

This Week's Top Articles

- **Megan Scott on multitasking in a COO world** *Graham Hand*
- **A-REITs outperform but will it continue?** *Patrick Barrett*
- **Why bank hybrids are far too expensive** *Jonathan Rochford*
- **Is it time to sell bank hybrids?** *Justin McCarthy*
- **An easy fix for Dick Smith's franking problem** *Graham Hand*
- **The value of 'value' and Benjamin Graham's three core beliefs** *Miles Staude*

Megan Scott on multitasking in a COO world

Graham Hand

Megan Scott is Chief Operations Officer (COO) for Martin Currie Australia, a Legg Mason affiliate.



GH: The Chief Operations Officer has been described by Accenture as the least understood role in business. What does a COO do?

MS: Other industries would be different, but the simplest way to describe my role is that our business has three parts: investment, distribution and operations. Operations supports the other two while looking over the entire business, including compliance, human resources, technology and office management.

GH: I expect as you went through your education, you did not set your sights on becoming a COO one day. How did you reach the role and what skills do you need?

MS: That's right. I did a BA at university because I wanted to learn broadly, then I worked in travel before stumbling into this industry through a friend. I really enjoy the operations side. Obviously, organisational skills are critical, and I've always been the person who had the list going and making sure friends had their diaries up-to-date. Also, good communication including talking to people at different levels of the business. Curiosity, and asking what might seem a dumb question. And being able to multitask as you move from one part of the business to another.

GH: From the mundane tasks one minute to complex tasks the next?

MS: Yes. I had a quick meeting recently with the office manager on our coffee policy, then the next meeting was an Executive Risk Group talking to our Edinburgh office. You need to be able to wear many hats and switch them according to the decisions required.

GH: And hold many thoughts in your head at one time.

MS: I've had a bit of practice because I'm also a Mum and I have two daughters, so I have to move off what the kids are doing and on to the business every day. It's a skill you can learn.

GH: How do you prevent yourself spending all your time in the day-to-day operational issues and problems to focus more on the big picture strategies?

MS: That is the biggest challenge, not getting bogged down in the detail. I delegate where I can and I have excellent people around me, plus I try to block out time in my diary for thinking and the big picture. I also write a log of issues as I think of them, to revisit later when I have time. But I admit that more often than not, the thinking time gets interrupted. We all struggle with the right mix.

GH: Martin Currie is a global business within Legg Mason, so how does the Australian operation contribute to policies or innovations?

MS: Yes, we have offices in Melbourne, Singapore and Edinburgh, and each region has different regulations and legislation and we can't adopt everything here. Reece Birtles our CIO is on the Global Executive team and we share ideas and best practices. For example, we recently launched an Emerging Markets ETF here and with offices in this region, we can trade to 'equitise' ETF flows during our day while Edinburgh is asleep.

GH: What drove the strategic decision to launch Active ETFs in Australia, which is a relatively new listed product compared with the most-established Listed Investment Company structure?

MS: I admit it was a challenge when we started the Active ETF conversations with the different intricacies versus our established managed fund processes. It was a new way of doing things. The usual Legg Mason products gave us cash flow numbers once a day complete with application forms. ETFs are tradeable with flows in and out multiple times a day. It involved many conversations driven by BetaShares and Legg Mason. We've done the hard part early with RINC* and EINC* and it seems people want Active ETFs.

GH: I've personally had an investment in RINC since it was first launched, and the performance has been excellent with exposure to listed property and infrastructure in the last year. I see it's taken about \$35 million. Is that considered a good result given it was launched at an ideal time?

MS: It was the first ETF we launched, and Active ETFs is a new structure. We've done a lot of marketing to develop more platform and adviser support, and we're pleased with progress.

GH: It's an open-ended ETF, so if someone invests a large amount at say 10.30am, would you look to do a transaction off the back of that?

MS: It's a decision for the portfolio managers. We have guides and ranges where we will deal out the exposure, so a significant flow might be invested immediately. We also must watch transaction costs such as brokerage and custodian fees, so it's better to deal a net amount than small pieces.

GH: The last 12 months with the Royal Commission and consequences for ASIC and APRA and the industry generally have been significant for anyone with compliance responsibilities. Has it changed your role much, and is there potential for increased scrutiny to go too far and stifle innovation?

MS: Certainly, compliance roles and functions have increased, but we have always focused on being transparent. The Royal Commission problems were caused by people not being transparent and not acting in the best interests of clients. Managing other people's money should never be taken lightly. As long as you stay true to the right principles, I don't think innovation will be stifled. But there's certainly more compliance focus, also driven in Europe by MIFID II.

A few of us, including in the investment team, have completed the Australian Institute of Company Directors (AICD) course, to better understand what boards and management are supposed to do. Having done that course, I would not want to be a director, but we want better engagement and discussions with boards.

GH: What parts of the business potentially keep you awake at night? You mentioned technology earlier, there's plenty of scope for problems there.

MS: On technology, I ask a lot of dumb questions. I've been in this role for a little over 12 months, and the main thing I think about at night is whether I completed what was on my list and added it to tomorrow's list. But it doesn't keep me awake ... ask me again in a year and it might have changed. Cybersecurity is an issue we're constantly watching, but I have a lot of support with the average tenure in our team at 14 years.

