

This Week's Top Articles

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On franking, all public funds are not the same

Graham Hand

Many SMSF trustees who may lose their franking credit refunds under Labor's proposed policy are considering transferring to a large industry or retail fund. It's become a common assumption that such a fund will give retirees access to franking credit refunds. For example, Robert Gottlieb writing in *The Australian* last weekend said:

"But the ALP plan is that if you save via an industry super fund or a large retail fund, then you can receive your cash franking in full."

This is not correct. Some large super funds are receiving a refund that they will lose under the Labor policy. When it comes to franking credits, all public funds are not all created equally.

Why are we assuming all large funds can use the full franking credit?

Under the imputation system, the franked credits attached to a dividend can be used to offset tax payable by the recipient. For an individual, excess imputation credits can offset tax liabilities on other taxable income, including salary.

Large pooled funds with members in the accumulation phase incur a tax liability on both their assessable contributions and earnings. Where this tax liability is sufficient to utilise the franking credits generated by all members (including those in pension mode who pay no tax), the franking credits are fully utilised and there is no refund.

Not all large funds are in this position

There are some existing funds with a large proportion of pension phase members that already receive a refund of excess franking credits. In the future, more funds will reach this position as the population ages and more people retire. Such a fund would have less assessable contributions, especially when combined with low or negative investment returns, and the net cash refund will be lost under Labor.

In the accounts of the super fund, where once a dollar value of a tax benefit would have been added to the unit price, the loss of the franking credit will reduce the unit price and the investment return.

How does someone who is contemplating transferring to a pooled fund due to the Labor proposal know which funds are likely to be affected? The main indicator will be the proportion of accumulation phase members (and how much money they contribute and hold in the fund) relative to the retirement phase.

As examples of each:

Unlikely to lose franking credits

A fund which attracts new, younger members as a natural part of its business (and purely as a guess, examples might include REST, which services retail employees, or Hostplus, which targets the hospitality and tourism industries) should have a steady stream of accumulators. Traditionally, their older, top-end members drift into SMSFs, although this trend seems to have reduced recently.

More likely to lose franking credits

According to Craig Day, Colonial First State's Executive Manager Technical Services, some superannuation wraps are similar to industry funds with significant numbers of members in the accumulation phase. However, he advised in a technical note that others may be vulnerable:

"It is important to note superannuation wraps may be more exposed to the ALP proposals compared to large pooled funds as they tend to have larger proportions of older retired members with larger balances in the retirement phase compared to pooled funds."

Check the fund before you switch into it

All public superannuation funds should make a statement on their expected treatment of franking credits under Labor. For example, this week, Colonial First State advised for its super funds under their FirstChoice and FirstWrap banner:

"Impact on FirstChoice

Based on our current assessment of the Fund's historical tax positions, we expect FirstChoice to have enough assessable income from investment earnings and concessional contributions to fully absorb and utilise all the imputation credits that it may derive each year.

With significant numbers of members in the accumulation phase relative to members in the retirement phase, large pooled funds, such as FirstChoice, are likely to be impacted to a lesser extent by the ALP proposal as these funds will generally have sufficient levels of taxable income, including assessable contributions, to fully utilise any excess imputation credits.

Impact on FirstWrap

Based on our current assessment of the Fund's historical tax positions, we expect FirstWrap to be in a net refund position (with excess imputation credits). Being in a net refund position means CFS as trustee would need to equitably distribute the loss of excess imputation credits across all members of the fund.

Across the industry, superannuation wrap products, such as FirstWrap, are more likely to be impacted by the ALP proposals given they tend to have:

** larger proportions of older members with larger balances in the retirement phase compared to large pooled funds*

** many members that don't contribute their super guarantee or make any other concessional contributions into the wrap (as their default fund)."*

In summary, any SMSF trustee who plans to close their SMSF and go into a pooled fund needs to be sure the new fund can utilise the franking credits.

Addendum. Note from a very angry reader, Jane Abbott (identified with permission).

Good afternoon Graham

Yesterday I along with approx 100 other self funded retiree individuals proudly went to the Parliamentary Inquiry that finally occurred in Perth. I would like to make some comments on the vibe and feeling of this meeting.

Present were Josh Wilson and Matt Keogh, ALP parliamentarians from WA, and of course Tim Wilson and Craig Kelly for the Liberals. Plus a secretary.

We were all given 3.5 minutes to give our side and impacts of ALP's proposal to remove franking credits. There were some sad stories, for individuals and couples. I'm sure this Committee has heard the same stories hundreds of times all around Australia. We were average retirees, not the top end of town rich older folk here. They have no reason to attend.

The reasons given to invest in Australian companies that pay fully franked dividends are widely known: good returns, fully franked, Aussie companies, familiarity and knowledge of their businesses. Most had held shares for a very long time, e.g, TLS, CBA, BHP, WOW, WES. We all proudly like to support our country's businesses.

But it was very concerning to see these two Labor parliamentarians sit there and listen to everybody's story, then to turn around when asked a question and respond by saying these meetings were being turned in a political campaign by the Liberal Party.

If these meetings are NOT a sign of democracy, I am flabbergasted to know what is? Aren't we older, retired, self-funded Australians entitled to have a voice and lay out the bare facts to nominated representatives of the present Government and future Government (heaven help us) as to the impact of losing a percentage of our income.

If employees can go out on strike to demand an increase in wages, with unions backing them, why can't us older people say what and how the future will be if the ALP get this policy through. They say "they won't be turning" when in Government.

Their policy presents the biggest discrimination case this century, which determines which self-funded pensioners will receive the franking credits, depending on where they hold their retirement money, such as SMSF, as a individual or in an industry super fund. Or receive a Government Age Pension, CPI-indexed for life.

I am very cranky.

Signed Jane Abbott, who later added, "I am still seething".

Graham Hand is Managing Editor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

Cloud computing is an unheralded tech success

Michael Collins

In mid-2017, computer scientists at Google's security-research unit Project Zero helped discover two 20-year-old flaws in computer chips that were so widely used it meant just about every computer and network in the world was vulnerable to hacking.

