Firstlinks
By Cuffelinks

Edition 322, 6 September 2019

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Lessons from the Future Fund for retail investors

Graham Hand

Established in 2006, the Future Fund is Australia's sovereign wealth fund with assets now over $160 billion. The original seed capital was only $60 billion with no further contributions, demonstrating the power of compounding at 10.4% over the last 10 years.

In 2018/2019, when the top public super funds in the country delivered close to 10%, the Future Fund returned 11.5%. It's worthwhile understanding how the Fund has delivered these impressive results.

Investment process

The Future Fund employs what is known as a 'total portfolio approach', with a strong focus on risk and return at the overall portfolio level. The Fund has developed an 'Equity Equivalent Exposure' where risk in all asset classes is measured in terms of an equivalent equity 'beta' or market risk.

The Fund operates under a set of fundamental beliefs which guide the way it invests, including:

- Expected returns and risks vary over time and therefore the amount of risk taken should also change over time.
- Higher expected return per unit of risk can be obtained from diversification.
- Investment risk is not captured by a single metric and additional risks must be assessed and managed.

To construct the portfolio, the Fund combines top-down views with bottom-up research. Top-down analysis involves forming opinions about the global economy, financial markets and geopolitics. Bottom-up analysis identifies attractive investments with compelling reward for the risk taken.

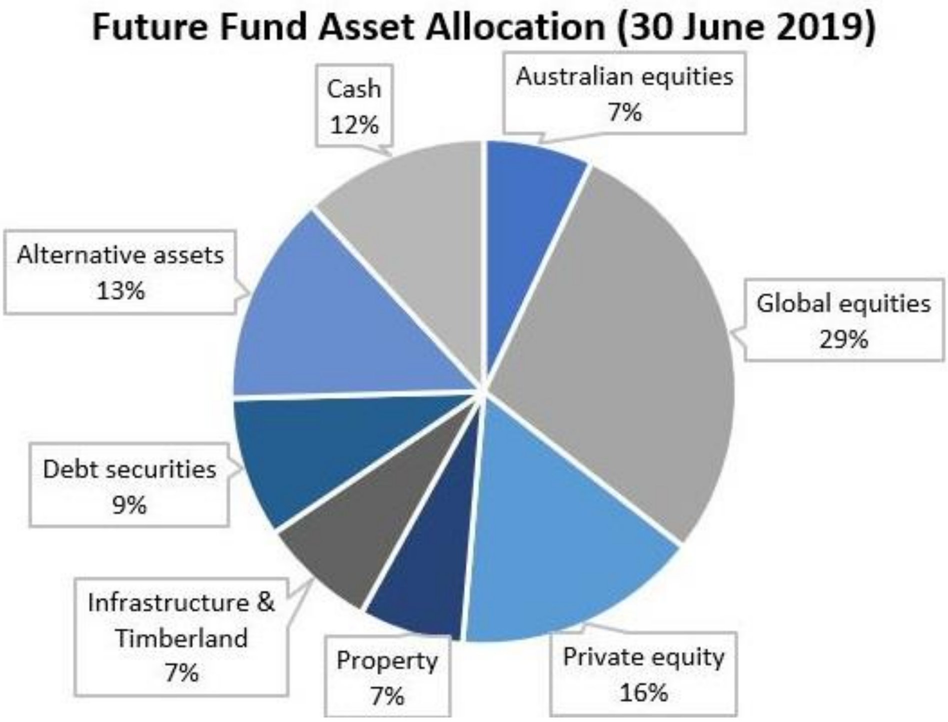
There is no fixed strategic asset allocation and therefore the portfolio is dynamic. In times of perceived favourable market conditions, the Fund is likely to increase allocations to riskier asset classes such as equities.

Asset allocation

The Future Fund's asset allocation reveals sizeable investments in private equity and real assets. As a long-term investor, private equity may help maximise returns by capturing an illiquidity premium and giving exposure to themes not available in liquid markets, such as disruptive companies or restructurings. Elsewhere, investments in infrastructure and timberland provide inflation protection and portfolio diversification. In fixed interest, the Fund has ventured into private debt, peer-to-peer lending, trade finance, bank capital instruments and distressed debt.

The Future Fund has historically employed a 'barbell' strategy, meaning there is a considerable allocation to cash but also a sizeable exposure to riskier strategies. Holding cash allows the fund to be opportunistic and buy cheaper assets in times of market corrections.

In stark contrast to SMSFs, the Fund has a much larger allocation to global equities (29%) than Australian equities (7%). The Future Fund's asset allocation as at 30 June 2019 was:



Alternative strategies (such as relative value or macro-directional 'hedge fund' techniques) give exposure to a diversified set of markets to provide uncorrelated income streams and help manage risk.

Performance over time

The Fund has consistently outperformed its benchmark target return of CPI + 4.5% to 5.5% pa until 30 June 2017 and CPI + 4% to 5% pa thereafter.

Table 1: Future Fund returns

Period to 30 June 2019	Return (% pa)	Target return[1] (% pa) (CPI + target return)	Volatility[2] (%)
From May 2006	8.2	6.7	4.1
10 years	10.4	6.5	3.7
Seven years	11.3	6.3	3.6
Five years	9.9	5.9	3.8
Three years	9.8	6.0	3.5
One year	11.5	5.6	4.4

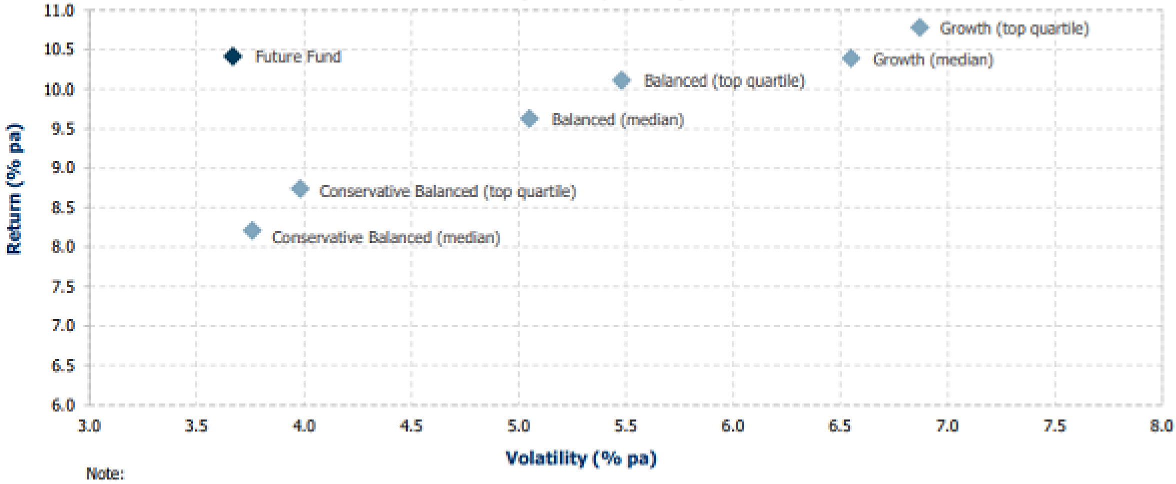
Source: Portfolio update at 30 June 2019, Future Fund

Risk and its measurement

It is in the measurement of risk that the Future Fund's numbers demand scrutiny. Measuring return against volatility, the best place in the following chart is the top left corner. Low volatility and high returns is ideal. The Future Fund claims it takes about half the risk of a median or top quartile growth fund with equal returns.

