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### Steps SMSFs may take to beat Labor's franking

Matthew Collins

A retiree with an SMSF portfolio of \$1 million in Australian shares may be worse off by around \$20,000 if Labor's franking credit refund proposal is legislated. What if this loss could be avoided while still investing in franked shares?

In May 2018, I [wrote about](#) how SMSF trustees may use public fund 'direct investment' (sometimes called 'member direct') options to counter Labor's proposal. Since then, the concept has gathered momentum with other articles on how public funds expect to treat franking. These include '[How do direct investment options deal with franking credits?](#)' by AustralianSuper's Tom Garcia, and '[On franking, all public funds are not the same](#)' by Graham Hand.

The question remains, how does a direct investment option work in practice? There are two ways for retirees facing a loss of franking refunds:

- Close their SMSF and invest exclusively through the direct investment option, or
- Hold some assets via a direct investment option while maintaining the more flexible SMSF.

The second option may be popular as it will allow investors to receive franking credits while preserving the flexibility of an SMSF which can hold a greater variety of assets.

#### Shifting shares into a direct investment option

The best way to explain the process of shifting investments is by an example.

A \$1 million SMSF portfolio holding only fully-franked Australian shares yielding 5% within a pension phase fund currently provides the following return:

- Cash dividend: \$50,000
- Refundable franking credit: \$21,429 ( $\$50,000 \times 3 / (10 - 3)$ )

The loss of the \$21,429 refund, or 30% of the investment return, will provide impetus for some trustees to transfer to a large fund that offers a direct investment option. How could you do this?

**Step 1** - Individual shareholdings cannot be transferred 'in specie' to a public fund so you must first sell your shares. The cash is then rolled over to the new public fund.

**Step 2** - The money in the public fund is initially held in cash. You then have the option of transferring most of it (usually up to 80%) to a direct investment option. The remaining 20% is left in the fund's other investment options and must include a cash allocation to cover items such as fees, insurance or income payments when in pension mode.

**Step 3** - Once money is in the direct investment option, you will be able to select investments from a predetermined list. The options are generally limited to:

- ASX 300 companies
- A selection of listed investment companies or trusts
- A selection of exchange traded funds
- Term deposits
- Cash

I have had first-hand experience with a direct investment platform and have found it user-friendly and similar to trading via an online broker.

I repeat that a maximum of 80% (this may vary by provider) of the balance can be invested in the direct investment option. The rest must be invested in one of the other options offered by the fund such as a balanced option, cash or term deposits. Some SMSF trustees may consider this a drawback of the member direct strategy.

#### **How much does it cost?**

Fees should be a major consideration whenever an investment is contemplated. Given that Tom Garcia from AustralianSuper wrote in Cuffelinks exactly how they expect to treat franking credit refunds under Labor, I have used their fee structure in my example. There are many other public fund options – both retail and industry – which should clarify their treatment of franking.

The fees associated with this strategy will include:

**Initial advice fee:** There is plenty to consider when contemplating a strategy like this and professional financial advice is a must.

**Brokerage to sell your portfolio:** It will be necessary to sell your portfolio before it is transferred to the new fund. For example, it would cost \$1,200 to sell a \$1 million portfolio held via Commsec at their brokerage rate of 0.12%. There will also be a period where investments will be 'out of the market' during the transfer process. This process may end up taking a couple of weeks.

**Brokerage to buy shares within the new fund:** The brokerage rate in direct investment options varies from fund to fund. AustralianSuper's fee is 0.12% for trades over \$50,000.

**Fee on the 20% investment not in the direct investment option:** This fee will vary depending on the investment option chosen. Index options are the least expensive. For example, AustralianSuper's balanced index fund has an annual fee of 0.16%, while the general balanced fund costs 0.66%.

If the 20% is held in the cash account in the member direct option, it can earn a higher interest rate (cash plus 0.9%) but it incurs a charge of 0.12% on the cash balance.

**Annual administration:** All large industry funds charge an administration fee which varies from fund to fund. On a \$1 million direct investment in AustralianSuper, the annual administration fee would be \$867 (an account keeping fee of \$117 and an asset-based administration fee of 0.11% capped at \$750).

#### **Total costs for a \$1 million portfolio**

##### **Upfront**

Assuming an online broker is used, the cost to transfer would be:

- Share sale (0.12%): \$1,200
- Share purchase in AustralianSuper: \$960 (for 80% of portfolio)
- Total upfront cost: **\$2,160**

On top of the brokerage, there may also be a fee payable to a financial adviser for advice on the transfer.

### Ongoing fees

Assuming the balanced index option is chosen for the 20% not invested in the direct investment option, the fees would be:

- Annual administration fee (pension): \$867
- Investment fees (balanced index for 20%): \$320
- Investment fees (member direct for 80%): \$395
- Total ongoing fees (per annum): **\$1,582**

### Fee comparison with SMSFs

According to a June 2018 report from ASIC:

*"The average annual cost per fund of running an SMSF in 2015–16, in terms of administration and operating expenses, was \$3,595 and, for investment expenses, was \$4,173."*

That totals **\$7,768**. Clearly, many trustees manage their fund for significantly less. However, the comparison shows that some trustees would pay lower fees in a direct investment option, on top of benefiting from franking refunds (if legislation changes), instead of using an SMSF.

### Is a member direct investing option worth considering?

At this stage, we're jumping the gun. Labor needs to be elected, and then it must obtain Senate support for its proposal, and already, the cross-benches are indicating a lack of support. It is premature to take action now, although it is worth knowing the alternatives.

The cost-effectiveness of this strategy depends upon a host of tax and investment considerations. Notably, SMSFs are far more flexible in the range of investments allowed in member direct. An SMSF would be required for direct property, many small cap stocks, unlisted bonds and more esoteric holdings such as collectibles.

In the example provided, the benefit from using a member direct investment will be at least \$20,000 per year, although most franking credit refunds are smaller than this. Such a benefit will be attractive to a retiree who is willing to compromise in terms of how they invest and what they invest in.

***Professional advice is required before contemplating this strategy. This article only scratches the surface of the issues that need to be considered.***

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## 3 key risks: banks are too big to behave badly

Kate Howitt

It's difficult to imagine the landscape without them. Indeed, history has shown that they're too big to fail. However, revelations from the Financial Services Royal Commission have certainly taken a toll on how we perceive our major banks.

