

## This Week's Top Articles

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## James Maydew on how demographics drives global real estate

Graham Hand

*James Maydew is Head of Global Listed Real Estate at AMP Capital.*

**GH:** How do you manage a global real estate business from Australia?

**JM:** It works well because we have team members all over the world. We firmly believe that real estate is a local game. Boots on the ground are really important. We have teams in Sydney, Hong Kong, London and Chicago operating across every time zone. My own location is not the most important issue, the locations of my team are.

**GH:** And do they go out and kick the tyres on every asset you buy?

**JM:** We're investing in listed securities, so kicking all the tyres is hard because there are thousands of properties. But it's important to engage with the company and understand the management team and the second layer, the third layer, the fourth layer of the team. And seeing the real estate is vital. I'm a real estate person by trade and our team understands the bricks and mortar. We all travel a lot.

**GH:** How do you cover Asia and what are the opportunities there?

**JM:** We think about AsiaPac as a region, and we have a team here in Australia and a team in Hong Kong. The primary markets are Hong Kong, South Singapore and Japan, and we also cover China, the Philippines, Korea, India and Vietnam. We have three people in Hong Kong, and our most recent hire there is a native Japanese investor because Japan is a difficult market and you definitely need local connections.

**GH:** What's the global distribution of your assets?

**JM:** About 60% are in North America, 25% is in AsiaPac, and the balance is in Europe. It's a US-centric capability. The US is the most liquid and deepest real estate market in the world, with the most opportunities.

**GH:** Other than the size and liquidity, is there something about the dynamism or growth of the US that attracts you there?

**JM:** Well, think about the asset classes. It's not just the three typical groups that you see in many other parts of the world, which are retail, office and industrial. The US has many other exciting sectors. There's multi-family residential, manufactured housing, storage, aged care, healthcare, forestry, prisons, data centres – all in the listed format. They are truly institutional. It will take 10 years for Australia to look like the US does today.

**GH:** What are some trends, demographic or consumer or company, that you really like?

**JM:** Demographics drives everything. We have a massive focus on long-term demographic trends. For example, we've got 20 years of Baby Boomer retirement, which will put pressure on aged care facilities and the healthcare system. How do you manage health? We're invested in companies that focus on life science, which is combating health challenges. About 10,000 diseases exist and only 500 have been dealt with. That's a long runway.

On the other side of the coin, we have the Millennials and their acceptance of technology, and how they interact with consumption. Commerce on mobile devices is still in the early phases of its trajectory. Retail is going online and we want exposure to the industrial facilities that benefit. In the US, for example, there's far too much retail, so you have to watch that segment. Index funds are simply not managing that risk.

**GH:** So the success in industrial of Australian companies like Charter Hall and Goodman is happening all over the world?

**JM:** Absolutely. In fact, Australia is playing catch up. The UK is leading, there is greater ecommerce penetration in the UK than any other market in the world.

I'm now thinking about 5G, because a lot of real estate investors ignore it. It's positive for three sectors in particular: logistics and ecommerce, communication towers and data centres. Data is growing at a phenomenal rate, and with 5G the demands and the movement to the Internet of Things will create even more data.

**GH:** You mentioned manufactured homes. What demographic change is that tapping?

**JM:** It's also linked to the ageing population. In the US, affordable housing is a massive issue. Manufactured housing is an affordable alternative to owning your own home or renting. We focus on housing parks that are located in the warmer southern states, which attract the snowbirds, including from Canada.

**GH:** Older people are tired of the cold?

**JM:** Yes, they want a higher quality of life and for many, that means better weather. The parks we focus on are typically age-restricted, and provide a service with the facilities and environment for people to engage with like-minded folk. It's not about trailer parks or the lowest cost alternative. It's a community location for retirees.

From an investment perspective, the return on capital is strong because we typically own the land and the tenant owns the building. They manage and pay for the cost of the maintenance and upkeep of that building, and they pay for a ground rent and the services. Rental growth is consistent and it's recession-proof because it's affordable housing. Not everyone sees that as institutional real estate but we look at the cash flows for our investors.

**GH:** In Australia, institutions struggle for exposure to residential property but there are better opportunities overseas, such as multi-family dwellings. Do you have much exposure to residential overseas?

**JM:** Well, just looking at the US multi-family market, it's absolutely massive, about 8% of our benchmark.

**GH:** What's the benchmark?

**JM:** It's EPRA NAREIT (*Ed, European Public Real Estate Association North America Real Estate Investment Trusts*). These residential apartment buildings are considered truly institutional. The servicing is done with technology using professional management and it's coming to Australia.

**GH:** This is where a fund owns an entire building with say 200 apartments in it?

**JM:** Yes, and they have the systems to understand the best opportunity to push up rates when occupancy is full, and create an environment and facilities which people are willing to pay for. They make it a great place to live, and people stay or come back.

The German residential market has also become a massive investable universe. Unlike Anglo nations, Germans don't tend to own their own home. They're happy to rent but not for one year, more like 12-year leases. It's logical. Just think about the financial leverage and risk to acquire a single asset with no diversification benefits. And then they sign a 25-year mortgage to pay it off.

