Firstlinks
Connecting investors with ideas

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Should your equity manager hold lots of cash?

Graham Hand

Constructing an investment portfolio should not begin with the investments. That's where it ends. There are several steps before you reach the stage of selecting funds or direct shares, such as:

- First, define your goals
- Second, assess your risk appetite and behaviour
- Third, decide your broad asset allocation
- Fourth, examine your costs, tax and administration structures
- Fifth, choose your specific investments, which might include a fund manager.

Every investment with a fund manager should form part of an overall plan and fit into an asset allocation decision that matches your goals and risk appetite. For example, you might not invest in fixed rate bonds because you believe rates are too low or they are about to rise or credit margins will soon widen. You are not looking for a fixed rate bond manager or listed vehicle, regardless of how good they are.

Similarly, if your asset allocation requires an exposure of 10% to global equities, you then compare the products available, usually unlisted fund managers, listed investment companies (LICs), exchange-traded funds (ETFs) or direct equities. You might be seeking the greater diversification into overseas markets, or you are worried about the Australian dollar falling. You want foreign companies on foreign exchanges with foreign currency risk.

It's your decision to suit your circumstances.

It's not for the fund manager to change your asset allocation

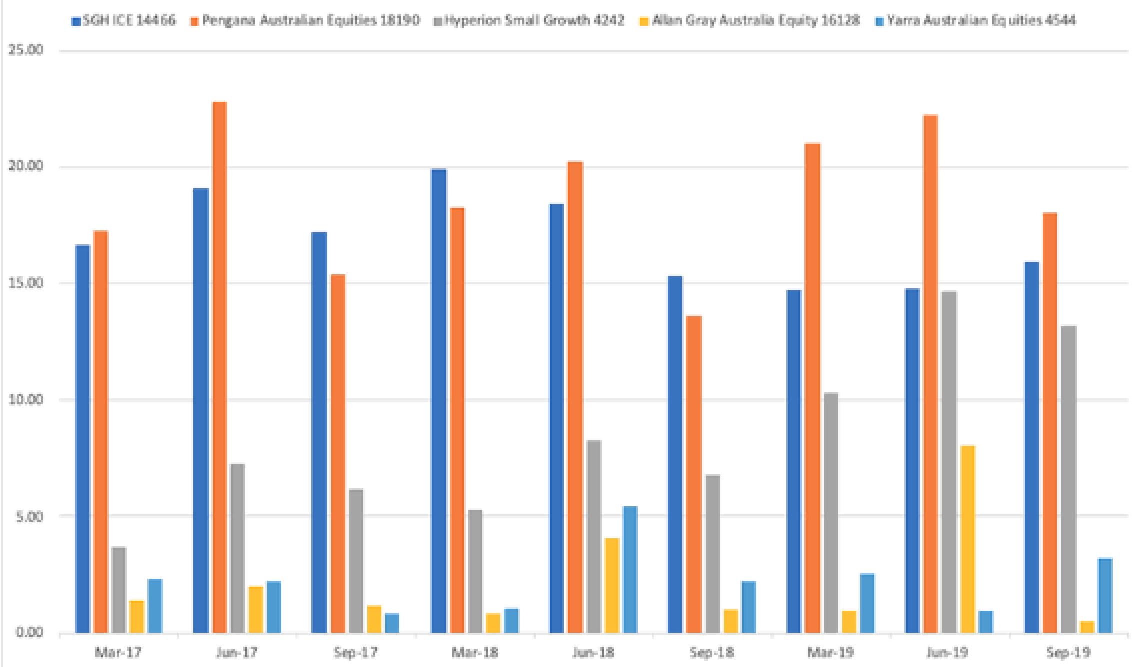
So you find a global equity manager you like, and you give them 10% of your portfolio to manage. You assemble the rest into a small allocation to cash for liquidity, some into Australian equities, and you like property and infrastructure. You look with some satisfaction at the portfolio on your administrative platform or spreadsheet, knowing where you stand as markets move around. It's a portfolio designed by you for you.

Then six months later, you attend an update from your global equity manager. He's worried about market valuations, feels the market has run too hard and he sees it as his job to protect your capital. He has moved 50% of his portfolio to cash, waiting for better valuations.

What? So now your cash allocation is 5% higher and it might not even be in a foreign currency, and you are 5% underweight global equities. That's not what you wanted, and you feel there's plenty of potential in global shares.

You wonder whether your Australian equity managers have done the same thing. There is also a wide variation in cash allocations in equity funds, as shown below in five prominent Australian funds from the Morningstar database. Several Australian equity managers held over 30% of the fund in cash at the end of 2019.

How much cash in these Australian equity funds?



Source: Morningstar Direct

Formal asset allocations in an SMSF

If you are investing for your SMSF, you have a defined Investment Strategy in a legal document lodged with your administrator as a prerequisite of managing an SMSF. If their portfolio software is good, it will monitor your asset allocation against your limits. If it's really good, it might have the ability to look through the manager's portfolio to their asset allocation.

You check your SMSF portfolio, and the red bars stare back at you. You are breaching your asset limits, overexposed to cash, underexposed to equities. You are a trustee and you may be breaching your fiduciary responsibility to other members. Fortunately, most Investment Strategies use wide ranges and it is probably not a major issue, but your asset allocation has changed without your knowledge or action.

Furthermore, the Australian Taxation Office (ATO) specifically instructs SMSF trustees to follow a defined Investment Strategy, such as:

"The percentage or dollar allocation of the fund's assets invested in each class of investment should support and reflect your articulated investment approach towards achieving your retirement goals ... You should also include the reasons why investing in those assets will achieve your retirement goals."

It's worth noting that an index fund such as a global equity ETF will always be fully invested. There is no active manager decision, and that is another reason why passive management has performed well in the bull market.

In the institutional mandate world, billions of dollars are allocated by major super funds to external managers according to asset allocation decisions agonised over by Investment Committees and Investment Consultants. They are measured precisely to the first decimal place. Do the trustees realise that the $100 million global equity allocation is actually $50 million in global equities and $50 million in cash? As a separate mandate, the rules may not allow this, but many investors put millions of dollars into pooled managed funds.

Personally, when I give a global equity manager a global equity allocation, I want near to 100% permanently invested in global equities.

It's not the portfolio manager's job to protect my capital within their overall portfolio. I do that myself with my asset allocation decisions, made long before I decided they were a worthy custodian of my hard-earned.

What if the fund manager cannot find good investments?

Global active management fees vary widely, but they are far more expensive than cash management fees due to the potential for adding alpha (or outperformance) and arguably a more complex universe to navigate. A common global active fee is 1.0% to 1.5% per annum plus performance fees, but cash funds for retail investors cost about 0.4% or less.

