Firstlinks
Connecting investors with ideas

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Kunal Kapoor on different paths to investor success

Graham Hand

Introduction: Kunal Kapoor, CFA, is CEO of Morningstar. Prior to taking this role in 2017, he served as President, responsible for product development and innovation, sales and marketing, and driving strategic prioritisation. He joined Morningstar in 1997 as a data analyst and has served as Director of Mutual Fund Research and was part of the team that launched Morningstar Investment Services, Inc.

Morningstar, Inc (NASDAQ:MORN) is a global financial services firm headquartered in Chicago, Illinois, United States and it currently has a market capitalisation of about USD7 billion (over AUD10 billion).

GH: You run a publicly listed company, but its main aim is to empower investor success. Can you give examples where you've had to reconcile differences between various stakeholders?

KK: We certainly have situations where we have to reconcile the way we work, such as the independence of our analysts when some clients have opinions on what our analysts ought to be saying. But when I was an analyst, I had carte blanche to deliver whatever opinion was researched and thoughtful as long as I could defend it. And I certainly delivered opinions that from time to time upset our clients.

GH: And maybe the commercial interests.

KK: Right, but it's no different today. Our analysts have the independence to say what they want to as long as it's well researched and thoughtful. Now I'm on the other side of the fence, I receive calls when people are mad. And I listen to them, but I cannot tell the analysts to change their opinions. In fact, I had one just in the last week where a CEO was upset with something and I was not able to pacify the individual. But I don’t change the language. I may ask the analysts to double check their work to ensure it is factually correct, but an opinion is an opinion.

As a public company, we operate very differently. We have a strong belief in democratising investing. In 2005 when we became a public company, we did an auction IPO (*initial public offering*). Everyone had access to it. We do not talk to any analysts or researchers during the year, except at our annual meeting when any investor can attend.

GH: So as a CEO, you don't do regular roadshows to investors or meet major shareholders in private?

KK: None of that. We don’t do earnings estimates, but nor do we do earnings calls. We set up our company for the long term, taking inspiration from people like Warren Buffett. It goes to the heart of what we believe around fairness and democratisation of the investing process. We answer questions monthly in regulatory filings. People can send us questions and we take time to answer these questions.

GH: Is that linked to something you say that a company gets the shareholders it deserves?

KK: Yes, I always say that. If you're managing the business for the short term, you're going to attract people who are chasing short-term returns. But if you are clear about how you want to operate and the rules you set up, you will get the right set of investors. Plenty of investors understand that management's time is better spent running the business versus spending time on road shows.

I believe the markets are efficient over time and that the value of a company in the public markets reflects the discounted value of future cash flows over periods of time.

GH: Do you say to investors, 'this is the way we run the company, if you don't like it then don't invest'.

KK: Yes, I’m totally comfortable to say that to people. I love that some of our largest institutional investors have been long-time shareholders for a decade or more.

Reaching all investors

GH: How is Morningstar addressing the fact that most of our engagement is either with financial advisers or sophisticated investors but the majority of people who probably need guidance are not receiving it?

KK: It's a challenge, but as someone who loves investing, it took me a long time to appreciate that many people are not particularly interested in investing. They don't live and breathe it in the way we do. So you have to meet people where they are. For us, that's meant doing things such as having a robo-adviser business, Morningstar Retirement Manager, in the 401k (*US retirement saving*) space in the US.

That's a perfect example of where somebody may not have much interest in investing, but they are looking for a thoughtful, fantastic long-term option that will help them reach their goals. We can reach a larger audience like that.

The other thing we think about is how to help younger investors. When you're young, you have a tendency to want to enjoy yourself, spending your money. But those are the years where you should lay the foundation for saving. Even if you're a great investor pumping out returns of say 100% a year, but it’s on a base of $1,000, it will not change your life. But for most of us, if we save well while we're young and we earn normal market returns, the power of compounding will work. But you need that base of savings.

Morningstar has a long history of using technology and design to explain financial concepts that sometimes come across as complex to the average person. We must make sure people feel information is accessible to them, which is why something like fund ratings are so helpful because they’re a snapshot that can guide their investment process.

GH: Do we need new ways of talking to younger generations? I sometimes feel my publication is too highbrow and we should have another at a different level with a younger voice.

KK: With any investor, younger or older, it must resonate for them before they will engage in an activity. For example, people approaching retirement have to figure out how they will live on their savings and pensions, they have a big incentive. But for younger people, it's hard to imagine what retirement looks like.

The most important way you can engage a younger investor is through the lens of personalisation. Technology allows you to personalise a portfolio in a more interesting way. For example, we have gone deeply into ESG because it makes investing resonate to more investors than ever before. You do ESG because you have a view of the future and you want your portfolio to succeed in a way that's aligned with the view of that future. It's not about what used to be called socially responsible investing, which is where people don't like tobacco or alcohol. This is about the future. You may believe that we're transitioning to a low-carbon world, so why would your portfolio not reflect that.

As transaction costs and barriers are coming down and people can invest with smaller amounts of money, they need to be educated. They need to understand why investing is important at any age, including help with behavioural biases that prevent a lot of people from being successful investors.

GH: Morningstar is devoting far more resources into behavioural coaching for advisers. What is some of the work being done there?

KK: We are modifying our software tools to include behavioural nudges that will help people reach better outcomes. There are some obvious wins such as making investors stick to a portfolio in difficult times, which is one of the most important ways to guarantee success. Or it can be more nuanced such as our new ESG preferences tool that considers the trade-offs being made in portfolios. Retirement tools can automatically encourage people to contribute more to their superannuation.

GH: Too many people buy at highs as the market rallies but sell after a market fall.

KK: Yes, sometimes it's envy or the madness of crowds or getting scared by a headline. Ultimately, investing is about reaching a goal and sometimes doing less equals doing more for yourself. Anyone buying a financial product should ask what they are paying for and how it compares with what else is available. They should always ask about the incentives of the people selling the product, to understand how it fits into representing your best interests.

GH: Do you expect Morningstar employees to call it out if they see something in the market which they think is a poor product – for example, the wrong assets targeting the wrong people and too expensive?

KK: Yes, our analysts are often doing that in the fund space. Others should raise issues with the research team. Our ultimate goal is to empower investors and to make them successful and it's important to call out products we think are both good and bad.

All styles of investing have their merits

GH: Many active managers who have struggled to keep up with the index in a strong growth market have said that their day will come when the market falls and their quality will protect investors on the downside. Do you buy that argument?

KK: I personally believe active management has a strong case and passive management has a strong case. It's not like one versus the other, which is how it's often framed. I would reframe your question into a high-cost versus low-cost issue. If you're an active manager, your day is not coming if you're high cost, but there are plenty of good index and active options that will do well even in a bear market. And part of the reason they will do well is because they are low cost.

Good active offerings should be bought for the long term with expectations of periods of underperformance. That's the nature of the beast. Active management leads to some deviation from the index, hopefully, but are they doing things in the way they said they would, regardless of cycle? Are their incentives aligned to investors and are they doing it in a low-cost manner?