**GH:** And their first investment outside their home is residential investment property.

**JM:** More people should think about using their own capital to invest for better returns and their dwelling is just consumption. But the Anglo mindset is different.

**GH:** Do you have Australian assets in your global portfolio?

**JM:** Yes, Australia is a really important market for AMP Capital. The main sector that excites us today is industrial. We believe Australian industrial is five years behind the US and UK with significant growth to come, and investors are underpricing it.

**GH:** Do you have a couple of listed favourites in Australia?

**JM:** Well, it's difficult to play the industrial sector in a highly diversified way. Goodman Group and Charter Hall have done well. Some people think they are expensive but we believe they will grow significantly larger in a sustainable way. They have capital-light business models.

Industrial is about the reconfiguration of supply chains and it's multi-level. The factories that were near the cities have become redundant and are often converted to residential or office or whatever else. It means the industrial supply, or land close to the consumer, has been shrinking. And that's a global issue at a time when the customer expects delivery of products in a very short period. If you don't get that, your business is not viable.

**GH:** The whole last mile trend as well.

**JM:** Yes. We believe rental growth expectations in this asset class are understated because there will be a step change in the ability of landlord to move rents up. Even a bricks and mortar retailer must deliver products quickly. The most expensive part of supply chain management is transportation, typically 50%. So if they can cut that down by being closer to the customer, they can invest more in real estate, which is typically under 5% of costs.

**GH:** An investor looking for exposure to this space could just say, "I'm happy with this asset class, I'll just go into the index and save active fees." How does your fund differ from the index?

**JM:** So this paper that I've written brings that to life, focussed on the Australian market. (*Ed, attached [here](#) in our White Paper section*). Billions of dollars in this sector have gone into passive investing, and that's been okay in the past. But in future, investors should not buy a passive fund because half of the assets are in a declining retail segment. There's a strong case for active management in this asset class.

**GH:** Listed property performed terribly during the GFC. Have the lessons been learned?

**JM:** Yes. Australia was the poster child of all of the things you should not do at the top of a real estate cycle. Leverage was too high, management teams went into markets with no competitive advantage, overpaying for assets and not managing their debt.

So where do we sit now? None of those companies or boards or investment committees ever want to go back there. The lessons have absolutely been learned. Most businesses have reduced their leverage in line with the cycle. They respect the cycle.

There's also better understanding that the real estate market is more localised, driven by local real estate cycles.

**GH:** It's about that building in that location ...

**JM:** Exactly. So people talk about the challenges of retail, but you can still have some great retail. You have to understand the socio demographic. The way we see active management is that when a market becomes more challenging, we'll sell that market and move money elsewhere.

*Graham Hand is Managing Editor of Cuffelinks. [AMP Capital](#) is a sponsor of Cuffelinks.*

*James Maydew is Head of Global Listed Real Estate at AMP Capital. The managed fund can be accessed on the ASX via the AMP Capital Global Property Securities Fund (Unhedged), ASX:RENT.*

*For more articles by AMP Capital [click here](#). For the White Paper by James Maydew, [click here](#).*

## We have many world best practice companies

Phil Ruthven

Overall, Australia’s businesses are way below world best practice (WBP) when it comes to profitability and have been for decades. Average returns on shareholder funds after tax (ROSF or Return on Investment, ROI) across the nation’s 2.3 million businesses have averaged just 3.7% over the past three decades (compared with the 10-year government bond rate averaging 5.5% over that period), although with a better 4.2% in 2018. Our largest 2,000 corporations averaged 6.9% ROI, and our Best 100 did a little better at 8%. The WBP level is 22%.

### What do we mean by world best practice?

In this article, I have treated WBP as a company profitability level above 22% ROI, not a single ‘best’ as we might do with best practice in other comparisons (such as OH&S, triple bottom line, stakeholder action). Even with best practice processes and products there are often subtle if not significant differences.

It’s instructive to see how WBP has evolved through the ages of economic progress.

- The **Agrarian Age**, up to the late 18th century. WBP profitability was probably around the 10-year bond rate of about 5.5%.
- The **Industrial Age**, up to the mid 1960s. WBP profitability was around double the bond rate, at about 11%.
- The current **Infotronics Age**, to the middle of the 21st century. WBP profitability has doubled again to 22%. The added returns come from intellectual property, brand strength, culture, etc, which often remain off balance sheet although shareholders accept them as real in valuing a company. The massive change has been in the value of intellectual property ahead of the audited net assets.

### Global performance comparisons

All of the ROI averages of Australian companies stated in the first paragraph are just over half the averages in the USA.

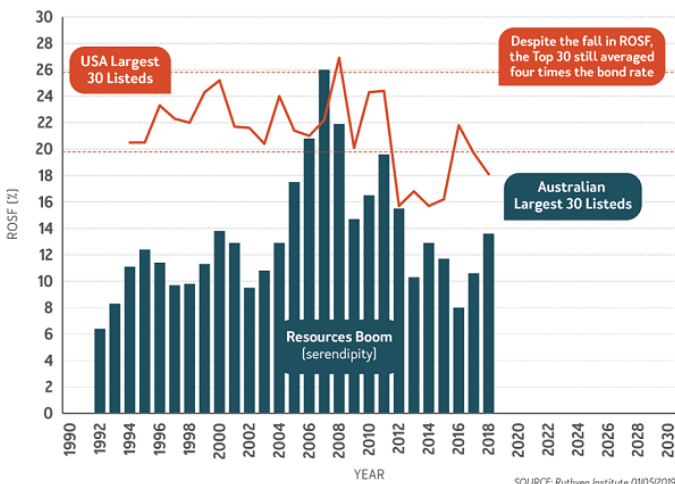
However, Australia had more than one in 10 of our largest 2,000 – that account for 46% of the nation’s \$5.3 trillion revenue in 2018 – achieving WBP of 22% in ROI terms over the 3-year period to 2018. Sadly, three in 10 lost money over the same period.

