

A Labor government according to my calculations will add a superannuation contribution of ($719.35 x 0.095) $68.34 per week for 18 weeks to be paid directly to the person's super fund or their employer who would make the contribution.

Policies which are not different

Not raise the age pension qualifying age to 70

One of the first initiatives announced by our new Prime Minister Scott Morrison was to abandon the Government's plan to increase the pension age to 70.

Labor and the Government are now on a unity ticket when it comes to increasing the pension age incrementally in 6-monthly intervals up to 67 by 1 July 2023.

The superannuation guarantee (SG) rate will increase to 12%

At this stage, both Labor and the Government are publicly united in the planned incremental SG rate increases despite the Productivity Commissions' recent counter recommendation. Labor has affirmed its desire to increase the SG rate as soon as practicable.

The SG rate is set to increase from 2021/22 at 0.5% per year until it reaches 12% by 2025/26.

Prevent direct borrowing by superannuation funds

Labor will prohibit direct borrowing by superannuation funds on a prospective basis. This policy aims to reduce asset concentration risk in Australia's SMSF sector.

Other financial services policy differences

Budget deficit levy – Labor will reinstate the Budget deficit repair levy of 2% for those earning over $180,000.

Reform dividend imputation – Labor will introduce a policy that stops cash refunds where excess franking credits exceed tax liabilities. An SMSF with at least one welfare pensioner as a member on 28 March 2018 will be exempt from the policy as part of the 'pensioner guarantee', as well as recipients of welfare pensions at any time.

Discretionary trust reform – Labor will introduce a minimum 30% tax rate for discretionary trust distributions. This is aimed at addressing tax minimisation and artificial income splitting.

Cap deductions for managing tax affairs – Labor will cap deductions for managing an individual's tax affairs at $3,000.

These are current policies at the time of writing.

Adam Shultz is Executive Manager of Policy and Advocacy at [Mine Super] and a Labor Councillor for Lake Macquarie City Council. This article represents the personal views of the author and not those of his employer.

Five rules for a market professional's manifesto

Rob Prugue

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently." – Warren Buffett

A manifesto is a published declaration of the intentions, motives or views of the writer where they say what their aims and policies are. We need more of them in financial markets, with actions to match the words.

What concerned me most over 2018 was how quickly the skepticism of members of superannuation funds morphed into cynicism. Like purveyors of medical treatments, we 'professionals' in the finance industry hold an economic advantage over members due mainly to information symmetry. How we exercise this advantage defines our professional integrity. This is as true for fund managers as it is for pension and superannuation funds and all other intermediaries such as financial advisers.

Here are five simple points on a potential manifesto towards better investor ethics:

1. Never sell a fund or investment vehicle which you would not sell to your parents, siblings or children. If you have a problem selling to loved ones, then why sell it to the broader market?

2. Assume it's your money you're investing. Caveat emptor should not only relate to your own monetary capital, but equally to your intellectual and ethical capital.

3. Stop creating marketing verbiage to impress others. For example, what the hell is an 'Absolute Return Fund'? Use the same words you would say at a BBQ when asked what you do or how you manage money.

4. Don't pretend your product can do something it can't. There is no such thing as asymmetrical risk. No one can build a portfolio which is top quartile in bull markets and beat cash during the bear.

5. When a peer breaks any of these aforementioned four points, then call them out on it. Much of our complacency lies from our not wanting to 'rock the boat'. Ironically, we are all in the same boat.

These rules should apply to anyone who relies on OPM, or other peoples' money.

With the recent release of Productivity Commission Report into Superannuation, a few more words to guide the design of a manifesto:

1. It's not all about fees. While no one wants to be overcharged, the truth is that it's all about net returns. That is, returns minus fees, where consistent outperformance is worth paying for.

2. Bigger super is not necessarily better. Economies of scale do capture benefits for members, but in the search for performance, large funds can equally have diseconomies of scale. Plus, any systematic failure has an air of 'too big to fail' moral hazard to it.

3. Default funds should not be limited to a few historically best-performing funds. I guess the authors of the Report have never heard of mean reversion. I believe immunisation (where assets are designed to match liabilities) is a more important target for a super and pension fund. When I was a manager, return-based fund awards scared me as more often than not, the funds that won awards would likely mean revert in a following period. I never met a portfolio manager whose stock selection criteria was based on the historically best-performing large cap names with low margins. Yet it seems fine for members to choose their super funds accordingly.

