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Adam Grotzinger on global bonds for diversified income

Graham Hand

Adam Grotzinger is a Senior Portfolio Manager at Neuberger Berman, the manager of the listed NB Global Corporate Income Fund (ASX:NBI). Neuberger Berman manages almost \$500 billion across all asset classes in 35 offices worldwide.

GH: Why do individual Australian investors and SMSFs underallocate to bonds compared with Australian institutions and particularly overseas individuals?

AG: A few reasons. Australia does not have a heavy bond issuance calendar and there's not a big local bond market that retail investors access. If you're a domestic investor, it's natural to invest in your local market. Yes, there are government bonds, but outside of that, supply is choppy. It's different overseas. Those are bigger, deeper, more liquid bond markets, particularly in high-yield bonds.

Investors here traditionally achieved a good fixed income return in term deposits but that's eroded now, and it's likely to get worse. Adding to that, investors had bank capital securities such as shares or hybrids to achieve an income stream. That has worked well in the past but people are now thinking harder and deeper whether that is achieving their goals, and how much concentration risk are they taking.

GH: Indeed. Bank TDs, bank shares, bank hybrids ... it's all an exposure to residential property, the same as their house and perhaps investment property. And people think they're diversified.

AG: Yes, and with the low level of rates in Australia, investors are looking abroad and saying, "Actually, there are better yield opportunities out there. And some of those give me a different type of exposure than I have here." And that's powerful because it's further diversifying their portfolios with a yield element to it.

More people are entering retirement and there's greater desire to reduce the price volatility in portfolios, and prioritising consistency of income. So there's a demographic argument as well.

GH: Tell me about Neuberger Berman. How does a business with almost \$A500 billion under management and 600 investment professionals coordinate its investing? How does an individual Portfolio Manager have a say in the portfolio?

AG: We're comprised of various teams managing money in different parts of the capital markets. One of the larger teams manages corporate credit, comprised of 55 people managing US\$60 billion of assets for clients globally. In the context of NBI (*Ed, the listed Australian vehicle, ASX:NBI*) in the corporate bond market, we have analysts, portfolio managers and traders in the team. The analyst jobs are sector- or industry-specific coverage, and the companies issuing within those industries. They are accountable and compensated and responsible for their views on which companies will outperform. The analysts make formal recommendations to the broader group, and the vetting of the decisions is done by our credit committee.

GH: So the actual investment decision is made by the team?

AG: Yes. It's highly integrated. The analyst makes the case to credit committee, but the credit committee is comprised of the analysts, the co-heads of research, all the senior Portfolio Managers. The buy decision must be unanimous.

GH: Unanimous is quite a hurdle with so many people involved.

AG: We've done this for 20 years and in many cases, we have a lot of documentation and a rich history of these companies that we've covered for many years.

GH: The breakup of your portfolio is about 90% into BB and B rated bonds but there's a 7.5% piece which is CCC. How are you comfortable with these non-investment grades?

AG: When we think about the high-yield corporate bond market, the rating definition is BB to CCC. We anchor the portfolio in BB and B, that's really our operating slot through points in the cycle. When we get more defensive in advance of an expensive market or maybe the economy is slowing, we rotate up a bit higher in quality to triple B, which is technically investment grade.

But we want to stay fully invested, because income is a priority and cash drag is a problem. And after the bottoming of the economic cycle, when the recession bottoms, we can get more aggressive, and buy the CCCs for the price and quality bounce. So in NBI today, we have 7% in CCC, but we've been as low as zero percent leading up to the bottom of the economy. Positioning for rebound, we've held as much as 25% in CCC.

So the low 7% weight in NBI today reflects that we're going through a slowing in growth in the global economy. Our central thesis is a lower but durable level of growth, which can extend the cycle longer here. The 7% in CCC is a much smaller exposure than in an index bond portfolio.

GH: A portfolio with 450 holdings and 300 issuers must have some losses. What default rate would you expect?

AG: Our goal as an active manager is to understand which companies are likely to deteriorate in future, and we've only had one default in 20 years of investing in high-yield bonds.

GH: Really? I thought the default rates for BB and B corporate bonds was about 2% a year and higher in the GFC, and CCC much higher.

AG: Yes, there have been over 1,000 corporate defaults over that period. But as well as understanding the quality of the businesses, liquidity is vital. We want to transact out of the bonds if we feel our original thesis has changed. If you own a bond today, you have a thesis, you have a view on management, you have a view of the business model and how they will service their debt? If in a year's time, that thesis changes, you can sell into the market.

GH: Okay, you don't have defaults but you might have sold a deteriorated position.

AG: That's right, that's our second bit of protection as a manager. If something doesn't pan out, we can sell the bond at two or three or five points below where we bought it. So we are realising a bit of a loss but it's more prudent risk management than riding that bond for another 60 point loss to wherever the markets will price its recovery value. We want to avoid that tail risk.

GH: In the GFC, regardless of what you owned in the non-government bond space, spreads widened and prices fell. How did the high-yield portfolio go in those years?

AG: Very interesting. For the two-year period, 2008 and 2009, if you bought this asset class passively as an index investor, you would have returned negative 27% in 2008 and plus 58% in 2009.

(Ed. At this point, Adam showed me the slide below).

RETURNS (%) ¹	INTERNET BUBBLE BURSTS							GLOBAL FINANCIAL CRISIS							COMMODITY COLLAPSE					YTD 2019		
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016		2017	2018
Neuberger Berman U.S. High Yield Composite (Net-of-fees)	7.6	5.6	-1.3	6.2	3.8	27.7	8.7	4.8	10.1	2.2	-17.8	52.6	15.2	4.1	15.6	7.7	2.0	-4.1	14.8	5.8	-2.1	7.1
Benchmark	2.9	2.4	-5.2	4.5	-0.5	28.0	10.9	2.8	10.8	2.5	-26.1	58.1	15.1	4.4	15.6	7.4	2.5	-4.6	17.5	7.5	-2.3	7.4

Source: Neuberger Berman as at 31 March 2019, benchmark is BofAML US High Yield Master II Constrained Index.