What happens when an active equity manager runs a large cash book for a long time and charges active fees on the total asset balance. They face three choices:

1. Return the money to their clients. Although such a step is common with hedge funds, where a fund manager may decide a style no longer works for the long term, the permanent loss of funds is unacceptable to most managers. There is no guarantee the money will come back in better circumstances.
2. Charge a lower fee on the cash component. Some fund managers reduce their fees if the cash component sits above a defined level. For example, in the Lazard Defensive Australian Equity Fund, investment costs fall from 0.67% to 0.37% when the proportion of the Fund in cash exceeds 50%.
3. Explain to investors that the cash is waiting for better opportunities while continuing to charge full fees on the entire balance. This may be a reasonable short-term position but a large cash allocation for long periods is difficult to justify. A fund manager who cannot find suitable investments over a couple of years probably needs another technique … or job.

Should an equity fund manager time the market?

It is difficult enough for fund managers to find good companies and outperform the index without also timing the market using macroeconomic tactical asset allocation. Fund managers who are active stock pickers should focus on their microeconomic, company analysis strengths.

Bank of America Merrill Lynch has developed a 'Cash Rule Indicator' which is a contrarian forecasting tool. It gives a buy signal for equities when cash balances held by fund managers rise above their long-term averages, and it has been a bullish indicator for almost two years. In other words, it says buy when cash is high and managers are least invested in equities.

In another example, in June 2019, The Australian Financial Review ran an article called 'Global money managers go defensive' which said:

"Fund managers are also holding more cash on average as they struggle to find appropriate assets to deploy excess money. "Of all the fund managers we talk to, we only know of one group that is overweight equities," Katana Asset Management Portfolio Manager Romano Sala Tenna said. "Most of them have mandates that preclude fixed income and bonds, so they're going to cash weight mandate peaks."

The market has rallied strongly since June 2019, so how well did that inability to 'deploy excess money' work out?

When Morningstar is rating an equity fund, it is a warning when an active fund consistently allocates large amounts to cash, as timing when to buy and sell shares is so difficult.

When is tactical cash allocation acceptable?

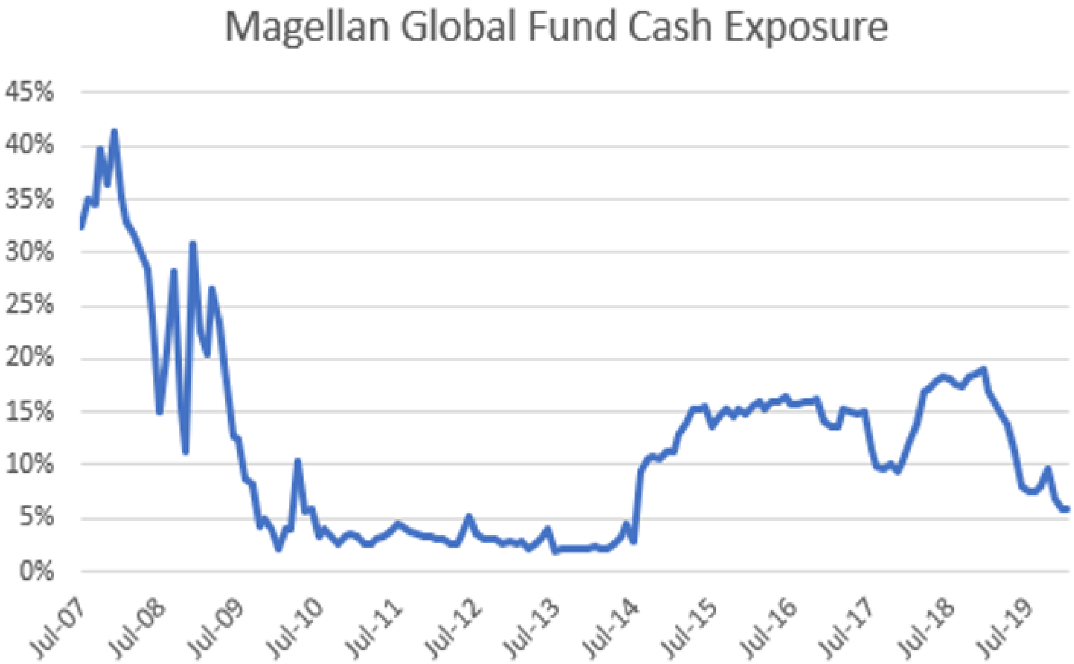
If a fund is specifically operating with a tactical asset allocation approach, marketed on the basis of its ability to switch between multiple asset classes based on the fund manager's expectations, it is legitimate to hold cash. It is not sector-specific and the investor knows at the outset that the asset allocation will change. Some funds are explicitly labelled 'tactical'. For example, the Legg Mason Martin Currie Tactical Allocation Fund is:

*"*A diversified portfolio of Australian equities, fixed income and cash designed to take advantage of relative asset class mispricing*

**Tilted toward the relatively undervalued asset class in anticipation that it will outperform as it returns to assessed fair value."*

Any investor in such a fund will need to either follow the changes in asset allocations for their own financial plan, or make some assumptions. It is what it is.

Another group of managers is explicitly focussed on capital preservation, with a benchmark-unaware style and an absolute return target. For example, Magellan's objective for its main Global Fund is 9% per annum across the investment cycle "*to achieve attractive risk-adjusted returns over the medium to long term, while reducing the risk of permanent capital loss.*" The Fund is allowed to hold up to 20% in cash (after the initial launch period), and it almost reached this level during the Fed tightening phase of December quarter 2018.



Source: Magellan

Know what your fund manager is doing

In summary, each investor should know how much cash is held by the funds they choose in sector-specific allocations, as the overall cash exposure in a portfolio may differ significantly from expected. When an equity fund manager has a maximum cash allocation of 5%, at least the investor knows where they stand. My preference is for an equity manager to remain fully invested and I will manage my exposure to markets through my overall asset allocation.

Please complete our [one-question survey](#) on whether you are happy that your equity manager can allocate large amounts to cash.

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

Worshipping at the altar of alternative assets

Simon Scott

Investors are faced with a difficult conundrum today: run the risk of accepting lower returns from traditional asset classes (stocks, bonds, cash) or use alternative assets to try to boost prospective performance, generate inflation-beating returns, and improve diversification.

In this article, we'll look at what the asset allocators in our rated universe are doing in the alternative, real return, or other portion of their portfolios and what this means from a risk and return perspective.

