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## Seven major trends affecting Australians in retirement

Anthony Asher, David Knox, Michael Rice

In designing a system that will be robust in the face of social, economic or demographic changes, it is useful to note major trends that will affect Australians in retirement. A sound system will be dynamic and require change from time to time.

This paper notes seven currently identifiable trends.

### 1. The loss of long-term confidence and trust

The provision of retirement income through superannuation savings is a long-term venture over decades.

Unfortunately, the process and findings of the recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry have undermined long-term confidence and trust in institutions operating in the retirement income system.

The frequent changes to superannuation taxation and age pension structures and rules over the last 36 years have increased complexity and worked against providing confidence and trust to Australians to plan for their retirement.

This paper is advocating consideration of further changes, but as a move to improvement, we also advocate more stability and fewer changes in future.

### 2. Reducing home ownership

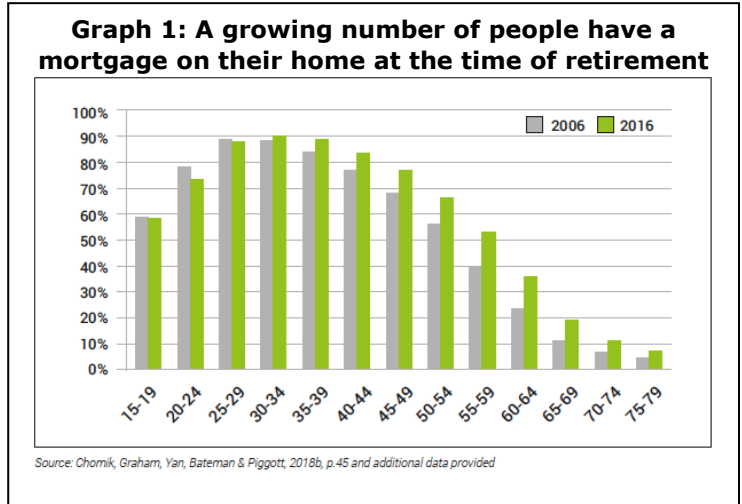
A system of integrated retirement provision needs to adapt to the changing pattern of home ownership.

There is an impending wave of retirees who will enter retirement as renters because home ownership has remained elusive. This higher proportion of renters is likely to persist across future generations unless housing affordability improves considerably. The needs of retirees who rent are very different from those who own a home given the vast difference in regular expenses on basic needs. Single pensioners who rent in the private market are poorly served by current arrangements. In fact, the ARC Centre of Excellence in Population Ageing Research (CEPAR) states 60-70% of older single people who rent private housing live in poverty.

Those retirees who own their home are in a more advantageous position than those in previous decades. Due to the long-term growth in property prices, the value of the home has far outgrown the value of many other assets. This provides a higher level of absolute wealth for retirees, but it is illiquid. This can be a dilemma for retirees, particularly those with limited other savings. Many may not wish to 'right size' to gain access to liquid savings because there is no suitable housing in their area.

In addition, some will also need to consider possible reduction in age pension eligibility and other government support. Furthermore, those retirees who own their own home increasingly do so with a mortgage at the time of retirement. This proportion has been increasing over time, from 23% in 2006 to 36% in 2016 for those aged 60-64 years, and even higher rates for those in the younger age group, as shown in Graph 1.

It seems reasonable to expect a growing number of Australian retirees will use part of their superannuation balances at retirement to pay off their mortgage. These trends will likely only reverse if there are significant changes to housing affordability. As a result, while superannuation will be an increasing proportion of people's wealth in future cohorts, it is likely there will be a need in some households for it to serve purposes other than provide an income in retirement – it will also need to extinguish debts on retirement (or service them during retirement).

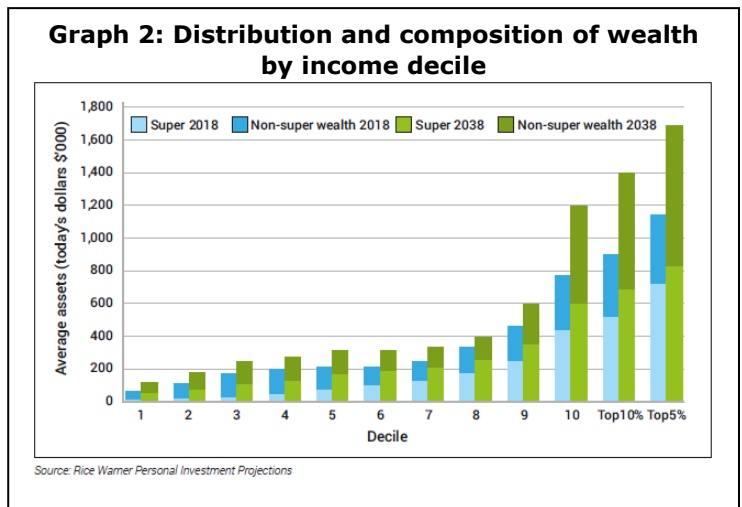


### 3. Growing dispersion in super and non-super wealth

The highest income deciles in our society tend to hold much more in non-superannuation assets than the general population. Graph 2 demonstrates this distribution both today and in 20 years' time based on projections from Rice Warner.

The results show that the top decile hold more than 2.5 times the fifth decile in non-super wealth today. This disparity is expected to increase to five times in 2038.

Overall wealth that includes superannuation savings will not see as large a growth in disparity, as those on middle incomes are largely expected to substitute some private savings/consumption for superannuation as the compulsory rate of superannuation contributions rises to 12%.



Most of this non-superannuation wealth is held either in investment properties or term deposits, so it will often provide regular income in retirement.

### 4. Changing life and health expectancy

Life expectancy, both as measured from birth and at retirement, has continued to improve. Therefore, the expected number of years retirees need to fund is growing. For those aged 60 to 90 years, mortality rates have been on a rapidly-improving trend since the 1970s (i.e. death rates have decreased) due to medical advances. That said, mortality rates for those aged 90 years and over have deteriorated (death rates have increased). The Australian Government Actuary has noted the improvements in mortality for 60-90-year ages have led to an increasing proportion of the population living to the older years which may have contributed to the decline in average health of the older age group.

The healthy life expectancy (that is the years lived free of a disability or a severe or profound core activity limitation) has also been increasing. The effect is that a greater proportion of the population should expect to live well into their mid to late 80s or beyond.

However, there is also [evidence](#) in several developed economies that the increased life expectancy may have slowed or even stalled. This result may be caused by several reasons, including an increasing difference in life expectancy between different socio-economic classes.

A natural consequence of a growing dispersion in wealth is a growing diversity in health outcomes, including for life expectancies.

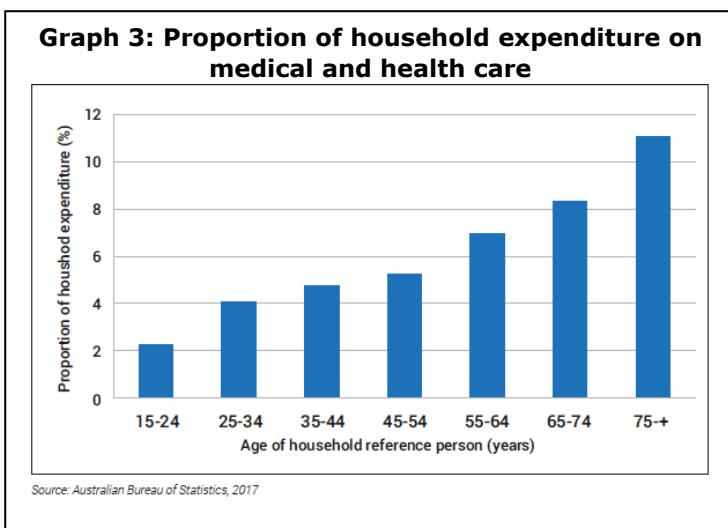
### 5. Growing health and aged care costs

An integrated system needs to cater for the likely significant growth in health and aged care costs. These costs are growing in real terms (i.e. faster than inflation and conservative investment returns) because of higher standards of care (increasing per unit cost) and the larger number of older people from increased life expectancy and the baby-boomer generation. CEPAR reports estimate that public spending on aged care will rise from 1% of Gross Domestic Product (GDP) to over 2% by 2050.