GH: If an investor chooses an active manager, how long do you believe they should persevere if there is a period of underperformance? Is it a 10-year decision?

KK: It's a personal preference, but three years is not long enough. They should give it somewhere between five to 10 years to judge properly. A deep-value investor may be in a five-year funk right now.

Supporting advisers and investors

GH: The financial advice industry is struggling at the moment with most advisers reconsidering their business model. What role do you see for Morningstar in helping advisers?

KK: For long-term advisers, it's a fantastic opportunity. Certainly, there's turbulence in the short run, but the end investor will win at the end of the day. The ecosystem will support them with great investment options, great advice and great tools. I view us as playing an important role in providing great research that people can use, taking the investment planning and linking it to their financial planning. We recently made the investment in AdviserLogic because as we think about how advisers work and their value proposition, they're under tremendous pressure because investors are demanding more value.

When you put together the pieces, advisers add a lot of value but they need to be thoughtful in the way they talk about it. ESG is a great topic when you talk about adviser value. For example, an adviser helping a retiree decide where to live 15 years ago would not have been looking at water tables in a seaside town. But now, part of the value proposition is the extra data that will help retirees consider what water tables may look like 15 years from now. It's a different decision given some of the changes that we're experiencing.

GH: The problems advice is facing with increasing compliance obligations and regulatory burdens, and the removal of vertical integration subsidies, means that full-service financial advice is increasingly for the wealthy. A lot of people are being left behind. There are quality advisers but it'll be for the top end.

KK: It's certainly true that's playing out exactly how you described it right now. But out of necessity is born innovation, and some of the advisers now serving wealthy households have not thought enough about newer business models. Today, adviser technology can automate parts of a practice so they can serve a midsize client more effectively and profitably than previously. It might take a while to shake out but I have great faith in the necessity, the technology and human ingenuity.

The Australian market is dynamic and firms like ours will step up and ensure that people get the advice they need. We must be open to the fact that it may not look exactly like what it looked like five years ago, but that's not a bad thing.

GH: One of the messages that Morningstar gives through Christine Benz, a thought leader in the business, is the priorities in an investment journey. She rightly talks about goals and saving and behaviour. Then she says, at the end, at the top of her of her pyramid, comes the investment decision and a legitimate way of investing is to hold some index funds. And yet Morningstar devotes considerable resources to fund and individual share research which may not be part of this journey.

KK: It's reflective of our culture that appreciates there are different kinds of investors. Christine is fantastic for onboarding investors who find investing is too complicated. She's thoughtful about what it takes to make investors successful particularly if they do not have a deep-seated interest in doing investing day and night. But she also recommends active funds as well. It's our way of saying there are different paths to success, and you can choose the path that you like best.

GH: It's a great way of communicating with people who may otherwise be left behind.

KK: Some people in Morningstar believe in 100% active and others believe in 100% passive and that's okay. The question is: does the portfolio that gets built ultimately measure up to the risk profile investors are seeking, and then ultimately does it get investors to achieve their goals? The only thing that matters is, does the investor have a successful outcome? Most investors don't sit around comparing results against benchmarks. They want to know if they have enough money to repay their college loan or take a vacation in Italy or buy that seaside home. That's what people care about. Success is hitting your goals and we should celebrate that.

Graham Hand is Managing Editor of Firstlinks, a Morningstar company. This discussion is an edited transcript which forms part of our Interview Series with leading executives around the world. This article is general information and does not consider the circumstances of any individual.

Do sin stocks really give your portfolio the edge?

David Walsh

Two recent papers looked at the historically strong performance (and recent weak performance) of what are known as 'sin' stocks. The analysis found that the stocks' past outperformance (or alpha) was not as simple as reaping the rewards of a 'deal with the devil'.

What are sin stocks?

'Sin' stocks are usually considered to be those whose activities are dominated by what would be considered unethical or immoral activity, usually alcohol, tobacco, gambling, adult entertainment and weapons.

We looked at two relevant papers covering the returns of such stocks:

- Blitz, D. and F.J. Fabozzi. *Sin Stocks Revisited: Resolving the Sin Stock Anomaly*, 2017
- Jorgensen, A. *'Sin' Stock Exclusions: What is the Impact?*, UBS Global Research, October 2019

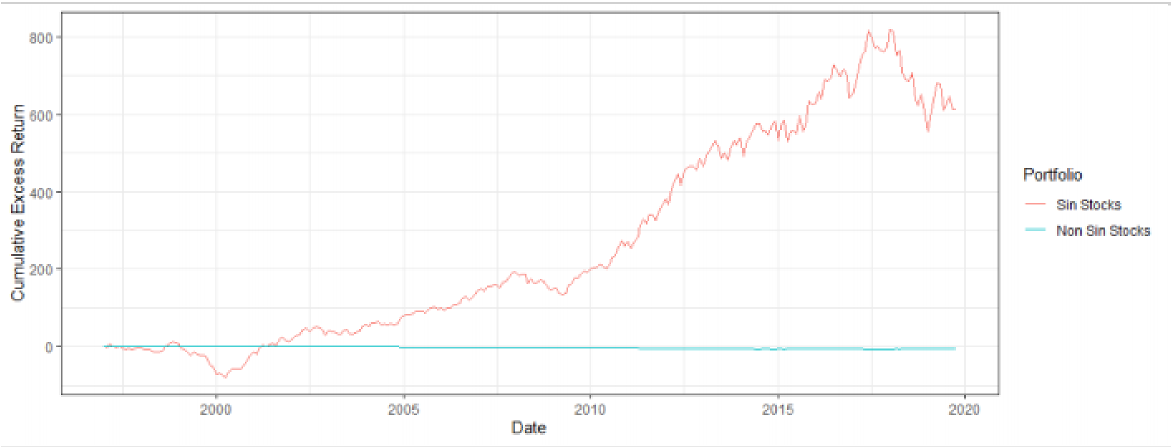
The data in both papers is drawn from Kenneth French's data library and covers tobacco, alcohol and weapons.

Note that this approach identifies only the manufacturers of these goods, and indeed only firms for which manufacturing the product is their primary business.

Performance of sin stocks in history

Chart 1 below (from the UBS paper) shows that these stocks had very strong performance from the early 2000s to about 2016 or 2017. In fact, the data show that over the past 43 years, a cap-weighted benchmark of the largest 50 'sin' stocks has outperformed the MSCI World by nearly 5% per year.

Chart 1: Sin stocks performance v benchmark: outperform the benchmark significantly and then sell-off over the last three years



Source: UBS. Chart: experimental "sin" stock portfolio, & MSCI world excluding the 50 "sin" stocks.

The chart also plots the excess return of a portfolio of the MSCI World without these 50 names, to see what performance drag the portfolio would have had from excluding them. The answer is – *very little*. In fact, the portfolio of MSCI World, excluding the 50 sin stocks, only underperforms the MSCI World itself by about 6bps (0.06%) per year, as per Table 1.