AG: In our portfolio, the bonds were still marked down, but we invest in more durable businesses and we had no defaults. In 2008, we were marked down 17% versus the index's 26%. Then at the end of 2008, we started rotating into risk again, we bounced with the market, but not as strong. We were up 52% versus the market up 58%. It was powerful for our clients. We had a better return than the market, but the income throughout that period was not compromised. The coupons were still coming in each morning albeit with a lot of price volatility. And that price volatility was still far superior to shares. Over the last 10 years, global high yield has an annualised volatility of about 7% versus global equities around 12%.

GH: So you need to educate your clients to hang in during tough markets.

AG: And share our view of the underlying businesses and our confidence in them. Bonds are very different from shares. They have legal, mandatory payments through a coupon from a company. The market marks down the bond but it is eventually forced to get its head around whether this company is solvent or not.

GH: The duration of the book is about four years, which means interest rate risk in a very low rate environment. Why are you comfortable with that?

AG: This asset class does well in periods of rising interest rates. If you looked at the first three quarters of last year, the high-yield market outperformed investment grade bonds when interest rates were going up. What's usually driving higher yields is the economy is doing well, and if you translate economic growth into these companies and their businesses, that's improving their revenues, earnings and cash flow. Markets have more confidence that they'll be able to service their bonds, resulting in tighter credit spreads. This fall in spreads absorbs some of the rise in underlying government bond rates and results in a strong price return for high-yield bonds.

If you look at the period from 2000 to 2016 for rising rate environments, the median rise in US Treasury yields was about 90 basis points (0.9%) over a three-month period. And what did high-yield do in that same three-month period? It delivered a positive 2.4% return. And then in the subsequent three months, after interest rates stabilise a bit, you get even stronger returns. The economy's doing well and markets rally. The opposite is true in investment-grade bonds, which have a smaller coupon and longer duration ... this is becoming a long-winded answer ...

GH: No, it's an important point.

AG: The other factor is a fat coupon is very powerful. It compensates for some of the default risk we talked about, but it also compensates for the interest rate risk. For example, if the bond has a four-year duration and rates go up 1%, in theory, this will be a 4% loss of capital. But if you're earning a 5% coupon, it can bring you back fast.

GH: Most closed-end funds listed on the ASX, in the Listed Investment Company space, trade at a discount to their Net Tangible Assets, the NTA. Why will NBI be different?

AG: This product is built for an income objective, which is defined by our target distribution that we broadcast to the market each year. It's different to a LIC where the underlying assets are shares as we own less-volatile bonds. The objective is more transparent in a way because people are buying into the target distribution for their portfolio. And to the extent we're achieving that target, seen on a high frequency basis, every month, it should create the right community of investors. They should not have a reason to sell it.

The community that owns a share LIC could have vastly different expectations about why they invested in that LIC and what they want from a return or income perspective. And that creates greater volatility in terms of buyers and sellers.

GH: So you want to see it trade at NTA.

AG: Yes, the proposition is straightforward about income. After our IPO, it did trade at about a 3% premium, so the way we can reduce that premium is by issuing new shares. That’s what we’re doing this new offer, after feedback from existing and potential investors that they would like to build more exposure to NBI at NTA.

GH: How does your portfolio differ from the high-yield index?

AG: Substantially. There are about 1,500 companies issuing bonds in our defined market, and we own about 300. We’re not taking undue idiosyncratic or individual name risk but we’re not owning the whole market. We can be selective on issuers, on credit quality, on industries, on relative value. Today, the portfolio is more heavily skewed toward defensive industries than cyclical types of businesses. That’s a reflection of market valuations.

Graham Hand is Managing Editor of Cuffelinks. [Neuberger Berman](#) is a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. Neuberger Berman is currently undertaking an Entitlements and Shortfall Offer for the NB Global Corporate Income Trust (ASX:NBI). For further details, see www.nb.com/nbi. Nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security.

WAAAX and the disconnect not making headlines

Robert Miller

When assessing the current landscape of the ASX, there has been a significant shift of investor dollars towards a highly select group of companies. Much has been made in the headlines about the WAAAX stocks (Wisetech, Altium, Afterpay, Appen and Xero). The share price performance of these companies has been exceptional, and in our opinion an element of FOMO (fear of missing out) has driven valuations to multiples much higher than their comparable global peers.

Impact of WAAAX moves

The demand for the WAAAX businesses has produced what we believe to be a disconnect between price and value that has developed over the past two-plus years. This disconnect exists between micro-caps and the wider market.

Recent Micro-cap Underperformance



Source: Bloomberg

For the purpose of this article, we define a micro-cap as a company with a market capitalisation of less than \$300 million. To illustrate, we have separated the domestic market (ex-resources) into two groups in 2019 to date: those with a market capitalisation above \$300 million, and those below.

The chart above shows that since the recent lows of December 2018, companies with a market cap of less than \$300 million have returned approximately 4.6%, whereas companies with a market cap of greater than \$300 million returned almost 17%. It's an extraordinary difference.

The reality of micro-cap investing

Micro-cap investing is not suited to all. It is a much more inefficient part of the market that takes patience and tolerance to navigate successfully. In our experience, the growth and development of companies generally takes longer than originally anticipated. When a company achieves certain milestones or hits its targets, often it is not immediately reflected in the share price. There are also many other factors to consider such as liquidity, management expertise, capital requirements and investment time horizon, all of which require significant analysis in an area of the market which is not widely covered by analysts.