We see the same performance gap in our 30 largest listed stocks (by market capitalisation) compared with the 30 largest NYSE-listed stocks (the Dow Jones Index list) below left.

So, a lot of share portfolios and SMSFs have become more heavily weighted into US equities in recent times (directly or via managed funds and ETFs). That has been a no-brainer when one sees the diversity of performance between the All Ordinaries, S&P500 and NASDAQ in the next chart, below right.

### USA vs. AUSTRALIA: PROFITABILITY

Return on shareholder funds after tax, to 2018



### WORLD: AUSTRALIA AND USA STOCK MARKET INDEXES

Monthly, to May 2019



## Tell us some good news about Australia

But, as always, there is good news as well as sobering news as shown below.

# PROFITABILITY: 100 BEST LISTED PUBLIC ENTERPRISES

Return on shareholder funds after tax (%), three-year average<sup>1</sup> to 2018

6.7% of Australia's revenue

	Number	ROSF (%) <sup>1</sup>
<b>FOCUS</b>		
Focused (mainly single industry class)	95	19.6
Theme conglomerates <sup>1</sup>	5	17.5
Classic conglomerates <sup>2</sup>	0	0.0
	<b>100</b>	<b>18.9</b>
<b>INDUSTRY SECTOR</b>		
Primary (Agriculture, mining)	12	18.1
Secondary (Manufacturing, construction, utilities)	23	25.6
Tertiary (Wholesale, retail, transport/storage/postal)	17	21.2
Quaternary (Information- and/or finance-related)	40	17.4
Quinary (Hospitality, health, recreation, other services)	8	21.8
	<b>100</b>	<b>18.9</b>
<b>OWNERSHIP ORIGIN</b>		
Local owned	94	18.8
Foreign owned	6	22.8
	<b>100</b>	<b>18.9</b>

Some 42 companies in the Best 100 Listed Stocks achieved or bettered the WBP of 22% ROI in the three years to 2018, and the weighted average of the 100 was a commendable 18.9%.

The good performance took place across all five industry sectors with the toughest sector – the secondary sector of manufacturing, utilities and construction – performing best. Most of the 100 Best were focused companies with only five being diversified, and even they were theme conglomerates rather than dangerous classic conglomerates which all fail eventually.

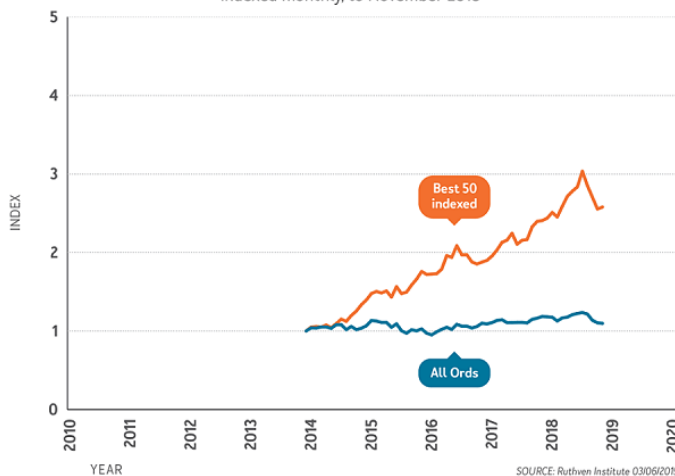
Note: 1. Weighted average basis.  
2. Same industry division.  
3. More than one industry division (of 19).

SOURCE: Ruthven Institute 01/05/2019

The best news of all is when we look at the Best 50 Listed companies over a 5-year period to 2018, and compare their weighted performance with the All Ordinaries Index, as below.

## LONG-TERM PROFITABILITY: BEST LISTEDS INDEX

Indexed monthly, to November 2018



A million dollars invested in the Best 50 five years ago would have yielded a capital value of \$2.5 million by 2018, a 30% pa return, plus dividends. The All Ords would have been worth just \$1.15 million plus dividends.

Our Best 50 not only outpaced the S&P500, but also the NASDAQ. It would seem fundamentals do matter.

Phil Ruthven is Founder of the [Ruthven Institute](http://www.ruthven.institute), Founder of [IBISWorld](http://www.ibisworld.com) and widely-recognised as Australia's leading futurist. A full 40-page online Summary of the latest Business Performance results is available from [www.ruthven.institute](http://www.ruthven.institute) along with a staggering amount of other strategic information.

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## Network effects: when big gets very big very quickly

Joe Magyer

One of our primary [investing fascinations](#) at Lakehouse Capital is around networks. Think marketplaces, exchanges, payment networks, social networks, or any other form of business exhibiting network effects.

