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Editorial

The stock market continues to defy most equity pundits and push through fears of ongoing recession, job losses, business closures and a second virus wave. But if there's one factor in Australia that is seriously underestimated, it is the loss of stimulus from population growth and immigration. Releasing new population data last week, ABS Demography Director **Lauren Ford** said:

"The population at 31 December 2019 was 25.5 million people, following an annual increase of 349,800 people."

Natural increase accounted for 39.8% of the population growth, while net overseas migration claimed 60.2%. With 305,800 births and 166,700 deaths, the natural increase of 139,100 was a drop of 5.2% over the previous year. In recent years, there has been a dramatic decline in Australia's fertility rate, with births per woman down to about 1.7 (Source: ABS).

Total fertility rate, 1934 to 2018(a)

(a) Births per woman.

We rely heavily on migration for population growth, with 533,500 overseas migration arrivals and 322,900 departures resulting in net overseas migration of 210,700 people in one year. It creates demand for a lot of houses and sofas and cars and washing machines.

That was before COVID-19. With travel bans in place, borders closed and many parts of the world unable to control the virus spread, net overseas migration is forecast by the Government to fall 85% for the next two years. It will continue at lower levels for years as we raise the drawbridge with political pressure to give Australians jobs before migrants.

This major change will also take some pressure off infrastructure, house prices and wages. **Shane Oliver** at AMP Capital estimates that underlying demand for houses will fall by 80,000 dwellings a year due to immigration falling.

ANZ Chief Executive **Shayne Elliott** said a few weeks ago: *"The reality is there is no V-shaped recovery because our economy is open and very, very dependent on exports and tourists and migrants and foreign students."*

The 300,000 less permanent arrivals over two years represent a further setback for budget recovery, as many would have been skilled migrants and high-level taxpayers.

Meanwhile, over in the US, the **Federal Reserve** injections of liquidity took a new turn this week with **Standard & Poor's Global Ratings** adding a record number of companies to its 'fallen angel' list. These are bonds the Fed is buying which might soon be rated junk or never repaid, and that's not how a central bank should manage public money. S&P said:

"Potential fallen angels, or issuers rated BBB- with negative outlooks or on CreditWatch with negative implications, climbed to a fresh record high of 126 in the five months to May from 111 in the January-April period on lingering credit pressures due to the coronavirus pandemic."

And if we ever needed proof that future returns will be less than in the past, Austria issued a Euro 2 billion bond this week for **100 years yielding 0.88%**. At least none of the buyers will ever see it mature.

In this week's edition ...

When a market continues to rise defiantly, it's because there is a source of new money or existing investors are doing something differently. **Damien Klassen** dissects where this demand is coming from to judge if it is sustainable.

Last week's article on '**Robinhood'** investing had a tragic footnote when the next day, **Forbes** reported that a 20-year-old had committed suicide when his balance was reported as negative US$730,000, said to be the result of the timing of some complex option trades. **Noel Whittaker** has been advising clients for decades, and in describing his worries about these new, inexperienced traders entering the market, he reveals a trading secret I had to double-check with him to believe.

A traditional 60/40 investment portfolio seeks to buffer the risk and growth of equities with the downside protection of bonds, but **Amy Arnott** believes it needs reviewing with bonds offering poor future returns. How do investors cope with the added risk if they go 80/20?

Rodney Lay researches many LICs and LITs, and the ongoing problems of funds trading at a discount to NTA have led him to the view that all boards and investment managers must review whether their structure is in the best interests of investors and not just themselves. He highlights a new development they should all consider. It's a frustrating space for investors, with another example this week at the highly-regarded **VGI Investors.** A senior portfolio manager, **Douglas Tynan**, resigned to move to a non-executive role, and at the time of writing, VG1 is trading at $1.89 versus an NTA of $2.32, a whopping 18.5% discount.

The latest data on SMSFs released by the Australian Taxation Office gives a much-improved picture compared with a previous study by ASIC. **Franco Morelli** reports on how much it costs to run an SMSF to see how you compare.

