

### This Week's Top Articles

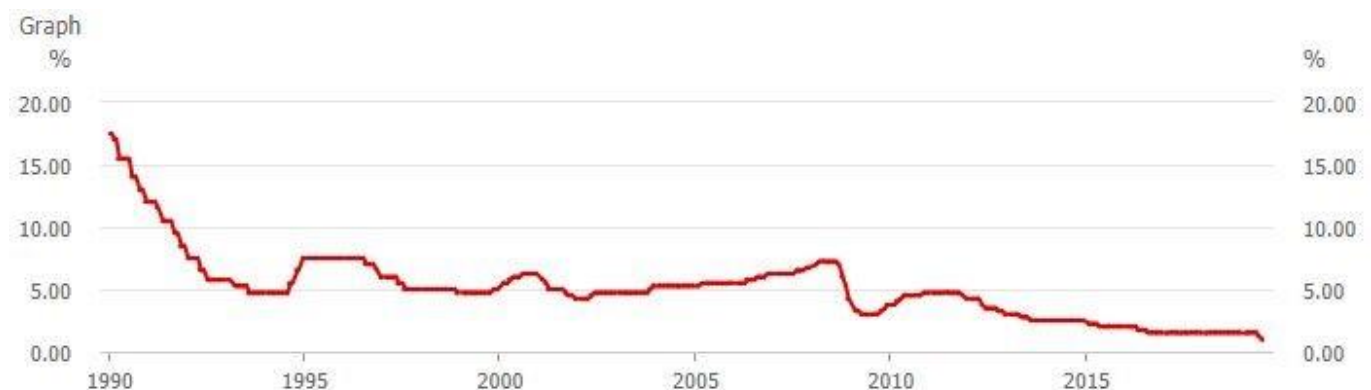
- **How to generate income without equity risk** *Graham Hand*
- **It's the large stocks driving fund misery** *Rudi Filapek-Vandyck*
- **Investing amid IoT-enabled disruption** *Crowley, Mak, and Rao*
- **Careful what you wish for chasing franking** *Raewyn Williams*
- **SMSF growth slower but future remains strong** *Graham Hand*
- **The 'six or out' VC approach to portfolios** *Benjamin Chong*
- **5 more mistakes to avoid with SMSFs** *Graeme Colley*

### How to generate income without equity risk

Graham Hand

The recent step down in cash rates was a final jolt to the savings of millions of Australians who live on interest from bank deposits. It took term deposits to 2% or less, barely keeping pace with inflation, while many savings accounts now pay negligible interest.

The temptation to invest in bank shares rather than bank deposits to sustain a living standard will be too strong to resist for many. However, it introduces a risk which conservative savers may come to regret as they hanker after the returns of the past, as shown below in the cash rate since 1990.



Source: RBA

### Facing up to the TANSTAAFL

People living on income from their savings face with an uncomfortable truth. Any investment that is not a short-term bank deposit or government-guaranteed bond carries added risk. The TANSTAAFL, better known as 'there ain't no such thing as a free lunch', is the reality of investing in a low interest rate world.

Over the last decade, the merit of bank deposits has changed dramatically. For example, in December 2009, Westpac offered a 5-year term deposit paying 8%. It attracted \$2 billion in a week and Westpac quickly closed it. That term deposit sat in the retirement portfolios of thousands of Australians until 2014, and it's been a rapid downhill since.

At the time retirees grabbed the Westpac deal, few people would have thought they would never see such a good rate on a bank deposit again in their lifetimes, even if they live until 100 years-of-age. For guaranteed income, it's more 'lower forever' than 'lower for longer'.

The risk appetite of every person, or acceptance of the reality of TANSTAAFL, varies according to their circumstances. Some older people with good savings capable of financing their later years and perhaps the need to buy into a retirement facility, cannot risk losing their capital. They may need to accept the 2% or less returns.

Other people with more lifetime options can accept some risk for extra return, so let's survey the income landscape in the listed market on the ASX, excluding investments that carry equity risk. Across Listed Managed Investments, Exchange Traded Products and its mFunds service, the ASX identifies 92 Australian and 38 global fixed income products. It's a far bigger range than most investors realise.

As an indication of how competitive and broad the listed sector has become, Vanguard now has a [seven fixed income ETFs](#) while [BetaShares has five](#). In fact, in FY2019 as shown below, fixed income ETFs generated larger inflows than any other asset class including Australian equity and global equity. It's a major change in investing habits and the first year this has ever happened.

#### Top 5 Category Inflows (by \$) - YTD

Category 3	Inflow Value
Fixed Income	\$1,377,451,652
International Equities	\$1,317,047,327
Australian Equities	\$852,041,235
Cash	\$375,087,194
Australian Listed Property	\$220,776,169

Source: BetaShares, year to 30 June 2019

This article focuses entirely on the listed market to demonstrate the choices, but the range of unlisted managed funds is even larger.

### 1. Cash

The least-risky listed products are ETFs which invest in bank deposits with short duration. The largest is the BetaShares Australian High Interest Cash ETF (ASX:AAA), while UBS issues the UBS IQ Cash ETF (ASX:MONY) with similar assets. Blackrock issues iShares Core Cash ETF (ASX:BILL) which can invest in a wider range of short-term securities. All these ETFs have returned around 2% in the last 12 months, but their returns will fall in line with cash and bank bill rates.

### 2. Cash-enhanced and floating rate notes

Staying in short-duration investments but adding securities with slightly better returns are the VanEck Vectors Australian Floating Rate Bond ETF (ASX:FLOT), the BetaShares Australian Bank Senior Floating Rate Bond ETF (ASX:QPON) and iShares Enhanced Cash ETF (ASX:ISEC). The extra income comes from buying notes with maturities up to five years, but it comes with a little extra risk because prices of such instruments fluctuate more than cash or bills. Again, returns are likely to follow cash and bill rates.

### 3. Investment-grade bonds

Now the field really starts to expand as many fund managers offer bond funds which invest in investment-grade credits rated BBB+ or better. With these high ratings, a diversified portfolio should produce acceptable credit risk, and the exposure to interest rates depends on the duration of the bonds. Each fund manager will accept different risks depending on their perception of the opportunities. There are also index funds which have lower fees.

Examples include Vanguard's Australian Corporate Fixed Interest Index ETF (ASX:VACF) which invests in investment-grade Australian corporate (ie non-government) bonds, while less risky is Vanguard's Fixed Interest Index ETF (ASX:VAF) because it also includes government bonds. Russell issues its Australian Select Corporate Bond ETF (ASX:RCB) and BetaShares has an Australian Investment Grade Bond ETF (ASX:CRED) and an Australian Government Bond ETF (ASX:AGVT).

