Firstlinks
Connecting investors with ideas

Edition 338, 3 January 2020

Chris Cuffe's 10 favourite articles of 2019, plus 2

Franking credits made easy

Graham Hand

Dudley requested: "Please publish a simple article to explain company tax, dividend imputation, franking credits and double taxation. It would help eliminate some of the woeful nonsense written on the topic. My guess is that less than 1% of the public can describe the taxation of dividends, yet it is simple and most people have some level of understanding of imputation through the PAYG system. Let's make the debate more grounded in fact."

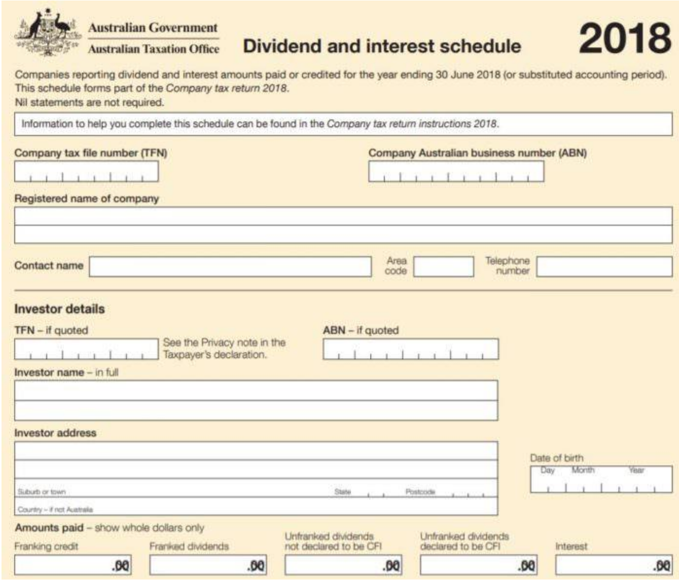
Cuffelinks has published several explanations on franking, such as by Geoff Walker, Warren Bird and Jon Kalkman.

Here's the short version: **to avoid taxing company profits twice, tax must be paid at either the company or individual level, but not both. If it were paid only at a company level, high income people would benefit from the 30% tax rate. So our system taxes company profits at the individual's level. Any tax already paid by the company is refunded.**

Shareholders pay tax on franked dividends at their personal marginal tax rates and receive a credit for the tax on profits paid by the company. For example:

1. A company makes a profit of $100 and pays company tax of $30 at the 30% rate.
2. The franking credit account of the company increases by $30.
3. The company fully distributes the profit after tax by declaring franked dividends to shareholders of $70.

4. The company informs the Australian Taxation Office (ATO) how much dividend was paid to each shareholder and the proportional amount of franking credits for each shareholder. The ATO return looks like this, from Dividend and interest schedule 2018:



Australian Government
Australian Taxation Office

Dividend and interest schedule **2018**

Companies reporting dividend and interest amounts paid or credited for the year ending 30 June 2018 (or substituted accounting period).
This schedule forms part of the *Company tax return 2018*.
Nil statements are not required.

Information to help you complete this schedule can be found in the *Company tax return instructions 2018*.

Company tax file number (TFN)

Company Australian business number (ABN)

Registered name of company

Contact name Area code Telephone number

Investor details

TFN – if quoted See the Privacy note in the Taxpayer's declaration.

ABN – if quoted

Investor name – in full

Investor address

Suburb or town State Postcode

Country – if not Australia

Date of birth Day Month Year

Amounts paid – show whole dollars only

Franking credit	Franked dividends	Unfranked dividends not declared to be CFI	Unfranked dividends declared to be CFI	Interest
.00	.00	.00	.00	.00

5. ATO imputes (or 'allocates' or 'assigns' or 'credits') the franking credit to each shareholder, and reduces the company's franking account by the same amount.

6. When shareholders complete their tax returns, they add the $70 of dividend to the $30 of franking to declare the $100 of taxable income, in this form here. The $100 of company profit is therefore subject to tax.

7. Shareholders pay tax on the $100 at their marginal tax rate and claim the $30 that was already paid by the company as a tax credit.

8. If the shareholder's marginal tax rate is 45%, the tax is $45 but $30 is a tax credit and the shareholder pays the extra $15 to the ATO.

9. If the shareholder's marginal tax rate is 0% (for example, someone with income below the tax-free threshold of $18,200 or an SMSF in pension mode), the tax is $0 and the $30 is refunded to the shareholder (in the current system).

10. Under the Labor proposal, the franking credit can be used to pay tax on other income but there will be no refund for investors who cannot use the full $30 credit (with some exceptions).

The denial of refunds of franking credits results in a minimum tax rate the same as the company rate for the shareholders earning only fully franked company dividend income. Those shareholders would not be able to access the tax rate previously offered by the 0% and 19% tax bands.

Here ends the simple bit.

Why is there such an argument going on?

The treatment of three different people earning $17,500

Warren Bird provided this example of unwelcome consequences:

- Person A does some part-time work that earns $17,500 a year, just under the income tax threshold. They don’t pay tax.
- Person B is semi-retired, but runs a small sole trader business that brings in a net of $17,500 a year. They also don’t pay tax.
- Person C is retired and owns shares in a company that earns $17,500 of profit on C’s shares. Being a company with other shareholders, it pays 30% company tax and most of the rest is distributed to shareholders as dividends. Person C receives a dividend of $12,250 (that is, 70% of $17,500). They have effectively paid $5,250 in tax on their income because of the veil that the company structure has created.

Under the current imputation system, Person C receives a franking credit for that amount and a payment of $5,250 comes from the ATO. This recognises the fact that the full $17,500 earned by the company should belong to Person C, just the same as Person B’s business income or Person A’s part-time salary.

It’s similar to someone getting a tax refund at the end of the year because their PAYG taxes didn’t take legitimate deductions into account. They overpaid tax and so are allowed to get it back. It is their money.

Why we tax companies based on their shareholders’ marginal tax rates

Steve Martin had a senior technical career in financial services, is a CTA Chartered Tax Adviser (retired) and a FIPA Fellow of the Institute of Public Accountants (retired). He provided this summary.

At its heart, our company tax system operates on the proposition that company profits are taxed at the shareholder level. To understand why we do this, you need to understand the history of company tax and the options for alternatives.

In fairness, you want to create a system that taxes company profits once, but you have some options. You can tax at the company level (say 30% on all company profits); or, you can do as is done with partnerships and trusts, and use the company as a conduit and tax the profits solely in the hands of the shareholder. When taxing the hands of the shareholder, there is a risk to revenue collection, so there is a strong case to withhold tax at the company level to make sure that the company profits (i.e. dividends) are ultimately disclosed at the shareholder level.

Voila! the Australian system.

If the Australian tax system did not have the withholding tax at the company level but just taxed shareholders, would self-funded retirees have been any better or worse off since 2000? Neither, they would have received untaxed company profits – i.e. a $100 dividend instead of a $70 dividend with a further tax refund of $30 at tax time.

Why not just tax companies?

Because there would be a significant shortfall in revenue. While all of the attention has been on those shareholders who have a tax rate of under 30%, far more of our company profits are taxed in the hands of shareholders who are on a **higher tax bracket**. Also, the tax burden on lower income earners is unjust and this plays into the present controversy.

In 1979 the Fraser Government commissioned an independent review into the Financial System. The Campbell Review considered the then double taxation of company profits: firstly in the hands of the company and secondly in the hands of the shareholder. The committee set a critical benchmark when it said at paragraph 13.8:

"the taxation system should meet the tests of neutrality, equity and simplicity."

The Campbell Review set out in beautiful simplicity the company tax system we have now enjoyed for some 30 years.

In dealing with the system of imputation, it described the tax paid at the company level as a "withholding tax" (at 14.39) and it contemplated as part of a full imputation system that there would be a refund of excess credits to lower income earners (at 14.40).

The Report highlighted that company tax profits ought to be taxed once, effectively by reference to the marginal tax rates of the shareholder. It looked through the corporate veil and asked the central question at Para 14:

"the relevant question is how the individual shareholders overall tax burden compares with the tax he would have paid had the equivalent income been received through non-corporate channels and the whole amount being taxed at personal rates."

It described as inequitable when the 'effective combined company and personal income tax rate' is higher 'than the marginal personal income tax rate'.

Labor proposal puts that inequity back into the system

In setting out the blueprint for the present imputation system, it recognised that such a radical new approach could adversely affect government revenue and so, as a first step, it recommended that refunds could be held back as an 'interim' measure.

The Hawke-Keating Government in 1987 gave effect to the 'interim' recommendation of the Campbell Review. What Keating did was not, as represented by Shorten and Bowen, the original Keating model; it was the interim recommendation of the Campbell Review.

The interim arrangements ended following the Ralph Review in 1999. The legislation giving effect to refunds of excess franking credits was introduced under the Howard Government. Our present system was designed by an independent body and was implemented with bipartisan support.

The proposed change is unfair to low to middle income earners and compromises the company tax system that has held us in good stead for nearly 30 years. The proposal fails the essential integrity tests of equity and neutrality, and this failure is made worse by the exemptions given to unions and other not-for-profits and pensioners.

Should a potential Treasurer of our country understand this? Yes. So, why would a potential Labor government create a policy that hurts lower income earners?

Graham Hand is Managing Editor of Cuffelinks.

Marks and the tax system explained in beer

Howard Marks

The following explanation of the tax system has been popular for many years, and in his latest memo released yesterday, Oaktree's Howard Marks quotes it and says,

"I've been waiting a long time for a chance to use this. The numbers may not be exactly right but the idea is. The unarguable bottom line is that everyone's view of the fairness of the tax system - like most such matters - depends largely on the angle from which you look at it."

Here is an example of the beer explanation:

"Suppose that once a week, ten men go out for beer and the bill for all ten comes to **£100.** If they paid their bill the way we pay our taxes, it would go something like this...

The first four men (the poorest) would pay nothing.
The fifth would pay £1.
The sixth would pay £3.
The seventh would pay £7.
The eighth would pay £12.
The ninth would pay £18.
And the tenth man (the richest) would pay £59.

So, that's what they decided to do.

The ten men drank in the bar every week and seemed quite happy with the arrangement until, one day, the owner caused them a little problem. "*Since you are all such good customers,*" he said, "*I'm going to reduce the cost of your weekly beer by **£20**.*" Drinks for the ten men would now cost just **£80.**

The group still wanted to pay their bill the way we pay our taxes. So the first four men were unaffected. They would still drink for free but what about the other six men? The paying customers? How could they divide the £20 windfall so that everyone would get his fair share? They realized that £20 divided by six is £3.33 but if they subtracted that from everybody's share then not only would the first four men still be drinking for free but the fifth and sixth man would each end up being paid to drink his beer.

So, the bar owner suggested that it would be fairer to reduce each man's bill by a higher percentage. They decided to follow the principle of the tax system they had been using and he proceeded to work out the amounts he suggested that each should now pay.

And so, the fifth man, like the first four, now paid nothing (a 100% saving).
The sixth man now paid £2 instead of £3 (a 33% saving).
The seventh man now paid £5 instead of £7 (a 28% saving).
The eighth man now paid £9 instead of £12 (a 25% saving).
The ninth man now paid £14 instead of £18 (a 22% saving).
And the tenth man now paid £49 instead of £59 (a 16% saving).

Each of the last six was better off than before with the first four continuing to drink for free.

But, once outside the bar, the men began to compare their savings. *"I only got £1 out of the £20 saving,"* declared the sixth man. He pointed to the tenth man, "*but he got **£10!***"

"Yeah, that's right," exclaimed the fifth man. "*I only saved a £1 too. It's unfair that he got ten times more benefit than me!"*

"That's true!" shouted the seventh man. *"Why should he get £10 back, when I only got £2? The wealthy get all the breaks!"*

"Wait a minute," yelled the first four men in unison, "we didn't get anything at all. This new tax system exploits the poor!" The nine men surrounded the tenth and beat him up.

The next week the tenth man didn't show up for drinks, so the nine sat down and had their beers without him. But when it came time to pay the bill, they discovered something important - they didn't have enough money between all of them to pay for even half of the bill!

And that is how our tax system works. The people who already pay the highest taxes will naturally get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy and they just might not show up anymore. In fact, they might start drinking overseas, where the atmosphere is somewhat friendlier."

8 problems the Royal Commission missed

Graham Hand

Commissioner Kenneth Hayne and his staff have done a good job, and rightly, he now has an exalted place in Australian financial markets history. It's almost sacrilege to criticise, but either due to the limited time allowed, the mandate or his focus, the work was not perfect.

The lack of time was somewhat self-inflicted. Many months ago, as someone who watched maybe 100 hours of hearings, I became frustrated with the amount of time the Commission was spending on a few issues. I wrote this editorial on 10 August 2018:

"Okay, we get it, please move on. The Royal Commission is doing great work uncovering poor practices in financial services, but after nearly three days on superannuation, it had interviewed only one company. The witness list has 16 entities on it. We already know from Round 2 in April that there is a systematic problem with advice fees. I have listened to a dozen hours of the Commission this week and we have run around in circles with two MLC/NAB witnesses, and one has returned for more questions today on Day 4 ...

There's so much else it should address: performance reporting, fee calculations, rates paid on cash, valuations of unlisted assets, definition of 'defensive' assets (credit, property, alternatives), performance fees, active managers hugging the index, risk versus return, bid/offer prices, etc. And what about the dubious banking practices which have changed little in the 20 years since I wrote Naked Among Cannibals?

These issues will have more long-term impact on the vast majority of customer returns than charging fees for no advice or to dead people. I hope the Commission does not run out of time."

How Hayne rewrote the rules and achieved strong results

Hayne set new standards of enquiry which will lead the way for regulators. We knew something was unique from the moment the Commissioner aggressively pointed his finger at National Bank's counsel, Neil Young QC, who was questioning why his client needed to return the next day. Young had said, "*On our instruction, her answer will be that she had no involvement in these matters.*" Hayne hit the roof.

"*You will not give her her answer, Mr Young. You will not. Do you understand me?"*

And barely a peep was heard from any QC for the rest of the year.

The Royal Commission struck gold with a simple approach. Prior to the commencement of hearings, financial institutions were given the opportunity to come clean with their past mistakes. Hundreds of pages of misdemeanors flooded into the Commission, and thereafter, the skilled QCs assisting Hayne played back the admissions before embarrassed executives. Rowena Orr's '*Let me show you a document*' become a chilling phrase. Witnesses were forced to admit the sins of themselves, their companies and colleagues, and along the way, many did not survive. Sam Henderson, Terry McMaster, Chris Kelaher, Craig Mellor, Catherine Brenner, Andrew Hagger, the four majors, AMP, IOOF and many more became victims.

Major issues missed by the Commission

Acknowledging the Royal Commission did a great job in shining light into dark corners, what did it miss, touch on or struggle with?

1. How banks price their products

Banks and other financial institutions offer a vast array of services. They are effectively the 'plumbing system' of the economy, especially in providing payment systems and intermediating between borrowers and lenders. Yet it is not difficult to find vital services which received little or no Commission attention.

Take the example of the way banks price their products. Why do the banks rollover the term deposits of existing customers at sub-market rates, forcing loyal customers to make a phone call to achieve a better rate? The vast majority can't be bothered or don't know the benefits, and what banks call 'retail inertia' makes a major contribution to interest margins. Why have credit card rates remained above 20%, when the poorest customers without the ability to pay off their cards each month suffer the most? Why do new customers receive lower mortgage rates than existing? Ross McEwan went to RBS in the UK after he missed the CBA CEO job to Ian Narev, and he said in 2014 that he found it,

"... absolutely abhorrent that you would give a new customer a better deal than someone who has been with you for 30 years."

I have written extensively on the subject of how banks price their products to protect profits, including in this article. For me, failing to address this was Hayne's biggest shortcoming, because it affects millions of Australians in their everyday banking. Instead, the Commission spent day after day on financial advice and issues such as 'charging fees to dead people' which impact a relatively small number of people.

2. Difficulty pinning down culture

The complex subject of 'culture' seems at the heart of the problem in banks, but like many before him, Hayne struggled to define and grasp it. The most common phrase in response to the Commission will be 'rebuilding trust', which is convenient because there's no real way to measure it.

In the Final Report, Commissioner Hayne said:

"Too little attention has been given to the evident connections between compensation, incentive and remuneration practices and regulatory, compliance and conduct risks."

But what to do about such a culture?

A significant problem is how to define community expectations. A leading law firm, Allens, told *The Australian Financial Review* that while Hayne was extremely well placed to opine on matters of the law, he had no special expertise in deciding a benchmark for community standards. Banks do not have one dominant type of culture, although Hayne said poor behaviour could be traced to the pursuit of profit over other purposes.

We have written more on culture here.