The big idea with network effects is that the product gets better with each additional node in the network. For example, being the first person you knew who had a telephone would not have been much good except for bragging rights, but the usefulness of having a phone exploded as they became fixtures in offices, homes, and then pockets. Or we could be talking about a two-sided network like PayPal: the more users who pay with PayPal, the greater the usefulness for the merchant, and the more merchants who accept PayPal the greater the utility for the user.

Network effects are not exactly a new concept and we're hardly the first to appreciate their virtue and value. However, many Australian investors underestimate just how quickly value can be created by some businesses with a network effect at their core. Indeed, while seven of the world's 10 most-valuable listed companies as of 31 March 2019 were powered by network effects, only one of the 10 most valuable listed companies in Australia is truly network-driven.

### When networks get big fast

Many businesses powered by network effects can scale quickly and capital-efficiently, enabling a significant amount of value creation in short order. Remember the seven of the world's 10 most-valuable listed companies are powered by networks? They're an average age of only 27 years compared to the average age of 154 years for the non-networked giants. eBay reportedly was profitable from the first month it started charging for listings while Facebook was only 12-years-old when it first outearned the then-100-year-old Commonwealth Bank of Australia.

Why are networked businesses able to scale to such heights at such a speed? The rise of the internet, digital commerce and connected mobile devices has enabled a hyperscale that previously did not exist as new networks can reach larger audiences with greater efficiency than ever before.

Another reason that networks create value at rates that can sneak up on investors is that the lifetime value of each user added to the network increases as the network scales. For example, the value of the 2019 new user cohort at PayPal in per-user terms is likely far higher than it was just a few years ago because PayPal is now accepted by many more merchants, which enables new users the ability to transact in more places and increase their value.

Another surprise to investors is that networks are often able to scale with very high incremental margins thanks to relatively fixed overheads. The one-two punch of operating leverage and increasing incremental returns on investment is a powerful combination that can set such networks up for a long series of surprises relative to expectations. Again, PayPal, which is widely followed and presumably well understood, has beaten consensus expectations for normalised net income in 14 out of the 15 quarters since the company was spun off from eBay.

Scaling networks also have increasing optionality. For example, a network with a large and growing user base is well positioned to leverage its size and engagement to take new shots on goal. Prime examples include the likes of Tencent's WeChat Pay, Apple Music, Uber Eats, third-party logistics at Amazon, and data packages from securities exchanges, among many others.

Such call options are hard to price and predict, but they can often prove lucrative in their own right with the added benefit of increasing engagement across the network. For that matter, networks that are leaders in their space, have attractive unit economics, and are growing users and usage at healthy rates find themselves getting 'lucky' by virtue of that strong position and significant user loyalty.

### When networks are built to last

The above all sounds great, however, not all networks are created equally. Most fail to reach critical mass. Wikipedia lists 39 defunct social networking sites and that tally neglects the countless sites that failed to gain enough notoriety for their failure to be catalogued.

The ones that do reach a self-sustaining level are not necessarily huge winners either. You would have done incredibly well as an angel investor in Twitter, for example, but public market investors have fared poorly as the

shares are down 7.5% over the past five years. Meanwhile, its chief rival, Facebook, has roughly 16 times as many daily active users across its platforms and a market capitalisation that is more than 19 times the size.

Why is Facebook's larger set of networks more valuable on a per-user basis? To users, larger networks make for more connections, which make for greater utility and engagement. For advertisers, a larger audience delivers a wider range of inventory while a more engaged audience makes for sharper analytics and savvier ad targeting.

But wait. Couldn't Facebook be the next MySpace? Maybe. Then again, MySpace reportedly only had around 76 million monthly active users at its cultural zenith, which is only about 1/31 the size of the core base of Facebook 'blue' monthly users. If anything, Facebook's relative position is vastly understated on a user basis because of the network dynamics. Working off [Metcalf's Law](#), the number of potential connections within Facebook today is something like 980 times that of the number available on MySpace at its peak. Little wonder then, for all the talk of deleting Facebook, its monthly active user base has increased by 8% over the past year.

We can't know for sure when or how Facebook will be toppled, which is true of every other powerfully-networked business. Still, by seeking out leading, growing networks with attractive, improving unit economics, investors just might find themselves discovering a business that the market might be sorely underestimating.

*Joe Magyer is the Chief Investment Officer of [Lakehouse Capital](#), a sponsor of Cuffelinks. This article contains general investment advice only (under AFSL 400691) and has been prepared without taking account of the reader's financial situation.*

*Lakehouse Capital is a growth-focused, high-conviction boutique seeking long-term, asymmetric opportunities. Lakehouse is the investment manager of two strategies: the Lakehouse Small Companies Fund and the Lakehouse Global Growth Fund. Amazon, Facebook, PayPal, and Tencent are holdings of the Lakehouse Global Growth Fund. Joe owns shares of Amazon, Facebook, and PayPal.*

*For more articles and papers by Lakehouse Capital, please [click here](#).*

## Franking debate is signal to review SMSFs

Andrew Varlamos

To say that the Labor Party's proposal to cancel cash refunds for excess franking credits caused consternation among Cuffelinks readers would be an understatement.