Among those vulnerable to the microprocessor flaws named 'Meltdown' and 'Spectre' were the providers of cloud computing that offer IT resources from data centres over the internet. Meltdown, for instance, could theoretically allow a hacker who had penetrated a system to access information in a computer's memory, which is typically shared by many users on the public cloud. By the time the flaws were [made public in January 2018](#), however, the major cloud-service providers such as Amazon, Google and Microsoft had secured their systems and enhanced their reputations for competence and security.

Cloud computing surpasses all expectations

The ability of cloud service providers to remind people of their worth when such a vulnerability emerged is among reasons why the practice of cloud computing has become a US\$176 billion industry over the past 15 years or so.

The practice of renting computing infrastructure over the internet, which is a key segment of cloud computing, is thriving because it is propelled by several favourable forces. One is that rather than having to build an expensive data centre that will be costly to maintain, businesses can access the most advanced computing services immediately and only pay for what they use. Another is that cloud-service providers benefit from such huge economies of scale that they can offer the most-up-to-date services at reasonable prices. By mid-2017, Amazon had cut the price of its ever-improving cloud services at least 62 times in 11 years. And as Project Zero

scientists showed, cloud-service providers are better able to secure a system than most businesses or governments.

The sharing of remote IT resources is expected to grow in coming years. [Morgan Stanley estimates](#) that by 2021 businesses will send 44% of application workloads to the public cloud, more than double today's figure of 21%. US consultancy [Gartner predicts](#) the global cloud services market will reach US\$278 billion by 2021. All up, cloud computing is proving a rare part of technology. It is surpassing predictions of its usefulness and doing so in a relatively trouble-free manner in an era when much technology is shrouded in controversy.

To be sure, any large, fast-growing industry is bound to stir up some issues. Data centres can have technical problems that put them temporarily out of service. Their large energy demands attract criticism, although cloud computing is a more efficient use of resources at a society level and cloud providers are adept at maximising energy efficiency. Issues about 'data sovereignty' have prompted some governments to force cloud service providers to contain data within country borders. No part of the internet, including cloud data centres, will ever be fully secure. The [European banking regulator worries](#) that the outsourcing of core banking systems to the cloud is a systemic risk. Increasing market dominance by the likes of Amazon and Microsoft could attract the attention of anti-trust regulators.

It must be said too that for all the benefits the cloud offers, not everything will shift to data centres. Cost-wise, for instance, cloud computing may be better suited to variable volumes of data processing. Certain core operational workloads might stay on the premises, as might critical IT and customised processing. The same goes for data that must stay on site for compliance reasons. Another brake on cloud growth is that applications such as autonomous driving still benefit from having computing resources closer to the data source.

But these caveats pale next to the bigger trends. Favourable economics, technological advancements and security concerns will prompt businesses to outsource more IT to the large data centres that comprise the cloud. In the foreseeable future, cloud computing is likely to fulfil upbeat expectations of its benefits without stirring up too much trouble for itself.

Nothing new but Amazon rewrites the rules

In 1996, the term 'cloud computing' was coined to describe the concept for people to access software, files and computer grunt over the web. The term seems to have been inspired by drawings where the network was shown as a cloud. (Who said it first is [disputed](#).)

The practice of sharing resources, however, is far from new. It began when people used terminals with no processing power to access mainframes by 'time sharing' – a concept devised in 1955 to overcome the limitation that only one person could use a computer at a time. Sharing of access effectively by timetable for a wildly expensive room-sized computer with ample storage made [computing more economical](#).

While other companies had been offering software in the cloud, such as the sales-automation software provider Salesforce in 1999, years before Amazon Web Services was launched in 2006, Amazon commercialised a new and much broader cloud-computing model on a massive scale.

Amazon's entry into the industry came about because after the online retailer launched its web-based retail services in 2002, it realised that it only used 10% of the system's capacity, a common ratio at the time. So, the company asked itself what opportunity the other 90% might provide. In 2018, Amazon's public cloud-computing business generated nearly US\$26 billion in revenue.

As businesses ponder their [cloud needs](#), several forces are helping strengthen the dominance that Amazon, Microsoft and Google hold over the industry outside of China. Among them are the breadth of their global data centres, their technological leadership, and the trust of clients and industry relationships (with software vendors, consultants, etc.) they have built over the years.

To appreciate the size of the networks the cloud providers have built, consider the global cloud infrastructure Amazon has. The company over time has built 60 operational zones that help ensure latency and reliability across 20 regions. Each 'availability zone' as they are known contains data centres. The most in a zone is 14 while the minimum is two. A data centre, which is typically 7,450 square metres in area, can contain as many as 300,000 servers, with an assortment of servers, storage, networking hardware and proprietary software. To improve reliability and operations, Amazon operates a network that directly connects users to its data centres. This network has about 150 'points of presence' to link with other networks globally, and 89 direct connect locations.

The networks of Amazon and the other providers are likely to grow in coming years as cloud computing keeps proving itself more economical and secure than do-it-yourself, especially in an era of rapid data growth and heightened cyber-security risks and, perhaps, more discoveries of flaws in everyday microchips.

Michael Collins is an Investment Specialist at [Magellan Asset Management](#), a sponsor of Cuffelinks. This article is for general information purposes only, not investment advice.

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In asset allocation, you can have anything but you can't have everything

Richard Rauch

One of the more challenging aspects of helping clients solve their investment-related problems is figuring out their true investment objectives. Here is a fictional conversation between a client and an adviser that exemplifies the challenges when working through an investor's objectives:

Q: What would you say are your key investment objectives?

A: We want to generate a return of 5% per annum over 5-year periods.

Q: Ok great, is that before or after inflation?

A: Not sure. Does it make a big difference given inflation is so low? I suppose we do want to preserve the real purchasing power over time; so, after inflation.

Q: And how would you describe your risk tolerance?

A: Fairly high; the investment committee understands that returns only come with taking risk, so we are comfortable.

