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Charles Dalziell on life as a contrarian investor

Graham Hand

Charles Dalziell is an Investment Specialist at Orbis Investment Management. Orbis was founded in 1989 and manages over \$50 billion in its Global Equity Fund from 10 offices around the world, including Australia.

GH: Orbis describes itself as 'investing differently', and in [the article](#) you wrote for Cuffelinks, you talked about the long game and the arduous process of investment research. But every investment involves some level of personal judgment. How do you make that final investment step between the empirical research and the subjective judgement in a concentrated portfolio?

CD: It is difficult, and can take months of work. Each analyst has to convince one of the five key stock pickers globally before a stock goes into the client portfolio. We have a formal policy group meeting where the analysts present their investment thesis to their peers, including to the global stock pickers. And the policy group will say, "Have you considered this? Have you considered that? What about these concerns?"

That isn't a decision-making meeting, although everyone at the meeting votes on whether it's a buy or a sell. But it's not a vote on whether it goes into the portfolio. At the end of the meeting, there are only two decision-makers. One is the analyst, who can say, "I like the stock. We've been through the key points, there's nothing that's changed my mind so I want to buy this stock for my paper portfolio." Their paper portfolio usually consists of about 10 stocks and analysts live and die based on the performance of that.

The second decision-maker is one of the five global stock pickers that direct capital into our Global Fund. One or more of those could say, "I think this is a really great idea. It fits well into our portfolio from a risk, return or uniqueness perspective. And I want to buy this in my slice of the portfolio."

GH: This is the actual portfolio, the client portfolio.

CD: Yes. Or they may just say that it might be a good idea but it doesn't fit in. Or they may not be convinced by the thesis. We make final decision-making an individual activity because consensus decisions don't work well in a contrarian style. We want individuals to back themselves and their own ideas and be accountable. The analysts probably would like to see the stock go into the portfolio. But if it doesn't, they have still bought it in their paper portfolio and they are rewarded if the stock does well.

GH: Even though the results are not reflected in the external fund performance?

CD: Yes, they'll be paid a bonus based on the performance of their own paper portfolio but conversely, if the stock does poorly, they might miss a bonus. The performance of that 10 stock paper portfolio will be tracked over time. It's designed for us to collect great data across the entire analyst team on who's got skill at picking stocks and who has the right temperament to be a contrarian investor. It's really not for everybody. And so we have higher number of analysts than we need because we know that there will be a high level of attrition in the early years. For some, it's uncomfortable and they don't like this way of investing.

Every stock must go through this process. We've got 34 analysts globally, with theoretically 10 stocks each, that's 340 stocks, but we only have 60 stocks in the portfolio. So most ideas don't make it.

GH: And given that analyst has spent three months researching the stock, and it's a big step for them to put it to this committee, do they often get talked out of it at that stage?

CD: They can do. It's intimidating, and they have to tick all the boxes and have a very strong investment thesis. We have divided the world geographically with a US team, Europe team, Japan team and emerging market team but we also have a global sector team, with a banking specialist, healthcare specialist, tech specialist, for example, which gives us the broadest possible coverage across the world. This means that we often have more than one analyst covering a particular stock or sector which leads to more productive discussions in meetings.

GH: How do Australian stocks fit into that structure?

CD: We have our association with Allan Gray in Australia, and the global team sees that research. We have one Australian stock in the global portfolio, Newcrest.

GH: In the article you said: "Stock pickers have to kiss a lot of frogs before they find the prince or princess." It's a great line. Are there common characteristics where companies fail to make the portfolio?

CD: Yes. First, we may do a lot of work and realise we just don't have a unique insight or something that differentiates our view from the market. Second, history might not reflect well on what will happen in the future for this company. We have amazing data sources and excellent filtering tools and part of the analyst's job is to establish that the stock looks good relative to history. But maybe we find questionable accounting practices, unusual executive remuneration, or strange depreciation schedules. Or the business may have changed, and while they used to earn 15% margins, now it's 5% because somebody came up with a better mousetrap, and we don't think 15% margins can be achieved again.

GH: Some other public funds turnover 200% of their asset size each year, with adverse tax consequences. For a business like yours, a long-term contrarian, what do you think is an acceptable turnover level?

CD: At a basic level, if your investment horizon is four to five years, then 20% to 25% is theoretically about right. The reality is that stock prices move rapidly which can influence turnover. For example, when prices are moving down, you may be allocating more capital into those stocks. So I don't think there's any hard and fast rule. But if a fund manager's turnover is high, it's usually because they are a trader. If a manager says they are long term, doing fundamental bottom-up research, and then portfolio turnover is 200%, you should ask some pretty hard questions.

I'm amazed nobody measures after-tax performance because it ensures fund managers have little incentive to think about the tax impact of turnover.

GH: The last five years have been difficult for 'value' versus 'growth' and a lot of stocks on high P/E ratios have just kept running. How has this played out for Orbis, and in particular, how have you managed your client relationships in that time? I'm wondering about patience for an explanation that goes for one or two years and how long that story can last?