Cuffelinks received well over a thousand comments on the proposal and wasn't alone in preparing SMSF trustees for the potential impact had the Federal Election panned out as many expected.

So, it's not surprising that the hundreds of thousands of SMSF investors receiving income via franking credits breathed a huge sigh of relief when the Coalition claimed victory.

### Don't exhale too hard, too soon

Many SMSF trustees may now believe they don't need to think about making any changes to their portfolio to deal with the impact of a franking credit removal. In fact, it's actually an excellent opportunity to reconsider whether portfolios are really fit for purpose.

The over-reliance on franking credits has meant too many SMSFs have investment portfolios that are dangerous for their purposes. The available data and anecdotal evidence from accountants who administer many SMSFs suggest that a significant percentage of self-directed SMSFs have an over-reliance on the ASX Top 10 in their portfolios.

There are two main reasons for this. SMSF investors long ago fell in love with high, fully-franked dividends as an income stream, but they also feel a degree of comfort investing in companies that they're familiar with and always thought of as stable pillars of our economy. But such overly-concentrated portfolios highlight the dangers of insufficient diversification.

The following table is instructive. It shows the Top 10 shares held by SMSFs, according to the [Class SMSF Benchmark Report](#) (March 2019; based on Class's database of 160,000 SMSFs, so it is representative).

We've added the column on the far right, showing the price performance of each stock over the past five years, excluding dividends.

Rank	Security Code	Description	5-year performance (excluding dividends)
1	WBC	Westpac Banking Group	-19.0%
2	BHP	BHP Group Ltd	4.4%
3	TLS	Telstra Corporation Ltd	-28.9%
4	NAB	National Australia Bank Ltd	-19.8%
5	CBA	Commonwealth Bank of Australia	-2.2%
6	ANZ	Australia & New Zealand Banking Group Ltd	-15.7%
7	WES	Wesfarmers Ltd	-11.2%
8	WPL	Woodside Petroleum Ltd	-17.0%
9	WOW	Woolworths Group Ltd	-15.79%
10	CSL	CSL Ltd	189.1%

*Prices as at 7 June 2019.*

Eight of the Top 10 stocks are worth less now than five years ago, while the broader S&P/ASX200 Price Index is up about 18% over the same period, with other international markets rising even higher.

We also know SMSFs are underweight global equities compared with local institutional superannuation funds, missing many sectors and opportunities not available in Australia. And about 20% of SMSF assets are held in cash and term deposits where it's a struggle to achieve positive real returns.

### **The world of investing is the real world**

What does this tell us? The most obvious take-away is that set-and-forget share portfolios make little sense, even when they seem to work for an extended period. It is folly to pretend that we live in a static and stable world where the fortunes of major companies do not change.

The world we live in is a complex place. Political upheaval, management failings, regulatory shocks, aggressive competitors, demographic change and technology breakthroughs impact markets just as they impact people's lives.

If you're not thinking about these issues and managing your portfolio accordingly, your 'strategy' is one of hoping for the best, rather than planning for the best. It's rolling the dice rather than playing chess.

As an SMSF is the primary means its trustees rely upon to give themselves a dignified retirement, and to provide for their dependants, the stakes are too high for such a gamble. The franking credits 'scare campaign' ought to be the wake-up call many of Australia's self-directed SMSFs needed.

### **What should self-directed SMSFs do?**

Revisit your portfolio and ask yourself:

*"Am I really managing my portfolio, making appropriate changes as required, and ensuring that it's appropriately diversified for the current conditions and my circumstances?"*

If you can't answer "Yes" confidently, then ask this one: "Do I need to find a professional who can manage my portfolio for me or with me?"

Your options are to find a trusted licensed financial adviser, or access professional asset management expertise and choose one or more to manage your portfolio.

After all, you shouldn't be losing sleep or money, let alone losing sleep *about* losing money!

*Andrew Varlamos is Co-founder and CEO of [OpenInvest](#), a sponsor of Cuffelinks.*

*OpenInvest is a new end-to-end online solution for self-directed investors, including SMSF trustees. OpenInvest empowers you to choose how your wealth is managed, providing direct access to portfolios managed by your choice of investment management firms and designed to meet the needs of investors seeking diversification, security, income, and growth.*

## Mary Meeker's 2019 Internet Trends Report

### Cuffelinks

We provide Mary Meeker's Internet Trends Report each year, and it's always popular.

There is an enormous amount of information to absorb, and while Meeker provides a quick-fire 30-minute video as shown below, she admits the material is supposed to be read and not presented.

For a copy of the 333 slides and analysis by Recode, [click here](#). The video link is below.

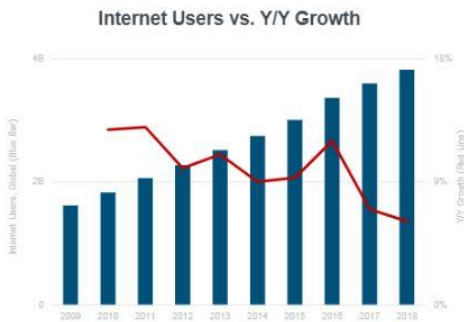
We have extracted five slides below to give a taste of Meeker's presentation.