In fact, the Future Fund's Chief Investment Officer, Raphael Arndt, told *The Australian Financial Review*: *"The story is in the risk and not in the return."*

10-year risk and return Future Fund and superannuation options (tax adjusted)



Note:
1. Returns are net of all costs

Source: SuperRatings data grossed up to address the Future Fund's tax position using an estimate derived by the Future Fund

How does it make such good returns with less risk? Acting in its favour is the relatively high proportion of assets held in unlisted markets, which are not revalued as regularly as listed. Assets such as private equity (16% of portfolio), alternative assets (13%), and any unlisted property (7%) or infrastructure and timberland (7%) which are revalued less frequently than daily market movements create a perception of a lower level of price volatility. Eventually, however, there is no difference in the value of an airport or toll road whether it is listed or unlisted.

Sam Sicilia, Chief Investment Officer at Hostplus, tweeted (in his personal capacity) in response to the report:

"The problem is using volatility as a measure of risk. It is NOT. Unlisted assets cannot be valued frequently, so their Vol is mostly zero. Hence nonsensical use of Vol for those assets. But that's not a case against unlisted assets, it's a case against Vol as a risk metric."

Nevertheless, the results are impressive. They made some good calls with a more defensive stance early in the financial year then more aggressive into 2019. They allocated to hedge funds where the results are not dependent on market direction. Even the defensive assets such as long bonds performed well. Infrastructure and property delivered further strength on the back of falling bond rates. The Fund carries high exposure to an asset class that is difficult for smaller investors to both assess and access: private equity allocations, especially venture capital. Finally, global equity markets performed well. The Future Fund keeps its costs down in equities by using factor indexes rather than paying active fund managers whose style might simply be capturing a market 'factor', offsetting the high cost of its 'alternative' strategies.

The Fund does not reveal returns by asset class, but the amount in private equity inceased by about 24% over the last year, suggesting either strong returns or greater allocation, or perhaps both. Three former staff members have set up a private equity business called Potentum Partners, and they claim to have generated net returns over 10 years of 17% plus.

Lessons for individual investors

Of course, replicating past investment success with a similar asset allocation is no guarantee of future performance as the it might not perform as well. Even the Future Fund expects lower future returns from its strategy.

Nevertheless, the experience of the Future Fund offers investors valuable lessons in long-term investing.

1. Diversification is key

A diversified portfolio enables an investor to maximise returns for a given level of risk. Investing in a set of uncorrelated income streams can help to manage risk and make a prtfolio less 'volatile'.

The Future Fund thinks about its entire portfolio as one risk position. High cash holdings allow for market exposure elsewhere. Where credit risk is taken, it is quantified into an equivalent equity risk, while alternatives might have low expected correlation to equities. A heavy fall in one sector should not severely damage the portfolio, although obviously losses are possible. In extreme markets, correlations can rise quickly and there are few perfect hedges.

While it can be easy to find standalone investments which may be attractive, it is more difficult to construct a coordinated portfolio of individual bets.

2. Identify your competitive edge and exploit it

As a long-term investor with patient capital, the Future Fund can accept short-term market volatility and focus on identifying investments likely to perform well over the long run, such as private equity and infrastructure.

Retail investors with the right mindset can have competitive advantages of their own. For instance, they do not need to worry about the performance of benchmarks and peers and instead can focus on generating absolute returns within their own financial plan. A 50-year-old investor can plan for a 30- or 40-year investment horizon if they have the patience.

In reality, many retail investors panic when markets fall and cannot take advantage of a long-term horizon.

3. Cash provides optionality

While cash is typically the lowest-returning asset class, it gives the ability to take advantage of market dislocations or attractive opportunities as they arise. When markets are oversold, investors can opportunistically deploy capital at attractive prices.

4. Don't pay for something you can obtain cheaply

The Future Fund identified which of its asset managers were delivering what they call "lazy risk premia strategies such as momentum" and cancelled their mandates. That is, an active manager may be charging fees to deliver a return which is easily replicated in a 'smart beta' index for a much lower cost.

The main equivalent for a retail investor is an active manager charging 1% to hug the market index. This shows up in low tracking errors, where results always follow the market. It is now easy for any investor to replace such 'index huggers' with a cheap index fund or Exchange Traded Fund (ETF) in either listed or unlisted form.

5. Find non-traditional sources of return

Until recent years, it was difficult for retail investors to access alternative assets such as corporate bonds, securitisations, infrastructure, long/short funds and smart beta. The available range has dramatically expanded with hundreds of funds listed on the ASX, accessible in the same way as any listed share (except for mFunds which is an execution service for unlisted funds).

ASX Fund Segment	ETPs	mFund	LICs	AREITs	Infrastructure
Market Capitalisation	$50.59 bn	$937.17 m	$45.12 bn	$145.84 bn	$87.07 bn
Number Listed	198	219	114	47	7
No. Transactions/Day	6,356	71	5,115	120,587	48,866
Avg. Daily Volume	8,008,778	1,676,031	25,197,701	134,826,237	36,678,035
Avg. Daily Value	$207,018,803	$2,263,648	$39,169,493	$583,351,734	$255,161,089

For a large list of reports on ETFs and Listed Investment Companies (LICs) in many different guises, see our Education Centre on the menu bar of our website.

These two articles in Cuffelinks, for example, explain dozens of 'non-traditional' investments available to retail investors in listed markets:

- How to generate income without equity risk, linked here.
- Let's stop calling them 'bond proxies', linked here.

But a warning, dynamic asset allocation is tough

The Future Fund argues it can enhance returns by market timing and dynamic asset allocation. Even the best market professionals struggle to achieve this consistently, and retail investors are warned that switching investments in anticipation of market moves has brought many a strategy undone. Let's leave the final words to two investment legends:

Warren Buffett and his offsider, Charlie Munger

"Charlie and I spend no time thinking or talking about what the stock market is going to do, because we don't know. We are not operating on the basis of any kind of macro forecast about stocks. There's always a list of reasons why the country will have problems tomorrow."

