Firstlinks
Connecting investors with ideas

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## Duh! Of course geared funds won, but know the risks

### Graham Hand

When *The Australian Financial Review* published an article called, "Australia's best fundies for 2019" on 14 January 2020, it was obviously highly popular with readers. Who doesn't love a winner?

But half of the funds listed in the 'All Funds Report' based on Morningstar's database of 9,846 funds were geared funds. Well, duh! The S&P/ASX200 Accumulation Index was up 18.8% in 2019 and geared fund borrowing costs fell to about 2%. Of course leverage pays off when markets are so strong.

With many investors thinking the good times will continue, there's a temptation to gear into the action, especially with borrowing costs low. What can go wrong?

**How do investors gear into shares?**

There are four main ways to borrow to invest in shares:

1. Margin loans, where the assets secure the loan but the borrower remains responsible for any shortfalls.

2. Drawings against the equity in home loans, where the loan is secured against the value of residential property.

3. Instalment warrants, where one payment is made on first investment, and then the investor can choose to make a later second payment to achieve full ownership.

4. Internally geared share funds, where the borrowing and security are done within the fund itself with no recourse to the investor. These are the successful funds of 2019 referred to in the AFR article.

Here we focus on how geared funds works, and show the asymmetric returns.

**How does gearing work?**

Let's consider if the market index rises or falls 10%, how much will a geared strategy change in value, assuming a gearing ratio of 50%?

Surely, that's easy. If I borrow $100,000 to add to my own $100,000 and invest $200,000, don't I simply double the return? And if the market is down 10%, then my return will be down twice as much, or 20%. I can live with that risk, so let's go.

Sorry, it doesn't work like that.

Internally geared funds build the debt into fund structure. For example, a fund geared at 60% will take $10,000 from an investor and borrow another $15,000 to invest $25,000 on behalf of the unitholder ($15,000/$25,000=60%). The interest cost is significantly lower than in margin lending because these funds borrow in wholesale markets, currently at around Bank Bill Rate plus 1%, or 2%. However, management fees are charged on the gross assets (including the borrowed amount), so geared funds gross up the fees handsomely.

**The calculation which many geared investors overlook**

For a geared strategy to be worthwhile, the ungeared (or market) return must be enough to cover the interest cost plus any management costs and fees. Let's consider what happens in a strong market, which rises 10% in a year.

The formula, which can apply to any geared investment, is:

$$\text{Geared Return} = \frac{(\text{Ungeared Return}-\text{Gross Fees}) - (\text{Gearing Ratio} \text{X} \text{Interest Cost})}{(1-\text{Gearing Ratio})}$$

The gearing ratio is the amount of debt as a proportion of total assets, so if an investor puts in $40 and the fund borrows $60 on their behalf, the gearing ratio is 60%. Interest is only paid on the borrowed amount, so the lower the gearing, the less the impact of the borrowing rate. This calculation ignores the fact that income may be taxable and expenses may be deductible.

Let's use a typical example of a geared share fund with an interest cost of 2%, a gearing ratio of 60% and fees on the gross assets of the fund of 1%. Assume the normal accumulation index (price plus dividends) rises 10% over a year.

The Geared Return will be 19.5%, being 9% return after fees (10%-1%), less the interest cost (60% of 2% is 1.2%), leaving 7.8% net return, divided by the 40% equity put in by the investor, to give 19.5% (7.8%/0.4).

(The impact of low rates is significant. If the funding cost was say 5%, the return would drop to 15%).

However, here's where the risks come in. If the market is flat, the Geared Return would be -5.5%, being the cost of 1% in fees and 2% interest, divided by the capital of 40% (-2.2%/0.4=-5.5%).

Note that these examples consider total returns, so 'flat market' means prices have fallen enough to offset the dividends.

**If the index falls 10%, the 'loss' on the investor's capital is a hefty 30.5%**

This is where the asymmetry of returns can shock investors.

*How can the loss be over 30% when the market is down only 10%? It does not seem intuitively correct.*

Consider the exact dollars. An investor puts in $100,000 and borrows $150,000 to invest $250,000. The portfolio is down 10% or $25,000. The fund charges 1% on gross assets or $2,500 and the interest cost is $3,000 ($150,000 at 2%). That's a loss of $30,500 or 30.5% on $100,000. Oops.

By the same reasoning, many investors with margin loans during the GFC in 2007 lost 100%, even when gearing ratios were lower. They put in $100,000 and borrowed $100,000, and then their shares fell in value by 50%. Their loss was not 50%, it was 100%. All their capital was gone.

Here are the geared returns on a typical geared share fund for various levels of (ungeared) market performance (the same calculations apply to any form of gearing).

| Accumulation Index (Ungeared) | Geared Return | Gearing Ratio (debt/assets) | Gross Asset Fee | Interest Cost |
|---|---|---|---|---|
| -20% | -55.5% | 60% | 1% | 2% |
| -10% | -30.5% | 60% | 1% | 2% |
| 0% | -5.5% | 60% | 1% | 2% |
| 5% | 9.5% | 60% | 1% | 2% |
| 10% | 19.5% | 60% | 1% | 2% |
| 20% | 44.5% | 60% | 1% | 2% |

The point where geared equals ungeared is when the normal market is up about 3.6%, enough to cover the costs and provide an equivalent return.