3. Accessing the financial advice that people need

It's well established that most people are unwilling to pay enough for financial advice to cover the cost of providing the full service. Many financial advice groups are thriving by servicing wealthy clients, willing to pay 1% or $20,000 a year for advice on a $2 million portfolio (and of course, much more). But charge 1% on $50,000 and $500 pays for two hours with a decent adviser, which is barely enough time to crank up the spreadsheet let alone have a decent conversation and produce the obligatory 70-page Statement of Advice.

The large banks addressed this problem by cross subsidising, selling their own products such as managed funds to help pay for advice. This led to the claims of not putting the clients' best interests first and favouring in-house products.

The end result of the criticism is banks stepping away from providing financial advice and fewer Australians having access to the services they need. Long-term planning and retirement incomes are likely to suffer as a result. Financial advisers do not only focus on investing, but they address aged care, social security entitlements, superannuation structures, estate planning ... on it goes. Is it better that the bank teller will send the bank client to the adviser in the office above the real estate agent, and hope the conflicts are less there?

The unclear mix of a sales culture with provision of financial advice confused the best interest duty of advisers for their clients. The revelations at the Royal Commission have further undermined public confidence in financial advisers, and are no doubt partly responsible for the outflow from retail funds to industry funds. But most industry funds have modest advice businesses, often focussed on limited or 'scaled' advice given the difficult economics of servicing members with low balances.

4. Fund commissions remain in certain sectors

Hayne has come down hard on commissions paid by product manufacturers to financial advisers, recommending a banning. But what about commissions by another name, such as paid by new issuers in Initial Public Offerings (IPOs) on the ASX? Commonly, the issuer will pay the lead broker and other brokers a 1% or more selling fee. Some brokers then offer this to financial advisers to sell the IPO to their clients, and while some advisers may reimburse it to clients, many do not. Why is a financial adviser prohibited from accepting a commission from a fund manager for an unlisted fund under the Future of Financial Advice rules and now Hayne's recommendations, when a Listed Investment Company from the same manager indirectly pays the adviser a fee?

5. Underestimating the competitive role of mortgage brokers

According to a Momentum Intelligence survey of 5,782 borrowers, 79% were not concerned that brokers are paid commissions by banks. The report, called *Consumer Access to Mortgages*, found 96% of people who use or intend to use a mortgage broker would be unwilling to pay the average upfront commission of $2,000 that banks pay to settle a mortgage. There was a perception among those surveyed (who may not represent the entire population) that brokers source the best loans and deliver the widest choice. Of course, the Royal Commission and some bank CEOs have offered different examples of brokers acting in their own best interests with poorly-structured incentive schemes.

If the service were not available, a competitive force would be removed with borrowers dealing directly with the banks with the biggest branch networks. A KPMG survey says mortgage brokers have helped reduce net interest margins of the banks by up to 20% in the last 10 years through increased competition.

In the interests of full disclosure, it should be noted that Momentum Intelligence is part of a media group that publishes titles aimed at mortgage brokers and real estate professionals. Nevertheless, with brokers now commanding a market share of mortgage origination of over 50%, it's easy to see how a ban on payments by banks to mortgage brokers will increase the power of the big banks.

In the Final Report, mortgage brokers will be subjected to a best interests duty and a ban on trail commissions from July 2020. Many brokers argue they provide a significant ongoing service, but Hayne rejected this, saying:

"The chief value of trail commissions to the recipient, to put it bluntly, is that they are money for nothing."

In the only exception to agreeing to implement all 76 recommendations, Josh Frydenberg said the Government would delay its decision on Hayne's call for upfront commissions to be banned and replaced by a customer-paid fee.

In response to the Final Report, Peter White, the Finance Brokers Association of Australia Managing Director, said,

"If a user-pays model was implemented, we know that most borrowers wouldn't pay, and banks would make more money and standards would drop further. It's very disappointing that the Royal Commission wants to destroy some 20,000 small businesses for the monetary gain of the big banks, and we trust the government will see clearly on this and continue to work extensively with our industry to improve consumer outcomes."

6. Industry funds escape detailed scrutiny

If the Productivity Commission recommendation on choosing the 10 'Best in Class' superannuation funds as defaults is adopted, industry funds are likely to dominate and their success will be further consolidated. Retail funds will struggle to compete. As the dominant institutional provider of retirement savings, Hayne should have explored some of the criticisms levelled at them more.

Instead, we are left wondering if the claims of competitors such as retail funds have merit. Examples include the methods used to value unlisted assets, which carry a higher weight in industry fund portfolios than in retail funds. The role of union members as directors of the boards of industry funds and the extent to which their board fees are paid to their unions and ultimately to assist the Labor Party, was overlooked. There was some scrutiny of entertaining at major events and industry funds spending millions a year on The New Daily publication, but the not-for-profit sector enjoyed the Royal Commission.

7. Financial advisers have a right to charge 'fees to dead people'

It's a great headline and the type of phrase people can easily recall, and on the surface, it sounds terrible to charge 'fees to dead people'. But the profession (the legal people at the Commission) arguing financial advisers should not victimise dead people is the same profession that often charges 'fees to dead people'. When a lawyer handles the will of a dead person and helps to administer the estate, do they do so with a feeling of sadness and benevolence and not charge fees? Of course they don't, it's a major part of many legal practices.

Financial advisers often have considerable work involved with an estate. Accounts remain open until probate, the process of proving and registering the will of a deceased person with the Supreme Court. When a person dies, many people are involved with their estate, and the executor of the will administers the estate and handles the disposal of assets and debts. Is the financial adviser the only one who is not supposed to be paid?

8. Lack of financial literacy taught in schools

At the heart of many issues uncovered by the Royal Commission is a community with poor overall financial literacy. Many people do not know which superannuation fund they are in, its cost and features, they pay for insurance they don't need or can't claim on and hold multiple accounts with duplicate fees. They carry credit card debt costing 20% and buy properties off-the-plan from spruikers.

Okay, this was a 'misconduct' Commission, but with both the Government and Opposition promising to implement recommendations, it was an opportunity to direct funds to education and help better-informed people make educated decisions and reduce the misconduct opportunities in future.

Finally, back to the earlier point, what about ...

... performance reporting, fee calculations, rates paid on cash, definition of 'defensive' assets (credit, property, alternatives), performance fees, active managers hugging the index, risk versus return, bid/offer prices, etc.

Feel free to add any comments on other issues the Royal Commission could have addressed.

Graham Hand is Managing Editor of Cuffelinks.

My nine all-time essential investing lessons

Shane Oliver

I have been working in and around investment markets for 35 years now. A lot has happened over that time. The 1987 crash, the recession Australia had to have, the Asian crisis, the tech boom/tech wreck, the mining boom, the Global Financial Crisis, the Eurozone crisis. Financial deregulation, financial reregulation. The end of the cold war, US domination, the rise of Asia and then China. And so on.

But the more things change, the more they stay the same, and this is particularly true for investing. Here are the nine most important things I have learned over the past 35 years.

 # 1 There is always a cycle

Droll as it sounds, the one big thing I have seen over and over is that investment markets constantly go through cyclical phases of good times and bad. Some are short term, such as those that relate to the 3 to 5-year business cycle. Some are longer, such as the secular swings seen over 10 to 20-year periods in shares. Some get stuck in certain phases for long periods. Debate is endless about what drives cycles, but all eventually contain the seeds of their own reversal. Ultimately there is no such thing as new eras, new paradigms and new normal as all things must pass. Share markets often lead economic cycles, so economic data is often of no use in timing turning points in shares.

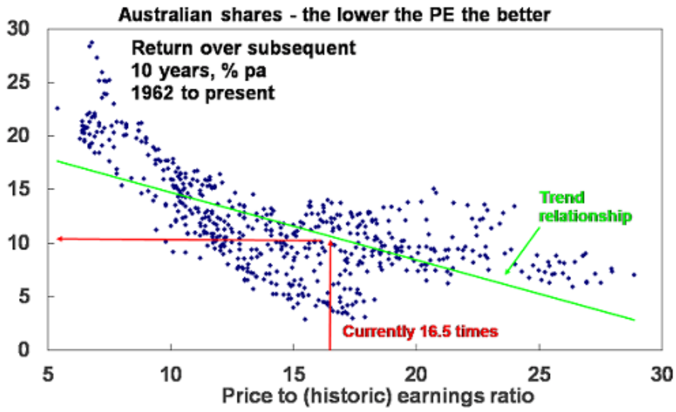
 # 2 The crowd gets it wrong at extremes

These cycles in markets get magnified by bouts of investor irrationality that take them well away from fundamentally justified levels. This is rooted in investor psychology and flows from a range of behavioural biases. These include the tendency to project the current state of the world into the future, the tendency to look for evidence that confirms your views, overconfidence and a lower tolerance for losses than gains.

It follows that what the investor crowd is doing is often not good for you to do too. We often feel safest when investing in an asset when neighbours and friends are doing the same and media commentary is reinforcing the message that it's the right thing to do. This 'safety in numbers' approach is often doomed to failure. Whether its investors piling into Japanese shares at the end of the 1980s, Asian shares into the mid-1990s, IT stocks in the late 1990s, US housing and dodgy credit in the mid-2000s or Bitcoin in 2017. There is no one left to buy but lots of people who can sell on bad news. So, the point of maximum opportunity is when the crowd is pessimistic, and the point of maximum risk is when the crowd is euphoric.

 # 3 What you pay for an investment matters a lot

The cheaper you buy an asset, the higher its prospective return. Guides to this are price to earnings ratios for share markets (the lower the better – see the next chart) and yields, i.e. the ratio of dividends, rents or interest payments to the value of the asset (the higher the better). Yesterday's winners are often tomorrow's losers because they became overvalued and overloved and vice versa. Many find it easier to buy after shares have had a strong run because confidence is high. Then they sell after a big fall because confidence is low.



Source: Global Financial Data, AMP Capital

 # 4 Getting markets right is not as easy as you think

In hindsight, it all looks easy. Looking forward, no-one has a perfect crystal ball. As JK Galbraith observed,

"There are two kinds of forecasters: those who don't know, and those who don't know they don't know."

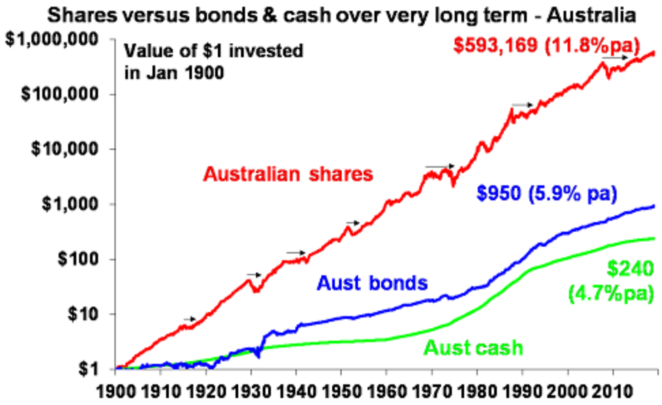
Usually the grander the forecast – calls for 'great booms' or 'great crashes ahead' – the greater the need for scepticism as such calls invariably get the timing wrong (in which case you lose before it comes right) or are dead wrong. Market prognosticators suffer from the same psychological biases as everyone else. Many are wrong due to blind faith opinions, such as "there is too much debt", "house prices are too high and are guaranteed to crash", "the Eurozone will break up". They may be right one day, but an investor can lose a lot of money in the interim. The world is getting noisier as the flow of information and opinion has turned from a trickle to a flood and the prognosticators become shriller to get heard.

 # 5 Investment markets don't learn

Investment markets repeat the same mistakes as markets lurch from one extreme to another. After each bust, many say it will never happen again and the regulators move in to try and make sure it doesn't. But it does! The details change but the pattern doesn't. Mark Twain is quoted, "History doesn't repeat, but it rhymes." Sure, individuals learn and the bigger the blow up, the longer the learning lasts. But there's always a fresh stream of newcomers to markets and in time collective memory dims.

6 Compound interest is like magic

This one goes way back to my good friend Dr Don Stammer. One dollar invested in Australian cash in 1900 would today be worth $240 and if it had been invested in bonds it would be worth $950, but if it was allocated to Australian shares it would be worth $593,169. Although the average annual return on Australian shares (11.8% pa) is just double that on Australian bonds (5.9% pa) over the last 119 years, the magic of compounding higher returns leads to a substantially higher balance over long periods. Yes, there were lots of rough periods along the way for shares as highlighted by arrows on the chart, but the impact of compounding at a higher long-term return is huge over long periods of time. The same applies to other growth-related assets such as property.



Source: Global Financial Data, AMP Capital

7 It pays to be optimistic

The well-known advocate of value investing Benjamin Graham observed that "To be an investor you must be a believer in a better tomorrow." If you don't believe the bank will look after your deposits, that most borrowers will pay their debts, that most companies will grow their profits, that properties will earn rents, etc then you should not invest. Since 1900 the Australian share market has had a positive return in roughly eight years out of ten and for the US share market it's roughly seven years out of 10. So getting too hung up worrying about the next two or three years in 10 that the market will fall risks missing out on the seven or eight years out of 10 when it rises.

8 Keep it simple stupid

Investing should be simple, but we have a knack for overcomplicating it. And it's getting worse with more options, more information, more apps and platforms, more opportunities for gearing and more rules and regulations around investing. We can't see the wood for the trees. We spend too much time on second-order issues like this share versus that share or this fund manager versus that fund manager, and we end up ignoring the key driver of your portfolio's performance: the high-level asset allocation across shares, bonds, property, etc. It's best to keep it simple, don't fret the small stuff, keep the gearing manageable and don't invest in products you don't understand.

9 You need to know yourself to succeed at investing

We all suffer from the psychological weaknesses referred to earlier. Smart investors are aware of them and seek to manage them. One way to do this is to take a long-term approach to investing. But this is also about knowing what you want to do. If you want to take a day-to-day role in managing your investments then regular trading and/or an SMSF may work, but it requires effort and a rigorous process. If you don't have the time and would rather do other things like sailing, working at your day job, or having fun with the kids, then it may be best to use managed funds.

It's also about knowing how you would react if your investment suddenly dropped 20% in value. If your reaction is to get out, you could be selling low and locking in a loss. You may need an investment strategy offering greater stability over time, which would probably mean accepting lower returns.

All of this underpins what I call the Nine Keys to Successful Investing which also covers diversification and seeking financial advice.

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at AMP Capital, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

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10 reasons many fund managers are now blank spaces

Graham Hand

So it's gonna be forever
Or it's gonna go down in flames
You can tell me when it's over
If the high was worth the pain
Got a long list of ex-lovers
They'll tell you I'm insane
'Cause you know I love the players
And you love the game

-Taylor Swift, Blank Space

Yes, Taylor, we loved the players and we loved the game. Swiftly, it's over, leaving a blank space.

It looks easy from the outside, but asset management is a tough game. Winners can win big, but there are far more strugglers. In a concentrated portfolio, a heavy overweight position in a losing stock can mean "*it's gonna go down in flames".*

Recently, an unprecedented number of fund managers have closed their businesses or some of their funds, including:

- KIS Capital
- Sigma Funds
- JCP Investment Partners
- Dual Momentum
- Janus Henderson Australian equity funds
- MHOR Asset Management
- Discovery Asset Management
- Denning Pryce
- Adam Smith Asset Management
- Concise Asset Management
- Arnhem Investment Management
- Ellerston Global Macro
- Colonial First State Global Asset Management 'Core' funds (transferred to other managers)
- UBS Asset Management Australian equity funds (transferred to Yarra Capital)
- Altair Asset Management

For many years, I managed the 'alliance' business for Colonial First State (CFS), where we would partner with portfolio managers to establish new operations. We saw all types of potential come across our desks, from a couple of people wanting to set up their own boutique, through to large global managers establishing an Australian business.

How hard can it be? While there are some overlaps in the following reasons, here are 10 industry hurdles to overcome. These may or may not apply to the above names.

1. The growth of index investing

In 2018 in the US, passive index funds (including unlisted mutual (managed) funds and Exchange-Traded Funds (ETFs)) enjoyed a net inflow of US$431 billion, while active mutual funds experienced net outflows of $418 billion, as shown below. Given the large fee difference, that represents a loss of hundreds of millions of dollars in fees to the asset management industry. It's also become widely-accepted wisdom that most active managers do not beat the index.

In Deloitte's 2019 Investment Management Outlook, 16 of the top 20 global funds by net flows were passive mutual funds and ETFs, gathering a net US$143 billion.

Source: Bloomberg and BetaShares

In the US, it is estimated that 34% of mutual funds and ETFs are passively managed. This number is only about 12% in Australia, but momentum is well-established. Most local ETFs are index-based and in the final quarter of FY2019, ETFs listed on the ASX exceeded $50 billion for the first time.

It is not only the fund flows that hurt active managers, but the price competition. Institutions can achieve index management on large portfolios for 1 or 2 basis points (0.01 to 0.02%), forcing active managers to compete as low as 20 basis points (0.2%). It is difficult to finance a fully functioning active operation of portfolio managers, analysts and support functions at such low fees unless billions of dollars are held. Even a good $250 million mandate would bring in only $500,000, which would barely cover the cost of a senior portfolio manager.

