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Connecting investors with ideas

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Advisers and investors in the dark on LITs and LICs

Graham Hand

A record amount of over $4 billion was invested in new Listed Investment Trusts (LITs) and Listed Investment Companies (LICs) during 2019, up from $3.3 billion the previous year. Fixed interest LITs were one of the success stories of the year, with $2.2 billion raised in four issues.

The overall sector now holds $52 billion across 114 issues, and while the fixed income LITs are trading close to the value of their Net Tangible Assets (NTAs) value, most equity LICs are struggling at price discounts to NTA.

But suddenly, there is also a cloud hanging over all new issuance, with financial advisers and stockbrokers unsure whether they can accept selling fees under the Financial Planners and Advisers Code of Ethics 2019. Amid the uncertainty, well-known global managers such as PIMCO, Neuberger Berman and Guggenheim are hoping to issue in early 2020.

Will advisers participate? Prominent columnist and fund manager, Christopher Joye, opened his *Australian Financial Review* article on 13 December 2019 in no uncertain terms:

> *"From January 1 commissions on listed investment companies and trusts will be banned, opening the way to huge compensation claims for losses incurred by any clients other than sophisticated institutional investors."*

Are financial advisers caught in another trap?

In the worst position of all, financial advisers are unsure whether they will breach their new Code of Ethics from 1 January 2020. The selling fee for placing clients into new LITs was one of their few bright spots in a tough 2019. The uncertainty arises just when it seemed there was little more that could be thrown at advisers already reeling from:

- the Royal Commission identifying conflicts of interest and not acting in the best interests of clients
- a mountain of compliance and paperwork at every client interaction
- the early removal of grandfathered commissions
- the exit of the major banks which were once big supporters, and
- new education standards pushing thousands out of the profession.

It’s hard to believe the potential consequences of the Financial Adviser Standards and Ethics Authority (FASEA) Code of Ethics are only two weeks away. FASEA has produced detailed obligations “*that go above the requirements in the law*”. It includes five values and 12 standards, and they are imposed on financial advisers personally:

> *“You have a fundamental, personal, professional obligation to understand and to adhere to your ethical obligations under the Code. You cannot outsource this responsibility … You will need to keep appropriate records to demonstrate, if called upon, your compliance with your obligations under the Code.”*

With responsibilities that are almost impossible to quantify and judge, the five values are Trustworthiness, Competence, Honesty, Fairness and Diligence, followed by pages of definitions. Advisers will not be able to pick up the phone to a client without worrying if they have met all potential requirements. Little wonder thousands of advisers are leaving the industry, and costs are rising so much that financial advice will increasingly become the domain of the wealthy.

Where do LICs and LITs come into it?

The impact of FoFA on funds and listed vehicles

The Future of Financial Advice (FoFA) regulations prohibit payments from product manufacturers to financial advisers. The financial advice industry was hauled over the coals by the Financial Services Royal Commission over conflicted remuneration and the Government is eliminating grandfathered commissions.

But in 2014, the Coalition granted an exemption from FoFA for financial advisers and brokers to continue to receive commissions in the form of ‘stamping fees’. Under Corporations Regulations 7.7A.12B on stamping fees:

> *“A monetary benefit is* ***not*** *conflicted remuneration if it is a stamping fee given to facilitate an approved capital raising.”*

And an 'approved capital raising' includes:

> *“interests in a managed investment scheme that are, or are proposed to be, quoted on a prescribed financial market.”*

Does it apply to both financial advisers and brokers?

At first glance, as the Code addresses ‘Financial Planners and Advisers’, it looks like another attack only on financial advisers. At the Royal Commission, the stockbroking industry barely rated a mention while advisers were hammered.

But it’s clear from the examples in the Code, discussed below, that it also applies to stockbrokers and every other Australian Financial Services (AFS) licensee. I checked this point with FASEA, who replied:

> *“The Code of Ethics is a compulsory Code for all relevant providers (as defined in the Corporations Act) when providing personal financial advice or services to retail clients on relevant financial products. Stockbrokers fall within the definition of a relevant provider and therefore must comply with the Code when providing personal financial advice or services to retail clients on relevant financial products.”*

Brokers have become major supporters of LICs and LITs in recent years as they receive fees similar to the rewards of floating a new company. When a new LIT or LIC comes to market, the issuer (manager) selects a syndicate of brokers with the ability to market and sell this type of transaction. A welcome development in recent deals is that the managers cover the up-front costs, enhancing the potential for the issue to trade around its issue price. The manager pays a selling fee, as noted in the recent KKR offer (the largest of 2019 raising $925 million) document:

> *“the Manager will pay to each Broker a selling fee of 1.25% (exclusive of GST) of the amount equal to the total number of Units for which the relevant Broker procured valid Applications.”*

KKR also states that:

> *“The Responsible Entity does not intend to pay commissions to financial advisers in relation to an investor’s investment in the Trust under this Offer.”*

However, there is nothing to stop brokers paying fees to financial advisers who place their clients into the fund. In some cases, the commission may be refunded to the client. In the case of KKR, half the transaction was placed to end-investor clients by brokers and half by financial advisers, with the adviser receiving most of the selling fee from the broker.

What does the Code of Ethics say about fees and commissions?

The FASEA Code of Ethics is a comprehensive 40-page document, with 32 specific examples designed to cover ethical issues facing financial advisers. Surely, FASEA must address ethical inconsistencies between listed and unlisted vehicles, and when advisers can accept fees.

Christopher Joye sees FASEA's position as clear:

> *"In one of the biggest shake-ups of the financial advice industry in years, the government's Financial Adviser Standards and Ethics Authority has blanket-banned conflicted sales commissions, including previously acceptable "stamping fees", for advisers recommending listed investment funds to both retail and wholesale clients* ... ***The ban on stamping fees for LICs and LITs for all advisers is therefore black and white*** *(my bolding).*

It might be written in black and white, but is it really clear?

Joye quotes from Examples 6 and 9 of Standard 3, including from page 17:

> *"The option to keep the stamping fee creates a conflict between [the adviser's] interest in receiving the fee and his client's interests. Standard 3 requires [the adviser] to avoid the conflict of interest. It is not sufficient for him to decline the benefit as it may be retained by his principal. Either the firm must decline the stamping fee altogether, or [the adviser] must rebate it in full to his clients."*

Joye says there's "no room for confusion" there. In fact, there is plenty.

There's no ban on 'stamping fees' if it's normal behaviour

Example 6 concerns a stockbroker, Yasmin, who is motivated to do the transaction because she needs the extra brokerage income to meet her monthly target and earn a bonus. FASEA says:

> *"the actual reason for advising the clients was to earn an increased proportion of total brokerage by 'churning' client accounts."*

The Code does not say she cannot accept the commission (stamping fee), it says it cannot be her primary reason for the deal. In fact, FASEA says the usual practice is:

> *"Her firm takes advantage of the carve out from the conflicted remuneration provisions introduced by the Future of Financial Advice reforms".*

So FASEA specifically says this is possible, it doesn't say there is a ban on stamping fees.

