

This Week's Top Articles

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Ken forgot it was Kenneth's stage

Graham Hand

In March 1976, Ken Henry and I started our commerce degrees at the University of New South Wales, both aged 18. Some 42 years later in November 2018, Ken stepped into the witness box at the Financial Services Royal Commission. What had happened over four decades of an incredibly successful public career that led Ken to [give evidence](#) in such an incendiary way that two months later, he would be forced to resign as Chair of National Australia Bank (NAB)?

Under the steely glare of Commissioner Kenneth Hayne, Counsel Assisting Rowena Orr had been interrogating witnesses since the beginning of 2018, drawing embarrassing admissions from cowering senior executives. Ken Henry would have none of that. He had been Treasury Secretary for 10 years, facing off senators in Estimates Committees and forcibly imposing his policy views on the nation's finances. He had seen bank executives at the Commission forced into humbling one-word answers, but that was not his style.

So when Rowena Orr pushed him on the poor performance of NAB's board, of which he had been a member for seven years, he could barely control his disdain:

Orr: *Do you accept that the board should have stepped in earlier?*

Henry: *I wish we had, let me put it that way. I wish we had – I still don't know.*

Orr: *I would like you to answer my question, Dr Henry. Do you accept that the board should have stepped in earlier?*

Henry: *I have answered the question how I can answer the question.*

Orr: *I'm sorry. Is it a yes or a no, Dr Henry?*

Henry: *I've answered the question the way I choose to answer the question.*

Looking on, Kenneth Hayne made a mental note. Nobody, but nobody, acts with such disrespect on my stage. Ken Henry forgot who was setting the rules. In the Final Report handed down on 1 February 2019, Hayne delivered a crushing judgement on the Henry performance.

A stellar career began in a humble way

Ken majored in econometrics while I studied economics. The fourth year of the course was mainly thesis work, and at the beginning of 1979, I was still finalising my topic. I had a chat with Ken:

"Should be a busy year. How are you going with your thesis?" I asked.

"Almost finished," he said. "I'll submit it soon."

It was not boastful or arrogant. It was matter-of-fact. I hardly saw him for the rest of the year. While the other five students in the honours year worked on their thesis, Ken was in Canberra, already on the next step of his career. He graduated with First Class Honours.

Many of the comments this week said Ken was 'always the smartest guy in the room'. He was certainly quick and intelligent, but at university, he faced an equally formidable competitor: Warwick McKibbin. My recollection is that Ken was not close to anyone at university, and there was a friendly but determined rivalry between these two men who would become Australia's leading economists over the next few decades. The University Medal was awarded to Warwick.

I recall a class where Ken, Warwick and a professor in the first year of his tenure, John Hewson, covered the board with numbers while arguing fiercely. I did not have a clue what they were talking about.

After his undergraduate degree, Ken gained a PhD in 1982 while lecturing at the University of Canterbury, then he joined the Federal Treasury in 1984 and was a Senior Adviser by 1986. He served as an adviser to the then Treasurer Paul Keating for five years until 1991. He was Head of Taxation Policy by 1994 and Secretary to the Treasury in 2001. He stayed in that role for an amazing 10 years, collecting a Companion of the Order of Australia in 2007. He is credited, along with others, for leading Australia's policy response in the GFC with his famous "Go early, go hard, go households" rescue package.

Ken left Treasury in 2011 and joined the NAB board in the same year and the ASX board in 2013. He was appointed NAB Chair in 2015. His other appointments and social contributions are too numerous to list, but include receiving the Centenary Medal in 2001 and chairing the Henry Tax Review from 2008 to 2010.

All this from a boy who grew up on a leased dairy farm near Taree, where his father was a timber cutter. He never lost his interest in wealth distribution and economics after seeing his father work hard for little reward. His Treasury work often focussed on wealth distribution, government funding and taxation reform. He always had a strong sense of social responsibility, including indigenous policy and wildlife welfare.

I have spoken to Ken only once since our university days. Our careers went in different directions. Despite his great success, my judgement is that he's a reserved, often quiet and perhaps shy person. He was always friendly and personable, but I don't recall him hanging around the university canteen at the end of a day of studying.

Strong views and 23 Senate Estimates Committees

Over the years, Ken argued economics and policy with McKibbin, Keating, Hewson, Cormann and Howard, to name a few, and fronted 23 Senate Estimates Committees including angry exchanges with Liberal Senators, especially Eric Abetz. At a 2008 meeting, Senator Mitch Fifield accused him of "*defying the committee*". The [SMH reported](#), "*At times during his evidence, Dr Henry groaned audibly*" and "*This account was W-R-O-N-G, he told the committee, spelling out the letters and adding 'with an exclamation mark'.*"

In 2009, the Crikey Newsletter said of him:

"Henry isn't always a fan of public debate ... has a decidedly unbureaucratic manner of public speaking and a willingness to have a go at critics ..."

Facing criticism of the Henry Tax Review in 2010, he said:

"Whenever an idea is ventured publicly by a person, whether that person is a policy advisor or whether it's a government minister, there's at least a handful of academics who will contest it. I've seen it on both sides of politics – this is not a partisan comment at all – but for governments, government ministers who are seeking to get ideas legislated – it is unbelievably frustrating, incredibly frustrating."

Anyone who manages the nation's finances for 10 years under no less a person than Paul Keating and holds a formidable public record of policy implementation must become familiar with power, dominating arguments and convincing people to understand his position. And with this comes an impatience when other people are too slow or too narrow to appreciate his view.

NAB was already on notice

The Royal Commission was particularly punishing for NAB long before Ken Henry reached the witness box. NAB's wealth management business in MLC and NULIS was a prime offender in the 'fees for no service' disaster

which became one of Kenneth Hayne's biggest targets. As Chair of the Board, Ken must have watched the evidence of his executives in horror, including a severe dressing down for the QC who was supposed to be guiding NAB's witnesses.