2. In-house management by large institutions

Many of the largest superannuation funds in Australia are boosting their in-house asset management capabilities and withdrawing mandates from external managers. The most high-profile in the last year was AustralianSuper's move of $7.7 billion internally from Perpetual Investments, Fidelity International and Alphinity Investment Management. These are not small boutiques but long-term successful fund managers with substantial operations of their own.

CIO, Mark Delaney, explained the change:

"We found there was an overlap in the shares held by the different managers. Over the last three or four years, we found that in Australian equities, in terms of the stocks held, we had the same stocks in the top 50 and these holdings did not change much. This is the nature of the Australian market. It has a narrow number of stocks and a narrow number of sectors."

Currently, about 58% of AustralianSuper's Australian equities assets are managed internally, and most of the external management is in the cheaper index funds.

The large superannuation funds now attract top talent receiving market-comparable salaries. While most of the leading CIOs could earn more in the private sector, the super sector's guaranteed inflows, stability of funding, lack of need to continually pitch for new money and clarity of a single stakeholder appeal to many. The top-earning CIOs in Australian super funds (according to *Investment Magazine*) are:

Name	Total Remuneration	Fund	Fund Balance
John Pearce	$1.6 million	UniSuper	$63 billion
Mark Delaney	$1.5 million	Australian Super	$140 billion
Alison Tarditi	$1.3 million	CSC	$47 billion
Raphael Arndt	$1.2 million	Future Fund	$180 billion
Damian Graham	$1.2 million	First State Super	$90 billion

3. Extreme variations in performance

Most investors are prepared to tolerate short-term underperformance from their fund manager, but others are impatient and bale out after a year or two. It's worse when the manager has a significantly-poor year.

The financial year 2018/2019 experienced some rapid price rises in companies where investors were willing to bank on future growth, including the Top 5 for the year: Nearmap (ASX:NEA) up 233%, Clinuvel (ASX:CUV) up 206%, Afterpay (ASX:APT) up 168%, Magellan (ASX:MFG) up 119% and Appen (ASX:APX) up 109%.

Managers without these types of high flyers in their portfolio have experienced significant underperformance as they stick to their valuation principles. For example, consider the NAOS Small Cap Opportunities Company (ASX:NSC). It operates under a Listed Investment Company (LIC) structure. In its April 2019 Investment Report, in explaining why it has not invested in these big winners, it says:

"… the main concern for us is the significant faith that is being placed in the earnings trajectory of these businesses for many years into the future."

As NAOS admits, the permanent capital of a LIC has protected it from heavy redemptions, due to this relative performance.

	1 MONTH	6 MONTHS	1 YEAR	INCEPTION (P.A.)	INCEPTION (NOM.)
NSC Investment Portfolio Performance*	+0.69%	-4.31%	-9.71%	-9.29%	-12.87%
S&P/ASX Small Ordinaries Accumulation Index	+4.11%	+11.91%	+7.18%	+7.31%	+10.49%
Performance Relative to Benchmark	-3.42%	-16.22%	-16.89%	-16.60%	-23.36%

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Connecting investors with ideas

The Zenith 2019 Australian Shares Long/Short Sector Report for the year to 31 March 2019 reported an average return of 5.2% for the funds they rate, versus 11.7% for the S&P/ASX300 Accumulation Index. Zenith Investment Analyst Jacob Smart said:

"In 2018, the spread between the cheapest and most expensive stocks reached record highs and, even after the fourth quarter correction last year, remained at elevated levels. The cheaper segment of the market continued to become even cheaper throughout 2018."

4. Managing with an out-of-favour style

Every fund manager must have fundamental beliefs about how to manage money and select investments. The most obvious style variation is 'growth versus value', and others such as 'small cap versus large cap' and 'long/short versus long only' move in and out of favour.

Growth has been rewarded for at least five years as the market chases companies with blue sky earnings potential, even when the revenues are not yet realised. The WAAAX stocks are all classic examples, where the market assigns massive P/E valuations and two of them do not even make a profit. Value managers look for companies which are inexpensive relative to a fundamental value, with sustainable earnings and low valuations, such as 'buying $1 of value for 80 cents'.

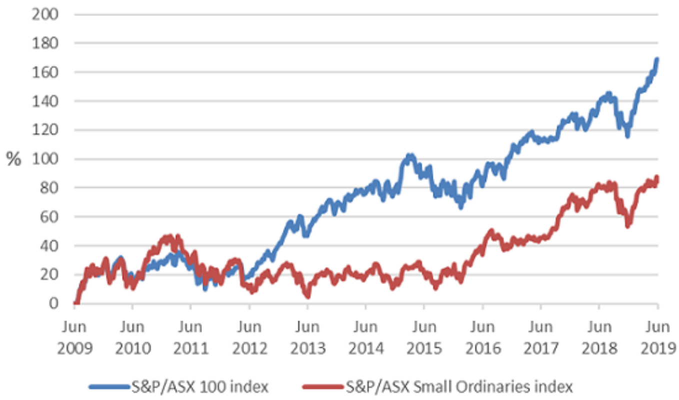
According to JP Morgan, there has never been a worse time to be a value investor. In the US, value stocks are trading at the largest discount to the market in history. They measure the median forward P/E ratio of value stocks in the S&P500 and compare it with the broader S&P500 and the spread is now at a record 7 points.

Another segment which is out-of-favour is small cap investing, trailing large cap. As shown below, in the last 10 years, the S&P/ASX100 index has substantially outperformed the Small Ordinaries index, leaving many small cap managers struggling to deliver decent returns.

Long/short investing is also battling on with many casualties. KIS Capital launched in 2009 and its funds peaked at around $300 million, but it closed recently after a difficult 2018 where results were "*disappointing*". It advised its clients:

"Given the state of the market, KIS Capital directors have concluded that the best course of action at this point is for us to close both funds and return capital to all investors on an equitable basis."

S&P/ASX Small Ordinaries Index vs S&P/ASX100 Index, 10 years to 30 June 2019



Source: Bloomberg, CFSGAM. Cumulative total returns 30 June 2009 to 30 June 2019.

5. Inadequate marketing and distribution

Build it and they may not come. Most fund managers would prefer to sit at a desk all day, study their screens and analyse companies. However, especially in a small boutique which relies on the profile of one or two managers, they must wear out the shoe leather and tell their story. It's a tricky balance. Their main skill may be stock picking, but they need to become extrovert marketers, not simply hire a Business Development Manager with a Rolodex. They must establish themselves as thought leaders.

Research by leading consultants, Tria Partners, concludes:

"… thought leadership is the single most important factor that underpins improvement of buyers' understanding and perception of external asset managers – i.e. it's the most value-adding activity marketing can undertake."

Significant resources are needed to cover institutions, middle market gatekeepers and retail sectors properly. Many fund managers have realised in recent years that they need a direct conversation with end investors, and they particularly target SMSF trustees. The combined value of ETFs and LICs listed on the ASX is now $100 billion, and SMSF trustees often manage their own portfolios directly through the listed market. Previously, some managers confined their marketing to institutional investors, believing it was better to win a $100 million mandate than source thousands of smaller investments. Now those mandates are drying up, the fees are lower and the competition is intense. Marketing through dealer groups to find financial advisers is also not enough, as increasingly, advisers are acting independently and not following the central directive of an Approved Product List.

Tria released the following research on the most effective forms of marketing.

6. Lack of institutional and retail investor support

When MHOR Asset Management announced the closure of its Australian Small Cap Fund in June 2019, it advised:

"… it has not been able to grow the funds under management to a sustainable level and does not expect any material growth in the short-medium term … We will commence the realisation of the Fund's assets, which is consistent with an orderly closure of the Fund."

The Fund had achieved an impressive annualised return of 24.2% net of fees since inception on 1 August 2016, managed by former Vocus CEO James Spenceley and former Renaissance Asset Management Portfolio Manager, Gary Rollo. MHOR was added to the ASX's mFund service in 2018 to improve investor access, but they gathered only $25 million in total. Clearly, the problem is not simply a performance or access issue.

At CFS, when we assessed portfolio managers wanting to set up a new boutique, we would always check whether they had any major institution willing to back them. Often, these portfolio managers worked at large wealth businesses managing many billions of client capital across multiple portfolios. They developed close relationships with their clients and became friendly with each other. A nod and a wink from a large investor can lead people to believe if they set up on their own, then maybe a $200 million slice could seed a new fund. New boutiques will often offer clients a fee discount to come in at the start, and $200 million at 0.3% is a healthy $600,000 to cover some fixed costs. The test comes when the portfolio manager actually leaves.

When John Sevior departed Perpetual Investments to set up Airlie, many clients went with him. But John Sevior is one of the few 'rock star' managers in Australia. If a new boutique cannot deliver immediate institutional support, it can take years of pitching and building up a track record before decent money flows. The retail market is a tough slog full of gatekeepers who must support the new business long before a fund features on a major platform. Research analysts, rating agencies and asset allocators all need convincing.

Going directly to a LIC is difficult for fund managers without a proven track record. Although this looks like direct-to-market distribution, behind the scenes are brokers and financial advisers who are paid fees to support the issue, and they must be convinced there is a story to tell.

7. Misunderstanding the business model

Portfolio managers in large businesses are supported by a phalanx of helpers, from accounting, tech, call centre, compliance, legal, documentation, marketing, business development … on it goes. They can indulge their passion for investing.

Then they set up their own businesses. Suddenly, they become involved in finding premises, negotiating leases, hiring staff, selecting systems to prevent cyber-attacks, finding new investors … and all the drudgery of owning a business where the buck stops with the founder. What a pain! Previously, they were Masters of the Universe in a big dealing room, where they blasted the tech guys if the internet went down for 10 minutes. Now the fundies are responsible for making sure their tech is good, and there's nobody on staff to shout at.

Which is why many talented fund managers sell part of their equity to groups like Pinnacle, Fidante, Channel Capital or Bennelong. In exchange for say 40% ownership, these companies provide support services for boutique managers, leaving them to focus more on investment management. They still need to perform a marketing role but it is done with considerable business development support.

How much does it cost to open the doors? It depends mainly on how much the portfolio managers pay themselves. Remember, many have been highly paid in a previous role and have big mortgages and private school fees to cover, so it's not easy to take the startup route of no salary for a couple of years. So let's say they are senior portfolio managers on $500,000 (if that seems too much, consider the salaries of the super fund CIOs listed above, and the CIO of a major retail business can earn $5 million or more a year). Let's say three other staff cost $500,000, then there are premises, systems, legal, advertising, etc. There's not much change out of $50,000 to be a major sponsor at a leading industry event. That's a total of $2 million on the credit card.

Revenues come from clients paying fees. Not only are the big clients pushing down fees, but retail investors can access funds management for free (products such as HostPlus Balanced Indexed Fund - the 'Scott Pape Fund' – are effectively free, and the cost of many index ETFs is negligible, less than 0.1%). This new boutique business will need, say, $300 million of institutional money at 0.3% and $300 million of retail money at 0.4% to break even. That is not easy in a market with hundreds of competitors all essentially doing the same thing while striving to sound different.

And the sobering outlook is that for most fund managers, fees are only going in one direction.

8. Inadequate product diversity

Many small fund managers have only one fund based on the skills of one or two people. For the first few years, all their efforts will go into promoting and managing that one fund. It leaves them vulnerable to poor performance and an out-of-favour style. Which is why larger managers branch into income funds, infrastructure, alternatives, ethical or a completely different asset class like an equity manager hiring a fixed interest specialist. The diversity can reduce the business risk.

A comment on relying on performance fees to make a profit. Not only are the fees elusive in a period of underperformance, but such fees are usually structured with a 'high water mark'. This means the previous underperformance must be recovered before the fee kicks in again. Therefore, a poor year can set back the profitability of the business for many years.

9. Loss of key personnel

Funds management is an industry with massive key person risk. Especially in small boutiques, there are often one or two portfolio managers who have investor support, backed by talented analysts and trainees with little or no market profile or reputation. As funds under management grows, the team increases and resilience builds for long-term survival.

Until this point is reached, however, if the main man or woman wants to leave, the business has nowhere to go. It's simply not possible to bring in a new person at short notice and expect investors to stay.

The highest-profile demise of all was the closure in 2010 of 452 Capital when Peter Morgan was misdiagnosed with brain cancer. Peter was a doyen of fund managers following his time at Perpetual (*Disclosure: I set up the CFS alliance with 452 and was on the Board for a while*). At its peak, 452 Capital managed $9 billion, rapidly raising money from 2001. But much of the money exited during Morgan's time off and with the impact of the GFC, the remaining staff were managing less than $3 billion when the business closed. The Sydney Morning Herald reported:

"Yesterday another high-profile Australian business in this industry, 452 Capital, became the talk of the financial services industry when it was revealed that this business had essentially imploded."

Fast forward to the recent closures. In 2019, when the AFR reported that Discovery Asset Management was returning funds to its clients, it said the move was driven by the co-founder and Managing Director, Stuart Jordan's decision to retire. A message to clients said:

"Over the last week, Stuart has cemented his decision to head down the retirement path after a long and successful career in the Australian investment management industry. Given this, and also that Discovery have a small number of institutional clients (only), we have communicated to each of them that Stuart is planning to retire, and we are now working with these institutional clients to 'hand back' or transition out, their mandates with Discovery."

It is believed that the loss of a mandate from UniSuper contributed to the decision.

A larger ($5 billion under management) and long-established business, Ellerston Capital, closed its Global Macro Fund in June 2019, following the departures of economist Tim Toohey and one of the portfolio managers, Robert Chiu. This was not an under-resourced fund. Former Reserve Bank Governor, Glenn Stevens, was an adviser, with Ellerston announcing on his hire:

"Our main focus is on his international perspective and how other central banks see their economies. He's here to challenge and debate all of our investment theses".

The Head of the Global Macro Fund, Brett Gillespie, is himself a high-profile figure, frequent presenter at conferences and writer of a detailed monthly newsletter on global macro conditions. Yet the loss of key clients took the Fund from $190 million to $30 million and not commercially viable. Returns since inception in 2017 were flat, as shown below.

As at 31 May 2019	1 Month	3 Months	6 Months	1 Year	Since Inception p.a
Fund +	1.77%	-0.13%	-0.19%	-1.25%	-0.77%
Benchmark	0.13%	0.38%	0.75%	1.50%	1.50%
Excess	1.64%	-0.51%	-0.94%	-2.75%	-2.27%

10. Failure to manage expectations

Every fund manager will underperform at times, but not every fund manager faces large redemptions. Those who emerge into better markets have often spent years explaining their process and when it might not work, and why it will pay off to stay with them.

One manager who has experienced torrid performance in the last year is Steve Johnson's Forager. A year ago, its LIC was so popular that it was trading at a premium, and his presentations filled conference rooms. The net asset value of the Australian Shares Fund has fallen from $1.82 a year ago to $1.30 now (after a $0.21 distribution). That's a fall of 19% in a market that is up 12%, a whopping 31% underperformance. Making it worse, the LIC now trades at a discount as some investors have exited, but also as LICs generally have struggled.

Forager has been at pains in the past to stress its investment approach is to buy out-of-favour or unpopular companies, and to ride out the recovery. It has warned that company turnarounds can take longer than expected, and this has been the case. In its recent newsletter, Johnson said:

"Since we started Forager almost 10 years ago, we have told our investors to expect significant periods of underperformance. That's one promise we have delivered on over the past year ... We have made genuine mistakes over the past year. Part of our poor performance has nothing to do with industry turmoil. But periods of dramatic underperformance like this are not just part of investing with us. They are an essential prerequisite to future outperformance."

Forager is supported by believers prepared to wait for better days, although it helps that the main fund is a LIC with permanent capital.

Why does this matter to you?

There are three reasons why investors may be adversely impacted by a fund closure, putting aside the impact on the lives of the staff directly affected.

1. Costs of realising the portfolio

Although a small cap manager may not own a substantial portfolio in the overall size of the market, it may be a significant shareholder in some small companies. When it is announced that the funds business will close, the market knows there is a substantial seller of certain companies and the bid price can drop away rapidly. Spreads open. So in addition to other closure costs such as brokerage, the value of the portfolio may fall during liquidation. And, of course, anyone else who owns those stocks will also be hit.

Even where a fund is not closed but transferred to another manager, using a 'transition manager' to sell the old portfolio and buy a new one, the realisation costs can be substantial as most transition managers just want to do the job and move on.

2. Unplanned capital gains or losses

Money is returned unexpectedly to investors, and this might deliver a taxable capital gain or a capital loss which cannot be tax-effectively managed at a convenient time.