These funds usually introduce duration risk which benefits from falling interest rates, and therefore their one-year returns have been impressive as rates have fallen. But here's where TANSTAAFL kicks in. Future returns depend on the movement of interest rates, and these funds will suffer when rates rise. The decision for the

investor, therefore, is not so much credit risk as interest rate risk at this ratings level, although we saw in the GFC how ratings agencies don't always understand the real risks.

A competitor stock exchange, Chi-X Australia, will join the mix soon with the launch of its own funds market in second half of 2019. It will offer a range of both ETFs and Quoted Managed Funds (QMFs). Around 36% of all Australian ETF trading already takes place on Chi-X so the Funds Market is a logical natural next step.

#### **4. Higher-yield products**

As bonds purchased move down the ratings spectrum, default risk on lower credit quality names starts to become a major TANSTAAFL factor. The benefit of investing with a quality fund manager is their portfolio might include hundreds of issuers with no more than 1% of the exposure to one name, such that a modest number of defaults does not erode capital. However, in a severe economic downturn, the lower credit quality may cause losses. Investors need to weigh the merits of return versus risk.

In the actively-managed ETF space, the BetaShares Legg Mason Australian Bond Fund (ASX:BNDS) carries exposure to government bonds as well as semis, corporate bonds and asset-backed securities, managed by Western Asset.

Moving away from ETFs to Listed Investment Products, the individual fund characteristics vary. Operating in the global market across issuers in many different countries, credit qualities and industries is the Perpetual Credit Income Trust (ASX:PCI), which aims to hold 50 to 100 issues with an overall target return of the RBA cash rate plus 3.25% after fees, over the cycle. The Neuberger Berman Global Corporate Income Trust (ASX:NBI) is even more diversified with 450 global holdings, and it works on a declared annual distribution level, currently 5.25% paid monthly. Vanguard's most popular global offer is their International Fixed Interest Index ETF (ASX:VIF).

Coming soon, Chi-X will quote its first series of actively-managed fixed income QMFs including ActiveX Kapstream Absolute Return Income (CXA:XKAP) with target return of RBA plus 2-3%, Schroder Absolute Return Income (CXA:PAYS) with target return of RBA plus 2.5% and various eInvest Daintree Capital funds with target returns up to RBA plus 3-4%.

In Australian credits, the Metric Credit Partners MCP Master Income Trust (ASX:MXT) holds a portfolio of directly-originated corporate loans, rather than buying public bonds, with a target return of RBA cash plus 3.25%. Gryphon's Capital Income Trust (ASX:GCI) invests in asset-backed securities (or securitisations) issued in Australia and targets cash plus 3.5%.

Of course, all these targets are not guaranteed but more like manager aspirations.

At this end of the market, skill and diversification play important roles to manage TANSTAAFL. The reason a manager may deliver 4% or 5% rather than 2% is the added risk dimension.

There are a few 'notes' listed on the ASX which don't receive much attention, are unrated and not highly liquid, but their structure offers good investor protection. They are debt instruments backed by the assets of a larger Listed Investment Company structures. Two examples are NAOS's ASX:CAMG and Whitefield's ASX:WHFPB.

#### **5. Hybrids**

Hybrids have become a major part of the credit structure of many companies, particularly banks. They mix characteristics of debt and equity but come in a vast array of variations. It is not possible to summarise all the alternative choices here, but they are certainly not all created equally. Many mandatorily converted to equity in certain events, or have their coupon payments suspended.

Margins over the bank bill rate vary according to expected first call date, investor appetite and issuer funding needs, and they are lower in the bank capital structure than senior and subordinated debt, but above shareholder equity. While difficult to generalise, major bank hybrids currently offer up to 3% above the bank bill rate (including franking benefit).

Morningstar has a couple of four-star rated hybrids as at 31 May: Macquarie Group Capital Notes 2 (ASX:MQGPB) carrying a 'running yield' including franking credits of 6.44% and Ramsay CARES (ASX:RHCPA), with a running yield of 6%.

For those who prefer not to face the idiosyncrasy of individual issuers or tranches, BetaShares offers the Active Australian Hybrid Fund (ASX:HBRD) with expert selection from the hybrid universe.

## 6. Other listed products

Two other products are worth mentioning:

### **mFunds**

To improve access to unlisted managed funds, the ASX has an execution service which allows investors to buy and sell managed funds through a participating broker. There are 221 mFunds holding almost \$1 billion, of which 19 are Australian fixed income and 29 are global fixed income. Major brands such as Legg Mason, PIMCO, Schroders and AMP are represented.

### **XTBs**

Rather than investing in broad fixed income sectors or funds as with most of the examples in this article, Exchange Traded Bonds or XTBs allow retail investors to choose specific borrowers who have issued bonds in the Australian wholesale market. Buying a bond of a single company removes the benefits of diversification.

## **Don't forget the TANSTAAFL feeling**

Some of the highest income potential in the listed market comes with an acceptance of risk in other asset classes such as property, shares and infrastructure. Balanced funds provide combinations of assets to match risk appetites.

This is where TANSTAAFL dominates. While a fund might call itself 'equity income', it will invest heavily in shares with an income bias, such as the banks and Telstra. There is the tradeoff. A bank might offer a dividend of 8% including franking, but the share price could fall heavily in a market correction, and dividends may suffer in an economic slowdown. This week, we saw AMP suspend its dividend.

Investors in this space must accept TANSTAAFL as the total return from good income may be outweighed by falling capital values.

Also consider investment costs. Placing only \$5,000 in a listed product for a 0.5% yield pick up is only \$25 a year, which barely covers brokerage and management expenses. It might be better to accept 2% on a term deposit. Take care with some cash-enhanced funds that stray into unusual securities without a reward for the risk.

*Graham Hand is Managing Editor of Cuffelinks. This article is general information and does not consider the circumstances of any investor, and professional advice should be sought. There are no recommendations in this article. And repeating that the article only focuses on the listed market and there are many unlisted choices.*

*For more information on the ETFs and LICs mentioned in this article and many more, visit our Education Centre for regular reports. In particular, [ETF Reviews are here](#).*

## **It's the large stocks driving fund misery**

### **Rudi Filapek-Vandyck**

The first six months of calendar 2019 have again superbly proved why this equities bull market has been dubbed "the most hated in history". At face value, equity markets have rallied by up to 20% suggesting making money from asset price inflation via the share market has seldom been easier for investors. A closer look reveals nothing could be further from the truth.