At one stage, Neil Young QC, questioned Kenneth Hayne on why his client needed to return the next day. Young said, *"On our instruction, her answer will be that she had no involvement in these matters."*

Hayne hit the roof. *"You will not give her her answer, Mr Young. You will not. Do you understand me?"* he said as he jabbed a pointed finger towards Young.

What to make of Ken's Royal Commission performance

On the ABC programme [The Drum](#) on 8 February 2019, veteran journalist Geraldine Doogue responded to a question on why the behaviour that had pushed Ken to the top of the public and private sector now lead to his downfall. She said:

"I'm a real fan of Ken Henry. What he did in the GFC was an incredible contribution to Australia. I'm in the minority but I heard that interchange with Rowena Orr. I didn't like her style at all. Others rolled over, people like Shayne Elliott said 'I plead guilty, sir. Don't send me to the colonies.' He (Ken) just didn't play that game. He did say 'I wish we had'. Did he have to do it exactly with the tone? ... it was a star chamber, and if you didn't exactly deliver the tone as requested, you paid a price."

"Will the NAB be well-served by the departure of those two men, in terms of trying to get themselves in a new position? The reporting has been bloodsoaked and I don't like a lot of the reporting."

We could examine Ken's entire testimony line-by-line, and there's no doubt he was in a bombastic and impatient mood. But consider the extract at the start of this article. Rowena Orr asked if the board should have stepped in earlier. Ken replied with "I wish we had." That was a solid answer. He added "I still don't know." Fair enough, he did not know why they did not act. Then Ms Orr demanded he answer her question with a yes or no. This was more point-scoring than genuine enquiry. She had what she needed without demanding a yes or no.

In the Final Report, Kenneth Hayne attacked Ken Henry, including:

"I was not persuaded that NAB is willing to accept the necessary responsibility for deciding, for itself, what is the right thing to do, and then having its staff act accordingly. I thought it telling that Dr Henry seemed unwilling to accept criticism of how the board had dealt with some issues."

There. Judge and jury. Guilty. Henry then issued a reply which in the eyes of many people proved the Commissioner was right:

"Commissioner Hayne said I seemed unwilling to accept criticism of how the board had dealt with some of the issues raised by the Commission. I am disappointed the Commissioner formed this view. I know that it is not so."

Which was Ken Henry true to form. Disappointed by the Commissioner. Ken knew better. Same as in 23 Senate Estimates Committees. He was still not reading his predicament well, but he had won these arguments for 42 years. Kenneth Hayne would not even need to defend his position. His work was done and there would be no follow up.

By the end of the week, both Henry and his Managing Director, Andrew Thorburn, had resigned, and Henry gave an interview to Leigh Sales on ABC's 7.30. He was humble and contrite, but it was two months too late. He said of his brief time at the Commission:

"I can't tell you how many times I've re-lived that appearance. I really should have performed quite differently. I should have been much more open."

Where to now for Ken Henry?

Ken's achievements and contribution to the country are too significant to allow a poorly-judged appearance to dominate his legacy. It is highly doubtful he achieved what he hoped for at NAB, but Kenneth Hayne could have looked beyond the hearings for evidence of Ken's values and intentions. For example, in [a speech on the future of banking on 5 April 2016](#), he said:

"The importance of a deep interest in the aspirations of our customers is being driven, Board down, through our business. We are determined to be customer-focussed. We know that this is what will drive our success.

Successful businesses put the customer at the centre of everything they do. In a successful business the customer drives product design and the suite of products offered. No customer is encouraged to buy something they don't need or charged more than they need to be charged to cover the cost of providing the product. No customer of a successful business buys something that they don't understand well enough to have a high degree of confidence that the product will deliver what they want, when they want it."

In a [speech in December 2009](#), he mused that his generation had not delivered on the social ideals of its university days:

"How else might one explain our failures? How do we explain the failure to prevent the continuing destruction of habitat, vital to the survival of many of our endangered species of native flora and fauna? And how do we explain the failure in dithering for decades about an appropriate response to climate change?"

Did we want our leaders to take instructions from QCs who told their clients to cower to the Commissioner, or rather, to stand up for what they believe and speak their minds? Watching bank executives unable to explain the decisions they made and resort to one-word answers, I know which I prefer. As Ken said back in 2010: *"it is unbelievably frustrating, incredibly frustrating"*.

Graham Hand is Managing Editor of Cuffelinks.

Survey: Your reaction to the Royal Commission

Please complete this [survey](#) to record your reaction to the Hayne Royal Commission. Scrolling through the seven short questions will take only a few minutes. Results will be published soon.

Franking credits made easy

Graham Hand


A reader has requested: "Please publish a simple article to explain company tax, dividend imputation, franking credits and double taxation. It would help eliminate some of the woeful nonsense talked and written on the topic. My guess is that less than 1% of the public can accurately describe the taxation of dividends, yet it is simple and most people have some level of understanding of imputation through the PAYG system. Let's make the debate more grounded in fact."

We have published several explanations on franking, such as by [Geoff Walker](#), [Warren Bird](#) and [John Kalkman](#).

Here's the short version: **to avoid taxing company profits twice, tax must be paid at either the company or individual level, but not both. If it were paid only at a company level, high income people would benefit from the 30% tax rate. So our system taxes company profits at an individual level. Any tax already paid by the company is refunded.**

Shareholders pay tax on franked dividends at their personal marginal tax rates and receive a credit for the tax on profits paid by the company. For example:

1. A company makes a profit of \$100 and pays company tax of \$30 at the 30% rate.
2. The franking credit account of the company increases by \$30.
3. The company fully distributes the profit after tax by declaring franked dividends to shareholders of \$70.
4. The company informs the Australian Taxation Office (ATO) how much dividend was paid to each shareholder and the proportional amount of franking credits for each shareholder. The ATO return looks like this, from [Dividend and interest schedule 2018](#):


Australian Government
Australian Taxation Office
Dividend and interest schedule
2018

Companies reporting dividend and interest amounts paid or credited for the year ending 30 June 2018 (or substituted accounting period). This schedule forms part of the *Company tax return 2018*. Nil statements are not required.