GH: Do you have any role models? I guess the highest-profile female COO in the world is Sheryl Sandberg at Facebook.

MS: She's played an important role, but rather than look up to a Facebook executive, I try to learn from leaders more generally. For example, Jacinda Ardern's ability to mix work and the rest of her life so seamlessly, showing empathy one moment while getting things done the next. As a COO, you must get things done, but in a people-focussed way.

GH: To what extent are you involved in investment management?

MS: I usually attend the morning meeting, if I'm not doing school drop offs – my husband does the school more often than me, part of the shift from what was once considered a classic female role. Investing is the heart of what we do so I want to hear the stock updates and discussions. I'm responsible for ESG and I help analysts keep on top of best practices. It's a big focus in both the Edinburgh and Melbourne teams. ESG is still evolving in the industry in general, and many of our conversations with companies focus on governance in particular. For an analyst, ESG is another factor to consider, and there are different levels of understanding across our business and the entire industry.

Graham Hand is Managing Editor of Cuffelinks. Megan Scott is Chief Operations Officer at [Martin Currie Australia](#) (a Legg Mason affiliate). Legg Mason is a sponsor of Cuffelinks.

This article is general information and does not consider the circumstances of any investor.

**The BetaShares Legg Mason Real Income Fund (ASX:RINC) and BetaShares Legg Mason Equity Income Fund (ASX:EINC) are managed by Martin Currie. The (unlisted) Legg Mason Martin Currie Real Income Fund won the 'Retirement and Income Focussed' category at the 2019 Money Management/Lonsec Fund Manager of the Year Awards.*

For articles and papers from Legg Mason, please [click here](#).

A-REITs outperform but will it continue?

Patrick Barrett

The A-REIT (Australian Real Estate Investment Trusts) sector generated a total return of +19.4% in 2018/2019, outperforming the broader S&P/ASX300 Accumulation Index return of +11.4%. The returns were heavily skewed to the second half of the financial year and largely driven by firming bond yields and the rotation of capital into the yield sectors such as A-REITs and infrastructure. A-REITs also outperformed the Global REIT benchmark.

A-REIT and global REIT returns

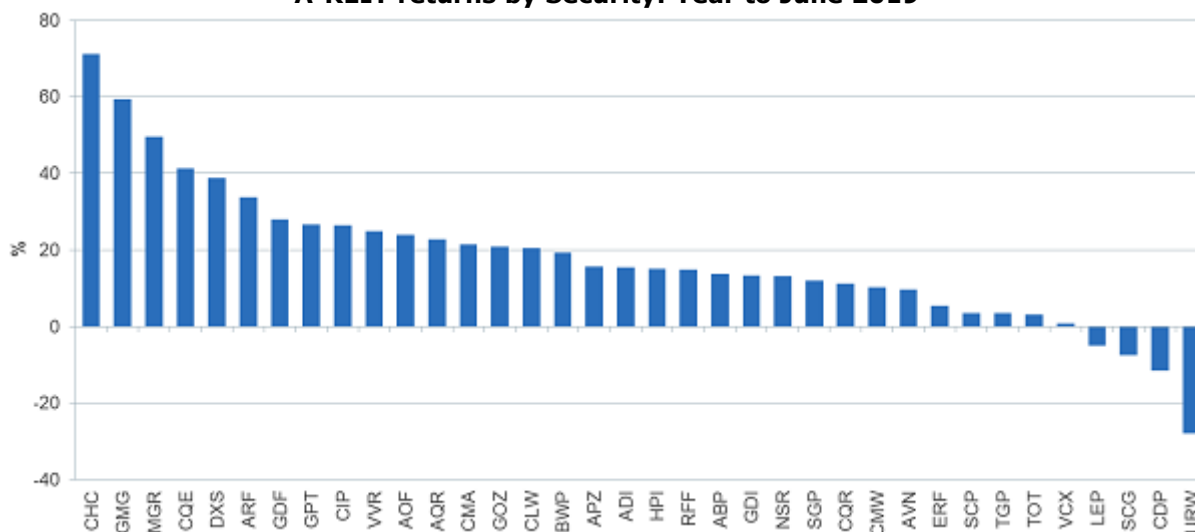
	Benchmark	6 months to Dec-18 %	6 months to Jun-19 %	1 year to Jun-19 %	3 years pa to Jun-19 %
A-REITs	S&P/ASX 300 REIT Accumulation Index	-0.2	19.1	19.4	8.1
Equities	S&P/ASX 300 Accumulation Index	-7.0	19.8	11.4	12.8
Global REITs	FTSE EPRA/NAREIT Developed Total Return Index (AUD)	-0.9	15.6	14.6	7.6

Source: IRESS

The A-REIT index was boosted by the industrial and office sectors that delivered +57.7% and +33.4% respectively in FY19, whilst the retail sector delivered -7.6%.

At the security level, the dispersion of returns between the best and worst performing A-REITs was one of the largest on record, as shown below. The x-axis corresponds to the ASX codes.

