

This Week's Top Articles

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10 reasons many fund managers are now blank spaces

Graham Hand

*So it's gonna be forever
Or it's gonna go down in flames
You can tell me when it's over
If the high was worth the pain
Got a long list of ex-lovers
They'll tell you I'm insane
'Cause you know I love the players
And you love the game*

-Taylor Swift, Blank Space

Yes, Taylor, we loved the players and we loved the game. Swiftly, it's over, leaving a blank space.

It looks easy from the outside, but asset management is a tough game. Winners can win big, but there are far more strugglers. In a concentrated portfolio, a heavy overweight position in a losing stock can mean "*it's gonna go down in flames*".

Recently, an unprecedented number of fund managers have closed their businesses or some of their funds, including:

- KIS Capital
- Sigma Funds
- JCP Investment Partners
- Dual Momentum
- Janus Henderson Australian equity funds
- MHOR Asset Management
- Discovery Asset Management
- Denning Pryce
- Adam Smith Asset Management
- Concise Asset Management
- Arnhem Investment Management
- Ellerston Global Macro
- Colonial First State Global Asset Management 'Core' funds (transferred to other managers)
- UBS Asset Management Australian equity funds (transferred to Yarra Capital)
- Altair Asset Management

For many years, I managed the 'alliance' business for Colonial First State (CFS), where we would partner with portfolio managers to establish new operations. We saw all types of potential come across our desks, from a

couple of people wanting to set up their own boutique, through to large global managers establishing an Australian business.

How hard can it be? While there are some overlaps in the following reasons, here are 10 industry hurdles to overcome. These may or may not apply to the above names.

1. The growth of index investing

In 2018 in the US, passive index funds (including unlisted mutual (managed) funds and Exchange-Traded Funds (ETFs)) enjoyed a net inflow of US\$431 billion, while active mutual funds experienced net outflows of \$418 billion, as shown below. Given the large fee difference, that represents a loss of hundreds of millions of dollars in fees to the asset management industry.

In Deloitte's 2019 Investment Management Outlook, 16 of the top 20 global funds by net flows were passive mutual funds and ETFs, gathering a net US\$143 billion.



Source: Bloomberg and BetaShares

In the US, it is estimated that 34% of mutual funds and ETFs are passively managed. This number is only about 12% in Australia, but momentum is well-established. Most local ETFs are index-based and in the final quarter of FY2019, ETFs listed on the ASX exceeded \$50 billion for the first time.

It is not only the fund flows that hurt active managers, but the price competition. Institutions can achieve index management on large portfolios for 1 or 2 basis points (0.01 to 0.02%), forcing active managers to compete as low as 20 basis points (0.2%). It is difficult to finance a fully-functioning active operation of portfolio managers, analysts and support functions at such low fees unless billions of dollars are held. Even a good \$250 million mandate would bring in only \$500,000, which would barely cover the cost of a senior portfolio manager.

2. In-house management by large institutions

Many of the largest superannuation funds in Australia are boosting their in-house asset management capabilities and withdrawing mandates from external managers. The most high-profile in the last year was AustralianSuper's move of \$7.7 billion internally from Perpetual Investments, Fidelity International and Alphinity Investment Management. These are not small boutiques but long-term successful fund managers with substantial operations of their own.

CIO, Mark Delaney, explained the change:

"We found there was an overlap in the shares held by the different managers. Over the last three or four years, we found that in Australian equities, in terms of the stocks held, we had the same stocks in the top 50 and these holdings did not change much. This is the nature of the Australian market. It has a narrow number of stocks and a narrow number of sectors."

Currently, about 58% of AustralianSuper's Australian equities assets are managed internally, and most of the external management is in the cheaper index funds.

The large superannuation funds now attract top talent receiving market-comparable salaries. While most of the leading CIOs could earn more in the private sector, the super sector's guaranteed inflows, stability of funding, lack of need to continually pitch for new money and clarity of a single stakeholder appeal to many. The top-earning CIOs in Australian super funds (according to *Investment Magazine*) are:

Name	Total Remuneration	Fund	Fund Balance
John Pearce	\$1.6 million	UniSuper	\$63 billion
Mark Delaney	\$1.5 million	Australian Super	\$140 billion
Alison Tarditi	\$1.3 million	CSC	\$47 billion
Raphael Arndt	\$1.2 million	Future Fund	\$180 billion
Damian Graham	\$1.2 million	First State Super	\$90 billion

3. Extreme variations in performance

Most investors are prepared to tolerate short-term underperformance from their fund manager, but others are impatient and bale out after a year or two. It's worse when the manager has a significantly-poor year.

The financial year 2018/2019 experienced some rapid price rises in companies where investors were willing to bank on future growth, including the Top 5 for the year: Nearnmap (ASX:NEA) up 233%, Clinuvel (ASX:CUV) up 206%, Afterpay (ASX:APT) up 168%, Magellan (ASX:MFG) up 119% and Appen (ASX:APX) up 109%.

Managers without these types of highflyers in their portfolio experienced significant underperformance. For example, consider the NAOS Small Cap Opportunities Company (ASX:NSC). It operates under a Listed Investment Company (LIC) structure. In its April 2019 Investment Report, in explaining why it has not invested in these big winners, it says:

"... the main concern for us is the significant faith that is being placed in the earnings trajectory of these businesses for many years into the future."

As [NAOS admits](#), the permanent capital of a LIC has protected it from heavy redemptions, and with this relevant performance, they would otherwise be experiencing significant outflows.

	1 MONTH	6 MONTHS	1 YEAR	INCEPTION (P.A.)	INCEPTION (NOM.)
NSC Investment Portfolio Performance*	+0.69%	-4.31%	-9.71%	-9.29%	-12.87%
S&P/ASX Small Ordinaries Accumulation Index	+4.11%	+11.91%	+7.18%	+7.31%	+10.49%
Performance Relative to Benchmark	-3.42%	-16.22%	-16.89%	-16.60%	-23.36%

The Zenith 2019 Australian Shares Long/Short Sector Report for the year to 31 March 2019 reported an average return of 5.2% for the funds they rate, versus 11.7% for the S&P/ASX300 Accumulation Index. Zenith Investment Analyst Jacob Smart said:

"In 2018, the spread between the cheapest and most expensive stocks reached record highs and, even after the fourth quarter correction last year, remained at elevated levels. The cheaper segment of the market continued to become even cheaper throughout 2018."