Micro-cap investing can also be an opportunity to obtain a meaningful position in a high-quality company before share price growth occurs. The holy grail of investing is finding a company with quality fundamentals that is growing its earnings before the wider market discovers it. Whilst these earnings continue to grow, its trading multiple expands, meaning investors are willing to pay a higher price for shares in this company. Many of the best ASX companies start out as micro-caps and have made those patient investors fortunes along the way.

Why has the current micro-cap disconnect happened?

In our opinion, this trade-off between 'reality' and 'opportunity' in micro-cap investing creates an area of the market that is cyclical in the court of public opinion. Investing in listed micro-caps goes in and out of fashion based on how much emphasis investors are placing on each end of the reality/opportunity spectrum.

There have been recent examples of institutional investors losing mandates to invest in the micro-cap sector. When a mandate is lost, a fund must return the deployed funds in a timely manner to the relevant mandate provider (e.g. an industry fund, non-for profit, charity, organisation, university, family office). This can result in large scale selling which is not correlated to the fundamentals of the underlying company.

As a result, many retail investors follow suit by selling their shares as lower share prices often triggers further selling. Furthermore, leading into the end of a financial year, retail investors may look to manage their taxable income by undertaking tax-loss selling on those positions which have underperformed during the financial year to offset their gains. Share prices then fall further, this time on very low volumes.

This disconnect can become self-fulfilling. The result is an environment in micro-caps where liquidity, and particularly buying demand, disappears.

When does this disconnect end?

Whilst the current environment may not paint a rosy picture of micro-cap investing, we are firmly of the view that the public opinion pendulum will at some stage swing back to more normalised levels. Micro-cap investing will again come into vogue. When will this disconnect end? Just like everyone else, we do not know.

What gives us confidence in our investment approach is the principle that despite short term disconnects between price and value, over the long term, price should match value. This is particularly the case in micro-cap investing.

In his book 'What Works on Wall Street', Jim O'Shaughnessy analyses compound annual returns for a period of 50 years of US equities, segmented into the market capitalisation bucket. During this period, micro-cap stocks outperformed large cap stocks by on average close to 3% p.a. The power of compounding means such that a difference of circa 3% p.a. means an outsized return of over at the end of that 50 years. As Charlie Munger said:

"The big money is not in the buying or the selling, but in the waiting."

We believe this current period of disconnect for ASX micro-caps has further widened the inefficient playing field that is micro-cap investing. During this period of 'waiting', we can increase ownership of quality businesses at low prices and also revisit companies we know well that have seen an earnings multiple reduction. Some have seen earnings multiples reduce for legitimate reasons that may be only short-term headwinds, others for

reasons less relevant to the business fundamentals such as mandate or tax-loss selling. These are the opportunities we like to see when making new long-term investments.

For those willing to spend the time doing the work on micro-caps, we believe there are compelling risk-adjusted returns on offer.

Robert Miller is a Portfolio Manager at [NAOS Asset Management](#), a specialist fund manager of three listed investment companies (LICs) with concentrated exposures to Australian listed industrial companies outside of the ASX-50, and a sponsor of Cuffelinks. NAOS' LICs are in micro-cap stocks (ASX:NCC), small-caps (ASX:NSC) and mid-caps (ASX:NAC).

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For more articles and papers from NAOS, please [click here](#).

A frank look at Chris Bowen's \$67,000 question

Geoff Walker

The \$64,000 question from the recent Federal election is, "Why did Labor lose?". Many well-informed retirees will say we should be talking about the \$67,000 question.

Some of you may ask, "Why bother with this debunking now Labor has lost the election?" The answer is that many people who heard Chris Bowen's favourite example about a nurse believe it is the truth, which is a clear risk for sensible future retirement income policy development.

Throughout the campaign, the then Labor Shadow Treasurer touted this \$67,000 example at every opportunity. For instance, on ABC's Q&A on 29 April:

"Let's take an example. If you've got a nurse who's earning around \$67,000 we charge that nurse around \$13,000 a year tax, roughly. Fair enough, that's what we charge her. If you've got a retired shareholder who owns their shares in a self-managed super fund, who earns \$67,000 in dividends, we don't charge any tax. Fair enough. Then we send a tax cheque refund for around \$27,000.

\$13,000 we take from the nurse; \$27,000 to the retired shareholder, through their self-managed super fund. Same income; different outcome. I can tell you it's not fair."

Sounds persuasive. That's an unfair **\$40,000** difference in outcomes. Maybe to some, but let's check the numbers.

The detail required for a fair analysis

As any taxpayer who has ever received a salary knows, wage and salary earners never receive their actual stated salary. They only receive what's left after PAYG tax is taken out, with a final reckoning at the end of the financial year. So Mr Bowen's nurse doesn't receive \$67,000. Before submitting her tax return, she probably receives \$52,000 throughout the year, assuming \$15,000 PAYG tax. In contrast, Mr Bowen's retiree's super fund is earning \$67,000 *after* various taxes have already been taken out. Thus the comparison is false – the nurse and the retiree are not receiving the same income.

We'll start with an informed investor who started his (or her) superannuation investing in 1988, just at the time that superannuation funds were first taxed. His aim, seemingly unachievable at that time, was to produce an income stream of \$67,000 per annum in retirement from dividends on Australian shares, on which he expected to pay full income tax when received from his super fund.

Back in 1988, dividend imputation had only recently been introduced for individuals and in the press there was widespread speculation that, in addition to individuals' personal portfolios, imputation would be extended to their retirement savings, i.e. superannuation funds. It was also widely believed that this extension would come at the cost of taxation of superannuation funds' investment earnings.

