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Phil King on the long and short of investing

Graham Hand

Introduction: Phil King is the Chief Investment Officer at Regal Funds Management and is responsible for portfolio management. Regal was founded in 2004 and manages alternative investment strategies with a focus on absolute returns from both long and short investing. Regal's Australian Long Short Equity Fund launched in 2009 with the strategy made available to retail investors in 2011. Regal has been named Australian Hedge Fund of the Year three times.

Technical note: 'Shorting' is the sale of a stock that the seller has borrowed from another party.

GH: I'd like to focus on 'long short' investing because that differentiates Regal. What's the skill difference in going long, which most equity managers do, versus going short, which few do?

PK: The main difference between longs and shorts is the fact when a short goes wrong, the problem gets bigger. When a long position goes wrong, the problem gets smaller. Some managers are good at investing on the long side and then they become traders on the shorts. And that doesn't always work well. I think you're either an investor or a trader.

We are investors on the long side but also investors on the short side. We take a longer-term perspective and we're valuation driven. We follow a similar investment process but the main difference between how we treat our shorts versus our longs is in risk management.

GH: And in theory there is potential for unlimited losses on shorts.

PK: Stocks never actually go to infinity but yes, you have to risk manage your shorts very differently. There are times when you have to reduce positions because they are going against you. Sizing is important and you should size your shorts a little smaller.

GH: Is there a difference in the time frame? Would you tend to keep your longs for longer than your shorts?

PK: I think that's a bit of a misconception. We're successful because we're happy to take a longer-term perspective on both longs and shorts. We have held many shorts for five to 10 years. I don't usually feel comfortable talking about my shorts, but there are certain manufacturing companies for example that we have been short for 10 years. They face such structural headwinds in Australia that you can't really see how they can succeed.

GH: So although it's a short, is a long-term view on the merits of that business.

PK: Yes, but you can't expect to make great profits on your shorts in a raging bull market. Anyone that's trying to make absolute profits in a strong bull market will be disappointed. Bull markets generally mean everything goes up, although there are always stocks that fall. That's why there's this misconception that you need to trade your shorts more aggressively.

We view our short book as insurance although we generate alpha (*Ed. outperformance*) on the short book. We run a long book as well and we don't have to worry about what the stock market is doing. We don't worry about tweets coming out of Washington or the Chinese economy. We focus on what we're good at and that's stock picking rather than all the macro factors.

Even the best stock picker who's long only generates most of their returns over time from the market going up. But in our market neutral fund, we generate all our returns from stock picking. We generate around 4% to 5% alpha from the long side but twice as much alpha on the short side because it's less competitive. Anyone can buy shares before they sell them but it's only a small minority of investors that can actually sell shares before they buy them.

GH: But one of your main funds is the 130/30 fund (*Ed. 130% long, 30% short*), so that faces the same influences as 100% net long. You have the same overall market exposure.

PK: Yes, and the 130/30 takes advantage of the fact the market goes up over time. Since inception around half of the returns have come from market beta (*Ed. the level in the overall market*) and about half has come from alpha. We generate returns from the market going up but we also run the short book to give the opportunity to generate more alpha than a typical long-only investor.

GH: What are the constraints on your shorting capacity?

PK: As I said, position sizing and risk management in case things go wrong. Shorts are smaller and ideally more liquid than longs. So there is a natural constraint. We have one of the largest short books in Australia, short a billion dollars of Australian stocks, and we think we can double that. But we probably wouldn't want to get much bigger because of the liquidity needed when things go wrong.

GH: How are dividends on your funds affected by your short book?

PK: On a stock that pays a dividend, the share price normally drops by the amount of the dividend. So we have to pay away to the lender the dividend on borrowed stock but we usually capture it in the company's share price. We pass through franked dividends on our long positions to our investors.

We generally borrow stock from international shareholders and therefore we only pay them the cash amount of the dividend and not the franking credits as well. The investors that we borrow shares from are usually index funds and large institutions based offshore. Occasionally, if we're very bearish on a stock and sometimes all the foreign capacity is utilised, we do use domestic stock. Then we make a judgment call about the timing of any dividends and whether the stock price justifies paying the extra franking credit on a dividend.

GH: How do you feel about the term 'hedge fund'? Do you think it compromises some of your marketing?

PK: There is a misconception about hedge funds in some minds. I think that's unfortunate because we are trying to provide attractive returns uncorrelated with the markets. It's simply trying to buy the cheap stocks and short the expensive stocks. It's all about valuation.

Often when we are shorting expensive stocks, we have a lot of respect for both the business and the management. It's not a reflection on the quality of the company, it's a view on valuation and people misinterpret why we're short.

Some people think hedge funds push stocks down and manipulate share prices. I think that's very rare and it's not certainly something we would ever do. In fact, I think there's more share price manipulation (as I call it) on

the long side and more people talking things up than talking things down. There are more participants in that market with more to gain.

There have been some well-publicised short reports over the last few years by both international and local managers. This is a welcome trend. People should be allowed to express views and not get criticised for having a different view. Too often, the broker research is just cheerleading for the company. There are too many cheerleaders in the market and it's good to have true independent research.

Where we feel a bit uncomfortable is where some of the research becomes personal and we have the philosophy that we want to play the ball not the man.

GH: So the reputation that shorting has, such as during the GFC when some types of shorting were banned, such actions discourage liquidity in the market?

PK: The experience in the GFC told us that banning shorting doesn't help stock prices. They continued to fall after shorting was banned and it was not the hedge funds pushing stocks down. It was more the circumstances at the time and the lack of confidence and the fact that financial markets were closed in some areas.

Hedge funds which are short a stock are often the investors who can cornerstone a capital raising. They can provide finance to allow a company to survive. Sometimes, we find management is the last to admit they have a problem and need to raise equity. They must accept the truth.

