

### This Week's Top Articles

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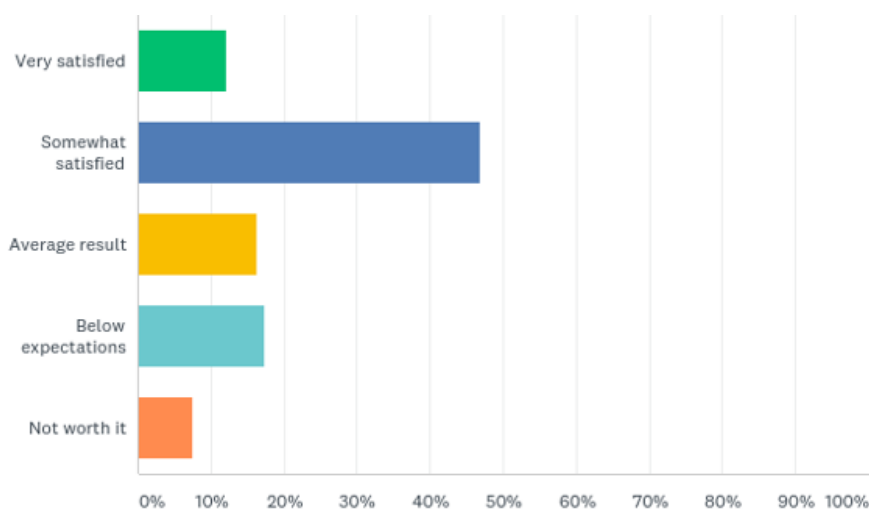
### Royal Commission survey: 12% very satisfied

Leisa Bell

About 850 readers fired up to share their reactions to the Financial Services Royal Commission. Here is a summary of the results, along with some of the comments received.

#### Q1. Overall, are you satisfied with the recommendations in the Final Report?

Although only 12% were 'very satisfied', the majority of survey takers (59%) were satisfied with Kenneth Hayne's recommendations.



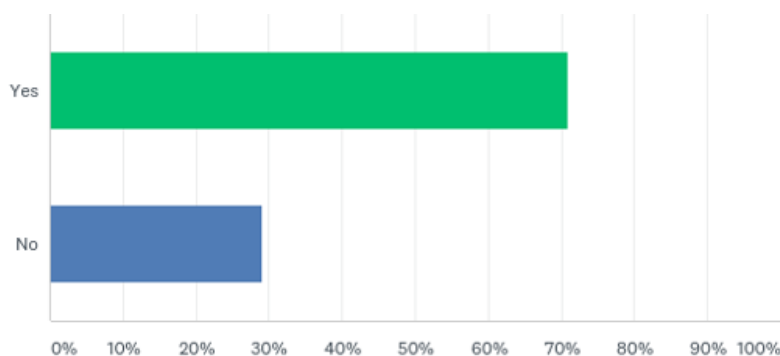
#### Comments

- Remember that the sole focus was misconduct
- Expected a 7 or 8 out of 10, give a 3 – more about politics than changing the landscape
- Execution of some recommendations may be quite difficult – the devil is in the detail

- No actual recommendations of prosecutions, therefore no disincentive
- Great job finding the ammunition, the RC just failed to fire their guns when the opportunity presented
- The Report on the whole is balanced
- Suggesting that customers pay home loan brokers will reduce competition
- A fee as a percentage of money under advice is still a trail commission and was missed
- The Commission did a great job and delivered a service to the hard working people of this country. The recommendations in the Final Report however are manifestly short of what is required to address the crimes uncovered. The banks must be laughing.
- The value of the recommendations depends on the implementation of reforms and that is hardly Haynes' problem
- Recommendations made with a complete lack of direct experience in individual financial disciplines. The recommendations on upfront commissions for Financial Planners (Life Insurance) & Mortgage Brokers reduces any independence and any opportunity for consumers to easily review other rates/life insurance premiums available in the market.
- Doesn't go far enough. Banks got off too easy. No one going to jail.
- Who is going to implement the recommendations when APRA and ASIC are embroiled in this?
- We should all remember that a Royal Commission can only report and recommend not punish, it's now up to Parliament

**Q2. Should the Commission have addressed vertical integration by separating financial advice from product manufacture?**

A clear majority wanted vertical integration addressed: 71% yes, 29% no.



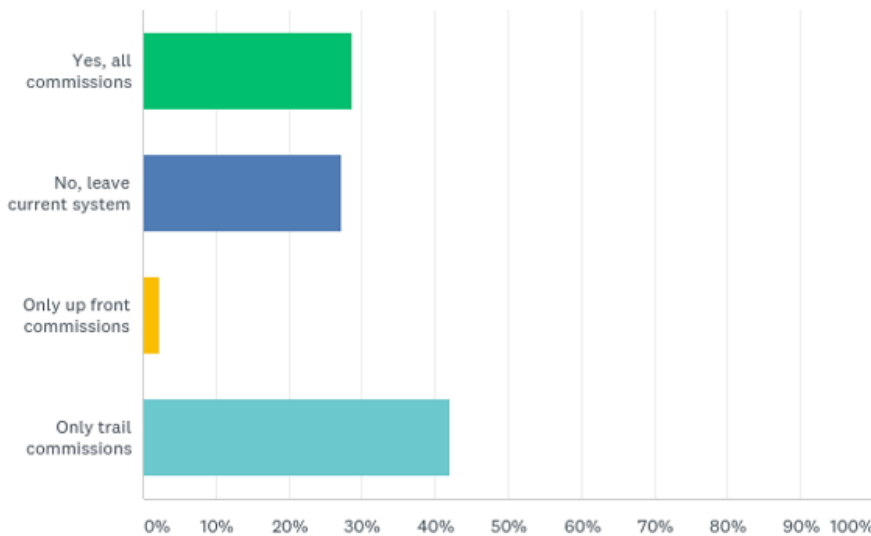
**Comments**

- One of the biggest issues wasn't tackled, very disappointed
- Advice led by internal product is never going to be in clients' best interests
- Customers should expect that by approaching a bank for advice they will only be offered products from that bank
- Always should have been. Advice and product must never be integrated. Sometimes best advice is to do NOTHING – no product
- What business would not expect its employees to promote its own products? The problem is the way the employees are remunerated
- Advisers are under an obligation to the client and if they take that role seriously it is easy to manage these conflicts. It is about being open and honest about them