As investors, we have been long-term beneficiaries of the regular dividends they pay and yet some of the conduct uncovered has been reprehensible. So as investors, how should we look at banks in the future?

For me, there are three key areas to consider:

### 1) The importance of managing risk

Since the GFC, banks have made many changes to shore up what were already strong capital foundations. Capital ratios have risen almost three-fold in 10 years to 'unquestionably strong' levels. Liquidity management

has also strengthened with banks switching to more stable sources of funding and increasing their holdings of liquid assets. As a consequence, Australian bank return on equity (ROE) [has slightly decreased to around 12%](#) but still remains strong by international standards (around 8% for large US banks).

Today, we're largely at the tail-end of this shoring up process, although as highlighted by the Royal Commission, there's still some work to do to mitigate operational risk stemming from poor culture. To date, the financial implications for 'banks behaving badly' have been relatively minor, but the consequences of reputational damage could significantly impact profitability if it continues.

## 2) A slowing credit market

In the last 12 months the credit market has noticeably slowed, as shown below. This is likely to continue, at least on the investor side, as a result of households becoming more cautious and banks tightening their lending standards. With household debt at high levels relative to global benchmarks, this isn't altogether a bad thing. In fact, longer term it will have a positive impact on our financial security as Australia and the banks will be more resilient to a downturn.

### Credit growth (six-month-ended annualised)



Source: APRA, RBA

Shorter term however it does have a couple of implications for the majors:

- Fewer loans mean less profit.
- Tighter lending practices mean more stringent checks and balances which increases the time it takes to process a loan application.

Tighter lending standards have meant more paperwork because it's new and the process is still quite manual. Over time, it will become increasingly automated making the process much faster and importantly cheaper. We can expect to see technology projects replace people as the need to reduce the cost of labour intensifies.

## 3) Disruption from an intruder

In the last 10 years, we have witnessed some remarkable changes in market leadership in other industries. Established Goliaths have fallen as disruptors have swept in and completely sidelined their business models. So, could something like this happen to the major banks?

There will continue to be smaller companies which pick off individual niches. For example, OzForex in foreign exchange and AfterPay in payments. But when it comes to the core banking operations, Australian banks have invested heavily in technology particularly around service and convenience and a disruptor would have to offer something unique to displace them in a material way. This is especially true in banking, given the time it takes to establish the 'trust' many of us seek from our institutions.

Perhaps what strikes me most about Australia's banks is their ability to adapt. Whether it be self-regulation to strengthen their financial health or investing heavily in technology to meet the changing needs of their customers, they really are the ultimate market chameleons. And they'll need to be.

The GFC proved they were 'too big to fail' but today the message from the Royal Commission is clear – they're 'too big to behave badly'.

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## **SMSF trustees may lose insurance after super changes**

Gemma Dale

The 'Protecting Your Superannuation' package, proposed in the 2018 Federal Budget, was passed earlier this year, and while the changes were designed to protect small superannuation balances, there may be significant implications for others. Many SMSF members, or others with large super balances, maintain smaller public offer accounts solely to access well-priced group life insurance. This legislation may place those life policies at risk unless members take action.

### **Super changes already legislated**

The key changes in this legislation take effect from 1 July 2019, and are designed to limit the erosion of small balances in the following ways:

- Fees will be limited to no more than 3% per annum for accounts with a balance of less than \$6,000.
- Exit fees on all super accounts will be banned to remove barriers to consolidation.
- Insurance will be maintained on an *opt-in basis for inactive accounts*, defined as those that have not received a contribution in 16 months. Funds will be required to contact inactive members before 1 May 2019 to confirm whether they wish to maintain their existing cover.
- Super trustees will also be required to transfer all inactive accounts with balances below \$6,000 to the ATO, which will then strive to transfer these balances to the owner's active superannuation account.

(Please note: The proposal to make insurance an 'opt-in' for those commencing a superannuation account under the age of 25, or with a balance of less than \$6,000, was dropped from this legislation and will be proposed in a separate bill, which has not yet passed).

If you have been maintaining a small inactive superannuation fund for insurance purposes, it is likely this legislation will affect you. You may have your insurance policy cancelled, or, if your balance is below \$6,000, your policy cancelled AND your balance transferred to the ATO. Neither of these outcomes is desirable if you are intentionally arranging insurance cover in an account separate from your existing active super balance.

### **Benefits of insurance through a large fund**

If you have an inactive account, your superannuation fund should contact you soon requesting that you opt in to maintain your insurance cover. However you will need to ensure they have the correct mailing details etc in order to contact you. If you have not heard from your fund by 1 May, it is strongly advised that you contact them directly to confirm that you wish to maintain your cover, if you wish to do so.

The implications of having insurance cancelled can be significant. It is widely accepted that thousands of small superannuation accounts are maintained in the public system by SMSF trustees purely for insurance purposes.

Superannuation funds can hold life, total and permanent disablement and income protection policies on your behalf. Large funds are also generally able to access group policies that offer lower premiums than personal policies such as those you can access through an SMSF. Large super funds also often offer 'automatic acceptance limits', which allow you take out cover up to pre-specified limits without having to undergo personal underwriting, which may include medical tests and so on.

In the event your existing cover is cancelled, you may not be able to get new cover on the same terms. You may need to disclose medical conditions that have arisen since you originally applied, and have higher premiums or exclusions as a result, or you may no longer be eligible for cover at all through that fund. In many circumstances, particularly if you are older, or have poor health or a high-risk occupation, your existing policy may be the only insurance policy you hold. It may also be the only affordable insurance you are able to get.

### **Qualifying a fund as active**

Insurance is critical if you have debt, dependents or rely on your income for your financial security. If that insurance is held in a super fund you're not contributing to, you will need to consider whether to make the fund active, or at least ensure that the trustee of the fund knows you want it by opting in. Part of the new legislation lists actions that qualify a fund as active, which include making contributions, rolling funds into the account, changing investment options, making changes to your insurance or making a declaration to the ATO. If you're not sure what you have, exactly, this could also present a great opportunity to review your insurance and ensure you have the cover you need.

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## **Fascinations: investment management can learn from sport**

Joe Magyer

For all their speed and dynamism, both sports and investment management are realms where change is slow in coming. Basketball hoops have hung at 10 feet ever since James Naismith invented the sport back in 1891. In the investment arena, even though most Australians have been online since 2001, it is still common for investors in an unlisted managed fund to provide a wet signature with their applications.