GH: I was looking at your long short fund over the last five years. 2015 up 21%, 2016 down 6%, 2017 up 18%, 2018 down 6%, then in 2019, Jan and Feb up 17%. Strong results but up well one year and down a little the next. Are there any common characteristics in the up and down years, or do you sometimes give a bit back after strong performance?

PK: Two points. Firstly, we carry the same market risk in this fund as long only investors with exposure typically around 100%. So, some of the weak years coincide with weak years in the market. For example, in 2018 the ASX200 was down 7% and this Fund was down 6%. Secondly, we are what some people call a 'double alpha' fund because we generate returns from both the short side and the long side. Sometimes, alpha is hard to find and we look like a typical long only manager. And then there are periods where alpha can be realised and we do well.

GH: Can we finish up with some questions around the listed vehicle you planned for a few months ago? What was the reason for not doing it at the time?

PK: We are experienced enough to know that it's always harder to do a new issue when the market is falling, although we plan to have a LIT that we hope will perform well in all environments. It's harder to ask investors to write a cheque when the market is weak such as in the December quarter. It's all systems go now and we expect to lodge a PDS in April and go on the road, with a listing planned for June.

GH: Do you expect any differences in the way you manage the listed versus the unlisted funds?

PK: The main thing we will do differently is to have a diverse portfolio of some of our strategies in one LIT. We realise that some of our unitholders will be retail investors and we want to reduce the volatility of returns. We think we can build a diversified portfolio and a lot of our strategies are not highly correlated with each other. We hope to provide a compelling product for Australians who have too much property and equity exposure in their portfolios.

GH: So it will not simply replicate the unlisted retail 130/30 fund?

PK: No, in fact, it will be cornerstoned by our market neutral strategy which has low correlation with the equity market, plus we'll include our emerging and small companies strategies which I personally think are exposed to exciting parts of the Australian market at the moment with good earnings growth.

People have been knocking on our door for many years to encourage us to list a vehicle and I've been reluctant to pull the trigger unless we could do it well. We only wanted to go down this route once we had the team in place.

GH: How you got your head around some of the structural issues that LITs face, such as drifting into a discount which disenfranchises some investors? Even going into a premium can be a problem as people buy expensive shares and drift back to NTA.

PK: That's true and we would prefer not to see a lot of volatility in the discount and the premium. We will have the ability to implement a buyback if it trades at a discount for a significant period of time. We will be judged on the quality of our returns but also the discount or the premium our stock trades at verse the NTA and we're very focused on those two factors.

GH: Finally, when I've heard you talk, you use a lot of sporting analogies. What's behind that?

PK: I've got three kids very involved in sport and I spend a lot of time watching them play soccer and basketball and surf. I love all sports actually, playing and watching, and having a family with three kids keeps me busy on weekends.

Graham Hand is Managing Editor of Cuffelinks, and [Regal Funds Management](#) is a sponsor. This interview is general information and does not consider the circumstances of any investor.

3 principles for finding dividend sustainability

Robert Miller

A recent podcast with Robert Millner, Chairman of Washington H Soul Pattison & Company Ltd (ASX:SOL) provided valuable insights into the mindset of a long-term investment conglomerate. What started as a chemist on Pitt St in the 1870s has turned into what some would argue is the closest thing Australia has to a Berkshire Hathaway.

Today, as a conglomerate with only 10 people in head office and a market capitalisation of over \$6 billion, SOL has delivered dividends to shareholders every year since 1903 and is one of only two companies listed on the ASX to deliver a growing stream of dividends over the past 20 years.

SOL is likely the 'gold standard' of income stability and consistency for investors. Whilst there are only a handful of companies on the ASX that can come even close to the 20-year dividend track record of SOL, one can never rely on past performance when looking ahead.

At NAOS we invest in small and microcap industrial companies. Whilst the concept of small stocks and dividends does not typically go hand in hand, there are plenty of companies in our universe which have demonstrated dividend success.

The principles which create an environment for stable to growing dividends are not company size dependent. For any of the principles below, we recommend looking at a medium to long term performance record as results can vary from year to year.

Principle 1 – free cash flow

The quality of any company's operations can be measured by the amount of free cash it generates. The ability of a company to 'compound capital' comes down to how a company utilises and reinvests a portion of its free cash. This can include activities such as acquisitions, debt reduction, or building a bigger cash balance.

Whilst companies can pay dividends without free cash flow in the short term, over the long term, it is not conducive to sustainable capital management. A company that is extracting cash at the expense of reinvestment capital is likely to be going backwards. We like to see capital-light businesses that allocate a portion of free cash to both strategic and balance sheet initiatives whilst paying a portion to their shareholders.

A basic way to look for sustainability is to compare the total dividend amount to the total free cash flow amount. For this exercise, we define free cash flow as operating cash flow less ongoing capital expenditure. A company that is generating sustainable income for investors would have higher free cash flows than dividends paid.

Principle 2 – payout ratio

As a dividend hungry market, payout ratios of ASX-listed companies have been rising to become an ever-increasing percentage of total shareholder returns.

A dividend payout ratio measures the dividend per share versus the earnings per share. Inverting the payout ratio shows how much profit the company plans to retain. There may be industry-specific or ownership-specific factors which vary results, but as a general principle, a high payout ratio can be a sign that dividends may not be sustainable over the longer term.

Earnings that are retained within the business should be a buffer for future expectations, therefore a high payout ratio is likely to provide an understanding of the intentions of directors. Businesses which do not reinvest will likely face headwinds in the future.

Over the medium term, a capable board is one which prudently builds the retained earnings balance at a rate greater than the dividend payments. It gives a buffer against unexpected losses or impairments and may allow a more consistent dividend profile.

Often a company can be valued by its dividend yield, therefore a high yield can artificially inflate a share price. But if this payout ratio drops, it can have a serious negative impact on a share price.