Example 9 is the same. This is headed, 'Selling IPOs'. It starts: *Scott works for a securities dealer which specialises in advising in small cap stocks."* Again, it's not a financial adviser, it's a broker. Scott's firm allows its advisers to either keep the stamping fee or rebate it to the client. However, on this occasion, Scott keeps the stamping fee to pay for school fees whereas he usually rebates to the client. This is how the conflict of interest arises, as it is a change of behaviour. It's not that keeping the stamping fee is prohibited.

The Code of Ethics offers flexibility

Further, even outside of these examples, on page 17, FASEA allows financial advisers to receive "*Income derived from ancillary products and services*". It says:

> *"You will not breach Standard 3 if you share in profits generated by the provision of ancillary products and services to clients providing that:*
>
> *- the ancillary products and services are merely incidental to the adviser's dominant purpose in providing advice, and*
>
> *- the ancillary products and services recommended are in the best interests of your client – conferring on the client value that is equal to or greater than that offered by any other option."*

The reason Examples 6 and 9 breach the Code is because of the change in behaviour, such that:

> *"You will breach Standard 3 where the dominant purpose of providing advice to clients is to derive profits from selling those clients ancillary products or services from which you personally benefit."*

As a further nod to flexibility, page 6 of the Code says to financial advisers:

> *"Individual circumstances will differ in practice and, as with every profession, there is allowance for differences of professional opinion on how the ethical rules of the profession should apply in a particular case. Doing what is right will depend on the particular circumstances and requires you to exercise your professional judgement in the best interests of each of your clients."*

The Listed Investment Company and Trusts Association (LICAT) argues in a recent release:

> *"We note, however, that there are significant gaps and differences between the explanatory wording provided in FASEA's Code of Ethics Guidance and ASIC's Regulatory Guide RG 246.*
>
> *The first significant difference is how conflicts of interest can be avoided in practice while continuing to ensure that investors receive the best possible advice. ASIC's Guidance recognises that there are practical ways in which conflicts may be eliminated including a client authorising a fee to be paid to their adviser for services that have been provided. At this time, FASEA's Guidance has not explicitly addressed this important point."*

What would a disinterested person, in possession of the facts, conclude?

At this point, it seems fine for both brokers and financial advisers to accept a selling fee from a fund manager, but what about conflicted remuneration and best interests?

Is there a difference between a fund manager with an unlisted fund paying commissions to an adviser (banned under FoFA), and a fund manager listing a fund and paying a selling fee to a broker, who then shares it with an adviser?

Notwithstanding anything in the examples, FASEA says there are overarching principles which should dominate decision-making by advisers and licensees, such as on page 17:

> *"You will breach Standard 3 if a disinterested person, in possession of all the facts, might reasonably conclude that the form of variable income (e.g. brokerage fees, asset based fees or commissions) could induce an adviser to act in a manner inconsistent with the best interests of the client or the other provisions of the Code."*

We cannot avoid the elephant in the room. How does a relatively unknown fund manager raise nearly a billion dollars in a month when there are plenty of similar managed funds readily available? For example, there are dozens of fixed interest funds on the ASX's mFund service offered by some of the best-known managers in the world (Janus Henderson, Legg Mason, Aberdeen, PIMCO, UBS) which struggle for attention, and there are many fixed income ETFs which are cheaper than LITs.

Have financial advisers and brokers really considered whether these are better for their clients than a new LIT which happens to pay a 1.25% selling fee?

Consider this: PIMCO has long offered the 'PIMCO Australian Focus Fund', a fixed interest fund with the asset types that LIT investors have scrambled into in 2019. Let's say they offer it in four formats:

1. A managed fund on various platforms. Commissions are banned under FoFA.
2. A managed fund accessed using the ASX mFund service. Again, commissions are banned under FoFA. This fund has raised less than $1 million over the years of its availability on the mFund service.
3. An active ETF listed on the ASX, with no selling fees (ETFs do not pay selling fees).
4. A new LIT with a selling fee of 1.25%.

It's the same fund from the same manager with the same strategy, and three of the vehicles can be accessed directly on the ASX. Money would trickle into the first three, but it would flood into the fourth. On the LIT, the brokers would hit the phones to their own clients and financial advisers and generate massive inflows for a 'leading global fund manager specialising in fixed interest securities'.

Can anyone really deny that many brokers and advisers are motivated by the selling fee? Some of the advisers rebate the fee to their client but what about the rest? Was a LIT offered in a particular month the best fixed interest fund available, and so much so, it deserved a billion dollars while flows into other structures trickle? That's a stretch.

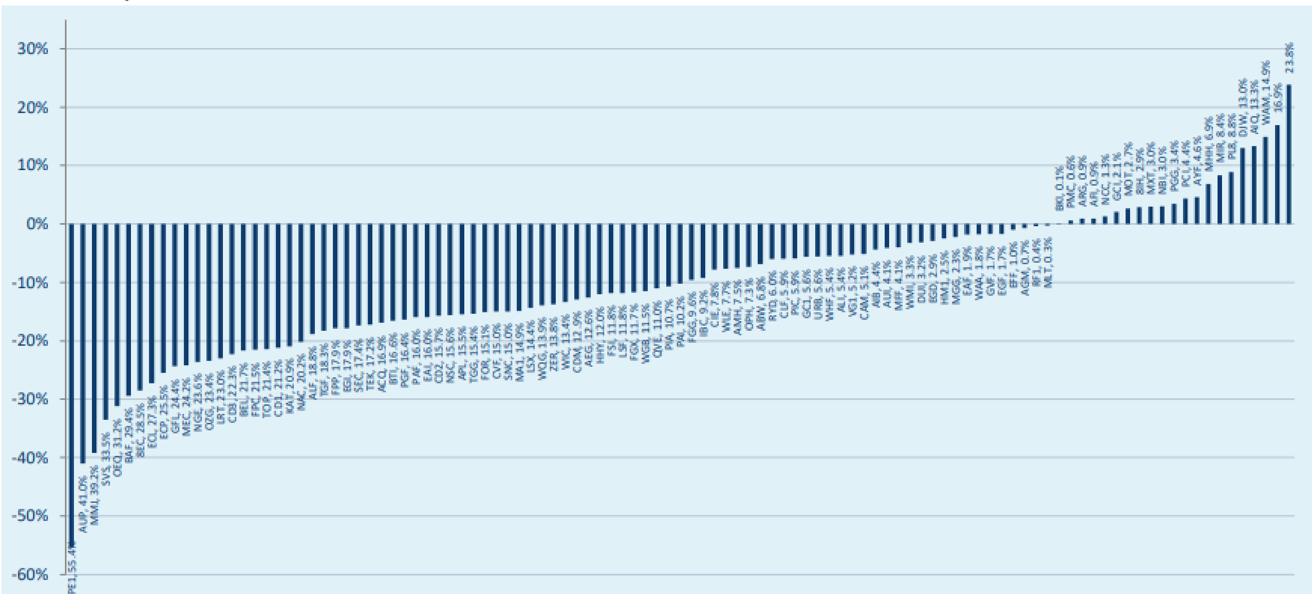
On FASEA's test: *What would a disinterested person, in possession of all the facts, reasonably conclude?*

When I recently asked a financial adviser how he can justify taking a fee for placing a client into a LIT, he said it was to offset his risk that the client does not proceed and he was left holding the securities. What about KYC, or Know Your Client?