Dr Paul Morelli examines social impact investing, and especially the potential to introduce a Social Impact Credit System to give investors far better information.

Jonathan Rochford's monthly look at the global media most of us miss always raises the quirky, revealing and unusual, and there's not shortage this time around. Always wish I had time to read more of the intriguing links.

In this week's Sponsor White Paper, **Neuberger Berman** makes the case for investing in credit and bonds in the coronavirus climate where new allocation decisions for FY21 are underway.

How much bigger can the virus bubble get?

Damien Klassen

Stock markets are almost as expensive as they have ever been on a range of different measures. The economy is almost as bad as it has ever been on a range of different measures. Take note of the analysts who are contorting themselves trying to reconcile the two and telling you to keep buying. These are probably the same analysts who cheer-led the stock market at the peak of the Dot-Com bubble or just before the GFC.

Last week I wrote that we are being given a rare second chance to sell stocks. This week I'm interested in how much further the virus bubble can run before collapsing.

Will it run for years like the tech boom, or is it more like the 2015 China stock market boom and over in a matter of months?

Defining bubbles

It is important to know what type of bubble we are dealing with as this is not typical. I'll look at it through the lens of James Montier's four flavours for context:

1. **Fad or mania.** These are the 'this time it is different' bubbles. The tech-boom, the Japanese bubble, the railroad boom of the 1800s, the South Sea bubble. These are the booms where the excitement over a new paradigm turns irrational. The virus bubble is not one of these.
2. **Intrinsic.** These are bubbles which assume earnings will grow at an unsustainable rate forever. Financial stocks during the US housing bubble, resource stocks during commodity booms are examples. The virus bubble has elements of this as the assumption for many companies that earnings will recover quickly (and in some cases at all) is unrealistic.
3. **Near rational or greater fool.** These are the bubbles where investors don't believe the intrinsic value but figure there will be a greater fool prepared to bid the asset price higher. The Dutch tulip bubble is the best example. The virus bubble is not one of these.
4. **Informational.** These bubbles see investors not act based on their own information. Instead, they are working on information revealed by others. i.e. stock markets are expensive, but if everyone else is buying, then they must know something I don't. The virus bubble has elements of this.

What will pop the bubble?

Given the virus bubble is a mix of an intrinsic and an informational bubble, it gives us clues as to what the demise will be.

Informational bubbles end when other investors start selling and everyone stampedes for the exit. So, that is no help on timing.

Intrinsic bubbles end once the irrationality of the earnings is acknowledged. My best guess is a mix of bankruptcies and continued weak earnings will eventually do it. It might take six months. It might take six minutes.

A Biden win in the US election, or even the increased threat of one, has the potential to shock the market into a dose of reality with the spectre of higher taxes and wages eating into profits.

How much bigger can this bubble get?

As long as new money is flowing, the stock market bubble can keep growing.

This bubble does have a higher hurdle. Many bubbles come with increased profits which are reinvested and help to sustain the bubble. The virus bubble is the opposite, it needs new money just to fill the hole that reduced earnings and increased debt are leaving behind. Only after that can it grow.

There are four primary sources bubbles rely on for new money:

1. New investors

Globally there has been a rush of new, generally younger investors into the market. The numbers sound impressive. Robinhood, a popular new US trading platform, has added three million accounts this year. If you take the top four US online brokers, we can find another 3 million accounts in the first quarter alone. Australia, at less than a tenth of the size of the US, in a six week period 280,000 new and reactivated accounts, while UK firms reported up to 300% more new accounts in the first three months. It is a global phenomenon.

But these numbers need context. The tech boom in 2000 was also (in part) driven by new retail accounts, peaking at around 19 million US households with at least one trading account (noting a different definition of accounts) in 2001. That fell to 17 million a few years later where it has remained since.