Table 1: Summary statistics of portfolios of sin stocks, MSCI World (ex-sin stocks) and the MSCI World itself

"Sin" Stocks	"Sin" Stock Portfolio	MSCI excl. "Sin" Stocks	Benchmark
Annualised geometric return (%)	11.20%	6.87%	6.93%
Annualised volatility (%)	15.06%	15.44%	15.33%
Maximum drawdown	-0.42	-0.54	-0.54
Annualised Sharpe ratio	0.78	0.51	0.52

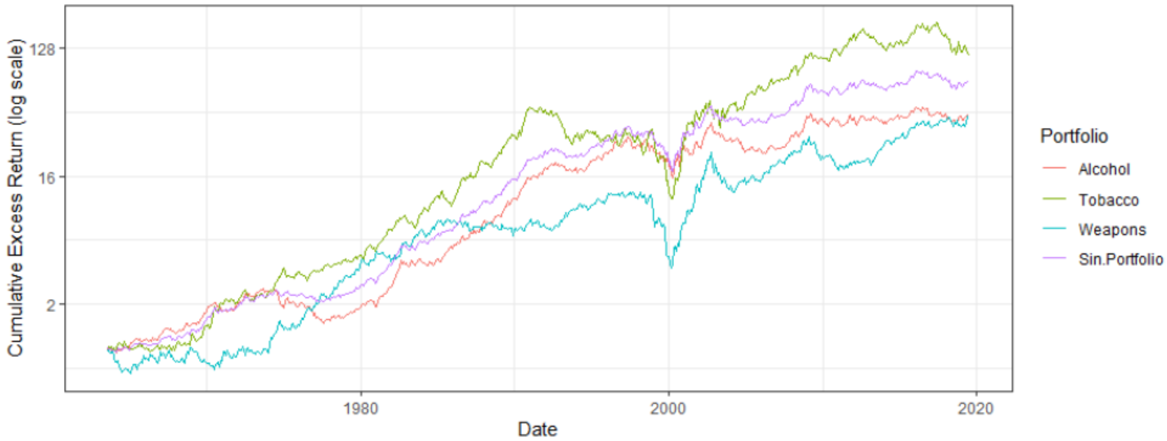
Source: UBS Quantitative Research. Time period is Jan 1996 – Aug 2019.

The reason for this is clear – these stocks only actually represent a small component of the investible universe (a global average of 2.2%). Blitz and Fabozzi (2017) state that the size of these stocks in Developed Markets portfolios is not large: "… the combined weight of the sin sectors averages 2.1% for the United States, 3.5% for Europe, 1.6% for Japan, and 2.2% for global." The UBS paper also notes that "… the low market capitalisation of these sectors means that, in practical terms, excluding them does not lead to significant change in performance."

Recently, the outperformance of sin stocks has reversed, with a portfolio of 50 sin stocks down about 6% per year for 2017–2019.

Chart 2 (again from UBS) shows the stocks' outperformance by broader sector categorisations, over a much longer horizon than Chart 1. The sin stock groupings here are alcohol, tobacco and weapons, which are easier to capture over a long period. All three sectors have participated in this alpha, with tobacco the best. The 1960–1990 period is truly remarkable, with the aggregate sin portfolio creating approximately 16 times the wealth of investing in the broader stock market.

Chart 2: Sin stocks outperformance by sector

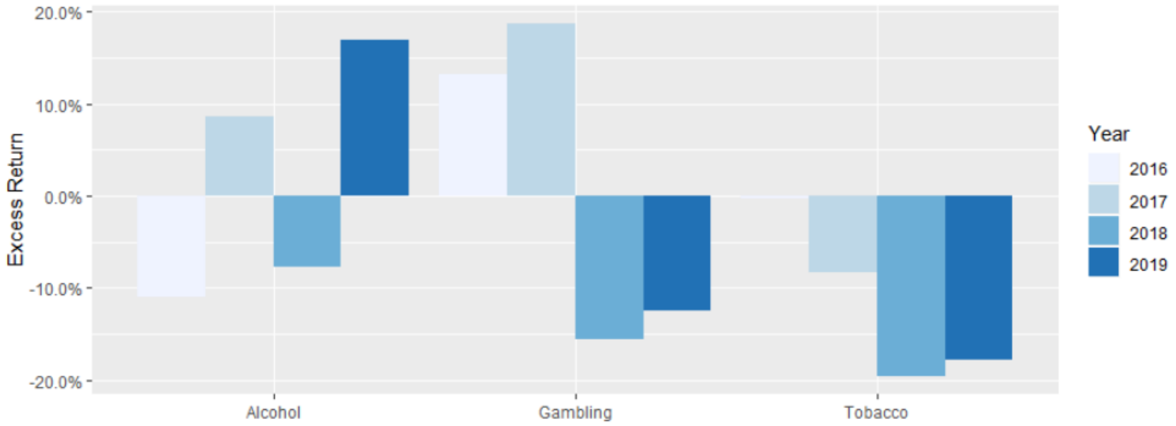


Source: UBS Quantitative Research. Data is Jan 1979 – Sep 2019.

Recent performance of sin stocks

As noted, Chart 3 shows that many sin stocks have sold off very strongly over the past three years. It appears the main drivers have been increased regulations, the rise of 'vaping' as a smoking alternative, and investors choosing to divest or exclude the stocks for ethical reasons.

Chart 3: Annual outperformance for each sector 2016-2019



Source: UBS Quantitative Research. 2019 is 1 Jan to 30 Aug.

Was there ever any alpha?

At first glance, the above charts would suggest that having an aggressive holding in these sectors would have delivered outperformance (alpha). However, the two papers agree conclusively that while apparent in simple excess return calculations, this alpha does not survive analysis when considering common factors such as size, value or momentum.

That is, *there is no specific alpha in these names*. The alpha is captured by well-known return factors, and so their factor exposure (and performance) could potentially be replicated by a portfolio of other ('non-sin') stocks.

The return factors used to capture any alpha (or detect unique insights) stem from the Fama and French class of models. The Blitz and Fabozzi paper, and the UBS analysis, both use the market return itself plus six other return premium factors:

- Size: smallest stocks over largest stocks, by market cap
- Value: cheapest stocks over most expensive stocks (measured using Book to Price)
- Momentum: highest 12-month momentum stocks over lowest 12-month momentum stocks
- Low beta (or 'betting against beta'): Low beta stocks over high beta stocks
- Profitability: highest profit margin stocks over lowest profit margin stocks
- Investment (or 'over investment'): lowest asset growth stocks over highest asset growth stocks

No sin in excluding these stocks

The observed outperformance is subsumed by a set of well-known return factors. Among other things, sin stocks seem to be low beta, are smaller than average and don't seem to have a systematic value or momentum tilt. Sin stocks can be excluded from a portfolio without compromising potential performance.

David Walsh is Head of Investments at Realindex Investments, a wholly owned investment management subsidiary of First Sentier Investors, a sponsor of Firstlinks. This article is primarily for information. It discusses ideas that are important to the Realindex investment process and clients but may not be implemented in the ways discussed here.

What is the likely effect of COVID-19 on the Australian economy?