Q: Would a drawdown (loss of capital) of say 20% in a given year be too high?

A: Yes! That would be unacceptable. Ideally, we would like to see positive returns over 12-month periods. However, we could probably tolerate a 10% loss in a given year.

Q: Understood. Do you have an income target?

A: 4% income per year would be ideal as we expect many of the underlying investors to be approaching retirement.

Q: Are there any other expected liabilities or cash flow requirements?

A: Possibly. Occasionally we have projects that need to be funded in the order of 5-10% of the total asset size.

Identifying multiple objectives

The most notable thing is the sheer number of objectives uncovered over the course of a short conversation. When working with clients, we always discover one or more 'hidden objectives', and often, the objectives can be contradictory. For example, an aggressive return target of 10% while keeping volatility below 5% is inconsistent. Often a client's extreme aversion to a real (after-inflation) capital loss would warrant allocating 100% of a portfolio to inflation-linked bonds, yet their return targets remain ambitious and out of reach. This solves one problem but creates others.

The bottom line is that we can likely build a portfolio and strategy to successfully achieve any one of these objectives but find it challenging, if not impossible, to achieve all objectives simultaneously. Investing is like life, as the self-help gurus often preach: you can do *ANYTHING* but not *EVERYTHING*.

A VaRy good idea?

Good risk management typically starts with good risk measurement. As management consultant, Peter Drucker, famously said, "You can't manage what you don't measure." There is now a relatively common set of metrics

most portfolio and risk managers use to assess the 'riskiness' of a portfolio, but they are often based on the flawed assumption of normal distributions and rely on historical data. Statistics such as standard deviation, value-at-risk (VaR), and drawdown are useful but only form one piece of the overall risk measurement mosaic. Other techniques such as stress testing a portfolio or determining how a portfolio would have behaved during a particular market scenario have become the new 'table stakes' within risk management.

This then begs the question: what risk management problem are we trying to solve? We can answer this by more clearly defining 'risk' which in the context of a broad investment portfolio is failing to meet the investment objective(s). And since we've already established that most investors have more than one objective, we need a way to maximise the chance of delivering on all of these multiple often-contradictory objectives.

To help solve this problem, we have developed a systematic method of maximising our chances of success (or minimising the probability of failure). And despite many people's worst fears, mathematics is essential in elegantly solving this problem.

Introducing the Weighted Risk Metric

To make an informed decision and address the trade-offs inherent in achieving most investors' objectives and risks, we invented a proprietary Weighted Risk Metric, which incorporates an overall risk score for each possible strategy.

The Weighted Risk Metric is a mathematical concept that calculates a score for each portfolio on the efficient frontier. The model determines the risks of not achieving the specified 'aggregate' goal, or the set of combined objectives. The Weighted Risk Measure can combine different risk measures for combinations of target returns and investment horizons. When the scores for all portfolio are known, we then select the portfolio with the lowest score which has the best chance of successfully delivering on the combined objectives.

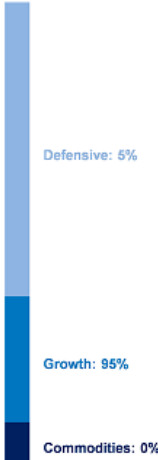
The mathematics and model are technical so we won't go into too much detail here, but you can request a [research paper](#) here.

Balancing risk and return to solve allocation problems

In a traditional strategic asset allocation (SAA) approach, a portfolio is constructed by optimising the asset universe available within a portfolio based on forecast risk, returns, and correlations. As many balanced portfolios implement a standard SAA approach and use long run or equilibrium capital market expectations, the resulting asset allocations look remarkably similar, as they only attempt to optimise one return or risk objective over a single horizon. In reality, investors do not have an unlimited time horizon and will typically only invest over a specified investment period.

The example below provides the output generated from running a traditional asset allocation analysis. In this instance, we are targeting a total return of 5.9% over an investment horizon of 5 years, or, a 4% return in excess of inflation of around 1.9%. Portfolio 1 has a 95% allocation to 'growth' assets and a 5% allocation to 'defensive' assets.

Asset class	Portfolio 1 Traditional Approach
Cash	5.0%
Australian Government Bonds	0.0%
Global Bonds (hedged)	0.0%
Credit - Investment Grade	0.0%
Credit - High Yield	0.0%
Emerging Market Bonds - Local	0.0%
Emerging Market Bonds - Hard	0.0%
Australian Equities	38.0%
World Equities	30.0%
Emerging Markets Equities	27.0%
Commodities	0.0%
Total	100.0%



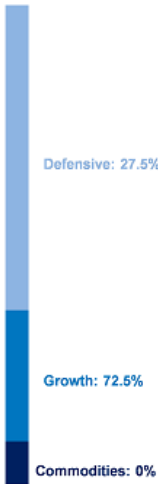
Source: Colonial First State Global Asset Management

The 'growth' weighting is higher than even a typical 60/40 balanced portfolio, due in part to the current low expected return environment. While this provides a good starting point, it ignores other factors used when making decisions to allocate capital in the real world. For example, in the mock Q&A above, there are many other considerations that are not normally found on the label of an investment product. These include but are not limited to: 1-year short fall risk (drawdown), inflation protection and an investor's individual time horizon.

To help solve for the additional factors, a multi-dimensional framework will provide greater insights, which is where the Weighted Risk Metric comes in. Portfolio 2 below has the same objectives as Portfolio 1, however, it incorporates some of the objectives uncovered earlier with weights to capture short-fall risk over any 1-year period and inflation protection over 3-year periods. We have still assigned a weight to achieving a total return target of 5.9% over the full investment horizon of 5 years but are no longer solely solving for this objective.

Adding additional objectives significantly changes the asset allocation, which intuitively makes sense as we are solving for multiple objectives. This is a more conservative portfolio but is also more representative of what the investor is actually expecting in terms of consistent outcomes.