If dividend imputation was so extended then our investor's challenging task of producing \$67,000 per annum in his retirement would be that much more achievable. Instead of having to generate \$67,000 in cash dividends after company tax, his fund would need only generate that same amount in grossed-up dividends. For example, if when he retired, company tax was 30%, then his cash dividend target would be 70% of \$67,000, i.e. \$46,900.

And on cue, the government released its May 1988 Reform of the Taxation of Superannuation, which did in fact so extend dividend imputation, at the cost of 15% taxation on investment earnings.

And since he was in an employer superannuation fund, it didn't matter that imputation credits were not refundable since they would be used by the fund to reduce its tax payable and then be apportioned back to him.

However, the May 1988 statement also contained an initiative that had not been contemplated in the run-up to its release. This was the taxation of employer and deductible employee contributions at the same rate as investment earnings, 15%. Fortunately for our investor, the Federal Treasurer, Paul Keating, explained that this initiative would not cost superannuation savers 1¢ in retirement benefits, as it was to be accompanied by a compensating reduction in income tax on superannuation benefits, be they lump sum or pension.

There is no difference in the end results between a given rate of tax taken out at the contribution stage and the same rate applied to the pension at the benefit stage. The amounts of tax are different, but that is of course simply the decades-long difference in the time value of money.

With 15% taken out of all the contributions that would finance our investor's retirement pension, that would leave the investor's contributions accumulating to generate a cash dividend of only 85% of \$46,900, i.e. \$39,865, which, including franking credits of \$17,085, grosses up to \$56,950 of taxable income in the fund.

Investor versus nurse

Let's now assume that the investor reached his target and consider how his outcome compares against that of Mr Bowen's nurse. The personal tax rates used are those applicable over 2018/19, ignoring Medicare and any other variations that might apply in individual cases.

Mr Bowen's nurse's tax on \$67,000 would be assessed at \$13,322, entitling her to a tax refund of \$1,678 after allowing for \$15,000 PAYG tax, leaving her with after-tax income of \$53,678.

For our investor (on a level playing field) there have been two lots of tax taken out:

1. contributions tax equivalent to 15% on \$67,000, i.e. \$10,050
2. company tax of 30% on (\$67,000 - \$10,050), i.e. \$17,085

Let us also assume that he has reached his preservation age so is eligible to start a pension from his fund, equal to the dividends and franking credits received by his fund, i.e. \$56,950. His final after-tax position will depend on whether he has reached age 60 or not. We'll look at both cases.

Aged under 60

Being under 60 he must pay full tax on his pension, less allowance for the effective pre-payment of income tax via contributions tax:

- marginal tax on \$56,950 = \$10,055.75
- less 15% tax on \$56,950 (already paid within the fund) = \$8,542.50
- gives tax payable = \$1,513.25

This leaves our investor with after-tax income of \$56,950 - \$1,513.25 = \$55,436.75.

Aged 60 or over

Being 60 or over he is no longer required to pay the under-60 tax bill of \$1,513.25. This will leave him with after-tax income of \$56,950.

A level playing field rather than a \$40,000 question

Let's put all these after-tax results side by side so that we can judge the validity of Mr Bowen's conclusions on a like-with-like basis:

Mr Bowen's nurse	Actual nurse	Mr Bowen's retiree	Actual retiree <60	Actual retiree >60
\$54,000	\$53,678	\$94,000	\$55,436	\$56,950

In other words, a retiree truly comparable to Mr Bowen's nurse is not **\$40,000** better off after tax, but rather a mere \$3,000, of which just \$1,500 can be attributed to over-60's tax exemption.

If more people knew the history and studied the facts, they could better judge the sheer unfairness of the Labor proposal to eliminate the refund of franking credits. As they say:

"A lie can travel around the world before the truth gets its shoes on."

The only tax this retiree didn't pay was the \$1,513.25 he didn't have to pay once he turned 60. And for this, Labor wanted to strip him of \$17,085. No wonder he and his numerous not-hugely-well-off ilk revolted at the election.

Geoff Walker is a former Chief Actuary at the State Bank of New South Wales and winner of the 1989 JASSA Prize for published research on the implications of the then relatively-new dividend imputation system. This article is general information and does not consider the circumstances of any investor.

A fireside chat with Hamish Douglass

Hamish Douglass

Provided by Morningstar from the 2019 Morningstar Investment Conference, held in Sydney on 30 May 2019

In this 'Fireside Chat', Magellan's Hamish Douglass delves into some of the secrets of Magellan's success, exploring key learnings from accomplishments and mistakes along the way, and providing crucial insights and takeaways for any business owner or leader. He reveals his current thinking on markets, where he sees the opportunities and risks, and how those are currently being reflected in Magellan's portfolios.

Hamish Douglass, Chairman, CIO and Lead Portfolio Manager, Magellan Financial Group with Moderator, Tim Murphy, CFA, CAIA, Director of Manager Research, APAC, Morningstar.



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Westpac case and the digital fix for SOA mess

Claire Wivell Plater

It's Hotel California time for institutionally-owned advice businesses.

Having invested billions in buying and building advice businesses over the past 25 years, banks are only now realising that they can't run them both compliantly and profitably. But post-Hayne, divestment plans are in disarray due to impaired values.

While disgorging advice businesses might feel like a welcome short-term solution, banks are still left with legions of customers with unserved financial needs. With their wealth of consumer data, banks are in pole position to identify those needs, devise solutions and connect with customers at appropriate lifecycle points.

Confusion between 'personal' advice and 'general' advice

If as is claimed, the cost of human-delivered advice is prohibitive, automated advice technologies are clearly the solution for lower balance customers. So it is curious that banks appear to be delaying their introduction.