We will never know how much of the billions placed into fixed interest is motivated by selling fees to brokers and advisers struggling with the loss of commissions elsewhere, and whether they have really explained the risks to their most conservative clients.

Wait a minute. Didn't Magellan recently raise $860 million on a LIT that paid no commissions to brokers and advisers? Yes, but Magellan is a unique case, having spent a decade developing its own distribution channels and gathering the direct contact details of 200,000 investors.

Furthermore, as Joye points out, it's not as if LIC investors have had a wonderful experience. The chart below provided by the ASX shows the majority of LICs are trading at a significant discount to their NTA. While the recent LITs have done well, the fact is that closed-end funds listed on the ASX have not delivered a satisfactory experience for many investors. When a client cannot exit an investment at the market value, there is something wrong with an adviser recommending the product.



What about fees on other listed products?

Further complicating the matter, there's another elephant in the room. Supporters of LICs and LITs point out that there is no loophole because these products are treated the same way as the initial offerings of structures such as hybrids and real estate trusts (A-REITs) on stamping fees. For example, the recent CBA hybrid paid a 0.75% selling fee. Did the advisers check the dozens of other hybrids for better value?

LICAT argues:

> *"ASIC's Guidance (but not FASEA's Guidance) recognises the practical differences in the capital raising process for coordinated blocks such as listed entities which is done at a single point in time and that of the continuous raising of capital for other investment products such as managed funds and ETFs."*

These examples simply emphasise the problem. Financial advisers and brokers are accepting payments from product manufacturers to place investments with their clients. Every adviser and licensee will have to judge their motivations and whether their actions are a contravention of the Code of Ethics.

It matters little if it's legal when it's not ethical

My interpretation of the Code of Ethics is that it does not ban financial advisers and brokers from receiving commissions on LITs and LICs, but there's another issue. Consider how advisers receiving grandfathered commissions were treated at the Royal Commission, although these commissions were legal. Commissioner Hayne lambasted advisers for their behaviour in retaining the fees five years after the implementation of FoFA that made them legal.

Similarly, the advice industry has reacted with horror at CBA's recent decision to demand advisers obtain a signed form from fee-paying clients to give trustees comfort that clients are aware of the fees. This is not a legal requirement but was recommended by Kenneth Hayne. Fees are already disclosed annually and the client has agreed to the fees in the Statement of Advice. Imagine the workload in an adviser's office obtaining these signatures, in addition to the obligations under the Code from 1 January 2020. Advisers are calling CBA's decision 'virtue signalling', but that's what the big players are doing under pressure from regulators and the government.

ASIC Commissioner Danielle Press recently wrote an email to industry participants advising:

> *"ASIC does not expect advisers or licensees to change remuneration structures to comply with Standards 3 and 7 (of the Code of Ethics) until there is certainty with respect to these standards and how they impact on remuneration. This applies to existing remuneration streams such as asset-based fees and commissions that might be considered in doubt."*

Advisers and brokers seem safe for the near future during ASICs 'facilitative approach' period and maybe longer. But the comments by advisers in the trade press confirm they do not know how to respond to the Code of Ethics.

With dozens of senior executives from financial institutions losing their jobs over poor ethical decisions, the inclination will be to run away from the gallows rather than waiting for the guillotine to drop.

Graham Hand is Managing Editor of Firstlinks.

Three fascinating lessons overlooked by investors

Joe Magyer

Investing is a field where experience matters a great deal. And, yet, we're all prone to biases and leaning into heuristics that may not have strong empirical underpinnings. That's why it is important to stay current with the latest research in our field, challenging our own beliefs in the process.

There is no shortage of literature on behavioral economics and asset allocation. In the holiday spirit of distilling things down, though, here are seven studies that I thought presented fascinating insights. Even better, almost all of them are from the past few years -- in other words, not the Markowitz paper you read about at university -- tucked into **three** specific themes.

1. Funds managed by a single manager tend to perform better

That was one of the key conclusions from a study published in 2016 by the *Financial Analysts Journal*. The authors - Goldman, Sun, and Zhou - identified some intuitive yet unappreciated results:

> *"...we identified the organizational design behind the loss of abnormal returns associated with less concentrated portfolios. In particular, we found that mutual funds run by a single manager tend to have a much higher portfolio concentration, both across and within industries, than funds run by multiple managers."*

The traditional narrative is that two heads are better than one, and no doubt there are many situations where that is the case. What the authors found, though, was that more heads lead to more diverse portfolios that likely dilute the value added by the individual portfolio managers' highest-conviction holdings.

It is hard to overstate how diluted down these portfolios can get. The authors looked at 35,253 U.S. mutual fund portfolios and found that the average number of holdings was 144 positions. This is way beyond what is necessary to capture the benefits of diversification - 86% of possible tracking error is reduced with just 30 holdings, according to a 1999 study by Sturz and Price - and may help explain the widespread phenomenon of most active managers underperforming after fees and expenses.

The authors weren't sure whether there were other factors in play. For example, multi-manager funds tend to have larger asset bases than single-manager funds, so maybe the issue was less about portfolio dilution and more about size-driven headwinds. They also discovered:

> *"We further found that when funds' management designs are changed from single manager to multiple managers (or from multiple to single), portfolio concentration decreases (increases) and performance deteriorates (improves)."*

The study also has unflattering conclusions regarding older funds run by long-serving managers.

2. Active management can add value when it is actually active

Not all active management (active as in not passive) is very active. Morningstar's Caquineau, Möttölä, and Schumacher found in Europe that 20.2% of the European large-cap funds they studied had a three-year average active share below 60%. In other words, the funds were closet indexers.

Research suggests managers with higher active share on average better those with low active share (the closet indexers). A 2017 study by Lazard Asset Management's Khusainova and Mier found that, when global and international funds were split into quintiles based on active share, the best-performing quintile was that with the highest active share while the worst-performing quintile was the one with the lowest active share.

Given that the previously discussed study found that portfolio concentration was aligned with performance, that may not be too surprising. And yet, many investors do not make this distinction when discussing active management.

An even more interesting twist into active share is that Cremers and Pareek found in a study published in the *Journal of Financial Economics* that high active share alone was not indicative of outperformance. The authors found only portfolios with high active share *and* patient holding strategies (holding durations of over two years) delivered outperformance.

3. Australia's home bias is off the charts

Home bias is a global phenomenon, however, the magnitude of Australia's home bias is astronomical compared to similar Western markets. A Vanguard paper that I recently highlighted notes that the value of listed Australian equities makes up only 2% of the global market and yet Australians collectively hold 67% of their portfolios in Australian shares.

Granted, there are some good reasons for Australians to be overweight their home country - franking credits and a long history of economic excellence being key among them - but the 65% gap dwarfs that of the UK (19%) and US (29%).