### **Amazing highs and lows**

Imagine an investment portfolio consisting of Adelaide Brighton, Bank of Queensland, Challenger, Caltex Australia, Domino's Pizza, Flight Centre, Link Administration, Pandal Group (the old BT Investments), South32 and the old Westfield, now Unibail-Rodamco-Westfield.

An equal-weighted portfolio of these 10 household names in Australia generated a negative return of nearly -10% between 1 January and 30 June 2019. That's ex-dividends, but the average yield from the portfolio cannot fully compensate for the erosion in capital values. Besides, the S&P/ASX200 Accumulation index was up nearly 20% over the same period.

And that's assuming investors were not caught out by disasters such as Syrah Resources (-39%), Wagners (-42%) or Bionomics (-72%), and numerous others.

Many a self-managing investor has portfolio exposure to the big four banks, large resources and energy producers, as well as Telstra, Woolworths, and Wesfarmers-Coles. They don't necessarily need to compare their performance with a benchmark, so they most likely are feeling happy with the Big Bounce post the Grand Sell-Off during the closing months of 2018. In particular, if they also managed to pick up some additional gains from smaller cap high flyers such as Afterpay Touch, Austal and Credit Corp.

### **Fund managers doing it tough and consolidating**

For professional fund managers, however, the scenarios for share markets in 2018/2019 have made beating the index an extremely tough challenge at a time when ETF providers offer ever-cheaper alternatives and retail investors feel emboldened about their own talent and capabilities.

It should thus be no surprise that, with the notable exception of Magellan Financial (MFG), most listed asset managers have been relegated to underperformers on the ASX, with shares in Janus Henderson (JHG), Platinum Asset Management (PTM), Elanor Investors Group (ENN), K2 Asset Management (KAM), Pinnacle Investment Management (PNI), and others overwhelmingly in the doghouse at a time when most investors feel like celebrating.

The industry of actively-managed investment funds is ripe for consolidation, or otherwise a shake-out. Locally, all major banks with exception of Westpac (WBC) have unveiled plans to divest their wealth management operations, while Magellan Financial acquiring Airlie Funds Management and Ellerston Capital acquiring Morphee Asset Management are but two early indications the industry locally is equally facing major transformation in the years ahead.

But why exactly is it that most active managers cannot beat their benchmark?

One narrative is that investor exuberance is largely to blame. With stocks like Afterpay Touch (APT), Appen (APX) and other smaller cap technology stocks up 100% and more, the narrative goes that institutional investors cannot justify owning these expensive stocks, making beating the index a near impossible task.

Sounds plausible, yes? Except that it doesn't stand up to the test of deeper analysis.

### **The myth of the WAAAX**

Financials make up more than 30% of the S&P/ASX200 (of which the Big Four banks more than 20%) while Materials and Energy adds another 23%. Combined, these sectors represent more than 50% of the index. Add a few extra-large cap names such as Macquarie Group, CSL, Telstra, Woolworths and Wesfarmers and the index representation rises above 66%.

In most years, underperforming or outperforming against the index is determined by how these large cap stocks perform versus exposure in investment portfolios.

The WAAAX stocks as a group, comprising of Wisetech Global, Afterpay Touch, Appen, Altium, and Xero, represented a total index weight of only 1.58% at 1 June 2019. The average gain from these five stocks is a smidgen over 80%. However, Fortescue Metals (FMG) alone weighs 1.35% and its shares went up by more than 117%. Plus, Fortescue pays a big dividend and the WAAAX stocks don't.

In other words: Fortescue Metals shares have contributed more to the index gains than all of the WAAAX stocks combined. That's one myth gone.

This example does, however, further highlight one of the key characteristics of the local share market in recent years: the internal polarisation is enormous. The gap between winners and losers is extremely wide and both baskets contain plenty of household names each. It makes outperforming the index not only a case of picking enough winners; it's equally about avoiding the losers.

With most professional funds managers in Australia practicing a value-oriented approach, owning share market disappointments is pretty much par for the course, especially as corporate profit warnings came out in large numbers throughout May and June.

Making matters worse, most managers have been running their funds with larger-than-usual allocations to cash, and many have missed the large cap resource stocks. BHP Group (BHP) shares added 21%-plus ex-dividend, which is better than the index, while Rio Tinto (RIO) rallied 32% ex-dividend and Fortescue more than

doubled. In the Energy sector, Woodside Petroleum (WPL) narrowly underperformed the index including dividend, but Santos (STO) shares went up by 29%.

### **Most fund performance due to large cap investments**

What these numbers show is that underperforming or outperforming the local index over the past six months has been determined by a few large cap stocks only. Woolworths and Wesfarmers did not keep up with the index. In their place, large cap names Amcor (AMC), Brambles (BXB) and Telstra (TLS) – probably best described as ‘come back stocks’- all posted stronger than average gains.

Add Aristocrat Leisure (ALL) up 43% ex-dividend, Goodman Group (GMG) up 37% ex-div, Transurban (TCL) up 25.5% ex-div, and Newcrest Mining (NCM) up 51% ex-div and it is clear most of the strong index gains this year occurred on the shoulders of no more than 10 large cap stocks in Australia.

The most outstanding themes have been iron ore, gold, lower interest rates and bond yields, and structural growth stories in the case of Aristocrat Leisure, Goodman Group and the WAAAX companies. At the same time, less confidence and more investor caution has swung the market pendulum heavily back in favour of the large caps.

The Small Ordinaries index barely scraped in a positive return for full financial year 2019, and if we include dividends, it delivered 1.9%. Over the past six months, the Small Ordinaries’ total return was 16.8%. The Top 20 gained 26.7% ex-dividends.

The negative performance for stocks including Scentre Group and UR-Westfield contrasts sharply with the market-beating performances for Goodman Group and Transurban. In prior times, all four would have been considered beneficiaries of lower bond yields. This time around, however, investors are excluding the structural challenges from online competition and household budgets under pressure.

After five years of notable neglect, value stocks have made a sharp come-back post the late 2018 sell-off, as witnessed by (some) bank stocks, and via selective names among media companies, consumer-oriented businesses and resources stocks. Meanwhile, the lure of disruptors and new technology-driven business models has not disappeared.

The latter remains equally one of the key characteristics of this hated bull market. Hated by the fund managers who are supposed to be the experts.