A margin loan invested on the ASX in, say, cheaper Exchange Traded Funds (ETFs) or direct shares may save on the asset management fee, but the borrowing cost is much higher, making the above geared returns even worse. According to Canstar, margin loan rates are currently between 4.75% and 6.73%, way above the 2% on internally geared funds.

For example, if the market loses 10%, an investor with a margin loan at 6% would lose 33.5%.

**A geared investor needs high risk tolerance**

Gearing is not for the fainthearted, especially when low equity returns are a more realistic expectation. A gearing ratio of 60% will give an investment with 250% of the volatility of the standard equity index.

The same reasoning as above applies to any geared investment, including buying the family home. Residential owners are blessed by not having daily market valuations, so they do not realise when their geared exposure has made a massive loss. Plus they tend to consider property investment longer term, especially the house they live in.

This leads to the type of mindset you need to gear into equities. It is for the highly-risk tolerant and based on a long-term strategy, because short-term losses can be severe.

Also, borrowing within super is complex and expensive, and an SMSF may not be the best structure to learn whether you have the risk tolerance.

Any gearing structure should watch for gearing on gearing. Although almost all listed companies have some level of borrowing, property funds were historically highly geared going into the GFC, and the major feature of their subsequent restructuring has been to move to lower gearing levels.

Investors need far better performance to recover from a fall than the percentage fall itself. For example, if a $1 investment goes to 50 cents, it has fallen by 50%. But to recover from 50 cents to $1, it must rise 100%.

Next time an adviser or broker suggests an equity loan or internally geared fund, ask a simple question:

*"If the market goes down only 10%, how much will I lose?"*

If they don't know the answer, they will be shocked when you show them this article.

*Graham Hand is Managing Editor of Firstlinks. He was General Manager, Funding & Alliances at Colonial First State, during the GFC, where he was responsible for gearing management (not asset selection). At its peak, CFS's geared funds held $10 billion in assets. Nothing in this article constitutes personal financial advice or considers the circumsances of any individual.*

## Sweet spot helping bull market rampage

Roger Montgomery

Since the beginning of 2013, the real S&P500, which is adjusted for inflation, has risen by almost 200% and apart from two bouts of volatility in 2015/2016 and at the end of 2018, it's been smooth north easterly sailing especially since 2016.

Global stocks began a significant march higher in February 2016. At the time, the global economy looked bleak but major economic 'blocs' were about to accelerate (relatively speaking of course) thanks to a dovish Federal Reserve and a massive Chinese domestic economic reflation attempt.

**Difficult markets for value investors**

That we have been in a bull market for the last six years cannot be contested, and that's a difficult thing for a value investor to want (or need) to admit. What's challenging is not that we want lower prices to be able to buy more safely. What is challenging is holding on to what we have even when prices exceed the valuation estimates based on our most optimistic assumptions.

When we now take a balanced look at global market, we see conditions similar to those that existed in 2016. A manufacturing slowdown, as measured by the world industrial production excluding the US, is underway. And the US indicator for new manufacturing orders, published by the Federal Bank of Dallas, has fallen 30% cent from its 2018 highs.

But despite these simple measures, the market is focused ahead. With the US Federal Reserve easing and China again reflating, investors are looking past the gloom and are factoring in an improvement in conditions. At some point in the future, the market might even become fearful of inflation emerging but right now it's a trade truce between China and the US and a calming of Brexit uncertainties that has captured investors' imagination.

On top of all of that we have a Federal Reserve confronting a suite of structural factors that should keep rates low. Low rates don't render asset prices immune to sell-offs but they are of course supportive for all asset including equities.

The structural factors that suggest interest rates could remain low for a very long time and therefore support already stretched asset prices, include demographics and debt among others.

**The much-longer-term outlook**

Over the next eight decades to 2100, Planet Earth is forecast to see its population growth slow almost to a halt. More importantly perhaps, the proportion of the global population over the age of 65 will rise from 10% today to over 20% by 2100. A doubling of the proportion of people over 65 will have a significant influence on global growth as well as on government budgets.

We have seen in Japan when more people retire, productive capacity and economic output decline. Coincidentally, government healthcare and pension liabilities rise. Individually, and in combination, lower economic output and greater debt has a depressing effect on interest rates.

If an ageing population and increasing debt is a negative influence on interest rates, then the world may be in for an extended period of low rates. And the US Federal Reserve is in no rush to turn hawkish or tighten policy. Despite a continuing decline in unemployment, real wage gains remain muted.

In China, the economy is picking itself up from the mat after its trade war with a Trump-led USA. Understandably, Chinese shares were hit hard and are arguably 'under-owned'. They now trade at about 11 times current earnings. If Chinese stocks are included, emerging market equities are likewise trading at just 12 times current earnings.

The question is whether these earnings are bottom-of-the-cycle. If they are and earnings rebound, Chinese shares could be a bargain. We note reports that Chinese credit creation has accelerated, and manufacturing is also recovering. Industrial profits could also be at the low point of this cycle.

If global growth continues, the equity risk premium (ERP) should also decline. A decline in ERP while the risk-free rate remains subdued, will raise equity valuations even if earnings don't recover. But earnings may indeed recover as well. Under these conditions, stock market performances could exceed those of the year just completed.

**Have central banks created a 'sweet spot'?**

It could be argued that, much as we can now see was the case in 2016, global markets could be in a bit of a purple patch - a sweet spot, if you like – where aggregate profit growth is beginning to recover, while inflation remains low and central banks remain accommodative with no warnings about a change of tack.