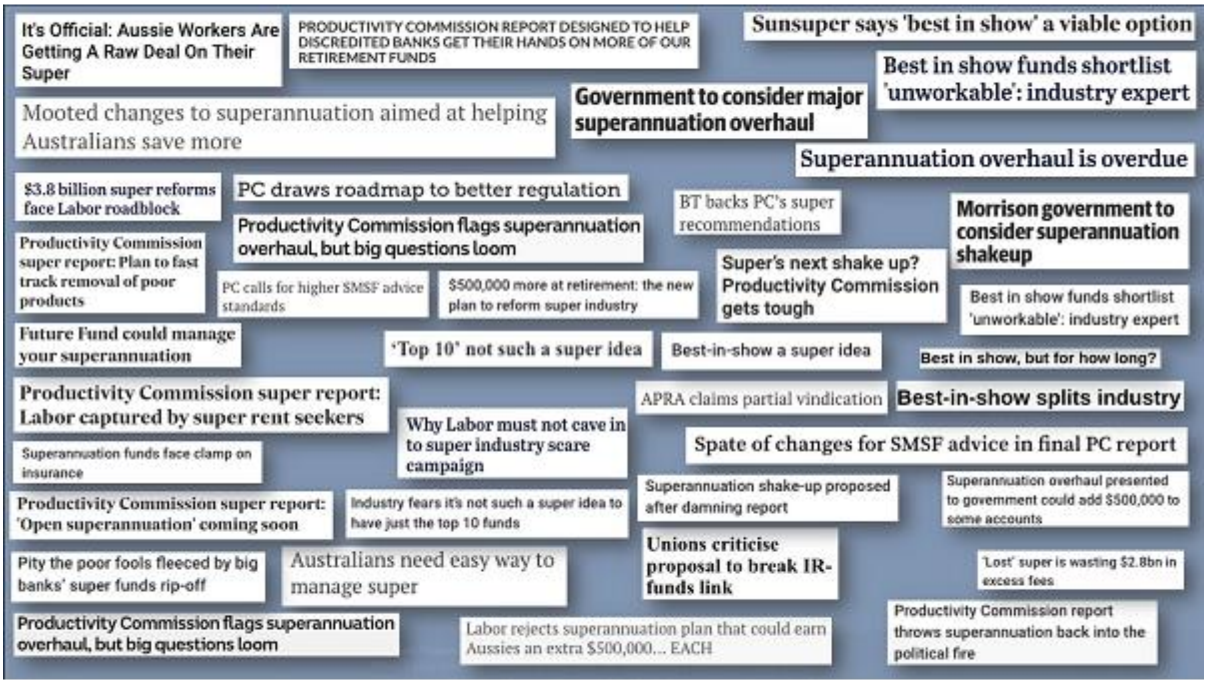
Rob Prugue has over 30 years in funds management; from market regulator, to investment analyst and manager, to pension manager, to asset consultant and, most recently, as a CEO of Asia Pacific at Lazard Asset Management. These opinions are his own, and stem for his 30+ years. Rob will soon come to the end of a one-year sabbatical, and would be an ideal resource for any business considering these issues.

10 reasons the '10 Best in Show' is ill-suited

Graham Hand

The Productivity Commission (PC) Report to assess the efficiency and competitiveness of the superannuation system has pushed the wealth industry into a spin since its release in January 2019. The full 700-page Report is an impressive piece of work, linked here. Its key conclusion is that structural flaws are harming millions of Australians, and fixing the problems could give a new job entrant today an extra $533,000 by the time they retire in 2064.

Here are a selection of the headlines the PC Report has generated, showing both support and opposition to the recommendations.



Source: Stephen Huppert

This article focusses on the proposal for a shortlist of Best in Show funds for new superannuation members. An independent expert panel would select 10 top-performing funds, and the two-thirds of new workers who don't know what to do with their super would be handed this list to choose from. The names would be updated every four years, and according to the PC: *"Our approach is one of employee (rather than employer) choice."*

Superannuation industry reaction

It's not often that the Financial Services Council (FSC) representing retail funds, and the Australian Institute of Superannuation Trustees (AIST) representing industry fund, agree. Change often benefits one over the other. In this case, both want to protect their clients, and choosing only 10 winners undermines most of their members. Chief Executive of the FSC, Sally Loane, said:

"Taking default superannuation out of the industrial relations system and putting choice into the hands of consumers should be the cornerstone of a modern superannuation system. The FSC is very concerned about the potential unintended consequences for the economy of a '10 best in show' model because it could create a monolithic concentration of funds, stifle competition and create huge barriers for innovative new products."