The numerical increase in dividend per share often doesn't tell us enough. We believe a better approach is that a company should 'earn the right' to increase its payout ratio. If previous investment decisions are compounding capital faster than a payout ratio increases, it demonstrates sustainability.

It could be a red flag if a company's retained earnings balance is consistently diminishing whilst dividends remain steady or increasing.

Principle 3 – financing cash flows

It may be best to read a company's financials back to front: the cash flow statement first and the income statement last. A company can't muddy the waters of a cash flow statement. The bottom section of the cash flow statement shows how a company 'keeps its lights on' during a reporting period.

A warning sign is a continual entries in the 'proceeds from borrowings' line of the cash flow statement, without any entry in 'repayment of borrowings'. There are short-term reasons such as acquisitions when this is acceptable (which in turn should hopefully generate further free cash flow) but there are other, more worrying reasons.

If a company is living on debt and not generating the free cash to pay it off, any dividends will eventually suffer and a capital raising may occur. A quick way to interpret sustainability of the funding of dividends is to compare dividend growth to debt growth. Artificially 'holding up' a dividend through debt is likely not sustainable.

These principles are a good start

The above three principles should not be solely relied upon, rather be considered as part of a wider analysis of a potential investment. The principles give a grasp of what might happen down the tract to a dividend, which in theory should be the most predictable part of total shareholder returns.

At NAOS, we invest in businesses where the earnings today are not a fair reflection of what we consider the same business will earn over the longer term, and over time the business can pay dividends. We do not invest solely for income, and avoiding 'yield traps' is just as important as finding a good sustainable dividend.

Robert Miller is a Portfolio Manager at [NAOS Asset Management](#), a specialist fund manager providing genuine, concentrated exposure to Australian listed industrial companies outside of the ASX 50, and a sponsor of Cuffelinks. This content is for general information only and has been prepared without taking account of the investment objectives, financial situation, or needs of any individual.

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Caveat auditor and feeble SMSF investment strategies

Donal Griffin

As lawyers in the area of wealth, we always read cases for interesting legal issues that affect us and our clients. However, two recent cases resonate for the people who refer clients to us.

They show the risk to professionals who are not even giving the financial advice arising from investments which may go down as well as up. An Irish expression is, "It could have happened to a bishop" and, we can now add "It could have happened to an auditor."

Case 1: Audits are not simply high-level reviews

The first case is *Ryan Wealth Holdings Pty Ltd v Baumgartner [2018] NSWSC 1502* which arose from a divorcee, Ms Crittle, entrusting her \$7 million property settlement with a Mr Moylan from Charlestown near Newcastle. She met Mr Moylan because her lawyer, Mr Turnbull of Turnbull Hill Lawyers, had offices on the same floor as him and he introduced her. You can see how this can happen, but it is rarely in the client's best interests.

Audits are sometimes considered high level reviews of other people's advice and decisions but when things go bad, lawyers will look to who to blame. The person who has to pay is not always the bad guy. In this case, the investments were worthless and most of the key companies were in liquidation, the advisers Mr Moylan and Mr Turnbull were bankrupts and their professional indemnity policies had lapsed. So they initiated proceedings against the auditor, Baumgartner Partners.

Baumgartner Partners undertook audits for the fund making the investments for the financial years ending 2007 to 2009. Their problem was that the investment strategy for those years was bland to the point of meaningless. It said the strategy for each investment class was "a normal investment range for each type of investment shall be: ... 0% to 100%".

We act for many excellent investment managers and they put a huge amount of effort and intellectual capital into the design of their asset allocation. It is considered the holy grail. So, when there is a bad strategy, it looks terrible.

The auditors claimed Ms Crittle was only entitled to an award of nominal damages of \$300 in total for the admitted breach of the retainers. The Court found the client Ms Crittle 10% responsible and the auditors **90% responsible** in this case, and 90% amounted to \$2,034,126 plus costs. Of that, the Court found that Moylan Business Solutions Pty Limited should be responsible for 20%. It's a lot of money no matter who is counting it!

The lesson for professionals is to be careful who they introduce to clients.

Case 2: Auditor needs to look behind the accounts

In another recent case, the NSW Court of Appeal in the case of *Cam & Bear Pty Ltd v McGoldrick [2018] NSWCA 110*, was asked to consider whether the actions of an SMSF auditor, John McGoldrick, caused the [losses suffered by an SMSF](#). The [trustee of the SMSF](#), Cam & Bear, was established for Dr Lance Bear and his wife, Ms Jennifer Campbell. Dr Bear and Ms Campbell were directors of the trustee for the SMSF.

Some years after the SMSF was established, a close friend of Dr Bear, Mr Anthony Lewis, who conducted a [finance business](#), offered to manage the fund's [investments](#). Sadly, this was not Dr Bear's best decision and Mr Lewis' advice resulted in heavy losses.

We applaud funny names like 'Cam & Bear' mainly because we love cheese. However, no-one was laughing except perhaps the lawyers after the initial seven-day hearing and then the appeal.

The main issue was whether the auditor should have looked behind a description in the accounts of "Cash – LS Holdings P/L" to see whether it was cash or cash equivalents. LS Holdings P/L was of course the vehicle for Mr Lewis. The poor Doctor had to give evidence as to his inferior understanding of investments and even cash. These were more correctly loans to that company but not necessarily recoverable.

Again, 10% of the loss was attributable to the trustee and 90% to the auditor but arguably Mr Lewis was more to blame.

We may complain that the bad guys got away again but these decisions are not surprising to those of us who read the cases and act in them. The practical solution is to have advisers that will be around to assist if things do not go to plan.

We know that most investment strategies for SMSFs are vague and not prepared by specialists in asset allocation. That is a form of madness and, in our experience, people who set up SMSFs sometimes suffer from taking their own advice or that of friends. We commend professional advisers and can give names if you contact us directly.