CD: If you look at the last 12 years, we've outperformed even though value has underperformed growth. Yet 12 years ago, value was expensive. Everyone was a value manager and we were finding good growth names. Now there are very few value managers left and we are finding better opportunities in that space. We've gone through a once-off downward shift in interest rates that we've never seen before in history, and growth stocks are long duration stocks so they have benefitted.

We don't make big sector or macro calls, we tend to be focused on idiosyncratic single stock risks. We've owned all the big tech stocks over the last 10 years, but once our assessment of the intrinsic value has been realised,

we tend to sell. When the margin of safety is gone, we move on because we think our competitive advantage has disappeared.

More recently, we added to a position in Facebook when it disappointed at the end of last year, because we think it's a terrific business. We haven't missed out on the tech side. The big tech companies have incredible cash balances and fantastic moats, with a lot of optionality, such as Facebook with Instagram and WhatsApp.

GH: And Apple has bought two dozen companies in the last quarter, so that's all about options.

CD: Options and plugins, things you can just plug into your infrastructure and your system and increase the value. So we're not dogmatic about being value managers and just looking for the lowest P/E or price-to-book ratio. We're thinking about discount to intrinsic value and growth has an important part to play in that estimate. The best stocks you can buy are growth stocks disguised as value, and we think we have a lot of those in the portfolio today.

For example, we own Naspers, a South African tech investment company that owns 31% of China's Tencent. Through Naspers, you can buy Tencent at a 45% discount. We own Autohome, a Chinese marketplace for new cars, a bit like Carsales. And we also have Facebook in our top 10 positions.

GH: Can we come back to the question about managing clients.

CD: Orbis does an amazing job educating our clients and ensuring we only attract like-minded clients. We are upfront about our history, and we say contrarian investing is not for everybody. Look at our history, there have been many periods in the past where we've underperformed our benchmark by more than 10%.

GH: Under the market, or drawdown?

CD: Not a drawdown but actually under the market. But over 30 years, we've beaten the market by over 6% per annum. The long-term numbers are great but the price you pay is short-term underperformance. As a contrarian manager, things will just go against you. And in the last 12 months, we've certainly seen that.

It's been a bunch of different things that have happened to the portfolio at the same time, and a couple have been mistakes. The majority of the performance has been stock issues that haven't affected the assessment of intrinsic value. In fact, it's made us more excited about the opportunity and we've added more capital into those ideas.

To date the clients have been extraordinarily understanding. Clients are not blasé about our performance, they ask all the right questions, but they understand why we are not performing in this particular environment. They can also see the opportunity. It's important to have the right clients because we will go through periods like this. And many are allocating more capital to us at this time.

I should also mention that we're owned by the Allan and Gill Gray Foundation, which is a charitable organisation. And that ensures perpetuity of ownership and it also ensures that when we go through a period of underperformance, we don't have a big brother demanding we change our process at exactly the wrong time.

GH: Do you have a couple of names where you think the market doesn't realise how valuable the companies are.

CD: XPO Logistics is listed in the US. It's a trucking and logistics company, but since mid-2018, its price is down around 50%. They downgraded revenue growth last year but to a level that is still above average for that industry, and they have economies of scale. There was also a short seller attack in 2018 and it got a lot of market coverage. We know this stock extremely well and we have a long relationship with the company. We hired a forensic accountant from New York University to examine the short report's claims and he did not see any cause for concern. XPO is one of only two US trucking companies that can execute on same day delivery and many retailers don't want to outsource to the other, Amazon, as they are often a competitor as well.

GH: And an Australian stock?

CD: The Allan Gray Australian Fund holds Newcrest. Nobody's investing in gold mines as the gold price is too low – we're at the marginal end of the cost curve. Newcrest is one of the lowest cost gold miners in the world with long reserve life.

GH: Last question. Does Orbis have any plans for a Listed Investment Company or Active ETF, to make access easier for an SMSF trustee or retail investor.

CD: We're on mFunds on the ASX, and on all the major platforms, or they can come to us direct. But no plans to list a vehicle at this stage.

Graham Hand is Managing Editor of Cuffelinks. Charles Dalziell is an Investment Specialist at [Orbis Investments](#), a sponsor of Cuffelinks. This report constitutes general advice only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person. Past performance is not a reliable indicator of future results. This interview represents Charlie's views at a point in time and provides reasoning or rationale on why Orbis may have bought or sold a stock for the Orbis Funds. Views may and do change as facts or circumstances change.

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From popular to unthinkable: do political outcomes impact investments?

William J. Adams

President Donald Trump warned us in his State of the Union address in February 2019 to resist the pull of socialism, while Senator Bernie Sanders told us in his campaign announcement that his ideas are now markedly more mainstream than they were in 2016. You can't pick up a publication without reading an assessment of the Democratic presidential candidates' shift to 'the left'. It seems an idea has become a trend in a short period of time.

Some may argue this is a logical evolution in a two-party political system characterised by growing divisiveness. Recent election outcomes markedly favored one party, so perhaps it shouldn't be a surprise to see the electorate move in an equally radical but opposite direction. Welcome to global politics in a polarised world.