What makes the outsized home bias gap even more puzzling is that Australian equities have a lower unhedged long-term correlation to international equities (0.58) than the UK (0.66) and US (0.76). In other words, Australians have historically reaped far more bang for their diversification buck from diversifying into global equities than the UK and US and yet our home bias is far, far stronger.

Joe Magyer is the Chief Investment Officer of Lakehouse Capital, a sponsor of Firstlinks. This article contains general investment advice only (under AFSL 400691) and has been prepared without taking account of the reader's financial situation.

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Sale and leasebacks benefit both companies and investors

Adrian Harrington

In the current low interest rate environment, corporate Australia is revisiting their property occupancy strategies to unlock value. For companies that own and occupy their property, a sale and leaseback transaction can be an astute business strategy. At the same time, the sale can provide attractive, long-term assets for funds and their investors.

Company ability to monetise an asset

Given the strong demand from both listed and unlisted property funds for long-term leased properties, together with the historically low cap rates (yields) at which these properties currently trade, it is an ideal time for corporates to monetise their property assets through a sale and lease back transaction.

A sale and leaseback arrangement effectively separates the 'asset value' from the 'asset's utility value'. A company can crystallise value and redeploy the capital tied up in a low-yielding property back into their business at higher rates of return in a more productive use. This might include acquiring another other business, paying down debt, or undertaking a return of capital to shareholders via a special dividend or share buy-back.

Sale and leaseback transactions have become particularly attractive to private equity firms acquiring 'property rich' companies. By carving out the property from the business concurrent with, or post, acquisition, the private equity owner has the potential to unlock a materially higher value for the asset than they paid for it. Often, there is a disconnect between a lower cash flow multiple paid to acquire a business which is property rich and the higher cash flow multiple placed on an asset-light enterprise.

How a company retains control and flexibility

With debt costs at record lows, an easy option for corporates is to utilise debt capital and borrow to assist in funding their business. However, the debt is typically only available for a short period of time (say three to five years) creating rollover risk. It may also come with arduous covenants, and only unlock between 30% and 65% (loan to value ratio) of the value of the property.

Given the low cost of debt, the lease payments under a sale and lease transaction may be more expensive than the interest payments on the debt, but a sale and leaseback can provide greater certainty to the company due to a long-term lease. The company can also secure 100% of the value of its property assets in cash.

For many companies considering a sale and leaseback, the ongoing control and use of an operationally critical property is paramount to the long-term objectives of the business. An appropriately structured sale and leaseback can allow the tenant to retain possession and continued use of the property for the lease term.

Typical sale and leaseback leases are triple net which means the tenant is responsible for outgoings, repairs and maintenance and most capital items. The leases are for between 10 and 20 years, although in some cases may be longer. The company may also negotiate lease extension options giving even longer-term certainty. In some cases, they may include terms for early lease surrender if more flexibility is required, and the new owner is comfortable to take on the risk of reletting or converting the property to an alternate use down the track.

Examples of long-term sales and leasebacks

Charter Hall has been involved in more than $6.5 billion of sale and lease back transactions in the past few years with high quality, creditworthy covenants such as the Federal Government, BP, Telstra, Coca-Cola Amatil, Ingham's, Bombardier Transport, Virgin Australia, Arnott's, Bunnings and Woolworths. These transactions span a range of property sectors including office, industrial, social infrastructure, pubs, convenience retail, fuel outlets and large format retail.

In one of Australia's largest sale and leaseback transactions, in August 2019 Telstra sold down a 49% interest in 37 telco exchanges to a Charter Hall led consortium for $700 million. The deal was struck on a capitalisation rate of 4.4%.

Telstra's CEO, Andy Penn, said the deal was part of Telstra's strategy of monetising up to $2 billion of assets to strengthen its balance sheet. Under the terms of the transaction, Telstra retains a 51% controlling interest in the entity that holds the assets and retains operational control of all the exchanges. In return, Telstra signed a

long-term triple-net lease with a weighted average lease expiry of 21 years, with multiple options for lease extension to accommodate ongoing business requirements.

Opportunities for investors

More recently, private equity giant KKR, as part of their deal to buy iconic biscuit manufacturer Arnott's from Campbell Soup Company, immediately on-sold Arnott's Australian production facilities. Charter Hall's acquisition, through its unlisted Charter Hall Prime Industrial Fund (CPIF) and the ASX-listed Charter Hall Long WALE REIT (ASX:CLW), of Arnott's 59,000sqm facility in Huntingwood in Western Sydney for $397.8 million, on a passing yield of 4.5% is one of the largest individual industrial asset sales recorded in Australia.

Arnott's signed a 32-year triple net lease with multiple 10-year options giving certainty of tenure over their premier Australian production facility, as well as unlocking significant capital to the new business owners.

The 32-year lease and uncapped CPI plus 0.5% annual rent reviews provide an attractive long-term investment with inflation protection to the CPIF and CLW investors.

Companies should consider capitalising on the growing demand from property investors for long-term predictable income returns as part of their overall capital management plan. A well-structured sale and leaseback programme provides access to an alternative source of long-term capital which can enhance the overall capital efficiency and value of their business, and place the asset in the hands of investors seeking long-term income security.

Adrian Harrington is Head of Capital and Product Development at Charter Hall, a sponsor of Firstlinks. This article is for general information and does not consider the circumstances of any investor.

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

A simple method to help mitigate sequencing risks

Roger Montgomery

The number of people in Japan of working age was outnumbered by non-workers for the first time in 1994. In China, that number turned negative in 2015 and in Europe, 2011. The global population is ageing and changing the expectations and needs of a class of investors who may presently be uncatered for. In particular, those approaching retirement must consider risk much more seriously for they can least afford a permanent loss of capital.

Drawing out capital is opposite of 'dollar cost averaging'

For retirees, regular withdrawals of capital may be required where income is insufficient to meet lifestyle requirement. In an environment of ultra-low rates, generating a sufficient income is made more challenging. Consequently, restricted income means many investors must decide between spending less or eroding capital to meet lifestyle demands.

When an investor is required to make regular withdrawals regardless of the market level, capital losses experienced early in retirement can be deleterious. Sequencing risk, which describes the pattern of investor returns, or the order in which they are received, therefore looms large for retirees.

The impact of sequencing risk on retirement incomes is the opposite to the impact of dollar cost averaging, which can be employed to accumulate wealth. Dollar cost averaging involves *making* regular investments, while retirees in pension phase are required to *take* regular payments from their investment portfolio.

Typical dollar cost averaging examples involve an investor investing a fixed sum of money at predetermined regular intervals, for example, $20,000 every month. By fixing the dollar amount, a discipline is forced upon the investor. When share prices are low, more units are acquired, and when share prices are higher fewer units are purchased. For the dollar cost averaging strategy, volatility becomes an investor's best friend. As a net purchaser of shares, lower prices can be anticipated with eagerness.

The opposite however is true for the retiree in pension phase and required to receive regular fixed dollar or percentage payments from their portfolio. For example, compulsary withdrawals from a superannuation pension account vary by age from 4% for people under 65, to 7% for aged 80 to 84, to 14% for over 94. These levels are set to encourage depletion of super assets to fund a retirement, not pass to an estate.