- The UK gives an example of why banning vertical integration is bad policy, they are now changing as they realised the ban did not benefit consumers
- There needs to be greater disclosure to customers when vertical integration applies
- Must be removed. Product and Service/Advice are two distinctly different elements of providing great quality results for clients
- Vertical integration is satisfactory providing the right checks and balances are in place
- It is a ridiculous form of hypocrisy to suggest grandfathered commissions are conflicts that must be addressed, and then leave vertical integration alone
- Separation would not of itself end corrupt & unethical practices
- The conflicts are obvious – how can you recommend your own product unless you contrast it with other products to show that it is superior and in the customer’s best interest?
- Are the vast majority of people really getting bad advice? Get rid of the thieves for sure but pretty hard to say which Aus Share fund is better than the other. They all hold the same stuff!

**Q3. Is the Commission right to ban commissions for mortgage brokers?**

Not all people are against the idea of commissions, with 71% agreeing that some, if not all, should remain. A sizeable 42% of respondents believe just the trail commissions should be abolished, and 29% want all commissions banned.



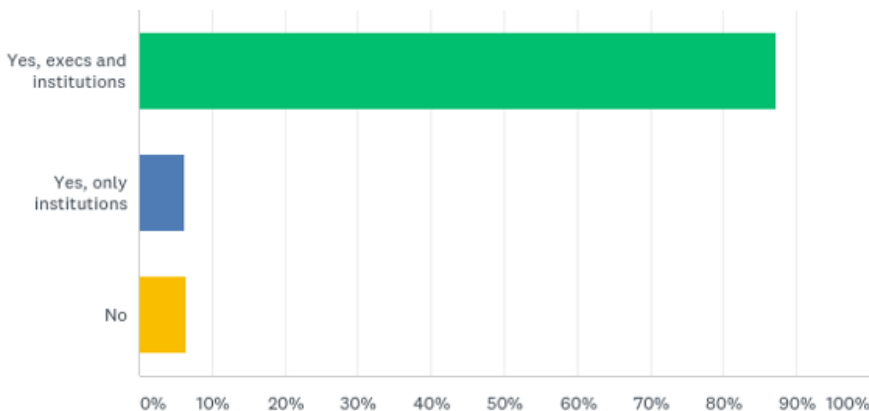
**Comments**

- May be worth a try at just scrapping them. They always do blur the line as to who the “adviser” is working for.
- They have a valuable role to play in the market. Find a way to transform that value into a new remuneration model.
- There needs to be more transparency, so clients know what the brokers are being paid to do.
- Need a fifth option. Mortgage brokers have helped mortgage competition. The system could regress from here. Maybe there is a better idea to limit/manage the ‘fees for doing nothing’
- Even though brokers are paid by banks they have helped produce a more competitive environment for borrowers. banning commissions will only help the banks, not consumers
- Leave it to the market to work itself out.

- Brokers are distributors not permanent advisers. They assist the bank with document completion and should be paid a distribution fee but not a commission as an incentive to continue to favour a particular lender.
- Trail commission doesn't make sense as rarely have I seen a broker regularly check in with their client.
- As long as the trail commission value is returned to customers not retained by the banks.
- I believe there is a positive role for brokers but controls need to be much stronger.
- Trail commissions reward the broker for getting their client into the most suitable product for the longer term. There is not one person in Australia who will pay an upfront fee.
- I see them as increasing efficiency, and a help to smaller banks.
- Mortgage broking is just not tick and flick. Most of my clients have difficulty obtaining a loan as its now so complex. They are also busy. I search the best option, collate all the paper work, lodge the loan, liaise with the real estate agent/accountant/solicitor/vendor etc. to make sure the transaction is smooth. The current system works very well and clients are very happy.
- Brokers have a role and deserve to be paid for that work. Maybe greater transparency required, but there is an element of "buyer beware" here.
- It appears that Hayne did not understand the true role of mortgage brokers i.e their responsibility continues after the mortgage is established.

#### **Q4. Should regulators prosecute in court more often as recommended by Hayne?**

The strong words from ASIC since the Final Report was released are supported by the majority of responses. More than 87% said that both institutions and executives should be subject to prosecution for misconduct more often. Only 6.5% of respondents thought regulators should not increase prosecutions.



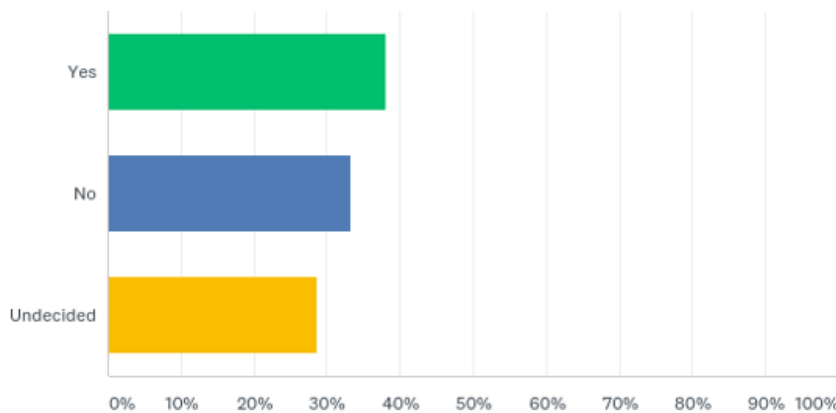
#### **Comments**

- The message that they are real crimes will not be evident unless there is prosecution.
- The threat of legal action 'should' positively affect behavior but want to avoid extending the lawyers' picnic
- But be selective about which cases to prosecute – don't waste resources on minor infractions.
- There should be clear guidelines on prosecution against executives. Ultimately, this may lead to some areas of higher executive pay as there is increased risk for execs.
- ASIC ceased taking parties to court because they kept losing cases. It was cheaper and more effective for ASIC to use enforceable undertakings. ASIC should continue to use EUs but not allow compromise by way of negotiation to the extent used in the past.
- The cost of litigation will be passed on to retail customers and paranoid institutions will become even more so.