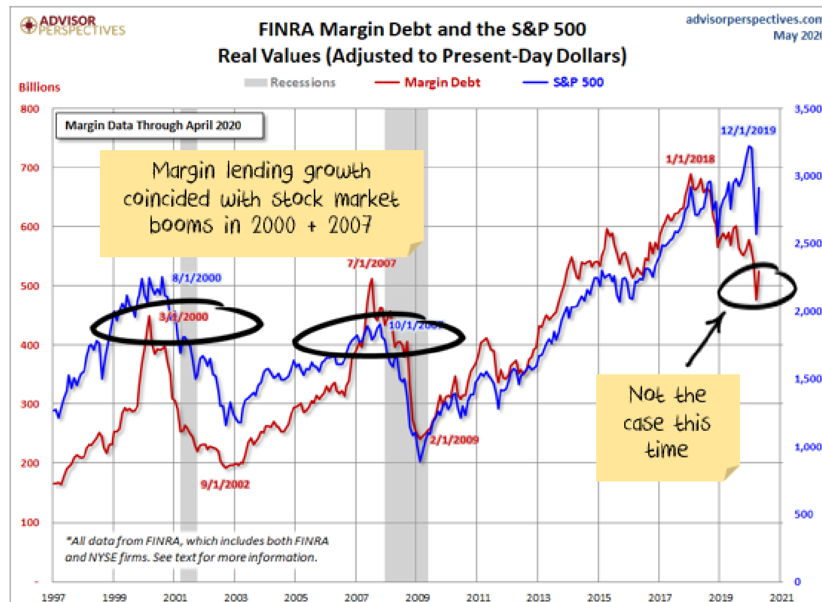
If we assume 9 million new US accounts this year, and 65% already had a household account, that gives 3 million new households with accounts. That would put household accounts above the Dot-Com boom peak.

Two conclusions: (a) the numbers are significant (b) we have probably seen most of the increase in accounts already.

But has the increase been due to bored workers stuck at home? If so, with sport resuming, we may see retail stock market trading drop away.

2. Increased gearing

Many booms involve a significant increase in debt to fuel asset price growth. This time around, however, it seems unlikely increased gearing has played a meaningful role in the boom.



3. Derivatives

The other way to obtain leverage is through derivatives which can increase the return and risk by many multiples of the investment. While the investor themselves might not be buying the stock, the market makers who are selling the derivatives need to purchase the shares to hedge against losses.

There has been a lot of additional derivative trading, with total option volumes close to double the five-year average and retail investors heavily involved.

4. Switching asset classes

The final way to get more money into a stock market bubble is to transfer money from other asset classes. This comes in two parts:

a) Central banks

Central banks are encouraging stock investment. By buying government debt, they are hoping to force investors to shuffle up the risk spectrum. Having said that, governments are also issuing massive amounts of debt.

So, to get investors to switch into equities, central banks need to buy more debt than what governments are issuing, otherwise the opposite will happen.

US government debt has increased from about US$23 trillion at the start of the year to about US$25 trillion at the beginning of May.

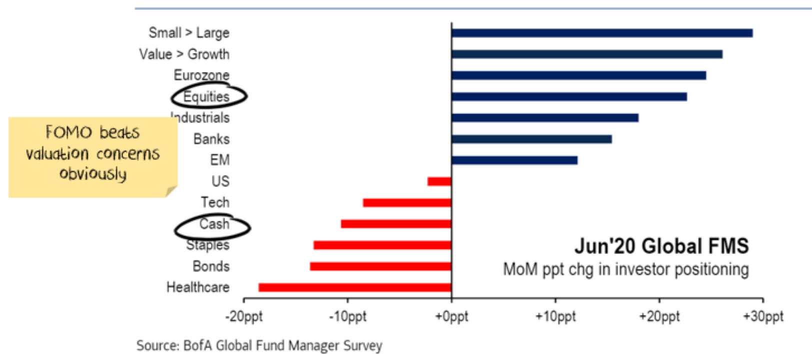
Over the same timeframe, the US Federal Reserve assets rose from US$4 trillion to US$7 trillion. US government debt will probably increase by about another US$4 trillion in 2020. So, if the US Federal Reserve does not also increase its balance sheet by $4 trillion, then money will flow into government bonds from other assets. The Fed will also need to increase its balance sheet to cover new corporate debt.