3. Lack of access to liquidity while the fund closes

Most fund managers announce their closure and immediately suspend redemptions to prevent a run and to allow for a more orderly share sale process. Investors wanting the capital for other purposes may be denied the expected liquidity.

Briefly, on the other hand …

In case this article paints too glum a picture for fund managers, let's mention the other extreme, Magellan (ASX:MFG). Its funds under management at 30 June 2019 reached $86 billion, up an extraordinary $4 billion in one month since 31 May 2019. This was mainly due to market movements and the fall in the AUD, but retail inflows were $132 million and institutional $356 million across global, Australian and infrastructure assets. A year earlier, on 30 June 2018, funds totalled $59 billion. That's up $27 billion in one year.

But here's the clincher to show how wonderful (or cruel) this business can be for creating wealth. On 2 March 2009, Magellan shares reached a low of 33 cents during the GFC. It recently traded at $55. Ignoring dividends, buying 10,000 shares for $3,300 would now be worth $550,000, only a decade later. Market capitalisation (gulp!): $10 billion.

To offer hope to the strugglers, I remember when Hamish Douglass and Frank Casarotti could gather only a couple of dozen people to Magellan's presentations, and CFS refused to put their global fund onto the main FirstChoice platform.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any individual.

13 of the best: reflections from an investor

Hamish Douglass

"Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher five, 10 and 20 years from now. Over time, you will find only a few companies that meet these standards."
Warren Buffett

While Buffett might make investing sound easy, few people achieve outstanding investment records over the long term as he has. The following sets out some of my reflections gained over the years.

These 13 reflections are organised into four topics: Finding the right investments, letting your investments work for you, risk, and the temperament to learn from mistakes. This list is not definitive and each day has moments of learning.

Finding the right investments

1. Standing on the shoulders of giants

"If I have seen further than others, it is by standing on the shoulders of giants."
Sir Isaac Newton

At Magellan, we believe in benefiting from the knowledge imparted by the best. Our investment philosophy has been influenced by some of the legends of the investment world: Benjamin Graham (*The Intelligent Investor*, in which he highlighted the importance of thinking of stocks as businesses, the concept that the stock market is a voting machine in the short term and a weighing machine in the longer term, and incorporating a margin of safety); Phil Fisher (*Common Stocks and Uncommon Profits and Other Writings,* where he highlighted the importance of investing in quality companies with superior returns on capital) and Buffett and Charlie Munger who brought these concepts together.

From such insights, we have developed an investment philosophy that at its core is about investing in a concentrated portfolio of the world's best businesses purchased at attractive prices. The returns such a portfolio earns over time reflect the underlying returns on capital, growth prospects, competitive advantages and management capabilities of these outstanding businesses.

Our portfolio-construction process can be likened to a process for picking a sports team that can win a grand final. We find no appeal in picking a team of B-grade players when we can scour the world for a team of A-grade players. Unlike the coaches of many sporting teams, we have no salary cap to handicap us as we assemble fractional interests in the best team of outstanding companies at the most attractive prices.

If our investment returns have been better than others it is in large part due to the fact that we are standing on the shoulders of giants. Investing in a portfolio of outstanding businesses at appropriate prices produces superior outcomes and is more reliable over the longer term than any other investment approach we know. Critically, having a portfolio of outstanding companies is a huge advantage in times of adversity because it lowers the risk of large capital loss.

As Buffett says: "*To finish first you must first finish.*"

2. The power of network effects

The network effect describes the process whereby an additional user of a product or service makes that item more valuable to all users. Facebook's social network is a classic example of a two-sided network effect. On one side, each new user makes the network more valuable to other users as there are more friends for people to link up with. At the same time, more users on Facebook make the advertising network deeper and more valuable to advertisers.

Powerful network effects usually result in dominant companies that have exceptional returns on capital. Many of the investments we have made over the years have been in businesses that exhibited strong network effects. These investments include the Visa, Mastercard, PayPal and American Express payment networks, Facebook's social networks (Facebook and Instagram) and messenger platforms (Messenger and WhatsApp), the Google search business and YouTube business, Apple's and Android's app stores, Microsoft's Windows operating system and Office productivity suite, and eBay's marketplace.

Other businesses in which we haven't made meaningful investments (to date) that exhibit strong network economics include credit-rating agencies, derivative exchanges and clearing houses, Amazon's marketplace, online travel agencies and the major Chinese technology platforms. We believe that autonomous driving software is likely to exhibit strong network effects as will the platforms for the sharing economy such as Airbnb and Uber.

An important lesson from investing in businesses that exhibit strong network economics is to be aware that they will usually attract the attention of regulators. We also note that there are many examples of businesses with powerful network effects where a competitor emerges with a business model that causes users of the product or service to leave existing networks. Classic examples where new competition has weakened a network include fixed-wire telephone networks (due to the emergence of mobile networks) and newspapers and television networks (due to competition from internet-enabled business models).

3. Beware of mistaking companies with high returns on capital or market leadership for outstanding businesses

There are many businesses that earn high returns on capital or are market leaders that are not outstanding businesses. To be exceptional, a business must have two characteristics: it must earn superior returns on capital and have deep and durable competitive advantages (or an 'economic moat') that protect excess returns on capital over time. The following are examples of sustained competitive advantages.

- It is expensive for consumers to depart from the incumbent provider because of high switching costs, inconvenience or regulatory restrictions.
- The leading market participant has material economies of scale that give it significant cost advantages over competitors.
- The business has a strong and unique brand or is protected by long-term intellectual property rights such as copyright, patents, exclusive licences or trademarks.

We have learnt important lessons from investing in businesses that exhibited high returns on capital or were market leaders but lacked long-term competitive advantages. Examples of such investments include Nutrisystem (a US meal delivery business for people seeking to lose weight) and US apparel retailer Abercrombie & Fitch. We now appreciate that few retailers have sustainable competitive advantages. The vast majority are low-quality businesses.

4. Don't rely on the rear-view mirror

"If past history was all there was to the game, the richest people would be librarians."
"In the business world, the rear-view mirror is always clearer than the windshield."
Warren Buffett

We naturally spend a lot of the time analysing the past to identify investment opportunities but it is dangerous to assume that the past is a reliable predictor of the future. Capitalism's creative and destructive forces are forever reshaping industries by growing new businesses and destroying dominant firms. To realise this, you only have to look at a list of the top 50 companies in the world 20 years ago and see how many have struggled since. We should all heed the advice of the great ice hockey player Wayne Gretzky who said: "*Skate to where the puck is going, not where it has been*."

Within our investment universe, for example, we question whether or not the best retail banking franchises and the best consumer brands will remain as dominant over the next five to 10 years. We believe it is likely that technology and new media and retail platforms will weaken the competitive advantages of many banks and consumer brands in coming years. Businesses in this space might well earn reasonable profits but they are unlikely to be as dazzling as they once were.

It is frightening that an industry has developed – the 'smart beta' industry – that is based on rear-view investing or optimising factors that worked in the past. Anything can work until it doesn't. Our job as investors is to assess where the puck is headed.

5. Your best ideas are often more obvious than you think

There is a finite number of outstanding companies in the world. The vast majority of these companies are well-known 'blue chip' investments. Many people think that you can only earn superior returns by uncovering hidden gems. In our experience, the best long-term investments are often hiding in plain sight. They are usually market-leading firms that have superior returns on capital, excellent long-term growth prospects and wide economic moats.

We have a defined pool of the market-leading businesses that earn attractive returns on capital and that possess deep competitive advantages. We try not to stray outside this group. Charlie Munger reminded everyone at the 2008 annual meeting of Berkshire Hathaway of the limited number of great companies when he said:

"Most big businesses eventually fall into mediocrity or worse. So it is a tough game out there."

We find that in assessing a new investment opportunity it is often better to buy more of what you already understand than buy the 26th next best investment idea. We have frequently revisited old investment ideas and reinvested in them.

6. Be careful of stocks trading at low multiples of earnings or those that offer high dividend yields

The market often fails to sufficiently differentiate between companies with vastly superior long-term prospects and those with more mediocre prospects. We suspect it is due to a combination of too much focus on short-term returns and the use of simplified investment metrics such as prevailing dividend yields or price-earnings multiples. These valuation measures, however, tell you little about the future growth in earnings, what incremental return on capital a business will earn over time, or the sustainability of a business's competitive advantages. Businesses with low price-earnings multiples or high dividend yields are often ones with unattractive prospects rather than opportunities that will deliver superior returns.

Occasionally, we find an opportunity to invest in an outstanding business at very favourable valuations and we have had the conviction to buy a meaningful amount; our decision to invest in Microsoft in 2013 is an example of this. We have also made mistakes in being attracted to businesses with low price-earnings multiples, such as our investment in 2015 in IBM, which had deteriorating business prospects.

7. Avoid turnarounds

"Both our operating and investment experience cause us to conclude that turnarounds seldom turn."
Warren Buffett

It is our experience that turnarounds rarely deliver superior investment returns and that they are best avoided. When a company gets into difficulty, typically two things happen: either the situation facing the company deteriorates further or it takes longer than expected for the turnaround to be executed. Time is the enemy and you will get little reward for being eventually correct.

We are conscious that many investors have caught 'falling swords' by making contrarian investment decisions on the basis that it must be a good time to buy when others are panicking. In our experience, many investments in turnarounds deliver sub-par investment returns.

Let your investments work for you

8. The magic of compound interest

"Compound interest is the greatest mathematical discovery of all time."
Albert Einstein

"Money makes money. And the money that money makes makes more money."
Benjamin Franklin

If we had to pick what were the most important factors driving our investment returns over the past 12 years, the answer would be our long-term investment time frame and our willingness to let the magic of compound interest do the heavy lifting. We have held long-term investments in many companies that have favourable characteristics for compounding capital at attractive rates. These characteristics include favourable growth prospects, high returns on capital, and deep and sustainable competitive advantages.

Post the initial investment, we have avoided the temptation of playing a short-term game of gin rummy by discarding investments frequently and seeking to find opportunities that might deliver higher short-term returns. An investment that can deliver a 15% return per annum for 10 years is usually far superior to an investment that can deliver a one-off 50% return over a short period. An investment that can deliver a 15% per annum return will multiply your money by four times in 10 years. In many cases, our best investment returns have resulted from situations where we have simply done nothing but let compounding work its magic. The nature of compound interest is that it takes time.

There are few ways to compound your money quickly. This is why the turnover of stocks in our portfolio is limited. Our investment style of patience and compounding is not well suited to many investment professionals as it is hard to feel you are adding value when for 360 days in a year you decide to do nothing. On average, we have made around four key new investment decisions per year. Our team is constantly assessing opportunities but the nature of our approach is that we make decisions infrequently. In our experience, investors don't get rewarded for activity. They get rewarded for patience.

Risk

9. Importance of portfolio construction

We believe that prudent portfolio construction is critical for reducing risk. Many people assume that prudent portfolio construction equates to holding a widely diversified portfolio. In our opinion, a well-diversified portfolio only ensures that an investor's portfolio will produce returns that are similar to the market's return. We do not believe in holding a widely diversified portfolio. Core to our portfolio-construction process are the following:

- We incorporate a margin of safety by not holding, at least knowingly, overvalued securities.
- We hold a meaningful amount of investments in companies that should perform strongly in an economic downturn.
- We minimise aggregation risk; i.e. the risk attached to similar economic, competitive or regulatory forces. We put defined aggregation risk limits on key risks to which our portfolios are exposed.
- We limit our maximum position size in any one stock.

It is inevitable that we will make mistakes. Even our best ideas can be wrong. Examples of where we were wrong with one of our 'best' (not such a great term in hindsight) ideas include the investment in the UK retailer Tesco and more recently the investment in Kraft Heinz. While it was disappointing to make such mistakes, the good news is that we had not aggregated the risk with similar investments so the overall impact on the portfolio from these mistakes were modest.

The lessons here are do not put all your eggs in one basket and avoid the temptation to buy more and more stocks that match your 'favourite idea'.

10. Beware of businesses where the competitive advantage is dependent upon government subsidies or vulnerable to government policy

In 2007, we made an investment in SLM Corp, which at the time was the leading private sector provider of government-guaranteed and non-government-guaranteed student loans in the US. SLM's business model depended upon the US Department of Education because it paid the private sector subsidies to originate and service government-guaranteed student loans.

We were fortunate (lucky would be a better word) that we sold the investment in October 2008, immediately after the collapse of Lehman Brothers, due to our assessment that the company might lose access to capital markets to fund private loans. Not long after we sold our holding in SLM, the Obama Administration announced that it would no longer pay subsidies to the private sector to originate government-guaranteed student loans. This decision killed a core part of SLM's business model. It taught us to avoid investments where the core competitive advantage is vulnerable to government decisions.

11. Know what you don't know

"Real knowledge is to know the extent of one's ignorance."
Confucius

It is easy in investing to have confidence in what you know, or think you know, about an investment. After completing due diligence on an investment opportunity, the most important things to assess are what you don't know about an investment and whether or not this missing knowledge creates material uncertainty.

Investors should always ask themselves: What is it about this investment that I do not know? This state of mind does not come naturally as confirmation bias leads people to information that confirms existing conclusions. To overcome this natural tendency, we try to invert the investment case and ask ourselves why we are wrong. This better equips us to look for what we don't know about an investment.

We have developed a risk-assessment framework that sets out the things that could enhance or harm our assessment of a business. We try to assess the impact on the investment if any of these events were to occur. We then try to estimate the probability as to whether or not they might. It has been rare that we have made mistakes because we had not thought an event might occur. Usually we have not properly assessed the probability of an event taking place.

It is critical that investors know the limitations of their knowledge or what is knowable. Buffett describes this as knowing your "circle of competence". There are many things in investing that are unknowable and we believe investments are best avoided if there are too many unknowns. We believe that many large banks (particularly with sizeable investment banking arms) are simply too complex to understand and are outside our circle of competence. As Donald Rumsfeld, the former US Secretary of Defense, famously said:

"There are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."

The temperament to learn from mistakes

12. Don't become emotional

"An investor will succeed by coupling good business judgement with an ability to insulate his thoughts and behaviour from the super-contagious emotions that swirl about the marketplace."
Warren Buffett

The market often provides us with excellent investment opportunities to buy or sell at prices significantly different from our assessment of the intrinsic value of underlying businesses. In chapter eight of *The Intelligent Investor*, Graham introduced the concept of 'Mr Market'. Mr Market is an obliging business partner who every day is prepared to tell you what your interest in a business is worth and on that basis is prepared to buy your interest or sell you an additional interest. Sometimes, he quotes you reasonable prices based on the business prospects and developments as you know them. Often, Mr Market is unpredictable and temperamental and quotes you ridiculously high or low prices. Additionally, Graham wrote:

"Price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times, he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

It is important that investors do not become emotional about movements in share prices. The unpredictable nature of the share market and wide fluctuation in prices are there to serve an investor. Buffett also famously said that you should be greedy when others are fearful and fearful when others are greedy.

We think it is critical that investors do not become emotionally attached to a company or its management. A company does not care who you are or whether or not you are a shareholder. The nature of the share market is if you don't buy the shares on offer for trade then someone else will. It is difficult to be emotionally detached after you have spent considerable time getting to know management and feel that you have a trusted relationship. This emotional connection can affect your decision to sell your shareholding.

13. Don't make the same mistake twice

"Those who cannot remember the past are condemned to repeat it."
George Santayana, Professor of Philosophy

It is inevitable that as an investor, you will make mistakes. There are three key principles we follow when we make a mistake.

- Correct the mistake. In most instances, a decision to sell the investment is the most appropriate course of action, as wishing for our money back is usually another mistake.
- Don't repeat the same mistake.
- Learn from the mistake.

To try to ensure we do not repeat a mistake, we:

- Own the mistake. We do not attempt to avoid the blame. You will never learn from a mistake unless you take ownership.
- Acknowledge the mistake publicly. I do this within our investment team and publicly with our clients.
- Write down what went wrong and revisit our mistakes. You will never learn from your mistakes if you pretend they didn't happen.

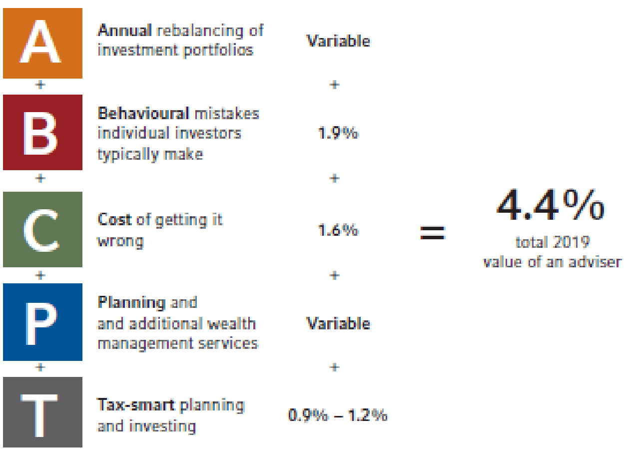
People who acknowledge and learn from their mistakes will make fewer mistakes and will become better investors.