Culture can change faster than the rules of engagement, but the tendrils of tradition are still long and potent. There aren't many hard rules around where baseball players may stand on the field, for example, but teams today still use the same positions as did the first World Series winners, the 1903 Boston Americans.

Where change *can* happen, though, is when it comes to how best to connect and focus the team. For example, since the creation of the National Basketball Association, players have been lumped into three positional categories – guard, forward, and center – and that mix was only marginally more refined in the 1980s. Unless a team had a Michael Jordan (and there is only one of those), the standard basketball strategy was to try to find a big man to build around. The nine highest-paid players in the NBA were all big men.

NBA coaches and executives slowly realised, though, that if the ultimate goal of an offense was to put a ton of points on the board, the best way to do so was to take more and better shots. It sounds obvious in hindsight but slowing down to pass the ball to your least-skilled player so that he could try to make a difficult shot with another 7-footer in his face was not an optimal strategy.

The net effect is that today's NBA is scoring a staggering 21% more points per game than it did 20 years ago while also shooting for a higher percentage. Oh, and by the way, only two of the 10 highest-paid players today are big men. The other eight are more agile guards and forwards who can find open space and create their own smart shots.

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## The 'big man' problem in investment management

Investment management, particularly among global equity funds and those with wide mandates, has its own version of the flawed 'pass it to the big man' model that has been culturally slow to change.

Let's say that you're a portfolio manager overseeing a team of analysts. Let's also say you are fundamentally-focused and long-term-driven, so odds are good that the ultimate objective of your idea generation process is to identify outstanding businesses to buy and hold.

Most global funds follow tradition and establish their teams around one of two sets of fault lines: sector or geography. On the face of it, these are practical structures because they cover the waterfront, provide diverse feedstock for the idea-generation process, and allow individual players to play to their strengths.

The rub is that, for a fundamental, long-term-driven investment process aiming to identify outstanding businesses, a forced choice between focusing efforts along the lines of sectors or geographies is a false dichotomy.

There are also other large inherent problems reminiscent of the 'big man' problem. For example, not all sectors are created equally. As a [study](#) by McKinsey emphasised, industries with sustainable barriers (e.g. software and household products) tend to have high and persistent returns on invested capital, while industries that are capital intensive (e.g. materials and energy) and highly competitive (e.g. retail and transportation) tend to have persistently low returns on invested capital.

If the ultimate goal is to find outstanding businesses, sending an analyst to find a long-term winner in energy or retail is like sending them to the desert to find a glass of water. Maybe they'll get lucky but they're more likely to come back thirsty and sunburnt. Or, to bring it back to basketball, it's like giving the ball to your center, asking him to take 15-foot jumpers with a fellow giant in his face, and then wondering why you keep getting outscored.

Also, just like any basketball player will heave up shots – even poorly selected ones – if that's what their coach asks of them, analysts also have a habit of falling in love with their area of coverage. Ask an analyst to cover energy and, if for no other reason than career preservation, they'll probably pitch you a steady flow of ideas from the space even if the timing is off because that's the job you've given them.

## A 'fascinations'-based framework

Rather than ease into one of these traditional frameworks at Lakehouse, we inverted the process and asked a very basic question: what is the best way to identify outstanding businesses to buy and hold for the long-term?

Starting with that fresh sheet of paper, we focused on the backbone of our philosophy: well-run, competitively-advantaged businesses that can reinvest at high rates for a very long time offer the most compelling potential for the long-term investor. That clarity led us to focus on our core **fascinations** when it comes to stock selection:

**Loyalty:** Think enterprise software, payment processors, subscriptions, or any other form of business with an intense focus on customer loyalty and retention. Importantly, we view loyalty as not just switching costs, which make it difficult for customers to move on, but also the delivery of value and delight to customers that makes them want to stay.

Businesses with extremely loyal customers are often underestimated by the market because of their staying power, pricing power and ability to cross- and up-sell. In our experience, many investors lump recurring revenue businesses into one big pile, which creates an opportunity for discerning buyers to separate the coal from the gems.

**Networks:** Think marketplaces, exchanges, payment networks, social networks, or any other form of business exhibiting network effects. We're passionate about businesses with network effects because many of them scale quickly and capital-efficiently, creating a significant amount of value in short order. Markets tend to underestimate the staying power of a leading, well-established network.

**IP:** Think brands, data, patents, or even corporate cultures that are difficult to replicate. Businesses with strong IP have enduring pricing power and, often, an innovative culture and strong distribution network that creates and scales new and valuable IP.

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## The strength of fascinations

Ultimately, the beauty of a fascinations-based model is that we're not trying to cover all parts of the waterfront. We're covering places where empirical research suggests we're more likely to find more and bigger fish. The approach also has the benefit of developing deep subject matter expertise on business models and ecosystems.

A fascinations-based framework may not suit every situation. Traders need not apply, for example, or deep value investors who jump from one beaten-down market or geography to another. For the long-term, fundamentally-driven shop, though, we think letting one's core investing beliefs and fascinations drive process rather than a following a false construct is a far more sensible approach.

*Joe Magyer is the Chief Investment Officer of [Lakehouse Capital](#), a sponsor of Cuffelinks. This article contains general investment advice only (under AFSL 400691) and has been prepared without taking account of the reader's financial situation. Any person reading this message should read the product disclosure statement and seek professional advice.*

*Lakehouse Capital is a growth-focused, high-conviction boutique seeking long-term, asymmetric opportunities. Lakehouse is the investment manager of two strategies: the Lakehouse Small Companies Fund and the Lakehouse Global Growth Fund.*

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## Australian real assets driven by Asian trends

Daniel Fitzgerald

Real assets are tangible assets like property, infrastructure and utilities and they are different from financial assets (cash, bonds and shares) as they mainly rely on you, and the rest of the population, to help them generate investment returns.

### A day in the life – you use real assets every day

We all use real assets in numerous ways – probably multiple times – every day. The alarm goes off and you turn on the light courtesy of electricity providers like AGL Energy. You take a shower using water that is heated with gas, perhaps also supplied by AGL, and travels down utility-owned water pipes. The electrical wires that power the appliances that toast your bread or blend your smoothie are owned by companies like Ausnet Services or Spark Infrastructure. Driving your car to work means you may travel down one of Transurban Group's toll roads and then spend your day in an office that is owned by a commercial real estate investment trust (REIT) like Dexu. On the way home, you need groceries for dinner, so you drop into a shopping centre that is owned by a retail REIT, think Scentre Group or Vicinity Centres. Going on holidays? You may be flying from Sydney Airport.