Longer term projections show aged care is the second fastest growth category of expenditure (behind the National Disability Insurance Scheme). For aged care, the Commonwealth government meets around three-quarters of total costs and individuals meet less than one-quarter. Furthermore, aged care providers may ask for (but no longer demand) significant lump sum payments by individuals if residential care is required. Meeting these costs may require release of equity from the family home.

Given life expectancy improvements, the lifetime risk of needing to enter permanent residential aged care is increasing. Most recently (in 2014), for a person aged 65 this risk has been estimated at 42.8% for men and 59.3% for women (up from 33.5% and 53.8% respectively in 2000). These percentages are likely to increase with ongoing mortality improvements.

For medical and health care costs, government meets nearly 70% of total costs across the whole population, health insurers meet nearly 10% of total costs, and individuals (net of private health insurance refunds) meet nearly 20% of total costs. Significantly, the proportion of household expenditure net of any government rebates or health insurance refunds, steadily increases on these items with age (Graph 3).



### 6. Changing work patterns

Work patterns, which have become more variable, also need to be supported by an integrated system of retirement provision. Women have increased their participation in the workforce at all ages, including returning to work after having children. Part-time employment across the whole population has doubled from 16% of the workforce to 32% over the last 40 years [Australian Bureau of Statistics, 2019a]. Potentially, if the 'gig economy' continues to grow, this development will further contribute to greater variability of work patterns and lower superannuation contributions for many gig workers. Job security also appears to have reduced for both full and part-time workers in the past ten years.

Many older workers are increasingly choosing to work longer with transition to retirement by engaging in part-time work. Australia's part-time employment share of over-55s has more than tripled from just under 10% to 34% over the last 40 years.

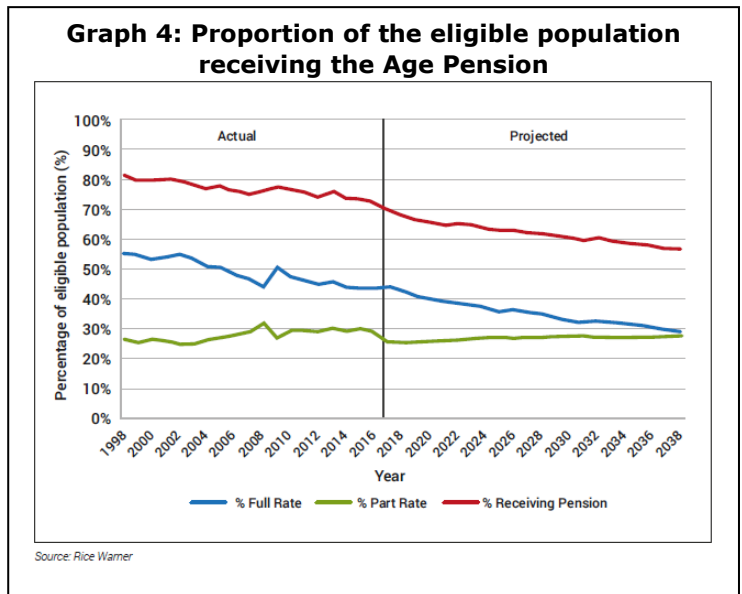
Greater variability in work, and therefore income, affects people's capacity to accumulate savings for retirement and how they begin the pension phase if they choose to transition to retirement by working part-time. In the case of those transitioning to retirement, they also need to navigate the interaction of superannuation and Age Pension systems.

## 7. Decreasing age pension dependency

Over coming decades, a smaller proportion of the aged population is expected to receive the age pension as income support. Through a combination of the maturing superannuation system (with people accumulating more superannuation assets over their life), the transition to an increasing age pension eligibility age and recent changes to age pension means tests, the projected proportion of the eligible population receiving the age pension will fall.

Graph 4 shows the proportion receiving a full age pension has reduced significantly over the last 20 years. The number of retirees not receiving any pension has also grown.

It also shows that the proportion of the eligible population receiving the age pension is projected to continue to fall from around 68% in 2018 to around 57% in 2038 assuming the SG increases to 12% as legislated. This fall is comprised of a significant fall in the proportion of the eligible population receiving the full rate of age pension (from 42% in 2018 to 29% in 2038) and a relatively smaller increase in the proportion of the population receiving a part-rate Age Pension (from around 25% in 2018 to 28% in 2038).



### Retirement planning is essential

One consequence of these trends is that more retirees will face greater complexity in retirement planning because they will be subject to the complex means tests. Another consequence is more retirees may therefore be very deliberate in how they structure their financial affairs to ensure they maximise their age pension entitlement, because the opportunity cost of not doing so is potentially high.

For a full copy of the Actuaries Institute's 'Options for an Improved and Integrated System of Retirement', Green Paper, August 2019, [click here](#).

The article above is an extract from Section 3, written by Anthony Asher (University of NSW), David Knox (Mercer) and Michael Rice (Rice Warner). It draws on three papers presented at the Actuaries Financial Services Forum in May 2018, namely:

- *The Age Pension means test: contorting Australian retirement (Dr Anthony Asher & John De Ravin)*
- *Retirement Incomes – Australia vs the Rest of the World (Dr David Knox)*
- *The Age Pension in the 21st Century (Michael Rice)*

## FoFA, the Failure of Financial Advice, Part 2

Graham Hand

(Substantial parts of this article were published last week. We are running it again with feedback from Adam Curtis of Perpetual, plus readers may have missed the insights from many financial advisers in the comments section).

The Future of Financial Advice, or FoFA, reforms came into effect on 1 July 2013. They imposed a ban on conflicted remuneration and required financial advisers to act in the best interests of their clients. Existing commission arrangements were grandfathered, and looked like staying until the Financial Services Royal Commission tore them down.

This week, the final nail was hammered into the grandfathering coffin. The Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Bill 2019 passed in the House, banning conflicted remuneration paid to financial advisers from 1 January 2021.

However, the advice industry has not found another business model that allows average Australians to receive comprehensive financial advice. It is right that conflicted advice should be stamped out, but if most people now cannot access detailed and personal services, then we have fixed one problem and created another.

### **Why is full-service advice expensive?**

I recently asked a financial adviser who services older, high-end clients about her first question at an initial meeting. "Tell me about your family," she replied. Not money or assets, but a person talking to a person about their family, life and goals. And there is the affordability dilemma. Comprehensive financial advice takes a lot of time. A full Statement of Advice (SOA) runs over 100 pages and the need to review all circumstances and develop a plan takes 10 to 15 hours and costs between \$3,000 and \$5,000 depending on complexity.

But focussing only on the SOA overlooks a bigger point. There is far more to a comprehensive relationship than an initial document. The Financial Planning Association (FPA) identifies six steps in the advice process:

1. Defining the scope of the engagement
2. Identifying the goals
3. Assessing the financial situation
4. Preparing the financial plan
5. Implementing the recommendations
6. Reviewing the plan

The first year of working with a client takes more like 35 hours which limits the number of clients a new adviser can accept. The cost of 35 hours at \$300 an hour is about \$10,000. A financial advice group that charges an ongoing fee of 1% of the portfolio (usually a declining percentage for large balances) requires \$1 million to earn \$10,000 for full-service advice. Most people do not have \$1 million. Other groups are moving to a charge a percentage of income as the advice work is more labour intensive.

The recent ASIC survey results in '[Financial advice: what consumers really think](#)' found:

*"Perceiving financial advice as too expensive was the most commonly identified reason for not seeking advice. Overall, 64% of all the online survey participants agreed that financial advisers were too expensive."*

The most common reasons for not seeking advice were (multiple answers allowed):

- Financial advice is too expensive 35%
- My financial circumstances are too limited for it to be worth getting financial advice 29%
- I like to manage my finances by myself 26%
- I do not trust financial advisers 19%
- I do not see the value of consulting a financial adviser 18%

Metlife recently reported it costs \$5,000 for an adviser to complete a risk insurance plan, but consumers are willing to pay only about \$1,200 in up-front fees. A leading boutique advice CEO told me their minimum fee is \$6,000 a year, and this gives only a basic service of one meeting a year. Another CEO said high touch is now reserved for clients with over \$2 million, mid touch is from \$750,000 to \$2 million and low touch is sub \$750,000.