4. Managing with an out-of-favour style

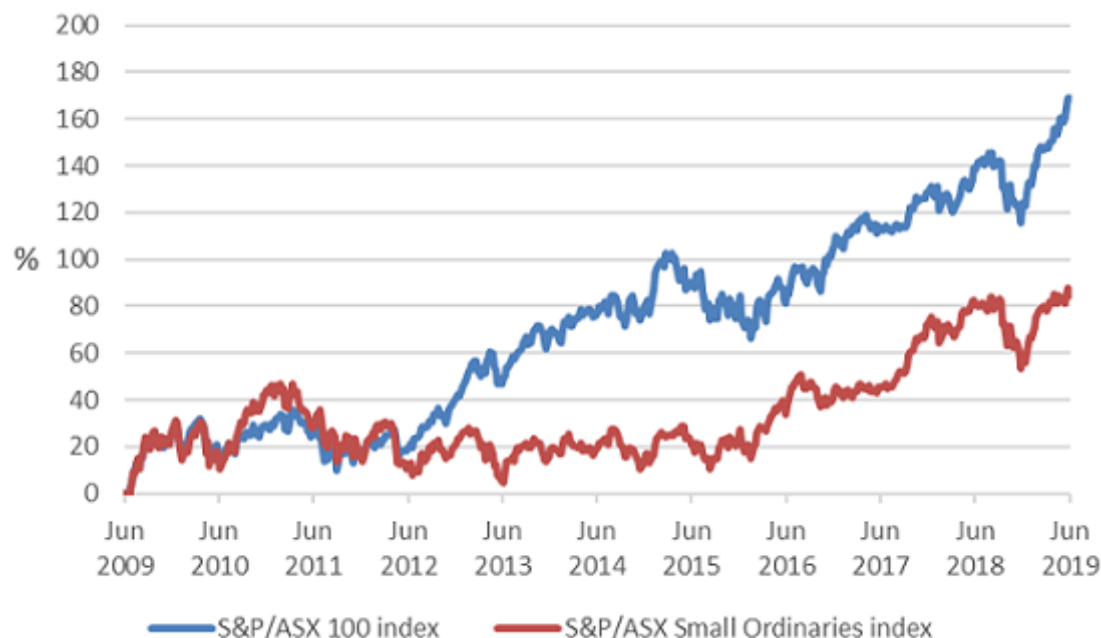
Every fund manager must have fundamental beliefs about how to manage money and select investments. The most obvious style variation is 'growth versus value', and others such as 'small cap versus large cap' and 'long/short versus long only' move in and out of favour.

Growth has been rewarded for at least five years as the market chases companies with blue sky earnings potential, even when the revenues are not yet realised. The WAAAX stocks are all classic examples, where the market assigns massive P/E valuations and two of them do not even make a profit. Value managers look for companies which are inexpensive relative to a fundamental value, with sustainable earnings and low valuations, such as 'buying \$1 of value for 80 cents'.

According to JP Morgan, there has never been a worse time to be a value investor. In the US, value stocks are trading at the largest discount to the market in history. They measure the median forward P/E ratio of value stocks in the S&P500 and compare it with the broader S&P500 and the spread is now at a record 7 points.

Another segment which is out-of-favour is small cap investing, trailing large cap. As shown below, in the last 10 years, the S&P/ASX100 index has substantially outperformed the Small Ordinaries index, leaving many small cap managers struggling to deliver decent returns.

S&P/ASX Small Ordinaries Index vs S&P/ASX100 Index, 10 years to 30 June 2019



Source: Bloomberg, CFSGAM. Cumulative total returns 30 June 2009 to 30 June 2019.

Long/short investing is also battling on with many casualties. KIS Capital launched in 2009 and its funds peaked at around \$300 million, but it closed recently after a difficult 2018 where results were "disappointing". It advised its clients:

"Given the state of the market, KIS Capital directors have concluded that the best course of action at this point is for us to close both funds and return capital to all investors on an equitable basis."

5. Inadequate marketing and distribution

Build it and they may not come. Most fund managers would prefer to sit at a desk all day, study their screens and analyse companies. However, especially in a small boutique which relies on the profile of one or two managers, they must wear out the shoe leather and tell their story. It's a tricky balance. Their main skill may be stock picking, but they need to become extrovert marketers, not simply hire a Business Development Manager with a Rolodex. They must establish themselves as thought leaders.

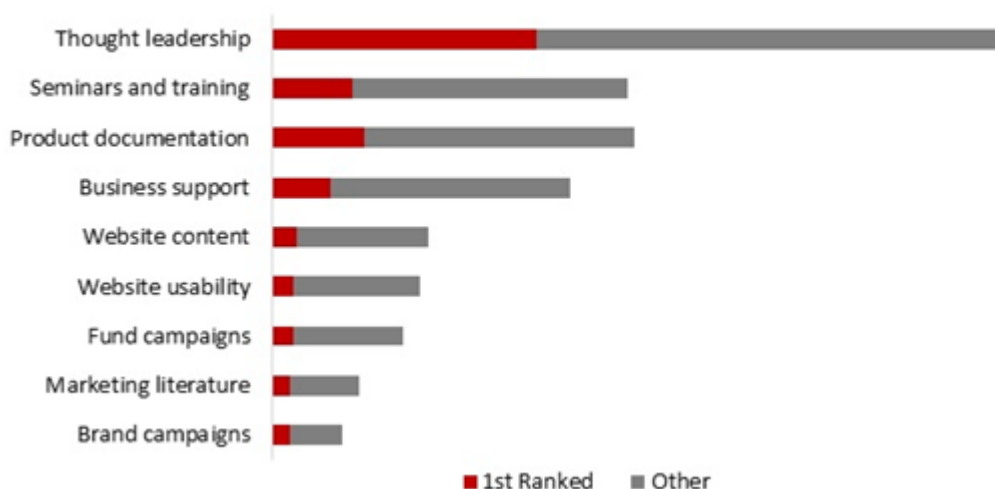
Research by leading consultants, Tria Partners, concludes:

"... thought leadership is the single most important factor that underpins improvement of buyers' understanding and perception of external asset managers – i.e. it's the most value-adding activity marketing can undertake."

Significant resources are needed to cover institutions, middle market gatekeepers and retail sectors properly. Many fund managers have realised in recent years that they need a direct conversation with end investors, and they particularly target SMSF trustees. The combined value of ETFs and LICs listed on the ASX is now \$100 billion, and SMSF trustees often manage their own portfolios directly through the listed market. Previously, some managers confined their marketing to institutional investors, believing it was better to win a \$100 million mandate than source thousands of smaller investments. Now those mandates are drying up, the fees are lower and the competition is intense. Marketing through dealer groups to find financial advisers is also not enough, as increasingly, advisers are acting independently and not following the central directive of an Approved Product List.

Tria released the following research on the most effective forms of marketing.

Importance of different marketing factors, all institutional markets



6. Lack of institutional and retail investor support

When MHOR Asset Management announced the closure of its Australian Small Cap Fund in June 2019, it advised:

"... it has not been able to grow the funds under management to a sustainable level and does not expect any material growth in the short-medium term ... We will commence the realisation of the Fund's assets, which is consistent with an orderly closure of the Fund."

The Fund had achieved an impressive annualised return of 24.2% net of fees since inception on 1 August 2016, managed by former Vocus CEO James Spenceley and former Renaissance Asset Management Portfolio Manager, Gary Rollo. MHOR was added to the ASX's mFund service in 2018 to improve investor access, but they gathered only \$25 million in total. Clearly, the problem is not simply a performance or access issue.