*Rudi Filapek-Vandyck is an Editor at the FNArena newsletter. This article has been prepared for educational purposes and is not meant to be a substitute for tailored financial advice.*

*FNArena offers independent and unbiased tools and insights for self-researching investors. The service can be trialed at [www.fnarena.com](http://www.fnarena.com).*

## **Investing amid IoT-enabled disruption**

Thomas P. Crowley, Bradford J. Mak, and CV Rao

### **Executive summary**

1. The impact of the internet of things (IoT) is the ability to leverage real-time data to drive real-time decisions that can bring broad-based economic benefits to companies and consumers.
2. In the context of ‘smart factories’, IoT-enabled automation has led to a dynamic landscape for incumbent industrial automation vendors as they seek to offer integrated hardware-software solutions for industrial customers, i.e., manufacturers. To do so, vendors are either building or buying software capabilities, or partnering with software companies or doing all of the above. Their manufacturing know-how is a key advantage over potential new entrants.
3. Pure software companies are also entering the industrial automation space, and their business models are evolving. A change from traditional licensing models to subscription-based models can bring better customer insights to drive product offerings, but whether this will be acceptable to industrial customers is yet to be seen.

4. The demand from industrial customers for universal, open standards in industrial infrastructure — a change from today’s proprietary, closed architecture — is likely to change the profit equation for existing vendors. Open standards allow factory systems, supply chain, and customers to communicate seamlessly and realize the full benefits of IoT-enabled automation. The industry is likely to move in this direction despite resistance from existing vendors.

5. Investing in this space requires a global and cross-sector view of industrial automation to determine who will benefit from these trends. It is clear that new profit pools are being created as IoT is incorporated into factories (and elsewhere), offering a broader investment opportunity set for active research and management. Our global research platform generates critical insights that help us continually test the investment theses for our industrial automation holdings and spot emerging opportunities in software and other cutting edge technological areas such as machine vision and robotics.

Manufacturing is going through an extended IoT-enabled automation refresh cycle. This is likely to change the traditional global industrial automation vendor landscape as they have to offer new software capabilities in order to be successful in the changing marketplace. The MFS capital goods and technology sector teams did a global cross-sector analysis to assess the impact of IoT-enabled automation in manufacturing and its investment implications.

### Impact of real-time information and analytics

The graphic below shows an example from rail operations. Using a continuous data feed from a physical system (a locomotive and its environment), a digital model can be built to simulate live operations, to the extent where the ‘digital twin’ can optimise the locomotive’s journey by controlling speed and braking. The result can be significant savings from the efficient operation and predictive maintenance of the physical system.

### IoT-enabled rail operation and predictive maintenance

Rail operation and predictive maintenance...

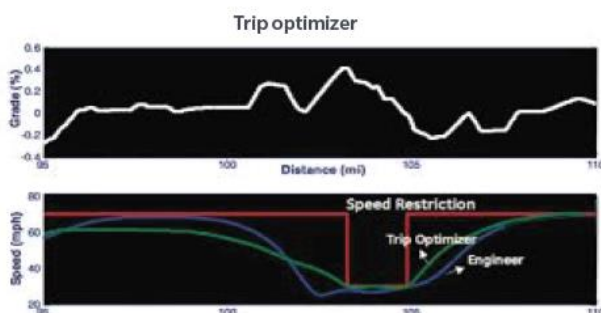
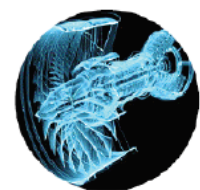
...achieved through a digital twin



Physical Asset



Digital Twin  
A Learning Digital Model



Digital twin for a locomotive

- **Through life cycle:** design, build, testing
- **Live, continuous learning:** continuous IoT data feed to the model to simulate live operations
- **Scalable:** component-level to system-level to network-level

Use cases

- **Route optimization**
- **Predictive maintenance**
- **Track inspection**
- **Minimizing human error**

Source: Adapted from GE, "Digital Twin for the Railway Network," 2018.

### Implication for industrial automation and software companies

In the context of ‘smart factories’, IoT-enabled automation has led to a dynamic landscape for incumbent industrial automation vendors as they seek to offer integrated hardware-software solutions for industrial customers, i.e., manufacturers. To do so, vendors are either building or buying software capabilities, or partnering with software companies or doing all of the above. Their manufacturing know-how is a key advantage over potential new entrants. Pure software companies are also entering the industrial automation space, and their business models are evolving.

A change from traditional licensing models to subscription-based models can bring better customer insights to drive product offerings, but whether this will be acceptable to industrial customers is yet to be seen. The demand from industrial customers for universal, open standards in industrial infrastructure — a change from today’s proprietary, closed architecture — is likely to change the profit equation for existing vendors.

Open standards allow factory systems, supply chain, and customers to communicate seamlessly and realize the full benefits of IoT-enabled automation. The industry is likely to move in this direction despite resistance from existing vendors.

## Conclusion

The traditional industrial automation landscape is changing from an IoT-enabled automation refresh cycle, and the winners and losers are still in the making. Investing in this space requires a global and cross-sector view of industrial automation to determine who will benefit from these trends. It is clear that new profit pools are being created as IoT is incorporated into factories (and elsewhere), offering a broader investment opportunity set for active research and management. Our global research platform generates critical insights that help us continually test the investment theses for our industrial automation holdings and spot emerging opportunities in software and other cutting-edge technological areas such as machine vision and robotics.

To learn more, please read our white paper on the subject [here](#).

*Thomas P. Crowley, CFA, Bradford J. Mak, and CV Rao, CFA are Equity Research Analysts at [MFS Investment Management](#). The comments, opinions and analysis are for general information purposes only and are not investment advice or a complete analysis of every material fact regarding any investment. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Cuffelinks.*

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

## Careful what you wish for chasing franking

Raewyn Williams

With the near-death experience of losing refundable franking credits now behind us, it is timely to consider how they can be used – and abused – in equity portfolio construction.

What we know (and like) about franking credits as a yield source is:

- A dividend of \$100, fully franked, converts to \$121 in the hands of a taxable (accumulation-phase) superannuation fund and \$143 in the hands of a fund portfolio in tax-free retirement phase. This reflects the 30% corporate tax rate that most companies still face.
- Many studies show that franking credits are not fully valued in equity prices. So strategies that participate in run-ups to dividend ex dates are likely buying into franking return streams at discount prices.
- As the past financial year in Australia has reminded us, companies who manage their capital through off-market share buybacks can legally stream franking credits to investors who most value them.
- Franking credits reflect underlying corporate tax paid by the dividend-paying company. Some managers argue that a store of franking credits is a sign of the strong underlying revenues and financial health of the company as a quality signal on the stock for the investment manager.
- As long as the investor is materially exposed to the economic risk on the stocks (what is called a 'delta' of 0.3), Australia's tax rules generally allow investors to explicitly value franking credits and target higher yields from franking through thoughtful portfolio construction.