Information to help you complete this schedule can be found in the *Company tax return instructions 2018*.

Company tax file number (TFN)
Company Australian business number (ABN)

Registered name of company

Contact name
Area code
Telephone number

Investor details

TFN – if quoted
See the Privacy note in the Taxpayer's declaration.
ABN – if quoted

Investor name – in full

Investor address

Suburb or town
State
Postcode

Country – if not Australia
Date of birth
Day
Month
Year

Amounts paid – show whole dollars only

Franking credit	Franked dividends	Unfranked dividends not declared to be CFI	Unfranked dividends declared to be CFI	Interest
.00	.00	.00	.00	.00

5. ATO imputes (or 'allocates or 'assigns' or 'credits') the franking credit to each shareholder, and reduces the company's franking account by the same amount.
6. When shareholders complete their tax returns, they add the \$70 of dividend to the \$30 of franking to declare the \$100 of taxable income, in this form [here](#). The \$100 of company profit is therefore subject to tax.
7. Shareholders pay tax on the \$100 at their marginal tax rate and claim the \$30 that was already paid by the company as a tax credit.
8. If the shareholder's marginal tax rate is 45%, the tax is \$45 but \$30 is a tax credit and the shareholder pays the extra \$15 to the ATO.
9. If the shareholder's marginal tax rate is 0% (for example, someone with income below the tax-free threshold of \$18,200 or an SMSF in pension mode), the tax is \$0 and the \$30 is refunded to the shareholder (in the current system).
10. Under the Labor proposal, the franking credit can be used to pay tax on other income but there will be no refund for investors who cannot use the full \$30 credit (with some exceptions).

The denial of refunds of franking credits results in a minimum tax rate the same as the company rate for the shareholders earning only fully franked company dividend income. Those shareholders would not be able to access the tax rate previously offered by the 0% and 19% tax bands.

Here ends the simple bit.

Why is there such an argument going on?

The treatment of three different people earning \$17,500

Warren Bird provided this example of unwelcome consequences:

- Person A does some part-time work that earns \$17,500 a year, just under the income tax threshold. They don't pay tax.
- Person B is semi-retired, but runs a small sole trader business that brings in a net of \$17,500 a year. They also don't pay tax.
- Person C is retired and owns shares in a company that earns \$17,500 of profit on C's shares. Being a company with other shareholders, it pays 30% company tax and most of the rest is distributed to shareholders as dividends. Person C receives a dividend of \$12,250 (that is, 70% of \$17,500). They have effectively paid \$5,250 in tax on their income because of the veil that the company structure has created.

Under the current imputation system, Person C receives a franking credit for that amount and a payment of \$5,250 comes from the ATO. This recognises the fact that the full \$17,500 earned by the company should belong to Person C, just the same as Person B's business income or Person A's part-time salary.

It's similar to someone getting a tax refund at the end of the year because their PAYG taxes didn't take legitimate deductions into account. They overpaid tax and so are allowed to get it back. It is their money."

Why we tax companies based on their shareholders' marginal tax rates

Steve Martin had a senior technical career in financial services, is a CTA Chartered Tax Adviser (retired) and a FIPA Fellow of the Institute of Public Accountants (retired). He provided this summary.

Company profits are taxed at a shareholder level

At its heart our company tax system operates on the proposition that company profits are taxed at shareholder level. To understand why we do this, you need to understand the history of company tax and the options for alternatives.

In fairness, you want to create a system that taxes company profits once but you have some options. You can tax at the company level (say 30% on all company profits) or you can do as is done with partnerships and trusts, which use the company as a conduit and taxes the profits in the hands of the shareholder, but at the risk of a loss of revenue. In the interests of administrative efficiency, is there a strong case to withhold tax at the company level to make sure that company profits are disclosed at the shareholder level?

Voila! the Australian system.

If the Australian tax system did not have the withholding tax at the company level but just taxed shareholders, would self funded retirees have been any better or worse off since 2000? No, they would have received untaxed company profits – i.e. \$100 dividend instead of a \$70 dividend with a further tax refund of \$30 at tax time.

Why not just tax companies?

Because there would be a significant shortfall in revenue. While all of the attention has been on those shareholders who have a tax rate of under 30%, far more of our company profits are taxed in the hands of shareholders who are on a **higher tax bracket**. Also the tax burden on lower income earners is unjust and this plays into the present controversy.

In 1979 the Fraser Government commissioned an independent review into the Financial System. The Campbell Review considered the then double taxation of company profits: firstly in the hands of the company and secondly in the hands of the shareholder. The committee set a critical benchmark when it said at paragraph 13.8,

"the taxation system should meet the tests of neutrality, equity and simplicity."

The Campbell Review set out in beautiful simplicity the company tax system we have now enjoyed for some 30 years.

In dealing with the system of imputation, it described the tax paid at the company level as a "withholding tax" (at 14.39) and it contemplated as part of a full imputation system that there would be a refund of excess credits to lower income earners (at 14.40).

The Report highlighted that company tax profits ought to be taxed once, effectively by reference to the marginal tax rates of the shareholder. It looked through the corporate veil and asked the central question at Para 14:

"the relevant question is how the individual shareholders overall tax burden compares with the tax he would have paid had the equivalent income been received through non-corporate channels and the whole amount being taxed at personal rates."

It described as inequitable when the 'effective combined company and personal income tax rate' is higher 'than the marginal personal income tax rate'.