Asset class	Portfolio 2 Weighted Risk Metric
Cash	5.0%
Australian Government Bonds	0.0%
Global Bonds (hedged)	4.5%
Credit - Investment Grade	7.0%
Credit – High Yield	0.0%
Emerging Market Bonds - Local	0.0%
Emerging Market Bonds - Hard	11.0%
Australian Equities	29.0%
World Equities	33.0%
Emerging Markets Equities	10.5%
Commodities	0.0%
Total	100.0%



Source: Colonial First State Global Asset Management

This portfolio has a 72.5% allocation to 'growth' assets and a 27.5% allocation to 'defensive' assets and the portfolio is more diversified across asset classes than the previous example.

While Portfolios 1 and 2 both are based on the same fundamental view of the economic climate and expectations, they have different risk and return characteristics due to the additional objectives.

I'm a model, you know what I mean

Risk management should be fully embedded in all aspects of an investor's thinking and process, not just an afterthought. Indeed, although sophisticated risk monitoring is critical, we should not lose sight of what risk is: failing to meet portfolio objectives. We are the first to acknowledge that the tools we have developed, including the Weight Risk Metric, rely on qualitative inputs and subjective decision making. In this model, we ultimately need to determine how important each objective is and no level of complex maths will help us here.

However, as the British statistician, George E.P. Box said, "All models are wrong, but some are useful." The Weighted Risk Metric provides a systematic approach to buttress traditional asset allocation methods to capture the subtle nuances within investment objectives. Maybe we can get MORE of what we want after all.

Richard Rauch, CFA is Investment Director for Fixed Income and Multi-Asset Solutions at [Colonial First State Global Asset Management](#), a sponsor of Cuffelinks. This article is for general information and does not consider the circumstances of any individual. To delve more deeply into the themes covered in this article, [sign up for Richard Rauch's upcoming research paper](#).

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The case for global high yield bonds

Vivek Bommi

The current geopolitical tensions across the globe including Brexit, trade war fears, changing global allegiances driven by the Trump administration, and the recent US government shutdown, have caused a new level of disruption and noise. However, it is not all bad news as we begin to see pockets of improvement in the world economy.

Growth in the US is helping to sustain the global economy. Meanwhile, closer to home, Australians have been fortunate to experience stable employment growth and in general, corporate balance sheets are in good shape.

Investors face a challenging time when it comes to portfolio construction. After years of slow economic growth and low interest rates post-GFC, we have recently seen rates rise in the US, but investors should pay close attention to the risks taken in their portfolios to obtain the necessary income. Given the RBA cash rates is just 1.5%, sitting on cash is not a long-term solution for real sustainable income.

We believe fixed income can provide a more stable source of income given mandatory coupons, and global high yield corporate bonds represent an attractive asset class for investors searching for a diversified source of income.

As an asset class, global high yield bonds have historically been mired in confusion, so let's explore why it is worth considering them.

1. Global high yield bonds have evolved

Mention 'high yield bonds' and some investors will label them as 'junk bonds'. This was an apt description in the 1980s, when small and speculative companies dominated the sector, but the market has matured dramatically since then.

The high yield market has now evolved into a financing mechanism widely used by companies with sound fundamentals looking to diversify their funding mix away from pure bank debt or shareholder equity. There are now more than 2,000 companies in the market, which has grown from less than US\$200 billion in the 1980s to approximately US\$2.8 trillion today. These include household names such as Netflix, Hertz, Fiat and Mattel, as well as numerous important players in the telecom and internet industries. All these companies have significant revenue and profit streams to service their high yield debt, and the label of 'junk bond' is no longer suitable.

2. Bond allocations need to be diversified

There are important fundamental principles in building an allocation to bonds. The allocation should lower risk and stabilise returns, offsetting the more volatile performance of equities and creating a steady income stream within the overall portfolio.

While traditional bonds provide diversification, they are more susceptible to interest rate fluctuations than global high yield bonds, which tend to be linked to corporate credit fundamentals. High yield bonds provide attractive returns and a lower risk profile than equities, making them an intermediary diversification tool within a traditional portfolio.

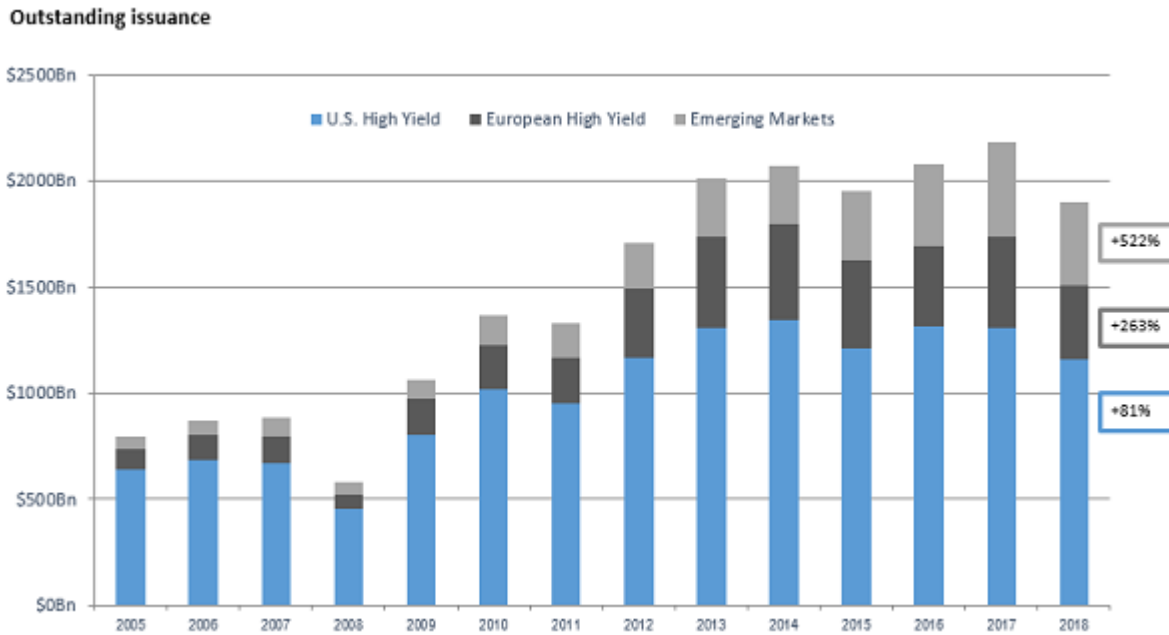
Global high yield bonds also offer geographic and sector diversification. While the US still dominates this market, companies from Europe and emerging markets across a wide array of industries issue high yield bonds. The market offers meaningful global exposure for investors looking for diversification, as shown in Figure 1.