Donal Griffin is the Principal of [Legacy Law](#), a Sydney-based legal firm specialising in protecting family assets. The firm is not licensed to give financial advice. This article does not consider any individual circumstances and Cuffelinks does not know the merits or otherwise of the case.

Court holds SMSF trustees accountable

Kimberley Noah and Bryce Figot

The recent case of *Re Marsella* [2019] VSC 65 (*'Re Marsella'*) concerned a dispute over superannuation death benefits. This decision highlights the importance of SMSF trustees exercising their discretion to pay death benefits in good faith, with genuine consideration and in accordance with the purpose for which the power was conferred.

It is an important decision in the context of superannuation law as the Court ultimately removed the trustee on the basis that the discretion was not exercised appropriately.

Facts of the case

The case concerned the payment of death benefits from the Swanston Superannuation Fund ('Fund'). Helen Marsella was the sole member of the Fund and her daughter from her first marriage, Caroline Wareham ('Caroline'), was a co-trustee.

Helen Marsella died in April 2016, at which time her Fund balance was an estimated \$450,416. She was also survived by her husband of 32 years and executor of the estate, Riccardo Marsella ('Riccardo').

Following the death, the relationship between Riccardo and Caroline became strained and a dispute arose when Caroline, as trustee of the Fund, appointed her husband Martin Wareham ('Martin') as a co-trustee. Immediately before Martin was appointed, Caroline exercised her discretion to pay the deceased's death benefits in her own favour. Immediately after Martin was appointed, Caroline and Martin re-made the same decision to pay the deceased's death benefits in Caroline's own favour.

In response, Riccardo sought the removal of Caroline and Martin as trustees of the Fund, the appointment of a new independent trustee and the repayment of the death benefits with interest to the Fund. Riccardo made submissions that the trustees did not exercise good faith, with a real and genuine consideration of the interests of the Fund's beneficiaries and accordingly the payment to Caroline should be set aside.

Caroline and Martin made submissions that the deed provided them with absolute discretion in relation to the payment of death benefits and submitted that they were not required to provide reasons for their decisions.

Key questions for the Court

The Court considered:

- Whether Caroline and Martin properly exercised their discretion in good faith, with real and genuine consideration and for the proper purpose for which the power was conferred.
- Whether Caroline and Martin should be removed.
- Whether a new, independent trustee should be appointed in their place.

The decision on a failure to exercise proper discretion

McMillan J held that Caroline and Martin failed to exercise their discretion in good faith with a real genuine consideration of the interests of the Fund's beneficiaries and subsequently removed Caroline and Martin from the office of trustee.

When considering whether their discretion was exercised appropriately, McMillan J looked at whether they had acted in good faith and in accordance with the conferred power's proper purpose.

McMillan J emphasised that Caroline's actions, particularly in relation to her arbitrary payment of benefits to herself was conducted with "... ignorance of, or insolence toward, her duties ..." and was beyond "mere carelessness" or "honest blundering".

In the context of the improper exercise of discretion and the significant personal acrimony between Caroline and Riccardo, McMillan J held that Caroline and Martin were to be removed as trustees of the Fund. Moreover, it was held that Riccardo was to file further submissions for the appointment of an independent trustee to ensure that the Fund met the definition of a complying superannuation fund for the purposes of the *Superannuation Industry (Supervision) Act 1993*(Cth).

Trustee duties of good faith and genuine consideration

It can be drawn from this decision that while an SMSF trust deed may afford unfettered discretion (eg, in relation to payment of death benefits), SMSF trustees must ensure that they exercise their discretion in “good faith, upon real and genuine consideration and in accordance with the purposes for which the discretion was conferred”. This is consistent with the well-established principles in *Karger v Paul* [1984] VR 161 regarding the proper administration of a trust and in what circumstances a trustee’s exercise of discretionary powers may be challenged.

Trustees must act impartially and in good faith. In *Re Marsella*, Caroline’s actions were found to be inconsistent with these standards. Among other things, she was found to have acted arbitrarily when distributing the death benefits to herself, with indifference towards her duties. McMillan J also found that Caroline had failed to properly inform herself in the proper discharge of her duties which required her to properly consider the estate as a potential beneficiary, and correspondence between her lawyer and Riccardo evidenced a dismissive tenor.

Moreover, this decision highlights the importance that trustees exercise their powers in accordance with the purpose for which they were conferred.

Where there has been a break down in relationships, SMSF trustees need to be especially mindful that they do not let any prejudices interfere with their proper exercise of trustee duties and high-handed communication with potential beneficiaries can be grounds for setting aside a decision in relation to the payment of death benefits.

What impact does this have for SMSFs?

In light of this decision, SMSF trustees should consider reviewing their SMSF succession planning to ensure the fund is properly managed on the loss of capacity or death of a member. In particular, SMSF trustees should ensure that the fund is placed in trusted hands and importantly, SMSF trustees should seek independent, specialist legal advice where uncertainties arise. This is particularly crucial where the fund has a significant balance or if there are any complexities.

Kimberley Noah is a lawyer, and Bryce Figot a special counsel at leading SMSF law firm [DBA Lawyers](#). This article is for general information only and should not be relied upon without first seeking advice from an appropriately qualified professional.

Why Budget infrastructure spending matters

John Julian

In the Federal Budget delivered last week, Treasurer Josh Frydenberg outlined \$100 billion in infrastructure spending over the next decade, mostly on road and rail projects. Two days later Opposition leader Bill Shorten said a Labor Government would spend more than \$100 billion on the roads and rail network.

They were big numbers and there was spending for all states and territories, but is it enough for Australia to fulfil its long-term economic potential?