Ray Dalio, Founder of Bridgewater Associates

"You should have a strategic asset allocation mix that assumes that you don't know what the future is going to hold."

Graham Hand is Managing Editor of Cuffelinks. Thanks to Wilbur Li for his research assistance. This article is general information and does not consider the circumstances of any investor.

Five reasons SMSFs are making asset allocation changes

Gemma Dale

The diversification challenges facing Australia's 600,000 SMSFs are well documented. Whichever data source you prefer, the vast majority of SMSFs are heavily overweight cash and Australian listed securities, and underweight fixed income and international equities.

To what extent does this reflect rational investor behaviour? Recent data from the nabtrade SMSF investor base suggests that while this allocation may have been well informed and intentional, it is starting to change.

The merit of a different asset allocation

Asset allocation is not a perfect science, and the argument for greater allocations to bonds and international shares is often made most vocally by those who happened to manage products and assets in those classes. That doesn't mean the argument is without merit. For some years it was also believed that the average asset allocation of the SMSF was leading to significant underperformance of SMSFs relative to institutional super funds, notably in the post GFC era.

Interestingly, 10-year data to 2016 suggests otherwise. SMSFs appear to have delivered returns of approximately 5.7% pa, while APRA funds delivered 5.3%. SMSF performance is estimated by the ATO, while APRA fund performance is reported by APRA. As the data sets are different and the formulae are also different (eg the ATO includes contributions tax and insurance premiums as expenses, while APRA does not), there is sufficient evidence to assume that SMSFs have at least not underperformed their professionally-managed peers after costs.

Minor variations in performance can deliver material benefits to the member when compounded over many years, making asset allocation important. To this end, the historical asset allocation of the average SMSF could be considered rational and even prescient.

Recently, however, some data sources suggest that SMSF trustees are choosing to increase their allocations to previously-unloved asset classes. It is difficult to identify shifts in asset allocation from the most comprehensive data source available, the ATO's SMSF Statistical Report, as it is based on the fund returns submitted at the end of each tax year. Once collated and published, this data can be two to three years old.

Funds flow data is much more up-to-date

Funds flows, however, can be far more contemporary. nabtrade data suggest that while SMSF trustees are still holding sizable cash balances and actively trading their preferred Australian equities, they are also choosing to deploy capital to diversify their portfolios into those sectors where they have traditionally been underweight. Generally, they are doing this using product structures that allow easy and cost-effective access to these assets, most notably Exchange Traded Funds (ETFs) or Exchange Traded products (ETPs) and to a lesser extent, the ASX's mFund service.

For example, the top five ETFs on nabtrade in the week ending 23 August 2019 were:

- BetaShares Active Australian Hybrids Fund (Managed Fund)
- BetaShares Australian Investment Grade Corporate Bond ETF
- BetaShares Australian Equities Strong Bear Hedge Fund
- VanEck Vectors Australian Corporate Bond Plus ETF
- Vanguard Australian Government Bond Index ETF

To put this in context, ETFs and ETPs comprised more than 10% of nabtrade trading volumes, so while investors were seeking to benefit from volatile conditions on the local market (largely due to volatile conditions on international markets), they were also seeking to avoid market volatility through listed credit products. nabtrade investors typically show a strong contrarian bent and buy their favoured stocks on weakness during periods of volatility; SMSFs are even more likely to exhibit this behaviour.

In the same week, investors bought the following mFund products:

- 4D Global Infrastructure Fund
- Legg Mason Western Asset Australian Bond Fund
- Platinum Global Fund
- Plato Australian Shares Income Fund - A Class
- Hyperion Global Growth Companies (Class B Units)
- Invesco Wholesale Senior Secured Income Fund
- Walter Scott Global Equity Fund – Unhedged
- Fidelity China Fund
- Antipodes Global Fund (Class P)
- Aberdeen Standard Diversified Fixed Income Fund

The majority of these flows have gone to international equities products, in addition to fixed income and infrastructure. It should be noted that while ETF and ETP flows are significantly greater than those to mFunds, SMSFs are the most significant buyers and holders of mFund products.

LIC challenges

While investors continue to hold them, Listed Investment Companies (LICs) are struggling, including substantial discounts between net tangible assets (NTA) and the security price for most managers. LICs are also dominated by products that invest in Australian equities, with fewer international and fixed income products than are available via the ETF and mFund markets. There is not the diversity now desired by SMSFs among LICs as offered by ETFs.

Many SMSF trustees explicitly believe that they are capable of managing their own Australian equity portfolios, and are only willing to pay for portfolio management (passive or active), in asset classes that are more difficult to access or where investors are less confident in their asset selection abilities. The market capitalisation of ETFs exceeded that of LICs for the first time last year, and flows indicate the divergence between the two product structures is likely to increase rather than narrow.

Five reasons for changing allocations

It can take some time for flows to influence the percentage asset allocation of the overall SMSF sector, given the nearly $700 billion invested. However, as SMSF trustees are increasingly comfortable with assets beyond cash and shares, possible reasons for this realignment are:

1. A shift away from cash as declining interest rates force investors to look for yield elsewhere.
2. An understanding of the benefits of diversification in reducing overall portfolio volatility.

3. Concerns about future returns from equities as market volatility increases and indicators of future economic performance deteriorate.
4. Greater availability of low cost and easily accessible products in other asset classes make them more attractive.
5. Product information and market insights are now far more widely available to the retail investor, helping inform portfolio decisions.

Previously SMSF trustees would generally have needed to access these assets via actively managed funds on a platform charging an asset-based administration fee of up to 0.77%, often via a financial planner. Now, they can access them via the ASX at a relatively low cost. Ultimately, the big shifts in asset allocation and their benefits remain to be seen over the long term.

Gemma Dale is Director of SMSF and Investor Behaviour at nabtrade, a sponsor of Firstlinks. This material has been prepared as general information only, without reference to your objectives, financial situation or needs. For more nabtrade insights or to open an account, visit the website. You can also access Gemma's weekly Your Wealth podcast on nabtrade, or via Apple podcasts, Spotify or Podbean.

For more articles and papers from nabtrade, please click here.

All's fair in love and super: why couples should equalise super

Craig Day

It is common for couples to have very different super balances. If one partner has taken time out to care for children, undertake casual work, or work part-time, the disparity can be pronounced. Super balances will also vary depending on the individual's age and salary.

But changes implemented by super reforms since 1 July 2017 have brought greater incentives for spouses to consider equalising their superannuation balances, including tax and estate planning benefits.

Some of the major changes

The transfer balance cap limits the total amount of superannuation that can be transferred from the accumulation phase to the tax-free retirement phase.