At the latest Association of Financial Advisers' National Conference, EQ Wealth Director Simone Du Chesne, said:

*"I find it incredibly ironic that accessing financial advice has become the privilege of the middle class and that those who may need it most or just as much as any other Australian are not able to afford to see an adviser ... While I appreciate and support the need for operating in a compliant manner when providing advice, I believe the paperwork has become onerous."*

It's one of many consequences of the Financial Services Royal Commission. It identified the problem of conflicted remuneration without providing a mass market solution.

### **Producing a financial plan**

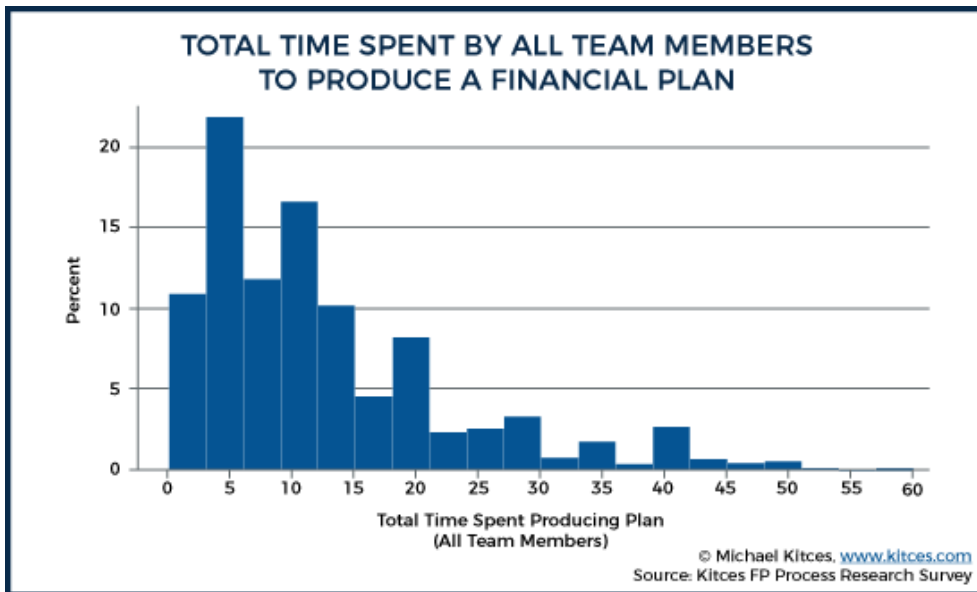
A 2018 FPA survey of its members found the average cost for an initial SOA was \$2,435. The average ongoing fee was \$3,354 per annum, taking the average cost to almost \$6,000 in the first year. Of course, there was a wide range.

Some advice firms are managing compliance by treating clients as 'wholesale', which removes the need to provide an SOA for a 'retail' client.

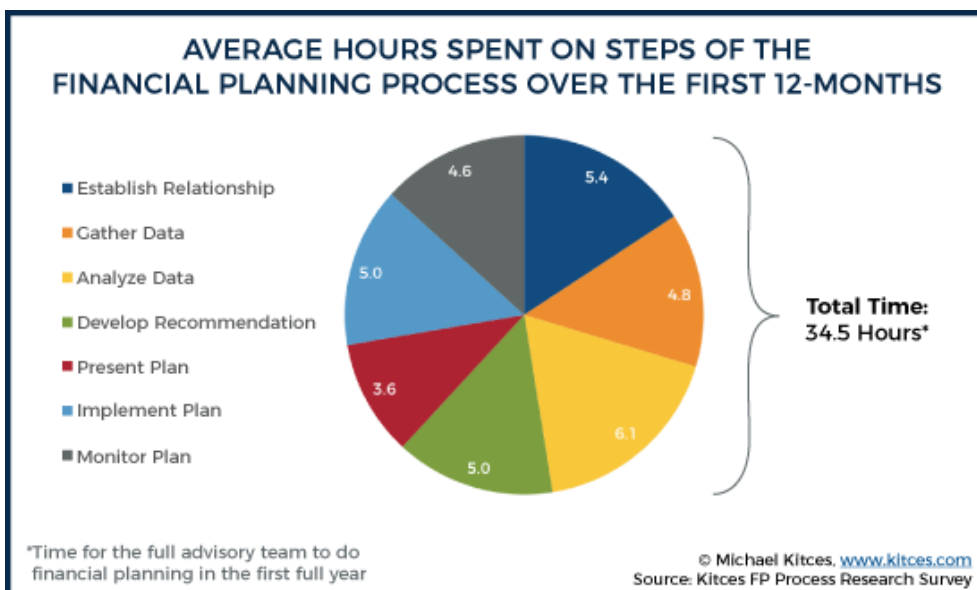
Kitces Research in the US has studied how long financial planning takes. I will assume the numbers are similar in Australia because there's little to suggest our regime is less onerous. Ask any financial adviser what they must do with a new client and their eyes will roll as they think about compliance, legal, best interests duty, conflicts, etc.

The Kitces article '[How Financial Advisers Actually Do Financial Planning](#)' provides details on how long they work and what they do. Notably, only 19% of time is spent meeting clients with 17% spent on business development. The most time-consuming part is designing financial plans and preparing for meetings with clients.

The following chart on time spent to produce a financial plan shows a median of 10 hours, but an average of 15 hours with a long tail due to some complex and time-intensive plans.

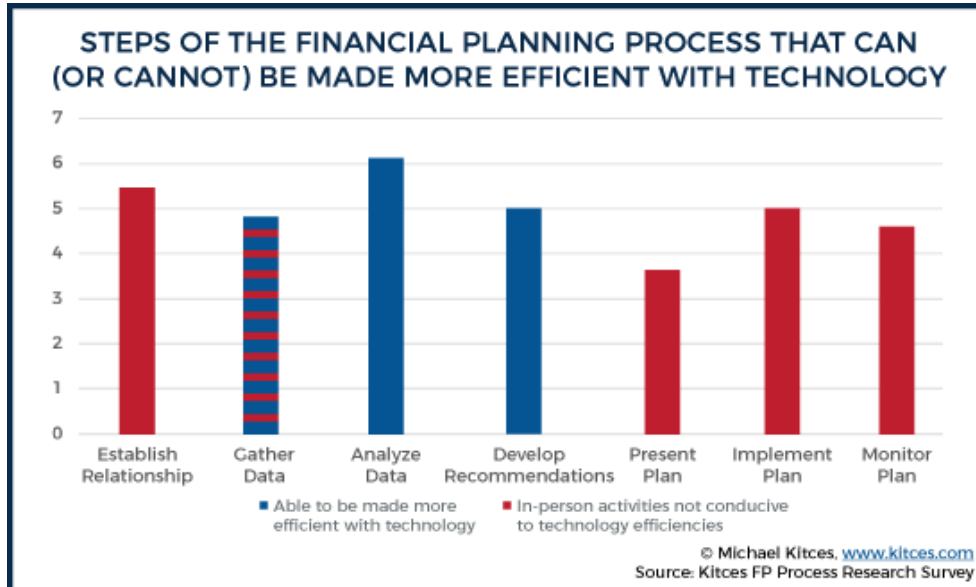


Similar to the FPA model, Kitces identifies seven steps involved in the first year of a relationship, and the chart below shows how this can consume the best part of a working week. On one client. In addition to these steps, depending on the structure of the adviser business, a good chunk of extra time is taken simply running the business. It doesn't leave much space for other new clients, which is another reason the industry believes there will be a shortage of advisers as education standards hit in coming years.



## How much will technology assist?

Surely, this is where adviser technology and software come in. Here is Kitces' most significant insight. The majority of the financial planning process involves client meetings and activities which technology has limited scope to replace. In the following chart, only the blue steps can be made more efficient with technology, and there's a lot more red.



The steps of gathering and analysing data and developing recommendations are number-crunching processes which technology can improve. It can't help much with client conversations, discovery of goals, a deep understanding of risk appetite beyond some simple tests, and coaching the client in how to use a new plan. This is person-to-person stuff.

## ASIC 'advisertech' and 'regtech'

At a recent [ASIC Regtech Financial Advice Files Symposium](#), providers of 'regtech' solutions were challenged to:

*"Demonstrate how technology can be used to help in determining the level of risk and regulatory compliance of financial advice based on a sample of client files in different formats provided by ASIC and any wider sample of client files or other related client profile and transactional data obtained independently by demonstrators."*

The six providers were Tiqk, GIRO by K&L Gates, IRESS, IBM, Flexprod and Advice Regtech.