Then, repeat this problem in just about every country globally. Otherwise, money won’t continue to flow into the stock market.

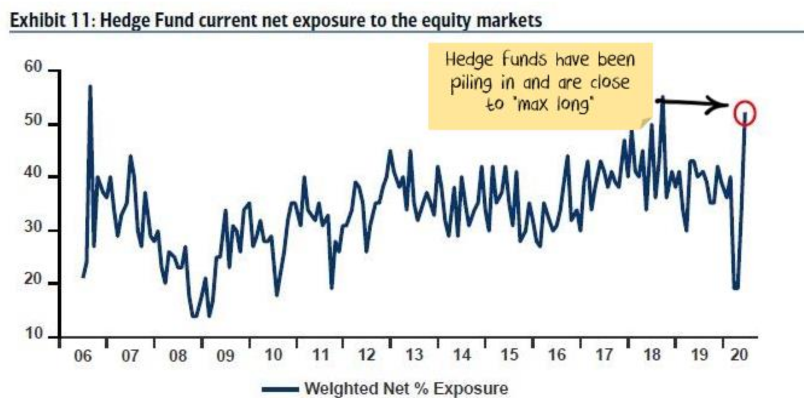
b) Investors

According to the latest Bank of America survey, fund managers agree that the stock market is overvalued:

And in April (reported in May), they acted that way, with net sales of quities. But not in May. Fear Of Missing Out (FOMO) took over, and they were buying stocks:



And hedge funds now have one of their highest ever weightings to the stock market, which suggests they are unlikely to buy much more.



Keep in mind that all bubbles are built on a grain of truth. That truth here is that central banks and governments 'have your back' and will buy anything and everything to keep the stock market high.

I think central banks will continue to bail out corporate debt markets where they can, but already we are seeing cracks with Hertz and several airlines filing for bankruptcy.

The more significant issue is small and medium businesses which (a) make up 50-70% of most economies (b) don't have traded debt that central banks can buy.

Where does that leave us?

- There are probably not that many new retail investors to add to the stock market.
- There is scope to increase margin lending but no signs of that occurring.
- Derivative use is already very high, probably can't grow too much more.
- Hedge funds (in aggregate) are a lot closer to their maximum equity exposure than their minimum. So not much more buying to come there.
- Fund managers (in aggregate) talk a good game about overvaluation but are actually relatively fully invested and so don't have a lot of scope to buy more equities.
- Central banks are running hard just to keep up with government and corporate bond issuance. It is possible for central banks to do more. They are the bull's best hope for an extended bubble.

The US tech Dot-Com boom took about two years to play out but was a different type of bubble. The China 2015 Bubble took four months before economic reality sunk in.

I expect the virus bubble will be closer in timeframe to the China bubble than to the Dot-Com bubble. But bubbles often last longer than seems reasonable.

It has been a surprisingly raucous party in share markets, but the hour is late, and the party seems to be dying down. Some partygoers are trying to find more alcohol to keep the party going. They may be successful. Regardless of their success in extending the party, given the amount of alcohol already consumed, investors will feel a lot better in the morning if you leave the party now.

Damien Klassen is Head of Investments at Nucleus Wealth. This article is general information and does not consider the circumstances of any investor.

Share trading is the new addiction

Noel Whittaker

These are nerve-racking times for investors, with stock markets bouncing all over the place. We were euphoric when the ASX hit 7162 on 20 February 2020, but that emotion was short lived as it plunged to 4546 just four weeks later.