This cap starts at $1.6 million per individual. Any excess transfer balance amount must be removed from the retirement phase and will be subject to tax. Equalising super between spouses can therefore maximise the amount that can be invested in the tax-free retirement phase and the amount that can be kept in the tax-friendly super environment if one spouse were to die.

In addition, from July 2018, individuals with a total super balance less than $500,000 are allowed to carry forward unused concessional contributions (ie pre-tax super contributions) and 'catch them up' in later years.

This rule also creates an argument for equalising super between spouses, so both can potentially use the catch-up concessional contribution measure to maximize their retirement savings.

How to equalise super between spouses

A number of strategies can be used to equalise super balances between spouses, including regular spouse contributions, contributions splitting and recontribution strategy.

If a member's income is below $37,000, their spouse may receive a tax offset of up to $540 if they make a spouse contribution of up to $3,000 to their spouse's super each year. If the receiving spouse's income exceeds $37,000, the amount of the tax offset available starts phasing out and cuts out completely at $40,000.

Couples can also consider contributions splitting, which allows one member of a couple to roll over up to 85% of their concessional contributions made in a year to their spouse.

Another option for couples who have reached age 60 is a recontribution strategy. This involves withdrawing some super benefits from the account of the spouse with a higher balance, by starting a transition to retirement income stream or making a lump sum withdrawal (if a condition of release is met) and recontributing to the spouse's super account.

These withdrawn funds can then be contributed to the spouse's account either via a spouse contribution or a personal contribution (ie the spouse making a member contribution for themselves).

Either way, the contribution counts towards the receiving spouse's non-concessional contribution cap, which is $100,000 per year, or if the receiving spouse is under 65, the bring-forward cap of up to $300,000 may be available.

These strategies can be a useful way for couples to maximise the amount that can be held tax-free at retirement, which is $3.2 million in total. For members in the accumulation phase with a total super balance of less than $500,000, they can also help both members of a couple qualify to make catch-up concessional contributions to maximise their super savings in the lead to retirement.

The recontribution strategy can also be useful for estate planning purposes, as it potentially reduces the tax payable from death benefit proceeds. It may boost an older spouse's amount of age pension if the older spouse is the person with the higher balance where the younger spouse is under their qualifying age pension age and their super accumulation accounts are not assessed for social security purposes.

Other considerations

The new catch-up rule for concessional contributions will also increase the flexibility of salary sacrifice arrangements.

For example, if Anne receives $5,000 in employer superannuation contributions and does not make any additional pre-tax contributions, she will have $20,000 of unused concessional contributions left in the 2018-19 tax year. This can then be carried forward for up to five years.

For Australians who have been funneling income into other areas, like a mortgage, kids' education, or paying off personal debt, this new rule provides a welcome way to add more to super when they can afford to.

If both partners have low super balances, for example if both are self-employed, low income earners or recent immigrants to Australia, there may be no need to split contributions. But there are still strategies available to help with maximising super.

Those with income below $38,564 may consider taking advantage of the government co-contribution of up to $500 by making an after-tax member contribution of $1,000 if eligible. The cut-off threshold is $53,564. To qualify, the member must be under 71 and have personal exertion income (such as a salary) of over 10% of their total income.

The increase in the spouse income threshold from $10,800 to $37,000 for spouse contribution tax offset purposes also provides greater incentive for partners to make super contributions on behalf of a low-income spouse. The contributing spouse can potentially claim a tax offset up to $540 per year by making super contributions on behalf of a low-income partner.

Concluding observations

Members of a couple equalising their super balances can bring tax benefits, help with estate planning and boost the retirement nest egg of a partner with minimal retirement savings.

While couples may be concerned about the impact of equalising super in the event of divorce, as super is considered a divisible asset under Australian Family Law, there should be little impact.

There are, however, other risks to consider, such as ensuring no caps are breached and that members meet the conditions required for each strategy.

Given the number of potential strategies on offer and the complexity of some of these, we recommend that anyone who is considering ways to boost their super should seek financial advice.

Craig Day is an Executive Manager at Colonial First State. This article is for general information only and readers should seek professional advice on their personal circumstances before taking action.

Four companies riding the healthcare boom

Mike Murray

Healthcare is a sector with plenty of tailwinds. This article identifies four companies that stand to benefit from demographic and economic trends while also providing a social good.

Three major trends to follow

Three major trends are underway that are positive for companies operating in the healthcare sector:

1. The ageing of the population means more money is being spent more on healthcare.
2. Rising living standards cause people to preference healthcare spending over other consumer goods.
3. Technology improvements create additional opportunities.

Along with these trends, healthcare is a sector that aligns well with our core beliefs as an ethical funds management business. Healthcare technologies have made phenomemal advances that enable people to live longer, healthier lives. But that doesn't mean we will invest in any healthcare company. Alongside our disciplined investment criteria we are also guided by the Australian Ethical Charter. For example, we have strict restrictions when it comes to medical testing using animals and we require biotech companies to conduct their research responsibly.

These ethical considerations and economic tailwinds combine to make healthcare a significant part of our Australian Shares Fund at approximately 15-20%. We try not to pay too much attention to macro factors or the index when we think about stocks, and we invest in smaller sized companies which often have a longer pathway of growth.

The healthcare companies we invest in are involved in a range of activities including pharmacy, insurance, radiology, medical devices and different sorts of pharmaceuticals.

Here are four examples of healthcare stocks we hold in our Australian Shares Fund.

Fisher & Paykel Healthcare

Fisher & Paykel is generally associated with household appliances, but it also has a healthcare division which was spun out in 2001. We've been invested in Fisher & Paykel Healthcare for around 10 years and it's a great example of a company that's managed to reinvent itself several times.

The big discovery for Fisher & Paykel Healthcare was that humidifying air used for breathing during intensive care (ie, emergency situations) improves patient outcomes. They've managed to take that core technology into non-invasive ventilation, sleep apnea and some surgical procedures. Their big growth focus currently is re-shaping the delivery of oxygen therapy with their 'Nasal High Flow' solution which is used in the care of infants and children.

These products have delivered handsome rewards to investors who have been attracted to Fisher & Paykel's high-margin recurring consumable earnings. As the stock has appreciated we've adjusted our position size down, but they still appear reasonably valued against some higher rated sector peers.

Healius

Healius was formerly known as Primary Health Care. It has been a long-term share market underperformer in which we have recently accumulated a position. Their core diagnostic and medical centre assets are potentially strategically valuable despite their operational struggles, and there has been public speculation about corporate activity in the stock. More importantly, we believe earnings have stabilised following a period of decline and the regulatory environment is benign. The company's balance sheet has improved following a capital raising and the accounting practices of the company have become more conservative through time. Valuation metrics look appealing in the context of the sector.