Some impressive progress has been made in improving the efficiency of reviewing documentation for regulatory compliance, and it fits in well with Kitces' argument that certain parts of the advice chain can be improved by technology.

My brief summary of how regtech works for client advice files is that the technology scans the words and tables in financial advice documents to check for compliance with company policies, consumer obligations and best interest duty regulations. It aims to make internal compliance more efficient by flagging shortcomings against a series of lists. For example, it flags high-risk portfolios for extra review and scans for key words. It checks every file instead of the usual sample taken for audit purposes. Risk monitoring is improved with greater efficiency than the labour-intensive and error-prone exercise of humans scanning files.

At this stage of its development, it's only the start of a machine-learning and AI journey that makes marginal improvements in efficiencies. It is confined to checking and monitoring but this is a minority of the time spent by an adviser on a comprehensive plan. Anyone thinking regtech will fundamentally change the comprehensive advice process is in for a long wait.

As Daniel Crennan QC, Deputy Chair at ASIC, said in the introduction:

*"In order to improve risk management and minimise your compliance risks, you must include the capacity to explore, test, and implement 'compliance-by-design' regtech solutions within your business model. Obviously, none of us know what the future holds in this space. It's a learning exercise and none of us can doubt that*

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*technology is front-and-centre of financial services provision ... it would be ideal to witness a decrease in the number of ASIC's compliance-related enforcement actions as a direct result of industry's uptake of regtech."*

'Advisertech' is not limited to regtech, and other tools that might help advisers include enhanced financial planning software, the design of the investment platform, customer risk management and other office management tools.

### **Where is the advice industry heading?**

Full-service financial advisers with high net worth clients will continue to have strong businesses. Their clients are willing to pay, and if comprehensive advice costs at least \$10,000 as outlined by Kitces and the FPA, financial advice will increasingly become the domain of middle to upper income earners. At some stage, technology might offer better solutions but if regtech progress is any guide, it's in the early stages of delivering marginal efficiency improvements.

For all the criticism by the Financial Services Royal Commission, much of it deserved, the vertical integration model where advisers were allowed to use in-house products, had the potential to serve the mass market. I explained here [how it could have worked](#), but the horse has bolted.

AMP's decisions on the future of its financial advice business point some of the way. In the face of the devastating blows from the Royal Commission, their commission-driven model is being dismantled. They can no longer provide comprehensive advice to most Australians. AMP will develop a model similar to industry funds which provides intra-fund advice without a comprehensive SOA. At the lower asset levels, the first touch will be a call centre or digital offer that will not be detailed financial advice and not seek to understand everything about the client.

It would be a mistake to underestimate where AI and machine learning may take the advice industry. Algorithms may one day listen to conversations and recommend a portfolio. Data should be easier to collect through sophisticated online registries and aggregation portals. Investment management is falling in price. However, most of the required automation is years away at best. In the meantime, the full-service offer will be reserved for the top tiers of clients willing and able to pay.

*Graham Hand is Managing Editor of Cuffelinks. The charts from Michael Kitces are used here with his permission and are taken from [this article](#), which gives more detail on his methodology.*

### **Additional comments on 'unintended consequences' by Adam Curtis, Head of Investment Specialists, Perpetual Investments**

Hi Graham,

I wanted to write you a short note essentially to flag how I really did enjoy your recent article in Cuffelinks 11 Sept re FOFA implications for Financial Advice.

I share many common views with you on what are some unfortunate and potentially unintended consequences relating to Financial Advice post RC. I've been thinking and reflecting on it a fair bit of late and your recent article I thought surmised it very well.

Life is full of unintended consequences but unfortunately I lament the brand damage the industry broadly has suffered. The actions of a few can destroy the brand of many. Whilst I am proud to work at Perpetual, I am even prouder to work in financial services, an industry that I consider plays an important and vital role in securing the future for many Australians. I know and have witnessed the value that quality fiduciary advice provides and the benefits that so many people receive from these services but unfortunately, in the short term, the brand of many can suffer due to the actions of a few.

Ultimately it serves a social purpose with many community benefits yet are we potentially at risk of unintended consequences despite best intentions, stemming from the RC and/or FOFA at least in the short term?

Surely the intention of this Commission and its recommendations is to ensure advice is of a high quality, advice is available, and advice is affordable yet for many reasons, perhaps less advice will be provided. Will those that need it be able to afford it or even seek it?

I don't know how it will all play out but I did enjoy reading the article – I'm sure good advisers will ultimately prosper and many will benefit from their advice but in the short term there is pain and risk.

I recently presented on some of these thoughts of mine, personal and professional – it was wrapped around the concept of Unintended Consequences. I always like a good story and always look for metaphors in history.

Here's an example.

As we are all very familiar with, in 1912, The *Titanic* sunk and the huge loss of life, spurred a number of reviews and inquiries, the largest of which was conducted by a US Senate Inquiry. It concluded, entirely reasonably, that the death toll would have been substantially lower if the *Titanic* had set to sea with a full complement of lifeboats. New regulations were developed for the ship building industry, existing boats were retrofitted to carry more lifeboats and new ships were redesigned to accommodate more.

One of the first ships to sail after this new regulation was the [SS Eastland](#). On July 1915, just yards from her moorings on the Chicago River, she tilted alarmingly, took on water, and rolled over in just twenty-feet of water. While some lucky survivors were able to literally step from the upturned hull onto dry land, many less fortunate individuals were trapped below decks or thrown into the water. More than 800 people lost their lives. **While the poor design of the ship and the owners' failure to carry out tests were also to blame, it was the extra weight of the lifeboats that ultimately caused the *Eastland* to sink.**

**Despite the best intentions of the senators and regulators, at least in the short term, they created an industry with unfortunate and definitely unintended consequences**

This story resonated with me. When I saw the article I did want to get in touch.

Regards, Adam Curtis

## Four financial advice changes nobody is talking about

Daniel Brammall

The long-suffering consumer of financial services has plenty to be pleased about thanks to sweeping industry reforms. The initiatives mark a renaissance for genuinely independent financial advice. There are reforms, however, of which the majority of financial planners and their clients are largely unaware.

Commissioner Kenneth Hayne examined some 10,000 submissions and conducted seven (very) public hearings to arrive at 76 recommendations addressing the problem of trust in financial services. Some of those recommendations have already been implemented by the government, and almost all of the rest will be underway before the end of June 2020, although most people do not realise it.

Treasury's Financial Services Royal Commission Implementation Roadmap is [linked here](#). Here is a summary of the major changes.

### 1. Definition of independent adviser

On 20 August 2019, the Federal Treasurer, Josh Frydenberg, announced that legislation will be introduced so that financial advisers are not permitted to provide advice to a new client without first declaring whether they are classified 'independent' under the law – and, if not, explaining the reasons why not.

The Commissioner said conflicts of interest are "deep-seated issues" at the heart of the many instances of poor advice aired in his hearings. The Future of Financial Advice (FoFA) reforms that started in July 2013 failed to deal with conflicts of interest properly, he said, and the new FASEA standards would likewise fail. He explained that neither increased education nor better disclosure would be sufficient because the "flawed premise" that conflicts can be managed is, in fact, the real problem.

Under existing laws, an adviser is required to 'manage' conflicts of interest and disclose, in general terms, certain information about the advice provider. However, there is no requirement for an adviser to bring to the client's attention the conflicts that prevent the adviser from being independent under the law.

Hayne's Recommendation 2.2 introduces this obligation by referring to the Financial Services laws relating to independent financial advice, something that few financial advisers fully satisfy. For an adviser to describe his

or her services as 'independent', 'impartial', or 'unbiased' (or even similar words such as 'independently owned' or 'non-aligned') certain conditions must be met, described in section 923A of the Corporations Act. This 'independence law' reads like a list of the obstacles to independence:

- receiving commissions
- conflicted remuneration (such as fees calculated on the volume of business placed, also known as 'asset fees') and
- associations with product issuers.

Furthermore, in circumstances where an adviser might satisfy these conditions as an individual, yet the adviser's Financial Services Licensee permits any of its other advisers to have these conflicts, the adviser still fails the independence test.

As yet unseen legislation to be introduced to Parliament by 30 June 2020 will ensure any adviser who does not meet the requirements set out above will – before providing advice – be required to bring that fact to the client's attention and to explain, prominently, clearly and concisely, why that is so.