AIST's Chief Executive, Eva Scheerlinck, dislikes the denial of default status for 90% of funds:

"It will remove many high-quality funds from the default system, which may also disadvantage members in these funds."

Let's look at some reasons why the PC's recommendations are unlikely to work.

1. The focus should be more on the worst funds, not the best

In diverting most attention to how the Best in Show will be selected, the PC creates the wrong emphasis. Although it acknowledges that many funds are poor performers, with low scale, high fees and inadequate compliance, its primary solution is to pick the 10 best and hope members gravitate towards them. However, the list is overwhelmingly for new super members who do not make a choice, and their balances are tiny in the super pie. The vast majority of members will not change, so the proposal will do little for the estimated five million members in poor funds who are victims of the 'unlucky lottery'.

For example, on scale, 93 of the 198 APRA-regulated funds have less than $1 billion in assets. The PC estimates cost savings of at least $1.8 billion a year if the 50 highest-cost funds merged with 10 of the best. Then it admits switching between funds is modest, and most people do not understand performance, fees and charges and therefore will see no incentive to change.

The PC is aware of the case for 'lopping off the tail' of poor funds but dismisses it in favour of Best in Show. On page 539 of the Report, Geoff Warren of ANU is quoted:

"The performance benchmarking analysis is notable for revealing what appears to be a tail of poorly performing funds. It is not clear that the remainder of the industry is delivering anything different from random variation around their benchmarks."

The main way to help people in poor-performing funds is not to take the hazardous path of picking 10 winners from 198. It will not matter much over time if a member is in the 11th, 15th or 30th fund. They are all likely to be acceptable as the better funds among 198. The main point should be rationalising the sub-par funds.

2. Change will be extremely slow

In fact, change in super fund allocations will be much slower than most commentators are suggesting. The Best in Show list is only a 'nudge' (to use the PC's word). Another recommendation to only have one default fund for life will increase the likelihood that people will not change. Members are not forced to select a new fund, the Best in Show is targetting new employees who do not make a choice, employees can continue to choose from the wide set of MySuper funds or select their own SMSF.

The PC's own numbers for contributions each year are:

- New workforce entrants: $1 billion
- Job turnover or workforce re-entering: $16.5 billion
- Voluntary switching: $2.2 billion
- Stay with existing fund: $128 billion

All this fuss is for a few billion in a system with $2,700 billion in balances and $150 billion in new contributions a year. New workforce entrants are the lowest-paid employees, and most higher-paid employees are generally disengaged and will not even notice there is a Top 10 list. How will anyone make them care? Are we having this debate over the $1 billion from new workforce entrants each year?

3. This year's winner is often next year's loser

Fund performance comes from asset allocation, stock (or manager) selection and fees. Even where two funds make exactly the same proportional allocation to, say, Australian equities, there will be a significant difference in the stocks held, directly or indirectly. Super funds either insource stock selection to an in-house equity team, pick active managers or select index funds. Some funds have a value bias, some growth, some large cap, others small/mid cap.

Consider the Morningstar data for sector performance to 30 November 2018 for Australian equities and property in percent per annum:

Style	1 year	3 years	10 years
Large Cap Value	-7.9	3.3	8.4
Large Cap Growth	-5.6	4.5	8.2
Mid/Small Value	-4.0	8.0	12.0
Mid/Small Growth	-8.5	5.4	11.7
Real Estate	0.7	6.4	9.9

These are all Australian equities. In large caps recently, a growth style has outperformed a value style, but over longer terms, value normally does better. In small and mid cap companies, the distinction is even larger between growth and value. A mean reversion might occur at precisely the wrong time for a fund selected based on recent success.

Industry veteran and former CEO of Lazard Asset Management, Rob Prugue, wrote in LinkedIn on the PC's recommendations:

"I guess the authors of the productivity report have never heard of mean reversion? Even indexes, when thrown into an investable universe, mean revert. When I was a manager, return-based 'fund awards' used to scare me as more often than not, these awarded funds would likely mean revert. Never met a portfolio

manager whose stock selection criteria was based on the historically best-performing large cap names with low margins. Yet it seems ok for members to choose their super funds accordingly?"

4. Large inflows (if they occur) may lead to average performance

Let's accept the Best in Show change might generate large flows, since many prominent people are arguing this. For example, former Labor Minister and Chair of IFM Investors, Greg Combet, said funds not selected will be "*just left to die on the vine*".