If the current combination of factors remains unchanged, then with the exception of a black swan event, that by definition is unpredictable, there is a strong reason to expect a continuation of the bull market with higher prices and expanding price/earnings ratios in 2020.

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## 20 great ways the government helps retirees

### Brendan Ryan

Here are some tips for retiree Australians (and their families and friends) as we kick-off 2020:

1. If you, or anyone you know are turning 66 this year, make a diary note to look closely at an age pension application 12 weeks before the actual birthday. This gives time to address any hiccups well in advance of your first payment being due. You should have some idea of whether you are eligible for the age pension, and the payment should form part of spending plans.

2. If you are turning 66 this year, and think you are not eligible for the Centrelink age pension, make sure you know exactly why, so you can get ready to apply if things change. You may even be wrong.

3. If you are turning 66 this year, and you are not eligible for the Centrelink age pension, then apply for the Commonwealth Seniors Health Card. This card is income tested and could save you more than $2,500 on healthcare costs.

4. If you think you were not eligible for the Commonwealth Seniors Health Card, check again. Low income returns on investments and changes in deeming rates mean that your eligibility may have changed. Unlike the Centrelink age pension, you can only apply for this once you reach age pension age. Something to do on your 66th birthday!

5. If you are already receiving a part pension, make sure Centrelink is up to date with the right data. For part pensioners, a change in assets of $1,000 means an extra $78 per year in age pension payments. Check the right value for the car or caravan is in the system, and household contents are realistically valued. These assets are means tested. Your savings may have changed due to a holiday, renovation or medical emergency. Make contact and increase your pension.

6. If you receive an age pension, make sure you are receiving these five entitlements:

- Gas Rebate
- Electricity Rebate
- Water Rebate
- Council Rate Discount
- Driver's License and Registration Concession

7. If you are applying for the Centrelink age pension, apply for the entitlements above as soon as you receive your Pension Concession Card. (Hopefully on your birthday - because you started application three months beforehand!)

8. If you are in the situation of (6) and (7), keep searching for entitlements, concessions, rebates, programmes or whatever they are called. In my list I have more than 40 and counting. Policies change, governments try and get re-elected, budgets have announcements - it's a moving feast. Everything from replacement appliances,

fishing licenses, pet registration, and stamps. And from all levels of government. Oh yes - in different departments in the different levels of government too. There are so many, there's work to do here.

9. If you are part of a couple, make sure you are registered for the Medicare safety net as a family or couple. This is something most people set up when they first get married but things can change a lot over time. With access to Concessional Medicare Safety Net thresholds as a holder of a Pensioner Concession Card or the Commonwealth Seniors Health Card, this one is a no-brainer.

10. If Christmas with the family has got you thinking about aged care, learn about it before it happens. You will be grateful for some basic knowledge. The Government Aged Care portal, gov.au has good resources to get you started. Look at local aged care providers. What are the costs? Are the assets of your parents organised enough to be called on to fund aged care? Can they be re-organised? June 30 this year is your deadline to make use of a financial year to sell assets, and then sell again the next day to reduce the cost of capital gains tax.

11. If you are trying to work out how your savings are going to last, try the ASIC Moneysmart Retirement Planner. It's much better than many of the services provided by for-profit companies as it includes age pension eligibility and works this out over time.

12. While you are making plans, check your spending compares to the ASFA Retirement Standard. This is a great tool for reviewing how your spending in retirement might look if things are going well, or if you have to tighten your belt.

13. If you are in NSW and hold a Commonwealth Seniors Health Card, apply for the Seniors Energy Rebate. If you *have* already applied, don't expect to get it again next year. You will have to re-apply. Governments make announcements, hide the application forms, then make you search again the next year to get the same benefit. Play the game!

14. If you are in NSW, hold a Commonwealth Seniors Health Card or receive an age pension, and live in a regional area, get ready for the $250 Regional Seniors Travel Card. It's not clear yet how you apply, but expect the same rules as (13).

15. If you are turning 66 or over, and you are still working, don't assume the Centrelink age pension is irrelevant. For someone with a small amount of savings, and a low-income job, there is a potential benefit. Here is how to get the full experience of how confusing it is: Work out your age pension eligibility, crunch the numbers on SAPTO, add a dash of LITO, stir in some Work Bonus - and then take this result to try and work out the right number of hours to work so you are not giving away 50% of your savings by forfeiting the pension via the income test. Sound confusing? It's one of the most baffling situations one can come across and those with low incomes and small savings are the ones hit with an effective 50% tax rate. Don't start me.

16. Travelling by public transport in NSW? If you want to make the most of government transport help, take a look at the following: Pensioner OPAL Card, Pensioner Travel Vouchers, Country Pensioner Excursion Tickets and Regional Excursion Daily (RED) Tickets. Got all that? Hopefully you have more time to plan now you are retired.

17. If your investments are hard to track, hard to organise, or you cannot link your investment strategy to your retirement plans, it might be time to consolidate and simplify. There is a link between asset allocation strategies and expected returns. ASIC explains it here. Use these expectations, an understanding of spending and availability of government support as the basis of long-term retirement spending plans. It's easier than it sounds. A long-term plan should be easy to hang your hat on. Allow for unexpected changes, such as medical emergencies, aged care, sudden yearning for travel, urgent house upgrades and maintenance, bailing out a child … the list is endless.