An investor, required to take fixed dollar withdrawals regularly from their portfolio, would experience the opposite of the dollar cost 'averager'. At lower prices, a retiree would be forced to sell more units simply because more units are required to meet their minimum pension payment. After those units are sold, the remaining portfolio is smaller, and with fewer units, a greater burden is placed on the remainder of the portfolio to recover the losses.

It is therefore essential that large losses early on the investment journey are avoided or the risk at least mitigated.

Reserving a cash allocation

One method employed by advisers is to quarantine from volatile assets the cash needed for spending, lifestyle and healthcare needs to cover a period estimated to be required for markets to recover.

Take a hypothetical investor with $2 million at retirement who is advised to quarantine $300,000 to cover three years of expenditure, and invest the remaining $1.7 million. What happens if the markets decline 50% at the end of the three-year period, when there is nothing left in the cash reserve?

Clearly, the solution is to ensure that $300,000 is always quarantined and therefore $100,000 must be withdrawn each year from the commencement of the second year.

An alternative is to mitigate the anticipated volatility by diversifying the portfolio into a suite of asset classes or funds where returns are not correlated with the share market. But here again, zero interest rate policies and QE have ensured very high prices across all asset classes, increasing the level of correlation between asset classes that might one have offered protection.

A less familiar option is to invest in funds that have demonstrated some ability to protect the downside to some extent.

Less of the upside with less of the downside

The hypothetical example in Figure 1 shows the benefit to retirees of investing in a fund that captures 80% of the upside when the market rises but only 60% of the downside when the market falls.

Figure 1. Retirees benefit from 80% upside and 60% downside.

The blue upper line represents the performance of a $1 million invested in the S&P/ASX 200 Accumulation Index (dividends reinvested) over the past 27 years, which is roughly a period of retirement for somebody in excellent health retiring at age 65 today.

The performance depicted by the index however is not that experienced by a hypothetical Australian retiree required to make regular 'super pension' withdrawals over the same period.

The red line at the bottom illustrates the experience of a retiree who is 100% exposed to the vagaries of the market and required to begin drawing 5% a year from the age of 65, ratcheting up to 14% annually once they reach 90 years of age. Their ending balance is $1.85 million and super pension payments have amounted to $10.1 million.

Being required to withdraw funds irrespective of market conditions dramatically changes the outcome for an investor exposed to 100% of the upside and downside of the market.

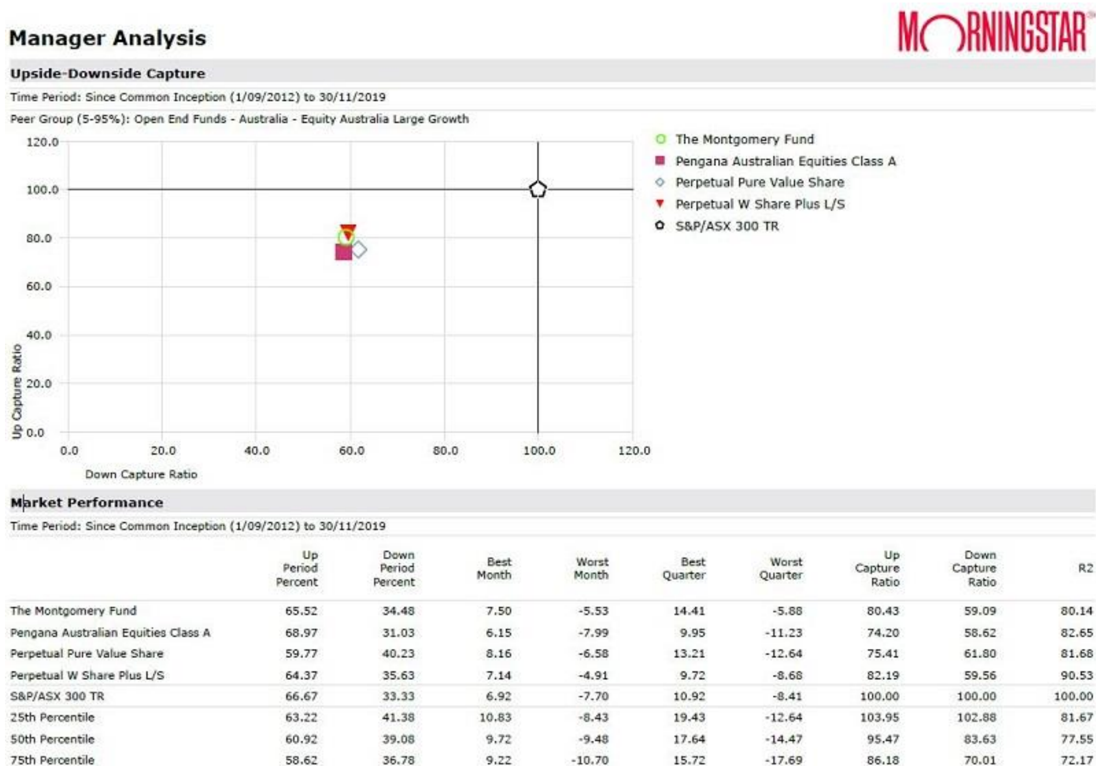
An understanding of this dynamic confirms there is merit in aiming to preserve capital for investors simply by capturing less of the downside.

The green line in Figure 1 represents the hypothetical picture for a retired investor who invests $1 million at 65 years of age in a hypothetical fund that captures 80% of the market's upside movements and 60% of its downside movements over the last 27 years.

The vast improvement over an index investment can be achieved by investing in a fund that preserves capital on the downside. The retired fund investor ends the investment period with a portfolio valued at just over $2.5 million and has received super pension payments of $12.9 million. The active fund investor's portfolio is worth 37% more than the 'index' investor and it has generated 28% more in pension payments.

A significant proportion of the population is rapidly approaching retirement or has just entered it. Market conditions, and in particular, stretched market valuations, must put sequencing risk at the forefront of advice. Therefore, finding a fund with an upside/downside capture strategy should feature in discussions between a retiree client and an adviser.

Using the Morningstar database, here are some examples. Other funds using terms such as 'managed volatility' or 'low volatility' attempt the same.



Market Performance

Time Period: Since Common Inception (1/09/2012) to 30/11/2019

	Up Period Percent	Down Period Percent	Best Month	Worst Month	Best Quarter	Worst Quarter	Up Capture Ratio	Down Capture Ratio	R2
The Montgomery Fund	65.52	34.48	7.50	-5.53	14.41	-5.88	80.43	59.09	80.14
Pengana Australian Equities Class A	68.97	31.03	6.15	-7.99	9.95	-11.23	74.20	58.62	82.65
Perpetual Pure Value Share	59.77	40.23	8.16	-6.58	13.21	-12.64	75.41	61.80	81.68
Perpetual W Share Plus L/S	64.37	35.63	7.14	-4.91	9.72	-8.68	82.19	59.56	90.53
S&P/ASX 300 TR	66.67	33.33	6.92	-7.70	10.92	-8.41	100.00	100.00	100.00
25th Percentile	63.22	41.38	10.83	-8.43	19.43	-12.64	103.95	102.88	81.67
50th Percentile	60.92	39.08	9.72	-9.48	17.64	-14.47	95.47	83.63	77.55
75th Percentile	58.62	36.78	9.22	-10.70	15.72	-17.69	86.18	70.01	72.17

Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](). This article is for general information only and does not consider the circumstances of any individual.