Definition of alternatives

The non-traditional or alternatives asset class is a broad church. Morningstar defines it as those strategies that don't offer a consistent beta (market return) to the more traditional asset classes. We bucket them into four groups:

- Unlisted real assets
- Hedge funds (including managed futures)
- Private equity and private debt
- Structured products

The believers

The table below shows some of our rated multisector managers and their allocations to alternatives. The funds in the table all reside in our balanced or growth categories to try to ensure a fair comparison. The balanced category is for funds with a 41-60% growth allocation and the growth category is for funds with a 61-80% growth allocation.

Table of Morningstar multisector funds with allocations to alternative investments

Manager Name	Alternative Allowance %	Current Alternative %	Portfolio Holdings Date
Diversified Funds			
Advance Balanced	0-22%	6%	Mar-19
CFS Balanced	5-15%	10%	Mar-19
MLC Horizon 4 Balanced	N/A	14%	Mar-19
Pendal Active Balanced	0-20%	15%	Mar-19
Perpetual Balanced Growth	0-30%	11%	Mar-19
Russell Balanced	0-35%	12.50%	Mar-19
Industry Funds			
AustralianSuper Conservative Balanced	0-60%	17%	Mar-19
CBUS Super Growth	0-81%	31%	Dec-18
Sunsuper Balanced	0-90%	32%	Dec-18

What is notable is the magnitude of the allowable ranges and the portion of the budget currently being used. Pendal introduced an alternative allocation into its strategic asset allocation in 2012 and is now allocating 15% of the portfolio, the highest among the non-industry funds in our rated universe.

At the other end of the table is Advance. The 6% weight appears modest compared with peers, but this allocation is likely to grow as the group plans to expand its unlisted alternatives programme over the next 12 months.

Unsurprisingly, the industry funds are far more aggressive with their allocations to non-traditional assets, due to their stickier client base and long-term investment horizon. AustralianSuper, CBUS, and Sunsuper are all permitted to have the majority of their portfolios invested in alternatives. According to our latest surveyed data, CBUS and Sunsuper have roughly 30% allocations, while AustralianSuper has roughly half as much.

Alternatives are a broad church

One important distinction in alternative investments is the choice between listed and unlisted assets. CFS, Pendal, Perpetual, and MLC have opted for the listed part of the spectrum, building real return strategies to deliver inflation-beating performance.

- CFS' Real Return strategy targets a return of 4.5% above inflation on a rolling five-year basis. The team invests in equities and bonds across both developed and emerging markets; but they are permitted to invest in commodities, currencies, and cross-asset relative value trades. The asset class ranges are very wide, so the beta to equities and fixed income can oscillate wildly.
- Pendal's approach uses two internally managed strategies: the Pendal Total Return Fund (16270) and the Pendal Multi-Asset Target Return Fund (42877). The former includes an AQR market-neutral hedge fund, a risk parity fund, and an alternative-risk premia fund, among others. The component strategies are given a long leash and often have volatility targets of 10% or more. The latter is a lower-risk fund designed for retirees that invests across equity, fixed income, commodities, and currencies. The portfolio is designed to have low-equity sensitivity to provide diversification benefits in a traditional portfolio.
- Perpetual allocates to the Perpetual Diversified Real Return Fund, which targets a return of Consumer Price Index plus 5%. There are wide allowable ranges and the team can invest across equities, fixed income, commodities, FX, and unlisted property and infrastructure. Options are used to manage currency risk and to alter other exposures in the portfolio. The team does avoid private equity and illiquid hedge fund strategies.
- MLC allocates a portion to third-party managers investing in catastrophe bonds. These instruments are insurance against natural disasters. They also use a Low Correlation Strategy that invest in specialist managers investing in government receivables, municipal bonds, relative value metals, and a range of other hedge fund programmes.

Industry funds are playing a slightly different game. These behemoths are able to access an illiquidity premium. That is, the additional return an investor should earn if the asset isn't readily tradable. The industry funds can take advantage of the largely predictable inflows from generally younger members and the long-term nature of their liabilities. The three industry funds under our coverage (AustralianSuper, CBUS, and Sunsuper) all have meaningfully higher unlisted allocations than their non-industry fund peers.

The majority of AustralianSuper's alternative portfolio is in direct investments in shopping malls, office buildings, industrial assets, toll roads, airports, seaports, and utilities. There is a smaller allocation to high-yield bonds, bank loans, and private equity. Similarly, CBUS has investments in property, with a notable domestic skew. This is hardly surprising given the occupation of its members.

However, CBUS does have more geographic diversity on the unlisted infrastructure portion of the portfolio. Similarly, Sunsuper has unlisted property and infrastructure exposure. They also have meaningful positions in a range of hedge fund and specialist alternative managers, including macro-hedge funds and event-driven managers.

It's important to note that the strategies and securities discussed above is not an exhaustive list. We've also seen commodities, alternative-risk premia, long volatility, absolute return fixed income, and structured credit alongside the more vanilla stocks, government bonds, and investment-grade credit. In our view, this is a dizzying list of complex assets, and it's important to understand whether multi-asset investment teams have the requisite skills and experience if they are increasingly venturing into these more complicated assets. It's particularly important for those groups investing directly, not through third- party managers. The internal teams might be able to rely on an array of asset consultants with specialist knowledge, but the final decision rests with them.

The short-term results

Historically, many multi-asset managers have been highly conscious of their peer-relative performance. In fact, part of their processes often involves an analysis of how their competitors are positioned. It is unsurprising, therefore, that the long-term return outcomes have been quite similar among the peer group. As more managers introduce alternative allocations to their portfolios, we think the outcomes could diverge.

As shown below, CFS Wholesale Diversified and Pendal Active Balance have seen a notable difference in performance. This spread is partly attributable to the results of their alternative programmes. CFS' Real Return

Fund was a stellar performer, delivering 15% for 2019. Pendal's Total Return strategy disappointed, as its allocation to the troubled AQR hurt.