3. Global high yield bonds generally perform strongly during periods of rising interest rates

While it is true that rising interest rates can cause falls in the value of bonds, the global high yield market has different characteristics to traditional long-dated government bonds and investment grade debt, with which investors are more familiar.

Historically, high yield bonds have performed well in rising interest rate environments, when the economy is doing well. There is usually growth in company earnings and overall improvement in corporate fundamentals. Consequently, credit risk for companies decreases, resulting in lower default rates. See Figure 2.

Figure 1: European and Emerging Market high yield bond issues are growing fast



Source: Bank of America Merrill Lynch. Universe represented by the Bank of America Merrill Lynch Global High Yield Index. Emerging markets defined as issuers with a country of risk other than an FX-G10 member, a Western European nation, or a territory of the US or a Western European nation. US High Yield represents non-EM USD HY bonds. European High Yield represents European currency HY bonds. Data as of December 31, 2018.

High yield bonds performance in rising rate environment

Figure 2: High yield bonds tend to do well when U.S. interest rates are rising

3 months ending:	Increase in 5-yr UST yields	US HY bonds return	US HY return next 3 months	Europe HY return next 3 months	Europe HY return next 3 months	EM HY bonds return	EM HY return next 3 months	IG corporate bond return	IG corporate bond next 3 months
May-87	1.4%	-1.6%	2.9%	***	***	***	***	-3.7%	0.3%
May-88	1.1%	0.6%	3.4%	***	***	***	***	-2.4%	2.1%
Mar-90	0.8%	-2.4%	4.9%	***	***	***	***	-1.0%	3.4%
Mar-92	1.0%	7.5%	3.2%	***	***	***	***	-1.4%	4.0%
Apr-94	1.6%	-5.1%	0.9%	***	***	***	***	-5.2%	1.5%
Nov-94	1.0%	-0.6%	5.8%	***	***	***	***	-1.7%	4.9%
Apr-96	1.2%	0.0%	1.8%	***	***	***	***	-3.6%	1.4%
Feb-99	0.7%	0.5%	2.1%	***	***	***	***	-1.5%	-0.1%
Jan-00	0.7%	1.5%	-1.3%	4.0%	0.8%	5.3%	-1.5%	-0.6%	2.2%
Jan-02	0.9%	3.3%	2.8%	3.6%	-2.2%	-2.4%	-1.4%	-1.8%	0.7%
Aug-03	1.2%	2.7%	6.3%	5.4%	5.0%	2.4%	5.3%	-3.8%	2.1%
Jun-04	1.0%	-0.8%	4.6%	2.4%	1.6%	2.4%	6.1%	-3.1%	3.5%
May-08	1.0%	4.1%	-3.9%	5.8%	-5.6%	2.8%	-12.1%	-1.8%	1.1%
Jun-09	0.9%	23.2%	14.8%	29.3%	22.8%	21.4%	13.3%	2.0%	4.2%
Dec-10	0.7%	3.1%	3.9%	-0.8%	4.2%	1.3%	4.3%	-2.2%	0.3%
Jul-13	0.7%	-1.3%	2.8%	0.1%	3.9%	-4.3%	3.7%	-3.8%	1.1%
Dec-16	0.8%	1.9%	2.7%	1.8%	1.9%	0.5%	3.8%	-3.5%	1.0%
Average	1.0%	2.1%	3.4%	5.7%	3.6%	3.3%	2.4%	-2.3%	2.0%
Median	1.0%	0.6%	2.9%	3.6%	1.9%	2.4%	3.8%	-2.2%	1.5%

Source: Bank of America Merrill Lynch. BofAML US High Yield Master II Index; BofAML European Currency High Yield Index; BofAML High Yield Emerging Market Corporates Plus Index; BofAML US Corp & Govt Master Index. The table presented above represents performance when 5-Year Treasury yields rose 70 basis points (or more) during a 3-month period. The periods are the three months ending in Jan 2000, Jan 2002, Aug 2003, Jun 2004, May 2008, Jun 2009, Dec 2010, Jul 2013 and Dec 2016. IG=Investment Grade.

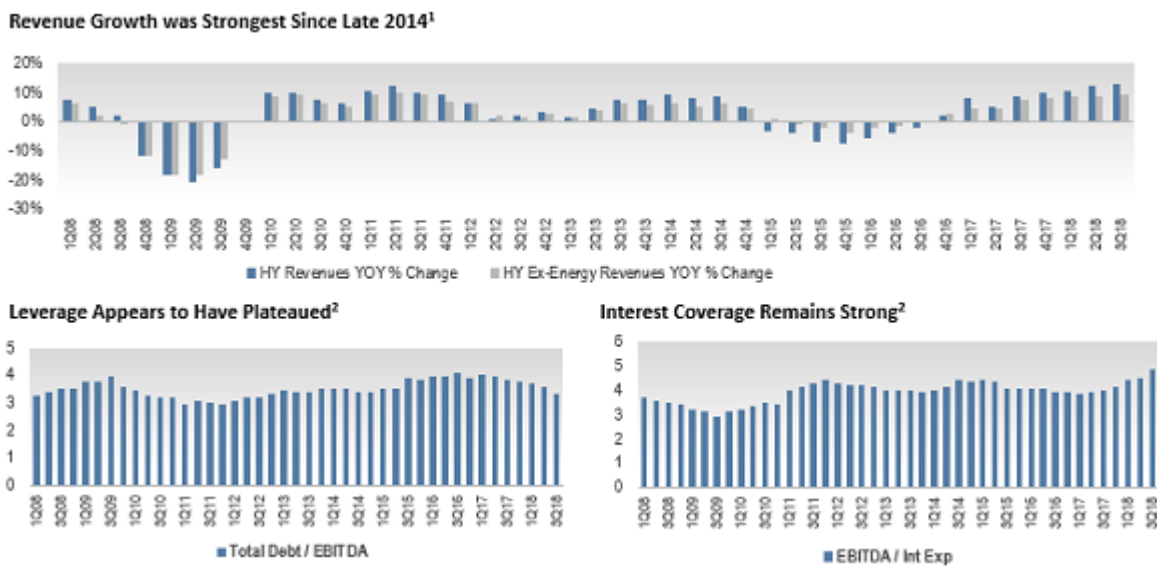
In the past few years, central banks have set interest rates at historically low levels, but they have started to move back to what is considered normal or 'neutral' settings. This recent trend is in stark contrast to the days when central banks were regularly hiking rates aggressively to slow economic growth and cap inflation. For corporates with fundamentally good balance sheets and trading prospects, the return to neutral interest rates has been a positive change.