The window of political discourse

This is a good example of the Overton Window, also known as the window of discourse. It describes how the level of acceptance for a political idea can shift over time as the 'window' grows in response to changes in public perception. Ideas and public policy once viewed as extreme can become acceptable to politicians and the public, often in response to increasingly-radical competing views.

Exhibit 1: The Overton Window



The political movement toward the left in the United States and elsewhere is in part a response to growing differences in income and wealth. While undoubtedly a global theme, it's particularly pronounced in the United States. Policy ideas promoted to compete with those of the current US administration are often presented through a lens of Pareto Efficiency, *i.e.*, when it's impossible to make one party better off without making someone worse off. A zero-sum game in other words. In this paradigm, allocating resources in favor of one group is only possible at the expense of another group.

This point is exemplified by the proposed increase in tax rates on higher earnings or a wealth tax to finance Medicare for all and universal college tuition. While the intention of these policies is clearly to redistribute income and wealth, it's worth asking whether they'll have unintended consequences with broader ramifications. Might policies such as these also impact government debt balances and economic growth?

Proponents of redistribution policies argue for greater equality and more money in the hands of those most in need — also the group most likely to spend any additional income, which would foster economic growth. Detractors argue policies of this nature sacrifice prosperity and create investment uncertainty that constrains growth. Wealth and income may be divided differently, but the pie may, in fact, shrink in this scenario. There are more opinions on this subject than I can enumerate and I'll let elections decide the outcome.

Investment consequences of redistribution policies

That said, regardless of your views in this debate, there are undoubtedly potential outcomes and investment implications to be considered if this redistribution trend becomes policy. Higher tax rates will likely push investors into a tax-advantaged asset class. Increased public spending could find its way into state and local budgets, improving credit quality and benefiting projects with municipal financing. Infrastructure investment opportunities and utilities are also likely to benefit in this scenario.

What happens to interest rate exposure is a key question. Higher debt balances may exacerbate the structural challenges that characterise the US economy today: stagnant growth and disinflation. This scenario benefits duration and fixed assets, and has been a factor in our 'low-for-longer' rate investment thesis. However, high debt balances can be destabilising for an economy from a macroeconomic perspective, while rising debt-service may crowd out investment alternatives. Challenges to credit quality of this nature are often met with higher risk premiums and, consequently, also higher interest rates. In this situation, income redistribution might improve the economy, prompting a more aggressive Federal Reserve Bank. These outcomes would argue for less interest-rate exposure.

In a piece of this nature, I run the risk of over-generalising. Nothing is simple in the complex investment environment today. There are many cooks jockeying for a place in the public policy kitchen, and more and more ingredients being stirred into the pot. Headlines frequently reflect the heat of the current divisive climate, but seldom the substance of the issues.

Predicting political outcomes

Our goal at MFS is to invest in the framework of a long-term investment horizon rooted in an assessment of fundamentals and valuation. Political outcomes are challenging to predict. I'm not convinced that forecasting binary political results creates a competitive advantage for managers. Instead, we need to understand the investment implications of a *variety* of outcomes and create a probability matrix that maps all of them.

This is the kind of environment in which active investment management with a longer-time horizon should thrive. It's easy to get caught up in the short-term ebb and flow of eye-catching headlines. It's more challenging to invest for the long term, but this is typically the horizon needed for valuation to intersect with fundamentals — and the generation of more consistent risk-adjusted investment returns.

William Adams, CFA, is the Chief Investment Officer, Global Fixed Income at [MFS Investment Management](#). The comments, opinions and analysis are for general information purposes only and are not investment advice or a complete analysis of every material fact regarding any investment. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Cuffelinks.

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It's time for SMSF accountants and advisers to be friends

Alex Denham

From 1 July 2016, the Australian Financial Services (AFS) licensing regime applying to SMSF services provided by accountants changed such that they can no longer provide recommendations around establishing or winding up an interest in an SMSF unless they are appropriately licensed to do so.

For those holding licenses, a new "educational, experience and ethical standards" regime came into play from 1 January 2019, lifting the educational and experience requirements to be a licensed financial adviser.

Mainly for this reason, many accountants have chosen not to go down the licensing path and stick to what they do: accounting. Some – who had been setting up, running and winding up SMSFs for their clients for years with no input from licensed advisers – have been forced to significantly change their practices as a result.

At the same time, there were substantial changes to the superannuation laws in 2017 with the introduction of concepts such as Transfer Balance Caps (TBC), transitional CGT relief, and Total Superannuation Balances

(TSB) as well as complexities around Exempt Current Pension Income (ECPI). These all have direct and substantial impact on SMSF trustees and members.

Never has it been more important for a collaborative approach between accountants and advisers on SMSF advice and services. And yet, in my experience as both an adviser to SMSFs and more recently as a technical SMSF specialist working with accountants, there is still push back between the two professions in some pockets of the industry.

(Big, fat disclaimer here: #notallaccountants #notalladvisers)

Friction between professionals

Just as the builder and the architect mix like oil and water, so too do the accountant and the adviser often clash. The accountant seeks the best tax outcome for their clients within the framework of the relevant laws. The adviser does too, whilst applying sensible investment outcomes and seeking to ensure solutions remain workable, understandable and affordable.