A-REIT returns by Security: Year to June 2019



Source: IRESS

Massive difference in performance

The best performing A-REITs in FY19 were the fund managers, led by Charter Hall Group (ASX:CHC) at +72.4% and Goodman Group (ASX:GMG) at +59.9%. Both platforms benefited from strong demand for their real estate funds, their access to the strongly-performing office (CHC) and industrial logistics (CHC and GMG) sectors and the embedded performance fees in a number of their funds.

Unibail-Rodamco (ASX:URW) and Scentre Group (ASX:SCG) recorded negative annual returns, delivering -27.5% and -7.7% respectively. This was driven by concerns over their significant exposure to the discretionary retail sector. Vehicles exposed to non-discretionary retail spend, including convenience centres, such as Charter Hall Retail (ASX:CQR) and SCA Property Group (ASX:SCP) fared much better.

We have witnessed a significant flow of capital from domestic and global general equities managers into A-REITs, with higher multiples being paid by investors seeking the relatively-secure earnings growth in the sector. Many A-REITs took advantage of the strong appetite for yield and raised more than \$3.7 billion in the past six months, \$1.7 billion of which was raised in June 2019 alone. This was the highest level of equity raised since 2009 when the sector was forced to recapitalise at the height of the GFC. Anecdotal evidence from the investment banks indicates each of the raisings were significantly oversubscribed.

In addition, there was more than \$4.2 billion in A-REIT debt issuance in the first half of 2019. The US private placement market was a key source of debt finance, with four A-REITs (GrowthPoint, GPT, Mirvac and Stockland) tapping the US debt market, securing \$1.7 billion in borrowings with tenures of between 10 and 14 years and margins between 170 and 224 bps.

Market snapshot

Office

Australia's main office markets are well-positioned with historically low vacancy rates and modest supply levels. This has led to strong rental growth along the east coast. The Sydney CBD vacancy rate is the lowest it has been in 18 years, while Melbourne's vacancy rate is at a 10-year low. Vacancy rates in Brisbane and Perth are now falling on the back of positive demand. Given the strong positive office market fundamentals, capital values are expected to be supported by continued investment demand from A-REITs, superannuation funds and foreign investors.

Retail

The retail sector has been impacted by a combination of cyclical and structural issues. Cyclically, retail sales have been under pressure due to higher living expenses that have not been offset by wage growth. Structurally the market, particularly discretionary retail, is suffering from the rise of e-commerce. FY20 retail sales are expected to be boosted by the flow through of the Coalition's tax refund plan. This will see \$7.6 billion tax refunds (~0.4% of GDP) flow to consumers, with a large proportion of the refunds to be spent on retail consumption.

Industrial

The structural trends of urbanisation, rising e-commerce and the need for convenience is requiring logistics providers to reconfigure their supply chains. This has led to strong demand for urban industrial premises and higher investment into state-of-the-art distribution centres, driving longer leases. A significant pipeline of infrastructure projects and a lower AUD has also benefitted demand, leading to rental growth in most regions. The investment market is expected to remain strong given solid rental growth expectations and demand from institutions underweight the logistics sector.

Residential

Optimism appears to have returned to the housing market, following the Federal Election, RBA cuts and APRA easing of lending buffers. Whilst sentiment is up, this positive shift will take time to filter through the market and positive earnings of those A-REITs exposed to the residential sector.

The outlook for A-REITs

With interest rates at record lows and continuing low inflation, there are not many options for investors seeking a healthy yield. A-REITs is one sector that investors will focus on.

The sector benefits from solid operating fundamentals, low gearing and strong interest cover, good dividend coverage and demand for institutional grade real estate. A continuation of low interest rates, reasonable consumer confidence, and corporate activity (M&A) will support the sector. The lower Australian dollar adds to the appeal for offshore investors.

The sector is offering a 4.5% dividend yield, with forecast growth in dividends of ~3% per annum for the next four years. Profit growth is reasonably predictable driven by contractual rental arrangements and annuity-type management fees. Unlike some of the broader industrial companies, there are few question marks over A-REIT dividends.

In perspective, the current A-REIT dividend yield is 3.5x the current 10-year bond yield and 4.5x the cash rate. The greatest risk to the sector is a rising in bond yields, which would negatively impact pricing. This seems unlikely at the moment, but as the past year has shown, not all A-REIT are equal, and there will be winners and losers. This is a market for active stock-pickers.

Patrick Barrett is Portfolio Manager, Listed Securities at [Charter Hall](#), a sponsor of Cuffelinks. This article is for general information purposes only and does not consider the circumstances of any investor.

For more articles and papers from Charter Hall (and previously, Folkestone), please click [here](#).

Why bank hybrids are far too expensive

Jonathan Rochford

Yield chasing has spilled into nearly every asset class, with Australian listed bank hybrids no exception. The current average margin of bank bills at +2.40% is close to the lowest level for at least seven years. For institutional investors, there are some obvious alternatives that are both lower risk and higher returning. For retail buyers, the direct alternatives are fewer but nonetheless there are ways to receive a better return whilst taking the same or less risk.

What is a bank hybrid?