One-year performance of Morningstar multisector funds with allocations to alternative investments

Name	Return 2019-01-01 to 2019-12-31 AUD	Morningstar Category
Diversified Funds		
Advance Balanced Multi-Blend W	18.54	Australia Fund Multisector Growth
CFS Wholesale Balanced	13.43	Australia Fund Multisector Balanced
MLC Wholesale Horizon 4 Balanced	16.45	Australia Fund Multisector Growth
Pendal Active Balanced	14.73	Australia Fund Multisector Growth
Perpetual Wholesale Balanced Growth	13.00	Australia Fund Multisector Growth
Russell Balanced A	15.88	Australia Fund Multisector Growth
Industry Funds		
AustralianSuper Conservative Balanced	13.16	Australia Superannuation Multisector Growth
CBUS Super Growth (MySuper)	15.07	Australia Superannuation Multisector Aggressive
Sunsuper Balanced	15.51	Australia Superannuation Multisector Aggressive
Real Return Funds		
CFS Multi-Asset Real Return - Class A	14.95	Australia Fund Multisector Flexible
Pendal Multi-Asset Target Return	3.78	Australia Fund Multisector Flexible
Pendal Total Return	-1.90	Australia Fund Alternative Strategies Diversified
Perpetual Diversified Real Return W	7.35	Australia Fund Multisector Flexible

Investors should not overreact to short-term performance. However, the above example does highlight how the results can diverge due to different allocations to alternative assets. We'd urge investors to spend time assessing whether the multi-asset team responsible for their diversified funds have the requisite skills and experience to incorporate more-complicated assets to the strategic asset allocation.

We'd also recommend investors be vigilant about the risks these more esoteric assets bring. Traditional risk metrics, like standard deviation, aren't particularly good at identifying the risks in less liquid assets with infrequent, and often opaque, pricing.

Simon Scott is an Associate Director, Multi-Asset & Alternative Strategies at Morningstar Australasia. For full reports on managed funds in all asset classes and a wide range of listed stocks, subscribe to Morninstar Premium. Morningstar has compiled a list of more than 150 companies that release earnings results during February 2020 Reporting Season.

Where do sustainable returns come from?

Ashley Owen

Share prices across the Australian market have risen by an average of 20% over the past 12 months. This looks like great news on the surface but we need to look deeper to see where those gains came from and whether they are sustainable.

People have a tendency to mentally 'lock in' past gains and assume they are 'in the bank'. Consequently, we clear the decks mentally (especially after the end of year break) and look forward to the next year afresh.

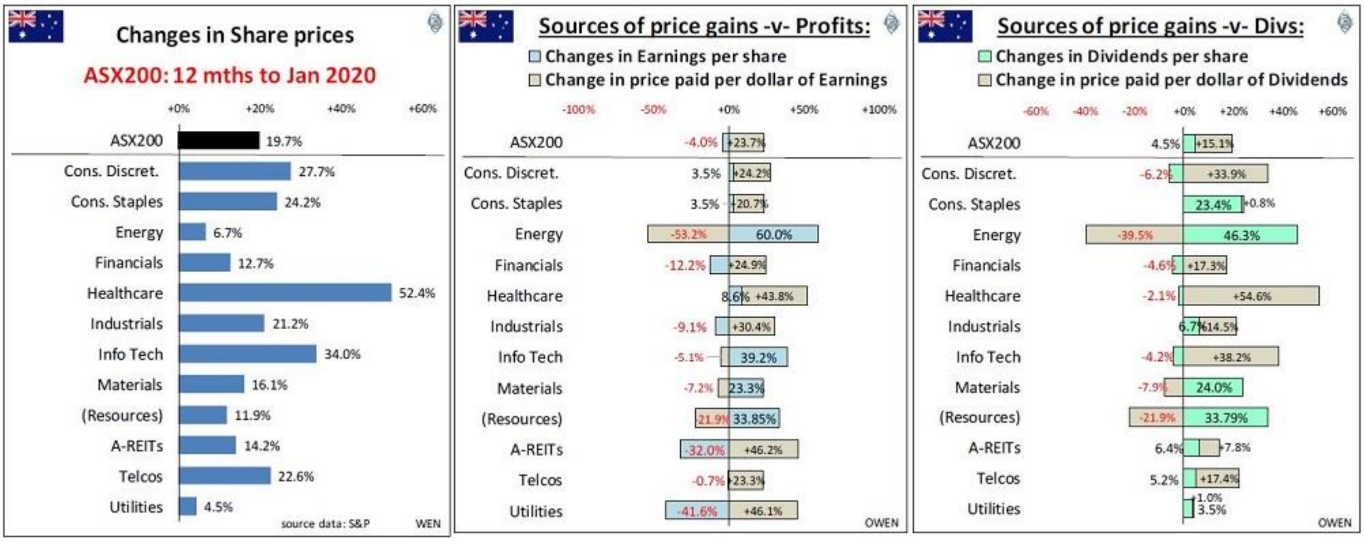
The problem is that almost all of the 20% share price gains over the past 12 months were fluff – much of it is probably only temporary and should not be assumed to be 'locked in' at all. Why do we consider them 'temporary'? Because the 20% share price gains were not underpinned by 20% higher company profits nor 20% higher dividends. Profits per share across the market actually fell over the period, and dividends per share rose by only 4% (and most of the dividend increases were due to temporary commodity price spikes from the miners).

Twelve months ago investors across the whole market were prepared to pay $16.25 per dollar of company profits, but over the past year they bid the price up to $20.40 per dollar of profits. They are now paying 25% more *per dollar* of profit than they did a year ago. Twelve months ago investors were prepared to pay $23 per dollar of company dividends (i.e. dividend yield of 4.34%) but over the past year they bid the price up to $26.40 per dollar of dividends (dividend yield of 3.8%). They are now paying 14% more per dollar of dividends than a year ago.

What caused this miraculous 25% increase in the price paid for a dollar of profits and 14% increase in the price of a dollar of dividends?

The main reason is confidence levels. At the start of 2019 people were very pessimistic and feared the late 2018 'global growth scare' might turn into the next GFC or possibly worse, especially as the US Fed was still raising interest rates despite signs everywhere of slowing growth and Trump's trade wars. Investor pessimism quickly turned to confidence when the Fed switched from rate *hikes* in 2018 to rate *cuts* in 2019. This makes no sense! The Fed was raising rates in 2018 because of their bullish outlook for growth – hence the need to raise rates to slow spending and inflation. Then the Fed switched to rate cuts in 2019 because they suddenly became bearish on growth outlooks. Central banks raise rates when they are bullish on the economy and cut rates when they are bearish. The crowd (investors) do the reverse!

The charts break this down by market sector. The left chart shows price gains over the past 12 months; the middle chart splits this into changes in earnings (profits) per share and changes in the price paid per dollar of profits; and the right chart does the same for dividends:



Looking at the two big sectors – First: Financials. Profits per share fell (across the big-4 banks plus other disasters like AMP) but share prices rose 13%, so investors *en masse* boosted the price per dollar of profit by 25%, and the price per dollar of dividend by 17% (dividends also fell). The crowd bid up the price per dollar of profit and dividend because they assume the current banking woes are temporary and they will miraculously return to the golden years of double-digit profit growth. Our view has been that those golden years are gone. The banks are facing not only cyclical pressures (margin pressure from ultra-low rates, and bad debts from property developers/investors) but also more lasting structural pressures (crippling regulations, expensive remediation and compliance, higher capital costs, deteriorating demographics).