- Executives need to take responsibility for their actions or lack of action.
- Executives are the people who implement the moral compass of a business and set the example.
- As an ex regulator I would agree that often the enforceable undertaking achieves what you would have in court, just for a lot less money. But there are egregious examples who will only ever understand a custodial sentence.
- I suspect ASIC isn't necessarily up to task and that industry will improve (anyway) following the report.
- It is disgraceful that shareholders' funds are used to pay for mistakes by executives who are still receiving rewards by way of bonuses.
- The regulator is there to regulate within the law so this must include courts.
- Like with our children, if there is no real punishment, the behaviour will continue.
- Gross breaches should be prosecuted but regulators need to guard against an overzealous approach to breaches that involve little or no loss to customers.
- In the absence of proper ethical standards, the law sets a minimum standard which must be imposed, or the law is hollow.
- Only if serious infringements of duty.
- Laws were already in place they just weren't used.

**Q5. Is Hayne correct to leave the implementation of his recommendations to regulators?**

There was an even spread of opinion on whether regulators should be guiding the implementation of Hayne's recommendations, with 38% supporting, 37% opposed, and 29% undecided or believe that it's too early to tell.



**Comments**

- Difficult to see ASIC or APRA change their spots.
- I just hope that they are selective and prioritised.
- I doubt much will change, regulators appear too afraid of embarrassing themselves when litigation fails.
- Regulators have turned a blind eye to obvious conflicts on interest for too long. We'll have to wait and see whether they now step up and enforce the law, particularly the obligation to act in the client's best interest.
- I agree that sufficient regulations are there now, they just need to be enforced properly and publicised.
- Regulators need to be accountable for the administration of financial regulation. Early enforcement will enable the industry to adopt compliance programs.
- Yes regulators should implement the changes, however, there needs to be MORE consultation regarding unintended consequences.

- Who else is going to implement his decisions if not regulators and legislators? It was never his role to go further.
- The regulators and their financing need attention now and in the future. Certainly bravery is needed.
- Knowledge can be a powerful thing. Put it on the record.
- Need to be careful not to over regulate and they now know if they prosecute they will get community and political support.
- Regulators need to be better funded to execute their obligations.
- What are the consequences for regulators who do not do THEIR job?
- Regulators are too often at the mercy of their political masters.
- Provided they have the right people who understand the industry no ex public servants who have no idea how the industry operates.
- Regulators and Industry to work together.
- The regulators have the responsibility to conduct such actions. If they perform poorly change the personnel in the regulators.
- The regulators should do what they are paid to do and should be resourced accordingly.

**Q6. How likely are you to change any of your financial service providers as a result of the Royal Commission?**

After excluding answers of 'not applicable', an average of just 15% of people indicated they were likely or very likely to change financial service providers following the Royal Commission. The providers highest on people's hit list were wealth/fund managers and financial advisers/planners with a dissatisfaction rating of more than 17% each. Least likely to be affected was insurance providers at just over 13%.

Changing superannuation fund/SMSF topped the 'very unlikely' category with 56% saying they would not consider a change. However, a decent number of 13% are 'likely' or 'very likely' to change.

	Very likely	Likely	Unlikely	Very unlikely
<b>Wealth or fund manager</b>	6.95%	10.34%	38.50%	44.21%
<b>Main bank relationship</b>	4.87%	10.13%	38.46%	46.54%
<b>Home loan provider or lender</b>	6.34%	9.82%	38.24%	45.60%
<b>Insurance provider</b>	6.58%	7.87%	39.97%	45.59%
<b>Financial adviser or planner</b>	8.58%	8.82%	35.50%	47.10%
<b>Superannuation fund or SMSF</b>	5.72%	7.39%	30.68%	56.21%

**Q7. What did the Royal Commission miss or any other comments?**

As question 7 was an open-ended question, with some 350+ comments, a selection can be [viewed in the accompanying article](#) this week.

*Leisa Bell is Assistant Editor of Cuffelinks. These comments by readers are shared in the interests of informing our community and no responsibility is accepted for their accuracy or fairness.*

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## What you think the Royal Commission missed

Graham Hand

The results of the reader survey on the Royal Commission are summarised in [another article this week](#). The response was excellent with about 850 people completing the full survey.

The seven questions drew hundreds of reader comments, too numerous to include them all, but here is a [long selection](#) from the open-ended final question. Some have been edited. These reader comments are shared in the interests of informing our community and no responsibility is accepted for their accuracy or fairness.

## Assessing Labor franking policy options

Damien Williamson

The Labor Party franking credit proposal to scrap the cash rebate when franking credits exceed tax payable has come under renewed scrutiny. The unapologetic response from Shadow Treasurer Chris Bowen on ABC radio to a retiree that would be \$5,000 a year worse off under the policy fuelled the fire:

*"I say to your listeners, if they feel very strongly about this, if they feel that this is something which should impact their vote, they are of course perfectly entitled to vote against us".*

Given the opinion polls currently indicate it is highly probable that Labor will win the 2019 Federal Election, a frequent question raised is the impact the implementation this policy will have on hybrid valuations. When this policy was first proposed on 13 March 2018, the hybrid market reacted by the average trading margin on major bank hybrids rising 23bp over the following three trading days.