Moray Vincent

In late January, we outlined two possible scenarios for economic effect on the Australian economy due to the spread of Coronavirus (2019-nCov) subsequently re-named COVID-19. The first was a situation similar to SARS, albeit with some key differences. Despite the lower fatality rate, it appears COVID-19 spreads more easily, or has got a greater hold before it was discovered. While both outbreaks occurred in China, the Chinese economy is far larger and more globally integrated now than it was in 2003. This is due to many years of high growth rates, meaning the absolute effect of even a small decline in China's economic growth will be far more significant to a greater number of countries – particularly Australia. With SARS, the virus was contained and effectively eradicated over a nine-month period.

In the second more frightening scenario, the virus is not contained and becomes a situation like the H1N1 swine flu pandemic, where the virus circulates freely round the world. Estimates by the WHO and other reputable sources for the 2009 – 2010 H1N1 pandemic, put infection rates at 11% to 21% of the global population. Between 284,000 and 579,000 people died from H1N1 which proved fatal for 0.034% of those infected based on these numbers. The frightening difference is that COVID-19 seems to have a fatality rate closer to 2%, meaning it is approximately 60 times as deadly.

Initial scenarios morph into a third

At this stage the situation is still uncertain, but some variation between the two scenarios is seemingly becoming a more likely third option. While technically the virus is either contained and eradicated or not contained and becomes widespread, the third scenario is the virus is contained for an extended period of time, sufficient for treatments and vaccines to be developed before it becomes 'not contained'.

Our logic in contemplating this third scenario is that experience on the Diamond Princess cruise ship indicates how contagious the virus appears to be where one person can cause the spread of the virus to over 600 people in just over two weeks - and this is despite quarantine efforts. Also of concern is once testing was extended from those people who had symptoms to those that did not, it became clear there were significant numbers of people who were infected but had no symptoms. If these people are contagious and able to infect others, then stopping the spread of the virus within communities will be extremely difficult.

The second fact supporting this argument is the number of infections in South Korea, Iran and Italy and to a lesser extent Singapore, Japan and Hong Kong where cases are rising. In these countries the virus has essentially 'escaped' in that efforts to trace all the people infected from an initial carrier have likely failed and the virus is now circulating in the community. If new cases cannot be isolated quickly enough, then the virus cannot be eradicated and will either continue to circulate at low levels for a long period; or, if it is highly contagious then number of infections will rise rapidly and more extreme 'Wuhan-type' measures will be necessary. Countries with currently contained infections will likely begin to institute travel bans (similar to the ones in force currently for China) on anyone coming from these places to other countries.

Economic disruption

Economically, the impact of steps to contain the virus being isolation, quarantine and travel restrictions are likely to be extremely disruptive. The full effects of factory shutdowns in China have abated to date as inventories have been run-down to cover production disruptions at a customer level and built up to avoid production disruptions at a supplier level.

However, this is a temporary situation and it is only recently the flow-on effects of the shutdowns on business in Hubei province have really begun to affect other parts of what is a very large and complex supply chain. It currently appears as if the restrictions will need to stay in place for much longer than initially forecast by optimists because the COVID-19 virus is both deadly and contagious.

Further as we've seen with the recent spread of the virus to other countries, efforts to contain it are likely to cause economic disruption locally, which may be mild at first but may become more severe over time if the virus continues to spread. For example, it would be fair to say the Tokyo Olympics are under threat of cancellation at this point if the local situation in Japan worsens in the next five months.

We predict this will have a greater effect on Australia than other countries because of our very close links to China and the facts that:

a. China is our largest trading partner due to resource exports,
b. one in four of our international students are from China and
c. one in six of our tourists are from China.

It is not unthinkable the impact on Australia will be enough to cause negative GDP growth within our economy in both the first and second quarters of this calendar year. Of course, this is the technical definition of a recession and in such a circumstance the RBA will almost certainly look to cut interest rates from their current levels and also probably introduce other emergency measures as well.

This recession if it occurs will likely be different from many others experienced previously in that different parts of the Australian economy will be disproportionately affected. The three areas above are obvious ones, but secondarily airlines and the travel industry in general are likely to suffer greatly as the obvious method for Australia to protect itself is to stop the free movement of people between itself and infected areas, and as these grow, the list of countries with travel bans is only likely to increase in the short to medium term.

Moray Vincent is executive director Amicus Advisory, an independent fixed income research firm that provides advisory services to conservative wholesale credit investors. Operating since 2008, it currently has around $1.8 billion of funds under advice.

Poor pricing of life insurance products and the impact on Australians

Roy Agranat

In 2019, APRA wrote to all life insurers and friendly societies to advise them to 'get their houses in order' in relation to pricing, especially insofar as this pertains to disability insurance premiums.

For example, if a 30-year-old effects an income protection policy with a benefit period to age 70, the expectation is that the product, whether funded on stepped, level or hybrid premiums, will protect them throughout their working life at a fair and correctly costed price. Unfortunately, this is currently not the case and the client will be price-forced off their policy in later years. This happens most notably in respect of Income Protection, Total and Permanent Disability (TPD) and Trauma cover.

To further exacerbate the problems relating to pricing, insurers have been offering discounts to obtain new business at rates that are not sustainable. These 'campaign' discounts of up to 25% of premiums in the first year of a life policy make a mockery of the Life Insurance Framework (LIF) reforms. Lapses are up but not because of 'churn'. They have increased due to issues relating to affordability.

Poor pricing practises have gone on for decades, occur on multiple levels and simply cannot continue. This article outlines 'what occurs', but also notes numerous 'potential solutions', which, if considered, we believe could help solve the problem.

What occurs

- Insurers bring to market new policies at lower premium rates than their closed product, or prior series offerings. Insurers have done this for years knowing this is unsustainable.
- Insurers underprice products to artificially drive new business knowing they will need to increase base rates regularly and within a short space of time.

- Discounted premiums that are offered to new clients are not passed on to existing clients. How can insurers argue the need to increase rates for existing clients while offering lower rates to new clients?
- Insurers provide lower rates for new clients on policies within a series. This results in consumers being insured under the exact same product, but at different premium rates depending on when they took out their policy.
- Cross-subsidising or providing package discounts and in some cases providing third-party services that, if taken up, will result in premium discounts for a period of time. Insurance should be correctly priced on its own merits from the outset.
- Some larger insurers are prepared to use predatory price discounting for the first few years of a policy to stifle the competitiveness of smaller insurers. Then, as larger groups acquire smaller insurers (which has been the case), it exacerbates the legacy book pricing issues.

Table 1 below cites three insurer examples (same product series) with 2019 base rates and initial discounts offered compared to policies taken out in 2014.

		Base Rate 2014	Base Rate 2019	2019 With Discounts
Life / TPD / Trauma / IP	Premium	381	317	256
Male, ANB 41	% difference		-17%	-33%
Life / Trauma / IP	Premium	704	724	613
Male, ANB 54	% difference		3%	-13%
Life / Trauma / IP	Premium	1,116	941	860
Male, ANB 52	% difference		-16%	-23%

Source: Fairbridge

How can insurers offer these discounts and at the same time apply base rate increases to existing policy holders?