Of course, there were headlines galore proclaiming how many billions had been wiped off our wealth, and many retirees went into panic mode. My inbox was flooded with emails asking whether to sell now and then come back in when the market had turned. Or in more extreme cases, put all superannuation into cash and then "enjoy a risk-free retirement" for the rest of their lives.

I reiterated what I have been saying for years: picking the top and bottom of markets is impossible, and the only sensible way to handle the current volatility is to take a long-term view and hang in there.

From the low day, the ASX went steadily upwards till it hit 6148 on 10 June—that's a rise of 36% in just 10 weeks. Since then it's been moving more down than up, and now we are seeing a flood of headlines indicating a second crash may be upon us. Who knows? As far as I'm concerned, it's all too difficult, and I continue to look at my portfolio on a long-term basis.

Rise of gambling-trading is a big worry

But what concerns me enormously is the rise of gambling in our community. We are bombarded with gambling advertisements, even in prime time when young people are watching, and statistics show that stock market trading has exploded during the COVID-19 lockdowns. Graham Hand has written about this in detail. One newspaper carried a two-page feature on the new breed of share traders, quoting one exclaiming, "*This is not right – it should not be this easy*." In the US, the number of active trading accounts has increased by 70%, helped by the popular trading app, Robinhood, which is offering zero commission on trades.

And that's the problem: it is all too easy. You just pick a stock, noticing it's up $0.30 today then down $0.30 tomorrow and that pattern keeps repeating. You tell yourself that there's nothing to it. Sell high, buy low and make a fortune.

Well, there is no such thing as a free lunch. The problem with trading like this is that it is essentially gambling, and it's highly addictive. Psychologists claim the hit the person gets from a successful share trade, or even a great golf shot, is remarkably similar to the hit from injecting drugs.

Let me share a first-hand experience

It's been a volatile year, and early in May when I was talking to my stockbroker, I told him I was intrigued by the ups and downs happening with such boring regularity, and thought maybe I should have a part of the action. Having watched the NAB share price rise for weeks, I sold 5525 shares at $16.38. I figured I had a good hedge as a large part of my super fund is invested in the index.

Jackpot—eight days later, NAB had fallen to $15.50 and I bought 5775 back and I was ahead. Then 14 days later, I sold that holding for $16.42 and was congratulating myself for making some easy money. But you guessed it, the next movement was up ever upwards and at date of writing, NAB is sitting at $18.67. Yes, my index funds rose, but they would have done that anyway. My first venture and last venture at trading cost me over $10,000.

(It's true—it was my first go at trading at the tender age of 80. I thought that up-and-down would keep on going. It's like the racehorse system I invented about 40 years ago which is almost foolproof.

I found that horse number two wins one in six races but there would be win, loss, loss, win, win, loss, loss, win and usually a win followed one or two losses and then there was a gap. So the trick was to look for a win and then start to bet. The trouble was you had to use a staking system to recover previous losses. Which meant you are betting increasing amounts of money, and about once every three years, a win was followed by another long run of losses which took all your money. That was a long time ago.

A professor of mathematics told me my system is nonsense because each race is a separate event).

Charlie Munger, Warren Buffett's business partner, summed it up perfectly when he said:

"In the modern world people are trying to teach you to come in and trade actively in stocks. Well I regard that as roughly equivalent to trying to induce a bunch of young people to start off on heroin."

He is spot on. A major benefit of shares is their unique ability to be bought and sold quickly in small parcels. But this benefit is also their biggest drawback. It encourages people who should never get near the share market to start to use it as a casino. Just last week, *Forbes* reported that a 20-year-old from Illinois had committed suicide when his account went US$750,000 ($1 million) into the red.

And to make matters worse, all this gambling is contributing to the volatility.

Trading is not investing

I understand we are living in uncertain times. But anybody serious about keeping their finances in good shape needs to understand the difference between investing and trading. Investors take a long-term view and do not try to catch a rising or falling market. Traders are like people who hunt day-to-day—many finish up dying of starvation.

American economist Paul Samuelson put it simply:

"Investing should be like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas."