18. If you own property and need a top up for your day-to-day living expenses, the Pension Loans Scheme may be right for you. The interest rate has dropped to 4.5%. If you are eligible for the Centrelink age pension at $0, maybe you can apply for a loan even if you are a self-funded retiree. This may suit people with illiquid assets that stop them from getting an age pension, who may be cashflow poor. People with income streams that prevent them getting the age pension (via the income test) may also apply for a top up. It's a scheme for everyone. And make no mistake - the government is keen for you to tap into your property value to support your spending in later life.

19. If you want to try and understand how the Pension Loans Scheme could work for you, start playing with the Money Smart Reverse Mortgage Calculator. Change 'Lender and Product' to 'Other (no loan restrictions)' and

set the borrowing plan to 'fortnightly payment'. It's still not super clear - but it is better than anything else you will find. (Why are these government tools so hard to find?)

20. If you are feeling a bit hopeless about how hard it is to get properly organised, read this. In 2014, Joe Hockey needed four treasury officials and a few weeks to work out what every Australian turning 66 must grapple with. There is no manual, no list, no comprehensive website.

But it's well worth the effort.

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## Despite strong 2019, institutions wary of GFC coming

### Louise Watson

Last year, 2019, was better than many expected, but as 2020 is underway, institutional investors are not particularly upbeat. According to the annual Natixis Investment Managers global survey, institutions around the world are concerned that ongoing low yields, stalled trade talks and slow global growth represent significant risks to portfolio performance. In fact, 83% expect a GFC-type event within the next five years.

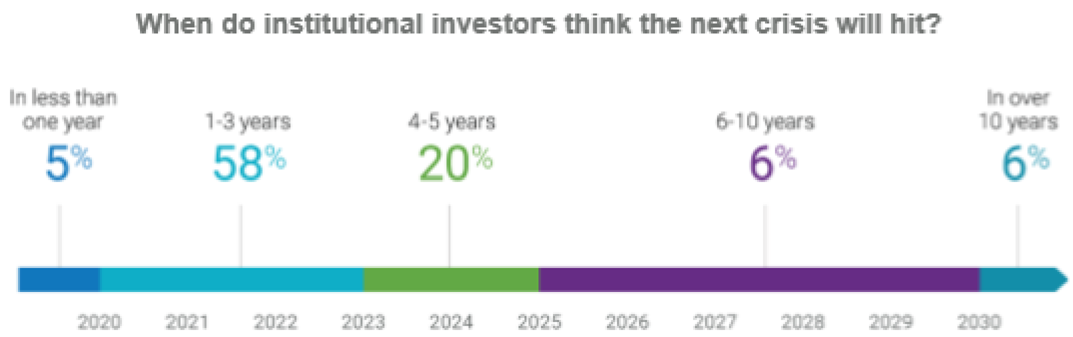
The survey collates the views and expectations of 500 institutional investors, including 19 from Australia. Those surveyed control USD15 trillion of assets and include superannuation funds, sovereign wealth funds and other corporate pension funds. Their views on what's in store and how to respond offer compelling insights into what Australian institutional investors are likely to do in 2020, and how this will affect returns.

**The major portfolio risks**

The survey findings showed investors' top five portfolio risks for the year ahead are:

- market volatility (53%)
- interest rates (50%)
- credit crunch (37%)
- liquidity (36%)
- deflation (20%).

The question isn't which risk will do the damage, it's more a question of when. A majority of institutional investors say they expect the next GFC within the next five years, as shown below. Almost three-quarters (73%) project trade will have a negative impact on performance, as well as slow growth and the low yield environment. About 58% see the potential for asset bubbles to thwart performance and 89% are concerned about the impact of rising public debt on global financial security.




**Allocations between active and index**

When asked about how they intend to respond to these risks, 74% of institutions said that uncertain markets call for active management. As shown below, despite the strong returns from passive investments in 2019, most institutions believe a 70/30 split between active and passive is the right mix. They believe that large inflows into passive investments present significant risks, partly because they indicate that the market is ignoring fundamentals, but also because large flows risk amplifying volatility.


74% of institutional investors agree that the current market environment is favorable to active management.

## The investment outlook

Australian institutions are asking how they should invest to achieve a target return, without becoming too caught up in macroeconomic factors over which they have no control. There is a sense that the global macro and geopolitical events – Brexit and trade tensions for example – are taking a long time to play out. There is widespread acceptance that keeping a sharp focus on meeting investors' retirement and investment goals in the face of difficult market conditions is their number one priority.

Even though they see challenges on the horizon, institutions are not planning significant allocation shifts. In fact, current allocations are within one or two percentage points of what institutions projected for 2019, as shown below. Those looking to adjust alternative allocations say they will increase allocations to private debt, infrastructure and real estate.


## Diversification and the role of non-traditional assets

What does a diversified, robust portfolio actually look like? Lower yields have rekindled risk appetite globally, including in Australia. Faced with historically low yields, and a Governor of the Reserve Bank of Australia (RBA) who has explicitly stated that 'lower for longer' is likely to be the new reality. Investors understand that they have to move up the risk curve in order to achieve reasonable rates of return.

As a result, we are seeing more niche strategies included in portfolios. In Australia, institutional investors are looking outside traditional asset classes to real estate, infrastructure, private equity, hedge funds, global macro strategies, ESG-focused funds and global credit. They are also looking outside of traditional asset managers to provide exposure to these markets. This means greater willingness to unclude offshore asset managers if they are convinced of the value the manager can bring.