In quantifying the impact on an SMSF in accumulation phase, we considered the following example of an SMSF that currently only holds one asset, a Westpac hybrid (ASX:WBCPH):

- a \$600,000 investment in WBCPH generates \$22,050 cash and \$9,450 in franking credits.
- the SMSF would lose a surplus franking cash rebate of \$4,725 under the Labor policy.
- to maintain the same level of after-tax income, this investor allocates \$300,000 or half their WBCPH holding into an investment such as NB Global Income Trust (ASX:NBI), a high yield corporate bond fund which carries no franking credits in its interest payments.
- assume both WBCPH and NBI pay 5.25% per annum.

The results are shown below.

In holding only the Westpac hybrid under current rules, gross income including franking of \$9,450 is \$31,500 (\$600,000 X 5.25%). This is taxed at 15% or \$4,725, to give cash income after tax to \$26,775.

Under the Labor proposal, the surplus franking rebate of \$4,725 will be lost, reducing cash income after tax to \$22,050.

Following the switch to a bond fund without franking, the smaller franking credits balance can be fully used by the 15% tax. In effect, more of the return is in the form of unfranked dividends, returning the SMSF to income after tax of \$26,775.

**Figure 1: Income impact of ALP franking policy on hybrid investment portfolio**

<u>Investments:</u>		<u>Gross Income:</u>		
Westpac Capital Notes 5 (WBCPH)		5.25%: 3 month bank bill (2.05%) + issue margin (3.20%)		
NB Global Income Trust (NBI)		5.25%		
<u>Policy / Portfolio</u>	<u>Coalition / Existing</u>	<u>ALP / Existing</u>	<u>ALP / Reallocation</u>	
WBCPH	\$600,000	\$600,000	\$300,000	
NBI	\$0	\$0	\$300,000	
<u>Income</u>				
WBCPH Cash	\$22,050	\$22,050	\$11,025	
WBCPH Franking Credits	\$9,450	\$9,450	\$4,725	
NBI Cash Interest	\$0	\$0	\$15,750	
<b>Gross Income</b>	<b>\$31,500</b>	<b>\$31,500</b>	<b>\$31,500</b>	
Tax Payable at 15% (SMSF)	\$4,725	\$4,725	\$4,725	
Franking Offset	-\$4,725	-\$4,725	-\$4,725	
<b>Tax Payable (cash)</b>	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>	
Cash Income: WBCPI & NBI	\$22,050	\$22,050	\$26,775	
Surplus Franking Cash Rebate	\$4,725	\$0	\$0	
<b>Cash Income After Tax</b>	<b>\$26,775</b>	<b>\$22,050</b>	<b>\$26,775</b>	
<b>Surplus Franking Cash Rebate Lost</b>	<b>\$0</b>	<b>\$4,725</b>	<b>\$0</b>	

SOURCES: COMPANY DATA, BELL POTTER SECURITIES ESTIMATES

Reallocating investments away from the capital structure of banks to an offshore high yield income trust is likely to increase bank funding and capital costs, although there are many holders such as institutional superannuation funds who will still claim the full refund to offset tax liabilities.

The availability of this investment strategy also brings into question the quantum of revenue the policy will generate. Of course, the assets have also changed, giving the investor a different risk profile.

*Damien Williamson is an Analyst at [Bell Potter Securities](#). This article is general information and does not consider the circumstances of any investor.*

## What game is your fund manager playing?

Charles Dalziell

An excellent article by Shane Parrish on [Farnam Street](#) highlights the necessity of choosing to play the long game in order to achieve success in any given pursuit. Investing is no different.

As Shane points out, when it comes to life (and investing) we tend to overestimate the importance of luck on success and underestimate the role of making the small, every day choices that will eventually lead to success. Too often, we convince ourselves that another's success was just luck. We comfort ourselves with the idea that highly-successful investors like Peter Lynch and Howard Marks are merely the statistical outliers found in every game of chance. The reality is they aren't. They are playing a different game to the rest of us. They play the long game.

*Success is simply a matter of luck. Ask any failure. – Earl Wilson*

### The long game is harder than it sounds

With investing, the long game is hard to play, and frankly, it can be dull. It usually involves meticulous research, countless meetings, fact checking, number crunching, statistical analysis and rigorous peer review. But the results can be exceptional. The long game changes how you think about and conduct your investments.

Doing what everyone else is doing pretty much ensures that returns will be average. Doing something different or contrarian takes thought, discipline and a process that gets the details right and minimises mistakes. Doing the small things well everyday eventually compounds into something bigger.

By contrast, the short game involves forgoing the difficult or mundane jobs for activities which feel productive but are often not conducive to better investment decisions. The share market in particular bewitches investors with the promise of riches every day, but it is a conduit for transferring wealth from the lazy to the well informed. Watching stock prices rise and fall on screens, reading the on-line financial press, chatting to stockbrokers, checking emails and trading a portfolio for no other reason than 'it feels right' all look like useful activities. They aren't.

### **Many activities are simply distractions**

They are in fact distracting from what investors really need to be doing. Falling into this trap is easy, even for professionals. The short game offers promises of easy gains through 'foolproof' trading systems, hot tips from friends and stockbrokers or just because gut feel says a stock is going up or down. It is the difference between investing and speculating. For example:

- Why study a company's remuneration report when I can get my favourite stockbroker's view on it over lunch?
- Why try to understand financial statements when the latest research shows changes in consensus earnings forecasts are key drivers of stock returns?
- Why bother with fundamental analysis when I can add value trading the portfolio all day using price momentum and my gut feel?
- Why write-up questions before a company meeting when I can ring an analyst and ask their opinion?
- Why think about where a company will be in five years when it's the next quarter's earnings that count?
- And so on and so on ...

In the absence of a big chunk of good luck, the negative effects of the short game multiply the longer it is played. On any given day, the impact is small but as days turn into months and years the results usually compound into disastrous performance. Fund managers who play the short game don't realise the costs until they become too large to ignore. By then, it is too late.