At CFS, when we assessed portfolio managers wanting to set up a new boutique, we would always check whether they had any major institution willing to back them. Often, these portfolio managers worked at large wealth businesses managing many billions of client capital across multiple portfolios. They developed close relationships with their clients and became friendly with each other. A nod and a wink from a large investor can lead people to believe if they set up on their own, then maybe a \$200 million slice could seed a new fund. New boutiques will often offer clients a fee discount to come in at the start, and \$200 million at 0.3% is a healthy \$600,000 to cover some fixed costs. The test comes when the portfolio manager actually leaves.

When John Sevier departed Perpetual Investments to set up Airlie, many clients went with him. But John Sevier is one of the few 'rock star' managers in Australia. If a new boutique cannot deliver immediate institutional support, it can take years of pitching and building up a track record before decent money flows. The retail market is a tough slog full of gatekeepers who must support the new business long before a fund features on a major platform. Research analysts, rating agencies and asset allocators all need convincing.

Going directly to a LIC is difficult for fund managers without a proven track record. Although this looks like direct-to-market distribution, behind the scenes are brokers and financial advisers who are paid fees to support the issue, and they must be convinced there is a story to tell.

7. Misunderstanding the business model

Portfolio managers in large businesses are supported by a phalanx of helpers, from accounting, tech, call centre, compliance, legal, documentation, marketing, business development ... on it goes. They can indulge their passion for investing.

Then they set up their own businesses. Suddenly, they become involved in finding premises, negotiating leases, hiring staff, selecting systems to prevent cyber attacks, finding new investors ... and all the drudgery of owning a business where the buck stops with the founder. What a pain! Previously, they were Masters of the Universe in a big dealing room, where they blasted the tech guys if the internet went down for 10 minutes. Now the fundies are responsible for making sure their tech is good, and there's nobody on staff to shout at.

Which is why many talented fund managers sell part of their equity to groups like Pinnacle, Fidante or Channel Capital. In exchange for say 40% ownership, these companies provide support services for boutique managers, leaving them to focus more on investment management. They still need to perform a marketing role but it is done with considerable business development support.

How much does it cost to open the doors? It depends mainly on how much the portfolio managers pay themselves. Remember, many have been highly paid in a previous role and have big mortgages and private school fees to cover, so it's not easy to take the startup route of no salary for a couple of years. So let's say they are senior portfolio managers on \$500,000 (if that seems too much, consider the salaries of the super fund CIOs listed above, and the CIO of a major retail business can earn \$5 million or more a year). Let's say three other staff cost \$500,000, then there are premises, systems, legal, advertising, etc. There's not much change out of \$50,000 to be a major sponsor at a leading industry event. That's a total of \$2 million on the credit card.

Revenues come from clients paying fees. Not only are the big clients pushing down fees, but retail investors can access funds management for free (products such as HostPlus Balanced Indexed Fund – the 'Scott Pape Fund' – are effectively free, and the cost of many index ETFs is negligible, less than 0.1%). This new boutique business will need, say, \$300 million of institutional money at 0.3% and \$300 million of retail money at 0.4% to break even. That is not easy in a market with hundreds of competitors all essentially doing the same thing while striving to sound different.

And the sobering outlook is that for most fund managers, fees are only going in one direction.

8. Inadequate product diversity

Many small fund managers have only one fund based on the skills of one or two people. For the first few years, all their efforts will go into promoting and managing that one fund. It leaves them vulnerable to poor performance and an out-of-favour style. Which is why larger managers branch into income funds, infrastructure, alternatives, ethical or a completely different asset class like an equity manager hiring a fixed interest specialist. The diversity can reduce the business risk.

A comment on relying on performance fees to make a profit. Not only are the fees elusive in a period of underperformance, but such fees are usually structured with a 'high water mark'. This means the previous underperformance must be recovered before the fee kicks in again. Therefore, a poor year can set back the profitability of the business for many years.

9. Loss of key personnel

Funds management is an industry with massive key person risk. Especially in small boutiques, there are often one or two portfolio managers who have investor support, backed by talented analysts and trainees with little or no market profile or reputation. As funds under management grows, the team increases and resilience builds for long-term survival.

Until this point is reached, however, if the main man or woman wants to leave, the business has nowhere to go. It's simply not possible to bring in a new person at short notice and expect investors to stay.

The highest-profile demise of all was the closure in 2010 of 452 Capital when Peter Morgan was misdiagnosed with brain cancer. Peter was a doyen of fund managers following his time at Perpetual (*Disclosure: I set up the CFS alliance with 452 and was on the Board for a while*). At its peak, 452 Capital managed \$9 billion, rapidly raising money from 2001. But most of the money exited during Morgan's time off and the remaining staff were managing less than \$3 billion when the business closed. The [Sydney Morning Herald](#) reported:

"Yesterday another high-profile Australian business in this industry, 452 Capital, became the talk of the financial services industry when it was revealed that this business had essentially imploded. The senior key staff had decided to walk and the company was left in a mess."

Fast forward to the recent closures. In 2019, when the [AFR reported](#) that Discovery Asset Management was returning funds to its clients, it said the move was driven by the co-founder and Managing Director, Stuart Jordan's decision to retire. A message to clients said:

"Over the last week, Stuart has cemented his decision to head down the retirement path after a long and successful career in the Australian investment management industry. Given this, and also that Discovery have a small number of institutional clients (only), we have communicated to each of them that Stuart is planning to retire, and we are now working with these institutional clients to 'hand back' or transition out, their mandates with Discovery."

It is believed that the loss of a mandate from UniSuper contributed to the decision.

A larger (\$5 billion under management) and long-established business like Ellerston Capital closed its Global Macro Fund in June 2019, following the departures of economist Tim Toohey and one of the portfolio managers, Robert Chiu. This was not an under-resourced fund. Former Reserve Bank Governor, Glenn Stevens, was an adviser, with Ellerston announcing on his hire:

"Our main focus is on his international perspective and how other central banks see their economies. He's here to challenge and debate all of our investment theses".

The Head of the Global Macro Fund, Brett Gillespie, is himself a high-profile figure, frequent presenter at conferences and writer of a detailed monthly newsletter on global macro conditions. Yet the loss of key clients took the Fund from \$190 million to \$30 million and not commercially viable. Returns since inception in 2017 were flat, as shown below.

As at 31 May 2019	1 Month	3 Months	6 Months	1 Year	Since Inception p.a
Fund +	1.77%	-0.13%	-0.19%	-1.25%	-0.77%
Benchmark	0.13%	0.38%	0.75%	1.50%	1.50%
Excess	1.64%	-0.51%	-0.94%	-2.75%	-2.27%

10. Failure to manage expectations

Every fund manager will underperform at times, but not every fund manager goes through tough times. Those who emerge into better times have often spent years explaining their process and when it might not work, and why it will pay off to stay with them.