### Focus on more than 'bolting on' franking

However, as we have warned in previous research, a superannuation fund or other sophisticated investor must be careful about how their managers take advantage of the franking credit opportunity set. To take a well-conceived set of ideas around equity portfolio exposure and simply 'bolt on' some tactics around franking credits can be folly.

Here's why. Let's take three funds with different ideas about future returns on Australian equities.

**Fund A** does not believe in active management and finds a manager to simply track the S&P/ASX 200 to harvest large-cap returns at low fees.

**Fund B**, a believer in active management, has a manager who holds health care and industrial stocks based on its research ideas.

**Fund C** adopts a 'smart beta' approach and asks its quant manager to overweight stocks with value characteristics and underweight stocks with growth and momentum characteristics. Perhaps Fund C reasons that value investing, as a long-cycle bet, is finally ready to pay off and growth and momentum are becoming crowded trades.

Now, enter franking.

Each fund then asks its managers to also invest in (or 'tilt into') stocks to generate a return from franking credits. This may seem like a good idea, given that over the past two decades (and last calendar year), franking credits have added 1.51% annually to the gross return of an S&P/ASX 200 index portfolio. The long-term volatility of this income source is only 0.50%. But by viewing a S&P/ASX 200 portfolio as a bundle of stock ('idiosyncratic') risks, sector and style factor risks (which can be identified using risk models), we see that adding a franking tilt can create problems for each of our three funds.

### **Problems created by franking tilt**

**Fund A**, our passive investor, suddenly introduces tracking error into its portfolio, which can be as high as 2.5% each year. This active risk seems counter to the Fund's passive investment philosophy. Our risk model also tells us that **Fund B's** franking tilt involves taking (relative to benchmark) short positions in health care and industrial stocks. But the manager is identifying these as sectors to upweight in the Fund's portfolio based on its bottom-up research insights. So the franking tilt could effectively unwind the manager's best (pre-tax) investment ideas.

Risk-modelling of a franking tilted portfolio also shows us that from a style factor risk perspective, higher-franking stocks exhibit short value and long growth and momentum characteristics, which is the opposite of **Fund C's** favoured risk positions. So Fund C could be committing the same investment crime as Fund B – inadvertently unwinding its best investment ideas by simply 'bolting on' a franking tilt without appreciating how this changes the risk exposures of the portfolio overall.

None of this is to suggest that pursuing higher returns from franking is a bad investment strategy. Rather, we caution investors to consider the full implications of favouring certain stocks and sectors simply because of appetising franking yield, to make sure this is compatible with the broader investment theses underpinning the portfolio. One way to do this is to avoid a 'bolt on' approach to franking: Instead, work with an investment manager who can use optimisation techniques to model different risk/return scenarios to show how franking ideas can be pursued compatibly with other investment ideas, rather than competing against those ideas.

*Analysis sourced from the author's 2017 research paper, "[A Fresh Look At Franking](#)", with additional franking return and volatility calculations updated to 31 December 2018.*

*Raewyn Williams is Managing Director of Research at Parametric Australia, a US-based investment advisor. This material is for general information only and does not consider the circumstances of any investor. Additional information is available at [parametricportfolio.com.au](http://parametricportfolio.com.au).*

## **SMSF growth slower but future remains strong**

### **Graham Hand**

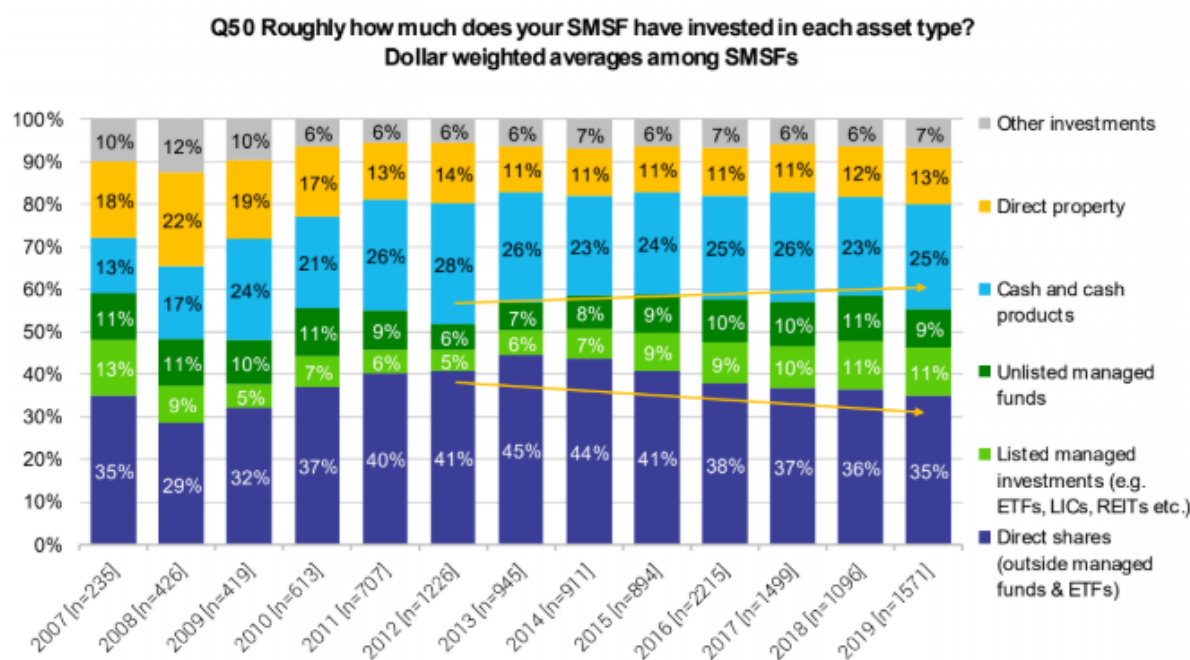
A decade ago, over 40,000 SMSFs a year were being established. It's now closer to 20,000, but that looks more like a maturity than a sector decline. The 2019 Vanguard/Investment Trends SMSF Reports show funds are being established when trustees are at a younger age, and one in five institutional super fund members is considering setting up an SMSF in the near future.