Playing the long game may mean some suffering today with no guarantee that it will add value. Finding good ideas takes time and patience. Stock pickers have to kiss a lot of frogs before they find their prince or princess. Most people don't like to suffer and when they see the ultimate success of others, they do not realise the many arduous steps it took to achieve that success.

*I fear not the man who has practiced 10,000 kicks once, but I fear the man who has practiced one kick 10,000 times – Bruce Lee*

### **Sorting out the long term from the short term**

Many investment managers will say they play the long game, but how do you really know which game a manager is playing?

Short-term performance (5 years or less) isn't always a clue because managers can get lucky with their stock selection or ride a wave of a temporary positive thematic. Strong, above average performance over 7-10 years is good and over 20 years is great. It's much harder to fluke long-term returns.

Stock turnover is another good indicator. Fund managers who are playing the long game rarely have high stock turnover above 60% or more because good ideas are so hard to find and detailed research takes time. Knowing exactly why you own a stock is the key to weathering and profiting from share price volatility. Not having an investment thesis leads to wild and erratic share trading that destroys returns.

Another clue is a clearly articulated investment philosophy and process for beating the market. Do the manager's actions and stock holdings reconcile with their articulations? A good stock picker should not hold a portfolio of 300 names, for instance. Few individuals can know more than 15-20 stocks really well.

Manager incentives can be a good guide. Manager incentives can be heavily weighted towards short-term performance which can lead to behaviour that is in the interest of the fund manager but not in the best interest of the client. An incentive scheme that is weighted towards long-term performance much better aligns the interests of both parties.

Firm ownership can also be important. Playing the long game can lead to periods of underperformance. Having an ownership structure that is supportive during periods of underperformance ensures the interests of clients are best served in the long run.

Playing the long game doesn't guarantee success but it is a key to achieving success. While some people win through sheer dumb luck, they are the tiny minority. Picking a manager who is playing the long game is the best way to maximise the chance of achieving compound investment returns that are materially better than average.

*Charles Dalziell is an Investment Specialist at [Orbis Investments](#), a sponsor of Cuffelinks. This report constitutes general advice only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.*

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## Welcome to the Great Australian Deleveraging

Roger Montgomery

Record levels of debt accompanied by declining asset prices means we have entered a deleveraging phase putting other spending on the backburner.

There's a lot of chatter about the reasons why retail sales, consumer foot traffic, car sales and housing activity have plunged. From US/China trade tensions, to wobbles in the Chinese economy itself, to plunging house prices and to the upcoming Federal Election, analysts, brokers and commentators have taken a shotgun approach to pointing at the catalysts and causes.

The explanation however is much simpler.

### Unprecedented household borrowing

In 2011, a study of the determinants of debt by the University of New England's Sam Meng, Nam Hoang and Mahinda Siriwardana observed:

*"Household debt in Australia has grown at an astonishing rate since the 1990s ... the debt-income ratio jumped from 70.6% in 1990 to 162.8% in 2005. To put this into perspective, the average Australian household would have to work more than one and a half years just to pay off their debt."*

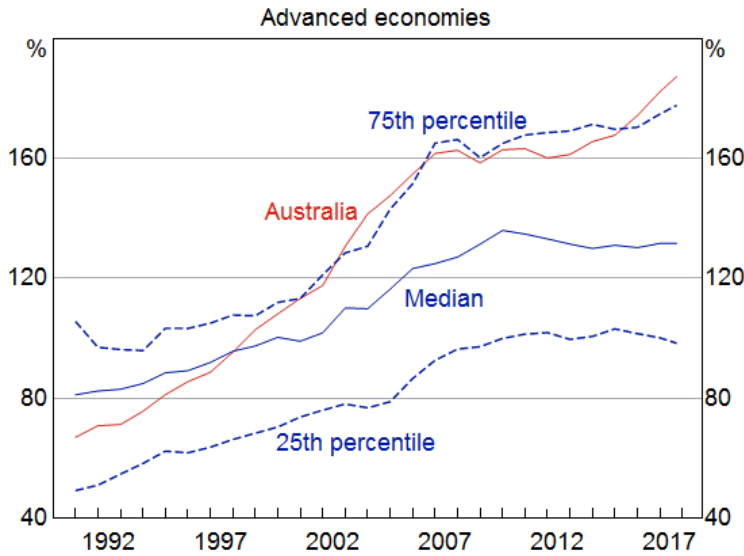
But that was then. Since 2005, Australia's household debt has continued to soar. There is a simple explanation for the rapid increase in debt. Debt capacity is a function of its price. If interest rates halve, the borrower can 'afford' almost twice as much debt when borrowing interest-only, with no change in their income.

In September 2018, Michele Bullock, the Reserve Bank Assistant Governor responsible for the area that focuses on financial stability, observed that household debt in Australia has been rising relative to income for the past 30 years, and from around 70% to around 190%. Thank three decades of falling interest rates for that.

As the chart below reveals, Australia has not been unique in experiencing rising debt-to-income ratios. While the median ratio for a range of developed economies has also risen over the past 30 years, Australia's debt-to-income ratio has risen more sharply. In fact, Australia has moved from the bottom third of countries sampled to the top quarter.