Labor proposal puts that inequity back into the system

In setting out the blueprint for the present imputation system, it recognised that such a radical new approach could adversely affect government revenue and so, as a first step, it recommended that refunds could be held back as an 'interim' measure.

The Hawke-Keating Government in 1987 gave effect to the 'interim' recommendation of the Campbell Review. What Keating did was not, as represented by Shorten and Bowen, the original Keating model; it was the interim recommendation of the Campbell Review.

The interim arrangements ended following the Ralph Review in 1999. The legislation giving effect to refunds of excess franking credits was introduced under the Howard Government. Our present system was designed by an independent body and was implemented with bipartisan support.

The proposed change is unfair to low to middle income earners and compromises the company tax system that has held us in good stead for nearly 30 years. The proposal fails the essential integrity tests of equity and neutrality, and this failure is made worse by the exemptions given to unions and other not-for-profits and pensioners.

Should a potential Treasurer of our country understand this? Yes. So, why would a potential Labor government create a policy that hurts lower income earners?

Graham Hand is Managing Editor of Cuffelinks.

4 lessons from Marks on protecting capital

Rachel Folder

"You can't predict. You can prepare." Howard Marks

It's easy for investors to be complacent about risk when equity markets are strong. Numerous recent company downgrades amidst a nervous market have reinforced the need for investors to prioritise capital protection. This article is guided by the words of Howard Marks, Co-Chairman of Oaktree Capital Management to explore how to think about capital protection. While it is near impossible to never lose any money, there are ways to limit the risk of permanent capital loss.

Lesson 1

"Investment risk comes primarily from too-high prices, and too-high prices often come from excessive optimism and inadequate skepticism and risk aversion." Howard Marks

Watch out for over-optimistic and expanding company valuation multiples when fundamentals remain the same. It may be a signal that the market is paying too much. Stocks trading on high multiples tend to price in optimistic future business conditions and growth expectations. Whilst, at times, high multiple valuations can be justified, this may become an issue when the market gets overly exuberant. At some point in time a correction is likely to occur.

There are generally two ways high multiple stocks can de-rate:

1. The multiple the market is willing to pay suddenly falls

When equity markets are driven by emotion, sharp corrections can become more likely as the market in aggregate becomes more expensive. Sentiment can quickly move away from exuberance to a state of fear, often driven by macroeconomic uncertainty. A lot of heat was taken out of the market during the final quarter of 2018, with the S&P/ASX300 market multiple dropping 10% from trading on about 16x to 14.5x. In these times, higher multiple stocks tend to de-rate more than lower multiple stocks as expectations taper. As a broad example, the S&P/ASX200 Information Technology index multiple fell 15% from 34x to 29x over the December quarter, de-rating 50% more than the wider market.

2. Underlying earnings of the business are lower than the market expects

Here both the multiple on which the company is valued as well as the underlying earnings per share of that company can take a hit. Take Costa Group (ASX:CGC) as an example. Until recently, this agricultural business

was optimistically trading on a 28x forward PE multiple. Costa is now trading roughly 30% lower on 20x since announcing earnings next year would be flat. So most of the 40% fall in share price on the day of the announcement was attributed to a multiple de-rate, rather than a change in earnings. In this case a circa 10% fall in EPS equaled a 4x larger fall in the company's share price.

The risk in owning high PE stocks is that the multiple can fall much faster than earnings, and faster than the overall market.

Lesson 2

"People who think it can be easy overlook substantial nuance and complexity." Howard Marks

Whilst a multiple de-rate might cause some pain, on the other hand, there is no guarantee that buying a cheap stock will protect the downside either.

If a stock is trading like there is something bad going on, it may well be. It may be the industry conditions it operates in are poor. It is worth understanding why a stock is cheap before thinking it's a bargain.

An example of this is iSentia (ASX:ISD), a media monitoring business that once had near-monopoly status and sticky clients. It now faces headwinds from competition and difficulty keeping up with a changing digital age, among other things. Prior to August 2018, ISD was trading on a 10x multiple, yet after downgrading during the same month, the stock lost 65% of its value going from \$0.80 to \$0.28. An already-cheap multiple became even cheaper, down to 6.6x. A low multiple can mean that the earnings base is actually much lower than expected.

Lesson 3

"Most things prove to be cyclical." Howard Marks

Whether from intensifying competition, waning demand or some other structural headwind, a stock's earnings may be at risk and investors should accept some movement to the downside or reposition the portfolio accordingly.

Industry headwinds can lead to cyclical recovery situations, but they can also be a source of downside risk. In the current environment of banks tightening their belts and weakness in consumer sentiment, some sectors may be better to avoid in the near term, including banking, property, automotive, aged care, retail and construction.

An example is Japara Healthcare (ASX:JHC), a quality aged care provider with strong return on capital and significant property assets. The announcement of the impending Royal Commission into Aged Care presented a reputational, and potentially, demand-damaging industry headwind that will not abate anytime soon. Since the announcement, the stock has drifted down an additional 17% even before the proceedings commenced.

Companies operating in tough industry conditions can do everything in their power to get ahead but some things are just out of management's control.

Lesson 4

"I believe in many cases, the avoidance of losses and terrible years are more easily achieved than repeated greatness, and thus risk control is more likely to create a solid foundation for a superior long-term track record." Howard Marks

It can be comforting for an investor to identify downside risk in a stock valuation. In times of market downturn, this can help to avoid severe losses.

One example is Elders (ASX:ELD) which has deep-seated relationships in the Australian agricultural market, and a wide and expanding presence across rural regions. It gives them inherent strategic value. Another is Macquarie Telecom (ASX:MAQ), which has a large amount of earnings security through well-serviced government contracts, which become increasingly sticky over time. Adelaide Brighton's (ASX:ABC) market position and assets are near impossible to replicate from scratch.