Superannuation remains a contestable and growing space, despite the banks withdrawing from wealth management and many fund managers struggling to retain money.

The Reports show responses from 5,000 SMSF trustees and 300 financial planners who advise SMSFs. This sector holds \$750 billion compared with \$1.8 trillion in all the large funds. There are now 600,000 SMSFs with average assets of \$1.2 million, although the more meaningful median measure is \$693,000, usually between two members. At \$350,000 each to last for decades of retirement, SMSFs are not only used by wealthy people.

### More defensive and diversified

Despite low interest rate, SMSFs remain heavily invested in cash and cash products, rising to 25% of assets in 2019 at the expense of a small drop in unlisted managed funds. Over the last eight years, the amount in listed investments such as ETFs, LIC and REITs has doubled, with much of it now going into fixed interest and global equities.



Source: Investment Trends 2019

SMSF trustees intend investing further in blue chip shares, with 54% nominating this investment choice for the next 12 months. While SMSFs are seeking overseas exposure, 52% of respondents still cite lack of knowledge about overseas markets and currency risk as a barrier.

Explaining the defensive mood, 31% say building a sustainable income stream is the main investment goal, while a rapidly-rising proportion now at 15% say protecting their assets against market falls is the main goal.

### Unmet need for advice

SMSF trustees want advice on estate planning, tax and income strategies, post-retirement planning, portfolio strategies and investment selection. About 15% of trustees say managing their SMSF takes more time than expected, with investment selection the clear leader among the hardest aspects of running a fund.

The number of SMSF trustees who use a financial planner remains unchanged but overall satisfaction among clients is at a seven-year low. With multiple responses allowed, SMSF trustees say lack of confidence in adviser expertise (32%), the level of fees (29%) and difficulty finding a skilled adviser (22%) are the three main reasons for unmet advice needs. About a third (36%) of advisers expect their SMSF business to increase over the next three years.

### Movements between types of funds

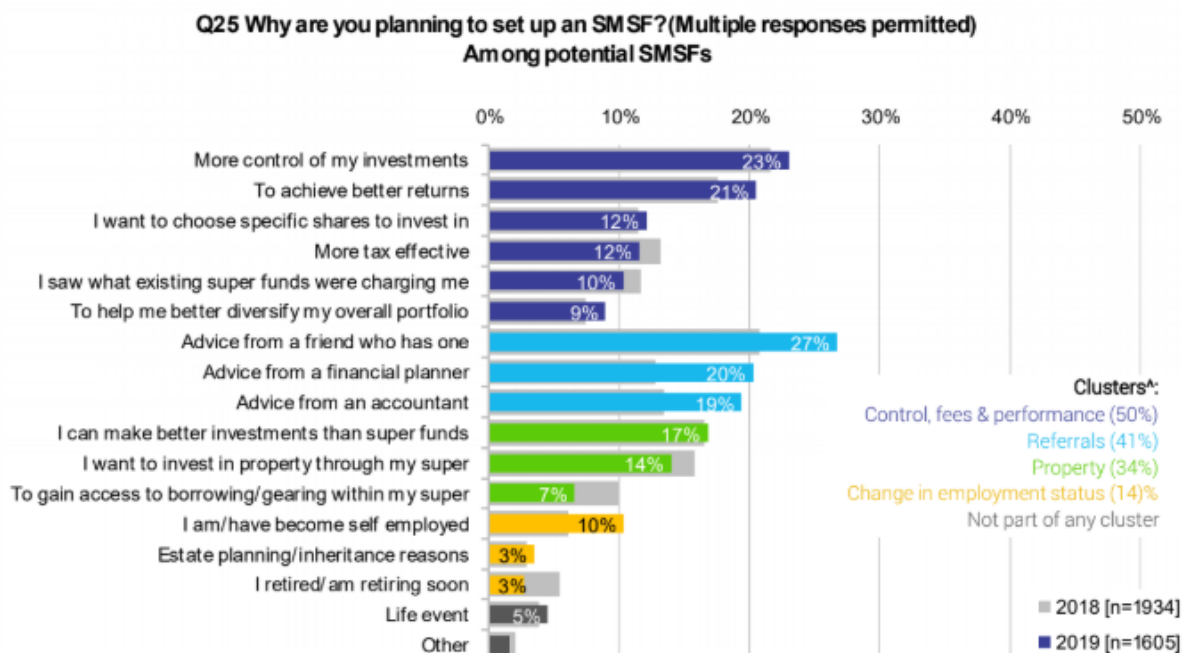
The Reports show 20% of large super fund members are considering setting up an SMSF, including 5% already doing it and 5% planning the move in the next 12 months. However, most of these are stated intentions and far fewer people actually take the step.

On the other hand, between 2013 and 2019, there is a massive increase in the number of trustees who have considered closing their SMSF and moving to a large fund, from only 4% to 20% (17% industry fund, 3% retail fund). The Royal Commission was a major factor, as well as the franking debate.

However, Investment Trends CEO, Michael Blomfield, said many factors favour retention of SMSFs:

*"Number one is that people think their fund is performing okay. They also want greater access to certain asset classes, including property, infrastructure, small cap funds and responsible investment options, and to be able to give them greater weighting. It is also the flexibility to choose which managers they use, whether they use listed solutions or unlisted solutions, or they opt to buy Australian firms directly to access specific sectors."*

The Investment Trends/Vanguard Reports also show the thoughts of potential new SMSF trustees. While reasons such as 'more control' and 'to achieve better returns' are high, it's a little disconcerting that 'advice from a friend' is the main factor, while accountants and financial planners remain highly influential. It begs the question whether an SMSF is in the best interests of so many people, especially when 17% say they 'can make better investments than super funds'.



Source: Investment Trends 2019.

It is also becoming more common to hold an institutional super fund as well as an SMSF, with half of new SMSF trustees also retaining their former super fund, perhaps to retain access to favourable insurance. This was only 29% as recently as 2017.

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

## The 'six or out' VC approach to portfolios

Benjamin Chong

American venture capitalists (VCs) often talk about home runs. VC portfolios are structured to maximise the chance of at least one successful investment that will return the fund multiple times the original investment. Statistically, we know that around 90% of returns for VC investors will come from just 10% of early-stage investments. These are the home runs. The other 90% of businesses will either deliver a modest return or worse-case scenario, no return at all. Home runs are essential to provide the returns that set VCs apart and that investors are expecting.