Invest in infrastructure, invest in economic prosperity

At a macro level, investment in infrastructure is an investment in the economic future of a country. It provides a major stimulus for economic activity and throughout history has been a fillip for many poorly-performing economies.

The most famous modern-day example was the New Deal in the United States, announced by President Franklin D. Roosevelt in 1933 in the midst of the Great Depression. The New Deal was a broad package of reforms, including government spending on highways, bridges, schools and parks.

The New Deal established the Tennessee Valley Authority to provide electricity (and jobs) to seven of the most impoverished states in the south of the country. To this day, it remains one of the nation's largest public power providers.

The New Deal also created the Works Progress Administration to employ mostly unskilled labour. It built more than 4,000 school buildings, 130 new hospitals, laid 9,000 miles of drains and sanitary sewer lines, planted 24 million trees, constructed 29,000 bridges and paved or repaired 280,000 miles of road.

But while President Roosevelt was overseeing a depressed economy needing substantial fiscal stimulus, Australia is a long way from that. Nevertheless, what the New Deal taught the world was that broad spending across major public projects can have profound effects for decades to come.

The New Deal spending transformed the economy and US society. It was the birth of the US road system that is still in place today, opening up cities and markets across the country.

Whoever is in government in Australia in the years to come has the same opportunity.

Spending on projects such as the so-called 'high speed' rail link between Melbourne and Geelong, with its intended 150 km/hr speed, will allow Geelong residents to quickly commute to jobs in Melbourne. The Government has promised \$2 billion to the project, and the ripple effects are expected to be substantial, from stimulating regional growth through to putting both upward and downward pressure on house prices and taking cars off the road in urban areas. This can be genuinely game-changing for the city of Geelong.

Its success (or otherwise) will be closely watched, and it could become the model for many more hub-and-spoke rail projects around major cities across the country.

But despite the merits of this and the other projects announced, the promised spending on infrastructure from both the Coalition and Labor is still below the long-term average of infrastructure spend as a percentage of Gross Domestic Product, and is focussed on big-ticket spending on roads and rail.

More than roads and rail needed

In Australia, with our vast distances and relatively sparse population, it makes sense for government and the private sector to work together to provide a modern infrastructure network that goes beyond just our transportation needs.

In the US and Europe, there is enormous investment going into power generation, from natural gas power plants in the Ohio Valley through to wind farms across Scandinavia. Water utilities and waste processing plants are being developed attracting billions of dollars in investment.

Power and water, just like in the 1930s, remain central to infrastructure programmes that benefit society but the modern model now sees them funded by a mix of public and private spending. Other infrastructure projects include data centres and telecommunications towers and small cells for the roll-out of the 5G network.

When compared to roads and rail, there was relatively little spending on these types of infrastructure projects in both the Government's announcement and the Opposition's response. An exception was the Snowy Hydro 2.0 expansion which will receive \$4 billion, most of which had already been announced.

Each state received funding for "roads of strategic importance". New South Wales received \$3.5 billion for the Western Sydney rail line and \$1.6 billion for the M1 Pacific Motorway. In Victoria there was \$1.1 billion promised for suburban roads upgrades, alongside the Melbourne to Geelong rail link. South Australia was promised \$1.5 billion to build a north-south road corridor.

There was also funding for a national road safety package and to develop business cases for a future fast rail line running down the east coast of the country. The Urban Congestion Fund increased from \$1 billion to \$4 billion, to fund projects aimed at removing congestion from urban areas.

The opening of investment opportunities

From a private sector investor's point of view, many public infrastructure projects will eventually be privatised. This has already occurred at airports, ports and utilities across Australia and is expected to occur with other infrastructure assets.

And while the increased funding provides a pathway to the delivery of much-needed infrastructure, questions will linger about whether it is broad-based enough, and large enough for Australia to fulfil its long-term economic potential.

John Julian is Fund Manager of the Core Infrastructure Fund at [AMP Capital](#), a sponsor of Cuffelinks. This article is for general information only and does not consider the circumstances of any investor.

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Report by franking credit inquiry released

Graham Hand

Report on the inquiry into the implications of removing refundable franking credits

In September 2018, the Treasurer, Josh Frydenberg, asked the House of Representatives Standing Committee on Economics to inquire into the implications of Labor's proposal to remove refundable franking credits.

The Report was [released last week](#).

From the start, the Committee's work was controversial, and this is reflected in the strongly-worded Dissenting Report from the Labor members of the Committee (at the end of the full report). I already wrote [an editorial](#) on the ways the Government led by Tim Wilson used the parliamentary committee process to agitate against the policy. At one stage, the Committee required people attending the public hearings to register for a petition against the so-called 'retirement tax'. The Committee received 1,777 submissions, plus 1,108 'form letters', essentially as provided by Mr Wilson.



I will attend the following Public Hearing
Bondi Junction, NSW - 2.00pm to 3.30pm - 8 February

I want to be registered for the petition against the retirement tax.
This field is required.

I want to be contacted on future activities to stop the retirement tax.

The Committee became a forum for hundreds of people to vent their anger at the loss of their franking credit refunds, usually retirees who were not wealthy and had planned for a self-funded retirement with the benefits of a full refund. For example, the Report records:

"Many affected retirees spoke of anxiety from the fear of losing a third of their income. There's Karen's story of 'exhausting and soul destroying' stress.

Others raised concern that abolishing refundable franking credits would compound the legacy of the gender pay gap. There's Margaret's story of historic sexism and how 'too many people making decisions for us' are 'totally unaware of history and our lives'.

And then there are straight stories of financial hardship. There's Michael's story of medical challenges and how the removal of refundable franking credits will cause him 'considerable hardship'."

Notwithstanding the genuine complaints that people had planned for their retirement legally under a prevailing set of rules, the Committee should be seen within a political context, especially in the month before a Federal Election.