Capitol Health

Capitol Health is a diagnostic imaging business. This was more of an opportunistic investment for us because it was a company going through quite a lot of problems when we first invested. Like many companies that make lots of acquisitions, it ran into problems after it grew too quickly and took on too much debt. We participated in the recapitalisation of the business at a share price of 14 cents as part of the company's plan to take out costs and reduce debt.

That strategy played out well with a few ups and downs along the way. The company's balance sheet received a major boost with the sale of its NSW assets at an attractive price. Capitol Health remains in our portfolio and trades at a reasonable earnings multiple. It's also within an industry that may present further opportunities for consolidation down the track.

Cyclopharm

Finally, Cyclopharm is a smaller emerging healthcare technology player that represents a small position in our portfolio. It's an early-stage company that actually has revenue and pays a dividend, which is somewhat unique for the sector.

Cyclopharm has a lung-imaging solution for patients who are suspected of having pulmonary embolism but who are unable to have CT scans. The company has developed a gas that's inhaled in a process called ventilation-perfusion. And they've actually commercialised this technology already. It's distributed in 55 countries and has been written up in guidelines as a highly-efficacious technology in that space.

The real opportunity here is that the major market in the world where this technology has yet to be approved is the US. It's currently going through a clinical trial in the US which has taken longer than expected. But this trial is once more advancing and we're quite excited about the opportunity it represents for us as investors and for the patients who stand to benefit.

Mike Murray is an Analyst at Australian Ethical, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

For more articles and papers from Australian Ethical, including Graham Hand's interview with AE's Managing Director, Phil Vernon, please click here.

Using equities to generate reliable yield

Michael Price

Regular equity income can help manage longevity risk and inflation but finding quality income in equities is not as simple as it seems.

Investors in the later stages of their accumulation phase, approaching retirement and in retirement can benefit from the use of equities as part of their overall income plan. With a rolling 10-year dividend yield of 4.2% (*Source: S&P Dow Jones, S&P/ASX200*), Australian equities can provide a vastly more attractive income than many alternatives.

Investors face two major risks that impact how much they have to fund retirement, and how long this will last: longevity risk and the risk of inflation. In simple terms, longevity risk is the risk of outliving your money. Inflation risk is the risk that rising costs (such as healthcare) reduce the purchasing power of your money each year. An equities approach to income can help outpace those rising costs and provide long-term capital appreciation to help replenish funds.

Why does active dividend income investing work?

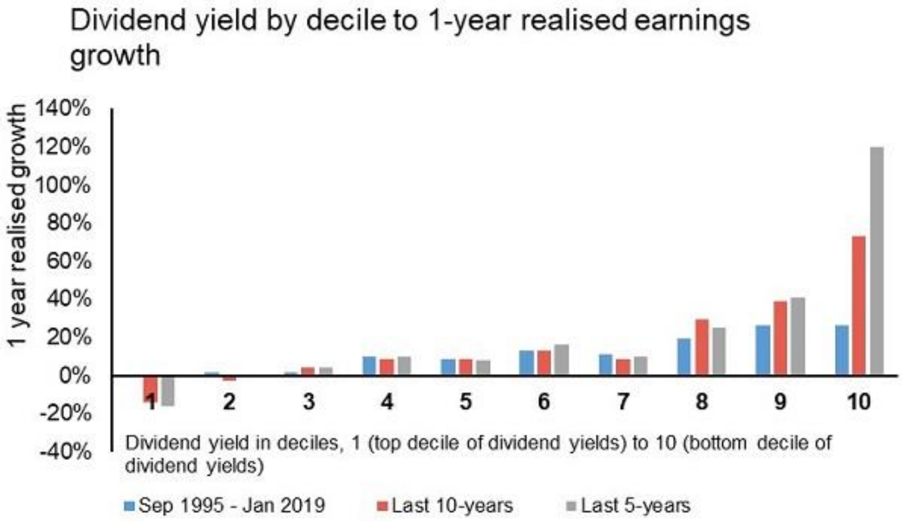
An active dividend investment approach can add value to a portfolio and generate outperformance through investing in quality companies with strong dividends and dividend growth. The focus is on companies with sustainable earnings growth, maximising the benefits available through the tax and imputation system and tactical allocation to capture a greater share of dividend income.

Markets are efficient, but not perfect. The first and most fundamental reason that an active approach to income investing works is the fact that the market is relatively inefficient, particularly in the short term. However, some inefficiencies can be traps.

The risk of chasing yield for yield's sake

Many income investors assume the relationship of current dividend yield to future earnings growth is linear, that is, the higher the dividend yield, the higher the future earnings growth from which dividends are paid. This assumption does not actually hold in the market.

Figure 1: The highest dividend yields do not equate with earnings growth the year ahead



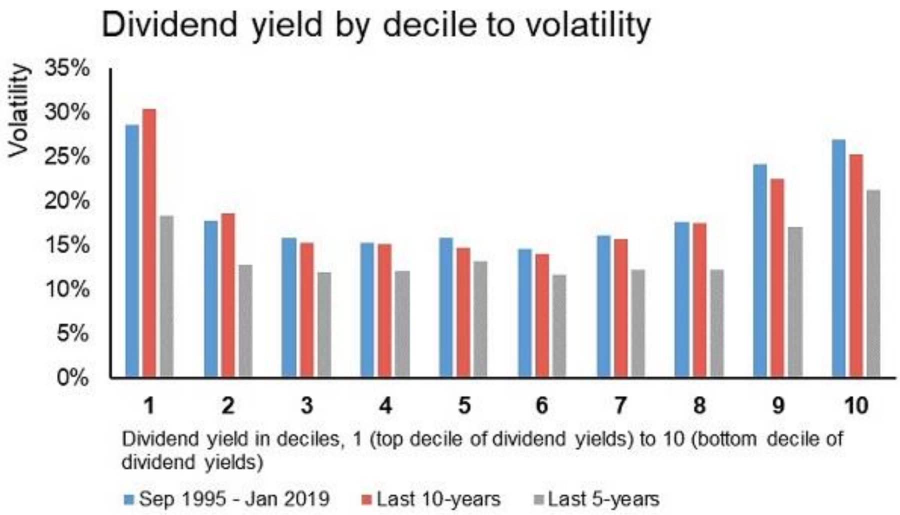
Source: Ausbil, Macquarie Equities.

On average, the top dividend yield companies actually see low, or even negative, earnings growth going forward compared to companies in the 4th to 7th decile of companies, as illustrated in Figure 1. This has been true for the last 20 years.

An active approach does more than simply chase the highest yield, as would a passive approach to yield. An active dividend income strategy can increase income from companies whose dividends are healthy, but maybe not the highest, because they are also investing earnings into a growing business, hence into better earnings growth in the year ahead.