**Australia's debt binge relative to developed economies**

**Global Household Debt-to-income Ratios**

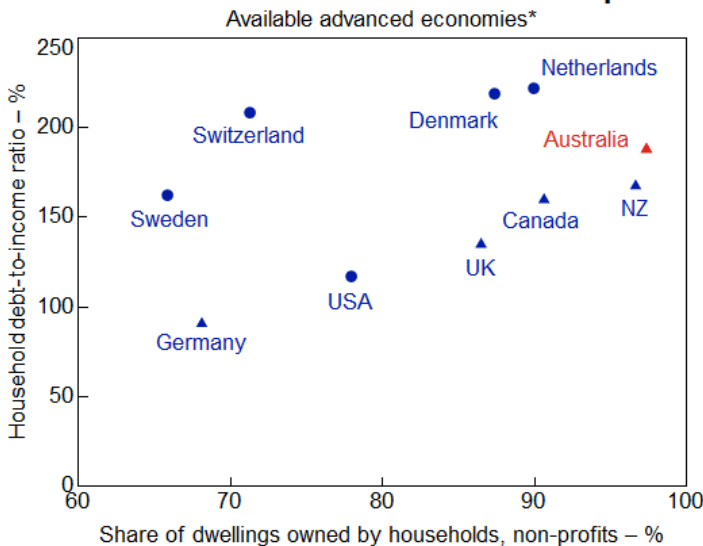


Sources: national sources; OECD; RBA

The reason for the acceleration is householders' belief that everyone can be a millionaire property mogul. Bullock observes, more diplomatically,

*"the increase in household debt over the past few decades has been largely due to a rise in mortgage debt. And an important reason for the high level of mortgage debt in Australia is that the rental stock is mostly owned by households ... This is different to many other countries where a significant proportion of the rental stock is owned by corporations or cooperatives."*

**Household Debt and Ownership**



\* Circles represent countries where owner-occupier mortgage payments are tax deductible

Sources: national agencies; RBA

In other countries where the yield on rental properties is much more attractive, 'mums and dads' don't invest as much in property. But here in Australia, where the net returns are often negative, mums and dads have piled in on top of each other to get a piece of the action. In other words, would-be property moguls are committing to purchases where savvier investors fear to tread.

The proliferation of unsophisticated 'mum and dad' property moguls must also increase the probability of price volatility. And most busts are preceded by a period where a broad section of the population believes they can 'get rich'.

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## Consequences of a period of deleveraging

On 15 February 2019, *The Australian* featured a story revealing terrifying house price falls. For example, for the year ending January 2019, Box Hill in NSW saw median prices fall more than 43%. In Victoria's Red Hill, prices declined almost a third. A raft of suburbs has also fallen between 17% and 40% in just 12 months. Of course, nobody should be surprised.

Billionaire investor Warren Buffett has previously warned against any complacency surrounding debt, noting:

*"It's not debt per say that overwhelms an individual, corporation or country. Rather it is a continuous increase in debt in relation to income that causes trouble."*

In their book [\*This Time Is Different: Eight Centuries of Financial Folly\*](#), Carmen Reinhart and Kenneth Rogoff noted that when housing booms are accompanied by sharp rises in debt, the risk of crisis is significantly elevated.

Australia's household debt must be reduced but the path that reduction takes has consequences for the Australian economy. One version of deleveraging allows for rising salaries to accelerate the repayment of debt but consumption still slows. A less desirable scenario sees no increase to income but rather an erosion of savings eventually forcing consumption cuts. Keep in mind, retail is the second largest employer in the country.

Finally, a much more volatile outcome adds rising mortgage interest rates (out-of-cycle possibly), which adversely impacts household budgets, producing negative equity, heavy debt burdens and a full-blown economic or financial crisis. Consumers are then left with an extremely high level of gearing, such that a small change in their income makes a big difference to their discretionary spending. The rollover from fixed rate to variable rate mortgages could be part of this income shock.

A hypothetical ability to increase debt levels allows a consumer to pay more for a property, or to spend more on goods and services beyond the amount of income earned. But when the cost of debt increases, the need to reduce debt levels sends everything into reverse. Consumers need to spend less than they earn, or the amount they can pay for a property declines. Both are now evident in Australia.

Throughout modern history, financial crises have been followed by an average of six or seven years of deleveraging. But deleveraging can occur in the absence of a crisis. This is where credit growth lags GDP growth – call it "belt tightening". Such debt-to-GDP ratio declines, in the absence of a crisis, have been observed in Canada (1988-1994), Switzerland (1969-74), Belgium (1997-2004), Ireland (1988-1994) and in many other countries.

### My biggest worry

With house prices now declining substantially, their record debt is what households will focus on. The biggest concern I have, that many analysts seem to ignore until its transpiring, is that, after house prices begin softening, the savings ratio begins climbing, reflecting a lack of consumer confidence (note Westpac's reference to confidence 'evaporating' below) leading to a much more rapid slowdown in the economy.

Credit growth is already slowing and possibly faster than GDP. And that means a decline in retail spending, precisely what we are now seeing. Big ticket items are the first to see the tide go out. National Mercedes sales fell 43% year-on-year in November 2018 and Ford sales fell 41%. Retail fashion sales slumped 3.8%, and while foot traffic plunged, Westpac reported consumer confidence had 'evaporated'.

Following any debt binge there must be a period of indigestion, followed by digestion. During a period of deleveraging, there is a much higher risk of negative surprises. Therefore, Australia is likely to enter a period of greater volatility in asset prices and economic conditions. For many borrowers now under water, the period of digestion will mean slow and steady repayments, for others at the pointier end of debt-to-income spectrum, expect forced asset sales.

In the meantime, whichever path is taken to reduce debt, expect retail sales and house prices to soften further. And then expect some time to pass before any sustained recovery occurs.

Welcome to the GAD – the Great Australian Deleveraging.

*Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](#). This article is for general information and does not consider the circumstances of any individual.*

## Global ETFs: insights into a multi-trillion-dollar industry

Ilan Israelstam

We recently launched the first edition of the quarterly [BetaShares Global ETF Review](#) to analyse key trends and developments in the industry outside Australia. Looking at more mature ETF markets globally gives insights into the potential future for the Australian market. The global review complements our monthly Australian-focused publication on the local ETF industry.

The full report is available for download, but I've captured key highlights below.