## **2. Annual, in advance opt-in**

One of the pieces of evidence tabled during the Royal Commission came to be known as the 'Fees for No Service' scandal, where clients were found to be paying fees, in some cases for many years, without receiving any service. The Commissioner said this had been allowed to happen because FoFA's 'opt-in' laws were 'backward-looking'.

Under existing laws, where a client has entered into an ongoing fee arrangement with a financial adviser, the adviser must give the client an annual Fee Disclosure Statement setting out:

- the amount of each ongoing fee paid in the previous year
- information about the services that the client was entitled to receive during the previous year, and
- information about the services that the client actually received under the arrangement.

Recommendation 2.1 from the Royal Commission reverses this to an annual, 'forward-looking' arrangement which:

- must tell the client clearly what fees he or she will pay, and what services he or she will receive in exchange for those fees, and
- must not permit or require the deduction of fees from any account held by the client except with the client's express written authority, which must also be renewed annually.

Frydenberg's legislation will effectively make illegal the ongoing fee arrangements most advisers operate under. It will no longer be possible for ongoing fee arrangements to exist where the client is not engaged with his or her adviser.

## **3. Ban on superannuation advice fees**

Australians' retirement nest egg is worth nearly \$3 trillion. As expected with such a vast sum of money involved, the potential for conflicts of interest is obvious. The Royal Commission heard evidence, for instance, that superannuation funds often permit members to pay for financial advice out of their super accounts. The member might, however, be seeking advice much broader than the subject of his or her superannuation assets alone.

Commissioner Hayne noted that the sole purpose of superannuation is to provide for retirement income. He put superannuation trustees on notice that where advice fees are deducted from member accounts that advice must be limited to the superannuation itself.

However, he went further in the case of the MySuper default accounts. *"It's difficult to imagine circumstances in which a member would require financial advice about their MySuper account,"* he said, and recommendation 3.2 banned any advice fees being deducted from MySuper accounts. The Commissioner further clarified with recommendation 3.3 that any advice fees deducted from a superannuation account will need to conform with the new rules about ongoing fees, captured under recommendation 2.1.

#### 4. The end of grandfathered commissions

This final change is better understood and publicised than the three above, but it is worth highlighting given its significance.

The 2013 FoFA reforms were intended to improve trust in the financial services industry. Unfortunately, extensive lobbying by deep-pocketed stakeholders watered down the effect of many of its key initiatives. FoFA more accurately stands for the 'Failure of Financial Advice', described one writer recently.

A good example was the notion to ban 'conflicted remuneration'. The government conceded a raft of exceptions so that eventually the definition of conflicted remuneration had more holes than a sieve. Trailing commissions in place before FoFA commenced were one of those holes. Advisers were allowed to continue receiving unearned income that ASIC says accounted for nearly one-third of their total income, an exception known as 'grandfathered commissions'.

Hayne's recommendation 2.4 proposed to end the grandfathered commissions and legislation introduced in August 2019 to ban grandfathered commissions passed through the House of Representatives. At time of writing, it is in the Senate where no significant opposition is expected.

#### Good news for both consumers and advisers

For years now, ASIC has conducted surveillance activities consistently concluding there is an unshakeable connection between poor advice and conflicts of interest.

The good news for consumers is that genuinely independent advice will become a lot more common than it is today. For advisers, there is a real opportunity to shrug off the shackles of a gravy train culture and enjoy the respect and trust that comes with being a member of a profession.

*Daniel Brammall is President of the [Profession of Independent Financial Advisers](#). This article is general information based on an understanding of proposed legislation.*

## Investing in the Electric Vehicle ecosystem

Zehrid Osmani

The market for electric vehicles (EV) is growing, driven by tougher regulation and increased consumer demand.

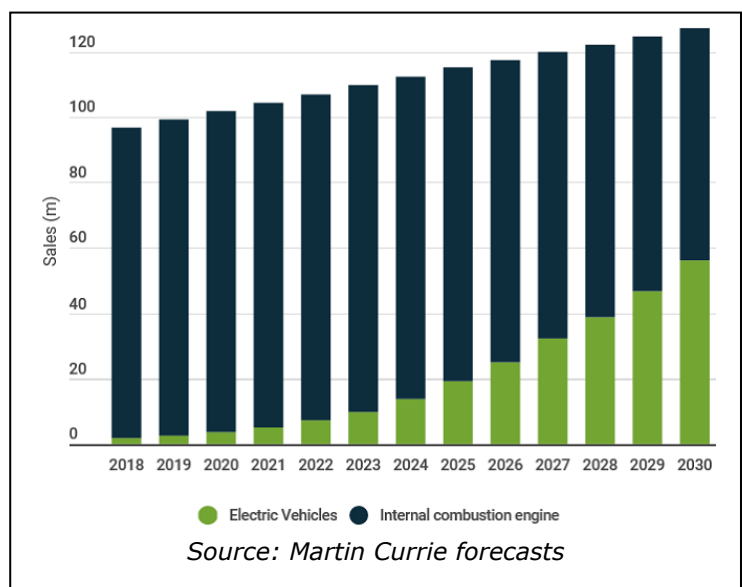
#### Time for change

There aren't too many occasions in business history where a well-established market shifts its form entirely in the space of just a few years.

But it looks like that's exactly what's in store for the motoring industry, as EVs become the norm and the internal combustion engine is rendered obsolete. Our own forecasts show the EV market's volumes are likely to grow at a greater than 30% compound annual growth rate (CAGR) to 2030, with the drive coming from tougher regulation and increased consumer demand.

#### The growth opportunity

China is currently the world's largest market for electric vehicles, and there is a huge push from its government to grow it even further. The country's green aspirations now mean tough minimum requirements for manufacturers to produce more New Energy Vehicles (including plug-in hybrids, pure-battery electrics and fuel-



cell autos). In Europe, a clean-mobility package, approved by the European Parliament, includes new CO<sub>2</sub> emission standards for cars and light commercial vehicles as well as incentives for zero-emission vehicles.

At the same time, while consumers have so far been slow to switch to EVs (only 16% of US motorists surveyed by AAA say they are considering an EV as their next purchase) there is evidence of growing consumer support for greener transportation measures.

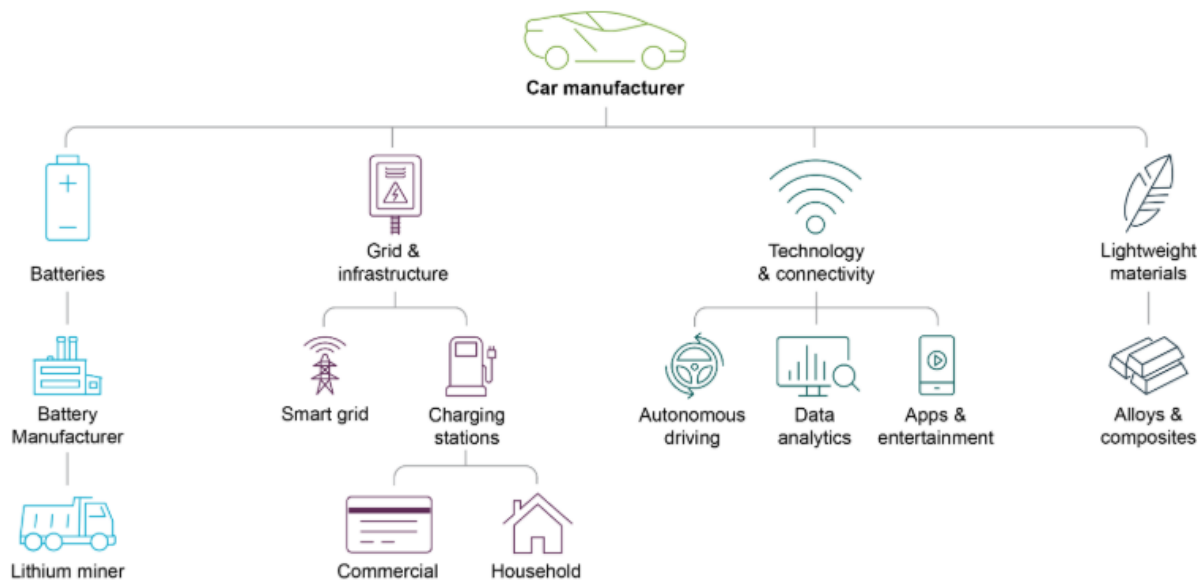
**The most obvious avenue is not always the right one**

Tesla is probably the best-known EV brand for now, with its Model 3 the best-selling model in 2018. Worryingly for Tesla, many other manufacturers have their own EV models, such as BAIC (a Chinese state-owned enterprise), Nissan, Toyota, Renault and BMW. What’s notable for us though, is that while this part of the value chain is the most visible, it is not such a rich mine of opportunity for investors.