This is currently manifesting in calls for more clarity around the dividing line between 'personal' and 'general' advice, being one of the reasons for Westpac's appeal against Gleeson J's December 2018 decision in *ASIC v Westpac* (see *AFR* article by James Eyers and Elouise Fowler [Future of Advice: boutiques for some, robo-plans for the rest](#), 20 March 2019). It's an odd rationale for the appeal, given that the court found that all the information Westpac provided to customers during its super consolidation campaign was either factual information or general advice.

I would have called that a win for Westpac on the general advice front.

Still, Westpac is not alone in its concern about 'general advice'. The [Productivity Commission](#) considers it a misleading term, requiring consumers to intuitively understand that general advice is like marketing. It takes a hard line, recommending that 'advice' only be used in association with 'personal advice', i.e. advice that takes personal circumstances into consideration, and that only professional advisers should deliver it.

ASIC agrees that 'no advice' and 'general advice' models are problematic, particularly if product complexity makes personal advice more appropriate, or other factors in the sales process may negatively affect consumer decision making (see [ASIC's submission to the Productivity Commission](#), para 47). The new [design and distribution obligations](#) may assist to ensure that products are only distributed to people for whom they are appropriate; but will not provide a complete answer.

Is this really about disclosure obligations?

The debate may be more about semantics if you take the view, **first**, that the function of the 'no' 'general' and 'personal' advice labels are to enable allocation of disclosure obligations, rather than identify the standard of advice required. (Only 'personal advice' attracts the stringent fiduciary duty to prioritise clients' interests and provide appropriate advice.)

And, **second**, regardless of the advice model employed, financial services providers have an all-encompassing [obligation](#) to provide their services honestly, efficiently and fairly and cannot engage in misleading or deceptive conduct or make misleading or false representations.

What happened at BT and Westpac?

In *ASIC v Westpac*, BT's call centre staff were drilled in recommending BT's rollover service without explaining that a prudent customer consolidating their superannuation would consider issues such as termination fees, loss of insurance benefits and the feasibility of employer contributions before making a decision.

Instead, Westpac liberally employed 'social proofing', where staff were trained to tell customers that people like them believed that it was better to have their superannuation all in one place to 'potentially' save on fees. Because this was not a sound basis for deciding to rollover superannuation, Gleeson J found that its use by Westpac to provide assurance to customers about the rollover service was not honest, efficient or fair.

The case puts to rest any view that 'caveat emptor' (buyer beware) applies to 'no' and 'general' advice service models, even though those models do not attract a best interests duty. Businesses employing these models will need to profoundly reconsider their sales strategy and techniques.

You may ask why businesses use these models, when the duty of care is so high? Simply, because they don't have to prepare statements of advice which have historically been perceived as too expensive for simple advice.

Digital technologies will change advice

This is all set to change. Digital technologies can now readily collect and analyse customer information, produce suitable strategic and product recommendations and auto-generate a compliant statement of advice (SoA) in a matter of seconds. While the algorithms to undertake complex holistic advice are a little way off, for the relatively simple scaled advice that is generally provided in 'no' or 'general' advice scenarios, current technologies are more than adequate.

Indeed, they arguably provide greater protection due to their compliant-by-design approach which meet the following requirements from the outset:

- Identify information as factual, general or personal advice
- Appropriately label and provide appropriate warnings for factual information and general advice
- Clearly scope personal advice and collect sufficient information to form a reliable basis for it
- Record and explain why strategy and product recommendations are suitable for the client.

Longer term these technologies are likely to see a shift to personal advice, making the no / general /personal advice semantics largely irrelevant. In the meantime, financial services providers who adopt them can be more confident of meeting the central obligations of honesty, efficiency and fairness post-Royal Commission, at low incremental cost and minimal reputation risk.

ASIC's timid response to fixing SOA mess

With all this promise, it is unfortunate that structural impediments persist. The financial advice legal framework was conceived well before 2002 and has barely been updated to accommodate technology developments, let alone, consumer preferences. ASIC's timid guidance on electronic delivery of financial services falls short and its insistence that the laws are technologically neutral don't stand up under scrutiny.

Two examples of sorely needed change include flexibility in the provision of Financial Services Guide content and permitting consumers to elect when they require a downloadable confirmation of advice during an online advice session. Currently, a separate SoA is required each time a consumer changes their data. Imagine the confusion for a consumer testing a range of scenarios before arriving at a desired outcome!

The Productivity Commission's welcome and long overdue call for increased competition in Australia's Financial System identified regulators as a key component ([see page 37](#)). According to them, core regulatory competencies must include the ability to anticipate that financial product design and delivery will change with technology and consumer preferences, and willingness and ability to change regulation accordingly.

One thing is clear. With human advisers reportedly unwilling or unable to cost-effectively service clients with balances lower than c\$500,000, increased trust, collaboration and creativity between regulators, technology companies, advice providers and consumer groups will be required to close the increasing advice gap.

Claire Wivell Plater is Chairman of boutique financial services legal advisory firm [The Fold Legal](#) and principal of Wivell Plater Consulting. She is a member of the Australian Government's Fintech Advisory Group and sits on five fintech advisory boards including digital technology company, Ignition Wealth. Claire has provided legal and strategic advice to financial services businesses for over 35 years.