Use of real assets is typically non-discretionary. You have to use them, and you don't really think about the decision.

### Real assets – population growth more important than the business cycle

If everyone uses real assets and you can't really avoid them, it follows that the more people you have, the more demand there will be for their services. A key point of leverage of real assets is to population growth rather than the ups and downs of the business cycle. Shopping centres, ports, toll roads and airports are all well positioned to grow their businesses as the population increases.

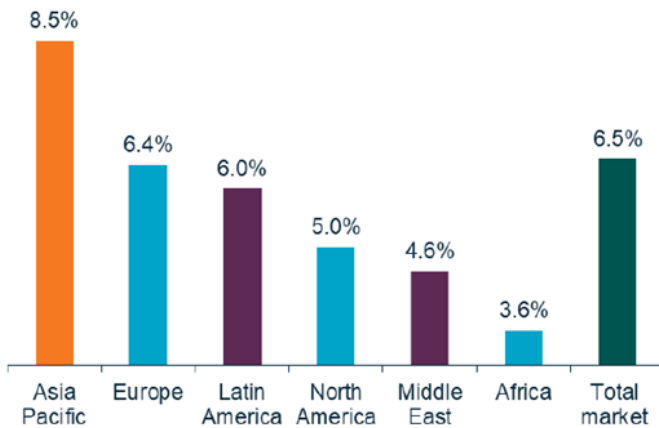
Consider the aviation industry, with a particular focus on the Asia Pacific region.

Two important demographic trends are highly favourable in our region – strong population growth and rising income levels. What is less widely discussed is how these positive trends could ultimately lead to increased demand for the region's real assets, including in Australia. Airports in particular, are expected to be a significant beneficiary, with more than half of all new air passengers expected to originate from within the region over the next 20 years.

### Asia already seeing strong growth

The Asia Pacific region has already seen the [highest growth rates for air passengers](#) of any region globally in 2018. Outbound travel from China is particularly significant. For example, [China had the strongest growth](#) for short-term arrivals to Australia for the year to June 2018 and was the largest source of visitors. Similarly, [China is New Zealand's second-largest international tourism market](#), and Malaysia's third (after Singapore and Indonesia).

#### Air passenger market growth (2018)



Source: IATA; as at 12 December 2018: "[Economic Performance of the Airline Industry](#)" report; passenger growth denotes Revenue Passenger Kilometers for 2018.

Asia has some of the fastest country and city-based population growth rates globally. According to [UN estimates](#), the region is second only to Africa. The number of 'megacities' in the Asian region (settlements with more than 10 million people) is set to increase by around 50% by 2030.

Not only is Asia already home to almost half the world's middle class, but by 2030, the [middle-class population is set to almost double again](#). Equating to an incremental 1 billion people (more than the combined middle-class populations of North America and Europe), this will lead to a significant increase in spending power for the region.

### Centre of gravity to move east

The [latest forecasts from IATA](#) show that Asia Pacific's strong passenger growth will continue in the long term.

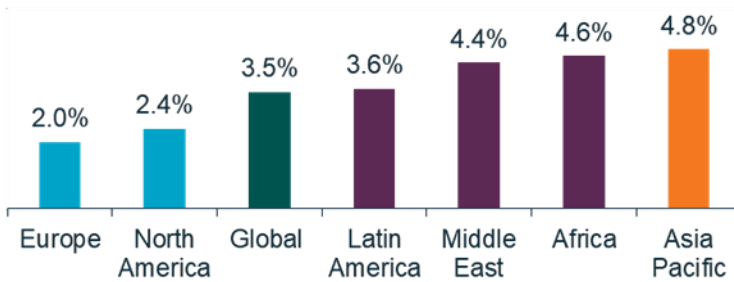
By analysing the same population and income trends that we believe drive broader real asset demand, IATA's data shows that the 'centre of gravity will move eastwards' in the global aviation industry, with more than half of new passengers over the next 20 years to originate from the region.

Ranking	2017	2037
1	US	China (#1 by 2025)
2	China	US
3	UK	India
4	Spain	Indonesia
5	Japan	UK
6	Germany	Spain
7	India	Japan
8	Italy	Germany
9	France	Thailand
10	Indonesia	France

Source: IATA; as at 24 October 2018: "[IATA Forecast Predicts 8.2 billion Air Travelers in 2037](#)".

This growth profile positions Asia Pacific as the largest-growing aviation market globally.

## 20 year passenger growth forecast (% p.a.) by region



Source: IATA; as at 24 October 2018: "[IATA Forecast Predicts 8.2 billion Air Travelers in 2037](#)".

Airline commercial market outlooks, such as those [provided by Boeing](#), also have China as the largest domestic-travel market by the end of the decade.

### **New assets needed to handle demand**

The Chinese airport regulator (CAAC) also has positive projections on future growth. [They forecast](#) strong passenger growth for the Beijing region, with passenger numbers expected to grow around 6% per annum to 2025 (to 154 million).

Indeed, based on our recent discussions with a Chinese aviation expert, even higher passenger numbers are possible in the longer term (around 200 million) based on Beijing's population growth and higher disposable income. A new airport, Beijing Daxing, is under construction and is expected to open this year.

Other airports across the Asian region are also looking at expansion plans as well as possible stock exchange listings, providing further investment opportunities.

### **Trade tensions shouldn't displace growth**

Increased protectionism could pose a risk to these growth forecasts, and current US-China trade tensions point to these real possibilities.

That said, tourism-related aviation has thus far been excluded from any trade discussion, and recent industry statistics show no material deceleration in passenger growth in line with any slowing pace of economic growth within China. Air cargo could still be impacted, but most tariffs have been placed on bulky goods that do not use air freight, such as steel or aluminium.

If we did see a reverse in globalisation, and more protectionist policies arise, we still believe that passenger growth for the region will be positive due to demographics trends, albeit at a more modest pace.