Another quirk of dividend investing is that the highest yielding stocks are more volatile, as illustrated in Figure 2.

Figure 2: The highest dividend payers are also the most volatile

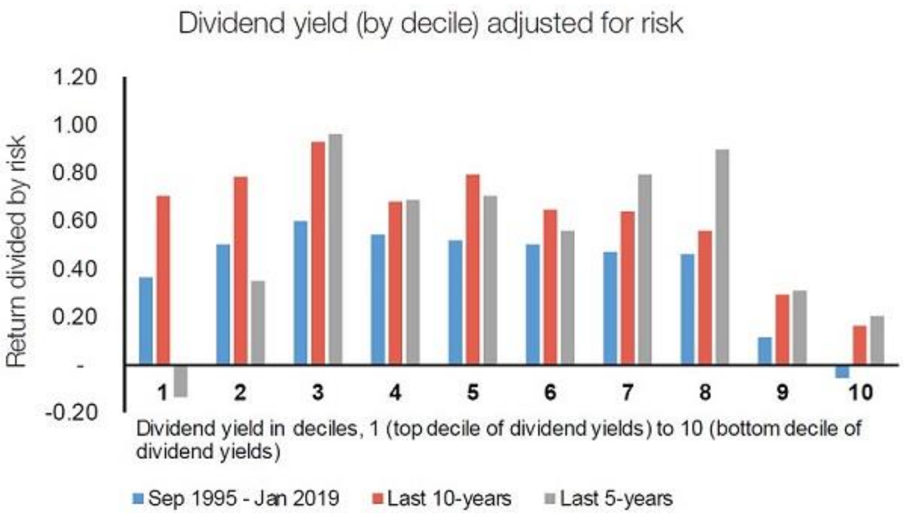


Source: Ausbil, Macquarie Equities

Top decile dividend yielding companies tend to show higher volatility in returns, on average. An active approach seeks to reduce portfolio return volatility by not chasing yield for yield's sake.

Finally, top dividend paying securities may not be good value-for-risk, as illustrated in Figure 3.

Figure 3: Top dividend paying securities may not be good value-for-risk

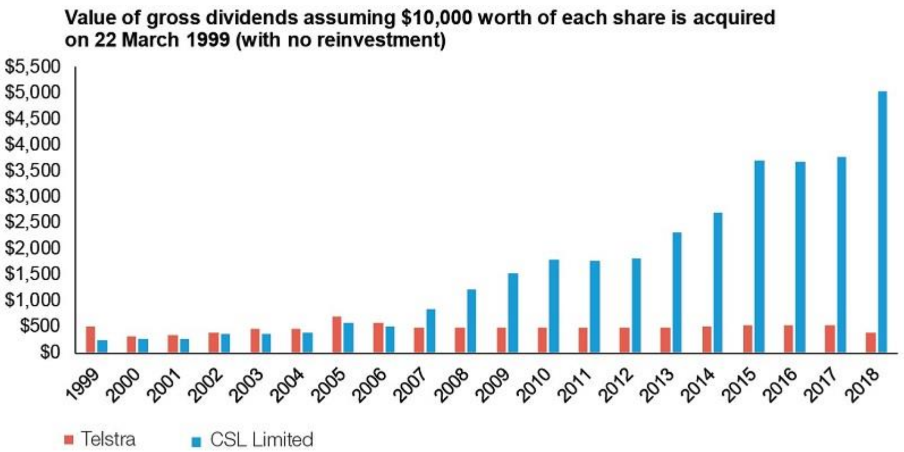


Source: Ausbil. Macquarie Equities

Chasing the highest dividend yield companies can provide poor value for risk taken when compared to the market. Lower decile stocks by dividend yield demonstrate a better performance for risk than for the top decile of dividend yield companies.

High dividend payout ratios may also be indicative of a lack of equity reinvestment opportunities for a company into growing its own business. A company with a sustainable dividend profile usually seeks to reinvest some earnings into their business, into positive return projects that can generate earnings growth in the future. A classic example of a high dividend paying company compared to a company which has reinvested some earnings into productive opportunities for reinvestment is the difference between Telstra and CSL.

Figure 4: The dividend journeys of two different companies



Source: Ausbil

It's not only about dividend yield

Telstra was long considered a key dividend paying stock but the burden of being the largest telco, legacy systems and infrastructure cost, rapid change and limits to growth have seen Telstra lose its status. By contrast, CSL has steadily transformed itself from also being government owned, as the Commonwealth Serum Laboratories, into a global leader in biotechnology. It has balanced the payment of dividends with significant reinvestment into areas that can generate future growth in earnings, as illustrated in figure 4. Of course, these relationships may change over time, but it can take a long time for a company to change its course.

Astute active dividend income approaches can seek dividend yield while avoiding companies with no opportunity to reinvest to improve earnings and returns. With active dividend income approaches, investors like SMSFs, retirees and investors approaching retirement can diversify away from traditional sources of income, like fixed income and term deposits, for a longer-term approach, diversified across high-quality Australian companies. They can do this in equities without sacrificing the potential for long-term growth.

Michael Price is Portfolio Manager of the Ausbil Active Dividend Fund at [Ausbil Investment Management](). This report contains general information only and the information provided does not constitute financial product advice. It does not take account of your individual objectives, financial situation or needs.

Why August company reporting season was poor

Ashley Owen

In Australia, most listed companies have financial years ending in June and they report their full year results in August. Some companies have December years and they report their half year results to June in August. There are also a small number of companies with financial years ending in other months – like September (notably ANZ, NAB, Westpac), March (notably Macquarie), July or February, and so their results are not included in the August reporting season wrap-up.