**The growing role of environmental, social and governance (ESG) factors**

The reasons for the institutional embrace of ESG are illuminating. More than half (54%) say that there is alpha, or excess returns, to be found in ESG, and 57% focus on ESG in order to align their assets to organisational values. Even more surprising perhaps is that it's not all about returns or even their own organization. More than a quarter (28%) of institutions said ESG in order to help make the world a better place.

We are also seeing an evolution in ESG thinking with more institutions integrating sustainable development goals into their portfolio. There is more rigorous thought process around the carbon footprint of an overall portfolio, rather than honing in on specific sectors or companies. For example, a key theme for Mirova, Natixis Investment Managers' affiliate manager dedicated to sustainable investing, is to identify which companies will likely benefit from the transition from old world reliance on fossil fuels to new world renewables, and to keep their portfolio's carbon footprint below the 2 degrees agreed by the Paris Agreement.

**Managing investor expectations in 2020**

When asked about investors' expectations for 2020, many institutions expressed concern that investors are not as acutely aware of the risks on the horizon as they should be, nor of the necessity of shifting portfolio allocations to more 'risky' assets in order to meet long-term goals. Over three quarters of institutions said that individual investors have unrealistic return expectations, while a similar amount don't understand their own risk tolerance and may even liquidate their assets prematurely due to fears of a recession.

The survey also revealed the tendency of individual investors to focus too heavily on short-term results. This problem, prevalent in Australia, can mean losing sight of the importance of staying invested for the long-term.

Education is key. Investment managers are taking steps to fully inform their investors about risk and return and the importance of diversification and active management. Our industry needs to rebuild trust post the Royal Commission, and we need to offer investors credible solutions at a reasonable price.

Investors need to tune out market noise, build meaningful positions within their portfolios and invest with conviction over the long term. Keeping a close eye on market conditions, maintaining a truly diversified portfolio – with a mixture of traditional assets and non-traditional assets – is the best way to help investors achieve their long-term goals.

*Louise Watson is Managing Director at [Natixis Investment Managers Australia](). This article is general information and does not consider the circumstances of any investor.*

## Bona fide ways to help bushfire victims

### Antonia Ruffell

Australia is experiencing a bushfire crisis of unmatched scale and precedent. Across the country, catastrophic fires have destroyed millions of hectares of land, devastating families, communities, property and wildlife.

With apocalyptic images of the fires beaming across the world, support for the firefighting and rebuilding efforts has been swift. Donations have been flooding into charitable organisations, but there is still an enormous need.

If you have the capacity to respond, money is what charities need most right now.  As well as delivering emergency relief in the short term, charities need funding for long-term support services to help people, communities and the natural environment recover in the years to come.

To help you consider what assistance you can provide, here are some pointers to think about and a list of Deductible Gift Recipients (DGR) Item 1 charities prepared by the Australian Philanthropic Services (APS) Grantmaking team.

(If you have a private ancillary fund (PAF) or a public ancillary fund (PuAF/giving fund) make sure that you donate only to a DGR Item 1 charity).

**Money, not goods**

Many charities have been overwhelmed with generous donations of items like clothing, but do not have the capacity to sort and distribute them. The best way to help now is to donate financially.

**Donate to bona fide charities**

Do some due diligence to make sure your money is going where you expect it to go. The list below is a good place to start, or you could check the charity's status on the ACNC website.

Consider a long-term approach to your giving. Could you set-up a recurring donation, or support an organisation focused on recovery, rather than immediate disaster relief?

**Give your time later**

The Centre for Volunteering has developed some information for people interested in registering to volunteer their time to support the bushfire recovery, once the immediate bushfire threat has passed, and when affected communities ask for it. Remember that many volunteering positions require you to take some training first.

**Nationwide**

These national charities are providing frontline emergency assistance right now, and long-term recovery support, across multiple states and territories:

- **Australian Red Cross Society** (ABN 50 169 561 394) is accepting donations through its Disaster Relief Fund, which helps those affected by bushfires, heat, floods, cyclones and other national emergencies. As of 6 January, ARC is providing direct emergency assistance to bushfire victims.
- **The Salvation Army (NSW) Social Work** (ABN 46 891 896 885) is conducting an emergency and disaster appeal which provides material support, such as meals, clothing and accommodation support, to evacuees and frontline responders around the country.
- **Food Bank Australia** (ABN 58 073 579 254) is the only Australian organisation that provides direct food relief in the wake of natural disasters. Donations to their bushfire appeal go towards providing essential supplies to support emergency workers and affected communities during recovery works.
- **Givit** (ABN 21 137 408 201) is collecting donations for the purchase of new household items as well as coordinating public donations of goods-in-kind (including clothing, furniture, whitegoods) across Australia.
- **The Foundation for Rural and Regional Renewal** (ABN 27 091 810 589) is focusing on long-term recovery support via their perpetual Disaster Resilience and Recovery Fund, which supports national disaster preparedness and recovery by enabling local leaders to access funds for emerging needs that they have identified as most important for their community.
- **Save the Children** (ABN 99 008 610 035) has launched a bushfire appeal to establish child-friendly spaces in communities affected by bushfires, including Wagga Wagga and Bairnsdale, where qualified early childhood specialists support children while their families receive referrals to other services.
- **Good360** (ABN 93 161 292 664) is a matchmaker connecting the needs of communities with businesses' brand new goods. Donations to their bushfire appeal go towards coordinating the delivery of the right goods to the right people at the right time over the many months and years of recovery of this unprecedented disaster.