The goals of each profession are intersecting and certainly both parties are working for the common good of the client's best interests. Why can't they get along?

The problem is that the lines between the two functions have blurred. The regulatory system is not perfect and advisers are stepping into areas that were traditionally the domain of accountants.

We have moved into an era where different specialists either have to work together hand-in-glove, or upskill and deliberately cross over into each other's territory.

Consider the introduction of the \$1.6 million transfer balance cap

Most retirees with substantial superannuation savings needed advice and assistance to prepare for the new rules and avoid penalties, and SMSF trustees in particular. Who do they turn to for this assistance?

This table summarises some of the issues involved in getting a fund TBC-ready.

Issue / Questions	Who is responsible?
<p>My pension balance is going to be over \$1.6M on 1 July 2017</p> <p>How much will it be over?</p> <p>What can I do?</p> <p>What should I do?</p> <ul style="list-style-type: none"> - Roll to accumulation in SMSF? - Roll to accumulation in another fund? <ul style="list-style-type: none"> o Which fund? - Pay out as lump sum? 	<p>Accountant or adviser</p> <p>Accountant or adviser</p> <p>Adviser</p> <p>Adviser</p> <p>Adviser</p> <p>Adviser</p>
<p>Transitional CGT relief</p> <p>What's that about?</p> <p>What does the fund need to do?</p> <p>What method to use?</p> <p>Documentation and Reporting to ATO?</p> <p>Ensure correct cost bases are recorded so the CGT impact of future investment sell downs can be estimated?</p> <p>Report new cost bases to investment platforms?</p>	<p>Accountant or adviser</p> <p>Accountant</p> <p>Accountant</p> <p>Accountant</p> <p>Accountant needs to inform adviser</p> <p>Adviser</p>
<p>TBAR of 1 July 2017</p> <p>When? What? How?</p>	<p>Accountant</p>

Issue / Questions	Who is responsible?
I need some money/I drew out more than the minimum pension Lump sum or pension? From the pension or accumulation account? Impact on TBA? TBAR?	Adviser or accountant depending on the phrasing (ie is it purely tax advice or is it product advice as well?) Adviser or accountant Accountant
Reversionary nominations on pensions, death benefit nominations on accumulation accounts Should I? How? Documentation Noting in fund records	Adviser Adviser or accountant Adviser or accountant (in conjunction with lawyer) Accountant
It's all too hard, should I wind up? Should I? What should I do with the assets? Rollover, pay out, in specie transfer or sell down to cash? Yes, I'm winding up.	Adviser Adviser Adviser and accountant
I've contributed more money Can I commence a pension with it? Should I commence a pension with it?	Accountant Adviser

And on it goes. Both the accountant (or SMSF administrator) and the adviser play complementary and vital roles, but with grey areas and crossing-over of responsibilities, where once it was quite separate. It's easy to see how friction can occur.

SMSF trustees are caught in the middle

It's a new world for SMSF trustees, too. A trustee heading into retirement who prefers to be self-directed in investment selection may not have an adviser on an ongoing basis. In the past, they looked to their accountant for tax optimisation strategies. However, the regulatory system now prevents the accountant from advising on starting pensions and the trustee is forced to see an adviser and pay for a full Statement of Advice. It was previously done as part of the accounting service.

I'm not saying that the new licensing requirements are all bad. Several years ago, I had the heart-breaking experience of a new client, a widow, who with her deceased husband had built up their business. They had sold it in retirement and put the proceeds into an SMSF on the advice of their long-standing and well-meaning friend and accountant.

Their accountant recommended that 100% of the \$2 million cash be invested conservatively into mortgage funds. Safe as houses, right? Then the husband died, comfortable with the knowledge that he had ensured his wife was set up for life. Then the GFC struck, and she's now on the age pension.

A collaborative approach

With the new licensing regime bedded down, it's time to bury the hatchet and for both sides to recognise that each brings essential expertise, experience and professionalism to the table.

The SMSF trustee who aligns with an accountant (or SMSF service provider) and a licensed financial adviser that can take a collaborative approach will gain the most, well ahead of the trustee who relies on two people who work separately. As an SMSF adviser, fund accountants often worked against me not with me. It cost the trustees in missed deadlines and lost opportunities to optimise the fund's tax position and it was (frustratingly) completely out of my control.

Equally, it's often the other way around, where an adviser has made recommendations that frustrate accountants because they completely ignore important tax planning which the accountant has carefully crafted with the client over many years.

Client education is essential

I am a strong believer in client education, and this is absolutely essential for SMSF trustees. They have serious legal responsibilities and obligations to uphold. Failure to meet these obligations can result in adverse consequences which may be extremely costly.

A well-educated trustee can recognise opportunities or threats as they arise through legislative developments. Education puts them in a position to take action when required. The possible removal of franking credit refunds case in point. The informed trustee will look for solutions in anticipation of a possible change, and talk to their accountant *and* adviser about the best strategies.