In the more popular language of cricket for Australia, VC investors need to maximise their chances of hitting a six when constructing their portfolio. And those of us who have dedicated many a summer (or winter in the recent Cricket World Cup) to watching cricket will know that if a batsman protects their wicket too intensely,

they can't take the backswing necessary to hit the six. Instead, they will be forced to settle for singles and dot balls.

### Losing wickets is inevitable in early-stage investing

VCs also know that losing a few wickets is an inevitable and necessary part of the game. VCs are generally comfortable with this but for some investors the idea that loss is inevitable can be uncomfortable and off putting. These investors are hindered by loss aversion and the belief that losses fundamentally loom larger than gains.

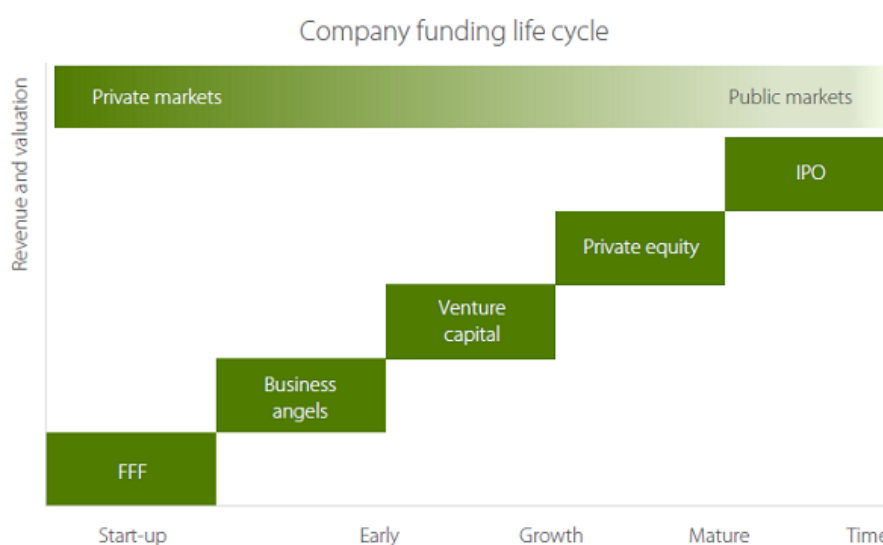
VC is different and requires a different mindset. Every investment is made with the conviction that it could be the outlier and an acceptance that many will not. It is okay to lose if there's a big winner in the portfolio.

To labour the cricket metaphor, we can look at the statistics of cricket legend and former Indian captain, Sachin Tendulkar. During his test career, Tendulkar did not score a single run from 57% of the 29,000 balls he faced. He either blocked or let them go through to the keeper. But of the total runs he scored during his test career, over half (55%) were from fours or sixes although these made up just 7.2% of the total balls he faced. Like Tendulkar and the 29,000 balls he faced, investment in early stage businesses requires VCs and their investors to face a lot of companies and know which are worth a big swing. This is a strategic and disciplined approach to risk taking that VCs gain after years of facing start-ups.

### Management of the risk

Portfolio construction in VC is geared to address and mitigate against risk factors as much as possible. Good VCs will ensure that there are enough companies in the portfolio and that there is enough diversity in terms of the different sectors and the underlying technology. Experienced VCs are also adept at spotting patterns and identifying strong founder characteristics, technical expertise and market opportunities that maximises the chances of success.

Hitting a six is not always the end game for VCs and their investors. For larger investors, this is often the beginning of a long partnership, particularly those looking to move the needle on a multi-billion dollar fund. Having identified those start-ups that are rapidly gaining traction and showing accelerated growth, larger institutional investors such as superannuation funds are able to write bigger cheques with lower risk at later stages of the business' lifecycle. Table 1 shows the company funding life cycle with private market investors at the earlier stages and public market investors being involved at the later stages.

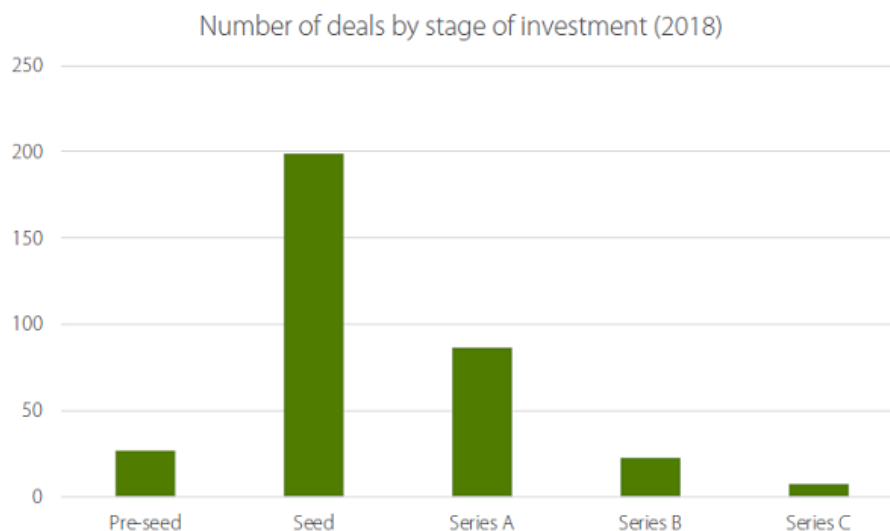


Source: Right Click Capital

The big wins afford VCs and their investors the opportunity to double down on later funding rounds (A, B or C rounds) and participate in growth across other stages such as co-investment opportunities, whether directly or through a mandate structure, and public listings. As high-performing investments progress through the

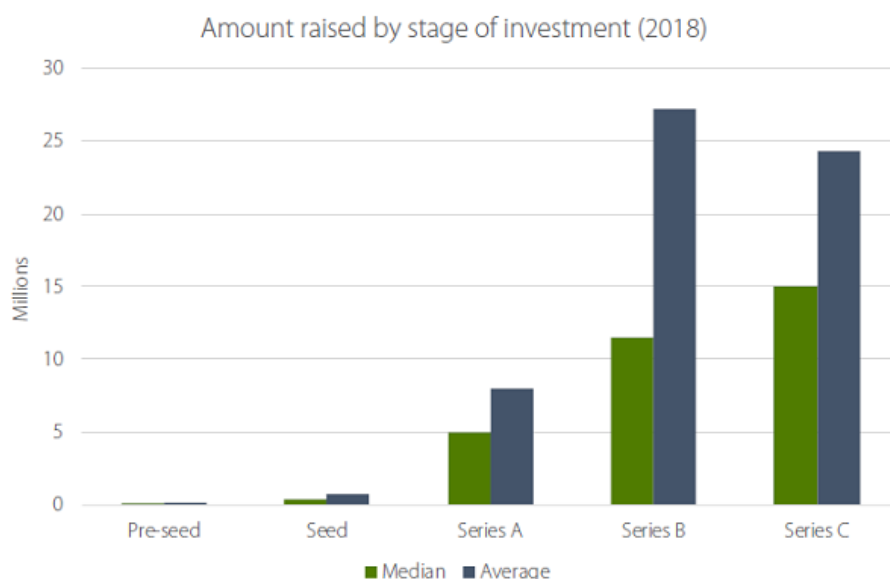
business lifecycle, over time they provide strong returns for a superannuation fund’s venture capital, private equity and listed equities teams.