**New South Wales and the ACT**

- **St Vincent de Paul National Society of Australia** (ABN 50 748 098 845) is raising funds through its bushfire appeal, in conjunction with Channel Nine, to support victims of the fires around NSW.
- **The NSW Rural Fire Service and Brigades** (ABN 88 311 702 546) operates a Donations Fund providing support for bushfire relief and local brigades.
  Australian comedian Celeste Barber's Facebook donation page has raised a phenomenal $45 million (and climbing) for the NSW Rural Fire Service. If you have a PAF or PuAF/giving fund, please give directly to the Rural Fire Service, as donations on Celeste Barber's page are being collected via a DGR Item 2 fund.

**Victoria**

- **Victorian Bushfire Appeal**. To make an eligible donation in support of the Victorian government-backed bushfire appeal, being conducted in partnership with the Bendigo Bank Community Enterprise Foundation, PAFs and PuAFs/giving funds can do so via the Salvation Army (ABN 18 730 899 453) which is also a partner in the appeal. If you have a PAF of PuAF/giving fund, you cannot give to the bushfire appeal directly as Community Enterprise Foundation is a DGR Item 2 charity.

- **The Country Fire Authority** (ABN 29 419 704 198) operates a Donation Fund that allows you to specify the local brigade in Victoria that you would like to support.

- **Gippsland Emergency Relief Fund** (ABN 66 660 282 945) is a volunteer-run organisation which is collecting donations to support to Gippsland residents who have lost their homes or had their property damaged by a bushfire, flood or storm event.

**Queensland**

- **The Rural Fire Brigades Associate of QLD** (ABN 37 417 474 709) operates a Public Fund which supports rural fire brigades and volunteers.

- **Lifeline Queensland operated by UnitingCare Community** (ABN 28 728 322 186) is running a disaster appeal supporting provision of psychological first aid to communities impacted by disaster.

**South Australia**

- **The South Australian Country Fire Service** (ABN 91 442 189 358) operates the CFS Foundation Volunteer Support Fund which supports voluntary rural fire brigades.

- **Blaze Aid** (ABN 72 456 906 612) helps families in rural Australia, including South Australia, who are affected by natural disasters. Blaze Aid volunteers have been active recently on Kangaroo Island.

**Our ravaged environment**

If you would like to support injured and affected wildlife and landscapes:

- **Foundation for National Parks and Wildlife** (ABN 90 107 744 771) is conducting an emergency appeal that will provide targeted funding for first aid and rescue equipment for injured animals, as well as providing support for wildlife carers across Australia.

- **Worldwide Fund for Nature Australia** (ABN 57 001 594 074) has a bushfire appeal that aims to save injured wildlife and recover lost landscapes in critical koala habitat.

- **Wildlife Victoria** (ABN 27 753 478 012) operates a Wildlife Rescue and Rehabilitation Fund that supports wildlife shelters and carers during emergency and recovery periods.

- **NSW Wildlife Information, Rescue and Education Service** (WIRES) ABN 30 768 872 928 is coordinating an emergency response appeal to rescue injured wildlife through its Public Gift Fund.

- **RSPCA NSW** (ABN 87 000 001 641) has a bushfire appeal assisting with evacuating wildlife, livestock and pets in NSW and beyond.

**More than money**

**#buyfromthebush**

For those who use Facebook, consider supporting affected communities by subscribing to this platform which showcases small business gems across rural and regional Australia. You can buy produce or gifts that help support small livelihoods in communities facing fire and drought.

**Accommodation initiatives**

- Find a Bed has been developed to offer beds or homes to evacuees. In East Gippsland, any offers of emergency accommodation can be made by emailing the local council.

- Airbnb has established the Open Homes initiative, where hosts can offer free accommodation to affected people as well as rescue workers.?

**Give Blood**

Australian Red Cross Blood Service is calling on Australians to consider donating blood in response to the ongoing bushfire crisis.

*Antonia Ruffell is CEO of Australian Philanthropic Services (APS), a not-for-profit organisation that sets up and administers private ancillary funds, offers a public ancillary fund, the APS Foundation, in which people can establish a named giving fund, and provides grantmaking advice. Chris Cuffe is the pro bono Founder and Chairman of APS.*

## A simple method compares hybrids with term deposits

### Norman Derham

The extra return paid to investors for taking risk has been heavily influenced by the reach for yield. It affects many spread margins (or excess returns) such as high-yielding corporate bonds and (even) ordinary equity.

**What 'lower for longer' means for prices and returns**

With cash and bond rates set to remain 'lower for longer', the transfer mechanism from 'risk free' with almost zero return to 'risk on' becomes self-fulfilling. We only have to look to Japan where credit assets issued by Japanese corporates in Yen trade 'tighter' (higher in price) than (say) a corporate bond issued in USD's by a US corporate. While the reach for yield or demand for 'risk' is integral to spread margins contracting (prices rising), underpinning this is the fact that in Japan, interest costs have been so low for so long that fewer Japanese corporates or households default.

This is the situation that Australia now finds itself in. Low interest rates, and predicted by the 10-year bond rate to remain so for an extended period, and if Japan is the template for corporate and household default rates, benign default conditions.