There are only two recommendations: 1) not to remove refundable franking credits, and 2) any policy should be part of an equitable package of tax reform.

Highlights of the Report

Tim Wilson's summary rightly points out that wealthy people with large SMSFs are less likely to be affected by the loss of refunds, while those people who earn less than the \$18,200 tax-free threshold would be better outside superannuation.

"It also does not take account of the introduction of the transfer balance cap in the 2017/18 financial year that applied a 15 per cent tax rate on income earned on balances above \$1.6 million. These funds will continue to enjoy the use of franking credits to fully offset their tax liability, while those under \$1.6 million will not.

"Abolition of refundable franking credits is fundamentally regressive. Australia has a tax free threshold of \$18,200 for workers, yet the abolition of refundable franking credits would apply an effective 30 per cent tax from the first dollar earned."

There is also a problem with the data, as the Report uses 2014/15 numbers which do not reflect the introduction of the \$1.6 million transfer balance cap on 1 July 2017. There is far less in the pension phase of super than the Report suggests. Nevertheless, the Report quotes the Alliance for a Fairer Tax System data which stated that in 2014-15, over half of those receiving cash refunds had incomes below \$18,201, and 96% had taxable incomes of less than \$87,000.

Much of the Report quotes individuals who will be adversely affected, and financial services groups defending their members.

The revenue implications are huge. The independent Parliamentary Budget Office (PBO) estimates the policy will collect \$5.2 billion in 2020-21 and \$48.6 billion by 2027-28.

For the record, in its conclusion, the Committee:

".. is of the view the policy is inequitable, deeply flawed and the timeline is rushed ... the ALP's policy will unfairly hit people of modest incomes who have already retired, and who are unlikely to be able to return to the workforce to make up for the income they will lose."

The Dissenting Report

The three Labor members of the Committee produced a long Dissenting report, with their main argument being the inequitable nature of franking refunds. Their comments particularly target SMSFs:

"This analysis from the PBO shows that 92% of taxpayers in Australia did not receive any cash refunds for excess imputation credits in 2014-15. 90% of all cash refunds to superannuation funds accrued to SMSFs (just 10% went to APRA regulated funds). Labor understands that this is despite SMSFs accounting for less than 10% of all superannuation members in Australia.

The PBO analysis indicates that of all excess imputation credits refunded to SMSFs in 2014-15, 50% of the total benefits accrued to the wealthiest 10% of SMSFs by fund balances (which had balances in excess of \$2.4 million). The top 1% of SMSFs by fund balance received a cash refund of \$83,000 (on average). Labor's analysis shows that this is an amount greater than the average full time salary."

Where does that leave us, other than with two sets of political statements?

Shadow Treasurer Chris Bowen shows every sign of toughing it out with the policy and taking it to the next election and beyond, but if Labor wins the Lower House, it is unlikely to control the Senate. Bowen will argue he has a mandate but he will probably need to relax parts of the policy to gain the numbers to pass the required legislation. Changes such as allowing the first \$5,000 of excess refunds would still allow him to claim he has targetted the wealthy.

Graham Hand is Managing Editor of Cuffelinks.

Private equity grows as listed companies are only the tip of the iceberg

Nick Griffiths

Private equity is not an asset class at the top of most individual investors' wish lists. Why? It is certainly an asset class people are aware of. It gets a lot of press, and it is an asset class that large institutional investors value and allocate to. The Future Fund, for example, has a 15% allocation to private equity.

So why don't individual investors invest significantly in this asset class? The overriding theme is that it is too hard to access. Reasons may include a lack of suitable investment vehicles which would enable investors to

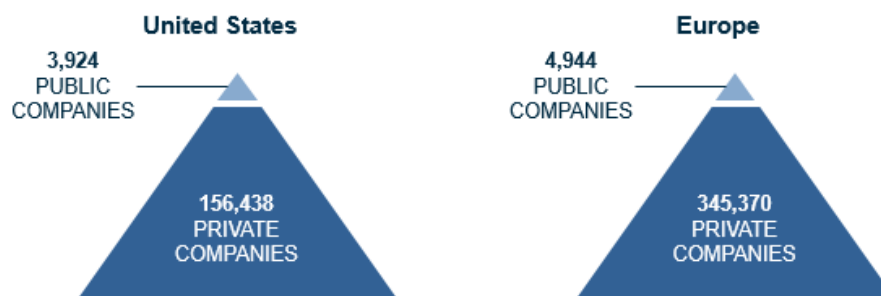
obtain meaningful and diversified access. The investment process is also complicated by minimum equity commitments, the management of progressive drawdowns, irregular distributions, and long-term lock ups.

What is private equity?

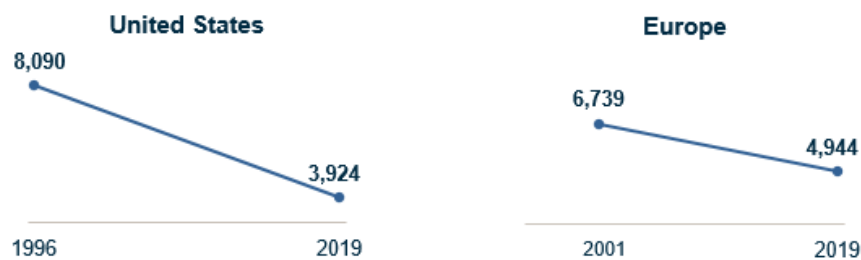
Private equity typically involves taking an ownership interest in an unlisted, private business or asset. It includes a broad range of longer-term and company-specific exposures which, because they are not listed on a public market, tend to exhibit somewhat lower correlation to traditional stock and bond markets. Private equity managers seek to generate superior returns through taking an active role in monitoring and advising companies through restructuring, refocusing and revitalising tactics in order to sell the investment at a profit. It is a more hands-on investment compared to an investment in the shares of a listed company.