### Index strategies dominate investor preferences

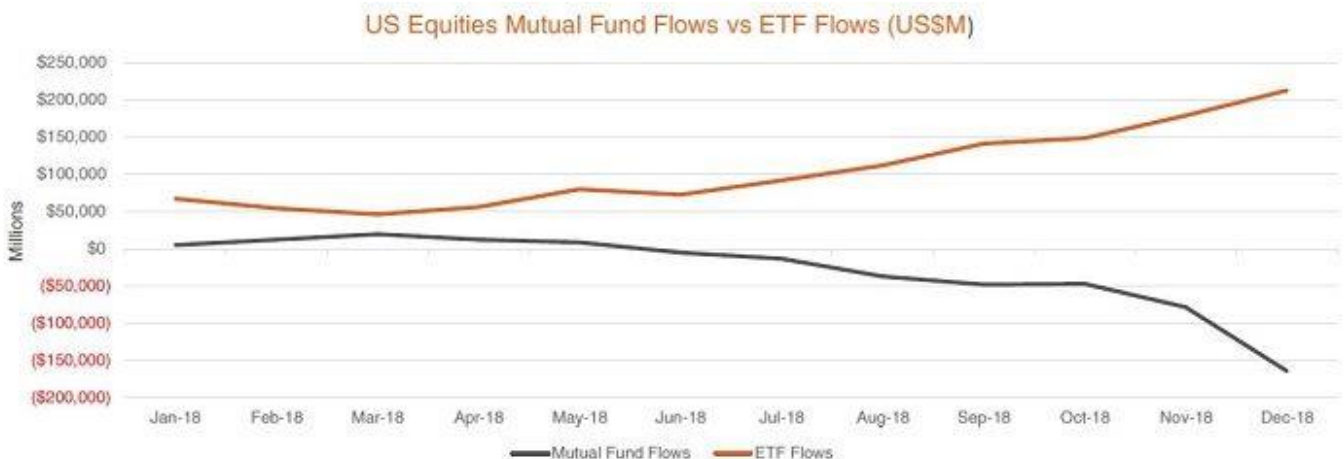
The global ETF industry ended 2018 at US\$4.8 trillion in assets under management (AuM), posting a robust annual growth rate of 20% since 2005. The strength of ETFs can be largely explained by the growing preference for passive strategies, which still dominate the global ETF space. More broadly, unlisted funds (known as 'mutual funds' in the US) are also evidencing a tilt towards passive strategies. In the US in 2018, passive funds (including traditional unlisted mutual funds and passive ETFs) attracted net inflows of US\$431 billion. In comparison, active mutual funds in the US reported net outflows of US\$418 billion, the highest level of annual outflows for this category on record.

The chart below illustrates the trend away from traditional active mutual funds. Since 2012, there have been net inflows into Active ETFs as well as passive ETFs, indicating investor preferences for the ETF structure whether or not the underlying investments are actively or passively managed.



Source: Bloomberg.

Investor preferences are perhaps even more strikingly evidenced in the chart of U.S. equities mutual fund v ETF flows. With both categories including passive and active strategies, the investor trend towards the ETF product wrapper is clear.

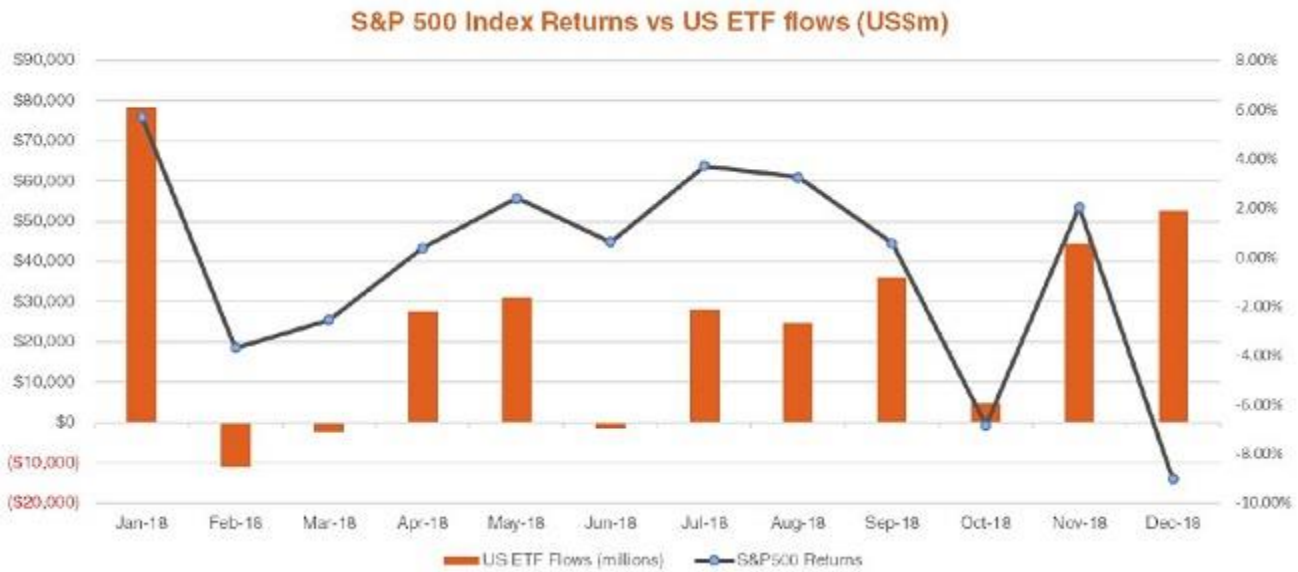


Source: Bloomberg.

Compared to larger and more mature markets, such as the US and Canada, Australia sits behind in terms of net inflows and size. Putting the size of the Australian industry in context, in the US, ETFs represent about 16% of the size of the broader mutual fund industry. In Australia, the penetration is far smaller, at about 1.5%. While recent local growth has been fast, we believe Australian investors are just starting to scratch the surface when it comes to ETF usage.

**Who owns the sharemarket? Not ETFs**

The popularity of ETFs has raised concerns that they are fuelling sharemarket volatility. These fears are unfounded. The graph below for 2018 data compares the flows of U.S. equity ETFs traded in the US versus the performance of the S&P 500 Index. Market moves were entirely independent from flows into and out of ETFs.