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New ways for listed funds to fix their price discounts

Rodney Lay

Some listed investment companies and trusts (LICs/LITs) are taking initiatives to remove long-standing discounts to net tangible assets (NTA). This has recently transpired either by way of converting to an active ETF (such as Monash's MA1) or an unlisted unit trust (such as Ellerston's EGI). Alternatively, the dual structure of an unlisted unit trust and active ETF was pioneered by Magellan and Mainstream and launched last week with the Airlie Australian Share Fund (ETMF, ASX:AASF).

While some other boards have announced share buybacks, such buying has proven largely ineffective in closing discounts to NTA over the medium to longer term.

Time for boards and managers to act

With the precedents now set for all three avenues to permanently eliminate discounts to NTA, there is additional impetus from boards, investment managers (those acting in the best interests of investors) and investors to take action. Potentially, activist investors may seek arbitrage opportunities to convert or possibly wind up LICs and the sector may well now or soon be 'in play'.

For some LIC investment managers, conversion to an active ETF presents the opportunity to grow funds under management (FUM), notwithstanding arbitrage-related divestments upon conversion. Many such LICs have been precluded from growing FUM due to the persistent and material discounts to NTA. The potential for growth in FUM for solid managers is likely to be facilitated by the ongoing growth in the active ETF segment, a dynamic that is being facilitated by the structural decline of the platform space.

Given these dynamics, investment managers, whether of LICs or unlisted unit trusts, would be well placed to review their go-to-market strategies. A manager can sink the costs, time and resources now and benefit from being early to market or they can, should these dynamics come to pass, be 'forced' to do so at a later date (incurring the same costs) and be late to market.

In fact, we suggest all boards and investment managers of LICs that:

* have not shown an ability to capitalise on the single greatest benefit of a closed-ended vehicle, that is, captive capital, and

* have traded at a persistent and material discount to NTA, which is the vast majority

... initiate a review towards potential conversion.

Managed investments, in some regards, represent the peak of capitalism. If you live by the sword, then you must die by the sword. Running a fund is not some sort of gravy ride for boards and investment managers.

A discount to NTA can of course be viewed as an opportunity, over and above the prospect of solid returns from a strong investment manager. If the sector is now or soon to be in play then the likelihood of crystalising a gain through a share price reversion to NTA may increase materially.

The rise of active ETFs

The rise of active ETFs (sometimes called ETMFs or exchange-traded managed funds) will likely occur based on a combination of:

1. the fragmentation of the financial adviser sector post the financial services royal commission leading to the ongoing structural decline of platforms and unlisted unit trusts

2. the increasing use of listed investments

3. the launch of the dual ETMF and unlisted unit trust single-pool structure

4. the precedent of the first conversion of a LIC to an active ETF

5. the stamping fee ban (the irony is that the active ETF fund managers that pushed for a ban on stamping fees have just bought themselves a lot more competition), and

6. the likely resurgence of active investing versus passive investing.

With the Magellan/Mainstream dual structure now launched, every new fund managers should include in its constitution the ability to go down this route. Existing fund managers will need to carefully consider their strategic position, given the secular decline of the platforms.

The three roads to remove the discount

As described briefly above, there are at least three routes a struggling LIC or LIT could take:

1: Conversion of MA1 into an ETMF

Monash Investors is expected to change its name to Monash Absolute Active Trust and the likely listed code is MAAT. To do so, the manager will require at least 75% of votes cast in support of the resolution. The conversion, should the vote pass, is expected to be finalised by September 2020 and in which case investors will benefit from MA1 trading at parity to NTA (in contrast to the current 8% discount).

2: Conversion of EGI to an unlisted unit trust

Ellerston Global Investments (EGI) released a door stopper 408-page Scheme of Arrangement booklet regarding the proposal initially announced on 17 January 2020 to restructure EGI shares into unlisted units into the Ellerston Global Mid Small Cap Fund. This initiative is to close the sustained discount to NTA in EGI.