Table 2 illustrates the base rate increases across the market for existing policy holders for the three years up to March 2019. The insurers will generally have an increase within a range depending on the exact product as outlined below.

Table 2 Insurer pricing increases last 3 years to March 2019

Insurer	Increase From	Life	TPD	Trauma	IP
Insurer A	Mar-2019				8%
Insurer B	Apr-2017	0-10%	0-10%	7-20%	5-28%
Insurer C	Jan-2018			8%	13%
Insurer D	May-2017				8-13%
Insurer E	Oct-2016				10-15%
Insurer E*	Apr-2019	0-10%	0-10%	0-10%	0-10%
Insurer F	May-2017				8%
Insurer F*	May-2018			10-15%	10-15%
Insurer G	Jan-2019			10%	15%
Insurer H	Jan-2016				10%
Insurer H*	Jun-2018				8-30%
Insurer I	Nov-2018				8-23%
Insurer J	Oct-2016			5%	10-15%
Insurer J*	Aug-2018			10-13%	8-13%

Source: Fairbridge
** Note that a number of insurers will have multiple increases during this period.*

According to APRA, the Australian life insurance industry lost $417.8 million in the year to June 2019, down from a profit of $990.6 million the previous year. These are sobering statistics which highlight the urgent need for pricing reform in order to ensure a sustainable industry that is committed to protecting the future of millions of Australians.

Reasons insurers give for increasing rates

- Bad claims experience - Insurers use claims experience to price their books. If the claims in respect of the existing book are above expectation, this should be factored into the pricing of the new book. In fact, we see the opposite and history has shown that new products are artificially priced lower.

- Reinsurer treaty arrangements - These arrangements are not well designed and are not priced for the long term. Reinsurer 'musical chairs' with insurers is an issue.

- Past poor engagement with disability claimants - Every legitimate claim must be paid and this must be done in good faith.

- Income protection policies have been too generous on replacement amounts - If this was true, then current new business Income Protection premiums should be much higher than they are.

- Low interest rate environments - This is the most recent excuse given by insurers for income protection rate increases, yet those increases are not applied across the board.

Potential solutions

Insurer-appointed Actuaries, or Chief Actuary, should:

1. stand separate and independent from the management of the company and not be party to campaigns to drive new business at any cost.
2. have a 'trustee'-like responsibility to ensure the product is sustainably priced for consumers, providing the counterbalance required.
3. report to the regulator each time base rates are increased and provide an acceptable justification and/or explanation.
4. report to the regulator each time they price reduce within a product series for new clients and do not immediately pass this back to existing clients.

Insurers should:

5. not force clients to change products (or change within a product series) to obtain better rates that are on offer.
6. be obliged to pass back pricing improvements to existing clients.
7. not be allowed to have multiple series within a single product. This allows for price and definition changes but creates an impression the product has not changed. Instead, you get a conga line of legacy products.
8. price insurance policies correctly at the outset.
9. not allow short-term discounts on new policies.

The regulator should:

10. penalise insurers for poor pricing models.
11. monitor and step in when there is gross under-pricing, or incentive discounting.
12. not allow for products to be closed without a clearly defined and acceptable strategy to manage the closed book of business.

Notably, with reference to the sale of AMP Insurance to Resolution Life and the closure to new business, millions of Australian consumers are going to find themselves locked into expensive insurance policies as healthy lives leave AMP as clients. This is a disaster in the making as this will become the largest legacy book in Australian history.

APRA recently advised all insurers that from April 2020 they can no longer offer what are known as agreed benefit income protection policies. APRA has further advised that the structure of these products will need to change. However, there is scant detail on how these products will provide effective cover for Australians who would rely heavily on this type of insurance to protect themselves and their families. This is not a solution and frankly all of the current agreed value policy holders are going to find themselves price forced off products as APRA has handed them (the insurers) a licence to do so. The evidence for this can be found in the recent

Protect Your Superannuation legislation as insurers have been able to increase insurance premiums to unaffordable amounts, thus contributing to the erosion of superannuation account balances. We had a client have a premium increase of 46% using PYS as an excuse. How is this acceptable?

Most risk specialist advisers do an outstanding job for their clients and as an industry we have been pleading for years for these pricing practices to stop, but unfortunately to no avail.

Roy Agranat is a specialist risk adviser with Fairbridge Financial Services. This article is general information and does not consider the circumstances of any individual. Rates quoted are indicative only and may not apply for all people.

Spotting signs of trouble in a retirement portfolio

Dermot Ryan

Everyone has 20/20 vision in hindsight – and sometimes, even the most obvious risks to a portfolio are more common than you may think. On the flipside, there are income opportunities on the horizon this year, if you know where to look.

Two potential areas of trouble in a retirement portfolio in the current climate are concentration of risk around Australian property trades and accelerated draw-down of retirement assets due to low yields on offer on fixed income.

Property exposure

One particular area where we often notice concentrated risk in retirement portfolios is in residential property, both specifically within self-managed super funds and also as a large component of the total assets of many people entering retirement.

Currently, yields in domestic residential property are very low, and valuations are very high. With most investors having a direct stake in the asset class, and also considering ancillary trades around that, such as investments through banks and some of the REIT providers, it’s a stacked bet on one very expensive trade.

That approach has worked well over the last two decades or so, but in recent years we received a warning shot across the bow in the form of a small market correction. Although investors with a long horizon can take this kind of correction in stride, retirement investors should be very cautious about the sequencing risk associated with this kind of market event.

Low cash and fixed incomes yields

Another point of concern is the effect of a low-yield world on retirement incomes. The cash rate in Australia currently stands at 0.75%, with further cuts expected early this year, and fixed income assets are returning yields at record lows. Retirees are having to draw down on their asset base in order to generate income from these asset classes. This is a particular risk inherent to some fixed allocations in the current economic climate and we think it needs to be taken into consideration, given the likelihood that the current low-yield rate will continue for some time to come.

Similarly, cash exposure must be carefully managed to ensure inflation and financial repression don't eat into your asset base. One way investors can manage this risk is to tactically allocate to higher yield asset classes such as Australian equities. With the benefits of franking, Australian equities have been able to achieve over 6% income over the past decade since 2009 and has also delivered some capital growth.

There’s also the issue of longevity risk to consider. You should plan to live long and better while also managing your assets to cover that eventuality that you do live until a very old age. Retirement investors don’t want to outlive the value of their portfolio. Investing in equities makes sense if investors can look through the short-term volatility.

Key considerations: retirement versus accumulation

There are several key differences to consider between investing during the retirement phase as opposed to the accumulation phase – the two have distinct needs and profiles. It's important to understand the different needs and goals of each phase.

In accumulation, the investor is typically contributing towards their superannuation and at the same time making other investments outside that portfolio. The principal goal is growth, with the aim of reaching retirement with the largest possible portfolio of assets.

In retirement, investors will need to think a little differently.