Source: Bloomberg

December 2018, for example, saw a strong market decline despite the positive inflows to ETFs. Saying ETFs can move markets makes little sense. They are designed to replicate what their underlying securities do. Nothing more, nothing less.

**ESG and smart beta on the rise**

Two of the key trends observed by our research are the rise of ESG/ethically-orientated products and smart beta strategies.

In the U.S. last year, ESG ETF AuM grew by 26% year-on-year, while inflows grew even more rapidly with a 57% annual growth. Smart beta exchange-traded products weight shares in portfolios based on a methodology other than market capitalisation. Between 2009 to 2018, flows into smart beta strategies experienced a compounded annual growth rate of 60%, reaching a record high of US\$86 billion in 2018.

As the popularisation and sophistication of the ETF industry and of investors around the world continue to grow, we predict the uptake of funds with differing methodologies to continue to be adopted. The cost-effectiveness, transparency and accessibility offered by ETFs makes them appealing for all investor types, whether an institutional asset allocator, a financial adviser, a high net worth individual, or a millennial who is just starting to build an investment portfolio.

*Ilan Israelstam is Head of Strategy and Marketing at [BetaShares](#), a sponsor of Cuffelinks. This material has been prepared as general information only, without reference to your objectives, financial situation or needs. You should seek your own financial advice before making any investment decision.*

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## All that glisters: 3 tech 'watch-outs' for 2019

Ben Chong

From artificial embryos to cloud-based AI, 2018 was another year where the impossible became possible thanks to rapid advancements in technology. But as the online world approaches the milestone of 30 billion connected devices, all is not well in the real world. We may be on the brink of a technology backlash fuelled by fear and uncertainty around three burning issues: privacy and data security, facial recognition technology (and the right to it), and the definition of free speech.

### 1. Privacy and data security

Personal security is always a touchy subject. From the now infamous 2015 hacking of Ashley Madison's married client base, to the Facebook-Cambridge Analytica scandal, to the admission just last month that the Marriott Hotel hack had exposed the passport details of up to 500 million people and, of course, and many more, data breaches have a long history. The Federal Government's *Assistance and Access Bill 2018* could spell the death knell for consumer confidence while, simultaneously, undermining the efforts of tech entrepreneurs building businesses to fight cybercrime. Passed on Parliament's last sitting day of 2018, the bill's significance and its damaging impact became buried as Australia shopped, ate and drank its way into the festive season.

The new bill enables law enforcement agencies to access encrypted communications on platforms such as Facebook Messenger, Skype or WhatsApp if it is suspected that content contains plans for illegal or terrorist activity. This effectively means that security must be weakened in the form of a backdoor to allow decryption to take place.

There are three things fundamentally wrong with this picture.

Firstly, as in the real world, the strongest of locks on the front door provides no peace of mind if there's a backdoor wide open for burglars or, in this case, hackers. Consumers and businesses are right to be nervous, and we may see businesses storing data overseas with companies that have no presence in Australia.

Secondly, the Australian tech scene is home to many talented entrepreneurs working tirelessly on cybersecurity start-ups. Why would these businesses want to base themselves in Australia where the government is undermining their business?

And finally, the Government dictates the definition of 'terrorist' and law enforcers only need to 'suspect' someone. We often see the use of the word 'terrorist' or 'hijacked' by senior government members to exaggerate certain activities or occasions that don't fall within the historical definition of terrorism. Can we really trust them to use these powers fairly then?

### 2. Facial recognition

Another example is the growing use of facial recognition technology. This year, Sydney Airport and Qantas began trialling biometrics, with an initial phase of testing check-in, bag drop, lounge access and boarding. As with all new security, it is not long before vulnerabilities start to appear. A recent report from a Forbes journalist found it was possible to break through facial recognition security using a 3D print out of a head. In a test of a number of smartphones, Apple was the only phone that did not unlock.

In addition to security doubts, facial recognition technology has been the subject of ethical scrutiny as its use by government has not been clarified. Indeed, last year, Home Affairs Minister Peter Dutton introduced legislation that would allow his department to share biometric data with other government agencies when appropriate. So, when is it appropriate? This contentious question is shrouded in government secrecy. It could be for counter-terrorism but it could also be for broader surveillance and even road safety. There is no opt-out and no clear guidelines around the use of this data.

### 3. Free speech

Free speech is a highly subjective issue and difficult to monitor in its many forms, varying from individual opinion on social media platforms to the sharing of information that may be protected in certain jurisdictions. Although a recent Australian court imposed a suppression order that prevented Australian media from reporting on the conviction of a high-profile figure, international sites plastered the defendant's identity on their home pages. The internet has circumvented local laws and there needs to be further international collaboration and

uniformity to find a way that is both fair and realistic. Tech platforms need clear, strict and enforceable guidelines on this topic.

In 2018, some platforms banned websites, including Wikipedia on the controversial right-wing website, Brietbart, as a source of facts; Apple removed the app from its store after years of tacit endorsement; Tumblr prohibited adult content from its microblogging and social networking platform; and Facebook suspended alt-right content creators like Alex Jones from its platform. While we should defend the right to free speech, we must find a way to better manage those who express bigoted or offensive views. Tech platforms need clear, strict and enforceable guidelines on this topic.

### **Concluding**

For the tech community, the consequences of these tech 'watch-outs' are far-reaching. For users to start-ups and established businesses through to investors, these are high-stakes issues. Investors are regularly asking what the effect of these factors will be on investment performance of the sector.

The number one question they should be asking is around the value of data and how easily it can be compromised.

Moreover, ethical considerations will also play an important role in shaping investment decisions. Issues in technology will call for even better tech solutions and, in the entrepreneurial tech world, a solution to these issues may not be far away. In the meantime, it's a case of investor beware and be armed with all the available knowledge in your arsenal in order to make the best investment decisions.

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