Our understanding is the course Ellerston Capital has pursued was viewed as the quickest route to conversion. However, converting to an unlisted trust is contrary to a key reason why many investors may have invested in the EGI vehicle in the first place, being a listed investment vehicle.

3: Launch of dual unlisted unit trust and active ETF

On June 4, the Airlie Australian Share Fund (AASF) began trading on the ASX. It brings together the features of an unlisted fund and an active ETF into a single unit in a single fund. The structure provides investors with greater choice and flexibility in how they invest and will deliver efficiencies to fund managers.

Magellan and Mainstream have developed a means for fund managers to offer one fund that can be accessed by investors through the traditional means of applying and redeeming units in an unlisted managed fund. These investors are managed by the registry, effectively on an issuer sponsored sub-registry, and transact using a shareholder reference number (SRN). Alternatively, investors can trade on the exchange (either the ASX or Chi-X) through their broker, using their holder identification number (HIN). IIR notes that there are no adverse taxation consequences for existing unit trust investors through the restructure process.

For fund managers, the development is nothing short of a potential game changer. An investment manager of an unlisted unit trust can now seamlessly add the exchange-listed distribution channel (which a certain percentage of advisors and investors are oriented towards) in addition to the pre-existing unlisted unit trust distribution channel (which a certain percentage of advisors and platforms are oriented towards).

The potential of this dual structure to grow FUM for an investment manager should not be underestimated, particularly in the context of the strong (active) ETF market growth and the progressive changes in financial advisor business models who are in increasing numbers moving off traditional platforms.

A key drawback for unlisted funds has been the excess paperwork required from an investor applying to buy or sell units. Investors have been required to complete 15- to 20-page application forms for each fund and most of these are still paper-based in 2020. This existing system of listed and unlisted funds creates an unwieldy, inelegant landscape for investors, brokers and fund managers alike.

All stakeholders will benefit

In IIR's view, all key stakeholders benefit from the development of this dual structure.

For **fund managers**, they are able to offer the same benefits of dual funds to investors without the duplicate cost structures (fund managers can save in the vicinity of $150,000 per annum by consolidating dual funds into a single product). More importantly though, where a fund manager had only offered an unlisted unit trust, they are now given a highly prospective listed distribution channel.

For advisers, the development provides more choice in portfolio construction (as some only use listed, others largely unlisted), it potentially removes the administration burden of unlisted unit trust investments.

For investors, there is a simplified view of their investments. A key feature is ensuring investors can seamlessly move between SRN and HIN and vice versa. Investors will be able to access an investment manager's pool of assets through different entry points and then have the flexibility of moving their units between their brokerage account and the issuer sponsored sub-register.

For brokers, this product eliminates the need to build a bespoke 14-message system required for the ASX mFunds. By making use of existing messaging tools, the demand to introduce low-return infrastructure is removed and thereby so too are the barriers to adoption. Brokers are able to buy units in the fund for a client as simply as if they were buying any other security listed on the ASX.

The Airlie Australian Share Fund may well be the first offering for this dual structure, but there is nothing stopping other fund managers pursuing this path once they have developed the required infrastructure and expertise to manage the active ETF aspect and adhere to the ASIC guidelines.

We suggest all fund managers closely monitor the progress of AASF with respect to FUM growth and which of the two channels that growth is coming from.

Rodney Lay is an Analyst at Independent Investment Research. This article is general information and does not consider the circumstances of any individual.

What is happening with SMSFs? Part 1

Franco Morelli

The primary source of data for this review is the 2017–18 SMSF annual tax returns. The key limitations associated with these returns are their frequency (annual) and their currency—the deadline for the returns is a long time after the end of the financial year. However, the ATO has used 2018–19 information for registrations, wind-ups, total populations, demographic data, estimated total SMSF assets and asset allocation and auditor contravention reports (ACRs).