Both the fund accountant and adviser have an important role in providing this education to trustees.

The accountant's intimate understanding of SMSF matters such as segregation (or not) of assets, ECPI, and inhouse assets (to name a few) is just as vital as the adviser's focus on wealth creation and retirement income through contributions, pension structure and investments.

In the world of SMSFs, an aligned accountant and financial adviser can make a formidable, synergistic team. Specialists who can't be friends can be just the opposite.

Alex Denham is a Senior SMSF Specialist at [Heffron SMSF Advisers](#). This article is general information and does not consider the circumstances of any individual.

Is IPO access really worth the costs involved?

Raewyn Williams

There is considerable drive by regulators towards the power of transparency, and that shining a light deep into superannuation funds is empowering to fund members.

In line with this key theme, we recently 'lit up' the world of large superannuation fund investing to test the power of transparency on one area of Australian equity portfolio management – participation in initial public offerings (IPOs). The headlines and hype around IPOs may lead a superannuation fund investor to think it is a brightly-lit area. But there is considerable murkiness in the way IPO results are calculated and, in particular, what it really costs a fund to have an equity manager chase extra returns through IPO participation.

Our study sought to isolate the value an equity manager could have added through institutional bookbuild IPO participation, net of costs, across 2011-2018. We created a hypothetical large-cap Australian equity portfolio which, as a base case, participated in every IPO in the Australian market between 2011 and 2018 and received a fair (rather than preferential) allocation. The results were underwhelming, adding on average around 3.5 basis points each year to investment performance, before costs.

Is there value in superior IPO selection or better access?

Australian equity managers can be quick to assert that they can beat this 'base case' market experience and add value to their clients' equity portfolios by cultivating relationships with lead IPO managers (brokers). This can lead to two sources of value-add: *superior selection* of IPOs and a *preferential (better than fair) allocation* of IPO stocks. Without individual managers sharing their data with us, we could not test whether a specific Australian equity manager can really add value to large superannuation fund portfolios through IPO participation. But scenario testing our hypothetical large-cap portfolio led to some interesting observations.

A key finding is that IPO participation pay-offs have a hidden cost attached which are rarely included in calculations of IPO value-add.

The costs are in the form of directing trade volumes ('flows') to specific brokers and paying higher than execution-only brokerage rates on equity trades, day in and day out. This is a kind of investment to cultivate the manager's relationship with the broker – using the client's investment capital – with the hope that, amongst

other things, the manager can benefit when IPO deals come along from superior selection (judging which IPOs to participate in) and from receiving a generous allocation of the IPO stocks pre-listing day from the broker.

The costs of buying favour with a broker

That daily favouring of particular brokers instead of simply pursuing lowest-cost best execution on every equity trade costs more than one might think. Over our analysis period, brokerage rates on large-cap equity trades averaged 10-20 basis points (0.1% to 0.2%), while execution-only brokerage was available at 5 basis points (0.05%). For a \$1 billion actively-managed superannuation equity portfolio with modest 50% one-way turnover each year (100% two-way), the manager's alpha-chasing 'round trips' cost the fund \$1-2 million in brokerage instead of \$500,000 each year. That difference is quite a 'bogey' for IPO participation to beat. At a minimum, it is essential to capture some of these higher trading costs in any calculation of IPO participation pay-off.

Capturing these costs, a manager who is *twice as good* at choosing IPOs or securing access as the market (our base case) is still, after costs, only able to advance the portfolio by about 5 basis points (0.05%) a year. The manager has to be at least *four times better* than the market to even get the performance contribution from IPO participation into double digits (10 basis points or 0.1%); *five times better* lifts the value of IPO participation only to 12.5 basis points (0.125%) annually.

While every basis point of return counts, shining a light on this aspect of equity investing suggests a reality quite different from the hype that surrounds IPOs.

Declining opportunity set

We are nervous about the value of IPOs as an opportunity set, given how seasonal and unpredictable it is, not to mention the interesting U.S. trend for companies to shun public markets for capital raisings. Industry predictions are for 'slim pickings' for IPO deals in 2019 in Australia. This means even a manager with the best IPO selection skills securing the best allocations simply cannot add value when there is little company appetite to raise public funds.

There is an alternative, solid path for managers to pursue on behalf of their large superannuation fund clients. They could adopt, as a default position, simple, nuts-and-bolts best execution and transactional efficiency, without favour or generosity to any particular broker, every day on every equity trade. This opportunity set is always available and has pay-offs that are transparent, measurable and consistent.

We do not rule out the prospect of some managers (especially in the small-caps space) harvesting sizeable returns through IPO participation. But we see IPOs as another area that needs to be brightly lit, to empower large superannuation funds and other investors to look behind the headlines and hype to determine where the true value lies.

Raewyn Williams is Managing Director of Research at Parametric Australia, a US-based investment advisor. This is general information only and does not consider the circumstances of any investor. Additional information is available at parametricportfolio.com.au.

When is a share market sell-off really a crisis?

Don Stammer

The word 'crisis' is often used in descriptions of, and forecasts for, the share market, but over the years, many 'crises' have worried investors and affected their investments.