The other big sector - Resources - saw profits and dividends rise by 30%+ per share – a combination of recoveries from big write-offs from prior years, plus the fortuitous spikes in iron ore and oil prices. Investors have sensibly discounted this and only bid up share prices by 12% because they know this profit and dividend growth is not repeatable. Many of the miners are probably under-priced at current levels.

The market is now in expensive territory - with price/earnings ratios above 20 (more than $20 being paid per dollar of profits) and dividend yields below 3.8% ($26.40 per dollar of dividends). In order to hold on to the recent price gains, either profits and dividends need to rise substantially in 2020, or central banks need to keep cutting rates and buying up assets – i.e. central banks need to remain horribly bearish and pessimistic so that the crowd remains overconfident! In our view the latter is considerably more likely this year than the former.

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.

The moral hazard of a national super fund

Rob Prugue

Former Treasurer and now Chairman of the Future Fund, Peter Costello, regularly entertains the idea that Australia's sovereign wealth fund could run the 'wholesale management' of one mega national super fund. For example, he said in February 2019:

"The Future Fund could be of assistance to a public default fund in working out asset allocation or recommending managers or maybe even having a wholesale role."

Then again in January 2019, he said:

"I've never said the Future Fund wants to be a super fund itself, but if the government wants to set up a default (super) agency, we could act as a wholesale fund manager."

Encouraged by the critical findings of the Financial Services Royal Commission, especially relating to retail superannuation funds, some members of the Morrison government support the idea of a public entity directly accepting default super contributions.

Government purse to the rescue

With Australia's total pension savings around A$3 trillion, and with government regulators continually vocalising their preference towards further consolidation within super, any one of a number of persistent uncertain investment, liquidity, and operational risks could trigger a moral hazard-like event. No democratically elected government, especially one with an outspoken baby boomer constituency like Australia's, would ever allow a mega super fund to fail.

Facing the political reality of billions of dollars of retirement savings being lost by a government agency that was supposed to be protecting capital, 'caveat emptor' investment theory would be thrown right out the window.

Traditional government responses to rescuing financial institutions would not work under this consolidated mega fund model in an ongoing volatile market. At the moment, if a bank runs into trouble (such as the Bankwest and State Bank bailouts), a takeover by a larger bank is engineered. However, the larger the super assets under management by one provider, the less probable that another one or two unaffected super funds could bail another out given fiduciary responsibilities.

The government would be forced to use a taxpayer-sourced bailout and nationalise the fund, thereby making Paul Keating's idea of Defined Contribution (DC) obsolete. Under the current DC approach, with superannuation run by the non-public system (including industry funds), performance risk has been passed from the institution to the investor, replacing the old Defined Benefit (DB) system.

The precedent of 'daiko henjo', or handing back liabilities

While the collapse of a national super fund is obviously hypothetical, it would be equally wrong to assume that there is no precedence. Japan offers such an example, having an economic circumstance with uncertain market direction, negligible cost of capital (and corresponding anaemic government bond yields), and rapidly ageing demographics. And while the majority of Japanese pension funds are Defined Benefit, the majority of Japanese people retiring (and Japanese corporations funding such a retirement income) find it difficult to operate under the uncertainty of the 'Three D's' - Deficit, Deflation, and Demographics.

CFOs of publicly listed Japanese companies were complaining that while they sustained their business under difficult economic conditions, through fault not of their own, pension liabilities would influence their total debt (and balance sheet) under current international accounting standards.

So nearly 20 years ago, the Japanese government introduced 'Daiko Henjo', a Japanese word which loosely translates to 'hand-over'. Under Daiko Henjo, corporations could take pension liabilities off their books and hand back their pension liabilities to Japanese taxpayers. By implementing Daiko Henjo, Japanese corporations could effectively take their pension liabilities off balance sheet. For this to happen, however, the Japanese government required two things: that the pension fund be fully funded, and that the payout to each employee/retiree be quantifiable.

While there were a few notable exceptions, this free exit was too attractive for Japanese CFOs to pass up. The Japanese government set up GPIF, arguably the largest global pension fund with assets near A$2 trillion. The number of actual corporate pension funds shrank by more than two thirds, and the nationalisation of Japanese pensions has never looked back.

From its peak in 1990, the number of people employed within financial services similarly shrunk by over two thirds, including from institutional funds, brokers, administration, custody and asset consulting. And while the Japanese retail funds market remains robust, it is a shadow of what it once used to be.

Market extremes, strange at the time

While living in Japan, I observed how in the early 2000s, investors could buy a flat in Tokyo, mortgage the purchase at an interest rate of 1.5% and yet access a rental income of 10%! Coming from Australia, the obvious reaction was "How could this be?" Surely this will eventually be arbitraged away.

A decade later, this positive spread has fallen but remains significant. Following 30 years of real asset deflation, investors adapted housing pricing expectations under such extreme market conditions. The income was the compensation required for falling property prices, the complete opposite of Australia where miserable rental yields are the cost of buying into capital gain.

Yes, extreme conditions yield unexpected results. Like cutting interest rates in our demographic world no longer correlates with increased spending. Like negative bond yields in many countries.

In Japan, traditional monetary policy was already ineffective 20 years ago, whereby interest rate cuts were no longer followed by a commensurate rise in consumer spending. With a large population of retirees in Japan, continued cuts in interest rates actually saw a drop in consumer spending as retirement income fell. Sound familiar in Australia now?

Don't assume these things will not happen here

Before anyone wrongly assumes that I am prognosticating the same outcome for Australia, I'm not. What I am flagging, however, is that to write off the threat of a national pension system would be equally naive given our persistent economic and market uncertainties. A government entity accepting default contributions from shop assistants, apprentice bricklayers, coal miners and factory workers would be forced to top up savings in the event of a severe market crisis. We seem to forget the stockmarket receives a 50% crash about once a generation.

Furthermore, with more mega funds capturing economies of scale by moving towards internal manufacturing (whose threat of operational errors are funded by member capital), the risks within super is commensurately rising.

The government should be careful what it wishes for as every action is followed by a set of new reactions.