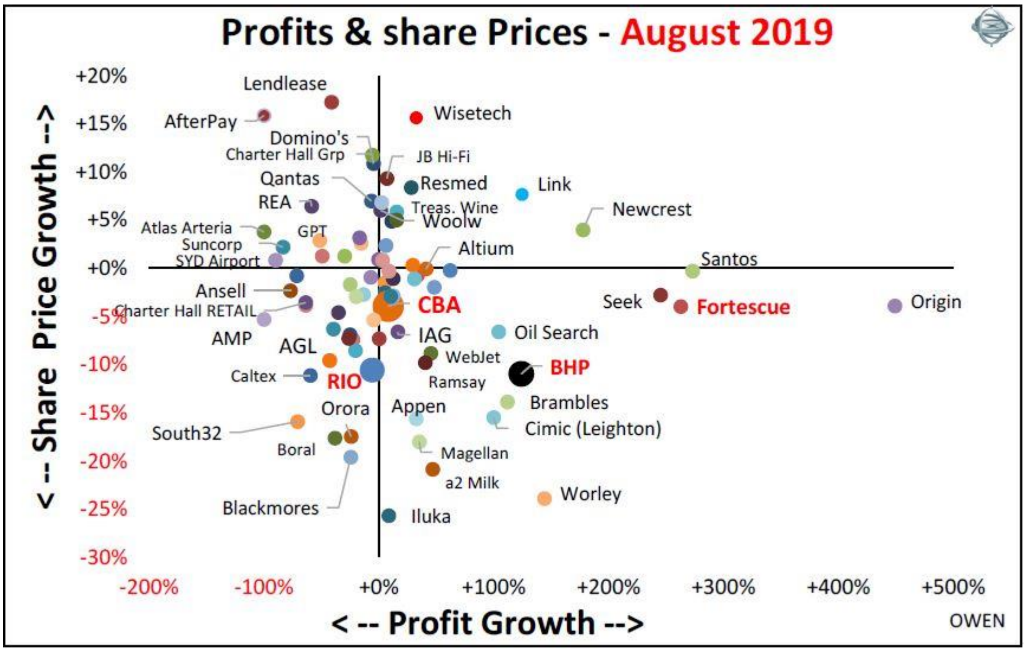
The overall results were poor

Across the 90 companies that reported out of the top 100, aggregate sales revenues grew by 4.6% over the same period last year, from $500 billion to $523 billion. This is no better than the aggregate growth in the local economy (nominal national income).

Aggregate reported profits grew by just +2.5% from $57 billion to $58 billion (excluding Wesfarmer's $3.3 billion one-off gains from its sales of Coles and three other subsidiaries during the year, and also excluding Woolworths $1.2 billion gain from the sale of petrol stations). If we also exclude the profit growth from the commodities producers driven by windfall global commodities prices, profits for the rest of the market actually fell by 15%.

The main culprits were AMP, Telstra, Suncorp, Crown Casino, Bendigo Bank, Challenger, Ansell, Blackmores, Transurban, Sydney Airport, Aurizon, Qantas, REA, Bluescope, Orora, AfterPay and most of the property trusts. There is always a lot of fiddling and fudging that goes on in profit reports and this year was no exception!

How did the results announcements affect share prices? The first chart shows the results for these 90 companies, with share price growth for August (vertical axis) versus profit growth reported based on full year results for companies with June financial years and half year results for companies with December years (horizontal axis).



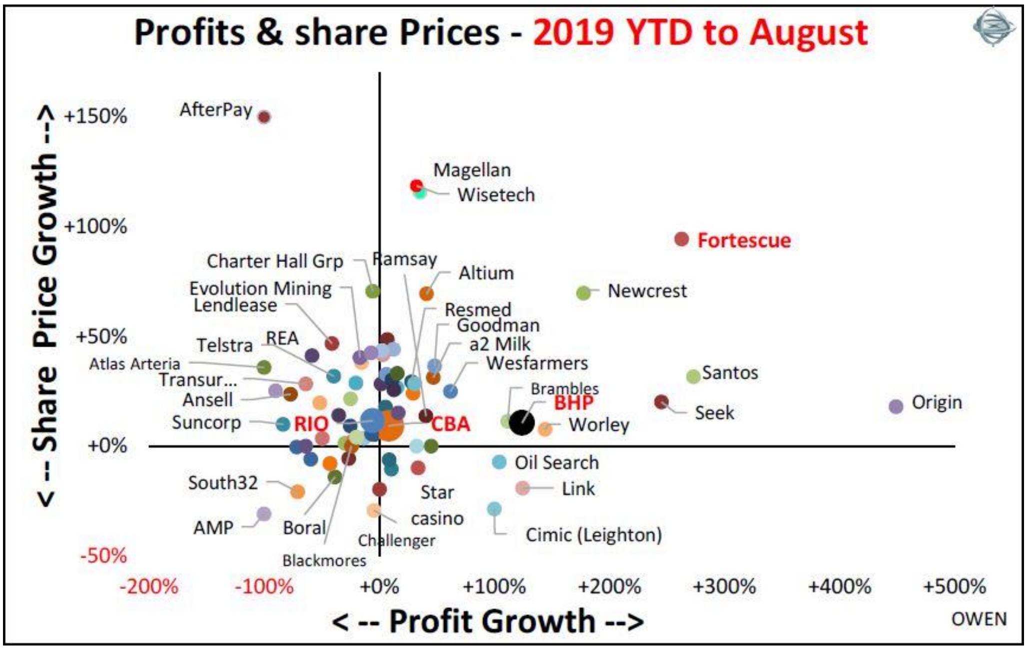
No short-term relationship share prices and profit growth

The chart illustrates that there is no relationship between profit growth and share price growth over short periods because share prices are driven largely by global sentiment. In August, share markets everywhere were hit by Trump's escalation of his trade wars, currency wars and his criticisms of Fed Chair Jay Powell.

Several companies posted high profit growth, but their share prices fell (lower right segment of the chart) – including Origin, Fortescue, Seek, Worley, BHP, Oil Search, Brambles, Cimic (Leighton), Appen, a2 Milk, Link, Magellan and a host of others. Conversely, many posted profit declines but their share prices rose (upper left segment) –including LendLease, REA, Afterpay, Evolution Mining (gold), Crown Casino, GPT, Suncorp, Qantas and many others.

Aside from macro issues driving share prices, the other main issue is that profits are backward-looking but share prices are forward looking. For example, iron ore producers RIO, BHP and Fortescue booked windfall profits from the iron ore surge this year after the mine closures in Brazil reduced global supply, but their share prices were hit when iron ore prices fell back 20% in August. A similar pattern in the oil price affected Origin, Santos, Oil Search, Worley and BHP – oil prices surged 29% from January to July but fell back 6% in August.

Of course, one month is not a sufficiently long period to assess share price growth and profits, so the second chart shows the same profit growth reported per company, but this time compared to the total share price gains so far in calendar 2019 on the vertical axis.



Again, we see that there has been no relationship between profit growth and share prices this year.

Half of the companies posted profit declines (left half of the chart) but the vast majority of share prices have still risen this year (top half of the chart). It was once again due to global macro issues, with share markets everywhere rebounding in 2019 from the late 2018 global sell-off.

Other factors in play

The main driver has been the Fed's switch from rate cuts last year to rate cuts this year and moves from other central banks toward more monetary stimulus –including two more rate cuts from the RBA. The sugar hits from more stimulus has overcome the negative effects of Trump's trade wars and their possible impact on slowing economic growth – so far at least.

Another global factor at work has been the decline in bond yields everywhere, which have lifted share prices despite falling profits (upper left segment) in many of the 'bond proxy' companies that are often perceived to have relatively 'safe' dividends –Telstra, Transurban and the property trusts. (However, just ask any long-suffering Telstra shareholder how 'safe' their dividends have been in recent years!).