It may surprise some that the universe of private companies is significantly larger than that of public companies, and that the number of listed companies has been steadily decreasing. As shown in the following diagrams, since 1996 the number of US listed companies has fallen 50%.

Private markets are significantly larger than public markets



The number of listed companies has been steadily decreasing



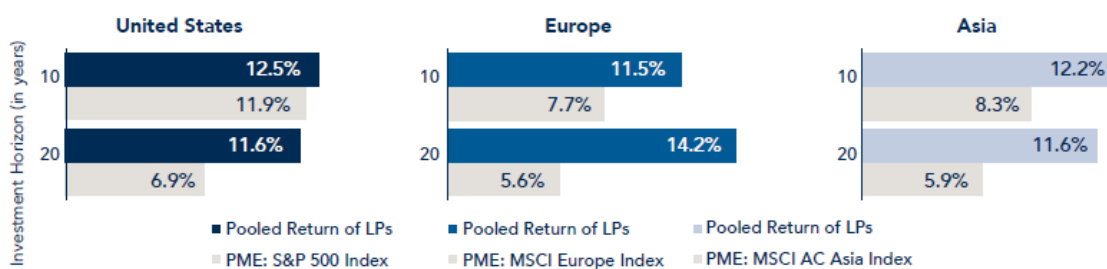
Source: S&P Capital IQ

Global allocations by investors to private equity have been steadily growing since 2000, having increased almost 6 times over the period.

How has private equity performed?

One of the key reasons for the increasing allocations to private equity may have been its performance. Private equity has outperformed public equity across long term time horizons (10 and 20 years) as well as geographic regions. The following graphs compare private equity investments against hypothetical funds that buy and sell shares of the relevant equity index at the same time the private equity vehicles call and distribute cash.

Annualised Performance (IRR) of Private Equity versus Public Equity across Time Horizons and Geographic Regions



Source: GCM, using data from Burgiss Group and MSCI

There are a number of factors that have historically contributed to the strong performance of private versus public equity. The most significant are:

- the lack of short-term public pressure allowing for a long-term investment orientation
- the historical resilience of performance across various market environments
- the illiquidity premium – investors prefer liquid investments and therefore demand an increased return on less liquid alternatives.

Five ways the risks are different from listed equity

The unlisted and hands-on nature of private equity investments suggest there are different risk considerations compared to public equity markets. Some risks are of course the same – economic, market, currency, political, etc. – but others differ, and we highlight these below:

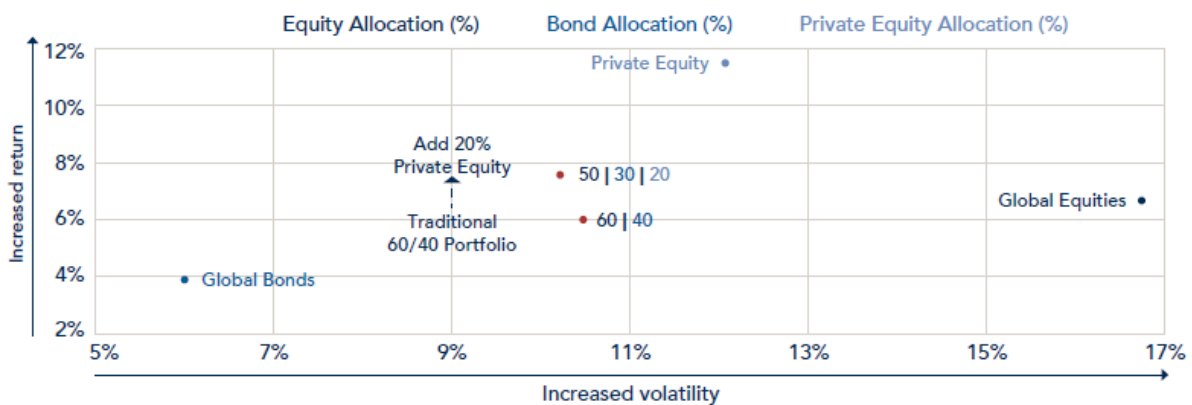
1. Unlisted private equity investments are typically illiquid. Private equity funds may hold securities or other assets in companies that are thinly traded or for which no market exists.
2. Distributions tend to be irregular and depend on the sale of an underlying investment.
3. Third party pricing information is also not available for a large proportion of private equity assets. Valuations may therefore require discretionary determinations and in certain circumstances investors may have to rely on valuations from the underlying managers themselves.
4. The companies invested in may involve a high degree of business and financial risk. They may be in the early stage of development, may be rapidly changing, may require additional capital to support their operations, or may be in a weak financial condition. While these are also opportunities, they clearly represent risks that need to be controlled by private equity managers.
5. There is also generally less information available about private companies than their listed peers. This means that investors with higher quality information are often able to make better investment decisions and is one of the reasons performance dispersion in private equity tends to be greater than in the public markets. Extensive due diligence and careful monitoring are essential safeguards when constructing private equity portfolios.

What does private equity bring to a diversified portfolio?

Historically, one of the key benefits of private equity has been its somewhat lower correlation to other traditional assets and the diversification benefits this has provided at a portfolio level. The chart below shows that adding a 20% allocation of private equity to a traditional 60/40 equities/bond portfolio generated higher returns with lower risk (as measured by volatility) over the last 20 years.

Risk vs Return

Annualised return (%) (the vertical axis) versus annualised standard deviation (%) (the horizontal axis), 20 years ending 30 September 2018. Annualised Standard Deviation¹¹ is a measure of risk of investing in the portfolio of assets.



Source: GCM using data from Burgiss Group

To an extent, the diversification may be derived from periods of economic stress such as the GFC.

How can retail investors access private equity?

Private equity has been a difficult asset class to access for individual investors. However, there are now a handful of unlisted and listed funds and trusts in Australia that overcome many of the hurdles.