High yield market fundamentals

We believe the probability of a near-term recession is low and while volatility is likely to persist, valuations for high yield bonds compensate investors for the modest default risk. The operating performance of underlying issuers has been stable; revenue and EBITDA growth have improved as leverage has plateaued; and refinancing activity has significantly reduced the number of bonds maturing in the near term.

However, global high yield bond markets are susceptible to a variety of factors, including uncertainty around government disruptions such as aggressive rhetoric, trade policy and the overall regulatory environment. Below-average new issue supply of high yield bonds continues to be supportive, and we expect issuance to remain flat year-on-year during 2019.

Figure 3: High yield market's credit quality improvements



Source: Bank of America Merrill Lynch. Data as of September 30, 2018. Adjusted metrics are calculated using Adjusted EBITDA which removes the impact of unusual items from earnings including but not limited to non-recurring items, impairments, goodwill etc.

An under-recognised asset class

In Australia, global high yield has traditionally been an under-represented asset class, and not one easily accessible to investors or SMSFs. By providing exposure to global credit markets, an allocation to global high yield bonds can provide diversification benefits to a domestically-biased portfolio and improve the overall risk profile.

Vivek Bommi is a Senior Portfolio Manager at [Neuberger Berman](#), a sponsor of Cuffelinks. This material is provided for information purposes only and does not constitute investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. It does not consider the circumstances of any investor.

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The S-curve beats the macro every time

Nick Griffin

Talk to most investment professionals about their investing style, and they will speak about macroeconomics, interest rates and sector valuations as their primary drivers of decision making. But will this really create investment performance and returns? We believe the macro picture is not the secret to success.

Rather, it is the ability to benefit from structural changes that underpin the earnings growth of companies. It is these companies that will deliver the strongest returns over the long term, regardless of the economic backdrop or point in the cycle.

Market evolution and the few companies that do really well

The key is to recognise what the stock market really is. It is a market of companies, and it is continually changing and evolving. For instance, oil and gas used to be the biggest sectors in the S&P 500 index but today it is technology. General Electric Company (GE) was once the biggest company in the world, but it is now at risk of falling out of the S&P 500, while Amazon – which did not exist 25 years ago – has taken its place, with a market cap of over \$800 billion.

It is only a handful of companies that truly create and deliver wealth for investors over the long term. A study in the Journal of Financial Economics by Hendrick Bessembinder ([Do Stocks Outperform Treasury Bills](#), updated 2018) looked at every company that has listed in the US over the past 90 years, and what happened if an investor bought and held every stock.

He found that most companies out of 14,000 in total destroyed value versus Treasury bills, with the vast majority going to zero. A further 8,000 companies made enough to offset what the other 14,000 had lost. And 1,100 companies or only 5% of the total delivered all the return in the US market (above Treasury bills). Of these 1,100, there were actually 50 companies that made up 40% of the entire wealth created in the US stockmarket over that 90-year period.

The trick for investors, therefore, is to identify these 50 companies early on, and buy and hold them.

Sounds simple? Of course, it isn't.

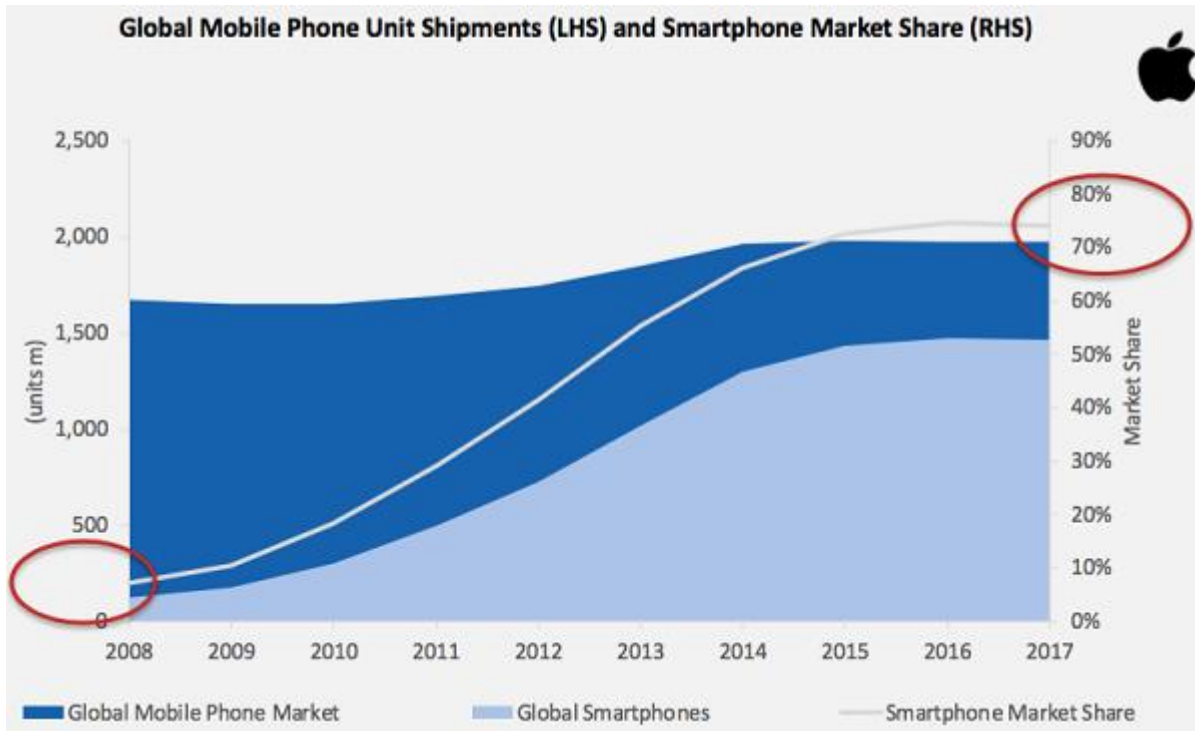
The S-curve helps identify the wealth creators