One manager who has experienced torrid performance in the last year is Steve Johnson's Forager. A year ago, its LIC was so popular that it was trading at a premium, and his presentations filled conference rooms. The net asset value of the Australian Shares Fund has fallen from \$1.82 a year ago to \$1.30 now (after a \$0.21 distribution). That's a fall of 19% in a market that is up 12%, a whopping 31% underperformance. Making it worse, the LIC now trades at a discount as some investors have exited, but also as LICs generally have struggled.

Forager has been at pains in the past to stress its investment approach is to buy out-of-favour or unpopular companies, and to ride out the recovery. It has warned that company turnarounds can take longer than expected, and this has been the case. In its recent newsletter, Johnson said:

"Since we started Forager almost 10 years ago, we have told our investors to expect significant periods of underperformance. That's one promise we have delivered on over the past year ... We have made genuine mistakes over the past year. Part of our poor performance has nothing to do with industry turmoil. But periods of dramatic underperformance like this are not just part of investing with us. They are an essential prerequisite to future outperformance."

Forager is supported by believers prepared to wait for better days, although it helps that the main fund is a LIC with permanent capital.

Why does this matter to you?

There are three reasons why investors may be adversely impacted by a fund closure, putting aside the impact on the lives of the staff directly affected.

1. Costs of realising the portfolio

Although a small cap manager may not own a substantial portfolio in the overall size of the market, it may be a significant shareholder in some small companies. When it is announced that the funds business will close, the market knows there is a substantial seller of certain companies and the bid price can drop away rapidly. Spreads open. So in addition to other closure costs such as brokerage, the value of the portfolio may fall during liquidation. And, of course, anyone else who owns those stocks will also be hit.

Even where a fund is not closed but transferred to another manager, using a 'transition manager' to sell the old portfolio and buy a new one, the realisation costs can be substantial as most transition managers just want to do the job and move on.

2. Unplanned capital gains or losses

Money is returned unexpectedly to investors, and this might deliver a taxable capital gain or a capital loss which cannot be tax-effectively managed at a convenient time.

3. Lack of access to liquidity while the fund closes

Most fund managers announce their closure and immediately suspend redemptions to prevent a run and to allow for a more orderly share sale process. Investors wanting the capital for other purposes may be denied the expected liquidity.

Briefly, on the other hand ...

In case this article paints too glum a picture for fund managers, let's mention [the other extreme](#), Magellan (ASX:MFG). Its funds under management at 30 June 2019 reached \$86 billion, up an extraordinary \$4 billion in one month since 31 May 2019. This was mainly due to market movements and the fall in the AUD, but retail inflows were \$132 million and institutional \$356 million across global, Australian and infrastructure assets. A year earlier, on 30 June 2018, funds totalled \$59 billion. That's up \$27 billion in one year.

But here's the clincher to show how wonderful (or cruel) this business can be for creating wealth. On 2 March 2009, Magellan shares reached a low of 33 cents during the GFC. It recently traded at \$55. Ignoring dividends, buying 10,000 shares for \$3,300 would now be worth \$550,000, only a decade later. Market capitalisation (gulp!): \$10 billion.

To offer hope to the strugglers, I remember when Hamish Douglass and Frank Casarotti could gather only a couple of dozen people to Magellan's presentations.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any individual.

Nathan Hughes on consistency in strange markets

Graham Hand

Nathan Hughes is Portfolio Manager for the Ethical SRI Fund at Perpetual Investments.

GH: Nathan, how does the Ethical SRI portfolio differ from other Perpetual funds which no doubt have an ethical screen as well?

NH: Fundamentally, the Fund draws on the same philosophy and quality filters that we use across the broader equities team. However, a two-stage screening process is overlaid on top of that. The first stage excludes companies from the investable universe when their activities are deemed too ethically unacceptable, at a 5% revenue-materiality threshold. Some examples are the manufacture or retailing of alcohol and tobacco, and fossil fuel production.

The second stage looks more at how a company acts, and we score companies both positively and negatively on a range of SRI (*Socially Responsible Investing*) factors. A company must have a net positive score to be included in the ethical universe. I build my portfolio from there with additional filters.

GH: So how does Perpetual screen for responsible investing across all portfolios?

NH: ESG (*Environment, Social, Governance*) is incorporated into our decision-making process for all equity funds and we've been a long-standing signatory to the UNPRI. The overall process is about balancing out those risks and potential rewards for investments. My Fund is different in that it's very explicit. Clients can invest in the Ethical SRI Fund knowing that it will not buy certain kinds of companies. There are hard and fast rules on what's in and out.

GH: Okay. Is there a committee process that you go through?

NH: Largely, the process relies on the objective, two-stage screening and filtering. We also have Richard Morris, who is Head of Responsible Investments, as the ultimate arbiter of the investment universe. As the

Portfolio Manager, I'm given a list of companies I can invest in and I'm independent of the screening process so I'm not trying to squeeze companies in or out.

GH: Can you give an example of a company that's in the broader universe but not in yours?

NH: The easiest examples are the big resource companies which are excluded from the ethical universe on fossil fuel grounds. So for example, Woodside, Santos or BHP Billiton. A more topical example is Commonwealth Bank, which was excluded from the ethical universe over 12 months ago based on corporate misconduct. There was a pattern of behaviour and events over a period, but that assessment is reviewed on an ongoing basis.

GH: Fund managers often get criticised as custodians of capital for not doing enough to change companies for the better. Is your approach more speaking at AGMs or in the media or behind-the-scenes?

NH: It's a range. Our preferred method is to talk to companies behind closed doors, and we certainly do engage with boards. But we have a history of going public as well, if we feel like our message is not being heard. Brickworks is the best example.

We are stewards of other people's capital and we have a fiduciary duty to look after it and grow their investment, to ensure that companies are acting responsibly and in a manner that can hopefully generate the kinds of returns we expect.

GH: Has ethical or sustainable investing moved beyond 'coming of age' to become part of the market noise and potentially investors are jaded by the story?

NH: Funny you should ask that. I wouldn't say 'jaded' given its ongoing popularity, it's growing strongly and investors are more active, especially the younger ones. They want more data on how their money is invested and what the companies are actually doing.

But you are right, there is an enormous amount of noise in the market as well, particularly on the ESG factors. There's a lot of data and much of it is inconsistent and noisy, and some of the things that we're looking at are hard to measure. Some of the social elements can be fluffy and difficult to quantify whereas things like emissions and energy intensity are easy to understand.

It is tricky, but it's an area in the market that people are interested in. We must be transparent about our product and what we're trying to do, but we can't be all things to all people.

GH: The removal of resources companies from your portfolio obviously creates tracking error versus the index, and there's an issue that some ethical themes will take 20 or 30 years to play out. But performance is judged every month. Is that a challenging communication issue?

NH: Not really. We demonstrate long-term thinking and we're not trying to outperform the market every day, every week, every month, it's just impossible to do. We have a process and philosophy here which has been out of favour recently, but obviously we're sticking to it. It doesn't change.