*Rob Prugue has over 30 years in funds management, from market regulator to investment analyst and manager, to pension manager, to asset consultant and, most recently, as a CEO of Asia Pacific at **Lazard Asset Management**. These opinions are his own. Now at the end of his recent sabbatical, Rob would be an ideal resource for any business considering a broad range of investment and planning issues.*

Dispelling the disruption myth

Charles Dalziell

The Theory of Disruptive Innovation was introduced by Harvard University's Clayton Christensen and Joseph Bower in 1995 and has proved to be enormously influential when thinking about innovation-driven growth. Business leaders globally have studied the theory intensively to ensure they can appropriately prepare, whether as the incumbent or the disrupter.

Regrettably, according to the original authors, disruption theory is in danger of becoming a victim of its own success:

'Despite broad dissemination, the theory's core concepts have been widely misunderstood and its basic tenets frequently misapplied … too many people who speak of 'disruption' have not read a serious book or article on the subject'.

The problem is many researchers, journalists, consultants, and investors are using 'disruptive innovation' to describe *any* situation in which an industry is changing. Disruptive innovation then becomes the key selling point for capital raisings (both private and public), funding products or services which don't remotely fit the real definition of disruption in the first place.

The lure of investing in the next Amazon, Google, Facebook or Netflix is strong, although even genuine disruptive innovations are far from guaranteed to be a success (in the 1990s there were any number of would-be online retailers that disappeared into obscurity) while non-genuine disruptive innovations are high-risk, low-probability investments.

Disruption Theory

According to the original theory:

"'Disruption' describes a process whereby a smaller company with fewer resources is able to successfully challenge established incumbent businesses. As incumbents focus on improving their products and services for their most demanding (and usually most profitable) customers, they exceed the needs of some segments and ignore the needs of others. Entrants that prove disruptive begin by successfully targeting those overlooked segments, gaining a foothold by delivering more-suitable functionality—frequently at a lower price. Incumbents, chasing higher profitability in more-demanding segments, tend not to respond vigorously. Entrants then move upmarket, delivering the performance that incumbents' mainstream customers require, while preserving the advantages that drove their early success. When mainstream customers start adopting the entrants' offerings in volume, disruption has occurred."

The theory has been refined and updated over the 24 years since original publication, but the basic foundations remain intact.

Typically (although not always) disruptive competitors tend to start in the low end of the market, where incumbents have lost focus, allowing the disrupter to come in with a 'good enough' product. Disruptive innovations are initially considered inferior by most of the incumbents' customers. Initially customers are not willing to switch to the new offering merely because it is less expensive. Instead they wait for the quality to rise enough to satisfy them. When the disrupter gets their business model right, they then move from the low end of the market to the mainstream, eroding the incumbents' market share and then their profitability.

Case study: the automotive industry

According to classic disruption theory, the automotive industry isn't in fact being disrupted despite widespread views that it is. McKinsey and Company calculate investors have poured over $220 billion into more than 1100 'disruptive' automotive companies across 10 technology clusters in the last decade with $120 billion coming in the last two years alone. Fund managers who have participated in these capital raisings write eloquently about their investments in companies like Tesla, Uber, Lyft and Waymo as ways to profit from the disruptive forces reshaping the auto industry. More specifically:

1. The shift from internal combustion engines (ICEs) to electric vehicles (EVs)
2. The shift in the economic model of car ownership to on-demand, and
3. The shift from humans behind the wheel to autonomous driving.

These forces are not technically disruptive, as defined by Christensen and Bower, even though they may eventually lead to fundamental transformation within the auto industry. Transformation in itself is not necessarily something to be feared, particularly when it brings around step-change improvements in an industry. The incumbent manufacturers themselves are largely embracing these changes and are often at the forefront of the innovations that are occurring which makes it very difficult for would be disrupters to win.

1. Electric vehicles

EVs in particular fail to meet the characterisation of a disruptive innovation. Globally, they represent less than 2% of annual sales, although this will certainly climb over time. The technology behind them is well understood and making EVs is far easier than assembling ICEs with fewer moving parts and engineering intellectual property required.

Tesla arguably hasn't actually changed anything; it has just added to the mix of vehicle choices available to consumers. Tellingly, UK billionaire Sir James Dyson recently announced the scrapping of his EV, not because it was too hard but because the market is too competitive and the economics of making EVs had deteriorated since the original business models were built. Similarly, Chinese EV maker Nio has suffered losses because of lack of demand, battery problems and an ultra-competitive marketplace.

To date Tesla has only participated in the high-end sports car market, which unquestionably hasn't been ignored by the incumbent car manufacturers. Tesla hasn't filled a niche in the neglected low-end of the market, thereby failing to meet even the original definition of a disruptive innovation. Tesla's success to date has been remarkable in that investors have been happy to fund 16 years of losses (because of the poor economics of selling electric vehicles) while incumbent car companies have been developing their EV options in the event the cost of batteries falls far enough to make production economically viable. Any perceived technological advantage that Tesla has is likely to prove ethereal in the face of genuine competition.

EVs today are a hard sell for manufacturers because consumers don't want them yet. Outside of the high-end market, EVs are expensive relative to ICEs and they have range limitations and charging infrastructure shortcomings that consumers cannot yet stomach. Saving the environment is to the benefit of all, but EVs are unlikely to be the near-term fix for reducing our respective carbon footprints. In Australia, with 20 million cars on the road and 1 million new cars sold every year, even if every new car sold from here on was an EV, we would take 20 years to become fully electric.

Building cars consumes natural resources and creates carbon emissions. EVs are estimated to produce between 1.6x and 2.7x the carbon dioxide of ICEs during manufacturing, which makes a more rapid regulatory push by governments into EVs, from a carbon perspective, counterproductive. The carbon payback on a new EV is estimated to range from 1.6 years to 17 years depending upon the assumptions regarding the size of the EV battery, power sources (coal, gas, wind, solar etc.), mileage driven and the type of ICE vehicle you drive now.

2. Car ownership models

Car-sharing models have been around in Australia since 1993 and globally since the 1940s. The economics of car sharing is compelling when you consider that the average car is utilised only 5% of the time and that the average Australian household spends around $350 per week on car ownership. This type of inefficiency makes technologists quiver in outrage. Globally, car sharing has grown strongly from an estimated 38,000 vehicles in 2012 to 332,000 in 2018 (although this is a negligible percentage of the 1.2 billion cars owned globally). Despite the growth, ride share companies have found it difficult to create a path to profitability. Indeed, one of the largest companies ShareNow (co-owned by BMW and Daimler) has announced it is pulling out of the UK and North America. Despite having 90 million users of its 'mobility services' apps, ShareNow has failed to make car-sharing viable because of the "volatile state of the global mobility landscape" (too much competition) and the "rising infrastructure complexities facing North American transportation".