Whether it is strategic value, a tangible asset like property, or a high level of earnings security, these traits in companies can provide a level of protection during a downturn.

In conclusion, whilst there are no hard and fast rules or guarantees for avoiding losses, we believe these lessons provide a useful starting point when analysing risk. They help to identify companies that will endure and even benefit through times of economic decline, and ultimately reduce the possibility of permanent capital loss.

Rachel Folder is an Investment Analyst at [NAOS Asset Management](#), a sponsor of Cuffelinks. This material is provided for general information only and must not be construed as investment advice. It does not take into account the investment objectives of any particular investor. Before making an investment decision, investors should consider obtaining professional investment advice.

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5G is coming: who wins and who loses?

Patrick Potts

It's regarded as the future of mobile, but a recent research trip to the US drove home that 5G will be one of the biggest themes of 2019.

Telecommunications companies ('telcos') are particularly excited about the implications of 5G for fixed wireless. The offshore companies we spoke to gave useful insights into what we can expect from the big players in our region.

Big speeds, big capacity, big opportunities

Telecommunications giant Verizon plans to use 5G network's capacity for fixed wireless. When fully operational, the company expects its new 5G network will be 10-20 times faster than with existing 4G technology and carry 10 times more data. It will also be 10-12 times cheaper (on a cost/byte basis) to run.

This speed and cost savings will significantly close the gap between fixed-line and mobile broadband services, and it is likely to result in many subscribers shifting to mobile-only services.

The decline of the fixed line

Verizon's target is to move 30 million homes in the US (around 25% of its subscriber base) to fixed-wireless services. The company has already stopped investing in fixed-line access, as wireless is set to be more profitable than fixed-network customers. As customers make the switch, Verizon is projecting fixed lines to revert to negative growth within five years.

In Australia, Telstra, Optus and Vodafone (and until recently and now apparently cancelled, TPG Telecom) are building 5G networks.

We believe that Telstra, with around 50% share in both mobile and fixed broadband markets, is well placed to switch some customers from fixed to mobile. Like Verizon, this should be a driver of future earnings, with Telstra's mobile business earning around 40% EBITDA margin versus a barely profitable NBN business.

Similarly, in New Zealand, Spark New Zealand is targeting approximately 25% of its subscriber base for fixed wireless. As incumbents shift customers onto more-profitable mobile products, competitors such as Optus and Vodafone will follow, with implications for fixed-line operators, such as NBN and Chorus New Zealand.

Cost savings from the cloud

The investments made by telcos into 5G will enable them to shift much of their legacy networks to the cloud, allowing automation of many of the manual processes in older legacy networks. This automation allows greater reliability, less human error and targeted cost reductions.

For example, Verizon is looking to reduce 47,000 positions (around 30% of the workforce) by next year. Telstra has also flagged a labour reduction, targeting 8,000 positions.

Unlike legacy networks, the greater automation employed by next-generation networks will allow telcos to evolve tiered pricing structures for corporate clients. Telcos will monetise the increasing demand for speed and connectivity, rather than becoming 'dumb pipes'.

Connected to incremental revenue

With the rollout of 4G, smartphone penetration grew rapidly, driving the 'app economy'. Similarly, the rollout and adoption of 5G, and the greater speed and capacity it offers, are likely to lead to more connected devices and new uses which are yet to be conceived. Think autonomous vehicles, augmented reality, surgery, wearable devices, gaming, smart homes etc.

This is all incremental revenue for a telco as it will leverage the existing infrastructure. Some investment will be required to capture this but, we believe, it will be within the current capex envelope (outside of the spectrum auctions).

The long-term picture

However, this will be a multi-year process. Most telcos will roll out a 5G network in line with customer demand, but customers will wait for 5G-enabled handsets to hit the market.

Samsung and some of the Chinese handset manufacturers are due to launch 5G-enabled devices in the first half of 2019. But it won't be until Apple releases its 5G handset next year that we will see a consumer shift to 5G, given Apple has a 54% share of the handset market (according to Statista, market share of mobile devices in Australia, year to April 2018).

It is shaping to be a more positive environment for the communications sector over the next few years driven by new technology and new operating models.

Patrick Potts is a Research Analyst with [Martin Currie Australia](#), a Legg Mason affiliate. Legg Mason is a sponsor of Cuffelinks. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable. Please consider the appropriateness of this information, in light of your own objectives, financial situation or needs before making any decision.

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How is 2019 different from 2018?

James Bloom

Perhaps simply 'queasiness' is more fitting. Certainly, that's an apt feeling among investors following sharp falls in risk asset prices in the last quarter of 2018, again bringing into focus the question of asset allocation for the path ahead. While many of the surprise falls reversed, at least in part, through January 2019, it's important to consider what may have driven the sharp declines. Are they symptomatic of a more prolonged malaise or a temporary setback?

It's hard to ignore the secular shift in the comparable risk/reward metrics of major asset groups. Sharemarkets rewarded investors almost without missing a heartbeat in the entire post-GFC environment, buoyed by central bank monetary stimulus. The combination of a stable tiller and cheap money was an intoxicating mix. But now, perhaps if the initial US experience is anything to go by, we're seeing for the first time in a long while the impact of having 'the training wheels off' and of borrowing costs moving back to a more normalised level, on a jittery equity market.

Fixed interest became relatively more interesting

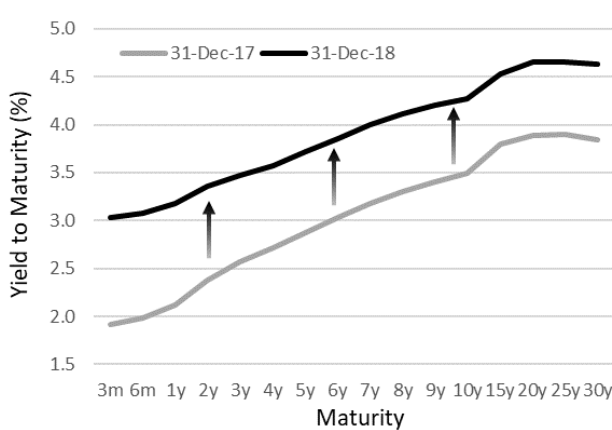
What we are faced with today is a shifting set of relative market dynamics combined with a much less certain political landscape, with neither being especially 'equity friendly'.