Hamish Douglass is Co-Founder, Chairman and Chief Investment Officer of Magellan Asset Management, a sponsor of Cuffelinks. This article is for general information only and does not consider the circumstances of any investor.

Advisers must step up and articulate their value

Jodie Hampshire

Market experts have been warning investors to brace for the end of the longest bull run in history. This should be a time when many Australians are turning to financial advisers as they look to preserve their wealth and financial security. But the perception of the adviser value proposition is at record lows and many financial advisers are also struggling to remain positive at this time of need for their clients.



In recognising the impact an adviser can make to an investor's overall financial well-being, Russell Investments has quantified the contribution professional advice can add to an investor's portfolio over their lifetime. Our aim is to aid advisers with a repeatable and memorable framework to help them have open and frank conversations about their value proposition.

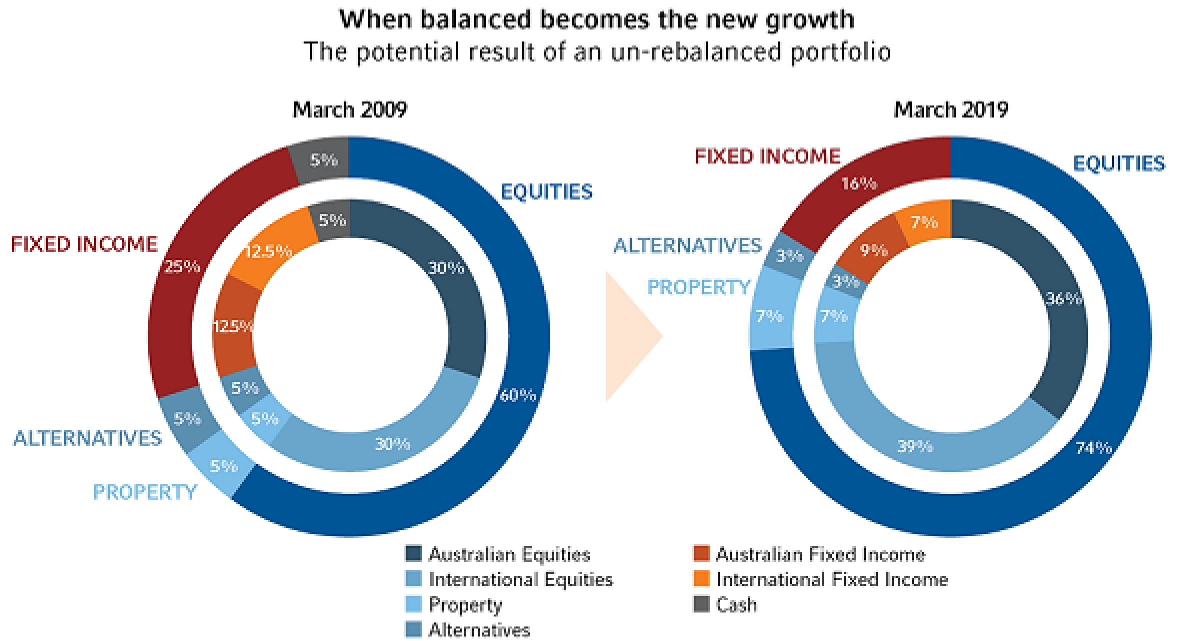
Our second annual *Value of an Adviser Report* estimates an investor gains a minimum of 4.4% p.a. through an advice partnership, which can make a massive difference to the financial security of the average Australian investor over their lifetime.

Building blocks that comprise an adviser's real value

Here, we take a holistic look at the building blocks that comprise an adviser's real value proposition throughout a client's investing journey.

A is for Annual Rebalancing = variable % p.a.

Left to their own devices, individuals tend to let portfolios drift and, as a result, portfolios can look vastly different from their initial state over time. The potential result of an un-rebalanced portfolio is demonstrated in the chart below. A hypothetical balanced index portfolio that has not been rebalanced would look more like a growth portfolio and expose the investor to risks not initially agreed to.



Source: Hypothetical analysis provided in the chart for illustrative purposes only. Source for the chart: Australian Equities: S&P/ASX 300 TR, Index AUD; International Equities: MSCI World NR Index AUD; Property: FTSE EPRA/NAREIT Developed NR Index AUD; Alternatives: Barclay CTA, Index (AUD Hedged); Australian Fixed Income: Bloomberg AusBond Composite 0 Year Index AUD; International Fixed Income: Bloomberg, Barclays Global Aggregate TR Index AUD; Cash: RBA Bank Accepted Bills 90 Days.

Disciplined rebalancing is crucial to avoiding unnecessary risk exposure when investing. For example, if a certain asset class is performing strongly it can be tempting to hold an overweight position in that class. If the market corrects, investors may find themselves with too much invested in a volatile asset class.

Rebalancing is a key positive value add of advice, but we consider it **variable** as it depends on markets in the measurement period.

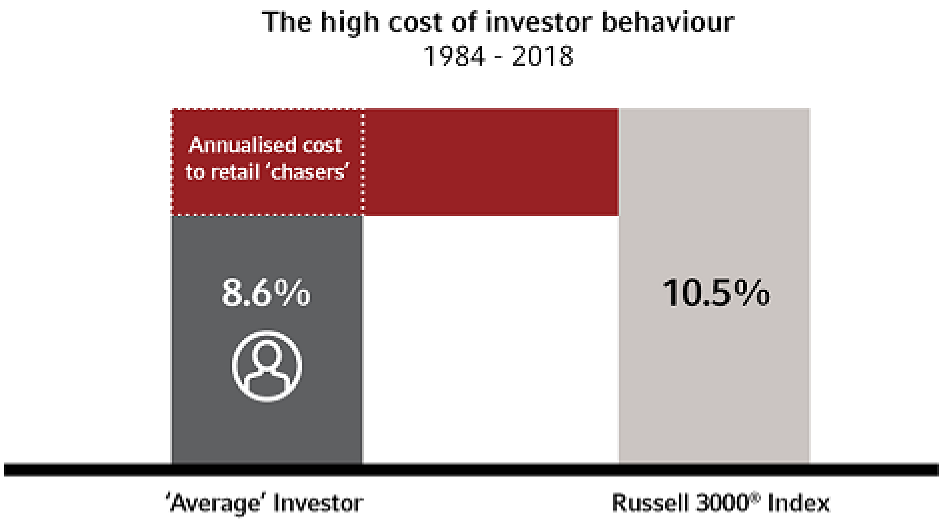
B is for Behavioural Mistakes = 1.9% p.a.

Despite strong evidence that portfolio value increases over time, investors can still feel compelled to react to short-term market volatility, serving to undermine their long-term objectives.

Advisers can play a critical role in helping clients adhere to their long-term financial plan and make better investment decisions by helping them skirt around some 200 identified behavioural tendencies that impact investing including Loss Aversion, Overconfidence, Familiarity and Herding.

If we just focus on herding, we look at the return if an investor bought and held an index. We then look at the flows into funds and ETFs through the market cycle. As markets rise, invariably, people put money in and buy high. As markets fall, investors lock that loss in by selling their funds and ETFs.

Our statistics show, the average fund investor's inclination to chase past performance came at a cost of **1.9% p.a.** from 1984-2018. This cost may well have been avoided with professional guidance.



Source: "Average" Investor – Russell Investment Group, Thomson Reuters DataStream. Return was calculated by deriving the internal rate of return (IRR) based on ICI monthly fund flow data which was compared to the rate of return if invested in the Russell 3000® Index and held without alteration from 1 January, 1984 to 31 December, 2018. This seeks to illustrate how regularly increasing or decreasing equity exposure based on the current market trends can sacrifice even market-like returns. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

C is for the Cost of Getting It Wrong = 1.6.% p.a.

There can be a clear disconnect between an investor's risk profile and return expectations. In fact, research by Deloitte Access Economics found younger investors were more risk averse than their older counterparts. The research found around 81% of investors under 35 years old said they were seeking guaranteed or stable returns, compared to 41% of those aged over 55. On another note, 21% of the most risk-averse investors expected returns over 10%.

Looking below at average returns of Australian equity and bond portfolios over a 20-year period, an investor with 70% of their portfolio in growth assets and 30% in defensive would earn an average annual return of 10.9% over the 20-year period. Meanwhile, an investor with 30% growth assets and 70% defensive would achieve annualised returns of 9.3% over the same period.

ALLOCATION	AVERAGE RETURN – 20 YEAR (1970 - 2018)	RETURN ON $100,000 INVESTED
Australian Equities	12.12%	
Australian Bonds	8%	
70/30 Portfolio	9.3%	$592,111
30/70 Portfolio	10.9%	$791,828

Source: Russell Investments, S&P/ASX 300 TR, Bloomberg AusBond Composite 0+ Year Index AUD from 2003, UBS Warburg Aust Composite Bond Index prior to 2003, Commonwealth Bank All Series All Maturities prior to 1990.

In this scenario, an investor under 35 invested conservatively instead of in the growth option would have forgone an average of 1.6% return every year for 20 years. On $100,000 invested, that's a significant difference of almost $200,000 to the final return.

Beyond investment-only advice

P is for Planning = variable % p.a.

Further to building and regularly updating bespoke financial plans and conducting regulatory reviews, financial advisers offer ancillary services including tax and estate planning, investment and cash flow analysis, retirement income planning and assistance with annual tax return preparation.

Like annual rebalancing, the quantification of this value add is **variable** as it depends on an adviser's practice and services offered.

T is for Tax-smart investing = 0.9% – 1.2% p.a.

Lastly, quality financial advisers have the technical expertise to help clients make the most of their tax circumstances as well as avoid any unexpected surprises at tax time as regulatory changes occur.

We believe that the value of an adviser for tax-smart investing is at least the sum of tax effective investment strategies and salary sacrifice pre and post superannuation contributions (depending on account balances).

Therefore, we estimate the value of an adviser to **range between 0.9%-1.2%p.a**. depending on whether the client is in an accumulation or transition to retirement phase.

The bottom line

Russell Investments believes the importance of articulating the tangible benefits financial advice provides investors cannot be understated. From the knowledge and expertise required to help clients build personalised portfolios, to the support they provide when market conditions change, and the range of additional wealth management services they offer, such as tax and estate planning.

While we are empowering adviser conversation with clients, we are also providing investors with a framework of what financial advice looks like.

Looking forward, we believe advisers practicing a full value proposition will thrive in the current challenging environment.

Jodie Hampshire is Managing Director, Australia for [Russell Investments](). Based in Sydney, Jodie has overall responsibility for Russell Investment's Australian business across Institutional and Advisor and Intermediaries Solutions. This article is general information and does not consider the circumstances of any individual.

99% of listed companies disappear worthless

Ashley Owen

When we talk about returns from 'Australian shares' or the 'Australian stock market', what do we actually mean? Australian stock markets have always consisted of a small number of 'investment grade' companies with real businesses, but the vast majority of companies are, and have always been, high risk speculative gambles.

They are little more than a way for promoters and brokers to harvest money from the pockets of the seemingly never-ending waves of newly minted speculators hoping to hit the jackpot, much like a casino.

37,000 companies tried, only 580 still listed and profitable

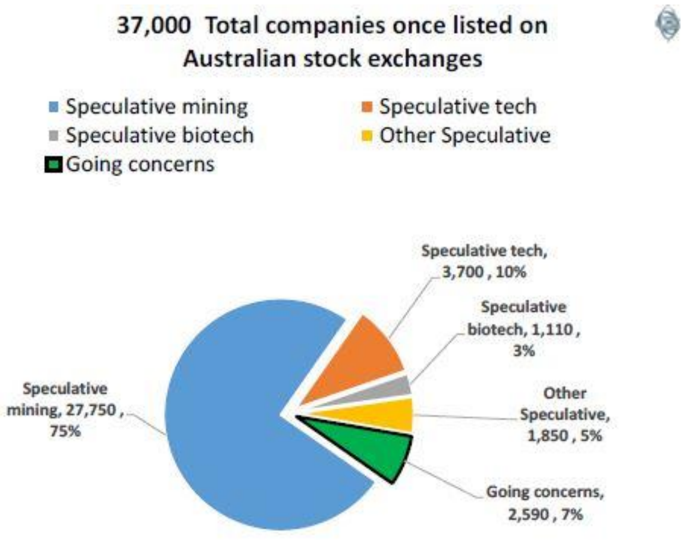
The chances of finding a winner on stock exchanges in Australia has been around 1%. Not a 1% chance of beating the overall 'market index'. I mean 1% just managing to survive and build a profitable business. Here's why.

I estimate that there have been about 37,000 companies that have raised money from investors and listed on one or more of Australia's stock exchanges at some time since the early 1800s. Today, there are only 2,300 companies left still listed on the ASX (6% of the total ever listed) and only 580 of those make any money. So what happened to the rest of them, and what happened to investors' money?

Note: The numbers are the author's estimates based on a study of dozens of exchanges.

In addition to the above, at least 3,000 Australian companies listed on the London market to harvest money from gullible Brits. Their success rate has been even lower.

The national 'Australian Securities Exchange' (ASX) is an amalgamation of the stock exchanges of Sydney, Melbourne (which once had four exchanges), Adelaide, Perth, Brisbane and Hobart in 1979. In addition there have also been several other thriving exchanges over time – mainly in mining booms – including Bendigo, Ballarat, Kalgoorlie, Charters Towers, Newcastle, and more. Each of the stock exchanges was owned by separate groups of brokers, all frantically finding and listing companies to attract money from over-eager investors in the boom years.



How do most companies disappear from the exchange?

I estimate that at least 75% of all companies ever listed in Australia were speculative mining ventures. The vast majority of these raised money quickly in the mining boom of the day and then disappeared worthless. The money taken from investors was pocketed by the promoters or exhausted looking for riches that were never discovered in profitable quantities. The most famous mining bubble stock was Poseidon in the late 1960s nickel boom. It did indeed discover a large nickel reserve in WA but it ran out of money trying to exploit it. Most mining explorers find nothing.

Another 6,500 or so companies were other non-mining speculative ventures, including tech stocks, biotech or other ventures in all sorts of other industries. (By 'speculative' I mean no profits or dividends).

That leaves only around 7% of companies that have listed over the years, or around 2,500 companies, that had actual businesses with real customers and positive cash flows.

If 37,000 companies were listed and only 2,300 remain today, where did the other 94% go?

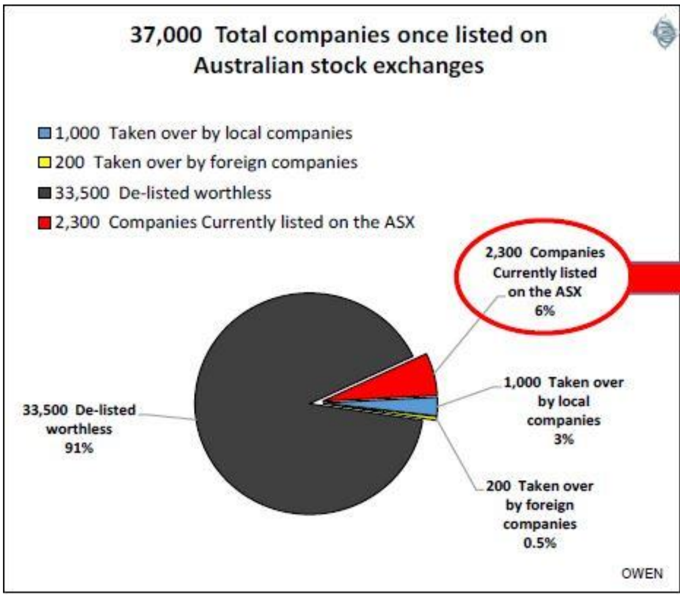
Up to 1,000 of them, or about 3%, were taken over by other local companies. Some of these generated real value for shareholders, for example BHP taking over Western Mining, and the 35 banks that amalgamated into the big four today.

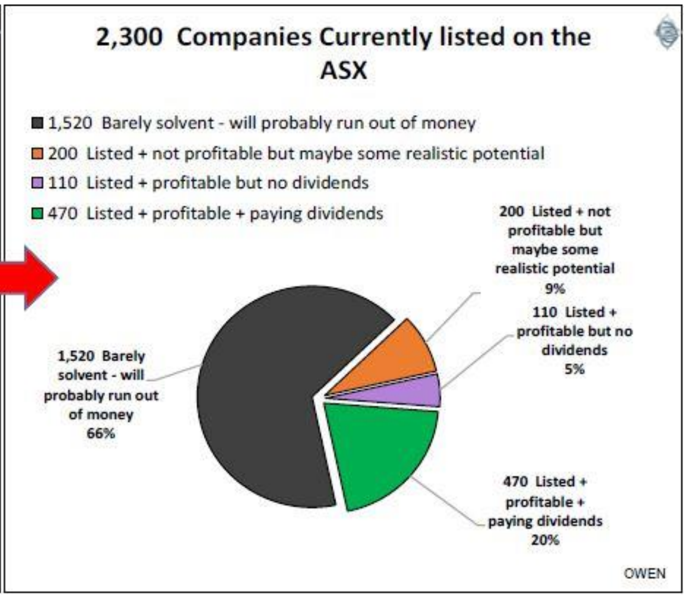
However, the vast majority were mining explorers that were mopped up at very low prices by promoters with high hopes of dressing them up again to take another shot at the next round of gullible 'investors'. There have been variations on this theme, such as failed miners dressed up as 'dot-coms' for the late 1990s 'dot-com', then failed 'dot-coms' dressed up as miners in the 2003-2007 mining boom, and now failed miners dressed up as 'fintechs'(e.g. Decimal Software, Bulletproof Group).