GH: Are there any trends that you've identified that the market underappreciates?

NH: We're not big on macro trends, our process is more bottom-up, research-driven. But any company that ignores sustainability, in my view, that behaviour just cannot go on. Most large companies are taking disclosure seriously. It's become a key part of their business proposition, and that's a trend some small companies must catch up with. Some of what we call ESG is simply good business practice, such as safety or employee engagement and culture.

GH: How do you feel about this market disconnect with interest rates at all-time lows suggesting economic slowdown, and equity markets at all-time highs, suggesting good trading conditions?

NH: Markets are in a very strange place. Even the Reserve Bank Governor can't understand why rates imply a slowdown while equity investors and credit investors are complacent about risk. We believe lower risk-free rates can justify higher valuations but that's only one part of the equation.

The other part of the equation is the outlook for earnings and margins, and according to companies we talk to, margins have probably peaked in the near term. And that is obviously negative for earnings and indicates lower growth in future. We also find puzzling some of the extreme valuations being paid for growth companies, which are now talked about in multiples of sales to justify their prices.

GH: It's hard to have a P/E ratio when there's no E.

NH: Yes. There are some companies where significant upfront investment costs such as customer acquisition expenses are going through the P&L as opex (*operational expenditure*) whereas historically we may have seen these costs go through capex (*capital expenditure*). There are many examples, such as Xero and previously Aconex, and this accounting treatment can mask true profitability or earnings growth over time. However, we think people get lazy and apply that thinking to a range of stocks. There are stocks trading at 20 to 30 times sales with a great hope of profitability at some point in the future. Many of these stocks are set for disappointment, as growth expectations may not eventuate. There will be exceptions, but many expectations are just too high.

GH: So other than the WAAAX companies, are there other examples?

NH: There's a company we used to own called Pro Medicus, PME, which is a fine business, strong growth, fixed cost leverage, high margins, but it's priced at 50 times sales. It's well-managed, but we can't get there on valuation. Nearmap has a great narrative but the earnings delivered so far are quite small. In the US, many big listings carry a history of losses.

GH: On the subject of history, Perpetual has a long history of developing some of the highest-profile fund managers in Australia, going back to Peter Morgan, John Sevier, Matt Williams. Is there something about the culture or training that produces that sort of person?

NH: We think so. The philosophy and the process are critically important, and they stay consistent over time. One way we do that is by encouraging promotion from within. Our current Head of Equities, Paul Skamvougeras, worked externally for a period of time but his two stints here cover two decades. He started in the back office and got a job as a dealer for Peter Morgan. Many of the team have come through the ranks and it's important that our process and culture are maintained. We add quality from external places where necessary. Our investing rules are not negotiable and they've stood the test of time.

Graham Hand is Managing Editor of Cuffelinks. [Perpetual Investments](#) is a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

For White Papers by Perpetual relating to Nathan's portfolio, see [The Perpetual Ethical SDRI Fund](#) and [Our Ethical SRI Screening Process](#).

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

Four foreign exchange secrets for travellers

Marcus Christoe

Each year like clockwork, when the Australian winter sets in, my Facebook newsfeed begins to fill up with pictures of Hawaiian or European summer destinations. With the July school holidays upon us, this process is well underway and conversations with friends inevitably turn to holiday check lists: where is everyone going, have they booked accommodation and what fun activities are planned for the kids?

A much less exciting item on the check list for most, but one that deserves more attention, is managing your currency before you go on an overseas trip. It is often forgotten, and people miss out on what can be significant amounts of money, or at least enough to encourage a splurge at a particularly good restaurant.

Here are my top four foreign exchange tips to consider before travelling overseas:

1. Plan around currency volatility

Leaving exchanging currency to the last minute means you are at the mercy of notoriously unpredictable currency fluctuations. A Twitter post from the US President can move currency markets several percentage points overnight whilst many overseas trips are planned months in advance. People should watch how the Australian dollar sits in comparison with the country they are visiting and exchange currency when the rate looks strong.

This can be done via the traditional method of visiting a foreign exchange bureau or more conveniently through the use of a multi-currency account. Citi's Global Currency Account holds money in 10 currencies and gives the flexibility to transfer between them or externally at any time, to take advantage of favourable rates. It's linked

to a debit card and knows your location, so you can pay in the correct currency via the card when you travel, or withdraw money from the card when you are ready.

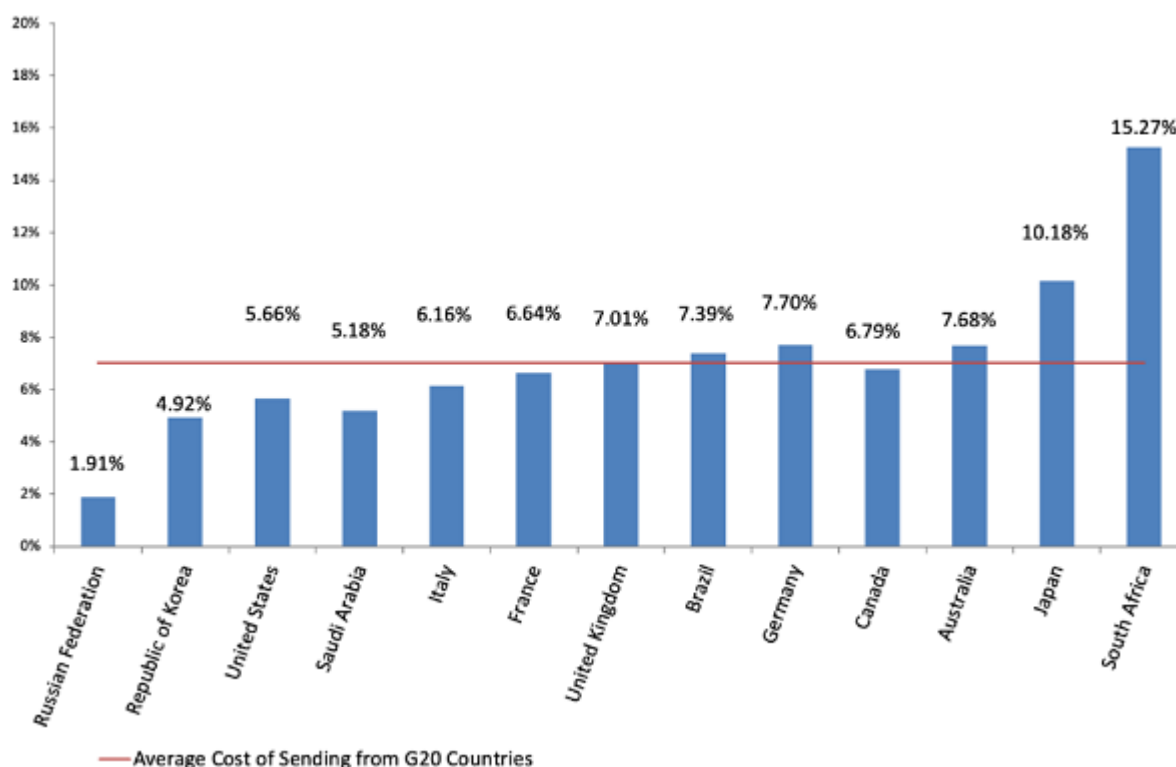
Similar accounts exist at other international banks and at fintech companies like OFX and Transferwise. Local banks offer comparable products, but these normally come with higher fees and wider currency spreads. The 'spread' is the difference between the price which you can sell the currency at (the 'bid') and the price which you can buy the currency for (the 'ask').