The \$1 billion quiet achiever in Australian philanthropy

Rachael Rofe

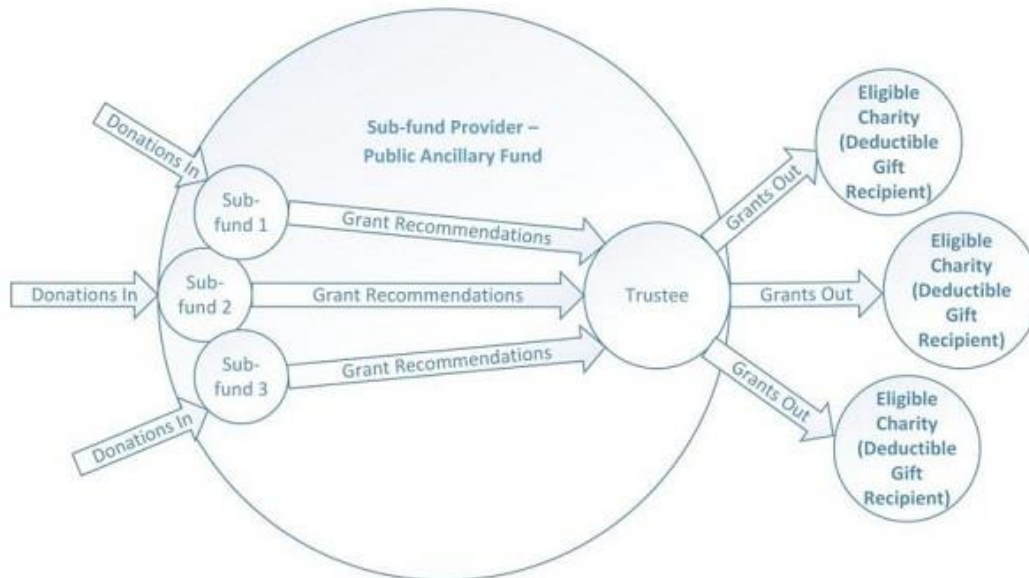
Attractive tax benefits and a hassle-free giving experience means more people are donating their money into philanthropic sub-funds – and they are giving a lot, especially as the end of another financial year approaches.

[New research](#) released by Swinburne University shows that sub-funds in public foundations are the 'growing force' in Australian philanthropy with assets held in sub-funds totalling over \$1 billion. More than \$123 million of donations flowed into these structures last financial year. In fact, there are now more sub-funds in public structures (Public Ancillary Funds or PuAF) than Private Ancillary Funds (PAFs) in Australia, demonstrating that

while PAFs and big philanthropy may be more publicised, the accessible and convenient sub-fund is more popular.

How does a public sub-fund work?

A sub-fund is a giving account or fund within a larger public charitable foundation (a PuAF). It is established by making a tax-deductible donation which is set aside into your own named sub-fund. Each year at least 4% of your sub-fund balance is given to charities recommended by you. While you think about who to recommend, the balance is invested and your charitable money is put to work. Returns are tax-free, so good investment management can see the balance grow, increasing the amount you can recommend to charity over time.



Source: Centre for Social Impact, Swinburne University of Technology

Attraction of immediate tax-deductability

Structuring giving in this way is an especially attractive strategy for donors who need a tax deduction now, and the flexibility to distribute the funds to charity over time. For example, pre-retirees in a higher tax bracket than might be expected in the future can bring forward multiple years of charitable giving and make a lump sum contribution to a sub-fund. It gives the donor the tax deduction needed while they are still earning assessable income but allows them to continue a regular flow of charitable giving throughout retirement.

Similarly, a sub-fund alleviates the pressure of a donor having to 'panic choose' a charity to support in the final days of the financial year. They can receive both the tax deduction and the liberty of time to take a breath and consider who they want to support. At the same time, the balance is being invested for growth.

The data reflects the experience of sub-fund service providers like Australian Philanthropic Services (APS). When Chris Cuffe AO founded APS as a not-for-profit organisation with the aim of helping people more easily give their money to charity, the focus was initially on a private ancillary fund (PAF) service. The organisation's offerings quickly broadened to include a PuAF, allowing people to establish a giving account within the APS Foundation.

What was initially a complementary offering for donors who did not want the administrative responsibility of a PAF, or who required a lower entry point to structured giving, has now become Australia's fastest growing PuAF. The establishment of sub-funds at APS now outstrips PAFs by three to one.

The growing popularity of sub-funds can largely be attributed to their accessibility and simplicity. They can be established painlessly in one day and with entry points from \$20,000. You don't need to be a multi-millionaire to take advantage of the benefits of structured giving.

PAFs remain a good option for donors with at least \$1 million to contribute. However, they come with greater administrative responsibility which might not suit donors who don't want to be concerned with board meetings or managing the investment of the PAF's assets. A sub-fund allows donors to focus solely on the giving.

A personal experience

Mark Lazberger, former Chief Executive of Colonial First State Global Asset Management, and his wife Anne decided several years ago to go down the sub-fund route.

"Choosing a sub-fund instead of a PAF was initially the best option for us because of its flexibility and there were some scale benefits that it offers."

The ability to transfer the balance of a sub-fund to a PAF (and vice versa) is a plus for donors who might want to change giving structures in future. For Mark, the investment credentials and acumen behind the public foundation were extremely important. A since-inception return of 11.5% per annum has increased the amount that Mark and Anne can recommend to charities. The fund is bolstered by the support of a number of specialist fund managers who deliver an investment and social return by providing their services pro bono. Instead of the fund manager receiving a management fee, it is rebated to the APS Foundation to be distributed to charities recommended by giving fund holders like Mark.

"If we hadn't had confidence in Chris Cuffe's investment acumen and how the APS Foundation goes about making its investment decisions, we would have had to take a different path."

The role of philanthropy in wealth transfer

As Australia approaches the largest intergenerational wealth transfer in history, baby boomers are looking to philanthropy as a way to nurture relationships through the generations, and to allow children and grandchildren who have been brought up in privilege to see a different view of the world.