A fund receiving massive inflows faces a continuous problem sourcing attractive investments. They will need to operate in the most liquid, highly-researched and transacted sectors to find assets in large volumes. Any of the CIOs of a large super fund will say there are certain asset types, such as hybrids and small caps, that they cannot access in large enough volumes to make investment worthwhile. Imagine a $100 billion fund buying a $10 million parcel. It is 0.01% of the fund, so even a doubling in value will have negligible impact on performance. It's not worth making a phone call or undertaking the research.

(As an aside, one of my past roles was to select fund manager relationships, and often these were new businesses. Performance invariably fell with volume, as a manager with a small portfolio can concentrate on a few best ideas, but then must add less convincing ideas as the money pours in).

In 2016, when John Pearce of Unisuper wanted to buy CBA's PERLS8, he dealt directly with CBA and underwrote the issue to the tune of $300 million. If he had waited for the secondary market, he would have moved the price buying as little as $1 million. In fact, one of the reasons Unisuper is not public offer is they do not want the fund to become too large and force it to compete even more for scarce quality assets.

Across asset classes such as infrastructure, small to mid cap companies and corporate bonds, the larger super funds like AustralianSuper (holding over $100 billion in assets) and benefitting from the Royal Commission focus on retail funds, and are already coping with massive inflows.

5. There are many definition problems

It is extremely difficult to compare super fund performance, if for no other reason than they all take different risks. The PC has made a good attempt at it. SuperRatings' current Top 10 funds ranked by returns in the Balanced Option (60% to 76% growth assets) category are shown below:

Rank	Fund Investment Option	Return	Return Period
1	Hostplus - Balanced	8.82%	5 year
2	AustralianSuper - Balanced	8.49%	5 year
3	QSuper - QSuper Balanced	8.43%	5 year
4	Cbus - Growth (Cbus MySuper)	8.41%	5 year
5	MTAA Super - My AutoSuper	8.09%	5 year
6	Sunsuper for Life - Balanced	8.00%	5 year
7	CareSuper - Balanced	7.98%	5 year
8	Mercy Super - MySuper Balanced	7.93%	5 year
9	Intrust Core Super - MySuper	7.89%	5 year
10	Catholic Super - Balanced (MySuper)	7.85%	5 year

The problems start with the asset categorisation. Funds in this group hold between 60% and 76% 'growth' assets. That is a massive difference in a period when the equity markets rally strongly and bonds are flat.

The inclusion of certain assets in 'growth' is controversial and left for the super fund to determine, rather than following an industry standard. Is a BB-rated corporate bond 'defensive' because it is a bond, or 'growth' because it is non-investment grade with price volatility typical of an equity portfolio? Are infrastructure assets ‘defensive’ due to their long-term inflation-linked monopoly structure, or ‘growth’ because they are listed equities? What if they are not listed and are revalued infrequently?

There is a lot of subjectivity and apples/oranges comparisons in fund return numbers. Issues include listed versus unlisted, smoothing of returns, arbitrary and opaque discount rates on assets, convenient selection of revaluation cycles and techniques when conditions change, etc.

Where do Environmental, Social and Governance (ESG) issues sit against performance and fees? If a fund has a strong ethical tilt and excludes many companies from its portfolio, should this influence the selection process? And whose ethics are we considering in a default fund?

What weighting is given to the insurance offer? For example, many members of a super fund like Mine Super work in mining with dangerous occupations, and Mine has negotiated special group cover for them. If Mine is not in the Top 10, would new workers in mining be denied such cover?

Trustees with responsibility for their own members can make these decisions, but the selection committee cannot cover the complexity for all members.

What might happen at a quality fund like Unisuper? It is not public offer, and would be overlooked by the selection panel although its performance would make it a contender for a Top 10 position. Would new university workers be pushed away from Unisuper despite its long-term track record and other features such as high-quality advice?

KPMG Superannuation Advisory Partner, Adam Gee, told the *AFR*:

“It is not so much the constitution of the panel that concerns us, it is more so the ability of the panel to undertake an appropriate assessment of the best-in-show list, as well as the criteria that will be used to select these funds.”

6. It should be about risk and retirement as much as performance and accumulation

The wide range of risk-taking in superannuation funds is rewarded or punished according to market conditions.