2. Factor in explicit and implicit fees

Ensure you are factoring explicit and implicit fees when you are choosing where to exchange currency. Explicit fees include account fees, ATM withdrawal fees, card load, telegraphic transfer fees, while an implicit fees is the foreign currency spread. Many banks are guilty of promoting low explicit fees and assume people won't calculate the implicit fees and work out they are being ripped off. They can do this because foreign exchange is still an area many struggle to understand, and part of this is because of the jargon involved (like the 'spread', 'bid', and 'ask' explained earlier).

The World Bank has found that the average cost of sending money from Australia (7.68% of the money sent in the world) is significantly higher than the G20 average. On a hotel booking of \$3,000, the average cost of \$230 far outweighs the cost of an international ATM withdrawal.

Average cost of remitting from G20 countries



Source: World Bank, Remittance Prices Worldwide June 2019

3. Avoid the traps

The worst trap of all is exchanging money at the airport. A study by News Corp and The Currency Shop showed that on A\$2000, travellers can lose as much as \$350 by exchanging cash at the airport. While it might be convenient, it's going to cost you.

Another way travellers get confused is when they are asked whether they want to pay in their own currency or the currency of the country they are in. If you pay in your own currency, the merchant or ATM operator will charge a foreign exchange fee at a rate they determine.

Prepaid travel cards can also be a trap. They often come with a range of fees e.g. for loading the card, using at an ATM or closing the account. It's important to consider how these different fees will impact your budget overall.

4. Use technology to your advantage

My colleague Matthew Hayja wrote a piece for Cuffelinks called: "[Retail FX: the last bastion of no competition](#)". While this remains largely true, there are some technological developments disrupting the FX space. Fintech players like Transferwise, Currency Fair and Worldremit specialise in small payments for individual customers. Using an online business model, they have low overheads and offer competitive rates.

Are we saying this is a reason not to transact with Citi? International banks have stepped into the ring to compete too. The rates on Citi's [Global Currency Account](#) sit better than the domestic big four banks but slightly higher than the fintechs, with at 1.5% spread on USD exchanges. The currencies are linked directly to a Citibank debit card, meaning users can switch between currencies instantly via their mobile app and pay with their card when travelling. There are no ATM fees charged by Citibank when using local currency.

It's worth doing your homework

Ultimately, the take-out for those about to head off overseas, is to do your homework before you go and be wary of traps that can cost you money. Hopefully, there will be continued disruption in the field of FX and providers will be forced to offer consumers more options that make it easier to go overseas and 'spend like a local'.

Marcus Christoe, Head of Banking and Wealth Management Product at [Citi Australia](#), a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any individual.

For other articles by Citi, see [here](#). You can also view Citi's guide to FX investing [here](#).

Property market fundamentals look strong

Justin McCarthy

Four key developments over the past few months have created a significant turnaround in the prospects for the Australian property market:

1. The Coalition election victory, and with it, the removal of capital gains tax, negative gearing and other Labor policies that were adverse for the property sector.
2. APRA's change to the serviceability criteria that banks must apply when assessing a home loan. This was formally implemented last week and in simple terms means a typical borrower is eligible for approximately 10-20% more in capacity compared to the old rules, and this loan size will grow as interest rates continue to fall. It also means a large portion of borrowers who were recently denied credit approval may be eligible for a home loan.

Of all the changes, this is likely to have the largest impact with a material increase in the amount borrowers can spend when buying a house or bidding at auction.

Assuming a mortgage rate of 3% in the coming months if interest rates continue to fall, serviceability calculations will be conducted at 5.50-5.75% versus 7.00-7.25% under the old rules. Here's an excerpt from APRA release dated 5 July 2019: '[APRA finalises amendments to guidance on residential mortgage lending](#)'

"In a letter to ADIs issued today, APRA confirmed its updated guidance on residential mortgage lending will no longer expect them to assess home loan applications using a minimum interest rate of at least 7 per cent. Common industry practice has been to use a rate of 7.25 per cent. Instead, ADIs will be able to review and set their own minimum interest rate floor for use in serviceability assessments and utilise a revised interest rate buffer of at least 2.5 per cent over the loan's interest rate."

3. RBA rate cuts of 0.25% in May and June and further expected. With the official cash rate at 1.00% there are now home loans available with interest rates less than 3.00%.
4. Tax cuts and fiscal stimulus.

Other developments will add to the positive property conditions

1. Co-ordinated action between the Federal Government, ASIC, APRA and the banks to increase lending.

The Australian recently reported: "Post-election positives for the property market are huge, says Stockland's Steinert" which included the following statement:

"Last week new federal Housing Minister Michael Sukkar signaled that he would bring together ASIC, APRA and the banks to help streamline mortgage approvals and cruck up credit flow."

This can, and in my opinion will, have the biggest positive impact on the property market in coming years. With the Royal Commission seemingly behind them, and with APRA's blessing, the banks have recently started loosening lending standards and increasing access to credit. In my experience, access to credit (and in particular cheap credit) is the key driver to asset performance. Combined with the serviceability changes and low mortgage rates, an increase in lending by the banks could see another property boom.

2. It is becoming increasingly likely that the Federal and State Governments will heed the call of RBA Governor Philip Lowe and spend up on infrastructure. The RBA Governor has been urging governments to take advantage of the lowest interest rates in Australian history (10-year government bond rate is below 1.5%) to fund long-term infrastructure projects. This would see a lift in GDP and employment. Further, infrastructure spend has a positive impact on surrounding property.

3. Unrest in Hong Kong has the possibility of reinvigorating the flow of both money and people from China/Hong Kong into the Australian property market

Sentiment has 'turned on a dime' since the week before the election

Following the Federal election, we immediately saw a jump in appetite for property deals, from both investors and funders. Many property deals have been presented to us and around half have been lost quickly to competition from other funders. Speaking to market participants, there has been a flood of new funders enter the market such as family offices, hedge funds, foreign funds and other non-bank providers in recent months.

There is an increase in appetite from regular sources and a potentially significant boost from the banks. This bodes well for an exit from the shorter-dated land deals we have been involved in over the past 14 months. Already, several funding transactions have redeemed early as testament to this trend.

With strong tailwinds for the property sector, we believe the low LVR land deals are a good place for fixed income investors. With expected internal rates of return in the high single digits or low double digits, the returns outweigh the risk on senior secured positions with LVRs in the 45-60% range and maximum time horizon of 12-24 months.