**Breakeven analysis: term deposit versus hybrid**

As the reach for yield intensifies, do investors know if the return on invested capital at risk is sufficient compensation versus the risk-free rate to justify the investment? This is the question investors should always ask themselves before making any investment.

There is no right or wrong answer because individual investor risk tolerances vary. For example, we might assess hybrid capital instruments to have little risk at present arguing that the improved credit health of the issuers justifies pricing closer to more senior instruments of the same issuer. However, other investors will rank them only marginally ahead of ordinary equity perceiving them to be highly risky.

We use a number of methods to assess the risks inherent in individual securities and in aggregate terms, in our portfolios. One method, breakeven analysis, provides us with a relatively simple method of assessing whether the excess return over a prescribed benchmark index or even the risk-free rate provides sufficient compensation for the additional risk. It helps to compare assets of differing seniority, term and credit quality.

Using an example of a major Australian bank term deposit returning approximately 1% on an annual basis and the PERLS VII hybrid capital instrument (ASX:CBAPD), currently yielding approximately 3.5% per annum, puts the excess return in perspective.

Assume $100 is invested in a term deposit for 2 years (a reasonable time frame) at 1% per annum. Ignoring compound interest, investors earn $2 or 2% over the 2-year period.

Now, investing in CBAPD, we can assume the floating benchmark reference rate will be 1% (i.e. BBSW), the return over the same period, including the value of franking, will be 3.5% in year 1 followed by 3.5% in year 2, a total of $7 or 7%.

While the return is 3.5 times the risk-free term deposit rate, the investment is in a 'risk' asset where there is some probability, albeit a very low, of a capital loss over the period. Using breakeven analysis, it is possible to make a value judgement on the return versus the risk.

**Making sense of the numbers**

Let's assume there is an 'event' and the capital value of the hybrid CBAPD declines. The question you should ask is:

*How far does the capital value of CBAPD have to fall by the end of the period (i.e 2 years) before an investor would have been better off investing in the term deposit?*

The capital loss on CBAPD would have to be greater than $5 (i.e the difference between earnings on CBAPD and the term deposit) before you would have been better off in the term deposit.

That is, if you buy CBAPD at $100 today you could sell it for $95 at the end of the period (year 2) and be no worse off than investing in the term deposit at 1% p.a. for 2 years. The table below summarises this information.

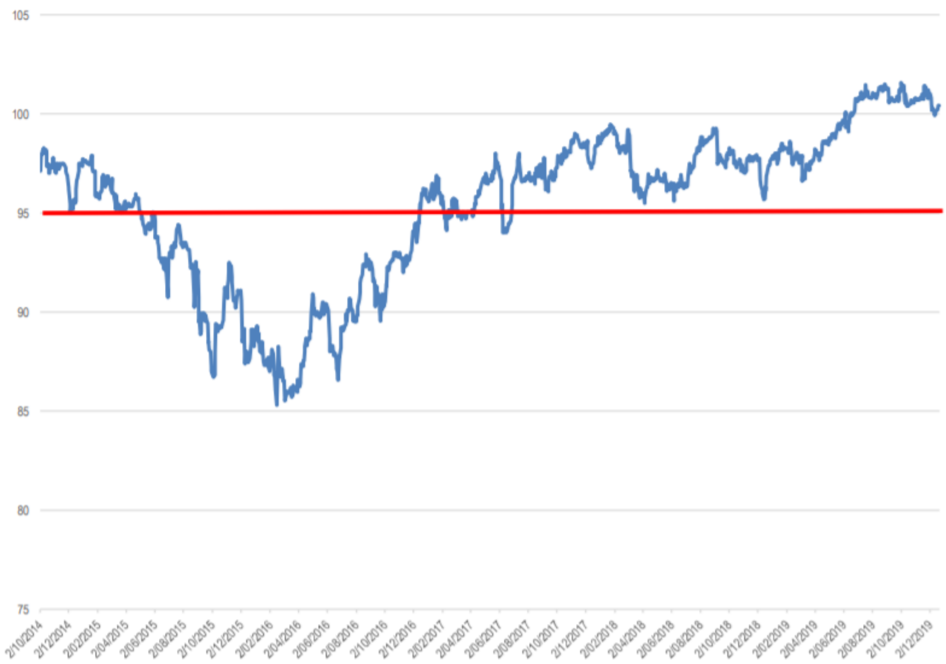
| | Income (annual rate) | Return @ end 2 years | Amount Invested | Income earned on $100 over 2 years | At end year 2 ($100 + income) | Breakeven CBAPD price @ end year 2 to = 2-year TD income |
|---|---|---|---|---|---|---|
| 2-year TD | 1% | 2% | $100 | $2 | $102 | n/a |
| CBAPD | 3.50% | 7% | $100 | $7 | $107 | $95 |

**What does this tell us?**

The interesting fact is that at a price of $95 in 2 years' time (in January 2022), the yield-to-maturity to the first call in December 2022 of CBAPD would approximate to 9% per annum. That is, the change in capital value plus the coupon and franking. At 9%, the spread margin represents an excess margin of 800 basis points or 8% over the risk-free rate which would be amazing value, everything being equal, for an asset of that credit quality (CBA risk) and term (one year).

While CBAPD has traded at a price below $95 in its life since its 2014 issuance, as shown below, it was only for a 12-month period in 2015 and 2016 when the term to maturity (first call) was in excess of five years. Since then it has traded at a price in excess of $95 and more recently above $100 (the security's par value) reflecting a rerating of the risks associated with major bank hybrids and a shortening term to maturity or first call specific to the CBAPD security.