Some were real crises with huge effects, such as the 55% collapse in Australian share prices from late 2007. The vast majority, however, were false crises. With today's overload of swiftly-transmitted information and opinions, as well as computer-based trading, false crises are even more prevalent than in earlier years.

Buying or selling on the dip

A false crisis is a major sell-off in shares brought on by widely-held expectations of an impending disaster that fail to eventuate or were massively exaggerated. A false crisis can inflict heavy losses on investors who dump quality assets at depressed prices during the panic. On the other hand, they can provide opportunity for investors to acquire good assets at low prices.

When a crisis – real or false – first hits the share market, many investors fear it’s the beginning of a long and painful bear market. But as Robert Buckland, a global strategist at Citigroup, puts it: “*Every bear market for shares begins with a dip but not every dip starts a bear market.*” Investors need to distinguish between a sell-off that should be bought and one that should be sold.

In my [Cuffelinks article in July 2017](#), I chose the collapse of share prices in early 2016 as the *cause célèbre* of false crises. (To attract readers’ attention, I used the words ‘fake crisis’ in that article).

The dominant view in investment markets in January 2016 was China’s economy was contracting and the US economy would fall into recession. Share markets, commodity prices, and the Australian dollar all plunged. The prevailing expectation was that we would be in for a long drawn-out bear market in shares.

As things turned out, China’s industrial production did not ‘contract’. China boosted demand on a scale the doomsayers had not allowed for and the US economy rebounded. Shares, commodity prices, global GDP and the Australian dollar bounced higher.

The false crisis of December 2018

More recently, we had an even clearer example of a false crisis: the turmoil and panic in share markets around the world in December 2018, which was quickly followed by an ebullient rebound.

In late December 2018, average US share prices fell to a level that was 20% lower than four months earlier, mainly because of fears the Fed would aggressively tighten US monetary policy. Other share markets followed the US lead, and predictions of a long-lasting bear market in shares abounded. US shares not only recovered their earlier big losses but in a few months were setting record highs.

Judging whether a particular crisis is true or false

Australian investors need to keep an effective watch on the key influences affecting US shares, including where the US is in its economic cycle, what’s happening to monetary policy there and how stretched valuations are on US shares. The dominant view in investment markets for economic conditions in China are also important.

Five factors to watch in judging a current sell-off are:

1. US shares generally set the direction that other share markets follow, and when the US goes into recession, investors need to expect a deep and sustained bear market in shares around the world.
2. The best warning sign of an early US recession is given by the relationship between short-dated and longer-dated interest rates in the US (that is, the shape of the US yield curve). When the US yield curve becomes ‘inverted’ – say with the ten-year bond yield lower than the yield on a two-year bond – for a sustained period, the risk of an early US recession is higher, though its precise timing is uncertain.
3. Some investment strategists look at a number of indicators that have good track records for forewarning investors of earlier bear markets in shares. In late 2018, a Citigroup survey found that only four of their 18 indicators had ‘red flag’ settings. This suggested it was too early to call the end of the 10-year-old bull market in shares. Instead, they suggested “buying the dip”. Their April 2019 survey again contained just four red flags, led by stretched corporate balance sheets and the hints of an inverting yield curve.
4. In December 2018, the majority view in markets was the Fed would raise cash rates two or three times in the coming 12 months, and also tighten liquidity by selling bonds. Instead, the Fed soon signalled that, because of “global developments” and “muted inflation pressures”, it would maintain an accommodative stance in its monetary policy. Investors assessing whether a panic is real or false need ask how likely is a change in policy?
5. Expectations the Chinese economy would soon experience a hard landing keep recurring – for example in the late 1990s (during the Asian crises), 2008 (the global financial crisis), 2016 (the so-called ghost cities because of over-building) and 2018 (from attempts to reduce credit). In fact, China’s economic management has been more effective than is generally recognised by commentators in the West, helped a bit by the country’s high rate of saving and abundant foreign exchange reserves.

What if sentiment turns too bullish?

When sentiment in investment markets turns highly positive, investors often do well to take a cautious view, by building up cash holdings to benefit from the next dip in share prices, focusing on the quality shares best placed

to deliver good growth in earnings when conditions are tough, and being highly selective in shares they take up in new listings.

Certainly, the prevailing view in the US share market has recently been highly optimistic. Indeed, investor sentiment lifted so much in early May 2019 that the phrase the “melt-up of shares” was often featured in share market commentaries.

The mood of investors could sour quickly – triggered from tariff wars, or higher inflation, or signs that global growth is fading – and bring on predictions of a long-lasting bear market.

In coming years, investors will again be facing new crises in the share market. They will need to distinguish between the sell-offs that should be bought and the ones that should be sold.

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The future of retirement is already here

Brett Jackson

The idea that when someone reaches the age of 60, it might be time to step out of work and retire into a life of leisure is relatively recent. But with more people living longer, expectations of retirement are being reshaped.

More years were added to human life expectancy in the 20th century than were added across all prior millennia of human evolution combined, [nearly doubling the length of time we are living](#). Recently, life expectancy has been increasing by around [one year every five years](#), and the number of older people in employment is also growing.