This is where the idea of the S-curve comes in. In business terms, the S-curve tracks how a company or industry grows over its lifecycle. There comes a point in the lifecycle when growth inflects, driven by a structural change. It is the tailwind created by the structural change that allows a company to deliver and create wealth.

We argue that the S-curve always beats the macro when it comes to investing.

Companies like Facebook, Amazon and Apple have ridden the wave of demand for technology products and services that did not exist 15 or 20 years ago, but which are now considered indispensable in our daily lives. As investors, we seek to identify the next structural changes, and then invest in the companies that will benefit from them, at the start of the S-curve and not at the end.

Apple is a good example here. From 2008 to 2017, while the growth in the overall mobile handset market was relatively flat, smartphone penetration went from less than 10% to roughly 70% over the same period. In 2008, there were 10 mobile phone stocks to choose from but only two really worked out – Apple and Samsung. Once household names like Blackberry, Motorola, Eriksson and Nokia failed to seize the structural growth opportunity in smartphones.



Source: Bloomberg.

The smartphone market has now stopped growing and Apple is relying on price hikes and its services revenue for growth. The smartphone industry is now at the end of its S-curve.

Video Streaming and Netflix, on the other hand, is still growing. Yes, Netflix’s earnings multiples are high, and it is not yet making material profits, but what’s important is how much earnings it makes 10 years from now, not what it makes in 2019 or 2020. And on this basis, Netflix is poised for immense growth. It is currently in just 10% of broadband homes around the world, and its monthly pricing is low relative to the value of content it offers, so its potential for earnings growth is huge. Video Streaming is still toward the beginning of its S-curve.

Successful company characteristics

Once we identify industries at the beginning of their S-curve, we then need to find the companies that can fully benefit from the structural change. To do this, we consider five company characteristics that we believe are essential for success:

- Potential for growth: exhibit faster earnings, EBITDA or revenue growth versus peers and growing Total Addressable Market (TAM).
- Economic leverage: exhibit pricing power or economic leverage to improve margins.
- Sustainability: exhibit ability to sustain growth due to scale, position, intellectual property or locational advantages.
- Control: exhibit strong management ownership and incentives.
- Customer perception: Exhibit strong customer reviews and rapid adoption.

Companies that display all these characteristics are best placed to capitalise on their structural tailwind. Examples we would highlight today would be Amazon in eCommerce, Danaher in Innovative Health and ServiceNow in Digital Enterprise.

Nick Griffin is a Founding Partner and Chief Investment Officer of [Munro Partners](#). This article is general information and does not consider the circumstances of any investor.

Inside view: Will the Hayne Report bring real change?

Pamela Hanrahan

Australia's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry certainly lived up to its name.

Across 68 sitting days, with 130 witnesses and 10,000 public submissions, ongoing revelations of systemic misconduct and unethical behaviour were rife.

Exposed was a toxic culture of customers being ripped off, as if they were acceptable collateral damage in a shameless pursuit of short-term profits and shareholder returns. Disadvantaged customers were particularly vulnerable and even dead clients were charged fees.

Commissioner Kenneth Hayne, normally so understated and forensic, appeared exasperated by the extent of rampant greed and blatant conflicts of interest.

His three-volume final report includes 76 recommendations for reform and refers 24 cases to regulators for civil and potentially criminal breaches of the law.

Pamela Hanrahan, a professor of commercial law and regulation at UNSW Business School, was an expert adviser to the commission. She reflects on her experience.

What exactly was your role?

I was the author of three of the background papers published by the commission – one on financial services, one on superannuation, and one on foreign financial regulation.

Which of the many revelations did you find most disturbing?

They were all pretty disturbing. I think the most shocking aspect of it wasn't just a question of people being engaged in sharp practices, or behaving in a way that with the benefit of hindsight you might not think was the best way to behave, but actually that there was widespread failure to comply with legal requirements.

Are the existing rules of conduct too complicated to follow?

They are not too complicated to follow, but they are unnecessarily complicated and there are lots of special exceptions and special qualifications to the regulations and that diminishes the normative force of the rules. The Commissioner thinks the law would benefit from being simplified. So, being less technical and more focused on the actual forms of behaviour that you want to encourage.

How has the sector got itself into this mess, again?

The Commissioner says it's because it has been too focused on performance, both at the corporate level and also at the level of individual incentives, and has lost sight of the fact that they need to achieve that result in a way that is compliant with law and serves the interests of customers.

Many financial services now provided to households are not that old and have really emerged during the past 25 years. The industry has grown very rapidly. We now have a situation where there are big organisations and big systems and it has got away from us.

How likely are prosecutions from the 24 cases referred to regulators?

I think it's likely that there will be prosecutions because, aside from everything else, there's significant community and political pressure on regulatory agencies to take that option wherever it's available.

What are the suggested new powers for the regulators, ASIC and APRA?