Aside from the commodity stocks (which rise and fall with global commodities prices over which they have no control), the upper right segment of the second chart does highlight some local companies that have real value-adding businesses with rising profits being rewarded with above-market share price rises – including Seek, Magellan, Wisetech, Altium, a2 Milk, Goodman, JB Hi-Fi, Ramsay, ResMed, Cochlear and CSL.

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My 10 biggest investment management lessons

Chris Cuffe

Editor's introduction. There are valuable lessons to learn from Chris Cuffe's experience with the Third Link Growth Fund. The Fund's managers are selected by Chris in a 'fund of funds' structure, and all fees paid by investors go to charities. In addition, he sits on the boards of several Listed Investment Companies and is an adviser to family offices.

This is a selected Classic Article first published in 2015, with some changes to bring it up-to-date.

After decades of managing investments and selecting funds, here are my 10 biggest lessons.

1. Most financial services are sold not bought

In commerce generally, the consumer finds the best products in the market, especially with such an open system as the internet. But financial services is an industry where products are sold not bought. There are a lot of middle men and women doing the selling. People struggle to find the best products in the world of investing.

If a fund does not have active sellers and marketers, it doesn't get much support. Listed Investment Companies (LICs) have broker networks that work their clients intensely in the offer period, while dealer groups have advisers who tell their clients where to invest.

We're not really long into the post-FOFA environment where financial advisers are no longer paid commissions by product manufacturers, but I don't think advisers scour the earth looking for the best products. They have to do the right thing by their clients, but that does not mean finding the very best. It's more what's on their radar screens.

2. Joe Average doesn't have a clue where to invest

In financial services, with most aspects of investing, Joe Average does not have a clue where to start to find the best products. To DIY in financial services is tough for the average person. I can DIY in my back yard by going to the hardware store, working out how to pave a path or tile a wall, but you can't do that easily in financial services.

3. Don't pay active fees for index management

It's astounding in Australia the number of managers who won't risk being too different from the index. If they underperform for a short period due to departure from the index, they worry they will lose funds (and maybe their job will go as well). If resources and banks are not doing well, a fund with managers that are index unaware should do well.

I listened to an active Australian equity manager tell me how proud he was of being index-unaware, yet his exposure to financials was 27%, not the 30% per the index. This is not an active position at all and he is surely being driven by the index. I would think that a position of half or double or nil is more like an active view.

The best investors I deal with are totally benchmark unaware, even as to what markets they invest into, local or overseas or cash or whatever.

4. Blending styles is a waste of effort

In my view, professionals blend managers in multi manager funds in exactly the way that gives a mediocre result. Typically, they will blend value managers, growth managers, large managers, small managers, etc and then wonder why they achieve the index less their fee. The results of these blended funds have never been great.

I am not the slightest bit interested in blending styles and so some people are put off Third Link because there is no formal scientific process. My process is called experience – one of finding competent, proven managers who will swing the bat and have a go. I do watch for concentration risk but I'm mainly interested in the willingness of managers to pick stocks ignoring the index. In fact, I like to see a high tracking error which is the opposite of most professionals.

5. Past performance is the best guide to future success

Every offer document in the country says something like 'Past performance is no guide to future performance' or similar. That is exactly the opposite of how I think. It's the best guide to knowing what a manager is really like over a long period. Past performance is extremely important and a great guide to the future.

Only long-term results are relevant. The managers I use are selected for the long term. I have no interest in their short-term results. If it looks like a manager is struggling (which I would only conclude after rolling three-year periods), I would only exit after say a poor rolling five-year result.

6. Never buy a bad stock because the price is low

I don't like 'deep value' investing where a manager is willing to buy a poor quality stock because the price is so cheap. I don't like people saying a bad stock priced cheap is low risk. I would hate to see any of the stocks held by my managers fall over.

Managers need to buy quality stocks. Adding that to a good track record and a high tracking error should mean my fund will do well in falling markets (which it does) which is a sign of a good portfolio.

7. Watch the level of funds under management

I do look at total funds under management in a manager and the types of stocks the manager buys. A small cap manager in Australia with more than $1 billion concerns me. And I am cautious about investing with a larger cap manager in Australian equities with more than say $6 billion under management. At that level, I need more convincing. It's less of a problem for a global large cap manager operating in a massive universe of stocks.

Size can get in the way of performance. It's no coincidence that most of my managers have performance fees, which enable them to remain smaller while making it economically viable to run their business.

Most managers talk about staying below capacity and refusing to take in more money but my experience is most don't do that, especially when there's an institutional owner. It's compelling to take more money. Boutiques are best at watching capacity as they can make a lot of money from performance fees if they are good.

8. Don't be afraid of performance fees

I believe managers deserve their high fees based on their performance. In my own personal investment portfolio, I don't care about paying a 20% performance fee (as long as the right hurdle exists) if I'm getting 80%.

It's a great part of the Third Link structure that the managers kindly refund all the performance fees, as well as the management fees. It's the sizzle in the Fund. For most professionals who provide a fund-of-fund product, the underlying fee of each manager is so crucial for their own economics that they cannot pay performance fees. But I'm agnostic to fees so I just look for the best managers.

I have not selected any of the managers based on their willingness to forgo their fees. I select on merit then ask if they will waive their fees.

9. Active versus passive depends on the asset class

The active versus passive debate is not a one-size-fits-all. It should be considered in the context of the asset class. In Australian equities, I'd never invest in a passive fund. You have to look at the index before you go passive. Why would you buy an index which is 30% in banks (mainly four stocks) and 15% in resources (mainly two companies)? Talk about a risky portfolio! It amazes me people would start with that. But internationally, say the MSCI World Index, index investing has merit. In Aussie small caps, you could invest in an index fund but I think there is no upside in having small resources because of their boom and bust track record. And I think the active managers of small cap industrials generally do better than the industrials index because they can find small under-researched stocks. But there's nothing wrong with indexing in parts of the fixed interest asset class.

I hope some of the roboadvice models use active management, especially in Australian equities, but I suspect they are unlikely to do so due to the cost.

10. Business risk guides a lot of investing

The lack of willingness to be different from a benchmark has a lot to answer for in encouraging mediocre investing across the world. The dominance of these behaviours is far greater than anyone will admit. It drives many professionals to bizarre investing.

I don't have any business risk or career risk in selecting my managers. Third Link is not a business and I'm running only one fund.

Chris Cuffe has a wide portfolio of interests across commercial, social and charitable sectors. More details on the Third Link Growth Fund are on www.thirdlink.com.au. How can we have a disclaimer after such firm opinions? Let's just say anyone should seek professional advice on how these lessons apply to them, as the circumstances for each investor are unique.