Ride-sharing companies are in the same boat. Despite expanding the market beyond traditional taxis, large companies like Uber and Lyft are funding billion-dollar losses every year with no clear route to profitability. This user price subsidy no doubt builds customer numbers but is ultimately unsustainable without material changes to the business model through higher service prices or much lower costs. Driverless cars would help (drivers being the biggest cost), and this is the long-term panacea for Uber and Lyft investors. However, it is now clear that this technology is much further away than previously expected which may explain why the share prices of both stocks are down 30% and 45% respectively from IPO.

This technology itself isn't disruptive, despite expanding the ride sharing industry, because it is unlikely to create a genuine alternative to car ownership in the foreseeable future.

3. Autonomous vehicles

Multiple autonomous vehicle trials are happening around the world at present with the leader being Waymo, Google's self-driving vehicle arm, announcing the completion of 20 million miles of testing in 2020. More than 30 private companies are working on technological advancements to assist autonomous vehicles which are commanding record levels of investment and funding. In addition to start-ups and small tech companies, large companies are also focusing on the future by advancing their thinking and knowledge. Companies like Apple, Bosch, Intel, Volvo, Tesla, Ford and Huawei are all working on technology to support a future of autonomous vehicles.

The hype surrounding autonomous vehicle technology has softened over the past 18 months or so. As recently as 2017, the NRMA was forecasting that by 2022 we would achieve Level 4 autonomy, meaning the driver would no longer be needed (except in extreme circumstances), and by 2025 we would have full autonomy where the car wouldn't even have a steering wheel. Since then the technological challenges have proved to be far more significant than previously thought and governmental regulatory requirements are enormous. Level 5 is now considered possible by 2040 but there are still many hurdles ahead.

The engineering challenge has been described by Waymo executives as "…more difficult than landing people on the moon" and the president of Cruise (General Motors' self-driving car company) described employing an autonomous fleet as "10,000 times harder" than demonstrating how a single vehicle can drive around the block.

Even autonomous vehicles may not be a disruptive technology. They may certainly change the way we drive, reduce the dreadful road death toll and may improve the existing utilisation rates of vehicles. This final point could have an effect on the numbers of cars manufactured each year and who the end customers are (being possibly big fleet owners rather than individuals) although it is not a given. Whatever the case, cars will still need to be manufactured and cars that are utilised 80% of the time presumably will need to be replaced more often than cars that sit idle 95% of the time. Without huge retail distribution costs, car company margins would improve although they may give a lot of that away to the big fleet buyers in the form of lower prices. Even so this is evolution not disruption and not something to be terribly fearful of.

Why does this matter? The BMW example

The simple answer is that if you view the auto industry (or any industry for that matter) through an evolutionary lens rather than a disruption lens then you get a different view of the future of the incumbent car companies and their respective intrinsic values.

For example, today BMW is as cheap as it has been for 40 years. Why? Well, the cycle has turned and could get worse. Europe is enforcing strict emission standards on car companies that will mean large fines if they fail to meet them.

But far more telling are the disruption fears that have gripped the industry. If you assume the last point is incorrect then the outlook changes considerably and it looks like business as usual for BMW. The company has been through cycles before and despite those cycles it has compounded revenue at 8% per annum since 1980 and profits at 12% pa. Also, because BMW is a premium brand, their ability to pass on costs of the emission standards to customers is much stronger than their mass market counterparts. BMW is well positioned in EVs (selling as many as Tesla globally) and has a very profitable auto financing business and €20 billion in net cash. Despite this, it only has a market value of US$49 billion compared to Tesla which is valued at US$140 billion (with $10 billion in debt). If BMW only trades back to the valuation multiples it has historically then the share price could triple.

If our thesis around disruption is wrong, what are the consequences of owning BMW? At its current valuation we believe you are paying for the financing business and the cash and getting the car business for free. Envisioning a scenario where the BMW car business is worthless is very difficult. Interbrand ranked BMW as the 11th most valuable brand globally in 2019 ahead of tech names like Intel, Facebook, Cisco and other consumer brands like Nike and Pepsi. BMW is well positioned already in EVs and has significant investments in mobility services. With its premium consumer brand, BMW is likely to be a key player in the automotive industry for the foreseeable future whatever form the industry will take.

Contrarian views can reveal opportunities

Investing in genuine disruptive technologies like Google, Amazon, Netflix and Facebook has been extraordinarily profitable, particularly in the past 15 years. Studying those innovations in detail to determine what made them succeed is important for determining whether other innovations could potentially follow a similar path. Blindly assuming technologies will be disruptive when they are not will likely result in poor outcomes when investing in the technology itself or avoiding good incumbent businesses which aren't actually facing disruption.

Challenging consensus views is never easy, which is why it isn't that popular, but done properly it can deliver exciting opportunities. Thinking beyond the seemingly obvious is a powerful way to deliver above average returns.

Charles Dalziell is Investment Director at Orbis Investments, a sponsor of Firstlinks. This report constitutes general advice only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

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What to watch with your SMSF's annual return this year

Graeme Colley

Making sure you lodge your SMSF's annual returns in time has taken on a new meaning since September 2019, and it's one to watch in 2020.

From 1 October last year, if your SMSF has annual returns outstanding by more than two weeks after its required lodgement date, the ATO will remove its compliance status from Super Fund Lookup.

This new approach has stirred up the industry, as some think that removal of compliance status two weeks after the official lodgement date is far too short, while others have no sympathy for those who fail to get their returns in on time.

The consequences of the new reality

However you feel about the cut-off date, the ATO's approach is a reality that must be taken seriously.

Removal of compliance status of your SMSF does not mean that the fund will be made non-compliant, but it does mean that no one will be able to confirm the fund's compliance status via the Super Fund Lookup.

So, what does it mean for an SMSF that has its compliance status removed? Well, it will not be possible to roll over benefits from an APRA fund to an SMSF, as the APRA fund will not be able to confirm the compliance status of the SMSF. This may not affect most SMSFs. However, for new SMSFs that are expecting rollovers or funds that are winding up, problems may arise.

Another impact is that employers who make contributions to SMSFs via SuperStream will not be able to make contributions to an SMSF where the fund's status has been changed to 'regulation details removed'.

This may mean that the employer ends up making the contribution to the default fund and you will then need to sort out the web to get the amount transferred to your SMSF. It's an unnecessary problem that is best avoided.

While the rollover and contribution issues create problems, there may be other wide-reaching consequences for your SMSF. Under the anti-money-laundering (AML) laws, it is compulsory for investment houses and other financial service providers to undertake identification checks of investors. When it comes to your SMSF, the investment house may use the Super Fund Lookup as an independent third-party check to confirm the fund's identification and compliance status.