One thing that is arguably *different* now as we contemplate future asset allocations is the risk premia or simply the forecast return spread between cash and bonds, and equities. The ~1% cash rate return of the past decade was utopia for equities. Dividend yields of 4% or 5% made them the darling of any asset allocators tool kit. But now that cash rates in the US exceed 2%, the equity dividend yield return spread is less attractive.

And that's before we factor in the tailwind that a rising rate environment ultimately brings to sovereign and credit yields. There may be some pain as rates rise if duration exposure is left unhedged, but the forward-looking returns from those bond assets today look more appealing. US 10-year Treasuries continue to oscillate around the 3% mark, and investment grade credit yields sit comfortably above 4% at the medium-to-long end of the curve.

Chart 1 illustrates the forward-looking benefit that the combination of sporadically widening spreads and rising rates – which characterized much of 2018 – provides to bond investors. They give higher yields across the maturity curve with no discernible elevation in the level of default risk. Suddenly, an equity dividend yield of even 5% doesn't feel quite as rich, and certainly not on a risk- or volatility-adjusted basis.

Chart 1: Investment grade corporate bond yield curve



Source: Bloomberg as of 31/12/2018 using Bloomberg's BVAL USD US Corporate Investment Grade Yield Curve. The yield curve is constructed using USD senior, unsecured fixed rate bonds issued by US investment grade companies.

All this in a climate of political instability brought about by populism and anti-globalism and protectionism with the power to materially disrupt global trade and harmony, and an increasingly embattled Donald Trump.

In 2018, defensive asset allocations won

After all the noise of 2018, those carrying the most defensive strategic asset allocations emerged victorious. It was a worthy reminder that through cycles there will always be periods where it pays to bias your objectives towards preserving money just as much as growing it. Regardless of whether risk asset volatility of the past couple of months proves to be temporary or more sustained, higher cash and bond yields signal a harder environment for equities to maintain the strong competitive edge that they have enjoyed over the past decade.

Chart 2: Short-term Treasuries top returns



However, our responsibility as investors to those that entrust their money to us means that we cannot sit idly by. This environment has developed as one where optimal balancing between prudent defense and sensible return-seeking becomes paramount.

To borrow from Nat King Cole, while there may be trouble ahead, we must face the music and dance. But perhaps from a safer point on the dance floor not too far from the exit should a hasty retreat become necessary.

James Bloom is Managing Director, Investor Relations at [Kapstream Capital](#), an affiliate of Fidante Partners. This article is for

general information, not financial advice. It has been prepared without taking into account any person's objectives.

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Top 10 ESG issues for 2019

Kristen Le Mesurier

Investors around the world take environment, social and governance (ESG) issues into account when deciding where to invest, how to invest and how to measure returns. The ESG issues most likely to come under the microscope this year include some old favourites and a few new ones.

1. Climate change

Three years after the Paris Agreement promised to cap global temperature rises to below two degrees celsius, there is little agreement among governments on how or what to do to lower carbon emissions.

Nevertheless, businesses have started investing for a lower carbon economy and investors are calculating how exposed their investments are to changes in global temperatures. The investment risks can be grouped into four key categories:

Physical risks	Indirect risks	Policy risks	Transition risks
Damage due to physical impact of volatile and extreme weather.	Secondary financial impacts of extreme weather, such as lower crop yields.	The financial impact of regulators altering climate change policies.	The changing of the value of a business as economies transition to renewables.

These risks are not clear-cut or easy to measure but investors in 2019 are asking companies to set goals around a transition to a renewables economy.

2. Regaining community trust

Following the Financial Services Royal Commission, investors are focusing more on issues at the core of the Commission: culture, remuneration and enforcement activities by the regulators.

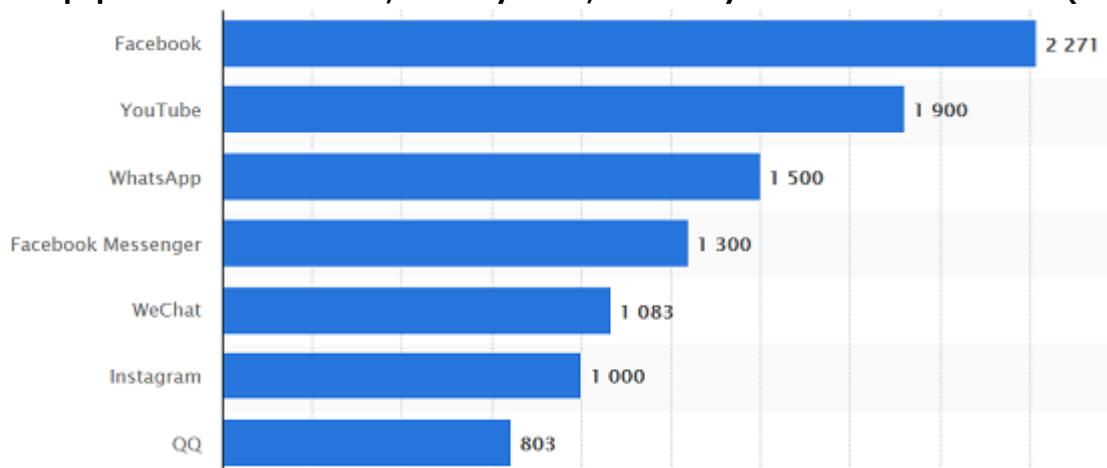
Investors will consider processes and culture, especially where sales and profit targets rank against customers' best interests. Attention is placed on regulators enforcing breaches of the law through the courts, which may impact companies' profits and potentially their business activities.