There were also around 200 listed companies that were taken over by foreign companies, such as all of the big Aussie brewers, Optus, BRL Hardy, Alinta, DUET, Rinker, and Westfield.

That leaves 33,000 (or so) companies that disappeared.

There were some colossal bankruptcies like Bond, Qintex, HIH, ABC Learning, Babcock & Brown, Allco, MFS, Timbercorp, etc, but most never saw the light of day. They simply ran out of money and de-listed, worthless.





Most of the current listed companies will probably end up worthless

Looking at the still-listed 2,300 'survivors' from the original 37,000 or so (in the right chart above):

- 470 companies (17% of the current list, or just **1.3% of the all companies that have been listed in Australia**) are profitable and paying dividends. Although there are 2,300 listed companies in Australia, nearly half of their combined total profits and dividends come from just six companies – the big four banks, BHP and RIO, which are all more than 100 years old.
- 110 companies that are profitable but pay no dividends. Many these probably have at least a decent chance of survival and success.
- 200-or-so listed companies (I am probably being generous here) that make losses and pay no dividends but they might have some realistic prospects for success. Nobody knows which ones they are, but there must be about 100.

That leaves the remaining 65% of currently-listed companies or around 1,500 in the current batch. These are barely solvent and will probably run out of money and suffer the same fate as the 33,000 or so other failures that disappeared worthless.

Why is this important?

It is important in understanding the difference between **investing** and **speculating** (gambling).

It is also important for setting expectations about likely risks and returns. When we talk about the 'All Ordinaries index' or the 'the Australian stock market' generating returns of 10% p.a. for the past 50 years or 100 years, we mean indexes of 'investment grade' companies only, which is a fraction of the total number of listed companies.

Even the broadest current index, the 'All Ordinaries Index', covers just 490 stocks or 20% of listed companies. Other than the returns from the indexes of the tiny minority of 'investment grade' companies, if we were to track down and measure what happened to investors' money in the other 95%+ of listed companies, it would be a vast sea of red ink, punctuated by the rare huge jackpot for the few lucky winners.

The overwhelming majority of listed companies in any given era are speculative stocks with nothing but hope and hype and almost all will disappear worthless.

I often come across 'investors' who point to their portfolios of a dozen or so tiny speculative stocks and say:

"*Look, I've got a diversified portfolio of lithium mining, wind farms, solar, rare earths, plus some biotechs and this fintech. Even if I don't hit the jackpot with any of them, I should get decent market returns from them if I hold them long enough!*"

In the words of Darryl Kerrigan in the classic Aussie movie, The Castle: "***Tell him he's dreamin'***"

We wish them well of course in their quest to hit the jackpot and strike it rich, but that's gambling, not investing.

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual.

Most investors are wrong on dividend yield as income

Peter Thornhill

Market commentators and investors regularly use the wrong metric and distort the investment dialogue on yield and income. Let me start this by reminding everyone of my preferred definition of investing: 'the use of money to produce a regular income'. Contrast this with the definition of speculation: 'buying and selling in an attempt to benefit from a fluctuation in the price'.

In general, the profit of a company is split broadly in two:

1. retained earnings for R&D, new technology etc and
2. the balance, or payout ratio, as a dividend.

In mature, quality companies, earnings drive dividends and it is dividend growth, reflecting growing earnings, that ultimately drives share price performance.

In an article *in The Sydney Morning Herald* by Elizabeth Knight, she writes on CSL:

"This is an old-fashioned growth stock - one that lifts profit every year - and ploughs much of it back into research and development and boosts its capital expenditure. It traditionally spends about 10 per cent of revenue on R&D and is currently working on, among other things, a $US550 million ($810 million) clinical trial to prevent secondary heart attacks. Investors have given CSL the mandate to invest rather than reward them with hefty dividends ... The factor that sets CSL apart from its peers among the largest five Australian companies - BHP, the Commonwealth Bank, Rio Tinto and Westpac - is that investors are not buying into it to chase dividend yield ... based on Wednesday's share price of $233, the yield is a relatively paltry 1.15 per cent."

On these quality growth stocks, the yield never looks attractive

As an investor, I never chase current yield. It is income over time I am looking for. Yield is an abstract obtained by dividing two dollar values, the most recent dividend and the current share price. Thus, this abstract is hostage to movements in either one or both of these numbers.

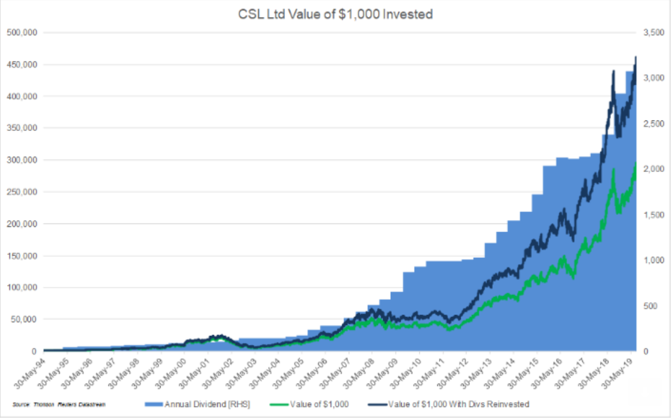
CSL, like a number of other successful companies such as Cochlear and Credit Corp for example, are low yielding for the simple reason that as the profits and dividends grow, the share price goes up. Because of the phenomenal growth in share price (a result of the phenomenal growth in profits) when you divide the dividend into a rising share price, the yield never looks attractive.

Added to this, the success and strong dividends associated with these three companies ensures that the price is at a premium which naturally puts downward pressure on the abstract yield. However, unlike the journalist, you should never assume that the low yield is an indication of low dividends and therefore low income.

The three shares mentioned, despite their low yields, have produced an extraordinary income stream.

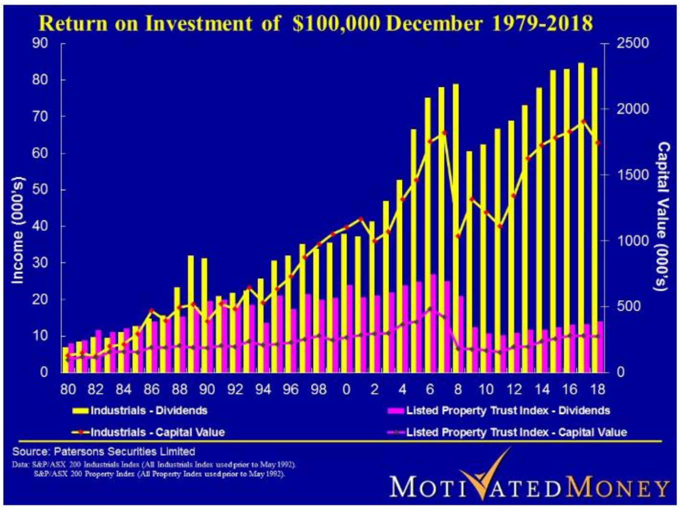
Credit Corp (ASX:CCP) is my favourite example. Since 2000 we have invested a total of $137,000. Our CCP shareholding is now worth $1.8 million. It sits on a paltry yield of 2%. Why so low? Because the share price has risen at the same stratospheric rate as the dividend. The good news for us is a current 'yield', as I judge it, the last dividend divided by amount invested, is 33%. If that isn't enough, total dividends paid since 2000 now stand at $290,000, a return of more than 200% (not adjusted for inflation) on our capital in income alone.

The same applies for CSL. The following Chart 1 shows the extraordinary growth in both share price and dividends that CSL has bestowed upon its shareholders since 1994.



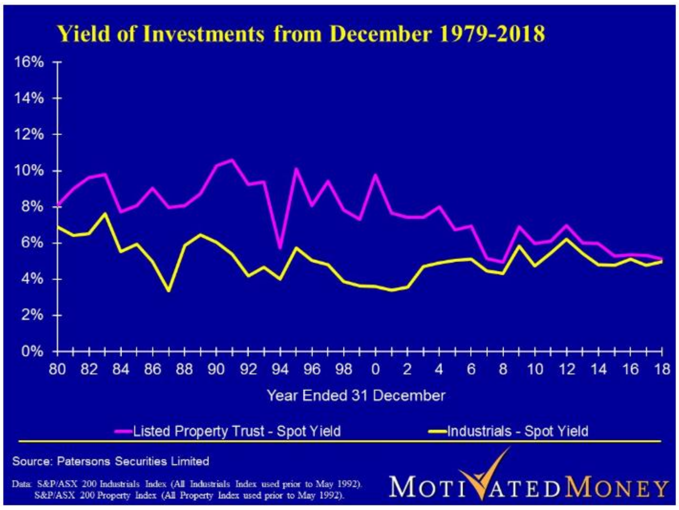
Ignore the spot yield quoted by many

Consider the listed property trust sector, now commonly called A-REITs (Australian Real Estate Investment Trusts). Chart 2 compares the income from listed property trusts (S&P/ASX200 Property Index) to the dividends from industrial shares (S&P/ASX200 Industrials Index) since 1979. Clearly the shares produce a far superior income over this long term. This is why I have often written about the long-term merits of industrial companies for income versus nearly every other asset class.



Now consider Chart 3 plotting the yield of these two sectors over the same period. There can be no doubt that property is a far superior investment for those seeking yield. Ever since I returned to Australia in 1988, I have had people, particularly retirees, telling me that property was a far better income investment than industrial shares because of its superior yield.

The reason the yield on property trusts is high is quite simple. As a result of their structure, they must distribute 100% of their income. Therefore, the vertical income bars (pink in Chart 2 above) represents a 100% payout ratio.



In contrast, the vertical yellow bars represent around 50% of the profits generated by industry. The corporate structure enables companies to retain profits without penalty for research and development, new technology etc.

Think of current yield as an abstract

The trap is baited by the fact that the yield is an abstract numeric (income divided by index value). If dividends remain stable and the share price falls, yields will rise. Conversely, if share prices rise, yields will fall. In Chart 2, the high yield of property is simply a function of the fact that the capital value line is well below the top of the dividend bars. Similarly, the industrials are low yielding because the value line is much closer to the top of the dividend bars.

Now, try and imagine the yield on shares if all companies, like listed property trusts, retained no earnings and paid out 100% of profits every year. If this happened, fewer people would buy property trusts for income rather than industrial shares.

Sadly, time and time again the yield word is used to describe income whilst the reality is that the link between the two is uselessly abstract. Experience has taught me that chasing the highest initial yield will almost certainly result in a worse income over the long term. Oh, and by the way, shares are not growth assets, they are income dynamos.

Peter Thornhill is a financial commentator, author, public speaker and Principal of [Motivated Money](). This article is general in nature and does not constitute or convey specific or professional advice. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon, and consider financial advice.

How to include homes in the age pension assets test

Anthony Asher

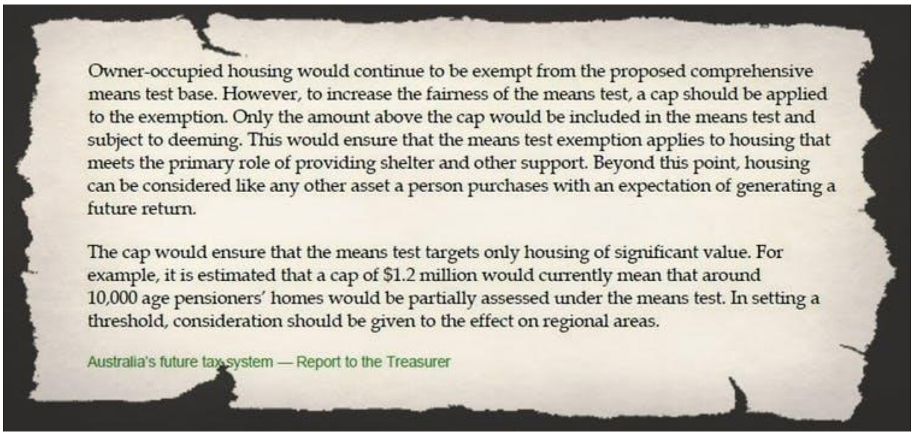
(Following the article by Anthony Asher on possible inclusion of the family home in the pension assets test, a reader who is required to remain anonymous by his employer demonstrates the inequity he feels).

Here's the boldest idea the government's inquiry into retirement incomes should consider but might not: no longer exempting all of the value of each retiree's home from the pension assets test.

The test would merely exempt part of the value of retirees' homes. The change would free-up funds to support other retirees who are struggling because they have to pay rent.

It's an idea with an impressive lineage.

The Henry Tax Review suggested exempting only the first A$1.2 million. The bit above $1.2 million would be regarded as an asset and subject to the test.



Owner-occupied housing would continue to be exempt from the proposed comprehensive means test base. However, to increase the fairness of the means test, a cap should be applied to the exemption. Only the amount above the cap would be included in the means test and subject to deeming. This would ensure that the means test exemption applies to housing that meets the primary role of providing shelter and other support. Beyond this point, housing can be considered like any other asset a person purchases with an expectation of generating a future return.

The cap would ensure that the means test targets only housing of significant value. For example, it is estimated that a cap of $1.2 million would currently mean that around 10,000 age pensioners' homes would be partially assessed under the means test. In setting a threshold, consideration should be given to the effect on regional areas.

Australia's future tax system — Report to the Treasurer

Henry Tax Review

The review said it would hit only 10,000 retirees. The $1.2 million figure was in 2009 dollars, meaning that if the change came in today the review would want it to cut in at a higher dollar figure.

The Grattan Institute suggests a lower cut in at $500,000. The first $500,000 of each mortgaged home would remain exempt from the pension assets test, the part above $500,000 would be regarded as an asset. Grattan says it would save the budget $1 to $2 billion a year.

The Australian Chamber of Commerce and Industry agrees, as does the Actuaries Institute.

The idea scares homeowners

Who could object?

The Combined Pensioners and Superannuants Association says asset testing the family home would be "massively unfair", targeting the vulnerable. But people with high-value mortgage-free homes aren't normally thought of as vulnerable.

Labor's treasury spokesman Jim Chalmers says it would push more retirees "off the pension, out of their homes, or both". He is right about the former, but wrong to think the retirees who suffered a cut in their pension or lost their pension would be badly off.

The worst off retirees, as recognised by a Senate Committee, are those without homes making do with grossly inadequate rental assistance.

Right now it is possible for a single person owning a $1.3 million mortgage-free home and $260,000 of other assets to get the full age pension.

Assuming that person draws down on those other assets at the rate of 5% per year, he or she can spend $37,000 per year and pay no rent.

Yet homeowners do well

A non home owner with $785,000, or half the assets, would be denied the pension. Like the much-richer homeowner, that person would be able to draw an income of about $37,000 per year, but half it will have to go on rent.

It's hardly fair. It encourages retirees with homes to stash more and more of their assets into them in order to get the pension (and pass something valuable on to their children). Retirees with lesser assets miss out and have to rent.

But fairness is in the eye of the beholder. The problem is that a ceiling on exemption from the assets test that seems fair in one part of Australia might not seem fair in another where home prices and perhaps the cost of living is higher.

Our suggestion could be sold as fair

In order to make more equal treatment seem fair to all retirees with homes I and fellow actuary Colin Grenfell have worked up an option that would use the median (typical) price for each postcode as the cut off point for exemption from the assets test.

It would happen postcode by postcode, updated every year using council valuations and as the median prices changed. Only the owners of homes who values were atypical for the area would be affected, and only that part of the value of their home that was atypical would be included in the assets test.

Its key selling point is that it wouldn't threaten homeowners with values at and below the average for their area.

The funds freed could increase the overall pension, but would probably be better applied to lifting rent assistance.

It's important to treat retirees in the same financial circumstances the same, regardless of whether they own a mortgage-free home, and fewer and fewer retirees are owning mortgage-free homes.

It would have the added benefit of reducing the pressure on our parents and grandparents to own houses with bedrooms on the first floor that are never opened, not until they die and their houses are sold.

Anthony Asher is Associate Professor at *University of New South Wales.* This article is republished from The Conversation under a Creative Commons license. Here is the original article.