- 1) Users
- 2) E-Commerce + Advertising
- 3) Usage...
- 4) Freemium Business Models
- 5) Data Growth
- 6) ...Usage
- 7) Work
- 8) Education
- 9) Immigration + USA Inc.
- 10) Healthcare
- 11) China (Provided by Hillhouse Capital)

1. The subjects covered in the 2019 Report.

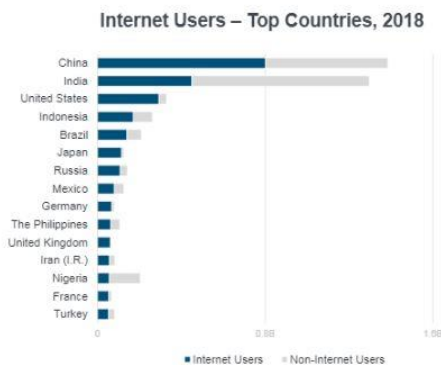
Global Internet User Growth =  
Solid But Slowing +6% vs. +7% Y/Y

2. About 50% of all people on the planet are now connected to the internet, but growth is slowing.



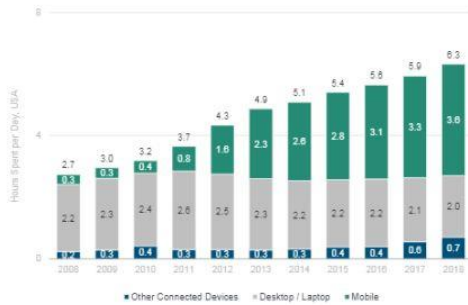
Global Internet Users =  
China @ 21% of Total...India @ 12%...USA @ 8%

3. The US internet market is saturated but the biggest markets of China and India (especially) have considerable future potential.



Digital Media Usage =  
Accelerating +7% vs. +5% Y/Y

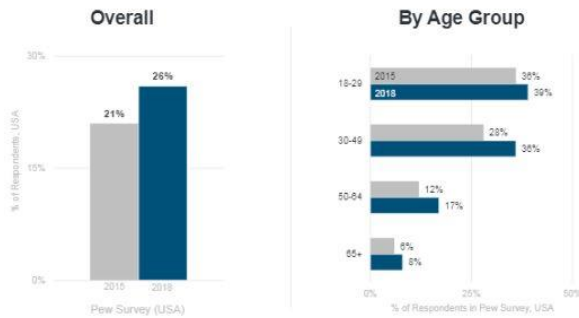
Daily Hours Spent with Digital Media per Adult User, USA



4. We are spending much longer looking at our phones every day, with an unhealthy average of 6.3 hours a day on digital media (US data). Desktops usage is holding steady.

Adults 'Almost Constantly' Online =  
26% vs. 21% Three Years Ago

% of Adults Online 'Almost Constantly'



5. Meeker spends many slides discussing the unwelcome side of internet usage, such as health and mental issues, with 26% of adults 'almost constantly' online, and 39% of people aged between 18 and 29.



Here is the [30-minute video on highlights](#).

*See presentation material for disclaimers.*

## How share buybacks boost the US market

John O'Brien

It is a stately process, and one that approaches the level of a ritual. In Australia, large companies announce their intentions to buy back shares using some of their excess cash. They mail out explanatory notices to their shareholders and invite them to participate in the buyback.

Everyone gets something: the company buys back shares, typically at a discount to their market price; remaining shareholders get higher earnings per share, and exiting shareholders, through the alchemy of tax, can sometimes get a financial benefit too. It is an almost perfect example of cooperative capitalism.

The only drawback is that it occurs in a small market at the bottom of the world. This is a description of the buyback regime in Australia, where for years companies have balanced the interests of investors seeking dividend income with those seeking earnings growth. Corporate share buybacks overall have consistently been 1-2% annually of overall market capitalisation in Australia over the past 20 years.

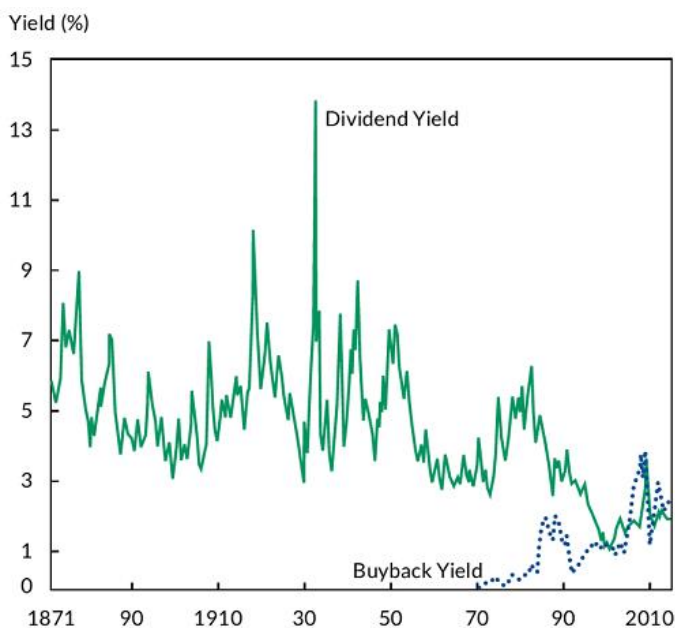
**In the US, a different process unfolds**

In the US, with low taxes on dividends but no dividend imputation, off-market buybacks are relatively unknown. But on-market buybacks have surged in the past 20 years, up to 3% annually of US market capitalisation. An even greater share of profits on average have been used to buy back shares than to pay shareholder dividends. Instead of everyone getting something, some get a lot. Current shareholders receive a boost to earnings growth from a lower share count. Company executives (whose compensation is frequently based on earnings growth accompanied by share price targets) often see the value of their compensation rise significantly.