In mid-2018, as equity markets continued the bull run of many years, the Chief Investment Officer of an industry super fund told to me that the trustees of his fund required him to hold risk at the bottom end of the 60-80% growth band in which his fund was judged. Consequently, his fund was in the bottom quartile on performance, and depending on definitions of growth, some of his competitors were arguably 90% growth and delivering great results. His relatively poor numbers did not reflect well on him as CIO.

This was not his fault, as he was following instructions, and indeed, it is inappropriate to criticise the trustees. They had decided their primary role was to protect the capital of their members, and naturally, this come at the cost of performance in a strong market. It’s a reasonable position with many members in retirement, who are likely to be more concerned about preserving their wealth than an extra 1% on the earnings.

In different circumstances unrelated to investment prowess, the CIO would look like a hero. He would be fated in the media, featured at conference for his foresight, and qualify as Best in Show.

The PC recommendations focus too heavily on the accumulation of super over a lifetime, rather than preserving wealth in retirement or drawdown. For retirees, the main destruction of living standards comes not from losing a small amount of performance due to not being in a Top 10 fund, but from high risks in a collapsing market. They face ‘sequencing risk’ issues where their balances are at their maximum, as they do not have the time to contribute more to recover losses. A National Seniors survey in July 2018 called ‘Once Bitten, Twice Shy’ showed 23% of retirees claim they cannot tolerate <u>any</u> 12-month loss on their retirement savings.

The best example in Australia of a fund that took excessive risk is MTAA Super, which delivered exceptional results in the five years prior to the GFC. Their exposure to commercial property in particular was then severely punished in the crisis and they delivered years of poor performance, yet they may have been on a Top 10 list selected in 2007.

7. Unwelcome consequences of a fund dropping out off the list

Checking the SuperRatings list in section 5 above for a five-year term against the names in the same category based on 1-year returns, only four super funds make both lists. The majority funds do not retain their status in subsequent time periods. The PC is recommending a review every four years, and turnover of names is inevitable.

So then a new list is issued, potentially creating switching out of the underperforming fund, which will need to liquidate assets to meet redemptions. This comes with costs such as brokerage and spreads. I was once involved in the closure of a fund and as money transitioned from one manager to another, hitting the bid to sell shares at rapidly-falling prices was far more expensive than we expected. The market knew we were selling and a significant cost hit fund members.

Generally, industry funds invest more than retail funds in illiquid assets (such as roads and airports) as they expect to remain in inflow, but a loss of status could impede their cash flows. Will they be forced to sell illiquid assets? Will the market anticipate these changes and sell down the assets?

Imagine the frustration of doing well against the vast majority of your peers, delivering excellent results for your members from 198 APRA funds, but coming 11th in the beauty contest.

And what happens if a Top 10 fund does really badly? It will reflect poorly on the entire selection process, and further undermine public confidence in the superannuation system.

Darren Stevens, Mercer's Head of Corporate Superannuation, warned a Best in Show list would result in funds copying the investment strategies of leading funds, over-exposing millions of members to particular investments or cycles.

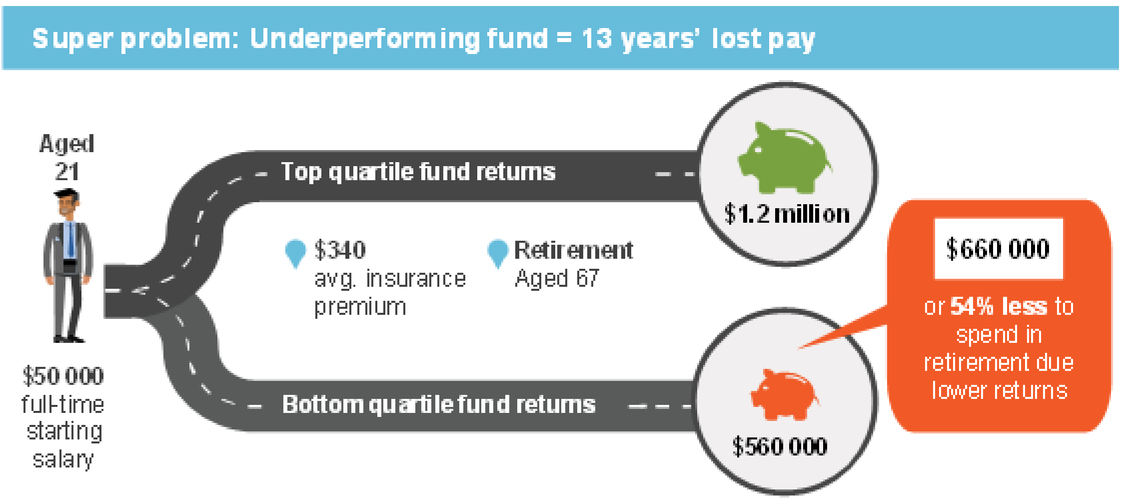
8. Top quality staff are essential for ongoing performance