Justin McCarthy is Head of Research at [BGC Fixed Income Solutions](#), a division of BGC Brokers, and a sponsor of Cuffelinks. The views expressed herein are the personal views of the author and not the views of the BGC Group. This article does not consider the circumstances of any individual investor.

For more articles from Mint Partners and BGC, click [here](#).

Bringing agribusiness investing to account

Cullen Gunn

As agribusiness works to meet the increased demand for food and fibre from a growing population, an innovative use of technology, science and environmental accounting is helping shape the future of impact investing.

The use of environmental accounting

Environmental accounting in agribusiness can shape the future for sustainable food and agriculture. As a sector, agribusiness has attractive thematics that are uncorrelated to traditional asset classes. The compelling combination of technology, science and environmental assessment is enabling progressive operators to track the health and condition of natural assets, such as soil, water and native vegetation. This monitoring ability is

invaluable in informing management decisions to deliver long-term sustainable food and fibre to customers and long-term value to investors.

Benchmark assessment of natural assets to grasp trends in environmental conditions began at Kilter Rural on a large scale Victorian commercial farming operation in 2008. More than a decade later, this farmland and ecosystem operation has successfully developed Australia's first farm-level environmental condition account. This innovative approach to agribusiness needs to become mainstream, as ongoing agriculture sustainability is an undoubted global necessity.

By 2050 the world is expected to feed 50% more people. However, increased production must be delivered in the context of diminishing arable land, reduced available water and the declining health of supporting ecosystems.

The next 30 years will demand significant improvement to the condition of these underpinning and irreplaceable natural resources, and agribusiness is central to the sustainable management of impact investments in these assets.

Recasting the balance between production and ecosystem protection will drive transformation to highly productive, sustainable farmlands. Accounting for improvement in the condition of natural assets is a much-needed component in sustainable agribusiness.

Accounting for nature

In environmental accounting, natural assets are physical landscape elements such as water, soil and native vegetation, of which key condition attributes are measured and then formally reported. Measuring the commercial performance of an agricultural operation has long been routine. Until recently, finding a rigorous, independent methodology to measure the condition, or management performance, of natural assets has been problematic.

In 2008, the Australian-based Wentworth Group of Concerned Scientists first proposed its *Accounting for Nature* framework, a scientific method for constructing natural asset condition accounts. The framework supports the goal of this independent science-based organisation to find, implement and drive solutions for environmental stewardship to secure the long-term health of Australia's land, water and biodiversity.

In the past three years, Kilter Rural has been working to implement a farm-scale trial of the framework on farmland and ecosystems managed for wholesale investors.

Unpacking the accounts

The *Accounting for Nature* model requires an environmental asset condition account to be accredited by an appropriate scientific body against a set of agreed national environmental asset condition accounting standards. The framework captures the biophysical condition of environmental assets by adoption of an agreed standardised unit, known as the **Econd**. Each asset is scored an *Econd* value, a calculated score between 0 and 100, with 100 representing pristine or 'reference' condition.

For farmland assets, target *Econd* scores are also established to reflect tangible goals within the farming context. Then annual accounts track progress towards these goals through ongoing measurement of primary asset condition indicators.

Improvement in *Econd* scores reflect a gradual improvement in asset condition, such as:

- through an increase in the extent and/or quality of native vegetation across the farming landscape, and
- improved soil condition through active soil amelioration in agricultural production areas, as well as natural gradual improvement of soils under regenerating native vegetation.

Improvement in asset condition

Through the environmental accounting process Kilter Rural has been able to quantify improvement in the natural assets on the 9000ha farmland under its management between 2007 and 2018, such that:

1. Soil condition has improved from an *Econd* score of 50 to 60 towards the 2022 aspirational goal.
2. Vegetation condition has nearly doubled from an *Econd* score of 11 to 20, or 90% improvement towards the 2022 targeted goal.

Improvement is evidenced in photos that have been periodically retaken from specific points in the landscape, known as *photopoints*.

2009



2017



Why it works and why it's needed

Protecting and enhancing natural ecosystems should be viewed as another form of primary production. This not just in the context of their intrinsic value, as healthy ecosystems fundamentally underpin long-term agribusiness output. Environmental condition accounts add significant value by informing management responses for improved ecosystem health.

The *Accounting for Nature* framework provides landscape managers with an approach that moves environmental condition assessments into the contemporary age of knowledge, rigour and accountability. Broad implementation of the accounts will reveal what is sustainable in farmland, water and ecosystem management.

In addition to supporting sustainable production, the condition accounts give transparency to investors seeking to measure 'environmental impact' at a granular landscape level. Implementing the accounts gives truth to the adage *what matters gets measured*.

Cullen Gunn is the CEO of [Kilter Rural](#). Kilter Rural has been managing institutional-grade impact investments in farmland, water and ecosystems for more than 14 years. Wholesale investors can find more information on the Australian Farmlands Fund, Balanced Water Fund or Kilter Water Fund on their website.

You've worked hard, but are you 'entitled'?

Warren Bird

Editor introduction. On many articles which discuss a change in entitlements, such as the caps on superannuation, the franking credits debate or access to the age pension, readers comment that they are 'entitled' to benefits after a lifetime of hard work. Here's one from a reader, Alfredo:

"When I came to Australia 40 years ago under the Skilled Migration program, I was told that by the time I reached pension age, the government would look after me in my old age, provided I worked hard and consistently. So I did. In the meantime, I managed to save enough to buy an investment property, which I am still paying off. I sacrificed luxuries, holidays, entertainment, even health issues so I could keep the property. Today, I am about to retire and I have been told I will be lucky to access a part-pension. I feel cheated and let down by the government and the saddest thing is there is nothing I can do!!!"

Warren Bird responds.

There are people who have recently retired or are close to retirement who are disappointed to find that they're not eligible for the full, or even a part, age pension. Sometimes these folk are heard to say that they feel disappointed because they believe the government had made a commitment to 'look after them' in their retirement.

My late father-in-law, who passed away in 2008 in his 90's, used to talk often about this notion – that he'd been 'told' by the government that if he worked hard all his life, the government would 'look after him' once he retired at 65. He did receive the pension until we sold his house when he was in his mid-80's to get him into aged care and the investment earnings resulted in him being ineligible. Indeed, for a while he paid a little bit of

tax. I have to confess we never told him this – he'd have been horrified! But he was financially better off than he'd ever been.

I'm in my 60's and started work 40 years ago but have never expected to be 'looked after' when I retire. I've never been told that this would happen. I knew there'd be a pension, but I also paid into a super fund from day 1 of work in 1979. I figured that saving for my retirement was an important long-term strategy.

But what form did this 'promise' take?

I suspect that it's a popular myth that dates back to the start of the 20th century when the old age pension was first introduced. Before 1900, people were assisted by benevolent societies, with some government funding (only the States back then of course) going to those organisations. No doubt those organisations used language like 'we'll look after you' because that was their purpose.