A quick description of the security types is useful for a fair comparison. The two types of securities captured by the moniker of bank hybrids are:

1. **Subordinated debt** (technically tier 2 capital) is the security type that ranks directly below senior debt and has interest payments that are compulsory unless the bank is insolvent. ASX:NABPE is the only listed security of this type from the major banks it is highly likely new issues will come soon (note, all the five-letter codes in this article are ASX codes).

Capital Type	Examples
Secured debt	Covered bonds
Senior debt	Term deposits, senior unsecured bonds
Tier 2	Subordinated debt
Additional tier 1	Preference shares
Equity	Ordinary shares

2. Preference shares (technically additional tier 1 capital) rank below subordinated debt. The major banks currently have 19 of these securities listed on the ASX with the largest for each major bank being ANZPG, CBAPD, NABPF and WBCPG. Preference shares are not debt securities and they receive discretionary dividend payments which the directors or the regulator (APRA) can stop even when the bank remains solvent.

The structural weaknesses of bank hybrids

Bank hybrids include [a range of issuer-friendly terms such as](#):

- The ability to delay (subordinated debt) or perpetually defer (preference shares) the repayment of the securities if the bank is in financial difficulty or if the share price falls below a threshold
- The potential to be converted into equity that has little or no value
- The lack of equity control rights, for instance being able to vote at shareholder meetings
- Limited covenants that protect the investor's position
- Higher drawdowns than standard senior ranking bonds in times of market turbulence
- Limited liquidity in times of financial stress and for larger amounts

Some financial advisers tell their clients that bank hybrids will not suffer a capital loss as the Australian Government will never let a major bank fail. This is a misunderstanding of the reason these securities exist. Bank hybrids are a protection mechanism to ensure that the Australian Government does not use taxpayers' funds to bail out a bank. It's like the safety features in a car. The crumple zones and airbags exist to protect the people, not to ensure that the car isn't damaged. If a major bank was in financial difficulty, APRA has the power to convert hybrids to equity or to completely wipe out their value.

Recent changes impact bank hybrids and relative values

Earlier this month, the regulator APRA [released its determination](#) on how much additional hybrid capital, and the major banks need roughly \$20 billion of subordinated debt each year for the next four years. This additional debt will be sold to institutional investors and issued as ASX-listed securities. Westpac and ANZ have both already issued institutional subordinated debt into strong demand.

The most recent subordinated debt issue was by ANZ on 19 July and it was priced at bank bills +2.00%. This is not far away from the average margin of listed major bank preference shares at bank bills +2.43%. This is scant additional return for the major increase in risk, particularly the risk of dividends being stopped whilst the bank is still solvent. Whilst this comparison is between an institutional security and the more retail-orientated listed hybrids, many large investors have both options available to them.

Alternatives to bank hybrids

Whilst some might question whether the relative value between subordinated debt and preference shares matters, the interest rates available elsewhere makes both options look miserly. Institutional investors can look to securitisation, syndicated loans and marketplace lending opportunities for a better risk/return outlook.

Retail investors can also take advantage of online savings accounts, marketplace lending directly or various other debt sectors accessed via listed and unlisted managed funds. Here is a quick summary of four alternatives.

1. Securitisation

The most relevant debt type that demonstrates the poor value in bank hybrids is 'non-conforming' securitisation. Investors in the subordinated AAA tranches are often receiving margins equal to or better than the margins on BBB-rated major bank subordinated debt. As well as a much higher credit rating, these securities have a shorter tenor and a history of lower drawdowns in market downturns. For an equivalent BBB

rating, securitisation tranches have been issued at around bank bills +4.30% this year, more than double the margin on the recent ANZ subordinated debt issue.

Comparing securitisation to preference shares isn't an apples and apples comparison. The predominantly equity features of preference shares, notably the ability for the directors or APRA to turn off dividends, means they cannot be fairly compared with a debt instrument that has non-discretionary repayments. Whilst ratings agencies do rate some of these securities (e.g. Standard and Poor's rates the CBA preference shares at BB+) these ratings ignore most of the risks created by the non-debt features of preference shares. Once these features are included, preference shares arguably have a risk profile more in line with a B rating for a standard debt instrument.

Either way, bank bills +2.43% for preference shares compares poorly to bank bills +6.30%/7.75% (BB/B rating) for securitisation issuance this year.

2. Marketplace lending

Institutional and retail investors can both access marketplace lending (also known as peer-to-peer lending) via a growing number of online platforms. There's a mixture of residential and commercial property secured loans available, as well as unsecured business and personal loans. For more conservative investors, loans backed by residential property with an LVR of 60% or less typically yield 5-7%. Commercial property loans, business loans and personal loans usually come with higher yields. Investors in riskier loans should be expecting to lose a portion of their total return when some of the borrowers default and should set their return expectations accordingly.

3. Online savings accounts

Retail investors have a profound advantage over institutional investors when it comes to rates for online savings accounts. NAB's online subsidiary Ubank, for example, has the best at 2.41%, requiring only a \$200 monthly deposit. There are other options with higher rates, but these have restrictions on withdrawals, spending requirements or are only introductory rates. Whilst this rate doesn't seem that high, note that two major bank preference shares, NABPC and WBCPF, are both trading with a forecast yield to maturity of less than 3%.