The first consideration is their tax situation. In retirement, investors will likely be in a lower tax bracket than they were through the accumulation phase, and with that comes a number of advantages. In retirement phase, franking credits are worth much more. Every dollar of franked income is worth $1.43 in retirement, and that has the potential to generate a very large income from the Australian equities and hybrid components of a retiree's portfolio.

Secondly, investors must consider longevity and the risk of outliving their asset pool. Portfolios in the retirement phase are typically more exposed to fixed income, and potentially cash and more conservative assets. The income from many of these asset classes is currently quite low, and expected to stay low for some time.

In order to prepare for the possibility of living a long life – or leaving a corpus for family members or benefactors, investors might need to consider their allocation between more conservative asset classes and other defensive positions in assets that have the potential to generate higher income in the current climate. This may help investors to retain sufficient equity in their portfolios so that over time they can draw down on their asset base as well as invest for the future and generate some capital returns in their retirement.

Finally, investors should keep a close eye on valuations, and how they relate to yields across different asset classes, and be prepared to adjust their allocation over time in accordance with changes in these relationships.

Dermot Ryan is Co-portfolio manager of the AMP Capital Australian Equity Income Generator Fund. AMP Capital is a sponsor of Firstlinks. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.

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Media worth consuming - February 2020

Jonathan Rochford

A monthly look at dozens of local and global media articles that often do not receive mainstream coverage in Australia.

Finance

The New York and Philadelphia Federal Reserve surveys have the US economy in rude health. However, the Cass freight readings for January were ugly and are likely to get worse once the coronavirus impacts flow through. Global shipping rates have collapsed from a combination of the coronavirus and seasonal slowdowns. If the virus doesn't clear soon a wave of Chinese SMEs will run out of cash, with some already taking drastic measures to reduce employee costs. Chinese car sales fell 92% in the first two weeks of February as the infection kept employees and customers away. Chinese steel mills are sitting on close to record high levels of finished product as demand has plummeted. China has warned its citizens not to expect large scale stimulus to offset the virus impacts.

The Chinese government is taking over the heavily indebted HNA Group. China's FX reserves are only half of what the IMF recommends. Argentina is talking up a deep restructuring with the IMF supporting substantial debt haircuts for bondholders in order to sure up recovery of its loans. Greece sold €2.5 billion of 15-year bonds at 1.9% and its 10-year bonds traded below 1% yield. Despite an enormous debt load, investors are now talking about Greece having a pathway to investment grade in coming years.

American investors are splurging on call options. Low volatility strategies aren't working as expected, perhaps due to their popularity. Stocks with high ESG ratings trade at a 30% premium to those with the lowest ratings. Natural gas is getting cheaper and in some places they will pay you to take it. Online mattress seller Casper saw its valuation slashed in its IPO. Germany's banks are building bigger safes as cash holdings have tripled in four years from investors trying to avoid negative interest rates.

Buying insurance against investment grade bond defaults is the cheapest it has been since the financial crisis. Deutsche Bank's $1.25 billion, 6% hybrid note sale was 11 times oversubscribed. LVMH is getting paid to borrow money to buy Tiffany & Co. The use of secured corporate debt is declining as business assets increasingly become intangible. Private credit is fuelling the next crisis by making loans that otherwise wouldn't get funded. Bond funds are hotter than Tesla. American auto dealers are telling customers to default on their old loans, rather than trying to trade in.

UBS's flagship real estate fund has been hit with $7 billion of redemptions. Two Irish property funds gated after asset write-downs spurred redemptions. Since 2003, hedge funds as a group have subtracted value from diversified portfolios. Executives at firms subject to SEC investigations have long been using their non-public knowledge of the investigations as an opportunity to sell shares and avoid losses.

Politics and culture

Trump boasted that no Americans were injured by the Iranian missile strikes, but the wounded count is now over 100. He also campaigned on cutting spending and paying off America's national debt but has failed miserably. The Russian conspiracy theories are back, this time used to smear Democratic Presidential candidates. The Washington Post was widely mocked for running an article that argued for elites to choose the presidential nominees. Democrats changed the rules to allow Michael Bloomberg to participate in debates.

Parts of Vermont are giving parents wide choice in their children's schooling options, whilst spending less and getting better learning outcomes. After including pension benefits, American teachers are arguably overpaid. US taxpayers look set to pick up the tab for $200 billion in student loan forgiveness.

Canada raised the tax rate for higher income earners and then collected less revenue from them. The Davos conference is full of billionaires mouthing platitudes they don't act on. America barely bothers to prosecute and punish white collar crime anymore. The Australian High Court has invented a new class of citizenship, overruling existing legislation. Women can also have a mid-life crisis, but it looks different from men. The Japanese government badly handled the Coronavirus afflicted cruise ship, making the situation far worse.

When young people say they support socialism, they typically don't know what it means and they wouldn't want to pay the cost for it. It is understandable that young Americans want free stuff when they see their parents getting social security and Medicare, after also getting cheap college. 9 basic questions democratic socialism ignores. Free speech isn't just about being free to speak, it is also about not being forced to speak. China has kicked three Wall Street Journal reporters out of the country after they called China "the sick man of Asia".

Economics and work

When looking at consumption rather than income, the poorest American households are doing surprisingly well. In aggregate, US consumers are seeing growing earnings and savings, but this hides a minority that are getting deeper into debt. How Costco delivers cheaper products and higher minimum wages. Technology has greatly reduced the time spent on household labour, just as John Maynard Keynes predicted.

Critics of neoliberalism choose to ignore that government spending and regulation are growing not shrinking. Supporters of MMT ignore the nearly perfect correlation between the growth in money supply and inflation and that government debt is far from a free lunch. The predictions of economic doom following Brexit were completely wrong. A World Bank Paper finds that corrupt elites siphon off 7.5% of foreign aid upfront.

A large scale, 12-year American experiment with UBI found that it dramatically reduced the incentive to work, despite the intention of the program to do the opposite. It's another reminder that if you kill the incentive to work, hard work disappears. In the US (and Australia as well) unaffordable rental housing has become entrenched. Berlin is trying to solve the problem by taking a very radical approach with rent controls.

Miscellaneous

You can save $300 on an airfare to Hong Kong, if you are willing to have a brief stopover in Wuhan. Taiwanese gaming machines are offering face masks and hand sanitiser as prizes. Thieves in Hong Kong stole a truck loaded with toilet paper. Chinese police published the names and photos of people who wore pyjamas in public.

Criminals are using car-sharing app Getaround to hire and steal cars for crimes. Hackers are attacking satellites to use them for ransom or as weapons to attack other satellites. Ransomware is so easy to use a journalist did it and wrote about it. Citigroup suspended a highly paid bond trader after allegations he was stealing from the canteen.

The economics of a buffet. Avocados are now worth enough to attract organised crime. Would you rather buy a packet of cigarettes or several days of food? Online food delivery services are taking orders for restaurants they have no relationship with. A Heston Blumenthal restaurant is accused of stealing $4.5 million from its workers. 60,000 people apply to be Chick-Fil-A franchisees each year but less than 100 make the cut. A central coast man wouldn't let floodwater get in the way of takeaway food going through the drive through on his jet ski.