There are two reasons for this. The first is the potential exposure to consumer choice risk. With decisions on brands dependent on consumer tastes, which can shift rapidly, making a call on whether the consumer will favour a Tesla, a Porsche or a Renault – or any other car brand – is an unnecessary risk for investors to take.

Secondly, being right at the forefront of the consumer end market exposes investors to a lot of competitive intensity, which again, as investors, we tend to want to avoid. In fact, looking at the increased R&D and capex intentions of car makers, there is a sizeable ramp up in production capacity, highlighting a growing competitive pressure in this part of the value chain. These increased competitive pressures might explain why Tesla recently announced a significant drop in its prices.

**Enhanced value-chain analysis**



The EV industry is a perfect example of the way we approach investing in companies. Fundamental data analytics and a clear understanding of industry structures are important aspects to help us generate attractive returns for our clients. By taking a broad and deep approach to analysing segments of the market across the entire value-chain, we are able to deploy our clients’ capital on the best ideas.

We prefer to analyse the whole ecosystem of EV and find opportunities in attractively priced higher value-add areas throughout the value-chain, where there is typically more pricing power.

Dutch firm ASML, for example, has an enviable position as the key supplier to the major semiconductor chip suppliers for these growing markets. ASML makes precision lithography systems that pattern transistors and other components onto chips. With a strong market position and close relationships with customers, the company is critical in enabling innovation and development in the semiconductor industry, and therefore its pricing power is very strong.

Another semiconductor-related firm, German firm Infineon, has a wide range of products for the automotive industry as it transitions towards EV and hybrid technology, as well as autonomous cars. These products range from power controllers to Advanced Driver-Assistance Systems (ADAS). Infineon’s leading position in the autos

segment is further cemented through the acquisition of chipmaker Cypress. Infineon is benefiting from the increased use of semiconductors in cars. While the average value of semiconductor products in vehicles is around US\$360 [Statista, IEA, May 2018], this figure is expected to increase rapidly – as some estimates put the value of content in EV/hybrids at closer to US\$1,000. When compared with the cost of a car, the benefit of increasing technological content in a car comes at a small additional cost, making companies like Infineon attractive ways to invest in the industry’s strong growth potential.

Another vital part of the value chain is batteries. Global material and recycling company Umicore has the patent to Cellcore®, which is an important brand name for NMC (lithium, nickel, manganese and cobalt), that forms the cathode of a lithium-ion rechargeable battery. It is the material of choice for the entire EV industry except Tesla. Umicore’s key competitive advantage is its closed-loop approach, where it recycles battery materials. This gives a distinct competitive advantage over peers who don’t make use of ‘urban mining’ and are therefore more reliant on raw materials from less-sustainable sources.

**The benefits of taking a wider approach**

The EV industry is a perfect example of the way we approach investing in companies. Fundamental data analytics and a clear understanding of industry structures are important aspects to help us generate attractive returns for our clients, analysing the market across the entire value-chain.

*Zehrid Osmani is Head of Global Long-term Unconstrained, Martin Currie, a Legg Mason affiliate. [Legg Mason](#) is a sponsor of Cuffelinks. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable. Please consider the appropriateness of this information, in light of your own objectives, financial situation or needs before making any decision.*

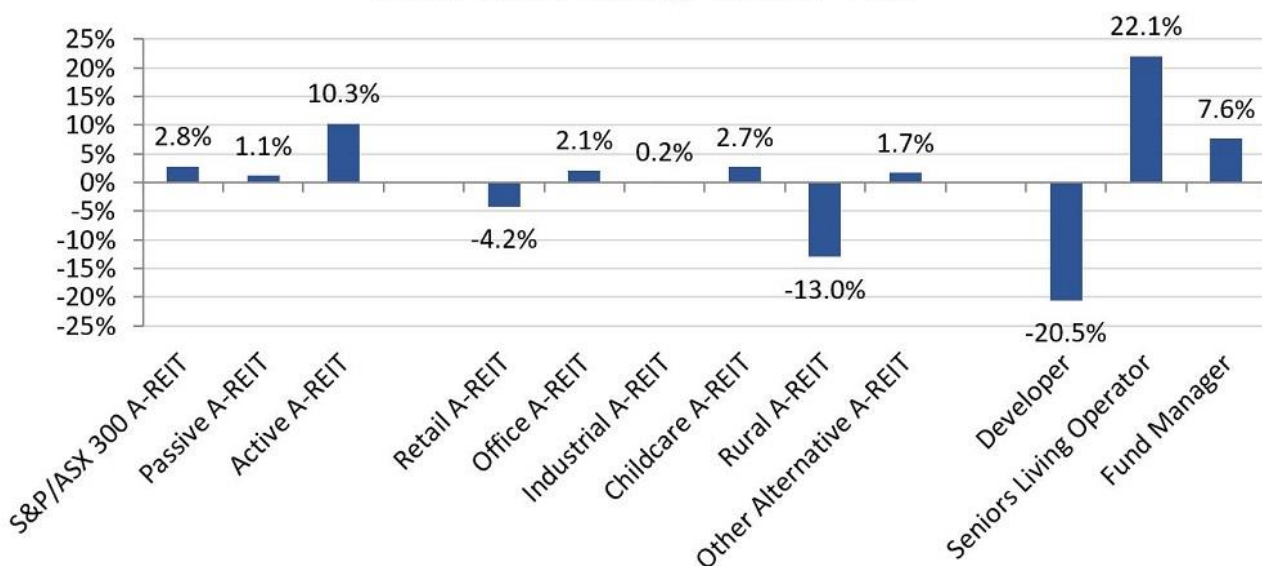
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**The big lessons from the A-REIT reporting season**

Jonathan Kriska

The A-REIT results from the August 2019 reporting season were generally positive and in line with our expectations. On average, A-REITs delivered annual EPS (earnings per share) growth of approximately 2.8% for the period ending June 2019. There were strong performances from retirement living operators and property fund managers, which delivered EPS growth of 22% and 8% respectively, and weak performance from residential developers, which delivered EPS growth of -20% for the year ending June 2019.

**A-REIT Sector Earnings Growth - FY19**



A key theme to emerge this reporting season was a moderation in underlying revenue growth across the A-REIT sector, offset by lower borrowing costs in most cases. Other themes included:

- continued solid performance from industrial and office portfolios
- weaker performance from retail portfolios, particularly those exposed to discretionary retail
- a deterioration in residential development performance and sectors linked to the housing market like storage and retirement-living development, and
- strong FUM growth from property fund managers who are benefiting from the lower interest rate cycle and the 'hunt for yield'-orientated investments.

#### **Office and industrial the standout sectors**

Turning to the A-REIT core sectors, both office and industrial continued to shine through the reporting season, with A-REIT results showing average like-for-like rental growth of 4.1% and 3.4% respectively. There were positive re-leasing spreads for many A-REITs.

Cap rate compression also continues to be evident for both sectors with office portfolios typically firming by 0.20% over the year and industrial portfolios even better with roughly 0.50% of compression. In contrast, results from the retail A-REITs were weaker, with average like-for-like rental growth of 1.3% and negative re-leasing spreads. Most retail portfolio values remaining largely unchanged on the prior year, but the stronger performance of non-discretionary retail A-REITs remains apparent.

#### **Non-core REITs provide opportunities**

Amongst the non-core property sectors, we noted positive results from childcare A-REITs, based on the continued under renting that exists in the sector. Solid results also came from service station A-REITs based on their long contractual leases.

However, there were mixed results for the rural-focused A-REITs. Rural Funds (ASX:RFF) delivered a solid result while Vital Harvest (ASX:VTH) was negatively impacted by weaker conditions in the berry market. A portion of its rent is derived from a share in the underlying earnings of its tenants.

Residential developers delivered much weaker results this reporting period, reflecting the weak housing market. Typically, volumes were 20% lower on the prior period and margins were in most cases were lower. This underlying performance translated to many listed residential developers delivering EPS growth which was roughly half the prior year. However, a more favourable outlook has emerged given positive sentiment returning to the sector, and we note most residential developers were experiencing increased inquiries, which have yet to translate into any meaningful lift in pre-sales.