4. Managed funds

Retail investors that cannot access securitisation, syndicated loans and various forms of private debt directly have a growing number of listed and unlisted fund options. As these types of securities are typically illiquid, care should be taken to (a) choose managers with a long track record of managing these assets well and (b) invest in a fund with a suitable liquidity profile for the asset type. Funds that offer daily liquidity whilst investing in illiquid securities have a history of blocking redemptions in substantial market downturns, as occurred in 2008-09.

Listed Investment Companies or Trusts meet liquidity demands via a sale of the units on the ASX rather than selling fund assets at prices that may be below their long-term fair value. Listed debt funds include GCI, MOT, MXT, NBI and QRI with these funds having various debt types, risk profiles and fee levels.

Jonathan Rochford, CFA, is Portfolio Manager for [Narrow Road Capital](#). This article is for educational purposes and is not a substitute for professional and tailored financial advice. This article expresses the views of the author at a point in time, which may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views.

Is it time to sell bank hybrids?

Justin McCarthy

Over the past five years, we have used a simple rule of thumb to assess the value of the new style/Basel III compliant Australian major bank hybrids:

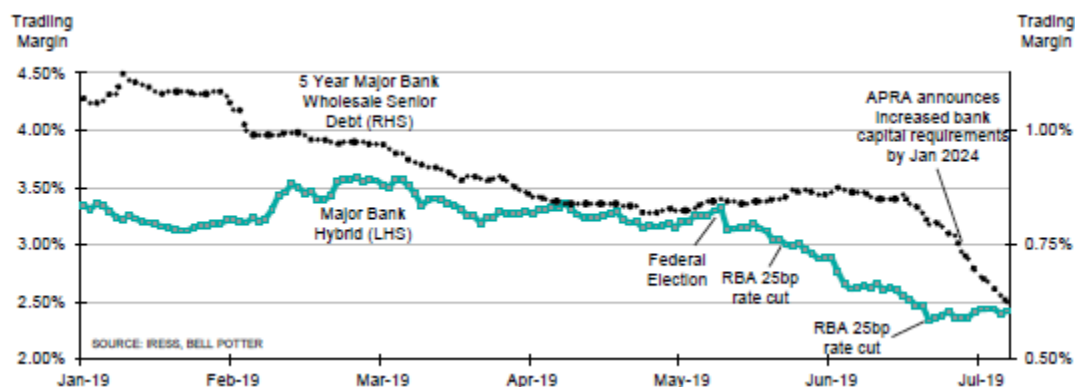
- Excellent value at a five-year credit margin approaching +500bps
- Expensive when the five-year margin is +300bps or lower

This simple rule is based on the tightest and widest issues we have seen from the major banks since Basel III Additional Tier 1 (AT1) hybrids were first issued in January 2013. The two 'book-ends' were both issued by CBA and only 18 months apart, which shows how quickly the market can move:

- CBA Perls VII (CBAPD) – issued in October 2014 at a credit margin of +280bps to call in 8.2 years
- CBA Perls VIII (CBAPE) – issued in March 2016 at a credit margin of +520bps to call in 5.5 years

Significant tightening of margins

Australian bank and insurance AT1 hybrid spreads have been tightening for some time but that trend has picked up since the May 2019 election win by the Coalition which removed the risk that Labor's franking policy posed, as the black line in the chart below demonstrates.



Source: Bell Potter

With demand increasing following the election, supply has been constrained with a dearth of new issues and little replacement funding expected in the near term. Issues approaching call/maturity dates in the next 12 months include just one major bank:

- IANG (IAG) 16 December 2019 (\$550 million)
- NABPC (NAB) 23 March 2020 (\$1,343 million)
- MBLPA (Macquarie Bank) 24 March 2020 (\$430 million)
- CGFPA (Challenger) 25 May 2020 (\$345 million)
- SUNPE (Suncorp) 24 June 202 (\$400 million)

Against this backdrop and the market's search for value, AT1 hybrid spreads are now the tightest we have seen since the new breed of Basel III compliant hybrids first hit the market in early 2013. The **widest** margin of any of the major bank hybrids (as at 22 July 23019) was the NABPF June 2026 call AT1 with a trading margin of just +288bps.

Inadequate reward for hybrid risks

Margins for the AT1s with a first call in five years are closer to +270bps. This is in contrast to last week's ANZ 10-year subordinated bond issue with a margin of +200bps. We argue that a differential of just 70bps is too low for the additional risks that AT1 hybrids present, including extension/non-call risk, no maturity date, automatic conversion to equity if Core Equity Tier 1 ratio falls below 5.125% and potential for coupons to be cancelled.

We believe it is time to take profits on bank and insurance company AT1 hybrids. We still see value in the legacy hybrids such as NABHA and MBLHB which are still trading at a discount to par, but those too have rallied strongly in recent times.

Whilst there is no immediate threat or trigger point to cause hybrid spreads to widen, history tells us that spreads are tight.