For Deborah and Miles Protter, structured philanthropy was a way for them to have conversations with their daughter about their family's values.

"Having the sub-fund has helped us to cement our long-term commitment to the Hunger Project and provides us with a way to give direction to our giving as a family. Our daughter, now 22, has always valued what we're doing with the Hunger Project, but never felt part of it. Having this vehicle provided us with a way to have that conversation and talk about what's important to us as a family."

The sub-fund market in Australia is yet to realise the boom experienced in the US with their equivalent, the Donor Advised Fund. Assets held in Donor Advised Funds are one hundred times the value of assets held in Australian sub-funds, surpassing US\$100 billion in 2017. The requirement in Australia that at least 4% of a sub-fund balance be distributed to charity each year provides comfort to donors in this country who take seriously their philanthropic responsibilities. Last year, \$57 million was granted by sub-funds to charities, well above the minimum amount required by law.

Many sub-fund providers, like the APS Foundation, are primed to support the growing number of philanthropists by doing away with chequebook charity and moving towards a more structured way of giving. The ease with which donors can use sub-funds to give and grow money for charity, coupled with appealing tax benefits, means their growing role in Australian philanthropy will continue unabated.

Rachael Rofe is the manager of the [APS Foundation](#), a Public Ancillary Fund offered by Australian Philanthropic Services. The research released March 2019, '[Snapshot of Sub-funds in Australia](#)', was undertaken by Krystian Seibert of Swinburne University's Centre for Social Impact.

5 flexible features of Managed Accounts

Jonathan Hoyle

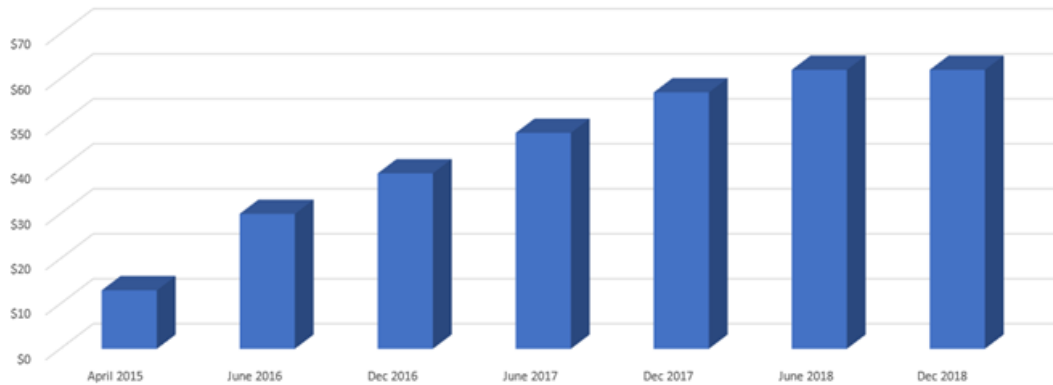
About half of Cuffelinks readers engage the services of financial advisers to help them manage their life savings. Most will meet with their adviser, review their portfolio and then listen to their adviser's recommended changes to these portfolios. This process of managing client money is old-fashioned, clunky and reactive. There is a better way.

Acceptance of Managed Accounts

Managed Accounts have been around for a while but over the last few years their popularity has soared, not only in Australia, but also in the UK and the US. There is good reason for this as the benefits of using Managed

Accounts are significant and varied. According to the 2019 Netwealth Advice Tech Report, 43% of advice firms now use Managed Accounts to run part of their client portfolios, up from 35% in 2017. A recent [IMAP/Milliman survey](#) revealed that \$62 billion of client funds are now managed via discretionary portfolio methods, double the level of just three years ago.

Growth in Managed Accounts Funds under Management
from 2015 to 2019 (\$ billions)



Source: IMAP Milliman

A Managed Account in its simplest form is an auto-rebalance tool. It permits the advice firm discretion to make changes to their clients' portfolios without requiring their written approval. This is how superannuation monies are managed in industry and retail funds. The manager has strict limits on the amount of risk that can be taken and the type of assets that can be purchased, and must adhere to these limits.

The Managed Account benefits

Managed Accounts offer a range of benefits that offer clients and their advisers increased flexibility.

First, the money is managed by a professional investment committee, rather than by an adviser who occasionally reads the Fin Review and a stock-tipping sheet. While portfolio outperformance is not guaranteed, the likelihood of things going badly wrong are reduced.

Second, the client's funds are managed in a much more proactive manner as portfolio changes can be made in an instant. Contrast this with the traditional process where changes were generally only made at the client meeting, which may happen just once or twice a year.

Third, Managed Accounts are more progressive and egalitarian than the traditional way of managing money. Currently, if changes need to be made, it's inevitably the adviser's larger clients who will be called first. With a Managed Account, all portfolios of the same risk profile are changed at the same time, which also offers scale benefits.

Fourth, Managed Accounts are transparent. Portfolio performance is published each month and is benchmarked against an equivalent risk profile. There is no hiding, obfuscation and evasiveness. "How are we doing?" is now easier to answer. We benchmark our clients' portfolios against their CPI+ targets and against a basket of comparable portfolios every month.

And **fifth**, with advisers freed from the tyranny of trying fruitlessly to add value by picking BHP over CBA, they can actually get on with the job of providing strategic financial planning advice, focussing on the clients' wealth plan and helping them achieve their important goals in life.

Sounds good so far.

Are there any disadvantages?

Yes. A Managed Account run by a professional investment committee will likely charge a portfolio fee. This is typically in the region of 0.2% – 0.3%, though lower rates are commonly offered for larger portfolios. This is an additional cost. However, most Managed Account providers are able to recoup most, if not all, of this cost in two ways.