While Retirement Living Operators continue to benefit from Australia's ageing population and low levels of supply of quality seniors living, the sector has recently been negatively impacted by the downturn in the residential market. The weak housing market has been increasing sale lead times as many retirees are taking longer to sell their existing homes, and this has had a negative impact on settlement numbers for retirement living operators.

Despite these challenges, we note strong results from Lifestyle Communities (ASX:LIC), Eureka Group (ASX:EGH) and Ingenia Communities (ASX:INA), with a weak result from Aveo Group (ASX:AOG). These differences largely reflect the recent emergence of more rental-type models in the sector (commonly known as MHE), as opposed to the Deferred Management Fee model which AOG still focuses on.

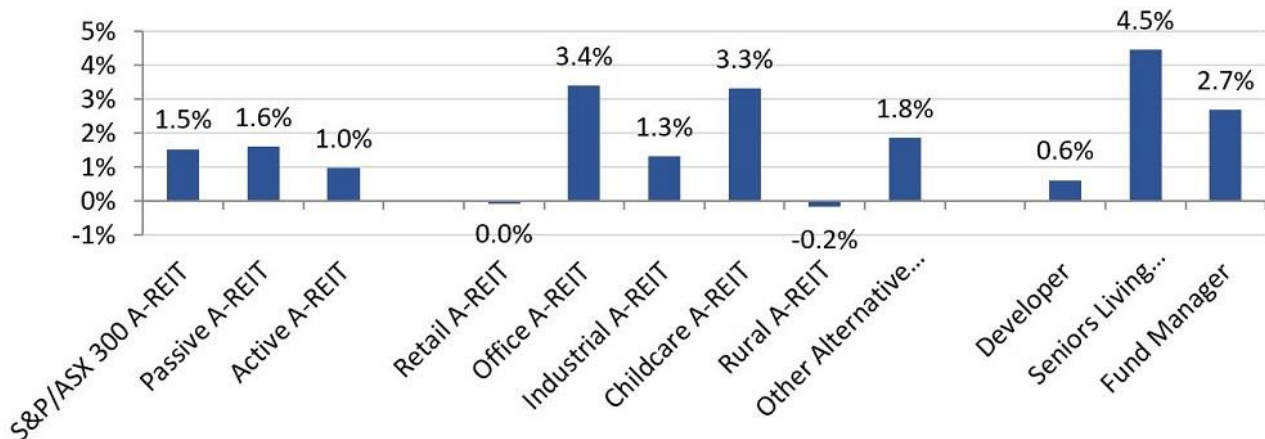
Property fund managers continue to benefit from low interest rates and the relative attractiveness of their product offerings for yield-orientated investors. This was again apparent at reporting season, with average annual FUM growth of 20% delivered by these groups for the year ending June 2019. We note strong results from Charter Hall (ASX:CHC) and Goodman Group (ASX:GMG) in particular.

#### **Investment case still compelling**

A-REIT balance sheets remained in good health with average sector gearing of approximately 30%, which was slightly lower than the prior year and over 10% lower than the levels recorded leading into the last sector downturn during the GFC.

Looking forward, the earnings guidance from A-REIT management teams implies a similar top line EPS performance over the next 12 months to the one prior. It also appears that lower debt costs will continue to be a positive tailwind to earnings for most A-REITs and in some cases lead to likely positive earnings surprises. Other contributors to earnings such as rental growth, funds management fees, and development profits should be incrementally better in most cases, meaning the underlying performance of A-REITs remains sound.

### NTA Growth - 6 months to June 2019



With this backdrop, and with the sector trading on near record yield spread to government bonds, the investment case for A-REIT investing remains strong.

*Jonathan Kriska is Portfolio Manager, Listed Securities at Charter Hall Maxim Property Securities. [Charter Hall](#) is a sponsor of Cuffelinks. This article is for general information purposes only and does not consider the circumstances of any person, and investors should take professional investment advice before acting.*

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

## Choosing your investment strategy is like a road journey

Aidan Geysen

Investors are faced with a significant and growing challenge. Stretched government balance sheets and an ageing population will likely place a growing emphasis on retirees to 'self-fund' their retirement. At the same time, the expectations for market returns have fallen in line with record low interest rates in Australia and elsewhere.

The traditional safe haven of term deposits are now offering on average just 1.5%, which may not even keep pace with inflation.

So for most of us, the requirement to take some investment risk will be essential to achieve our long-term savings goals. This is where the options can get a little complicated, so let's break it down.

There are many ways to take more risk, but let's focus on the two key actions that can easily be implemented within your portfolio: changes to asset allocation and investment strategy selection.

### Changes to asset allocation

In its simplest form, varying your equity versus bond mix can be an effective way to match your required return to your investment goals, but the potential for extra return does not come without taking on added risk.

Too much risk and you may not be able to stay the course through the inevitable market downturns on the journey to achieving your goal. Behavioural mistakes made along the way can cost years of investment returns, so best to match the risk of the strategy to your own tolerance.

## Strategy selection

Within each asset class, another way to seek a higher return is through the strategies that you select for your investment portfolio.

An active investment strategy generally seeks to take positions that differ from broad cap-weighted market indices, to deliver a higher return. Unlike changes to your equity/bond mix, which can increase the total risk of your portfolio, selecting an active strategy introduces what is referred to as 'active risk'.

To borrow a driving analogy, if the most direct route to your destination, which may be a main arterial road or freeway, is akin to a cap-weighted index, then using your local knowledge of back roads and traffic conditions to arrive at your destination ahead of time, could be considered the active strategy equivalent.

Traditional active managers employing skill and experience to outperform is not the only way however.

Over the last few decades, other strategies have emerged which can be used to pursue outperformance. These strategies - commonly either quantitative strategies employing sophisticated modelling techniques, or factor-based strategies seeking to harvest identified risk premia - endeavour to deliver a positive 'active return' against a benchmark.

To extend the driving analogy, systematic strategies could be likened to the rise of driving algorithms, such as Google Maps, which help to get us to our destinations faster by analysing data sets of past and present driving conditions.

Whether you prefer to test your own driving skill, utilise Google Maps or simply take the direct route, understanding the likelihood for success, and the risk you are taking if your choice doesn't work out, is critical to making an informed decision.

## Active risk

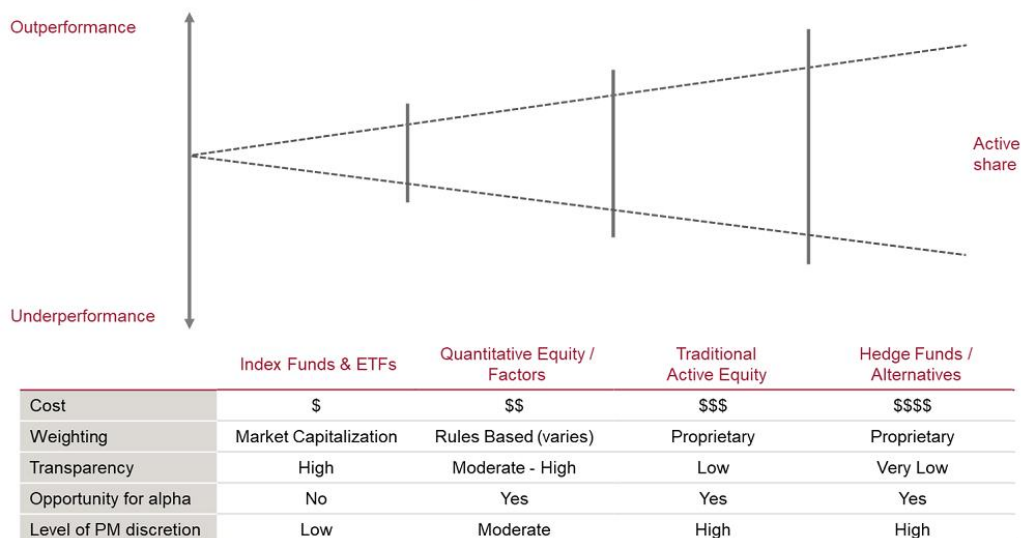
Active risk is typically measured in terms of the expected difference between the returns of the strategy and the returns of the underlying benchmark, which more often than not will refer to a comparable cap-weighted market index. You can look for active risk indicators from the fund manager which may be disclosed as 'tracking error' or 'active share'.