With the milieu following the GFC, such as low interest rates and lower return expectations, many will [struggle to save enough](#) by their mid-60s to support themselves for an extended period.

Globalisation and technologies have imposed a dampening impact on real interest rates, and healthcare, medical appliances, personal care services, robotics and other technologies supporting independent living, financial services, leisure and property are all fields morphing to reflect grey spending power.

Multi-staging a retirement

There are two ways to consider the impact of these trends. Firstly, some people will be forced to work longer as budding retirees struggle to save enough to maintain a satisfactory standard of living. But, on the flip side, others may embrace additional years of work for health and wellbeing reasons. Many retirees struggle to replace the sense of purpose they had during their working lives. For some, a blend of these two factors may apply.

Retiring in one's 60s or earlier might become the exception rather than the norm. Quite simply – it could end retirement as we know it. On the upside, work might become more varied, with opportunities to develop skills in new areas. Redeploying into lower-paid work with social purpose, becoming an entrepreneur in later life or bridging two quite different occupations won't be impossible. And less rigid gender roles, with more sharing between income-earning partners, seem likely too.

With more years to fill, education could become as vital for older people as it is for the young. It is unlikely the choices made early in a career will deliver skills for a working lifetime. There should be more time for leisure, too. Signs are already emerging of a striking upturn in older people heading to the gym, with facilities springing up to meet the needs of older exercisers.

Financial planning for a multi-stage life

Most people will need to take greater financial responsibility and spend more time planning. At present, it can be time consuming to find answers to even the most basic questions, like 'how much do I have in my savings pots?'. Retirees may need to deal with different companies on various platforms, as well as the administrators

of the state pension. It may be important, for example, for people to find [lost superannuation](#). At 30 June 2018, the Australian Taxation Office (ATO) estimated there is \$18 billion in unclaimed super. This is a problem the ATO has sought to address by encouraging people to [view all their super account details](#) and consolidate accounts by linking their myGov account to ATO online services.

In the future, the process might become easier, not only to identify pension savings, but also to monitor and control what is held in investment portfolios. Ideally, we could move to a single online portal to keep a close eye on metrics like life expectancy and net wealth. This would give users the capability to move all the sliders on the asset management side as needs change.

A holistic view of what is held in investment portfolios would encourage greater understanding of the current position and an appreciation of what could be done to improve it. In the accumulation phase, the opportunity costs of undertaking a second degree or a career switch would be clearer. In decumulation, it may include the implications of choices, for example, the cost of shifting to part-time, drawing income that exceeds natural equity dividend yields, or how mortgage release will deplete assets overall.

Meanwhile, with pensions freedoms allowing investors to take quite radical steps accessing lifetime savings from the age of 55, a greater focus on addressing longevity risk and delivering lifetime income to retirees is required.

Delivering income over long time horizons

Sophisticated multi-asset portfolios that protect on the downside and participate in the upside, combining asset management and capital markets skill sets, are being suggested as one way to deliver income in perpetuity. Unlike fixed income, these products rebase as equity markets rise. Nevertheless, the products are often not indexed, there may be caps on annual withdrawals (so they won't be flexible enough to deal with large costs like a family wedding) and are likely to be relatively costly as the assets are combined with an insurance wrapper.

Analysis by Aviva's investment strategists has found that over the 30-plus years spent in retirement, a drawdown product with around 15 to 20% allocation to illiquids (like private debt, infrastructure and real estate) could potentially add years of income, compared with a similar multi-asset portfolio 100% invested in traditional public market strategies.

Other innovations being considered include [retirement-targeted bonds](#). These instruments – suggested by professors of finance Lionel Martellini, Robert Merton and Arun Muralidhar of the EDHEC Business School in Lille, France – would differ from conventional bonds in that they would not pay coupons and a lump sum at maturity. Instead, they offer a secure income for an agreed term. Investors could acquire bonds to cover their income needs in retirement, probably in the later stages of accumulation, before switching to an annuity for later life.

[Investment circles](#), where individuals pool assets and then receive a lifetime income greater than that from an annuity (but without the certainty of an insurance-backed guarantee), are also being explored. Modern tontines (an annuity shared by subscribers to a loan or common fund) are designed for those who want to convert a pension pot into lifetime income; some have the advantage of paying longevity dividends to living members, drawn from the assets of those that pass away before them. Although it's early days, they may have the flexibility to include property, and the option to retain assets to pay a legacy.

Living with longevity is a gift, not a curse

The reality of being elderly with more time on the planet is not resulting in more time being 'old'. In fact, it seems to be leading to 'down-ageing', where people behave younger than their biological age. Professors Lynda Gratton and Andrew Scott of the London Business School, in their best-selling book *The 100-Year Life*, say a 65-year-old today is very different from a 65-year-old in the past. They are fitter, healthier, more productive and work for longer.

Studies on identical twins have also shown factors like [exercise can have marked effect on age-related decline](#). As a result, there can be extraordinary variety in the capabilities of people of the same age, even with an identical genetic make-up.