First, by negotiating lower management expense ratios (MERs) from fund managers. With scale comes lower fees, and Managed Accounts offer scale. It's important to check that your provider passes these rebates on to you, the client, in full. And **second**, many Managed Account providers are now offering lower financial advice fees if client portfolios are run in a discretionary manner, due to the reduced administrative burden.

It might be time to talk to your adviser about Managed Accounts. They are not suitable for everyone, but they are a big part of the future of advice.

Jonathan Hoyle is Chief Executive Officer at [Stanford Brown](#). This article is general information and does not address the circumstances of any individual.

What are professional fund buyers doing now?

Louise Watson

Professional fund buyers' decisions can provide other investors guidance on risk, asset allocation and the investment strategies most likely to succeed in current and future economic conditions.

This year, there is good and bad news in the advice fund buyers – responsible for selecting funds included on private bank, insurance, fund-of-fund and other retail platforms – are offering. The bad news is that the next 12 months are unlikely to be easy: 83% say they expect greater volatility in equity and fixed interest markets, 78% say rates will rise and 63% say the US bull market is likely to end. At the same time, geopolitical uncertainty, in particular the ongoing and escalating trade dispute between the US and China, will weigh on performance.

The good news is that professional fund buyers are confident they can tackle what's to come. The results of [this year's global survey](#) of 200 of these key investment decision-makers, conducted by Natixis Investment Managers, reveal the directions they are likely to take to satisfy the demands of their firms' clients.

To seek or not to seek risk in a low-growth world?

There is always a trade-off between:

- taking on enough risk to achieve performance
- preserving wealth by not losing capital, and
- going backwards because you took on too much.

Striking the balance has become more difficult than ever as 'lower for longer' is the new status quo. Short-term measures aimed at navigating short-term economic weaknesses are unlikely to succeed. Investors must deal with the economic environment they find themselves in, not the one they would like to have (and have had over the past decade).

The good news is that the 200 professional fund buyers surveyed say their long-term return assumption remains pretty solid. It's down from 8.4% p.a. last year to a robust but nonetheless healthy 7.7% p.a. this year.

Professional fund buyers, like investors generally, must trade off long-term investment goals (enough money to retire on, for example) with the more immediate demands of advisers and clients for above-average performance. The result is that fund buyers' time horizons tend to be shorter than many institutional investors and superannuation trustees, but longer than that of individual investors. Say between 5 and 10 years typically.

Risk-on as tough times call for risk assets and active management

The first overarching theme is the focus on active rather than passive investment strategies. All fund buyers acknowledged that passive index-based investment strategies have a role in a portfolio, and smart beta was singled out as a way of mitigating the risks associated with lower returns from markets generally.

However, only a quarter of these funds are managed passively, with three-quarters supporting the view that actively-managed investments are likely to outperform. There is a widespread belief that alpha is becoming more difficult to obtain and that paying higher fees for potential outperformance is acceptable. In fact, they

continue to rely on the performance potential of active management to balance the competing pressures of growth and safety.

The bias towards risk assets is continuing. While allocations to equities are slightly down, there is acceptance that the higher risk is worth the potential for higher returns over time. When it comes to other 'higher risk' investments such as hedge funds or alternative strategies, fund buyers tend to favour liquid versions of these strategies given their end-clients typically require liquidity. Most do not serve their clients' interests by investing in physical infrastructure investments, for example.

About 60% of fund buyers said that financial regulations put in place after the GFC have done little to mitigate current and future market risks.

Allocations are not wildly different but there are some changes

Projected portfolio allocations remain unchanged on the whole, but meaningful changes within asset classes are on the horizon. Equities and fixed interest retain their place at the top of the allocation tables and equities remain the first choice for growth, despite additional risk.

Within equities, however, increased diversification through the addition of global exposure is considered the best way to seize opportunities. For European equities as a class, half the fund buyers intend to increase allocations on the back of favourable valuations and earnings outlooks, whereas the other half are decreasing exposure due to persistent Brexit worries and a weak Italian banking sector. Asia-Pacific held steady. Despite the fact that growth in China is slowing, it's still better than growth elsewhere.

Allocation to fixed interest is likely to remain steady but higher-yield bonds are out of favour due to concerns about rates rising, the economy becoming weaker and the financial strength of the high-yield issuers.

Alternatives are the ultimate de-risk asset class

Allocations to alternative asset classes are on the rise to meet performance objectives, manage risk and diversify portfolios. Some 70% of fund buyers said that their alternatives allocation will go to liquid alternatives with most calling out long-short equity, long-short credit and private debt as top choices to enhance returns. When it came to diversification benefits, real estate strategies were top of mind.

ESG themes offer attractive investments but also satisfy social responsibility, and it's perhaps this duality that has contributed to ESG strategies becoming mainstream over the past year. The Natixis Investment Managers [ESG report](#), released in May 2019, revealed that professional investors are leading the charge towards ESG strategies. Institutions, including Australian super funds, are integrating a wide range of ESG strategies into their portfolios. The report also showed that ESG investing is making in-roads in wholesale markets, where 65% of fund buyers say it is part of their investment practices. Two-thirds of fund buyers say that ESG factors will be standard for all managers in five years, but they acknowledge a number of challenges including a lack of demonstrated performance track record and concerns around 'greenwashing' of data.

Conclusion

Almost half of fund buyers have trimmed their assumed rate of return in anticipation of stock market declines and rising interest rates. Instead, they are selectively using alternative investments to meet their clients' needs for growth and safety, as well as continuing to rely on the performance potential of active management, particularly in the unfolding riskier market environment.

Louise Watson is the Managing Director of [Natixis Investment Managers Australia](#). This article is general information and does not address the circumstances of any individual.

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