Fewer new LICs and LITs in 2019, but more funds raised

Peter Rae

Eight new listed investment companies (LICs) and listed investment trusts (LITs) joined the ASX in 2019. This was two less than in 2018, however, the $4.1 billion in funds raised via initial public offers exceeded the $3.3 billion raised by the sector in 2019 due to a lift in the size of the average raising. The biggest surprise of the year was the dominance of fixed interest funds, which were largely absent before the last two years.

The largest transaction was by KKR Credit Income Fund (ASX:KKC) which raised $925 million in November, followed by Magellan High Conviction Trust (ASX:MHH) which issued $862 million in October. The smallest raising was by Pengana Private Equity Trust (ASX:PE1) which raised $205 million in April. PE1 has announced it is returning to the market early in 2020 for a secondary raising.

Table: New Listed Investment Companies & Trusts

	2019	2018	2017	2016	2015
Aust Large-cap					
No. of Entities	0	1	1	1	2
Funds Raised $m	0.0	32.4	325.9	394.3	225.7
Aust Mid/small/microcap					
No. of Entities	0	1	2	2	5
Funds Raised $m	0.0	0.0	286.7	52.5	211.1
International					
No. of Entities	2	1	7	2	3
Funds Raised $m	1,418.4	465.5	2,446.1	404.4	715.0
Aust/International Blend					
No. of Entities	0	1			
Funds Raised $m	0.0	500.0			
Fixed Income					
No. of Entities	4	3	1		
Funds Raised $m	2,215.0	820.5	516.2		
Other Strategies					
No. of Entities	2	3	3	3	1
Funds Raised $m	486.8	1490.7	142.6	162.8	286.1
Total					
No. of Entities	8	10	14	8	11
Funds Raised $m	4,120.2	3,309.1	3,717.5	1,014.0	1,437.9

Source: Companies/ASX Announcements

Discounts as market caps and volumes increase

Despite the new LICs and LITs joining the ASX, overall numbers remain unchanged at 114 at the end of November. This reflects the removal of some LICs and LITs due to mergers, acquisitions and restructuring. Poor price performance was often the cause of the decision to close. Leading names issued in prior years, such as L1 Capital (ASX:LSF) and Antipodes Global (ASX:APL), have traded at discounts around 20%, which would once have been considered highly unlikely. Most equity LICs have struggled to match the rapid rise in the index during 2019.

We expect further corporate activity in 2020, with Ellerston Global Investments (ASX:EGI) already flagging its potential conversion to a trust structure to overcome the disappointing discount to Net Tangible Asset (NTA) prevalent in the sector.

Despite the unchanged total number, the market cap of LICs and LITs increased from $41.3 billion at 30 November 2018 to $52.1 billion at 30 November 2019. This reflects three factors:

- LICs and LITs that were removed were at the smaller end of the universe
- A significant number of secondary market raisings by existing LIC's and LITs
- A strong year for markets led to an increase in portfolio values in 2019.

Retail money eager to invest

With interest rates remaining low, there is still plenty of retail money looking for a home and this enabled existing LICs and LITs to tap the market for new funds. There were a significant number of secondary market raisings across the sector in 2019 with all the existing fixed income LITs returning to the market for additional funds. This should continue in 2020 with some players already foreshadowing raisings for early in the new year.

2019 also saw an uptick in both trading volumes and value as larger and more liquid issues replaced the smaller and less liquid vehicles. The rolling 12-month average number of transactions was up 42.1% and the rolling 12-month average traded value was up 26.6% through to the end of November 2019.

The year of yield

2019 will definitely go down as the year that the credit-focused fixed income asset class really established itself in the sector. Since January 2019, total assets under management in the fixed income asset class rose from $1.25 billion to over $5 billion at the end of November 2019. Four new listings during the year saw the fixed income group grow to eight.

The demand for yield from retail investors has intensified in 2019, and fixed income issues certainly benefitted. However, we remind investors that this asset class has different risk features and the risks associated with these products must be understood before investing. Each fixed income LITs has its own unique features.

Falling premiums and widening discounts

One additional feature of the sector over the course of 2019 was the reduction in the number of issues trading at premiums and the widening, or dogged persistence, of discounts. Capital management initiatives such as on market buybacks designed to eliminate or narrow these discounts have had limited impact. Here are the five largest premiums and discounts from the LICs we follow.

Discounts & Premiums to pre-tax NTA - (#)

Largest discounts		Largest premiums	
Company	**Discount**	**Company**	**Premium**
ECP	-27.3	WAX	18.3
GFL	-25.1	WAM	17.5
CD2	-23.6	PE1	11.0
CD3	-23.0	DJW	8.2
CD1	-21.4	PL8	7.4

We have noticed some narrowing of discounts in selected LICs in recent weeks and expect this to continue in the new year. Continued corporate activity could be a catalyst for discounts to narrow across the sector. Whilst we think there are some good opportunities for smart investors to enter well-managed issues at a discount, it's always important to identify a potential catalysts for a narrowing of the discount. Issues with poorly-performing portfolios are unlikely to see their discounts reduce in a hurry in the absence of a takeover offer.

Access the latest IIR Report with a more detailed list of issues and their discounts and premiums for December 2019 here.

Peter Rae is Supervisory Analyst at Independent Investment Research. This article is general information and does not consider the circumstances of any individual.

How much can retirees spend and not run out of money?

Graham Hand

The Australian superannuation system ensures most people retire with an account-based super pension, either instead of or supplemental to the age pension. A super pension is an attractive investment vehicle because earnings and withdrawals are tax free. People who have saved over their lifetime will hopefully accumulate enough in super to enjoy a reasonable standard of living in retirement.

Assuming a person has achieved a so-called 'Condition of Release', which generally means achieving the age of 65 (or 60 and ceasing an employment arrangement), they can move super from the accumulation phase of their working years to the pension phase of their retirement. They are then required to withdraw a minimum amount each year, depending on their age, as shown below (source: ASIC's MoneySmart website).

Age	Annual payment as a % of account balance
55-64	4%
65-74	5%
75-79	6%
80-84	7%
85-89	9%
90-94	11%
95+	14%

How much is needed for a comfortable retirement?

The obvious issue is whether taking this much out of a pension account each year means a retiree might run out of money in the account. Of course, superannuation is not the only source of wealth, and usually, people hold savings outside super as well as owning their own home.

The Association of Superannuation Funds of Australia (ASFA) produces an estimate of how much money is needed for both a modest and comfortable lifestyle in retirement. You can see their assumptions here. Crucially, the numbers assume retirees own their own home and are in good health. Home ownership is a massive issue in retirement, and the following amounts will be insufficient for people required to pay rent in major capital cities.