(The following note from a reader is published on condition his identity remains confidential. He has identified himself to us but his employer requires him to remain anonymous).

Hi Graham

It's frustrating the retirement review can't consider recognising the family home for the age pension.

My friend and I have a retirement plan of living in neighbouring townhouses. With our wives, we'll have a very convenient support and social network, especially as we age further and mobility issues set in or we can no longer drive.

When we get to age 67, we're estimating, in today's dollars, that his townhouse will be worth around $1.2 million in Sydney while our house in Albury will be $400,000. His and his wife's super will be around $700,000 while my wife and I will be around $1.5 million.

So, we'll both be worth the same, but because of the home exemption from the age pension he and his wife will get a part pension and all the benefits that flow from all three levels of government and anywhere that offers pensioner discounts.

But our plan will see me and my wife also using this age pension concession and joining the gravy train as well.

- If the family home was included in the age pension calculation, with an offsetting increase in the assets test, we've discussed the idea of moving to a regional coastal town. That would be a better lifestyle for us, and if enough retirees did the same it would help housing affordability and congestion in Sydney.
- The family home concession favours people in Sydney and Melbourne over other capital cities, who are favoured over large regional centres, who are favoured over people in smaller towns where house prices are generally lowest. It's the reverse of all other tax systems where the wealthiest pay the most.
- Not including the family home also ends up for many as an increased inheritance handout to children of retirees. If my parents downsized, they'd lose their age pension and all the other benefits. Uncles and aunts will either lose or see a reduced age pension if they downsize. So the older generation helping each other and my generation are helping to keep everyone in their home as long as possible as we get more money as a family.

Taking me and my friend, if we both moved up the coast and bought neighbouring townhouses we could end up in a scenario where we have exactly the same wealth in our homes and in super/personal names, but the other couple gets a part age pension and all the handouts and we don't.

I am happy for you to share these ideas.

OK Boomer: fessing up that we've had it good

Graham Hand

The newly minted 'OK Boomer' movement is increasing attention on generational inequity. *The New York Times* of 29 October 2019 carried this heading:

> 'OK Boomer' Marks the End of Friendly Generational Relations
>
> Now it's war: Gen Z has finally snapped over climate change and financial inequality.

'OK Boomer' is used by Gen X, Gen Y (Millennials) and now Gen Z (the newest generation) when a Baby Boomer says something dismissive, especially referencing the good old days. The younger person cannot be bothered explaining the ignorance of the older generation, and simply responds with 'OK Boomer'. It's pejorative, a put down. It has already been used in the New Zealand Parliament by a 25-year-old politician to stop heckling during a climate change debate.

Financial equality between generations is an emotive issue with legitimate arguments on both sides. Older Australians want to hang on to the outcome of their hard work, as they have legitimately planned for retirement based on a set of prevailing rules. Younger people see the Boomers enjoying property market, superannuation and investment conditions unlikely to be repeated. Already, the 27% of Australians who are over 50 hold half the wealth, and ASIC estimates 65% of the almost $3 trillion in super is held by fund members over 50.

Confining this article to financial matters, we will focus on:

1. Superannuation contributions
2. Residential property prices and the family home
3. Equity and bond markets
4. Cost of education
5. Death duties
6. Demographic change

It avoids the big social issues such as climate change, global political unrest, #metoo, over population or trade wars. Rather, let's see how Boomers' conditions have allowed them to build financial independence in retirement.

Now it's 'When I'm 84'

In 2014, Alex Denham, then a financial adviser, wrote an excellent article called '*Hey, what have you got against late 60s babies?*' Born in 1969, she feels her generation missed out on many of the advantages that set up older (and in some cases, younger) generations:

"I'm getting a niggling feeling that someone out there has it in for us late 60s babies. We just seem to keep getting hit by changing government policy, and not in a good way. Too old for this, too young for that."

At the time of publication, I recognised that many of the benefits had gone to Boomers. Born between 1946 and 1964, Boomers are now aged 55 to 73. I was born in 1957, the same year two lads named Paul McCartney and John Lennon first met, down the road from my birthplace. 'When I'm 64' is suddenly only two years away for me. I recently attended an amazing McCartney concert where he performed without a break for three hours in a spectacular collection of classics. He was born in 1942 and is now 77 years-of-age. Next time … 'When I'm 84'.

1. Superannuation contributions

Super schemes existed for many employees before the introduction of the Superannuation Guarantee (SG) in 1992. By 1974, an estimated 58% of the public sector and 24% of the private sector had some form of super. However, SG was a massive step forward for widespread inclusiveness when it started at 3% in 1992 under the Keating Labor Government. The compulsory contributions gradually reached 9% by 2002/2003, and the current level of 9.5% was set in 2014/2015.

A Boomer born in 1964 may not have received compulsory super until the age of 28, and would have been 38 by the time the 9% level was reached. It could be argued they have not received the full impact of the super system.

This disguises the limits and the generous ability to put more into super which operated for much of their working life. The limits have been reduced significantly for the following generations. The current maximum annual concessional contribution, the most tax-advantaged way to put money into super, is only $25,000. At various times in the past, this has been as high as $100,000 a year, and was $35,000 for people 49+ as recently as 2017.

The biggest opportunity to put large amounts into super comes from non-concessional limits, the amount from after-tax savings. The current non-concessional cap is $100,000 a year, but for three years until FY2017, it was $180,000 a year, and $150,000 a year for many years before that.

One reason many wealthy people have so much in super is Treasurer Peter Costello allowed $1 million in non-concessional contributions for a period of 14 months until 30 June 2007. Although there was no limit on after-tax contributions before 2007, pensions were taxed so the environment was not as attractive.

What made money in super so appealing was that in December 2006, Costello introduced a Bill to allow people aged over 60 to access their super tax-free. Not only are the earnings on assets in pension phase free of tax, but withdrawals (following a 'Condition of Release' until the age of 65) are also tax free, whether as a lump sum or pension.

This explains why the then Treasurer, Scott Morrison, in the 2016 Federal Budget capped the amount that can be transferred to the pension phase to $1.6 million. Anyone with a total superannuation balance greater than or equal to the transfer balance cap now has a non-concessional limit of zero. Super above $1.6 million must be held in accumulation with a tax rate of 15% on income earned (or 10% for capital gains), still highly advantaged versus the personal tax system.

The tighter caps make it far more difficult to establish large superannuation balances, especially via the concessional limits. The $100,000 years were massively advantageous for high-income earners. In 2016, when the Commissioner of Taxation, Chris Jordan, explained why 2,184 people had over $10 million in super (and six with over $100 million), he said the balances had been accumulated over 30 years or more. That's what high limits, good investing and compounding can achieve.

The rules around a 'Condition of Release' are surprisingly flexible. A person over the age of 60 does not even need to retire, they simply need to resign from a company. They can start work again the next day while also setting up a pension. Although the limits were tightened, a couple can still move $3.2 million into the tax-free phase.

While there is a requirement to take out the legislated minimum of 4%, anyone with other resources will leave the rest untouched because saving in super is subject to such low tax rates.

Let's face it, if a couple with a large super balance pays no tax on $3.2 million of assets and only 10% to 15% tax on the rest, then Australia is not collecting taxes from many people who can afford them (acknowledging that tax was paid before the money went into super). Even if they earn only 5% on $3.2 million, that's $160,000 of tax-free income which might otherwise incur personal tax at 45% plus a Medicare Levy of 2%. That's over $75,000 a year which can finance a decent Mercedes or a couple of amazing trips to Europe a year. Seven hundred Australians retire every day.

2. Property prices and the family home

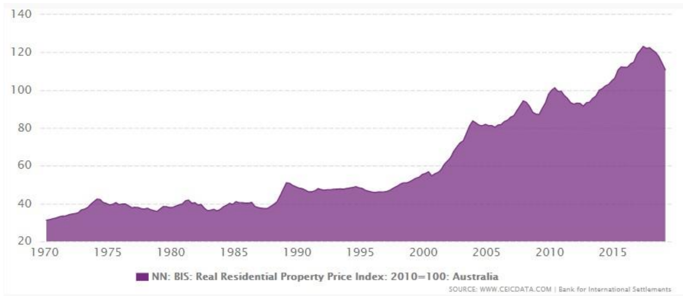
The first property I bought in Sydney in 1980 cost $56,000, for a three-bedroom terrace. It's now near a train station and would be worth maybe $1.5 million. Adjusting $56,000 in 1980 to current day dollars (using the RBA's inflation calculator) gives $241,000. The real cost is up by 330% over 38 years, but that's only 3.9% a year for inflation.

The second house, this time free-standing on the Lower North Shore, cost $104,000 in 1983. Let's guess it is now worth $2.5 million. Current day dollars for the $104,000 is $333,000, a change of 220% at an average inflation of 3.4%.

These examples are typical, give or take, of millions of people who entered the property market 20 to 30 years ago. The following chart shows real property prices for Australia since 1970, adjusted for inflation. The index is set at 100 in 2010, and this is not the most expensive markets of Sydney and Melbourne.

It shows how far ahead of inflation, and similarly wages, house prices have risen, although it's not a straight line. The index rose from 1970 until 1975 and then held its real levels for the next dozen years, with a strong kick up before the 'recession we had to have' in 1991. Many houses purchased in 1990 were worth less five years later. And yes, interest rates in the late 1980s were much higher, with the variable rate at around 13.5% for most borrowers. But anyone owning a house for the last 25 years has materially benefitted.

Australian Real Residential Property Price Index from March 1970 to March 2019



With this increase in wealth, consider what owning a family home gives under our current system:

1. Tax-free capital gains. I asked a fund manager many years ago where he invested his own money. He said that while he held his liquid assets mainly in his own fund, the best investment for tax-free capital growth was Sydney houses on large blocks of land in great suburbs. And in his case, it needed to come with its own tennis court.
2. Exemption from social security assets tests. Even for most people who have not accumulated much wealth outside the family home, but spent their life paying off their mortgage, they are now sitting on a substantial asset in retirement. A couple can receive a full age pension with other benefits such as cheap medical prescriptions if their assets outside the home are less than $394,500, and part pension up to a healthy $863,500. They can top up their cash flow through the Pension Loans Scheme up to 150% of a qualifying pension (the maximum age pension for a couple is $36,582 a year, plus pension and energy supplements). There are many reverse mortgage schemes which also give access to lump sums if needed.

For all the attention we rightly pay to superannuation, it is the ownership of a home, exempt from assets tests but giving access to cash flow through a reverse mortgage, which offers the greatest financial security and independence in retirement. Due to property inflation, newer generations are finding it far more difficult to reach this milestone, increasing the uncertainty of their futures.

3. Equity and bond markets

To avoid doubling the length of this article, let's consider a few data points which show how favourable investment conditions have been over the last 30 years, even including the GFC.

The 2019 Vanguard Index Chart gives financial year returns for major asset classes, with the averages since 1990 of:

- Australian shares, 10.0%
- US shares (unhedged), 11.8%
- Australian bonds, 8.3%
- Australian listed property, 10.6%

Investors should be delighted if these returns are repeated in the next 30 years. Even a balanced portfolio with conservative allocations to bonds and cash has delivered close to 10%. With bond rates now at 1% and markets fully priced, if anyone offered you these returns, bank them before they blink.

4. Free education

In 1974, Gough Whitlam abolished fees for university and tertiary education became free until the introduction of HECS in 1989. I went to university for four years from 1976 to 1979, with every year free. Now it is common for students to acquire $100,000 or more of HECS debt. I also benefitted from a Commonwealth Bank bursary that paid full salary while studying, but the Bank no longer offers such funding.

5. Death duties and super for estate planning

It is claimed that no other developed nation has policies that both exempt the family home from any form of taxation or social security test, plus imposes no death duties. It's also argued this places the tax burden on income which is unfair to younger generations, encourages a brain drain to lower-taxed countries and reduces the turnover of property.

Australia does have a form of death duty. Non-dependant children who inherit a superannuation lump sum will pay 15% tax plus 2% Medicare Levy on the taxable component of the balance. The best way to avoid this tax is to transfer money out of superannuation the day before death. Get the paperwork ready.

This raises another point on the purpose of superannuation. While it is widely accepted that super is intended to finance retirement, the reality for many wealthy Australians is that super is an estate planning tool. Keep the money in a favourable tax environment for as long as possible before handing it over to the children, and whip it out of super before buying the coffin.

Somewhere along the way, the bank of Mum and Dad might help in the property market.

At the last Federal Election, the Coalition successfully targeted 'death taxes' as a Labor strategy, even thought it was not on the policy agenda. Such tactics ensure unpopular policies are removed from debate, when a death duty potentially lowers inequality and reduces reliance on other taxes. Dead people do not vote, but they enjoyed passing their wealth to their children.

6. The Intergenerational Report

Somewhere in this divide is the harsh reality of future budget constraints. The 2015 Intergenerational Report assesses the long-term sustainability of government policies looking ahead 40 years, and it includes:

- In today's dollars, health spending per person is projected to more than double from around $2,800 to around $6,500 a year. State government costs will also be significantly higher.

- Aged care expenditure is projected to increase from 0.9% of GDP in 2014-15 to 1.7% in 2054-55, and from $620 to $2,000 in real, per person terms.

- Despite policy changes and greater super balances, payments made through age and service pensions per person are projected to increase from almost $2,000 in 2014-15 to around $3,200 in 2054-55 per person in today's dollars.

- Most significant of all, *"There will be fewer people of traditional working age compared with the very young and the elderly. This trend is already visible, with the number of people aged between 15 and 64 for every person aged 65 and over having fallen from 7.3 people in 1974-75 to an estimated 4.5 people today. By 2054-55, this is projected to nearly halve again to 2.7 people."* That's a lot less workers paying taxes to support the elderly.

They are coming to get us

Boomers are a large voting group. High post-war birth rates and longer life expectancies mean it's a cohort few politicians want to offend. We Boomers fight to retain our rights, as former Shadow Treasurer Chris Bowen discovered when he was completely out-muscled over franking credits.

There's little doubt the Labor Party will abandon the policy. New leader Anthony Albanese recently told the National Press Club following the review of Labor's election defeat:

"When you've got to explain dividend imputation and franking credits from opposition, tough ask. While the call on the budget of franking credit arrangements is large, many small investors felt blindsided and it opened up a scare campaign."

Data from demographer Bernard Salt shows Millennials already significantly outnumber Boomers, and they will increasingly hold the power at the ballot box. By 2040, the first Boomers born in 1946 will be well into their nineties and life expectancy increases will not save all of us.

The great generational divide

Population levels by generation, 2016 & 2019

Age group	Generation	2016 (m)	2019 (m)	Change
18-37	MILLENNIAL	6.9	7.3	405,000
38-57	GEN X	6.3	6.4	123,000
58-77	BABY BOOMERS	4.4	4.8	380,000
78+	PRE-BOOMERS	1.2	1.3	104,000
TOTAL 18+		18.8	19.8	1.012000

Source: ABS, The Demographics Group

Time to fess up

Of course, not every Baby Boomer has enjoyed the good times, and this article makes sweeping generalisations about opportunities. It focusses on the prevailing circumstances millions have faced, not whether they were fortunate enough to grab them. Female Boomers also did not have equality in employment and salaries.

Missing out on the war years and the immediate austerity that followed, Boomers have benefitted from a favourable superannuation system with high limits and then little or no tax in retirement, surging property prices, excellent bond and equity markets, free education and avoidable death duties … we could go on about cheap global air travel, rapid medical advances, low unemployment and a healthy environment.

The next generations worry about the climate change problems we will leave behind, how future education and health and social services will be funded, and how they will ever enter the property market.

Let's cut a little slack and campaign less against every change that might adversely affect us. We've had the politicians in our pockets, next to our bulging wallets, but it will not always be that way. The younger generations include our children and grandchildren.

Truth is, it's been good for us. OK, Boomer?

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any individual.

Sorry, there's no real place to hide

Graham Hand

Let's say you have saved $1 million to buy a home in a year, or you're a retiree who cannot tolerate losing any of the capital you live off. Where can you stash your cash safely and retain its purchasing power in real terms over short terms?

Sorry, there's nowhere.

Official cash rate, 1990 to 2019

Source: RBA

Investing was once relatively straightforward for highly conservative investors. As recently as 2012, the cash rate was greater than the 4% annual minimum drawdown required from a superannuation pension account. Further back to the 1990s, periods of double-digit cash and term deposit rates avoided the need to go into anything riskier than term deposits, although inflation was higher.

Fast forward to now, as we enter the 2020s, there is nowhere to hide that gives capital security, a return greater than inflation and avoids a continual drawdown on a pension.