Table 2 shows an estimate of the number of Australian-based companies raising money in 2018 by stage of investment and reveals a far greater number of opportunities to invest in seed rounds than series A, B and C rounds.



Source: Crunchbase

Table 3 shows the median and average amounts invested in the same deals in 2018 and demonstrates the ability of VCs to invest larger amounts at the later stages of funding as they identify the investments where they have hit a six. VCs who put money to work in businesses at earlier stages need to continue investing in a business’s subsequent rounds in order to maximise their upside when they’re on a winner.



Source: Crunchbase

### It’s more about the long term than quick wins

VC often marks the start of a long-term partnership between an investor and a start-up. Ram Nath Kovind, the first Indian President to visit Australia recently commented, *“The most successful Australian batsmen in India have been those who have shown patience, read the conditions carefully, settled down for a long innings, nurtured their partnerships and not fallen for spin”*.

The same is certainly true for VC investors.

*Benjamin Chong is a partner at venture capital firm [Right Click Capital](#), investors in high-growth technology businesses. This article is general information and does not consider the circumstances of any investor.*

## 5 more mistakes to avoid with SMSFs

Graeme Colley

There are myriad SMSF rules to follow. Following on from my earlier '[common mistakes](#)' article, here are more potential pitfalls.

### 1. Adding contributions to pensions

There are strict rules about what can be added to a pension account once it has commenced. You cannot add contributions or transfers from other superannuation funds after a pension has started. To add these amounts, the pension must be stopped and a new pension commenced based on a new set of calculations.

Each pension in an SMSF must be established under a separate account as well as any amount a member has in accumulation phase. There are tax benefits of keeping pension and accumulation accounts separate.

### 2. Withdrawing lump sums or pensions incorrectly

Superannuation can be accessed after the age of 65 or as a transition-to-retirement income stream once you reach preservation age, currently 57, even if you have not retired.

The type of benefits that can be paid from an SMSF are described in the trust deed. The deed may authorise payment of lump sums, account-based pensions, transition-to-retirement pensions or a combination to be paid to you or, on your death, to your dependants. In some circumstances, you may wish to direct your superannuation benefits to your surviving spouse, children, other dependants or to your estate.

A cap of \$1.6 million applies to the amount you can transfer into retirement phase. Depending on how your pension is drawn down, you can maximise use of the cap and the amount you can ultimately transfer into retirement phase.

If you take your money from your SMSF earlier than the superannuation rules permit, the amount withdrawn can be taxed at penalty rates, the fund loses its tax concessions and the trustees face penalties for allowing the money to be released early. Early release of money from superannuation can be approved if you are experiencing severe financial hardship or for compassionate purposes.

### 3. Making contributions the correct way

Accepting contributions to an SMSF using the correct techniques is essential and helps to avoid penalty taxes if the amount contributed is more than the tax deductible and non-deductible caps.

A contribution to an SMSF can be anything that directly or indirectly increases the value of the fund to provide benefits to members. It excludes income and capital gains that the fund earns from its investments.

Most contributions are made to an SMSF as cash, by cheque or the electronic transfer of money. However, it is possible for some approved investments to be transferred to the fund and the value at the time of transfer is treated as a contribution. A contribution can also include expenses paid by a member on behalf of the fund which are not reimbursed, or government payments such as the co-contribution or low-income superannuation fund tax offset. These amounts are usually credited to a member's accumulation account in the SMSF.

When accepting contributions to the fund a trustee should check:

- who has made the contribution
- the age of the member
- whether the member satisfies the work test if they are under 18 or older than 65
- whether they have quoted their tax file number.

If a member intends to claim a tax deduction for a superannuation contribution, an election must be provided to the fund which is required to be acknowledged.

While there is no limit to the amount of contributions that can be made to superannuation, a tax penalty may apply to any excess over certain amounts. The excess depends on the member's age, the type of contribution and the amount of the member's total superannuation balance on 30 June in the previous tax year.

#### **4. Paying death benefits and your will**

People often think that the payment of superannuation benefits is covered by their will. Generally, this is not the case as superannuation benefits are paid as authorised by the trust deed of the superannuation fund and any nominations the member may have made for the distribution of their death benefits.

If you wish to have your superannuation paid to your estate, make a clear direction to the fund trustee that on your death any benefit will be paid to your legal personal representative who will include the amount in your estate. If no clear direction is provided to the trustee for the payment of the benefit, it is possible that it may not be paid in accordance with the member's wishes.

#### **5. Making binding death benefit nominations**

Death benefits can be paid to your surviving spouse, children, other dependants or to your estate via your legal personal representative.

It is possible for your spouse to receive a continuing pension on your death as a reversionary pension. However, you may provide instructions for the payment of death benefits in a binding death benefit nomination. The nomination will require you as trustee to pay your death benefit to your spouse, dependants or even the legal personal representative of your estate as you choose.

If there are no reversionary pensions or binding death benefit nominations, the rules of the SMSF's trust deed will provide information on how and to whom the benefits can be distributed. If death benefits are paid to your estate, superannuation benefits will be distributed as provided in your will.

The trustee of an SMSF is obliged to ensure that benefits are paid in accordance with the member's or dependant's instructions or the SMSF's trust deed. It is essential that the binding death benefit nomination is valid and properly witnessed. If it is not valid, the trustee may be bound to follow the provisions of the trust deed which may not be consistent with the wishes of the deceased.

*Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at [SuperConcepts](#), a sponsor of Cuffelinks. This article is for general information only and does not consider any individual's investment objectives.*

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

#### Disclaimer

*This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.*

*For complete details of this Disclaimer, see <http://cuffelinks.com.au/terms-and-conditions>. All readers of this Newsletter are subject to these Terms and Conditions.*