An opportunity to re-enter the market might be seen in the coming 12 months if the banks use the retail ASX-listed market to help raise the additional \$50 billion Tier 2 capital required over the next four years, following APRA's clarification of capital requirements earlier this month. We suspect we will see a number of large, well-priced listed Tier 2 issues with margins in the low-200bps. There is also the potential for some out of cycle/non-rollover AT1 issues which could present good new issue margins.

One further impact of the tight major bank credit spreads was the recent BNP AT1 in AUD. It was initially launched with a margin of 412bps but priced 75bps tighter at a margin of 337bps. Despite the tightening in issue spread, the size of the order book (demand) and the relatively small issue size (supply) provided a pathway for the strong secondary performance which we have seen to date.

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](#).

An easy fix for Dick Smith's franking problem

Graham Hand

Yes, me too. I thought we'd finished with franking credits, then along comes Dick Smith wanting to hand back his \$500,000 refund. Of course, that's become a major headline story, and if you Google 'Dick Smith franking', you can see the media feeding. It's on again.

Dick Smith admits he's not a financial genius, and *The Sydney Morning Herald* reported on 17 July 2019: "*The entrepreneur said he had no idea what franking credits were before discovering the payments, and complained to the Australian Tax Office.*"

Then on 21 July in *The Sun-Herald*, influential columnist Peter Fitzsimons kicked the can further down the road, calling franking refunds 'ridiculous' and 'absurd' but with little attempt to analyse the issue or Dick's circumstances.

The only conceivable way to receive a \$500,000 refund is to hold Australian franked shares in an enormous SMSF, taxed at 0% and 15%. If investments are held on personal account and taxable income is over \$37,001 with a marginal tax rate from 32.5% to 45%, there is no refund of a 30% franking.

Dick can simply tell his accountant to switch his franked shares from the SMSF into his own name. Problem solved, and no need to complain to the ATO.

(Dick Smith is a genuine philanthropist and advises he has already donated the \$500,000 to charities).

If the real issue here is large SMSF balances, then that has been addressed by reductions in contribution caps and the total superannuation balance rules.

Here is Peter Fitzsimons' article and two responses from people who have written extensively on franking credits.

Extract from The Sun-Herald, 21 July 2019

It's franking ridiculous ... and Dick Smith says so too

Dick Smith took more brickbats than bouquets this week for his protest at receiving \$500K as a government refund for franking credits.

"I found I was getting this ridiculous money from the government," Smith [told The Sydney Morning Herald](#). "That's wrong, I said – I'm wealthy. My accountant said 'that's how it works, that's what you have to do'. I can't stop it. I think it's outrageous for wealthy people to be getting money from the government."

Instead of being lauded for speaking out, Smith took a lot of flak for not speaking out during or before the election campaign, as his case perfectly highlights the absurdity of giving so much money to so many already wealthy people, while so many other areas in desperate need of funding are being cut back. When I asked Dick Smith about it this week, his reply was stark.

"I did not know that my \$500k tax saving was due to franking credits," he said, um, frankly. "I am a car radio installer, not a financial genius."

He has written a letter to the Herald, in any case, saying he has given every cent of these tax refunds to charity. Either way, let the defenders of the franking credits defend a system that gives a multi-millionaire like Smith that kind of refund! Crickets.

(Then in the next section, he adds)

And just as personalising the issue of franking credits to Dick Smith helps everyone understand the absurdity of it, let me try this on Brexit.

So Peter Fitzsimons calls franking 'ridiculous' and Dick Smith calls it 'outrageous' without any explanation of how franking works. Our [simplest explanation of franking is here](#) (complete with 160 comments) but let's address Dick Smith's case.

Tony Dillon is a recently-retired actuary

Peter Fitzsimons recently weighed in on Dick Smith's predicament of receiving \$500,000 in franking credit refunds, saying, "let the defenders of the franking credits defend a system that gives a multi-millionaire like Smith that kind of refund".

It's not a matter of defending the franking credits system, which has already proven to be sound and equitable in many forums. Rather, this is a matter of understanding how Dick Smith could actually receive such a large refund.

Assume Dick received his franking credits via an SMSF, because to receive \$500,000 in franking credits investing outside super would require taxable income less than \$18,200, and that does not seem plausible.

Such a large franking credit refund is possible within an SMSF because of the generous tax concessions of such a superannuation structure. It is possible because the maximum rate at which super fund earnings are taxed is 15%, just half the corporate tax rate. So that in theory, franking credit refunds can increase with dividend earnings ad infinitum, all else being equal. In practice, natural limits will evolve, as tighter restrictions on contributions into SMSFs begin to bite. Funds like Dick Smith's will run off over time, until very large SMSFs cease to exist. Currently though, franking credit refunds are uncapped within an SMSF structure.

The introduction of the \$1.6 million Transfer Cap Balance in 2017/18 at least means that for super funds in excess of \$1.6 million, a portion of refundable franking credits will now be required to offset tax liabilities, and so would no longer be returned in full, because funds in excess of \$1.6 million are required to pay 15% tax on earnings outside the cap.

While acknowledging we don't know Dick Smith's exact circumstances, he has put his franking refund into the media, so we have a right to estimate the underlying numbers.

In Dick's situation, assuming a dividend yield of 5% before grossing up for franking credits, he would require a share portfolio of about **\$45 million** to enable \$500,000 in refundable franking credits.