3. The ethics of investing in social media

Social media users are typically happy to provide their personal information in exchange for free use of a platform. They provide this information assuming it will be handled and used in ways they expect. Trust is key. If user data is sold, stolen or mishandled, consumers will question the safety of their information, undermining the social media companies' business models.

The way social media companies respond in 2019 to laws and regulations being passed by governments to deal with privacy and the protection of users' data will be critical to the success of the companies.

Most popular social networks, January 2019, ranked by number of active users (in millions)



Source: Statista

4. Access to medicine

Most Australians have access to affordable medicine, thanks to the pharmaceutical benefits scheme. Residents of many other countries, both rich and poor, are not so fortunate.

Some investors have been supporting a right of access to medicine for many years. AMP Capital signed the Investor Statement on Access to Medicine in 2016, an initiative that ranks global pharmaceutical companies on their efforts to balance profit with purpose, acknowledging the tension between affordable access to medicine, the need to cover expensive research and development costs, and a financial return to shareholders.

5. Investing for impact and the UN Sustainable Development Goals

Impact investing, whereby an investor looks for a social return as well as a financial return, is growing rapidly in Australia. The size of the local market more than quadrupled between June 2015 and December 2017, mostly in green bonds.

The global market for impact investing is now worth around US\$228 billion in assets under management. The majority is invested in food and agriculture, financial services and energy.

Many projects are in emerging markets including Asia and Africa. But there are a growing number closer to home. The next frontier in Australia is set to include affordable housing.

6. Palm oil and deforestation

Palm oil is the most commonly used vegetable oil in the world because it has a long shelf life, can be used in everything from detergent to chocolate, and is higher yielding than most other oils. It is also the most controversial because it is produced in tropical rainforests and has led to some significant rainforest and biodiversity destruction in Asia.

Deforestation has led to a range of negative environmental impacts: carbon dioxide emissions, loss of pristine forests, soil erosion, air pollution, and loss of habitat for animals including orangutans, elephants, rhinos and tigers.

While some global initiatives have been put in place, challenges remain and investors are responding. They have started calling for better auditing and tracing of palm oil right back to the plantation.

7. War on Plastic – the circular economy

In 2018, waste became a key environmental issue for Australians. China stopped taking our recycling leading to huge stockpiles in warehouses all over the country. Around the same time, our largest supermarkets – Woolworths and Coles – banned single-use plastic bags.

At current rates of urbanisation and population growth, global waste is estimated to rise to 2.2 billion tonnes per year by 2025, which translates into 1.42 kilograms of waste per person per day. Australians generate 53 million metric tonnes of waste every year, or about four kilograms per person per day.

Waste management hierarchy



Source: Waste Management Association of Australia, "Never waste a crisis: the waste and recycling industry in Australia", Senate Environment and Communications References Committee, June 2018.

In response, businesses and investors are now talking about the circular economy – that is, a system without waste and pollution where materials are used and reused.

There have been some exciting initiatives. In 2017, Apple issued a green bond to fund the research and development of recyclable material for its iPhones. Coca Cola has committed to collecting and recycling the

equivalent of all its packaging by 2030 and McDonald’s claims that all of its packaging will come from sustainable sources by 2025.

8. Modern slavery and supply chains

Six years ago, the treatment of workers in clothing factories in Asia was exposed when a factory in Bangladesh burned down, killing 1,100 garment workers. Encouraging progress has been made on worker rights and safety in the country since then, partly as a result of investor engagement. But there is much more work to be done.

Workers are still not paid enough to live above the poverty line and there are many barriers to union representation and collective bargaining.

Minimum wage in A\$/hour



Note: Exchange rate used is 1 USD = 1.25 AUD.^{23, 24}

Source: Oxfam Australia, "What She Makes. Power and Poverty in the Fashion Industry." October 2017.

The Australian government took an important step last year by introducing a Modern Slavery Act which effectively forces large Australian businesses to understand the risk of slavery in their operations and supply chains. We expect even more attention on the treatment of the world’s factory workers in 2019.

9. Child labour in cocoa

Cocoa production is labour intensive. Farm wages are low and the use of child labour is widespread. More than two million children are estimated to work on farms in West African countries. Côte d’Ivoire and Ghana are the two countries that account for almost 70% of cocoa production worldwide.

Chocolate producers first started committing to take steps to combat child labour in 2001 and in 2010 committed to reduce the worst forms of child labour by 70% by 2020.

Our Responsible Investment Leaders funds have joined a global investor initiative, alongside investors that have been working with Nestlé, Mondelez, Hershey’s, Lindt & Sprüngli, and Cargill to identify and remediate cases of child labour.

10. Antibiotics in our food supply: human resistance to antibiotics

This year, antibiotic resistance is estimated to claim about 50,000 lives in the US and another 50,000 lives in Europe. The numbers are much higher in developing countries with high rates of malaria, HIV or tuberculosis.

By 2050, it is estimated that 10 million people globally may die every year because of antibiotic resistance. This exceeds the number of people who currently die from cancer every year.

The potential health and economic impacts are enormous and likely to be key public health issues and a focus for ESG investors in 2019. We expect investors will increase their levels of engagement with companies in the food and agricultural industries, calling for better disclosure and the reduction, or in some cases abolition, of antibiotics use in farming and food production.

Conclusion

The relevance of ESG issues has never been greater. Investors want data on, and progress around, some of the biggest ESG challenges. Get ready to hear much more about it throughout 2019.

[Learn more](#) about AMP Capital's ESG commitment.