Other indicators of active risk include the number of securities held by the portfolio, the maximum position size in any one security, the rules listed for deviations of sector or country weights in the case of a global strategy, and past results.

## The spectrum of risk

At the lower end of the spectrum, market cap index funds can be characterised by low cost, low to no active risk, and high transparency owing to the rules-based nature of market cap indices.

### Spectrum of investment options for your Investment Style



Systematic strategies such as factor funds can span a broad spectrum when it comes to active risk, however, most follow a set of rules which drive the weighting of securities in the portfolio, providing transparency of approach, assuming the rules are disclosed, and are typically lower cost than more traditional active strategies.

Traditional active strategies come in many forms, from highly-diversified, low active risk approaches, to very concentrated, high active risk strategies. The cost you are willing to pay should be scaled according to the level of outperformance you expect and the perceived skill of the manager.

### Your unique circumstances

Where you end up with your choice is highly personal, as a successful strategy is one that is structured to deliver on your investment goals. Recognise that your asset allocation choice, where you land on the growth / defensive spectrum, will be the main driver of your overall return.

Patience is critical to success and remains an accessible edge for those who possess it, whether you are a professional investor responsible for the goals of others, or an individual investor saving for your personal goals.

*Aidan Geysen is Head of Investment Strategy at [Vanguard Australia](#), a sponsor of Cuffelinks. This article is for general information purposes only and does not consider the circumstances of any individual.*

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

## What does a negative bond yield really mean?

Tony Dillon

It seems someone at the ASX must have read Graham Hand's introduction to Firstlinks Edition 320, about the ASX bond price calculator not being able to handle a negative yield. Because now it can.

We see that for the 3% coupon bond maturing in March 2047, that a minus 1% yield equates to a bond price of \$227.32. But does that seem reasonable?

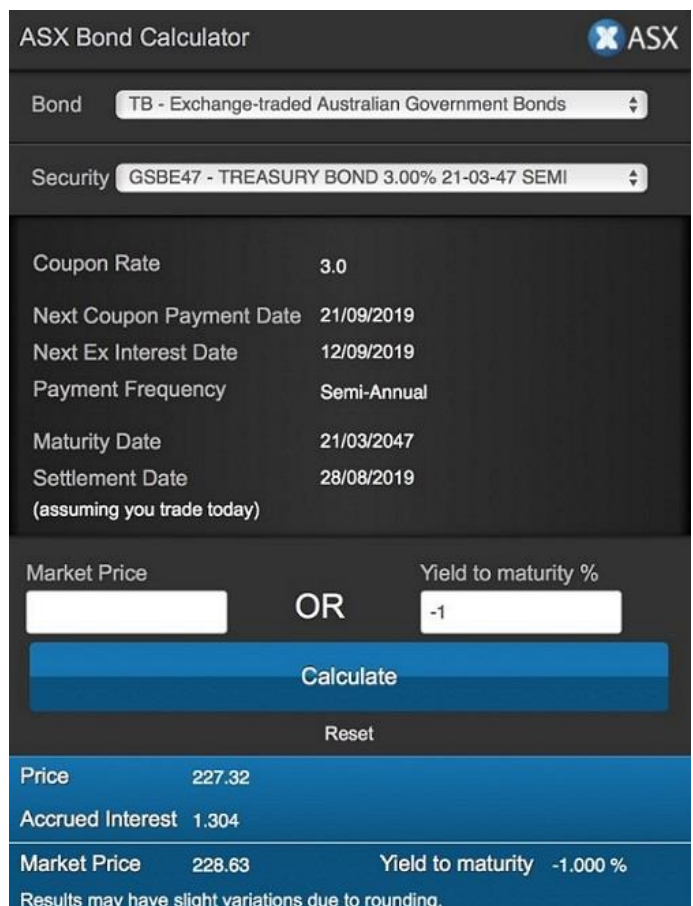
### How to understand this new world

Compare that to a price of \$148.08 for a yield of 1%. And at a 0% yield, the price will simply be the sum of the future coupons plus the face value of \$100 at settlement, being \$182.50. Therefore, a price of \$227.32 for a minus 1% yield would appear to pass the sensibility test (which can also be verified in a simple spreadsheet).

Negative-yielding debt is globally prevalent, but particularly in Europe, with Germany recently selling over 800 million euros worth of 30-year bonds yielding an average *minus* 0.11%. Investors are paying the government to hold their debt. For 30 years!

This phenomenon is foreign to many investors, and they are finding it hard to come to grips with what a negative yielding investment actually means. So let's try and rationalise it.

First, we understand a positive yield to mean that in recompense for locking away some capital, we receive payment in the form of interest from the



ASX Bond Calculator	
Bond	TB - Exchange-traded Australian Government Bonds
Security	GSBE47 - TREASURY BOND 3.00% 21-03-47 SEMI
Coupon Rate	3.0
Next Coupon Payment Date	21/09/2019
Next Ex Interest Date	12/09/2019
Payment Frequency	Semi-Annual
Maturity Date	21/03/2047
Settlement Date	28/08/2019
(assuming you trade today)	
Market Price	OR Yield to maturity %
<input type="text"/>	<input type="text" value="-1"/>
<b>Calculate</b>	
Reset	
Price	227.32
Accrued Interest	1.304
Market Price	228.63
Yield to maturity	-1.000 %
Results may have slight variations due to rounding.	

deposit-taker. A negative yield implies the opposite. That is, we pay the deposit-taker some interest for looking after the capital.

To illustrate and for simplicity, consider a zero coupon, 10-year bond with a face value of \$100. That is, depending on the yield, an investor pays an amount today to receive \$100 in 10 years' time, with no other income prior to maturity.

In the case of a positive yield of 1%, the price today of that bond is the present value of the redemption amount, discounted at the yield to maturity of 1%. So \$100 payable in 10 years will have a current price of \$90.53. That is, \$90.53 invested today earning 1% p.a. will accumulate to \$100 in 10 years.

If the yield was 0%, then the present value today is simply the \$100 redemption amount. And if the yield was minus 1%, then the present value of \$100 payable in 10 years will be \$110.57.

### **Present values with negative yields**

But what does a present value of \$110.57 at minus 1% really mean? It means that to have someone hold \$100 for a period of 10 years, we must pay them interest of \$10.57 today. That is, interest required for the whole period is charged up front.

Another way to think of this transaction is from the bond issuer's point of view. To look after \$100 for 10 years, they ask for \$110.57 today, being what \$100 would accumulate to in 10 years, at an implied interest rate of 1%. In effect, the bond issuer requires at the outset, the redemption amount accumulated at a rate approximately equal to the bond yield *paid* by the investor.

**To summarise**, with negative yields, the investor pays more today than the amount redeemed at maturity. Which makes sense intuitively if we think that the bond issuer needs more than \$100 today, if that amount is going to run down over time at negative market interest rates, and \$100 must be paid back in 10 years' time.

The logic also holds for exchange traded bonds that pay regular fixed interest amounts through to maturity, such as the 3% coupon, March 2047 bond highlighted above. In fact, using the accumulation approach for that bond, accumulating the future coupons plus the \$100 redemption to March 2047, at an interest rate of 1%, returns a value of \$226.60. A good approximation to the price of the bond at a minus 1% yield, of \$227.32.

### **Why does anyone invest at negative rates?**

With some \$17 trillion of negative yielding bonds now existing worldwide and growing, why would anyone invest in such debt? There are a number of reasons.

1. Scope for capital gains. If interest rates fall even further, bond prices rise.
2. Ride the yield curve. Assume a normal yield curve where the shorter the term, the more negative the yield. With the passage of time and all else being equal, holding a long-term bond will see the yield fall and the price rise. Therefore, capital gains are possible.
3. If deflation is expected. A negative 1% bond yield with negative 2% inflation, implies a positive 1% real return.
4. If liquidity is important. The highly liquid and cash-like bond market is usually preferable to holding a wad of cash.
5. It may be the best yield you can achieve without putting your capital at risk, with government bonds virtually risk-free.

We have a new world order when it comes to investment yields on government debt, and negative 10-year bond yields in Australia may not be too far away here. So we should at least try to make sense of a strange situation and adapt accordingly.

*[Tony Dillon](#) is a recently-retired actuary. This article is general information and does not consider the circumstances of any investor.*

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