ASIC has already been promised significant new powers and that legislation has been in the parliament since July last year. It's likely that will pass, strengthening the penalties and giving them more options. ASIC has also received additional resources and personnel during the past year.

They have new powers to come, but it's less an issue of not having adequate powers rather than not having exercised them. I think that's the clear finding in the report. So in order to whip them into shape, the Commissioner has recommended establishing a three-person oversight body.

He could have recommended the establishment of an independent board for each agency, which is used in other places. But he's gone in the direction of three part-time members, with a quite specific mandate to assess effectiveness and performance and report to government. You have to wonder how effective that's going to be in practice.

Why do you think Hayne did not mandate a structural separation between financial products and advice?

He does talk at length about a conflict that is very difficult to resolve, which inclined him to think that maybe we ought to require structural separation, and he talks about different options. And then he says that almost none of the submissions, including from ASIC, recommended separating product and advice, and that it would cause very significant disruption.

So, consistent with the rest of the report, which is conservative in nature, he takes the view that unless he's persuaded that the benefits of separation would outweigh the costs, he should leave the reforms already in train, and industry restructuring, to run their course.

Mortgage brokers will lose trailing commissions in three years' time. Why were they singled out?

They face the same problems that financial advisers faced and which was attempted to be addressed in the Future of Financial Advice (FOFA) reforms five years ago, where the commissions were banned for them. So it's the same issue in that you've got intermediaries, clients go and see them, ask for assistance in selecting the best financial products and believe, perhaps naively, that the mortgage broker is there to negotiate the best deal for them. But the product issuers are paying the mortgage brokers to do it and that creates a potential conflict of interest.

I think the Commissioner has concluded that existing arrangements around mortgage broking are detrimental to the community overall and they need to change.

Bank stocks and profits have soared since the release of the report. Will its implications just be a cost of doing business?

No, but the banks will have to change their approach. Of course, from bank shareholders' point a view, the report could have been much more radical than it was. And I think that had been built into the market price.

Regardless of the recommendations, it's the forensic process of examining their businesses and their business models that will have the most long-term impact. But this is the 70th inquiry that we've had in 10 years. Are we going to learn the lessons this time?

Banks are stubborn. They are very large, very powerful and are very resistant to change. They have complex systems. It's like turning around the Queen Mary. So it's going require a lot of effort – right from boards, which will have to think very carefully if they've got the right CEO, and the right business – because we can't go through this again. And what they'll find, if they don't respond, is that they will just end up being overtaken by new business models and disruptive technologies and so on.

The biggest difference is that, hopefully, their customers will realise that the bank is not there to help them and they have to be vigilant in their own interests. And that would be a significant improvement.

[Pamela Hanrahan](#) is a Professor of Commercial Law and Regulation, and Deputy Head of School (Research) at UNSW's School of Taxation & Business Law.

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Hey Mr Bowen, the franking credit is part of my taxable income

Jon Kalkman

In all the talk about franking credits, there is a part that nobody mentions and Shadow Treasurer, Chris Bowen, studiously avoids. As a shareholder, my dividend is paid out of the company's after-tax profit. The company tax rate is 30%, so my dividend is 70% of the total profit attributed to my shares. Most people now understand

that that 30% company tax becomes a tax credit, but few realise that the company tax portion is also part of my taxable income.

Pre-paid tax is held by the ATO and is part of my taxable income

If my dividend income is \$21,000 (70%) then the company has previously paid \$9,000 (30%) to the ATO as tax on those dividends. My taxable income, however, is not \$21,000 but \$30,000 because I am responsible for the tax on **all** the company profit attributable to my shares, not just the cash dividend. In other words, the ATO is holding 30% of my income, pending the lodgement of my own tax return.

Assuming this is my only income and there are no deductions, my personal tax liability on this taxable income is approximately \$2,200 (based on personal tax rates for an investment held outside super). At present, because the ATO is already holding \$9,000 of my money, I am entitled to a cash refund of \$6,800.

What Mr Bowen is proposing is very simple. According to Labor, any pre-paid company tax held by the ATO belongs to the government, even though it is part of my taxable income. Under the proposal, a return of my own money becomes a tax concession.

If I have a tax liability high enough to absorb the credit the ATO is holding on my behalf, I can use it to pay my tax. If my tax liability is greater, I have to make up the difference.

But if the money withheld by the ATO is greater than my own tax liability, the excess will simply be confiscated, because Mr. Bowen says there is nothing to refund – unless of course the taxpayer is a Future Fund, university, hospital, union, charity or an age pensioner.

In this example and in the current system, a PAYG taxpayer with a taxable income of \$30,000 will have an after-tax income \$27,800 (tax = \$2,200). Under Labor's proposal, the taxable income of \$30,000 gives an after-tax income \$21,000 (tax = \$9,000). In fact, this proposal ensures that shareholders pay a minimum of 30% tax on their dividends from the first dollar, regardless of their marginal tax rate, unless they belong to an exempt group.

Nothing to do with super or SMSFs

In this example, the taxpayer does pay tax and will still not get a refund. It has nothing to do with SMSFs. For example, there are many elderly self-funded retirees who are generally too old to have benefited from super tax concessions and they still pay tax. Many have acquired a parcel of shares precisely because the after-tax income return from Australian shares is worth the pain of market volatility. Because their tax liability is lower than the franking credit generated by their dividends, to date, they have enjoyed the cash refund of their own money from the ATO. Under this proposal, that refund too will be confiscated. There are many others in this position who invest in Australian shares outside super.

Mr. Bowen needs to explain whether the franking credit will be part of my taxable income or not.

If the franking credit is not part of a taxpayer's taxable income, because it belongs to the government, he needs to explain how some taxpayers can get a refund of money that does not belong to them and how other taxpayers can use government money held by the ATO, to pay their tax own liability.

If the franking credit is part of my taxable income and belongs to me, Treasurer Bowen needs to return that part of my taxable income that is not required to pay my tax.

Jon Kalkman is a Director of the [Australian Investors Association](#). This article is for general information only and does not consider the circumstances of any investor.

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