Dividend-focused investors get little, and those looking for increased corporate investment – investment that offers the prospect of boosting employment – can also be disappointed. Instead of the cooperative capitalism that characterises off-market buybacks, this is a capitalism that favours management and shareholders, each of whose focus has appeared increasingly short-term in recent years.

Traditional corporate finance theory split corporate profits into earnings to be retained, and those to be distributed to shareholders as dividends. During the 1980s, however, this model was revised – at least in the US – by deregulation, the hostile takeover movement and a new ideology of maximising shareholder value. By the end of the millennium, US corporate executives became focused on using repurchases, as well as dividends, as an important way of distributing corporate profits to shareholders. Chart 1 shows the increase of buybacks relative to dividends by US companies over time. Buybacks by US companies now constitute the single largest use of corporate profits.

**US corporation dividend yield and buyback yield**



Source: Straehl and Ibbotson, 'The Long-Run Drivers of Stock Returns: Total Payouts and the Real Economy', *Financial Analysts Journal* 2017.

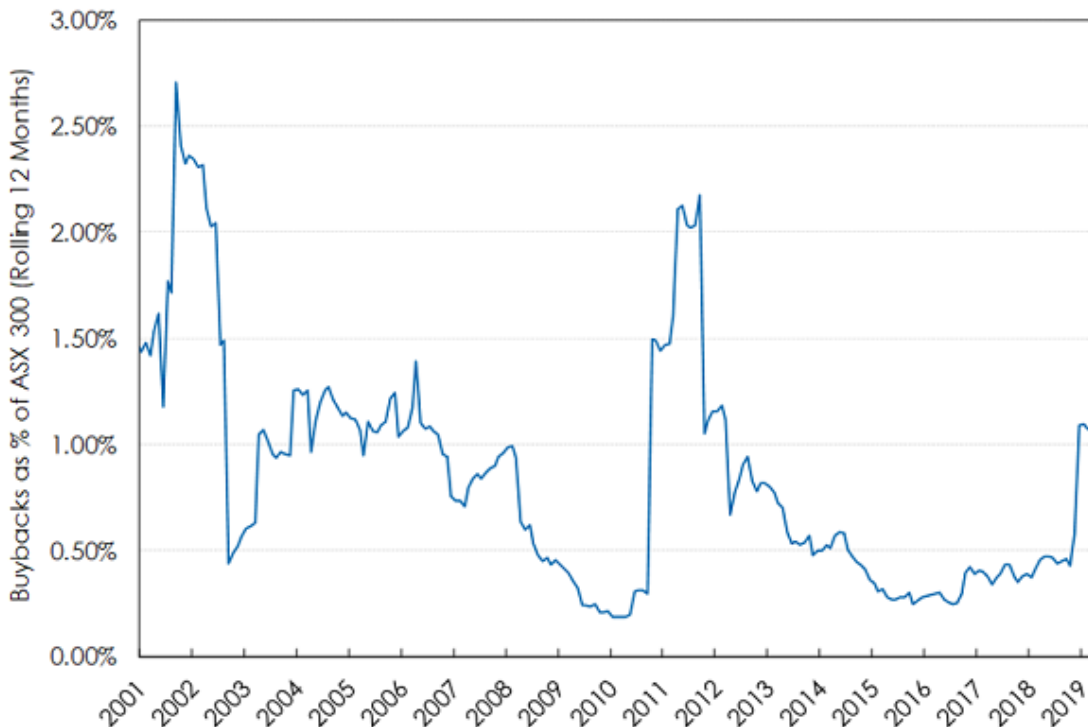
**In theory, corporate stock buybacks are a healthy financial activity**

The underlying rationale for buybacks is that a company without significant profitable investments to be made is better returning profits to shareholders, either through buybacks or dividends. The two modes of distribution, however, are fundamentally different. Payouts through dividends increase the income return of shareholders. Buybacks increase the price return per share, since a holding investor's share of the company through the buyback is increased on a per share basis.

They do so in two ways: in the short term, by providing a price return through the increased demand created by the buyback, and in the medium term by providing increased earnings per share, since the number of shares is reduced going forward.

The two effects together can be combined into a single expression of buyback yield which is the change in a company’s aggregate shares outstanding. US companies bought back an estimated 2.8% of their shares in 2018; ASX companies bought back about 1%.

**Buybacks as a % of market capitalisation for the ASX 300 (rolling 12 months)**



Source: Vinva Investment Management

Stock buybacks have unequivocally improved corporate earnings growth – mathematically, they must – but another collateral benefit has been company management compensation. Since large-scale, open-market repurchases give a boost to a company’s stock price, some of the prime beneficiaries of stock-price increases are the same corporate executives who decide the timing and size of the buybacks.