Outperformance of the market in investment management is limited to a few talented individuals with special skills. Overall, most active managers do not match the index. Every institutional fund has a Chief Investment Officer and a few key staff, and although trustees and boards play a role, they are often guided by the views of the CIO. These individuals are keenly sought by competitors and their abilities would be a major consideration for the panel selecting the Top 10 funds. What happens to a nominated fund if the CIO leaves?

9. The gains in final superannuation balances are too optimistic

It is obvious that if an investor always holds money in the top-performing fund throughout their life until retirement, then their balances would be significantly higher than if they had stayed in an underperforming fund. But funds cannot be selected in hindsight. The much-publicised $500,000+ extra that has featured in the headlines is the difference in final retirement amount between the bottom and top quartiles of 53 funds surveyed by the PC.

Cameo 1 **Underperformance compounds to substantially lower retirement balances**



Source: Productivity Commission Report on Superannuation, Overview, page 11.

This is wishful thinking. A top fund in the initial period is highly unlikely to stay in the top quartile over a lifetime, and investors continually switching into the Best in Show from the previous period are unlikely to keep backing winners. In fact, with a default fund only chosen once over a lifetime, with the employee taking that fund everywhere they work, most people will stick with one fund. It might go well, or it might not.

10. Selecting the experts will be fraught

In 2016, the Financial Conduct Authority in the UK recommended reforms in the role of major investment consultants that advise the largest pension funds, saying they work under potential conflicts of interest and are "not effective" at selecting quality fund managers. These consultants are supposed to be the world's experts at identifying good managers.

According to the PC Report, selection of the panel would be decided by a group of non-super experts:

"The process could be overseen by the Governor of the Reserve Bank of Australia (as committee chairman), with the Chairman of the Australian Competition and Consumer Commission and the Parliamentary Budget Officer. The consumer representative could be decided by the selection committee chairman … with heads of government agencies that are noted for their independence, judgment and intellect".

The panel members themselves should be *"free of direct conflicts of interest, and seen to be so by the public".* The obvious problem is this removes many people most qualified in superannuation and fund selection, since all come from a perceived vested interest. But then there is this statement which blows the field wide open to a range of experts from outside finance:

"To strike the right balance between expertise and independence, not all members would need to have a high degree of expertise in super. Some could be accomplished individuals with experience in collecting and evaluating evidence and advice, but who are also able to see beyond it (such as academics)."

Check the funds listed in the tables above and there is an obvious omission: none are for-profit retail funds. Will it be politically acceptable for an independent body to favour industry funds to the exclusion of all retail funds? The substantial businesses of Colonial First State, Macquarie, BT, AMP and MLC would be compromised over the long term. These funds handle the superannuation of millions of Australians, and while many of their legacy products should be mothballed, they have recently-developed offers which are competitive with industry funds.

In fact, it's likely that the inclusion of some of these retail funds would be required for competitive and political neutrality. The PC itself acknowledges this:

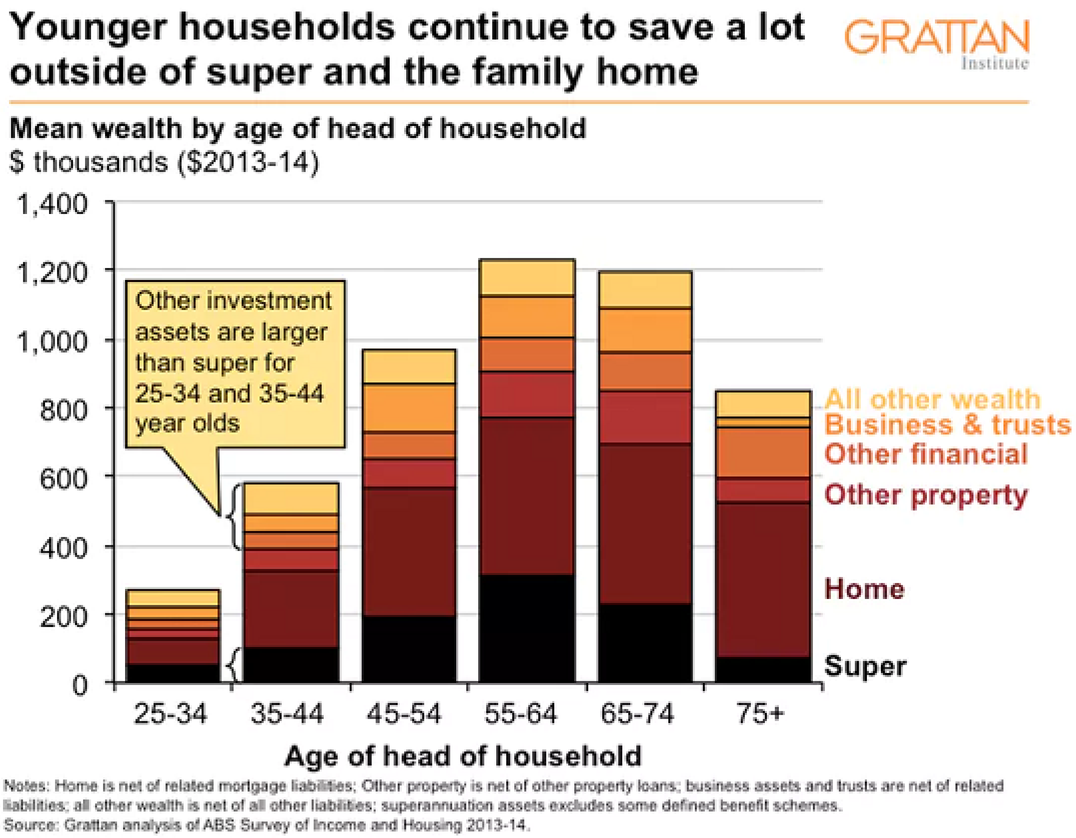
"the panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the 'best-in-show' list".

Given the massive commercial implication involved in any selection of funds, with considerable powers in the hands of a few people, they will no doubt be subject to intense lobbying, political pressure and media scrutiny. Claims of conflict are inevitable, and the public is already tired of the superannuation industry arguing with itself.

A final word: superannuation is not the main game for wealth accumulation

While superannuation is a significant political and social issue in Australia, especially because compulsory contributions are an alternative to wages, far more wealth is held outside superannuation, as shown in the chart below.

We do not interfere with individual selection of homes and other financial assets, we do not offer decent financial literacy courses in schools and we do not require trustees of their own superannuation to meet eligibility tests. There are 1.1 million Australians managing their own superannuation, free to invest in anything they wish.



Graham Hand is Managing Editor of Cuffelinks. This article is based on his reading of the PC Report on Superannuation, and readers are welcome to correct any misinterpretation. If is, after all, 700 pages, and it's impossible to do the issues justice in one article.

Risk is the permanent loss of capital

Chris McGoldrick

Our investment philosophy is that we will not forget in our search for returns that the primary risk faced by our clients is losing their capital. Our definition of risk is simple: the permanent loss of capital.

Lessons from history

One of the most shocking ways of losing capital is when ownership is taken without proper compensation, either by force or stealth. The majestic buildings on the Huangpu River in Shanghai serve as a good reminder of how quickly and terribly circumstances can change. Number 12, the Bund, was designed by British architects to be 'the best bank in the world' in the 1920s. This magnificent building was the headquarters of HSBC in Shanghai before it had to be handed over to the municipal communist government in 1956. Further along the road, the Keswick family lost control of number 27 on two occasions, first to the Japanese and then to the Chinese government in 1954[1].

Image source: Wikipedia

At this time, Great Britain was one of the most significant investors in China, four times larger than the USA, and had the most to lose from nationalisation. The then British Chamber of Commerce (chaired by J. Keswick in Shanghai – possibly slightly biased!) estimated British investment amounted to £1 billion in Shanghai alone. Another large loser was Shell. According to *The Story of Shell in China*, the company was the largest foreign operator of filling stations in Shanghai and employed some 2,600 Chinese staff. However, we are told "over the years 1951-53 Shell *relinquished* most of its depots, residences and service stations in the Republic to the government, together with various quantities of oil and chemicals". Not only were assets under threat of confiscation but income was reduced by insidious expense inflation after the government linked Chinese wages at British firms to the price of rice, which was in chronically short supply. It was a difficult time for foreign investors and what made matters worse was the absence of recourse in the law courts to claim compensation.