What you give up in exchange for "free" software. Many businesses claim to be disruptive, but few really are. The CIA used a seemingly independent Swiss encryption firm to spy on government and military clients. Two criminals were busted after police looked inside their bag which was labelled "bag full of drugs". The makers of the swag bag for the Oscars is being sued by its disabled workers for wage theft.

Temperature records have been broken in Antarctica with one base recording a balmy 18.3C. The mostly negative impacts of warmer weather on Norway's landscape. James Hanson's 1988 "middle of the road" temperature forecast turned out to be quite accurate. While the science of global warming is generally agreed, the economic consequences aren't. Transition bonds take greenwashing to another level. Drilling geothermal wells might cause earthquakes, but it offers the possibility of large scale cheap and clean power.

The things we often miss when we think something is easy. 12 tips on being a great leader. In 1849, New Yorkers rioted over a Shakespearean play. Some funny translations of what fund manager sales pitches really mean. The latest craze in endurance events involves climbing the same level of altitude as Mount Everest and taking the chairlift down.

Written by Jonathan Rochford of Narrow Road Capital. Comments and criticisms are welcome.

This article has been prepared for educational purposes and is not a substitute for professional and tailored financial advice. The accuracy of the material cannot be verified in all cases. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.

Poll results: Equity manager cash allocations

Leisa Bell

Last week, Graham Hand's article 'Should your equity manager hold lots of cash?' included a one-question poll for readers to air their thoughts on equity managers having large allocations to cash in times of uncertainty. Graham's concluding paragraph read:

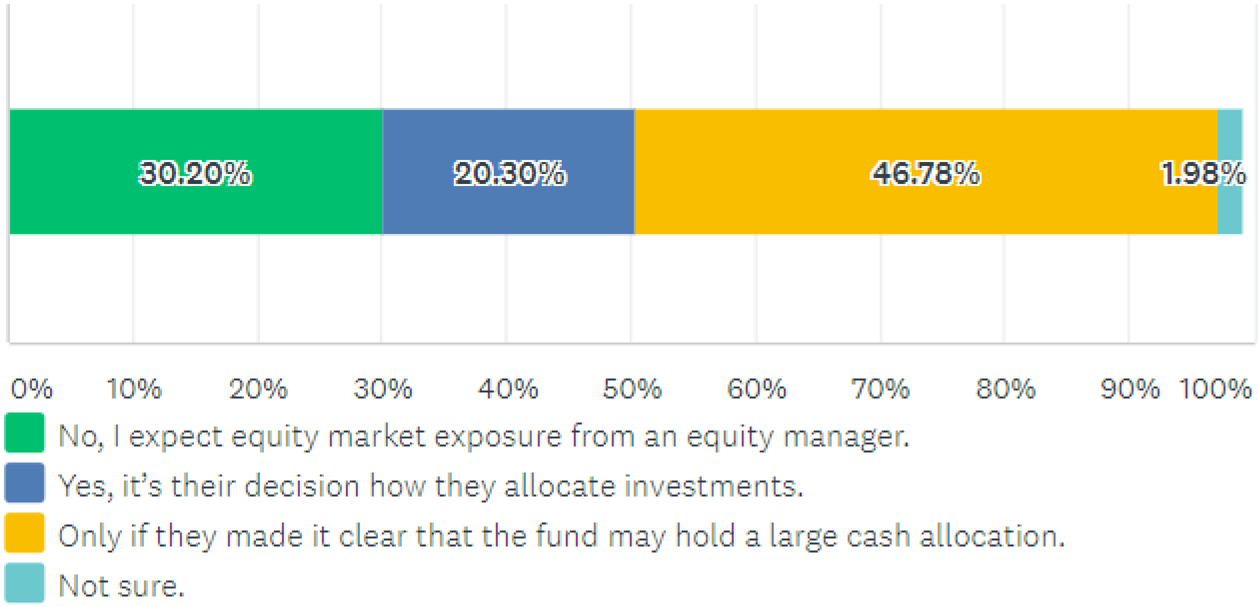
In summary, each investor should know how much cash is held by the funds they choose in sector-specific allocations, as the overall cash exposure in a portfolio may differ significantly from expected. When an equity fund manager has a maximum cash allocation of 5%, at least the investor knows where they 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.

Thank you to the 400+ readers who responded, giving us a healthy sample size.

We found that two-thirds of our readers are not as bothered by equity managers holding large cash allocation as Graham was. However, almost half of all respondents said it is only acceptable if the manager has made their intentions clear in advance.

Results and comments are replicated below.

Question: Are you happy that your equity manager sometimes makes large cash allocations?



Comments

- Provided PDS informs the investor that up to x% can be allocated to cash, I am comfortable. Usually a so-called value mgr. adopts this stance
- Cash may have poor returns, but how else can the fund manager take advantage of opportunities during market corrections (which will likely occur), if they don't hold a cash reserve? Ideally, that manager is active in the management of the cash, allowing it to rise and fall with changes in market valuations. When the market is deemed expensive, cash will rise, and vice versa.
- If execution capability to move in and out of safer/riskier asset classes is faster than I could as an adviser then I actually appreciate a more open mandate within clear parameters
- If you have built a portfolio of sector specialist managed funds then your control over asset allocation is heavily dependent on the ability of each fund manager to stick with their mandate.
- Noting a growing fund outperforms. Can down-weight poor stocks by buying others and has new cash to invest in pullback opportunities.
- Protection of my capital outweighs performance.
- Net return is the bottom line, how a manager achieves this their problem. Why keep a dog and bark yourself?
- I have put SOME of our funds with managers who make it clear they can (and will) go to cash in some circumstances. Hopefully, they will see a correction coming before I can. I control most of our funds. Hedging my bets sow to speak!
- I dont need to pay a professional 1.25% to lose money for me, i can lose it quite happily by myself.
- When I invest in a manager, I expect that they will stick to their mandate - such as "Australian small-medium cap growth equities". Clearly, they need some modest amount of cash for transactions. I generally invest in active managers rather than index followers. To get good value out of being an active manager, they need to have cash available when the market dips to buy stocks that are then worthwhile. I want them to recognise that, and not necessarly be fully invested when the available investment selections are mediocre. To select active managers that I trust, I look at how they have performed in markets over time, not just what they say.
- Need some cash for costs, redemptions, transactions etc
- I regard it as an important risk-management tool for a long only fund. I prefer that a fund manager goes to cash rather than experience a 50% drawdown
- The maximum cash equity should be stated in the product disclosure document. Cash should be held short term only.
- Mainly to preserve capital depending on market conditions.
- I am happy for them to hold significant cash reserves up to the maximum amount allowed in their published investment policy, if they expect excellent buying opportunities to arise in the near future.
- unless I otherwise like a fund that has internal road asset allocation. Then I consciously consider that as part of my cash and reduce my cash holdings accordingly to compensate.
- I can hold cash to deploy if need be myself thanks! It's fund managers being too scared at times to back themselves! Very disappointing when it happens!
- Preservation of capital important
- i can manage my cash (asset) allocation.