### **Portfolio implications – investing in both the outbound and inbound growth**

We believe the main investment opportunity within this theme is in the region's airports, rather than airlines themselves [we do not classify airlines as a real asset sector, as they are inherently volatile, with high competition, modest barriers to entry and exposure to fluctuating fuel costs], especially for Real Income strategies that only invest in low-risk listed real asset companies that have large sunk capital bases with high barriers to entry, such as airports.

Domestic Real Income strategies can potentially capture the benefits of rising Asian air travel to Australia by holding stocks such as Sydney Airport. Similarly, Real Income strategies that have a broader (eg regional) investment universe could also hold selected regional airports, enabling them to capture the strong growth in both outbound and inbound passengers.

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

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## BBB worries seen from beyond the headlines

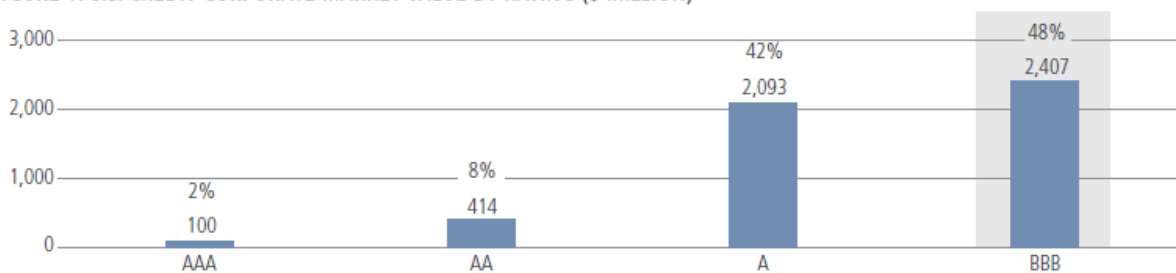
Adam Grotzinger

Investors have become increasingly concerned about growing credit risk in the investment grade corporate market. An area of particular concern is the BBB rating category, which accounts for roughly half of the investment grade index and is a third larger than the high-yield market. The fear is that, when the U.S. reaches the end of its economic cycle, much of the BBB segment will be vulnerable to downgrades that disrupt the credit markets by flooding the high-yield market with 'fallen angels'.

### The BBB credit picture

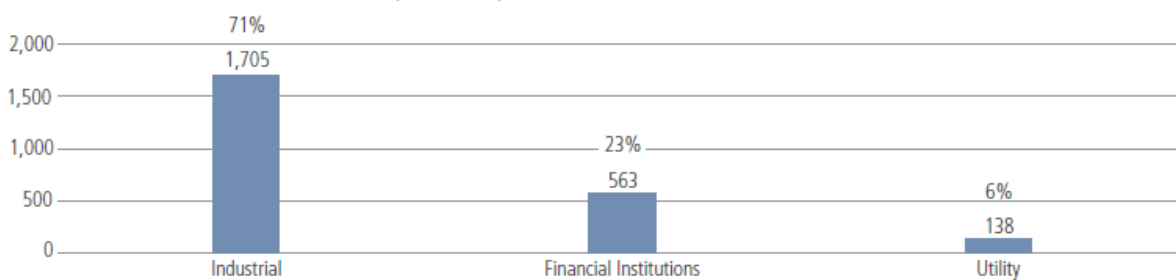
BBB-rated companies make up nearly half of the US Investment Grade Credit Corporate Index. Within the BBB component of the index, more than two-thirds of market capitalisation is in Industrial bonds, while roughly a quarter is in Financials and the remainder is in Utilities.

FIGURE 1. U.S. CREDIT CORPORATE MARKET VALUE BY RATING (\$ MILLION)



Source: Bloomberg Index Services, June 2018.

FIGURE 2. BBB MARKET VALUE BY SECTOR (\$ MILLION)



Source: Bloomberg Index Services, June 2018.

In the wake of the 2008 GFC, credit rating standards for financial institutions became far more stringent, while many institutions improved their capital position. This created an anomalous situation in that credit ratings for financial issuers moved lower even as credit quality improved. We do not believe that the growth of Financial BBB bonds presents a particular issue for investors. In fact, we currently have a favourable view of fundamentals in the Financials sector, where companies have reduced leverage and responded to stricter regulations, while taking a more even-handed view of bondholder and shareholder interests. Taking valuation into account, we believe that the sector appears relatively attractive at this point, even late in an economic cycle.

### BBB growth matches the market, but is weighted to lower quality

If we take Financials out of the picture, it becomes evident that, contrary to the perception of 'out of control' BBB growth, the segment's expansion since 2005 roughly matches that of the broader credit market, as represented by the U.S. Credit Corporate ex-Financials Index. A more concerning trend, however, is the weighting of growth within the BBB space, where lower-quality accounts for the bulk of recent market-value growth.

Since 2005, BBB Industrials have grown at a rate similar to the market, at about 270% on a cumulative basis. But within BBBs, low-BBB growth has been the highest, at more than 400%.