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How populism heightens portfolio risk

Jacob Mitchell

Around the world, political leaders are finding success selling deceptively simple answers to difficult questions, using the failings of free trade and mass migration as a convenient whipping boy for rising inequality.

Giving a voice to people's frustration is one thing, but addressing the cumulative long-term effects of privatisation, de-regulation, corruption and technological change that have silently eroded the economic rights of the individual is another. Investors need to be aware of this.

A global economy flush with cheap capital has not helped, generating asset price inflation to the glee of the wealthy and accelerating a boom in skill-biased technological innovation. Arguably, it is the failure of policy makers to equip their labour forces with the skills of the future that has been the most profound contributor to the growing angst around wealth differentials.

Equal opportunity and unequal reward

The real question for policy makers is how to return opportunity to the people, with the societies that prove more resilient being the ones that can afford to balance the need for equal opportunity with unequal reward.

What matters for investors is that populist policies almost always result in looser fiscal policy, often at the expense of productivity-enhancing structural reform with negative short-term social consequences.

The euro area is a case in point. Following the European sovereign crisis, the European Central Bank embarked on an asset purchasing programme to create a more favourable environment for unleashing market mechanisms in Europe's rigid economies and bloated welfare systems. It was a precondition for steady and balanced growth. The short-term impact of fiscal austerity, for example, created socio-political problems of rising unemployment and falling state revenues. It created a policy outcome no euro area government had a mandate for. Witness the social turmoil and political changes in Greece, France, Italy, Spain and Portugal as these countries experienced a powerful pushback to labour reform and austerity.

The rise of populism across Europe has also been accompanied by a surge in tensions between autonomists and centralisers, with the potential to further exacerbate fiscal risks. Interestingly, this trend is not a reaction to economic woes, being most pronounced in Europe's most successful regions. Northern Italy, the wealthiest part of the country, has long flirted with the idea of floating off to form a country called Padania. Catalonia, the most productive part of Spain, has been fighting for independence to cut its payments to poorer Andalusians. The continent's integration was meant to solve such questions, but they are surfacing once more to the angst of Europe's leaders.

Not even the United Kingdom, where the House of Commons plays the role of one of the oldest representative institutions on Earth, has been immune to the spread of populism. Britain has succumbed to the populist wave because it decided to apply the most powerful tool in the populist toolbox – the referendum – to the most profound question regarding its relationship with its main political and economic partner. While the visible result has been the re-shaping of British politics by 'Brexiters' claiming that the people have spoken, the less visible result has been a constitutional revolution. Before the referendum, Parliament reflected the best interests of the sovereign. Now, for the first time in Britain's parliamentary history, MP's feel obliged to give in to a populist revolution.

Recent events in Italy are a timely reminder that populism, fiscal policies, bank balance sheets and lending to the private sector are inextricably linked.

Through rising yields, bond markets sanction any perception of unsound fiscal policies likely to aggravate budget deficits and public debt, or in the case of the euro area, violate commitments to deficit and debt targets.

Rising bond yields shrink the value of bank assets which consist of large holdings of government bonds, in turn making banks more risk averse and less inclined to extend credit to the private sector.

With Trump's populist policies seeking to widen US fiscal deficits to levels last seen in times of war or recession, markets may soon begin to discount the US government's EM like sovereign risk profile and increasingly limited fiscal firepower.

With the populist locomotive now set in motion, increasing political risks have the potential to stress nations that have rapidly accumulated both public and private debt, reliant on external capital despite weaker institutional frameworks.

Set against the backdrop of tighter global monetary liquidity and the potential for slower growth and higher inflation, the financial and political tail risks are elevated.

Recent overindulgence

A decade of overindulgence has led to another set of risks. As generationally-low interest rates and QE-induced yield curve flattening has throttled excess capital towards increasingly risky financial assets, investors have been willing to pay a premium for the illusion of durability in an uncertain world.

The bubble in 'structural' growth is perhaps the most poignant example. Technology products and their suppliers have changed the world, making up a higher proportion of global market capitalisation than ever before (globalisation has been a conduit for even greater industry concentration and risk).

Tending to dominate their early niches, businesses such as the FAANNGM's (an ever-expanding acronym), Alibaba and Tencent have generated tremendous value protected by deep competitive moats.

In search for further growth, investors are investing in their competitors. Whether it's Amazon and Netflix competing on content streaming or Amazon's Alexa threatening Google's core search business with its voice search capabilities, the titans are bumping heads.

For competing software and internet businesses, barriers to entry are being eroded. The ability to deploy, then effortlessly scale their technology on platforms offered by Amazon Web Services, Microsoft Azure and Google Cloud reduces up-front capital expenditure. Combined with large addressable markets and a boom in cheap venture capital funding, particularly in the US and China, the seeds for intensifying competition have been sown. The next frontier of technological disruption won't be so easily won.

Preparing for uncertainty

The challenge with the current environment is the number of low probability, but potentially material, events that are difficult to build a portfolio around.

Accordingly, over the long-term, we believe that a holistic framework for managing uncertainty is likely to prevail. At the position level, we seek to own attractively priced businesses with a margin of safety and investment resilience, characterised by multiple ways of winning.

Looking beyond the more simplistic model of regional or sector diversification, our investments are grouped into clusters that share overlapping sentiment, idiosyncratic, end-market and macro sensitivities. As stocks within clusters are likely to exhibit a higher correlation to each other, we limit cluster sizes to no more than 15% of the portfolio while attempting to minimise the correlation between clusters. In this sense we aim to control, to a higher degree, concentration risk within the portfolio and mitigate the impact of the unknown unknowns. We also employ multiple levers, such as longs, shorts, active currency and cash management, to offset building portfolio risk.

Jacob Mitchell is Founder and Chief Investment Officer of active global equity investment manager [Antipodes Partners](#). This article is general information and does not consider the circumstances of any investor.

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