Many retirees cannot tolerate losses

Recent research by AllianzRetire+ reveals 79% of Australian retirees say they are responsible for their own finances and they need to feel in control of their money. However, only 44% feel secure in their current financial position, and:

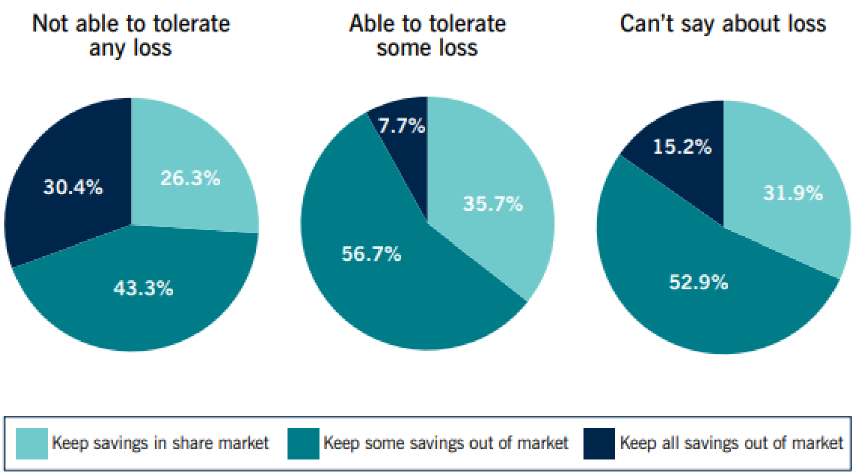
"The response from current retirees is to assume a frugal and conservative retirement investment approach to fund their retirement (75%)."

The consequence is that two-thirds of retirees are spending only on necessities, worried about unexpected costs and illness. This lack of confidence leads to a high allocation to deeply defensive investments, but what exactly is defensive in the current market?

A 2018 National Seniors survey called '*Once Bitten Twice Shy*' shows a high 23% of older Australians cannot tolerate **any** annual loss on their portfolio, and only 25% can tolerate a loss greater than 10%. A decade on, the impact of the GFC looms large for many retirees, as the survey quotes a retired man aged 54:

"The main issue with the GFC for me was the reduction in my capital investments of approximately $30,000. Up until that point I would be considered a medium risk investor, however following my loss, I changed to a low risk investor and transferred much of my capital into cash. The income from the cash stream is considerably less than a shares portfolio however I was not prepared to suffer another loss of that magnitude. My attitude has not changed to this day."

Another National Seniors survey from March 2019, *'Feeling financially comfortable? What retirees say',* shows the intractable dilemma this creates. Over 30% of the 'not able to tolerate any loss' group keep their savings out of equities.



Although data on SMSF asset allocation is notoriously unreliable, they hold about 25% of their assets in cash and term deposits. That's nearly $200 billion earning a negative real return, an extraordinary loss of retiree income over recent years. Little wonder some economists question the stimulatory impact of lower rates. An estimated $1 trillion of superannuation is in post-retirement accounts.

The current annual CPI inflation rate is 1.7% or 1.95% 'excluding volatile items'. Many of the items in a retiree budget, such as health and utility costs, are rising faster than CPI. As the last two quarters have recorded 1.1%, let's say a positive real return requires an investment return of over 2% a year. It doesn't sound like much, only $20,000 on $1 million.

So what's available, beyond the spin of fund managers, brokers and advisers dressing up risk with words like diversification and low volatility, and misleadingly quoting last year's performance?

Current cash and term deposit rates

Three broad categories of short-term investments offer a high degree of capital protection:

1. Bank (or any Approved Deposit-taking Institutions (ADI)) term deposits

The government guarantee on ADI deposits is up to $250,000 'per entity per ADI'. Anyone wanting the highest protection on $1 million will need to invest with at least four different ADIs. According to Canstar, the highest term deposit rate for 12 months is 1.7% from a couple of small ADIs, ignoring the 2% from a new startup bank. The highest rate from a subsidiary of a major bank is 1.3%.

2. Online savings accounts

There is a wide range of online accounts paying around 1.5% and up to 2% with so-called 'promotional and bonus conditions'. These include making a minimum number of 'tap and go' transactions a month, minimum deposit amounts with no withdrawals or using a related credit card. As they target genuine retail, there is sometimes a maximum amount, perhaps $100,000.

Anyone who can be bothered monitoring all the rules across multiple accounts can probably eke out 1.5% to 2%, after a heap of paperwork opening new accounts. Really, life's too short.

3. Cash or short duration government bond funds

Dozens of 'fixed interest' funds are now listed on the ASX, but there are only a few genuine 'cash' and very short duration government bond funds. Obviously, if they are investing in cash or government securities and taking out their own fees, they cannot achieve much more than the current cash rate.

The largest cash fund in the listed market is the BetaShares AAA ETF, which holds a healthy $1.8 billion at a fee of 0.18%. BetaShares does not pretend it is anything other than: *"competitive with 'at call' bank deposits and term deposits without the need for bank account opening or locking up capital".* The current interest rate is 1.22%. As with any fund, last year's rate of 1.9% is irrelevant. What's done is done, you can't invest in the past.

If you want the certainty of capital protection with no credit or duration risk, that's all you can invest in, folks.

What about all the other fixed interest products?

Surely, this is missing a wide range of products that have been launched recently and promoted as alternatives to term deposits. Fund managers have delivered a spate of Listed Investment Trusts (LITs), and bond funds and the like have been offered for decades.

For example, mortgage funds were widely offered as alternatives to term deposits even within the banks' own branch networks. Funds with five-year mortgage assets offering same day liquidity were an accident waiting to happen. When the GFC hit and investors wanted their money back, the funds were frozen until the loan maturity dates allowed repayment. In most cases, investor capital was not lost but pensioners needing the money waited for years.

Many of the new LITs are worthwhile additions to diversified portfolios, and we have written about them here and here. But the added return is available for a reason, and the investments are fine if this reason is understood and accepted.

Many of the conservative investors who have pumped billions into the new LITs and fixed interest ETFs are the same investors who cannot tolerate share market risk. They have traded one type of risk for another, albeit with less downside and less upside potential. But critically, downside potential there is, and it's not short-term capital preservation.

An adviser told me recently that some of his clients are using these funds for 'cash management purposes'. But how many retail investors understand 'spread risk', 'duration risk', 'default risk' or 'liquidity risk'? And what does 'mark to market' mean? What can go wrong?

What is 'mark to market' and why does it matter?

A bond bought to yield 5% for five years and held to maturity will earn 5% each year for five years (assuming no default). What it says on the box is correct.

However, a bond fund is usually made up of hundreds of bonds, and funds offering daily liquidity must revalue the bonds every day to calculate the unit price or Net Asset Value (NAV). In the case of an ETF or unlisted managed fund, investors enter or exit at this price and there is no maturity date for the fund. If a bond is repaid, the fund manager buys another bond.

It is not possible to invest in a bond fund (other than a government bond fund with very short duration) or any of the recent LITs and guarantee that $100 now will be worth $100 in a year. It could be $105, it could be $100, it could be $95. This article is addressed to the large number of people who cannot accept the risk of $95.

Credit spread risk in corporate bonds

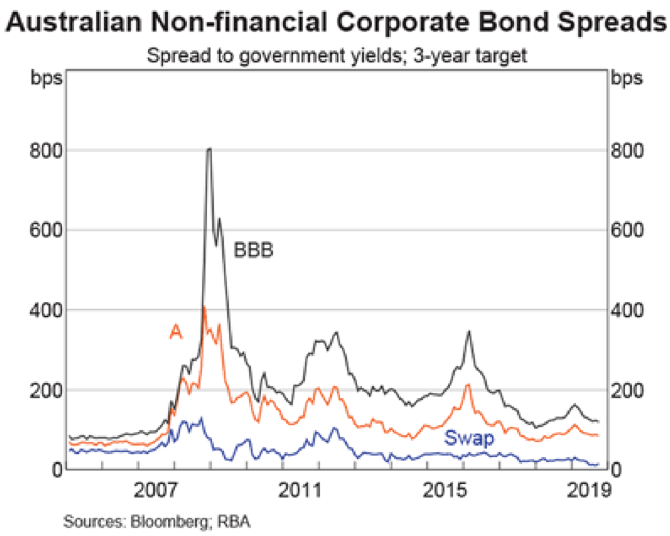
Most investors know about default risk, where a company cannot pay its debts when due. Many investors know about liquidity risk, where there is a poor market for the bonds in a portfolio and money cannot be withdrawn (or in the case of a LIT, buyers disappear). And there are other risks such as duration, where bonds of longer maturity lose more than shorter maturities when rates rise.

But for the purpose of illustrating the risk in many of the new LITs, let's focus on the credit spread risk in the corporate bond and loan market.

Let's say a fund manager buys a corporate bond yielding 5% for five years, and this is a spread of 4% more than a government bond. Even if interest rates do not move, a change in the market's perception of the company might lead to a sell off, and the yield might rise to 6%. That's a widening of the spread from 4% to 5%. The bond **price** would fall by about 5% (for simplicity sake, assuming a duration of five years, although duration is less with semi-annual coupons). It does not need the company to default for the bond to lose 5% of its value, and such spread widening for 'high yield' credit is common (non-investment grade or high yield bonds used to be called 'junk bonds' before the marketing people realised the obvious problem).

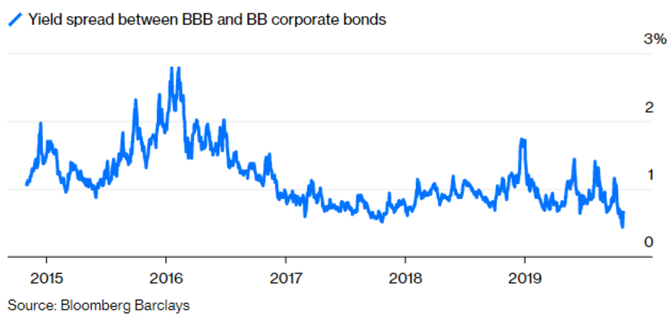
You may take comfort from the fact that the fund holds 100 companies, and a loss of 5% on one bond is only 0.05% on the whole portfolio. That is correct, but corporate credits spreads as a whole rise and fall depending on market factors.

The Reserve Bank of Australia chart (from 6 November 2019) on non-financial corporate bond spreads shows BBB spreads are close to their lowest for 12 years, since well before the GFC, and they move around.



The BBB rating is the bottom level of Standard & Poor's credit rating where the risk is still considered investment grade. The BB rating denotes 'high yield' or 'speculative'. As many institutional investors are not allowed exposure below investment grade, there is often a big divide between spreads on BBB and BB names.

However, in the global search for yield, investors are increasingly heading into riskier investments they may once have shunned. According to Bloomberg, the margin between investment grade and 'speculative' grade was at a new low at the end of October 2019. It is a reward for taking risk, but investors are buying BB bonds at a spread of only about 40 basis points (0.4%) above BBB. At the start of 2019, it was as high as 170 basis points (1.70%) and almost 3% in early 2016, as shown below.



Back to 'mark-to-market, the fall in both interest rates and spreads means bond funds which own BB securities have delivered excellent returns in 2019, and these results are often quoted in offer documents.

But this quoting of past returns is disingenuous on bond funds with rates and spreads at these historical low levels. What matters is the future risk of spread widening and interest rate rises.

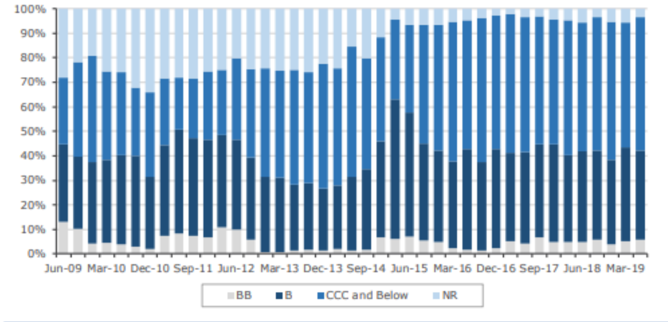
The credit deterioration in corporate bond funds is not confined to non-investment grade. In the investment grade bond index, BBB companies now make up over half the index for the first time in a decade.

I stress that including some of these corporate bond funds as an allocation in a diversified portfolio may be appropriate. What is incorrect is to consider these funds as capital protection vehicles over a time period such as one year.

A specific example

Consider the recently-listed KKR Managed Fund (ASX:KKC) which has 60% exposure to 'global credit' and 40% to 'European direct lending'. It launched with a minimum target of $200 million and accepted $925 million. KKR is a major global player in corporate debt with a 120 person global credit team and about US$70 billion in credit strategies.

As shown in the chart, about 50% of the securities will be CCC-rated, and the vast majority will be sub-investment grade. That's how the expected high returns are achieved.



Source: KKR Credit as at June 30, 2019

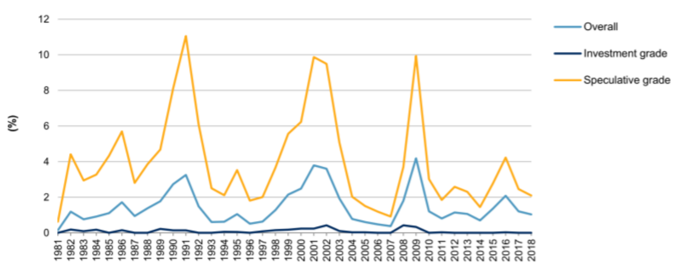
KKR discloses the risks, such as this from their offer documents:

"A KKR Managed Fund may hold debt investments that may be classified as 'higher-yielding' (and, therefore, higher-risk) investments. In most cases, such debt will be rated below 'investment grade' or will be unrated. Borrowers of this type are considered to be at greater risk of not making their interest payments or principal repayments. The market for high yield securities has previously experienced and may in the future experience periods of volatility and reduced liquidity. The market values of certain of these debt investments may reflect individual corporate developments. General economic recession or a major decline in the demand for products and services in which the relevant issuer operates would likely have a materially adverse impact on the value of such securities. In addition, adverse publicity and investor perceptions, whether or not based on fundamental analysis, may also decrease the value and liquidity of these high yield investments.

Commercial bank lenders may be able to contest payments to the holders of other debt obligations of the same obligor in the event of default under their commercial bank loan agreements".

S&P Global Ratings for 2019 show the following default rates:

Global Default Rates: Investment Grade Versus Speculative Grade



Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.
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This chart shows a portfolio of 'speculative grade' companies can have a default rate of 10%. KKR is highly-experienced and may not see similar levels.

The fee structure includes a base management fee, a performance fee, a responsible entity fee, recoverable trust expenses and indirect costs, and in the example provided by KKR, it adds up to 1.58% per annum. In a low interest rate world, investors should consider if this is a disproportionate share of the return.

In the unlisted fixed interest market, in recognition that taking high fees from low rates is a hard sell, many fund managers are lowering their fees. In Australia in recent weeks, Nikko, Kapstream, Schroders, Legg Mason and Aberdeen Standard have dropped fees. Bond ETFs are widely available and cheaper.

Investors who take comfort from the current benign conditions in the bond market must accept conditions can turn quickly into a reinforcing spiral. As investors see capital values fall, more attempt to sell. During conditions of poor liquidity, prices fall as weaker investors panic.

I asked Anthony Doyle, a cross-asset specialist at Fidelity International, what he thought of retail investors buying low-rated corporate bonds. He replied:

"I worked on a bond desk for 12 years in the UK. I think that these high-risk asset classes do well until they don't. It's important for investors to understand the risks that are involved in investing in essentially one notch above default corporate bonds in CCC."

Why do advisers and brokers put their clients into these funds?

Every relationship between an agent and client is different, and often there is a significant difference in expertise and knowledge which requires the client to trust an adviser. In most cases, this trust is justified.

Reasons why these newer-style exposures are selling by the billion include:

1. They are a legitimate part of a diversified portfolio. Fixed interest investments usually offer better defensive performance than equities, and the promise of 6% to 8% returns may be considered adequate compensation for the risk.
2. The fund managers coming to the market are among the largest and most experienced in the world, and their experts perform extensive due diligence before investing. For example, KKR has a strong private equity heritage and is familiar with corporate credits outside investment grade. By combining money into one fund, a wide diversity of corporate or loan exposures is delivered in one investment.
3. Some of the bond issuers are higher credit quality than KKR's fund, so the quality of the portfolio should be checked.
4. Or the elephant in the room is conflicted remuneration, where fees are paid to brokers and advisers to place clients into certain funds. This is a major subject in its own right and will be covered in another article.

Fixed interest for protection and as a risk diversifier

The traditional role of fixed interest, especially government bonds, was to protect a portfolio while providing some income. Investors could be confident about the low or negative correlation with equities. However, it is possible if rates rise on bonds (and prices fall), then equities will also see price falls.

Similarly, non-government bonds are subject to credit spread deterioration and credit default in the face of a declining economy.

There is a role for corporate credit in a diversified portfolio, especially with term deposit rates below 2%, but do not equate 'fixed income' with capital protection. There's a reason why short-term government bonds are called 'risk free'. Other bonds aren't.

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

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