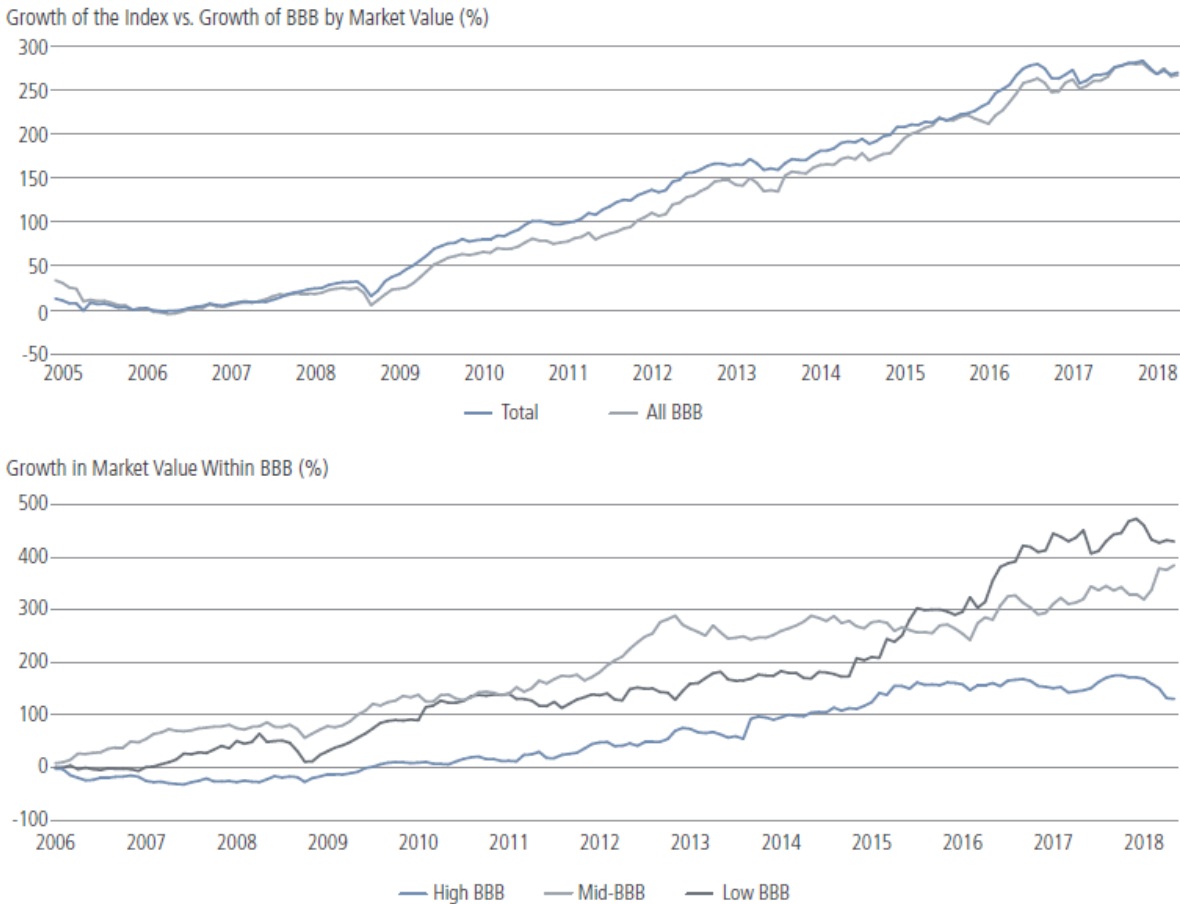
In recent years, debt financing related to energy infrastructure projects in the midstream sector has accounted for about 40% of the increase. Following the oil price decline, midstream companies have largely worked to

defend and stabilise their investment-grade ratings to diminish the threat of rating downgrades in the event of a cycle turn.

The remaining portion of low-BBB growth is attributable to leveraging M&A activity in historically free-cash-flow-generative sectors such as Health Care/Pharma, Food and Beverage, and Cable/Media as companies pursued growth opportunities amid changing industry dynamics.

**FIGURE 3. PERSPECTIVE ON BBB GROWTH**

U.S. Credit Corp Index ex-Financials

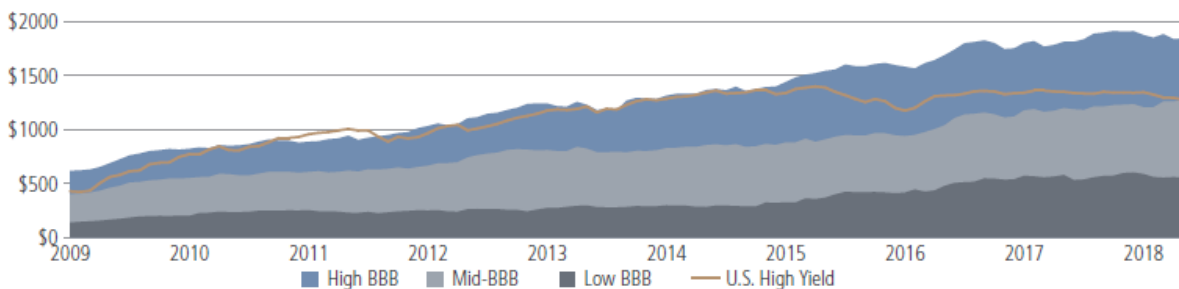


Source: Bloomberg Index Services, June 2018.

Aside from the overall volume of BBB, a source of worry has been growth compared to the high-yield universe. Indeed, after moving from rough equality five years ago, the entire BBB Industrials market is now worth \$1.8 trillion compared to the high-yield total of \$1.3 trillion. This change is not the result of acceleration in BBB-rated debt growth, but rather stalling of high yield growth, as shown in the chart below. On average over the past 20 years, about 3.5% of BBB Industrials by market value has migrated from investment grade to high yield each year.

**FIGURE 4. BBB HAS SEEN STEADY GROWTH WHILE HIGH YIELD HAS STALLED**

U.S. HIGH YIELD VS. BBB MARKET VALUE (\$ BILLION)



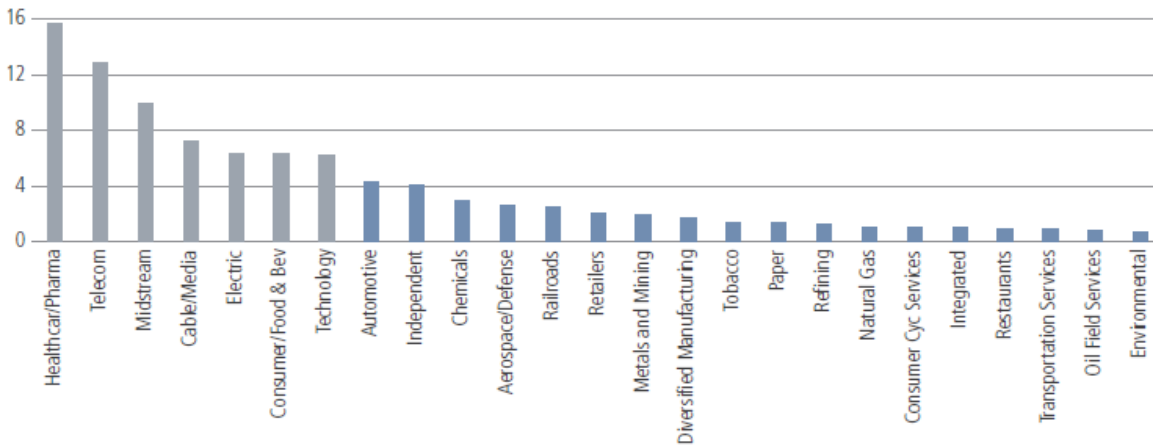
Source: Bloomberg Index Services, June 2018.