- Holding large amounts of cash is not a good strategy, inflation will see to that so stick it work, ie put it into the banks, WES, WOW, AFI even WAM but contrary to Fund managers mantra don't time the market ,got news for you that is what I do and it WORKS, you need patience though. Fund managers have to disperse the funds within a short time frame, that is recipe for disaster IE LSF and WGB) there that's just plucking a few in a manner of minutes. They call themselves fund managers I won't be using them!!
- I am my own equity manager! It is my money
- That is what you pay a manager for. Otherwise just use an Index.
- I do not want to force a manager to reinvest the very instant that they sell an asset. If they need a little more time, that is fine PROVIDED I KNOW their policy.
- Do not have one
- Cash rates are so low ... you have to decide if u want higher risk versus cash yield
- as long as the decision is the best interpretation of the clients risk profile and investment strategy
- I am assuming that they are making decisions to get the best return and I have chosen them to do this. I do it myself with my portfolio.
- For my strategy / exposure I WANT the manager to stay in cash if they have good reason to do so. I actively choose products on this basis.
- I'm paying active managers for their insights, including when to move more money to cash
- At the moment my share investments are following the Morningstar model income portfolio, except for the fact that I'm holding one third of my portfolio in cash. I'm about to invest 33% of that cash into four different funds, Aus Gold, US equities (un-hedged), Bonds and Cash!
- I like Jack Bogle's idea, buy an index fund and hold it forever. Actively managed funds will probably suffering reversion to the mean, less fees and commissions, thus giving a much lower long term result.
- And Yes they should make it clear that they have this right
- You have to clearly read the IP and the SAA to establish what you are buying. If you want full investment to equities fine as you can buy/sell the MIS to reflect your view but if not then do you really want your Manager always fully invested even when it's bleeding obvious what is about to happen or what about in a liquidity crisis, do you want to throw good money after bad.
- I want my funds working hard for me. Not sitting in cash and getting low returns.
- This is simplistic definition of "exposure", many managers hold higher beta portfolios and may hold the cash as offset. Key questions are do they have the skill? Is risk allocation reasonably sized? Are incentives appropriate? I am personally dubious about their skillset but measuring "exposure" is more complex than dollar weighting.
- Cash may be required to significantly increase certain positions in future which implies the manager is confident of predicting a market pull back with consequent 'bargain' opportunities emerging. I'd have to be convinced on their track record for that one but if that confidence seems justified and they have told me in advance about large cash allocations for bargain hunting purposes, then yes, I would accept such cash holdings as part of the strategy.
- I expect anywhere up to 15% cash holding depending on managers assessment of over v undervalued markets, but only as an option value. Most likely 5-10%. When everyone is greedy it should be high, when everyone is scared it should be low.
- Having cash to buy into the market is important and so some flexibility is required.
- I employ my equity manager to deliver appropriate returns (equity-like) taking appropriate risk. I am happy for them to decide the best allocation of cash to meet these two objectives at any point in the cycle.
- I rarely have "not sure" on surveys, but in this case, it all depends. If the FM is being prudent based on market events, then some flexibility is often desirable
- I am extremely frustrated when equity manages like Magellan do this. I pay fund managers to invest in the asset class they are in, not in cash or other products.
- I'm paying you to invest in equities. If I want cash, I'll buy that myself.
- I choose a credit manager (CCI) to have freedom of allocation as specified in their PDS & work around that for allocating to other asset classes
- I'll decide how much cash to hold, and allocate funds to equity managers for equity investments
- The value they provide is generating superior returns over a medium/long term than those generally achieved by an individual. Otherwise, they are of questionable use. So, if that means parking cash when they see fit, so be it.
- I believe it is my Fund Managers obligation to achieve good returns for me. If my Fund Manager foresees difficult times ahead I believe it is my best interest that he preserves my recent gains and goes to cash for a period.
- Who needs an equity manager?
- Equity fund managers need to allocate to cash when buying/selling, when application money's come in. They also handle some of the market timing issues that many investors don't want to deal with. Check the asset allocation framework before investing. If you want pure equity exposure then use an ETF or direct equity portfolio.
- And only if it's because their stock pickers can't identify companies with relative upside at current market pricing. They can keep a cash reserve to buy when they

find stocks they want. I don't want a manager taking a macro view of where the share market is trading. That's done elsewhere in my portfolio.

- Difficult question to answer, but I expect a manager to adjust to his current view on the market. If I was not happy then I have the choice to move.
- our fund manager Forager has recently acknowledged poor returns partly due to holding large cash reserves
- One would hope that an Equity Manager has more insight into potential market moves than me, but in the last three years it appears that I have been better at picking up sharp declines before they did. Hence I have my money where I control its ultimate allocation.
- Cash allocation should only be for emergency needs, no more than 5 to 10% of total investments, also depends on the investors AGE.
- And only if they do so for a relatively short period of time before allocating back into equities
- I have never used a manager and the only cash I have is for living
- No, because I would hold cash myself or invest in a bond ETF.
- This is an individual decision, after discussions with your equity manager
- I expect a manager to allocate cash for the best outcome they see possible. IF that includes CASH due to VALUATION or other RISK then so be it. I DO NOT WANT a manager at the top of the market to be fully invested if they believe the market is expensive and opportunities are minimal.
- While I want my asset managers to invest in the asset classes "as advertised", a temporary cash allocation is slightly different. If the manager has a well founded belief that their particular asset class is going to decline and lose money, I do not think that they should be forced to be 100% invested. A retreat to cash would seem the sensible option.
- To your point, I question those managers charging a performance fee to outperform and equity benchmark and do so by holding cash during falling markets. The performance fee should be aligned to generating alpha rather than rewarding managers for asset allocation timing.
- One expensive lesson I learned was when I bought a LIC that was trading at a sizeable premium due to outperformance. After I foolishly bought, the manager went to max cash taking the premium out of the share price. Lesson learned.
- Inappropriately high cash allocations reduce returns in bull markets, but provide some peace of mind in downturns. Many investors are not interested/informed/nimble enough to quickly adjust their asset allocations as markets move. The question is: does the average investor know more than a professional investor? Having said that, I do agree that if a fund manager has consistently high cash allocations then their MER should drop to reflect that fact.
- True to label is important, but I do want a manager who is prepared to de-risk when valuations are toppy. I am happy to live with underperformance as long as communication is clear.
- What's a large allocation? I get twitchy if more than 15% is held in cash for extended periods, say, more than 6 months unless it is very clear a bull cycle is in its last paroxysms.
- If they declare their position upfront & reasons why and it suits a particular investors needs, all good. For me right now, I'm long equity, mostly private and have spare cash to pounce if the opportunity presents.
- Managers should invest in line with their stated investment allocations - "true to Label"
- Of course they should. The idea is to make and then preserve money. It's pretty stupid to follow the market down "just because".
- Any major change should be referred to, and discussed with client first and not be made without client's approval.
- It really depends on who has the better asset allocation skill - the equity fund manager or the asset owner

Leisa Bell is Assistant Editors at Firstlinks.