**CBAPD Price Daily October 2014 to December 15, 2019**



**... but diversification is still key**

While our portfolios are of similar term and similar average weighted credit quality to the example above, the important difference is that our portfolios contain 35 securities spread across a range of sectors and sub sectors, including banking, insurance, building and construction and infrastructure. By investing across a broad range of sectors and sub sectors containing securities of different credit quality and term, the risks associated with investing in a single individual security are significantly reduced. Even with a credit of the quality of CBA, it's worth spreading the risk to other quality names. It is also possible that CBA will not call the hybrid at its first call date, although banks are reluctant to do this as it affects their subsequent visits to the market.

*Norman Derham is Executive Director of [Elstree Investment Management](), a boutique fixed income fund manager. This article is general information and does not consider the circumstances of any individual investor.*

## Poacher turned gamekeeper changes his wealth model

### Rob Garnsworthy

*(Editor's introduction: Rob Garnsworthy readily admits he 'fed from the trough' during his business career 'in his previous life'. Rob was Chief Executive Officer of Norwich Union from 2000 to 2003 after five years as Managing Director of Colonial Group's UK operation and then heading CBA's International Financial Services. In 2000, Norwich managed funds valued at $11 billion and administered an additional $6 billion through the Navigator Master Trust.*

*Rob is now long and happily retired, and he says, "Those writing about retirees are never actually retired - the thoughts and fears are different and they change over time."*

*So in what ways has he changed over time since experiencing retirement from the other side?).*

The articles in Firstlinks on Listed Investment Companies (LICs) and ASIC's disquiet over selling fees flirts at the edges of a much more fundamental challenge for advice and wealth businesses. The fees model right across the industry, from advisers to platforms to fund managers to retail and industry funds, is unfair and unsustainable.

Let's start with a very simple fact. The ASX200 Price Index climbed from 6,802 on 31 December 2019 to 7,042 on 10 January 2020, a rise of 3.5% in 10 days.

Not a single soul across the industry has done anything to achieve that result, their costs have not gone up by a single cent and yet most of their fee income has gone up by circa 3.5% (acknowledging that some business models use a flat annual fee).

Is that fair? No. Is it reasonable? No. Is it under attack? Yes.

**The reality of percentage fees**

Most investors do not even see the rising dollar amount of fees as the payment is hidden, and no doubt they welcome the market move of 3.5%. If they do think about it, then it's *"... little bit off the top in fees, so what?"*

Here is the reality. The rush into financial services was about jumping aboard this gravy train - revenue went up (and down) with markets, whereas costs per client remained largely fixed (with the exception of ever-increasing spends on IT and compliance). There is a lucrative disconnect between costs and revenue tied to markets that trend higher over time, even with some hiccups in between like the GFC.

Revenue and charges are not 'matched'. Businesses receive, say, a 7% increase in fees each year due to market movements, with say, an increase of 2% in your costs. It's a cracker of a business model!

SMSFs were first to spot the flaw. They figured out that their accounting and audit fees really did not change whether their fund was $1 million or $10 million. It's the reason nearly 30% of superannuation has moved into SMSFs, and larger the fund, the bigger the saving, and not only on administration.

The new kids – well, relatively - on the block, Exchange Traded Funds (ETFs) still charge percentage- based fees but as they bulk up, their fees generally go lower. There is an ever-widening gap in fees between ETFs from the big guys and LICs/managed funds, and it shows in the flows as ETF volumes have surged past LICs in the last year.

**It's asset allocation that matters**

The obvious and compelling question is: *"Why would I invest in a LIC or managed fund when the costs are higher and performance is often inferior?"*

Not only is the industry 'logic' under attack, the competition just gets hotter and hotter. Throw in an ever-increasing overlay of regulations and compliance, and the industry is getting tougher! A fee model that is unfair, performance differentials opaque and the cost of doing business rising. Not surprising that some are heading for the exits.

However, it gets worse. In this new world, asset allocation rises above the noise. It is. and arguably always has been, the most critical decision for any investor. Never before has it been so simple to get advice on asset allocation. Just look it up, copy whoever you like – the Future Fund, an industry fund, a diversified retail fund, whoever. Copy their allocation, buy ETFs to match and go back to sleep! That is now a genuine option.

And okay, if you have confidence in an active manager, throw them into the mix if you are prepared to pay active fees.

It really surprises me how few people actually understand the problem. If the retail investors of the world realised that the 'only' skills you need are asset allocation, supported by some good tax advice, then stock picking becomes largely irrelevant. Portfolios can be dominated by passive exposure with some active piece. It's a lot easier for ordinary folk to get their heads around.

I am about to turn 71, with about 20% of my portfolio allocated to passive exposure – the balance is all direct. By the time I get to 75, it will probably be 40% passive and by 80, reckon that might be 80%!

**My view of the future**

Looking forward, the old world will defend the traditional business model, in some cases to the death. The new world will build a model, including critically, financial and tax advice, based on dollar fees for service, rather than percentages, and portfolios will be dominated by low cost index allocations.

At the edges will be genuine super star managers who consistently outperform and can charge accordingly but one suspects there will be fewer of them!

*Rob Garnsworthy is retired after a senior wealth management career, and is currently a Trustee Director for the Colonial Foundation, a charity which has donated over $115 million in a range of philanthropic grants.*