## Gauging risk at the sector level

Despite these mitigating facts, it is undeniable that the amount of BBB corporate credit in the market has grown, and that leverage within the group has increased as well. A key task for investors is to identify where the risk lies. An assessment by sector helps draw those lines.

In the chart below, the seven sectors on the left (out of a total of 25 sectors excluding Financials) represent two-thirds of the category’s market value and have been largely responsible for the recent growth in the BBB category.

FIGURE 5. TOP SECTORS IN THE BBB CATEGORY (% BBB MARKET VALUE)



Source: Bloomberg Index Services, June 2018.

Naturally, the mere fact that a sector is a major weighting in the index does not point to additional risk. In the case of the BBB sector, we’ve seen an increase in general risk levels due to leverage-driven mergers and acquisitions in historically defensive sectors. For example, in Telecom and Cable/Media, changing consumer behaviour and technological disruption have resulted in debt-financed consolidation. In Health Care/Pharma, growth challenges in the face of pricing headwinds, patent expirations and maturing portfolios, have led to increased M&A as companies search for growth. In Consumer/Food and Beverage, evolving consumer preferences and challenges for retailers have led to leveraged M&A to help ‘buy’ growth.

In our research, we have sought to gauge the vulnerability of these categories to rating downgrades in the event of a cyclical downturn. The key differentiators relate to leverage levels, industry dynamics and the flexibility (or lack thereof) that sectors may have in dealing with economic adversity.

As noted, the growth of the BBB sector has been driven in part by sectors that have historically been regarded as more defensive with predictable earnings profiles. In some of these sectors, we are less worried because we expect free-cash-flow generation to be supportive of near-term debt reduction goals and note the availability of levers that can be pulled to preserve credit quality.

## Conclusion on BBB quality

The purpose of our research was not to discredit the idea that the use of leverage has increased, and indeed we believe that debt has reached unhealthy levels for some companies. However, it would be a mistake to indiscriminately sell BBB risk. Financial BBBs simply do not meet the definition of troubled credits, and in our view are attractive from a fundamental perspective. Moreover, within the Industrials segments, there is considerable variety with regard to business model and issuer flexibility. Some companies may be vulnerable to downgrades late in the cycle, even in traditionally defensive sectors. Specifically, the Health Care/Pharma, Cable/Media and Consumer/Food and Beverage sectors have traditionally been valued for their stable free-cash flows late in the cycle, but some issuers in these sectors now carry more aggressive debt levels. In contrast, other sectors, such as Utilities, should be able to perform ‘as advertised’.

As always, the ability to make such distinctions is a function of fundamental credit research at the sector, industry and issuer levels.

Adam Grotzinger is a Senior Portfolio Manager at [Neuberger Berman](#), a sponsor of Cuffelinks. This material is provided for informational purposes only and nothing herein constitutes 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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## Thematic exposure to global trends using the ASX

Don Hoang and Ilan Israelstam

Good share market returns require identifying companies likely to produce healthy earnings and dividends over time. Investors traditionally have had the choice of active managers attempting to pick winners, or passive managers taking a rules-based approach, such as investing in companies that meet criteria relating to price momentum, valuations or financial metrics, or the overall index.

The problem with many of these approaches is that the choice can be governed by short-run – or cyclical – dynamics. Deciding which part of the cycle we’re in, and which companies will do well in that part of the cycle, is no easy task.

Thematic investing offers an alternative approach, embracing the cost and diversification benefits of passive investing but with a rules-based strategy to identify companies with the potential to benefit from predictable, longer-run structural changes.

### What is thematic investing?

The goal of thematic investing is to identify megatrends and enduring structural forces that will affect the economy over time, and then position one’s portfolio to benefit from those forces, irrespective of the ups and downs of current or future economic cycles.

The table below summarises the differences between thematic investing and approaches relying on identifying and positioning for short-run economic cycles.

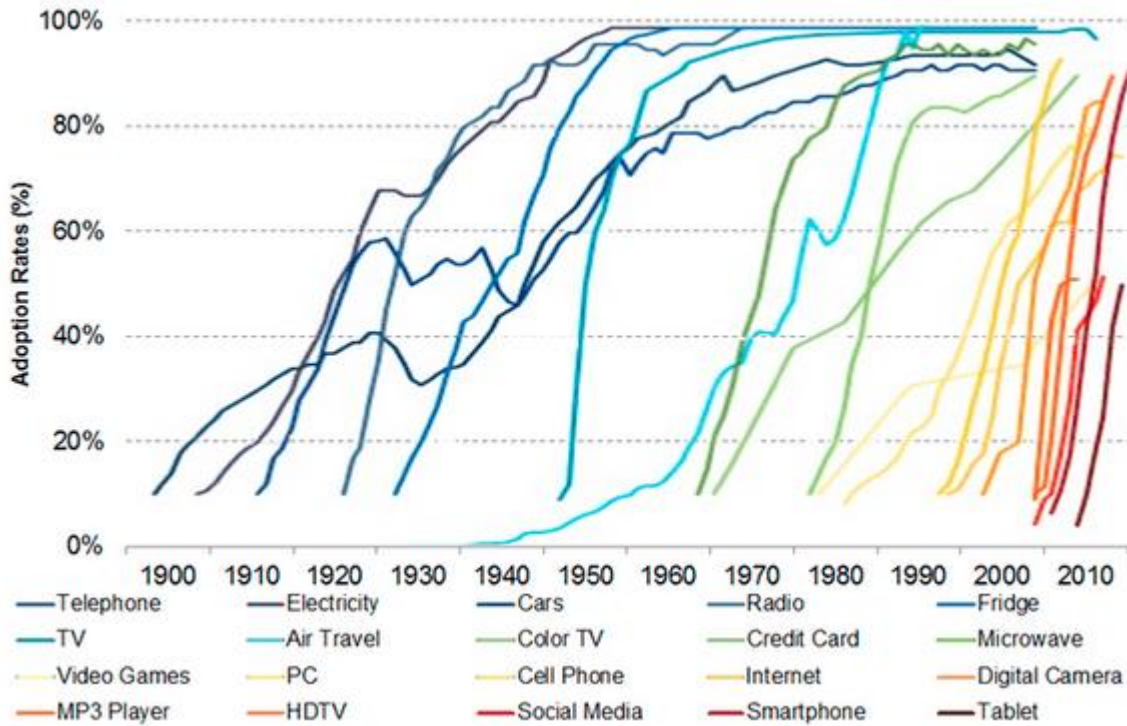
	Thematic or secular investing	Cyclical investing
<b>Investment Focus</b>	Megatrends: disruptive technologies, demographic changes	Geographic regions, sectors of the economy, factors such as momentum, value, quality, volatility
<b>Type of change focused on</b>	Structural	Cyclical
<b>Investment horizon</b>	Long term	Short-mid term
<b>Timing considerations</b>	Entry and exit timing less important	Entry and exit timing important
<b>Illustrative size of portfolio</b>	Smaller universe of securities	Larger universe of securities

### Advantages of thematic investing

A primary benefit of longer-term investment approaches like thematic investing is that the timing of entry and exit points is typically less crucial than with more cyclically-sensitive investment strategies.