Turning eastwards, the ever-developing skyline of the Pudong is an impressive sight. On a recent trip, we could actually see the futuristic skyscrapers set against a clear blue sky, rather than noxious clouds which have obscured the buildings in previous years. It is easy to get carried away with the sheer scale of the vista. It is intended that way! This special economic zone was the brainchild of the indomitable politician Zhu Rongji who wanted to inspire confidence in domestic and foreign investors after much social disquiet. This worked; the skyline is now one of most photographed in the world and has come to symbolise a bold future with wealth creation a plenty, although not for everyone.

Less impressed by this view are the farmers and families who were encouraged, with scant compensation, to vacate their homes and livelihood to make way for construction. Author Zhaohui Hong calculated these farmers received only one-third of the value of the land with the remainder benefitting the public coffers[2]. A study by the World Bank estimated that local governments expropriated around US$320 billion worth of land from farmers between 1990 and 2010[3]. The common thread is a continued disrespect for 'property rights'.

It is with this in mind that we are especially vigilant to study the substance rather than just the form of each possible investment in China.

Lessons that apply today

The extremely popular internet giants (Alibaba, Tencent and Baidu) and the legal structures on which they rely are a case in point. These structures are known as variable interest entities (VIE), an American creation, made famous by Enron in 2001. In the case of China they are used to circumvent restrictions on foreign investment in certain key industries, such as steel and media. It is a complicated arrangement as it permits two different parties (the Chinese regulators and foreign investors) to claim ownership of the same operating assets. Each VIE is different but the common feature is that investors can only buy shares in a listed company with no actual ownership of sometimes the most valuable assets, gaining only a promissory note of entitlement. Instead, investors are asked to rely on a legal agreement that entitles the 'listco' to a share of the profits from the separate company. Using the prospectus of JD.Com as an example, investors are clearly warned that the government could confiscate income or force interests to be relinquished if it is deemed that regulations, or the interpretation of existing regulations, is changed. It is worth pondering how companies incorporating such risks could be allowed to list in the US but the SEC (Securities and Exchange Commission) cannot ban offerings for being too risky or even potentially illegal, all they can do is require full disclosure of the risks. With such warnings in writing, it would be extremely difficult to protect investor's rights should anything untoward unfold.

These risks have arisen in China not just in the early decades of communist rule, but recently. In 2008, the Agria Corporation lost control of a Chinese subsidiary to a discontented executive. The asset was only retuned to the company when the executive received additional compensation. Another example is the disappearance of Alipay, much to the chagrin of minority investors, Yahoo and Softbank, to a company owned by the founder Jack Ma. More recently, shareholders of RenRen (a social media network) alleged in an open letter that the founders were attempting to "enrich themselves to the detriment of all other shareholders". In this case governance was tested, animosity lingers and the share price has fallen 75% from its all-time high. One further governance concern is an iniquitous number of votes, attached to different classes of shares, which is common among these companies. In the case of JD.Com, foreign investors need to be completely confident of their alignment with the founder as he controls twenty times more voting power should any disagreement occur. While these arrangements have so far been honoured, they are ripe for abuse and give no guarantee that they will stand the test of time or any political change.

Politics can change quickly

We are particularly nervous about Emerging Market billionaires who become politically connected and advantaged. Political connections can provide tailwinds but we find it very difficult to predict, as and when, such winds may alter course. At present, media in China is mostly closed to foreign competition but should the increasingly powerful Chairman of everything, Xi Jinping, feel threatened, or simply so inclined, circumstance could quickly change. We remember too well what happened to the share price of Russian company Yukos when its CEO fell out of political favour. He who giveth can taketh away! In addition to politicians, society provides a license to operate which, as in the case with Facebook, can be harmed if it is deemed to be overly intrusive or misused. Despite such apparent risks, Chinese internet companies have proven to be extremely popular. In 2017 they doubled in value and are collectively worth more than US$1 trillion in market capitalisation. Their substance is poor but their form is good with strong operating and share price momentum. For many investors this presents interesting behavioural challenges.

We follow a strict adherence to another tenet: *"We will not succumb to irrational exuberance in good times, nor unjustified gloom in bad times."*

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For more articles and papers from CFSGAM, please click here.

[1] M. Keswick, *The Thistle and the Jade*.

[2] Zhaohui Hong, *The Price of China's Economic Development: Power, Capital and Poverty*. p124

[3] China's Economy – What Everyone Needs to Know. Arthur Kroeber. P36.