These considerations are important for companies struggling to fill posts. Think of Japan where unemployment is at a record low, and where job advertisements welcoming applications from the over-60s have increased eightfold over the past two years (based on adverts on the job listing website Baitoru, run by recruitment

agency Dip). Looking to older workers may also be pertinent for companies simply seeking to engage better and more directly with their greying customer base.

Longer lives are changing the nature of work and retirement irrevocably. Although having more time on the planet is a wonderful opportunity, it also brings practical challenges, including the need for income to sustain oneself for years and years.

Varied paths that combine paid employment, work with social purpose, learning new skills, plenty of interaction with others and health-giving exercise are all worth investigating. To make the most of retirement in the future, it might be best to shelve assumptions about what retirement means.

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Franking credits lament: was it worth it?

Tony Dillon

Even in defeat, many Labor rank-and-file members and their leaders are arguing the merit of some of their tax policies taken to the election.

Especially the franking credits policy. There are those who lament the 'loss' of revenue as a result of franking credits refundability now remaining intact under a Coalition government. For example, Anthony Albanese said on the ABC's 7.30 Report just two days after the election, "the fact is that \$6 billion [per year] is a lot of money", not completely ruling out Labor's franking credits policy in future.

Was the policy worth it?

Refundable franking credits have not risen 10-fold

Labor consistently claimed during the election campaign that refunding franking credits is unsustainable because the amount has increased more than 10-fold from \$550 million in 2000/01 to \$6 billion a year, and rising. But is there any substance to that claim? What's the basis for these numbers?

The \$6 billion a year claim was the result of Treasury analysis that revealed \$5.9 billion worth of franking credits was refunded in the 2014/15 financial year.

According to Treasury documents, in 2014/15, \$47.5 billion worth of franking credits were distributed in Australia. Of that amount, \$23.5 billion were eligible for franking credit refunds, either in the form of cash or as offsets to tax liabilities. The other \$24.2 billion was distributed to foreign owners and Australian companies, which are not eligible for refunds.

Of the \$23.5 billion in franking credits eligible for refunds, **\$5.9 billion** was returned in cash and \$17.6 billion was used to offset tax liabilities. Of the \$5.9 billion returned in cash:

- \$2.3 billion was returned to individual investors outside superannuation funds
- \$2.6 billion to SMSFs
- \$0.3 billion to other super (including industry super funds)
- \$0.7 billion to tax-exempt entities.

So for a start, that's only \$2.6 billion to the main targets, SMSFs.

The \$23.5 billion is just over three times more than the \$7.6 billion of refundable franking credits distributed in 2000/01. A larger economy and a considerable increase in investment activity in Australia since 2000/01 would have contributed largely to that growth in Australian equities and distributed franking credits, but that would not be the sole contributor.

Prior to 2007/08, both the percentage of refundable franking credits received by super funds and the percentage actually refunded as cash grew modestly from a negligible base in 2000/01. Then when the tax

exemption of superannuation earnings in pension phase was introduced in 2007/08, growth in SMSFs and super fund investments increased sharply. And this saw the average franking credits refunded as a percentage of credits received by SMSFs increase from 35% pre 2007/08 to 60% post 2007/08. Almost double. Therefore approximately half of the \$2.6 billion cash refunded to SMSFs in 2014/15 could be attributable to the enhanced tax-preferred treatment of super, being \$1.3 billion.

Also, there were significant changes to individual tax rates and thresholds post 2006/07 that would have contributed to an increase in refundability. The lower the tax rates, the less tax to offset franking credits against, and hence the higher the amount refunded. And average cash refunds to individual investors as a percentage of total eligible franking credit refunds grew from 10% prior to 2006/07 to 15% post. A 50% increase. So of the \$2.3 billion cash refunded to individuals in 2014/15, approximately \$0.8 billion would be due to lower tax scales.

Therefore, strip out \$1.3 billion for abnormal super growth plus \$0.8 billion for lower tax scales, and cash refunds grew from \$0.55 billion to \$3.8 billion in adjusted terms. Then finally, adjusting the \$3.8 billion for inflation (average inflation rate of 2.7% over 14 years) brings the increase to just \$2.6 billion in 2000/01 dollars.

Other reasons to doubt the numbers

The \$1.6 million transfer balance cap for SMSFs was introduced in 2017/18, well after the numbers on which Labor's calculations are based. The cap has directed funds out of pension phase super accounts into accumulation accounts or other investments. The effect is a reduction in franking credits refunded as cash since 2017/18, all else being equal, as refunds can be used by large SMSFs.

And all this before the [many other ways](#) available to retain franking credit refunds or mitigate the impact.

Cash refunds are not actually a leakage of revenue. They are the rightful return of excess taxes withheld from investors, offset by those high marginal tax rate investors who need to top up their franking credits with additional tax payments.

Therefore, when Labor claimed that cash refunds on franked dividends are costing the budget \$6 billion a year, an increase from just \$550 million a year in 2001, and that its removal would improve the budget bottom line by \$58 billion over the decade, the claim appears highly exaggerated.

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