If your SMSF's compliance status has been removed you can expect, in some circumstances, that the fund will be prohibited from making certain investments depending on the policy of the investment house.

The problem may not only affect new fund investments. It may also apply to an SMSF if the fund has changed its trustee structure from individual trustees to a corporate trustee. The change will require the trustee's name as the legal owner of the investments be updated to reflect the change.

This will require the fund trustee to notify the relevant financial institution with details of the change and as part of their policies they may use the Super Fund Lookup to confirm the fund's compliance status. If the compliance details have been removed it is possible that your SMSF may not be able to transact on its bank accounts.

A lot of SMSFs fail to meet the deadlines

Obviously, the best way to avoid your SMSF's regulation status being removed is to ensure the fund's annual return reaches the ATO on time. In a perfect world this is achievable. However, the ATO's SMSF annual return lodgement records show that between 85% - 90% of SMSF returns are generally lodged on time each year, but not all of them make it on time. On these figures alone, it's possible that about 60,000 - 90,000 SMSF annual returns could be late.

The ATO's service delivery standards indicate that the fund's status is updated within 21 days. You would hope that reinstatement of the fund's status happens as quickly as it was removed. If your SMSF's compliance status has been removed it may pay you to monitor the Super Fund Lookup once the outstanding returns for your fund have been lodged. If the status has not been amended after 21 days, you or the fund's administrator should contact the ATO to see what is going on.

Whether the consequences of the ATO clamping down on the lodgement of SMSF annual returns are unintended remains to be seen. Still, the impact on your SMSF could be that the fund is left stranded until the outstanding returns have been lodged and the ATO has updated the Super Fund Lookup. Don't get caught out.

Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at SuperConcepts, a sponsor of Firstlinks. This article is for general information purposes only and does not consider any individual's investment objectives.

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SMSFs have major role but not for everyone

John Maroney

The marketplace for the whole superannuation system and for financial advice and SMSFs is highly dynamic. All the major banks are moving away from directly providing wealth management activities and owning major dealer groups. This will lead to an increased reliance on smaller dealer groups and self-licenced advisers to meet advice needs.

Only a few major groups, including AMP and IOOF, remain committed to the provision of financial advice as part of their overall offering to customers. There is much interest in how successful the future strategies of these groups will be, as other parts of the financial system step up to fill the gaps.

Expansion of choices

One interesting move is the offer by industry funds, such as Hostplus, to SMSFs to use some of their investment options without needing to become members. We support the continued expansion of investment options, especially in the infrastructure and alternative investment categories, to SMSFs. We are strong believers in choice and competition and believe the whole superannuation system will benefit from continued expansion in choice in competition.

We strongly believe that SMSFs are an appropriate vehicle for a large number of Australians but not for everyone. Hence, we should make it as easy as possible for those who wish to use an SMSF, where it is appropriate, to do so. We should also make it as easy as possible for those who choose to shift from their SMSF to a large superannuation fund to do so.

Looking at projections for the whole superannuation system, such as those prepared by Deloitte, it is likely that the SMSF sector will continue to grow strongly in absolute terms over the next decade or two, but its share of overall system assets may reduce. Many existing SMSFs are in the drawdown phase and the overall age of SMSF members is significantly higher than for large super funds.

We do not subscribe to the view that there is a contest between different parts of the superannuation system to be the largest part. Our aim is to ensure that the SMSF sector remains attractive for those Australians who seek greater control of their own financial destiny in conjunction with their advisers or via their own management of their SMSF. We do not seek a particular market share. That should be the outcome of people exercising their choice in a competitive market. Our role is to help encourage the SMSF sector to maintain high integrity, high levels of efficiency and strong professional standards, so that an SMSF remains an attractive and viable choice for many Australians.

Many of the issues now facing the SMSF sector, with a high proportion of members in the drawdown phase, will be faced by large superannuation fund members over the decades ahead. These issues include estate planning, dealing with cognitive decline, managing low real rates of return on defensive assets and dealing with longevity risk. To date, most large funds are focused on optimising their operations during the accumulation phase. There will need to be a shift towards optimising how the funds operate in the drawdown phase for the members.

Many ongoing impacts of the Royal Commission and Productivity Commission recommendations will take several years to work through the system. The impact of the Retirement Income Review will be important but is more uncertain, given the nature of the review is to develop a fact base rather than a list of recommendations.

The Review Panel has put a long list of important questions in front of the Australian community. Many of these questions have been asked from time to time over the past 30 years and we are still grappling as a community to provide answers to such basic questions as what is the goal of the retirement income system, including superannuation, age pension and voluntary saving, including my home ownership.

Addressing unmet advice needs

One of the most important concerns is the level of unmet financial advice that will make it much more difficult for people to plan for their retirement and to execute those plans with a degree of confidence. The level of complexity in the system and the continued volatility in investment markets where most of the risk sits with the individual member produces much stress for retirees.

Some longevity protection is provided by the age pension for those with modest assets at retirement or at older ages but for many retirees it is very difficult to share or manage their retirement risks.

The future role of financial advice regulation is crucial. We believe that a more customer-centric advice framework is needed, where consumers can receive trusted and professional advice.

Consumers really want affordable advice, delivered with the help of sophisticated technology, via a system of open superannuation similar to the open banking environment with clear consumer data rights. Important thinking is underway via the Senate select committee on fin-tech and reg-tech, chaired by Andrew Bragg, and many interesting ideas have already been put to the committee in the first round of submissions.

We expect market dynamics will continue to evolve and the financial advice profession will gradually look more like a medical profession, where regular health checks can be undertaken using real-time data that is readily available for consumers and can be shared with their advisers. Efficient initial advice could be more like a half-hour discussion with the doctor reviewing the results of general blood tests and measurements of height, weight, blood pressure, family history, rather than requiring extensive manual data gathering and days of manual analysis and report preparation that is primarily focused on risk mitigation for advisers, rather than value adding for consumers.

Of course, we do not want to reduce any of the consumer protections provided by the existing regulatory frameworks, but mechanisms are needed whereby most Australians can have access to affordable advice with significant trust in the system.

This will require continued advancements in technology, rebuilding of trust from all participants in the financial system and from focusing on what is in the best interest of the consumer in reality rather than in theory. Protecting retirement savings and financial health of all Australians is at the forefront regardless of which forms of retirement savings are chosen.

John Maroney is CEO of the SMSF Association. This is an edited transcript of a speech given for Pritchitt Partners on 23 January 2020.