The first \$1.6 million would earn \$80,000 in dividends plus franking credits of \$34,300. Total income tax free of \$114,300.

The next \$43.5 million would yield \$2.17 million in net dividends and \$931,400 in franking credits, for total income on that tranche of \$3.10 million. Tax on that at 15% being \$465,700, which offsets half the franking credits, leaving \$465,700 worth of franking credits refunded. **Total franking credits refunded across the SMSF therefore equals \$500,000.**

Franking credit refunds of that size are indeed possible, but it would take a mighty SMSF to achieve it, the likes of which are rare and will be phased out over time.

So it is the super fund tax concession rules that are the cause of Dick's bonanza, not the franking credits policy, which is merely a symptom. And the problem with Labor's approach to treating large franking credit refunds was to treat the symptom and not the cause. Without addressing the cause, symptoms will always persist.

However, as large SMSFs eventually become a thing of the past, franking credit refunds such as Dick's will no longer occur, which renders futile the calls from detractors to modify the franking credits system. In the meantime, Dick must endure his annual windfall if he leaves his shares in his SMSF.

As a footnote, Dick Smith is a savvy businessman, who would probably have been collecting franking credits since their inception in 2001. Why hasn't he objected in the past?

Jon Kalkman is a Director of the Australian Investors Association

Dick Smith is outraged that he received a 'ridiculous' refund of about \$500k from the government when he is already so wealthy. The first response is that if he invested in assets other than Australian shares he would not have such problem, because it is only Australian shares that generate these tax credits.

More seriously, if Mr Smith is getting a cash refund of \$500k from his franking credits, that can only happen if his marginal tax rate is lower than 30% and that suggests that his super fund is holding these shares rather than personally. Let's assume that Mr Smith has all his wealth invested in Australian shares – a very dubious assumption – and that all the shares get the full treatment of franking from the ATO – that too is not always the case. Then the franking credit is never more than 30% of the taxable income. At a minimum, Mr Smith's taxable income from his Australian shares is \$1,666,666 which is comprised of \$1,160,666 in dividends (70%) and \$500,000 in franking credits (30%).

If we assume that Mr Smith achieves about 4.5% dividend yield on his shares, we can calculate that his portfolio is valued at almost \$26 million. It may have been possible for Mr Smith to have such a large portfolio in a tax-free pension fund before 2017, but it is not possible now because he can only hold \$1.6 million in such a fund. If the bulk of this portfolio is an accumulation fund, the maximum refund is only 15% of the total and so the portfolio would need to be twice as big to generate the same refund as previously.

The government has recently legislated that the purpose of superannuation is to replace or to supplement the age pension. Clearly, super accounts larger than \$1.6 million held in accumulation funds are not required to replace or supplement the age pension and therefore, since there is no obligation to withdraw money from these funds, they make ideal estate planning vehicles.

Mr Peter Fitzsimons described franking credits as "(an) absurdity of giving so much money to so many already wealthy people".

If we are looking for an absurdity, we should look at allowing such large balances to remain in the concessional tax area of super accumulation funds in retirement because this is money that will never be used to fund a retirement. These funds will never be depleted with mandatory withdrawals like pension funds and, even if withdrawn after death, these funds will be concessional tax, always assuming they are not withdrawn tax-free before death.

If the total super in retirement was limited to \$1.6 million per member (we could call that a reasonable benefit limit), and held in a pension fund with its mandatory withdrawals that increase with age, there would be an automatic limit of the cash refund of franking credits and there would no need to cap or grandfather them.

Mr Smith's outrage is no doubt galling to younger people because they will not be able to accumulate more than \$1.6 million in super due to the cap on non-concessional contributions. They will not have the luxury of paying only 15% tax on income from super money in excess of \$1.6 million.

Wealthy funds like Mr Smith's allow uninformed commentators to distort the debate about franking credits by assuming that all super funds are high balance. Mr Smith and Mr Fitzsimons should do some homework and learn that (according to the ATO) SMSFs have a median balance is \$693,000. In other words, there are as many SMSFs with balances less than that as there are with balances above it. Moreover, only 0.7% of SMSFs with balances above \$10 million.

It is absurd to suggest that Mr Smith's annual cash refund of \$500k for franking credits in his SMSF is typical of the refund received by SMSFs used by an average retired couple to generate their retirement income.

The value of 'value' and Benjamin Graham's three core beliefs

Miles Staude

It's no secret that 'value' based investment strategies have generally underperformed market returns throughout the current bull-market, with this underperformance being particularly acute over the past three years. However, the underperformance of value as a style has not been driven by a failure of value investing to deliver what it sets out to achieve. Rather, in many ways, it has been a function of what value investing sets out to avoid.

The ideas behind value investing today are much broader than those originally envisaged by Benjamin Graham, the academic credited with its birth. Graham's work heavily influenced some of the world's most famous investors, notably Warren Buffett and Charlie Munger, who have expanded on his ideas and applied his approach to a much wider universe of investing strategies.

Nonetheless, the three core tenets of Graham's work have remained unchanged in the 85 years since he first published them.