In addition, until the regulation was changed in 2017, performance-based executive compensation – much of it tied to buybacks – also received favourable corporate tax treatment.

**The aggregate effects of stock buybacks**

The most relevant question with respect to buybacks, however, is not whether they are productive or not. Instead, it is whether a practice that appears to have contributed to large growth in market capitalisation is a stable one at an aggregate level. In particular, the use of debt to fund stock buybacks probably deserves greater scrutiny.

A significant percentage of US stock buybacks over the past ten years have been funded by debt. In 2017, for example, roughly one-third of all US stock buybacks were debt-funded. Global large-cap companies with intangible assets in their brand and franchises, including franchise brand companies such as McDonald’s, YUM! Brands, and Domino’s Pizza Inc., have bought back so much stock and issued so much debt to do so, that they have negative balance sheet equity – that is, the book value of their assets is less than their liabilities.

With central banks still providing ample credit and liquidity to financial markets, buybacks look set to continue over the short-term. US corporate share buybacks are so far setting a record pace this year, even higher than their record 2018 levels. For both corporate management and shareholders, earnings growth is cheap – to generate it, all management needs to do is keep buying back shares. It’s hard to see an end to this trend, unless government regulation or tax treatment changes.

**Impact of stopping buybacks on US market values**

The US stock market, which makes up 63% of the MSCI World Index, continues to be at a 33% premium to the rest of the world (in aggregate, on a trailing price/earnings multiple basis). However, if the stock buyback component of 9% average annual earnings growth over the past five years for US companies were to disappear

over the next five years, the cumulative loss of earnings would push the S&P500 price/earnings multiple to 23.5x. This compares to the rest of the world's trailing price/earnings multiple of 15x. The discrepancy in valuations between markets alone should give an investor allocating between regions cause for concern.

If stock buybacks in the US stop for any reason, both management and investors alike will have to shift earnings per share expectations downwards. Based on comparable recent history, that wouldn't be pretty.

*John O'Brien is a Principal Adviser at [Whitehelm Capital](#), an affiliate of Fidante Partners. The views expressed in this article are those of the author. This article is for general information purposes only and does not consider the circumstances of any investor.*

## Senator Hume imposes moral obligation before SG increases

Graham Hand

[Senator Jane Hume](#) is the new Assistant Minister for Superannuation, Financial Services and Financial Technology. In her 20 years before entering politics in 2016, she worked in banking, funds management and superannuation in roles at Deutsche Bank, Rothschilds, National Australia Bank and AustralianSuper.

In the last two weeks, she has given her first speech and interview, and while no new policies were announced, she gave a road map on what to expect for the next few years. Most significant was the requirement to meet a "moral obligation" for efficiency.

### The moral obligation before SG increase

Interviewed in *The Sydney Morning Herald* on 25 June 2019, Senator Hume said:

*"If a system is compulsory and it quarantines nearly \$1 in every \$10 that you earn for up to 40 years, it is imperative that the government make that system as efficient as possible ... There is no time to waste."*

*"Which is why we have to get rid of high fees, duplicate accounts, underperforming funds and unnecessary insurance, because that's what makes the system inefficient."*

She nominated better outcomes for superannuation savers as her most important priority. Improvements must be made as a "moral obligation" before the scheduled and legislated increases in the superannuation guarantee (SG) rate from 9.5% to 10% in 2021, up to 12% by 2025.

### Senator Hume's first speech

Her first speech as Assistant Minister was at the Bloomberg Buy Side Forum, and here are some direct quotations:

*"The Treasurer has stated publicly we are 'positively disposed to a review of the retirement income system as recommended by the Productivity Commission.' The Government will provide further information about the Review in due course."*

*"The (Productivity Report) found a number of structural problems in the system and concluded that the prevalence of unintended multiple accounts, pockets of entrenched underperformance and the sheer complexity of navigating the system have eroded members' trust in the system as well as their balances."*

*"In an industry crowded with opinion makers, industry groups and lobbyists, it is important that consumers themselves have a stronger voice. As such, the government has announced our intention to establish a superannuation consumer advocate and will be consulting on the scope of its activities, funding and governance arrangements."*

*"Currently, there is very little guidance on how retirees should draw down their savings when they reach retirement. The Government is addressing this by developing a retirement income framework, which includes a covenant requirement for funds to develop a retirement income strategy. The Government is also exploring ways of expanding the range of retirement income products available. Funds will need to consider the retirement income needs of their members, as well as provide guidance to their members to select the most appropriate retirement solution for their circumstances."*

Following the Bloomberg event, she told *The Australian*:

*"We made some pretty significant reforms in 2016 and I don't think there is any intention that we would do any more at this stage."*

This suggests changes will be more about implementing work already in the pipeline, but the Liberal Party also made promises in 2013 and 2014 not to change superannuation taxes but then Scott Morrison as Treasurer implemented numerous changes.

So watch this space for the review proposed by Josh Frydenberg, and a revisit of recommendations from both the Productivity and Royal Commissions.

*Graham Hand is Managing Editor of Cuffelinks.*

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