Listed and unlisted vehicles have their own pros and cons, but the key is liquidity. Unlisted funds may offer daily or monthly liquidity, however, given the illiquid nature of the underlying investments, they have the ability to restrict or freeze redemptions. Listed vehicles provide liquidity for investors who can buy and sell on market as long as an active market exists.

The private equity universe is vast, differentiated by types of companies, investment strategies, and implementation options. Private investment vehicles differ markedly across these variables and, as with listed equity vehicles, it makes sense to have more than one in your portfolio.

Nick Griffiths is the Chief Investment Officer of [Pengana Capital](#). This article is for general purposes only and does not consider the circumstances of any investor.

5 key ways to better engagement with boards

Maria Leftakis

Governance and shareholder engagement firm Morrow Sodali has released its fourth annual Global Institutional Investor Survey which includes feedback from a third of the world's assets under management representing \$33 trillion gathered from 46 respondents, including several domestic funds.

The results confirm that 2019 will be another year of transformative change as investors step up engagement to better understand the alignment between board composition and business strategy, especially in the way the board oversees corporate culture and the 'tone from the top'.

Increasing role of non-financial factors

In light of the report from the Hayne Royal Commission, these findings reinforce the increasing importance of non-financial factors in assessing a company's performance and corporate behaviour.

Investors want to engage with boards regularly throughout the year and they also want more substantive information about board composition and business strategy. They want clearer explanations on governance and executive remuneration. They also want an integrated narrative that explains environmental, social and governance practices in terms of business risk and sustainable financial performance.

Many investors are moving away from box-ticking and compliance checklists which is good news for companies. It gives companies greater flexibility to explain policies in terms of their specific business conditions and strategic goals. But a deeper dive by investors into companies' strategic decisions increases demands on the time and attention of directors, requires much greater transparency and needs to consider the continuous disclosure obligations.

Key survey findings

Five important issues raised by the results are:

1. The quality of a company's governance policies and practices will play a pivotal role when investors make voting decisions

Asked to rank the importance of various factors that determine how they make voting decisions, 93% of respondents selected "governance policies and practices", 72% selected "long-term business strategy", 65% selected "the quality and completeness of the company's communications" and 54% selected "environmental and social policies and practices."

2. Investor focus on board engagement continues to increase

A whopping 87% of respondents indicated that "proactive and regular engagement with the board of directors" helps in their evaluation of a company's culture, purpose and reputational risk. In addition, 72% selected

“proactive and regular engagement with management.” Thoughtfully planned engagements have become critical, strategic initiatives. They help secure favourable votes and minimise threats of activism. Additional context on proactive engagement can be found in the responses to “What are your goals when engaging with listed companies and their directors?” with 67% seeking to understand the company’s business strategy and capital structure and to understand how the board oversees corporate culture and the tone at the top. Only 35% see engagement as a way for investors to proactively inform companies about their voting policies and investment philosophy.

3. Investors will increase their focus on board composition and accountability in 2019

The spotlight will continue to be on director competence and boardroom transparency. Respondents made clear that the “skills” (70%) and “independence” (67%) of directors are critical factors in their evaluation of individual board members. These results are reinforced by their response to diversity. Gender and ethnicity scored much lower in importance than “skills and qualifications” (89%) and “professional experience” (72%) as criteria for judging the diversity of a board’s composition. Investors also signalled their support for board evaluation, done either internally or with an external third-party assessment.

4. Companies can expect more focus on disclosure and increased dialogue around climate change

85% of respondents said that they view climate change as the most important sustainability topic. This result is slightly different than responses to a previous question where, when asked to rank the importance of detailed disclosure on a list of topics, 83% wanted more detailed information about human capital management, while 76% wanted more detail on climate change. This result may indicate that currently more information is available on climate change than on human capital management. The challenge for both companies and institutional investors is to better understand and agree upon which metrics are relevant to a company’s long-term performance and agree on standards that permit comparability with its peers and within a specific industry.

5. An activist’s credible story focusing on long-term strategy is likely to attract investor support

Activism is on the increase both in Australia and internationally. But even so, activists need the support of their fellow shareholders to leverage their influence. In 2017 we identified that 57% of respondents would engage with activists when approached, and 43% would proactively approach activists. This year we sought to find out what are the issues that might trigger such a discussion. Whilst historically activists tended to rest their cases on financial restructuring and operational improvements, these days more strategic issues become common – for example M&A, capital allocation and other aspects of corporate strategy. It is therefore interesting to observe that institutional investors are most likely to support an activist with a credible story focused on long-term strategy (50%) and in cases where the target company has unclear business strategy (46%), misallocated capital (43%) or a lack of board accountability to shareholder concerns (41%). Strategic shareholder activism is now defined as an asset class. Activism is here to stay. The debate over whether activism creates or destroys value is now mainly a topic of interest to academics and regulators, while companies must adapt to the realities of a marketplace that encourages activism.

Looking ahead

The trends of increased investor engagement as well as deeper integration of ESG into the investment process are at an important juncture for equity capital markets; our survey highlights this with increasing conviction each year.

As asset owners demand greater transparency on how investment managers exercise their stewardship duties, not merely to attract investment returns but also increasingly to integrate ESG considerations into the investment decision making process, we observe the encouraging progress on this journey.

The change of pace around ESG integration, the continued rise of activism and recent corporate scandals all combine to create an ever-growing necessity for companies to keep abreast of the expectations and thinking of their Institutional Investors. Those who do this will observe that investors have shifted their focus from a company’s compliance with corporate governance codes, to sustainability related principles that have impact beyond proxy voting to engagement strategies and investment decisions.

Maria Leftakis is CEO Australia at Morrow Sodali. To read the Morrow Sodali’s Global Institutional Investor Survey in full, [click here](#).

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