Then in 1900, NSW introduced an age pension, followed by Queensland and Victoria. Soon after Federation in 1901, the Commonwealth held inquiries into the pension, resulting in them taking it over from the States in 1908. The pension was always means tested. It was never meant to enable the better off to keep living at the same standard they'd become accustomed to, but to provide a respectable, decent level of support to those who hadn't built their own nest eggs. Hence, from that point on it was the government that was the 'benevolent society' that would look after you in retirement if you didn't have the means to do so yourself.

BTW, it's always been a unique feature of our pension system that it's been unfunded. In most other countries, people had to contribute a social contribution levy of some kind during their working lives to support a pension scheme. More on this later.

Unfunded scheme was more affordable

Nevertheless, in the early 20th century, this unfunded scheme was affordable because life expectancy wasn't much longer than the retirement age of 65. Also, the working age population was much greater than the retired population because we were younger on average. So, yes, the government would 'look after you' because it had the taxation base to generate the funds and it didn't have to do it for very long!

That's where my late father-in-law got the expectation from.

There was a brief attempt to get rid of the means test, as part of the Whitlam Government's platform in 1972. (Remember the song, 'It's time for old folks ... ') This was abandoned by the Fraser Government in 1975 and hasn't been talked about since. The economic reality of longer life expectancy and an ageing population has kicked in.

The other consequence of that life expectancy and ageing population issue is the superannuation system we have today. From the mid-1980s, the conversation hasn't been about the government looking after people, but the government providing a tax-inducement scheme to get folk to save for their own retirement to a greater extent.

Maybe I'm only aware of this more than other people because I've worked for Treasury and in the financial markets for the last 40 years, but there's no way the government has been making 'we'll look after you' promises during my working life.

It's sad if people heard that message from whatever public memory it came. Back to Alfredo's comment above. Perhaps the bureaucrats who ran that Skilled Migrant program at the time hadn't been briefed on the modern world and were still communicating the message from half a century earlier. However, the actions of governments since Fraser have been communicating a different message.

The purpose of super and the franking backlash

The government does promise to help us save for our retirement by taxing us less on super, and the pension is still there as a basic level of income support for retirees, but the message for a few decades now has been 'you will need to look after yourself in retirement'.

This is why the backlash against Chris Bowen’s franking credit proposal was so strong. Folk had done what they’d been encouraged to do – to get ready to look after themselves – and then were being punished for it!

Remember how I said that Australia has always been unique in having an unfunded age pension scheme? Presumably Chris Bowen believes we should scrap that scheme completely, since he argued that the uniqueness of our imputation scheme was one reason we should scrap franking credits. ‘No one else does it’ was a common argument in that debate. However, things like our unfunded old age pension scheme that ‘no one else does’ proves that we are innovative, not strange or wrong!

Warren Bird is Executive Director of [Uniting Financial Services](#), a division of the Uniting Church (NSW & ACT). He has 30 years’ experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee. These are Warren’s personal views and don’t necessarily reflect those of any organisation for which he works.

What is the new work test exemption?

Julie Steed

From 1 July 2019 new legislation provides an opportunity for recently retired individuals to contribute to super without needing to meet the work test. In this article we will review the work test requirements and the new exemption.

Contributions test varies by age

Individuals under age 65 are eligible to make voluntary contributions to super regardless of their employment status. However, after age 65, individuals must meet the work test. The following table outlines the different types of contributions and the age-related conditions that must be met:

Age	Work test	Member*	Spouse	Salary sacrifice
Under 65	Nil	✓	✓	✓
65 to 69	40 hours in 30 days	✓	✓	✓
70 to 74	40 hours in 30 days	✓	✗	✓
75 and over	Not applicable	✗	✗	✗

* Excluding downsizer contributions

The work test requires individuals to be gainfully employed for 40 hours in a 30 consecutive day period in the financial year in which the contribution is made.

Trustee acceptance of contribution

Super fund trustees cannot accept voluntary contributions from members over age 65 unless they meet the work test. The work test only needs to be met in the financial year in which the contribution is made. Accordingly, it is possible for the work test to be met after the contribution is made. However, some fund trustees require the member to be able to make the work test declaration at the time the contribution is made.

Gainfully employed definition

Gainfully employed is defined in super law as:

Employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, occupation or employment.

The definition requires an expectation of income or profit in return for personal exertion. For an employed person this is generally easy to prove via a PAYG payment summary or income statement. Unfortunately many

self-employment ventures do not result in financial gain, but the expectation needs to be there. An activity which is of a personal or hobby nature will not qualify even if there is financial gain.

Volunteering will also generally not qualify as there is no employer/employee relationship.

Work test exemption

The new work test exemption provides a one-time opportunity to make voluntary contributions in the year after retirement if the following contributor meets the following conditions at the time of contribution:

- Age 65 to 74
- Total super balance is less than \$300,000 at the previous 30 June
- Met the work test in financial year prior to the year the contribution is made
- Not used work test exemption previously
- Contribution made after 1 July 2019

Once the work test exemption has been used for a financial year, it cannot be used again in a later financial year, however multiple contributions can be made within the financial year subject to the contributor's age at the time of each contribution.

The new work test exemption provides an opportunity for individuals to make non-concessional contributions if they triggered the bring forward rule whilst they were under 65 but were not able to fully utilise the bring forward rule at that time.

Case study

Dawn was 64 on 1 July 2018 and she contributed \$140,000 before her 65th birthday on 1 March 2019 when she permanently retired. Under the three year bring forward rules Dawn could contribute \$160,000 by 30 June 2021 however she would need to meet the work test in the year she makes the contribution.

If Dawn's total super balance is under \$300,000 at 30 June 2019, she could contribute \$160,000 in 2019/20 using the work test exemption.

Concessional contributions, including catch-up of unused concessional contributions cap amounts, could also be used.

Another area where the work test exemption will be valuable is for small business CGT contributions. For many small business owners, selling their business is their retirement plan and they often have small accumulated balances at retirement.

In many instances we see a great deal of effort put into the complex tax side of determining eligibility for the small business CGT concessions however sometimes the eligibility to contribute to super after age 65 is overlooked.

Case study

Arthur and Martha sell their small business at age 68 and 66 in July 2019 and embark on a round-the-world tour for the next 12 months. The proceeds from the sale of the business are received in August 2019 and arrangements made for small business CGT contributions and the appropriate forms to be made to their super fund in September 2019.

Under previous law, Arthur and Martha were not eligible to make the small business CGT contributions to super unless they met the work test in 2019/20.

However, if their total super balances are each under \$300,000 at 30 June 2019, they may use the work test exemption to make their small business CGT contributions.

Superannuation guarantee contributions and downsizer contributions are not impacted by the new measure as they are not subject to a work test.

Julie Steed is Senior Technical Services Manager at [Australian Executor Trustees](#). This article is in the nature of general information and does not consider the circumstances of any individual.

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