Budgets for various households and living standards for those aged around 65 (September quarter 2019, national)

	Modest lifestyle		Comfortable lifestyle	
	Single	Couple	Single	Couple
Total per year	$27,913	$40,194	$43,787	$61,786

A simple calculation shows the challenge for retirees in the current low rate environment. If a couple has $1 million in two pension accounts earning say 3% per annum, the income is only $30,000 a year. This is far less than the $61,786 a year required for a comfortable lifestyle if their only source of income is the pension account. They will therefore need to draw down their capital to meet expenses. Moreover, the average combined superannuation balance for a couple aged 65 to 69 is about $418,000 (men $247,000, women $171,000).

Consequently, most retirees fear running out of money. Recent research by AllianzRetire+ reveals only 44% of Australian retirees feel secure in their current financial position, and two-thirds spend only on necessities, worried about unexpected costs and illness.

In a previous article, Graeme Colley of SuperConcepts ran the numbers based on the ASFA comfortable standard for a retiring couple aged 57 and 59. There are many variables in calculating how long the money might last, but assuming income earned on the retirement savings is 5% per annum, and the capital is allowed to deplete to zero in the 25th year after retirement, the total amount required in today's money is $1.1 million.

Withdrawing safely with a better lifestyle

There is no simple answer to the safe withdrawal rate dilemma because it depends on many unknown factors, and there is considerable academic research on the subject. If the account delivers a healthy return of, say, 10%, then drawing down 4% each year is fine. But many highly-conservative retirees are restricting investments to cash which earns less than 2%. This barely covers inflation, and so the capital in the account is depleted each year.

This 4% drawdown level is a common guideline used in the financial planning industry as a safe drawdown rate, but it is based on a desire to spend only the fund's income and not the capital. This often means the retiree lives frugally and then leaves money in their estate, when they could have enjoyed a better lifestyle.

A group of Australian actuaries has developed a new rule to help retirees who have reached age pension eligibility decide how much they can withdraw from their savings. Their report is called, '*Spend Your Age, and a Little More, for a Happy Retirement*'. Actuaries Institute President, Nicolette Rubinsztein, said:

"The reality is that many people can have a better retirement if they have higher confidence that they are able to draw down a little bit more of their savings than the minimum required by the government."

"Many retirees draw a bare minimum from their account-based pensions, or their savings, after they stop work. They can't afford to pay for professional advice from a planner, and they live frugal lives because they fear outliving their savings. But the 'rule of thumb' is simple and accurate and takes into consideration a retiree's asset base and age."

They define 'optimal' as a draw down which allows the best possible lifestyle but allows for the fact that spending too much early in retirement means less is available later. The calculations allow for age pension eligibility.

Here is their simple 'rule of thumb' for a single retiree:

- Draw down a baseline rate, as a percentage, that is the first digit of their age.
- Add 2% if the account balance is between $250,000 and $500,000.

For example, a single retiree with a super balance of $350,000 could draw down $28,000, which is 8% of $350,000. The draw down amount would increase to 9% when the person reaches 70.

What about people with less money? The actuaries acknowledge that someone with only $40,000 might "*buy a caravan and go around Australia*", knowing they can rely on the age pension. But those with more money are more likely to use it wisely for a better retirement.

The main problem with these types of calculations is that hardly anybody knows how long they will live, and life expectancy continues to push out. The age pension is also a safety net for the majority of people. For many couples who own their own house and with other assets less than $394,500, the full age pension including supplements is $1,407 per fortnight, or $36,582 a year. This may be acceptable for a modest lifestyle, but people should aspire to better.

It is, of course, possible to assume a market scenario where someone withdraws only 4% a year and runs out of money, but investing should balance the probabilities. As Michael Kitces, a leading consultant to financial advisers, writes in this article on the old 4% rule:

"The bottom line, though, is simply to recognise that even market scenarios like the tech crash in 2000 or the financial crisis of 2008 are not ones that will likely breach the 4% safe withdrawal rate, but merely examples of bad market declines for which the 4% rule was created."

The lessons behind the numbers

The lessons from these insights, notwithstanding the potential for unlimited assumptions and uncertainty, are:

1. The money required in retirement depends on personal lifestyle aspirations, but the conservative 4% rule should not force retirees into living in a state of permanent frugality and thrift.
2. Life expectancy and future expenses are uncertain, and anyone who does not want to live on the age pension needs to consider saving more and working longer before they retire.
3. Owning a home is a significant risk mitigant (which also comes with the financial advantages of tax-free capital gains and exclusion of the home from the pension assets test).
4. Investing wisely and saving early allows the benefits of compound interest to build retirement balances over time. Education on financial opportunities is an important skill.

Retirement years should be a time to enjoy the rewards of a fulfilling working life, not worrying about when the money will run out.

Graham Hand is Managing Editor of Firstlinks, published by Morningstar. This article is general information and does not consider the circumstances of any person.

Technical analysis using four trading tools

Kim Cramer Larsson

On the back of one of the longest bull markets in history and with increasing market turmoil from geopolitical events and growing recession fears in financial markets, technical analysis is becoming more relevant. It can give a sense of direction in a specific instrument or the broader market and enhance risk management in volatile markets.

Starting with Japanese rice traders in the 17th century, the concept of technical analysis has evolved, and along with fundamental analysis, is the leading school of thought when investors analyse the future direction of financial markets.

Where fundamental analysis examines the key ratios of a business, technical analysis is based on historical data from charts to see where the market is heading. When making an in-depth analysis, it makes sense to have both methods supplementing each other instead of choosing one over the other.

Some tend to misunderstand what it is about, but technical analysis is simple in its core. It is about leveraging data to strengthen risk management, especially when to enter and exit a trade.

The danger of falling in love with a trade

The market is flooded with information and investors naturally filter out the stories that they dislike and place greater confidence in the sources they like. Many investors tend to follow a few companies or indices closely, making it easy to fall in love with a position.

It is common to take greater and greater risk when holding a losing position. And unfortunately, this often makes investors change their investment horizon, hoping it will bounce back tomorrow. Investors avoid the negative feelings of a losing position by adding to it to bring down the average price. These actions are driven by emotions and can be managed by using technical analysis tools to set a proper stop-loss position.

The importance of trends

When using technical analysis, observing trends is an important discipline. In short, a trend can be described as the general direction of the market during a specified time period. Trends can be both bullish and bearish, and the length may vary between hours and months. Utilising trends can help investors piece together a full investment overview and give indications when to invest – and when not to.