1. The future is unknowable

That the future is unknowable might sound trite but consider the authority that most analysts summon when setting out their forecasts. Much of the published investment research today suggests that economic forecasting enjoys a level of precision normally reserved for hard sciences like physics. Friedrich Hayek, a Nobel Prize-winning economist, referred to this as the 'Pretence of Knowledge'. Hayek described the task of economics as being:

"to demonstrate to men how little they really know about what they imagine they can design."

In the real-world, both economists and market forecasters have dismal records of predicting things like recessions or major turning points in the share market. In an \$80 trillion global economy driven by eight billion individual actors, divining such things is beyond the tools at our disposal.

2. Find a margin of safety

Without prediction, we are confronted with two choices. First, we can fall back on the ideas behind the Efficient Market Hypothesis (EMH). This proposes that investors are rational economic actors, and that all new market information is instantly reflected in security prices. We will earn the return of the 'market' and live with the 'risks' that this entails. If you invested your retirement savings in February 2009, bully for you. If you instead invested them in February 2008, well, that just reflects the risks that come with investing in the 'market'.

An alternative approach is an investment strategy where some form of a margin of safety exists. A buffer that can protect us regardless of the economic weather or the broader fortunes of the market is the second of Graham's key value-investing principles. In many ways it is the defining feature of the investment approach. Most value-based strategies are thus anchored on two equally-important goals, generating investment returns *and* preserving capital.

3. All securities have an intrinsic value

Graham's third key principle is the idea that all securities have an intrinsic value. If you can determine this intrinsic value, and then buy the asset at a discount to this price, you have created the buffer you need to protect yourself from the whims of the market.

This final concept is where many value-based strategies fail. Determining the intrinsic value of an asset can too often become a subjective exercise, as is determining a knowable intrinsic value in a world where the future is unknowable.

Regardless of its drawbacks, investors like Warren Buffett apply this method when they talk about their search for stocks with wide 'economic moats'. Businesses can have structural competitive advantages, either through a business model or brand that cannot be readily replicated. The 'moat' ensures a long-term competitive advantage, and if the business is bought at the right price, excess market returns are generated over the long-run.

Beware simple screens and 'value traps'

As with all investment approaches, value-based investing has its pitfalls. For example, many value investors screen potential investments using metrics like price to book value or price to earnings ratios. It is easy to construct a portfolio of 'cheap' stocks using such metrics. Whether they are companies truly trading below intrinsic value is another question.

One of the greatest economic forces of recent times has been the arrival of the 'disrupter'. Typically, these are technology-based companies with innovative approaches to competing in established industries. A defining feature of the disrupter business model is its low capital intensity. Given this, holding a portfolio of stocks today

that look cheap on a price to book value basis may in fact just mean owning a collection of companies in structural decline.

Stocks that look cheap on a price to earnings metric and cheapness relative to near-term earnings can often reflect a company with challenged longer-term prospects. Confusing 'cheap' with 'intrinsic value' is one of the key predicaments value investors must navigate.

Seeking both a return *on* capital, and a return *of* capital

Few of the drivers behind absolute market returns this cycle have demonstrated much in the way of safety for investors. Anyone doubting that markets today are mainly driven by central bank actions need only reflect on the magnitude of the share markets swings between September 2018 and March 2019. Global share markets collapsed 17% (in US dollar terms), and then rallied 19%, as the US Fed shifted from guiding to future rates hikes, to hinting at future rate cuts.

Collectively, central banks have injected US\$14 trillion into capital markets since 2008 via quantitative easing. Despite these actions, the recovery since the GFC has been anaemic and characterised by low to non-existent levels of inflation. In the US, the only developed economy to experience a meaningful expansion since the crisis, growth has averaged a mere 2.3%, much lower than the 3.6% average of the past three cycles.

Against this bleak backdrop, investors have craved 'growth' of any kind. They have found it most noticeably in a small handful of high-growth technology stocks. Some of these companies have revolutionised entire industries while many more remain a long way from delivering on grand promises. On our analysis, eleven stocks (Microsoft, Facebook, Apple, Amazon, Netflix, Google, Twitter, Tencent, Alibaba, Baidu and Nvidia) have accounted for 21% of all global share market gains over the past five years. Indeed, four of them, Microsoft, Amazon, Apple and Facebook, are responsible for 23% of the S&P 500's total return year-to-date.

The recent winners carry no margin of safety

From early 2000 through to the GFC in 2008, value as a style greatly outperformed growth. From 2000 to 2003 covers the dotcom crash and the ensuing broader market correction, while 2003 to 2008 were periods of solid global economic growth and normal levels of inflation.

The excitement surrounding FAANG stocks today has obvious parallels to the dotcom euphoria of 1999 and early 2000. That does not mean this basket of stocks cannot continue to propel broader markets higher for some time to come. How much longer, of course, is unknowable in the eyes of a grizzled value investor. What is clear, is that – having rallied 238% over the past five years – there seems little in the way of a margin of safety in owning them today.

Miles Staude of Staude Capital Limited in London is the Portfolio Manager at the [Global Value Fund](#) (ASX:GVF). This article is the opinion of the writer and does not consider the circumstances of any individual.

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.