As seen in the table below, the rate of adoption of major technology changes over the past century – such as the telephone, electricity, cars and radio – has been measured in decades. The pace of technological innovation is unrelenting, with more recent changes such as the internet, smart phones and social media just as disruptive, and take-up more rapid.

### Adoption of technology in the US (1990 to the present)



Source: Asymco, BlackRock

Other megatrends likely to be sustained over coming decades include:

- global population ageing
- climate change and the demand for clean energy
- Asia's rising middle class
- adoption of robotics, and
- the increasing threat of cybercrime.

Thematic investing can improve portfolio diversification, as returns are likely to have low correlation to swings in major regional or sector investment benchmarks.

Thematic investing readily lends itself to a globally diversified passive approach – using rules to identify companies with revenue exposure to a secular trend, and then investing in a broad selection of the leading players anywhere in the world.

Of course, active managers are also able to take a thematic approach to investing. However, they are likely to face just as many challenges 'picking winners' from secular change as they currently do in picking winners from cyclical change.

One of the benefits of a passive market capitalisation indexing approach is that it tends to increase portfolio weightings to emerging 'winners' with rising market cap over time, while cutting exposure to 'losers' with declining market cap. In dynamic forward-looking markets of the type that lend themselves to thematic investing, the market, on average, has demonstrated a tendency to get it right over time with prices (or market capitalisation) leading fundamentals such as actual revenues and earnings.

Thematic investing is an approach that resonates with investors, as it taps into economic changes they can see and hear taking place around them every day. What's more, many of these megatrends – such as environmental, social, or technology-focused themes – tap into an increasing interest in socially responsible investing.

### Megatrend opportunities on the ASX

Thanks to the advent of exchange traded funds (ETFs), it has never been easier for investors to gain diversified, transparent and cost-effective exposure to these major investment themes shaping our world.

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Don Hoang is an Assistant Portfolio Manager and Ilan Israelstam is Head of Strategy at [BetaShares](#), a sponsor of Cuffelinks. BetaShares offers a wide range of thematic ETFs. This article is for general information purposes only and does not address the needs of any individual.

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## Comment on franking and 'direct investment'

Graham Hand

Matthew Collins writes in [his article](#) on 'direct investing options' (DIO): "*The cost-effectiveness of this strategy depends upon a host of tax and investment considerations.*"

This comment draws out some other issues, some of which Matthew probably avoided for space reasons.

If the changes to franking credit policy do occur, the relative attractiveness of an industry fund DIO essentially represents a structural advantage. There are other examples of structural advantages that SMSFs hold, such as the ability to:

- Invest in almost any asset. The DIOs do not cover all shares, ETFs or LICs.
- Access the government guarantee on deposits, as this is available '[per entity per ADI](#)'. That is, the DIO only has one claim for \$250,000 which is irrelevant given its scale
- Borrow using Limited Recourse Borrowing Arrangements (albeit now diminished)
- Include more than one member and therefore spread the cost.

No doubt a skilled financial adviser can add many more ways an SMSF can be used for planning and they are welcome to add more comments.

Similarly, send through any material criticisms of the DIO not mentioned in either article, other than political arguments that it's all a union-inspired plot by Labor.

### What is best for the investor?

Advisers and investors should focus on achieving the best outcome for the individual and should be agnostic to the products or vehicles used.

It is likely that few financial advisers have used the DIO option, although many in the industry are working on responses to Labor's proposal. A sensible outcome might be that advisers and businesses serving the superannuant consider industry funds and DIOs as one of many attractive weapons in their arsenal.

But they are not mutually exclusive. It might be reasonable to run an SMSF and a DIO as well as other vehicles such as insurance bonds, retail funds, money outside super, managed accounts or whatever. Together, they may better meet the objectives of the client, as long as it does not become too complicated.

Maintaining an industry or retail fund account might be viewed as an 'end of life' transition strategy out of an SMSF as the members age or if their needs change such that the SMSF is no longer required. It is not one versus the other, as the two can co-exist.

The industry funds also have the motivation to improve their DIO product. For example, Matthew highlights the inability to transfer shares from an SMSF to a DIO 'in specie', requiring shares in an SMSF to be sold first. This capability could be built.

### The relevance of the DIO limitations

The article also touches on a number of constraints or limitations that might act as a disincentive for an SMSF superannuant or their adviser. These include (but are not limited to) the product rules, especially the maximum amount that can be invested in the DIO, and the limited approved product list (APL).

Whilst these rules might be construed as unnecessarily paternalistic, they are designed by industry fund trustees in exercising their fiduciary duties. They need to consider the appropriateness of their products and

services for the members for whom they are the custodians. There is judgement that an unfettered offering could result in sub optimal outcomes for inexperienced members who don't have an appropriate appreciation as to the risks.

There are other restrictions which Matthew does not mention, such as a maximum 20% of the total super balance in a single stock.

Again, this is an opportunity for DIO development, as the rules are imposed by the trustees, probably because they know the type of members they have. They could offer a more relaxed set of rules where a member is transferring from an SMSF and can demonstrate an understanding of the risks involved. Or where a member is under the advice of an appropriately qualified adviser. This may remove a friction point for many SMSFs.

### **It's another vehicle option**

All segments of the wealth management industry should realise that the DIO may become a more serious competitor to the SMSF, especially if industry funds improve the product and engage more with financial advisers. As a result of the Royal Commission and the removal of commissions under FoFA, more advisers realise they must act in the best interests of their clients. SMSFs will then need to stress and develop the advantages which the DIO cannot offer.

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

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