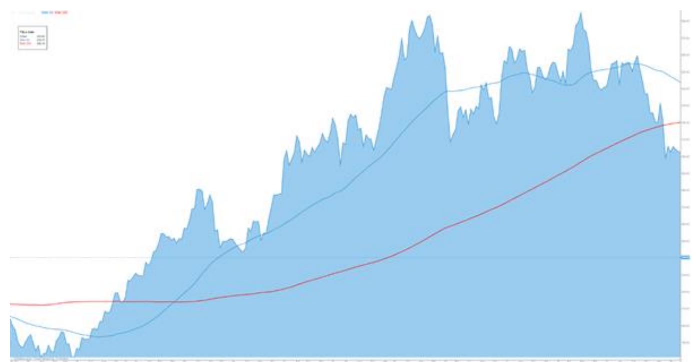
Four technical analysis tools and how to use them

1. Simple moving average

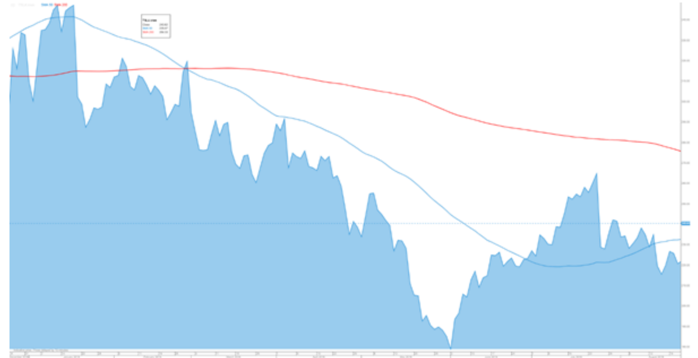
A simple moving average smooths out price movements and reduces 'noise'. It is calculated by adding the closing price of a security for a distinct amount of time – usually 20, 50 or 200 days – and then dividing this total by that same number. A shorter amount of days will lead to more volatility. When using a simple moving average, look for the time when the two moving averages cross which is usually referred to as either a 'death cross' or a 'golden cross'. While these can be used to see a coming trend, they are not the strongest signals as the simple moving average is a lagging indicator.

BULLISH SIGNAL:

The golden cross occurs when the 50-day simple moving average crosses above a rising 200-day moving average. This is considered a sign of a bullish market and a buying indicator. This chart shows Tesla stock, where the golden cross occurred in the beginning of 2017 marking the starting point of a positive trend in the stock price.



BEARISH SIGNAL:



A death cross is when the 50-day simple moving average curve crosses below a falling 200-day moving average. This is a sign of a bearish market, which could indicate it is time to sell. In this chart, the 50-day average crossed below the 200-day line (in red) indicating a longer downward trend throughout the year.

2. Trend lines

Setting up trend lines is a way to find indications on when to buy and when to cut your losses. Trend lines are made by drawing a line from between two or more price points either high points or low points to draw the resistance and support line.

BULLISH SIGNAL:

The upper trend line is the resistance trend line. When the price breaks the resistance line, it could indicate a positive trend for that given instrument and signals a buy signal. In this example it would mean the NASDAQ 100 index would have to break through 8100.

BEARISH SIGNAL:

The lower price points form the support trend line. It is to set stop-losses or identify short opportunities. If an instrument suddenly breaks the support line, it is often a bearish signal and indicates a price where the investor would typically benefit from cutting the loss rather than holding onto a falling knife. In this example it would mean the NASDAQ 100 index crossing below 7600.

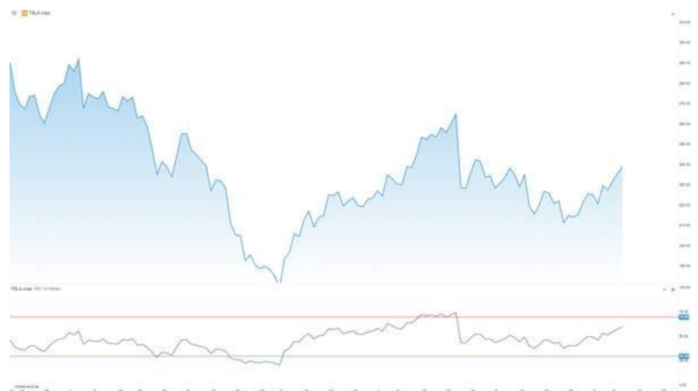
3. Relative Strength Index (RSI)

RSI is a momentum indicator ranging from 0-100 showing the relations between the latest movement in the market. This can help to indicate whether an asset is being overbought or oversold.

BULLISH SIGNAL:

When the indicator is between 0-30, it means the asset is being oversold, meaning it might be time to buy up before the trend is turning. In the case of Tesla in May, the RSI dipped below 30 before bouncing back up in the coming months.

BEARISH SIGNAL:



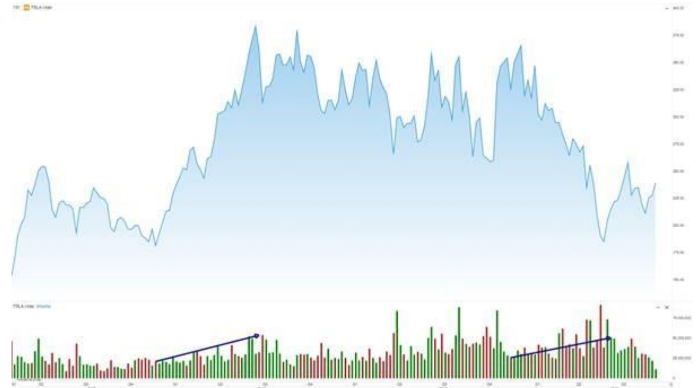
If the indicator is placed between 70-100, it shows the asset is being overbought. This means it might be the right time to withdraw before the trend turns. In the Tesla example, that is shown in July when the RSI went above 70, which marked a turn in trend.

4. Volume

Keeping an eye on the trading volumes can indicate when the market is about to go up or down. The volume increases when investors buy or sell a certain asset and decreases when it is not being traded. Price and volume go hand-in-hand since there is no market without price movement, and there is no price movement without volume. Volume represents balance of supply and demand that moves prices up and down.

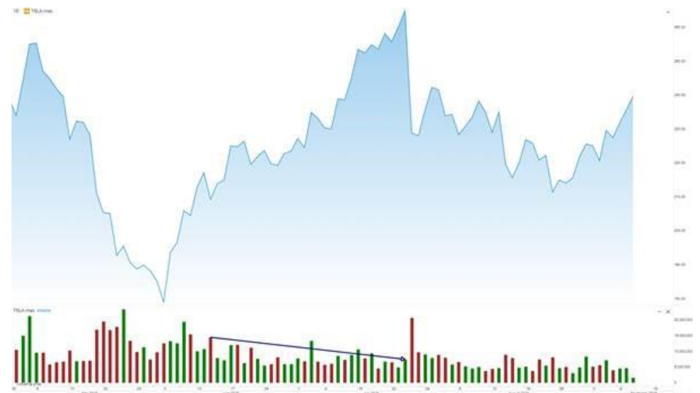
BULLISH SIGNAL:

When price and volume is rising, it is an uptrend confirmation and a bullish signal.



BEARISH SIGNAL

If the price is rising but volume falling it indicates an imbalance in the market and is a sign of price exhaustion.



Kim Cramer Larsson is a Technical Analyst at [Saxo Bank](#) (Australia). This article covers a specialist subject and does not address the circumstances or skills of any individual. As these tools require expertise, they should be used in consultation with professional advice.

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