The 2017-18 financial year was the first financial year after the extensive 1 July 2017 superannuation changes, which included the $1.6 million transfer balance cap coming into effect. Accordingly, the statistics provide interesting analysis of the behavioural changes of SMSF trustees after these measures took effect, particularly in relation to contribution levels and benefit payments.

The key take aways are:

- SMSFs are continuing to grow
- A reversion to normal for contributions and benefit payments, and
- A greater understanding of actual operating costs of SMSFs.

In addition, more granular data which breaks down how expenses are apportioned within an SMSF and for different sizes of SMSFs provides a clearer picture of the actual costs of running SMSFs. The typical operating costs are below $5000 a year for most newly established SMSFs.

SMSFs accounted for 99.7% of all super funds in Australia and collectively held 26% or $747 billion of the $2.9 trillion in super assets under management. SMSFs, therefore, continue to be an integral and significant part of the superannuation system.

There are 1.125 million Australians in nearly 600,000 SMSFs with an average fund balance of $1.3 million and a median fund balance of $720,000 (the median value is more reflective of the typical SMSF as a small minority of very large SMSFs distort the average figure).

SMSFs are typically made up of a couple with an average of 1.9 people in an SMSF and 43% of SMSFs are in some form of pension phase. These are two crucial factors that are typically glossed over when analysing SMSFs. Median assets have grown by 36% over the five years to 2018.

Better explanation of expenses

The biggest change to the ATO's statistics is a welcome update of the reporting of expenses for SMSFs. As many in the industry would be aware, recent expense data has made it difficult to objectively examine the operating expenses of an SMSF. This was recently highlighted in an ASIC SMSF fact sheet that we believe was well intended to help people consider whether an SMSF was a suitable choice. However, it lacked balance and would benefit from more context regarding different expense components.

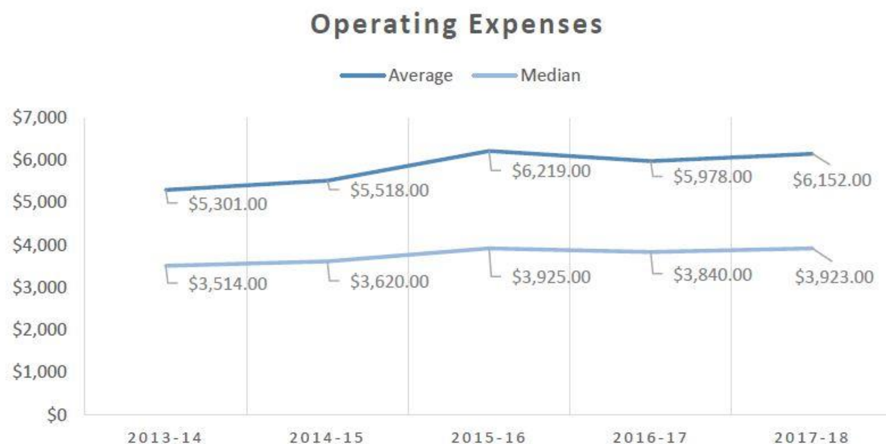
Previous analysis has relied on the use of averages, which ignores distortions from very large SMSFs and included SMSFs that have chosen to use extensive administration, insurance and investment services.

The SMSF Association has been encouraging the ATO to publish more granular expense data and we are extremely supportive of the updated data that has now been released.

So, what is new?

1. New tables that break down median and average expenses by type and asset size.
2. 'Administrative and operating expense' has been renamed 'Operating expense'. Its components of approved auditor fee, management and administration expenses, other amounts and SMSF supervisory levy remain unchanged.
3. 'Management and administrative expenses' therefore now only refer to amounts entered into management and administrative expenses in the SMSF annual return.
4. 'Investment expense' now only refers to amounts entered into investment expenses in the SMSF annual return.

With this new breakdown, the median 'operating expense' of an SMSF is $3,923. As highlighted above at point 2, this includes the typical expenses an SMSF would need to incur.

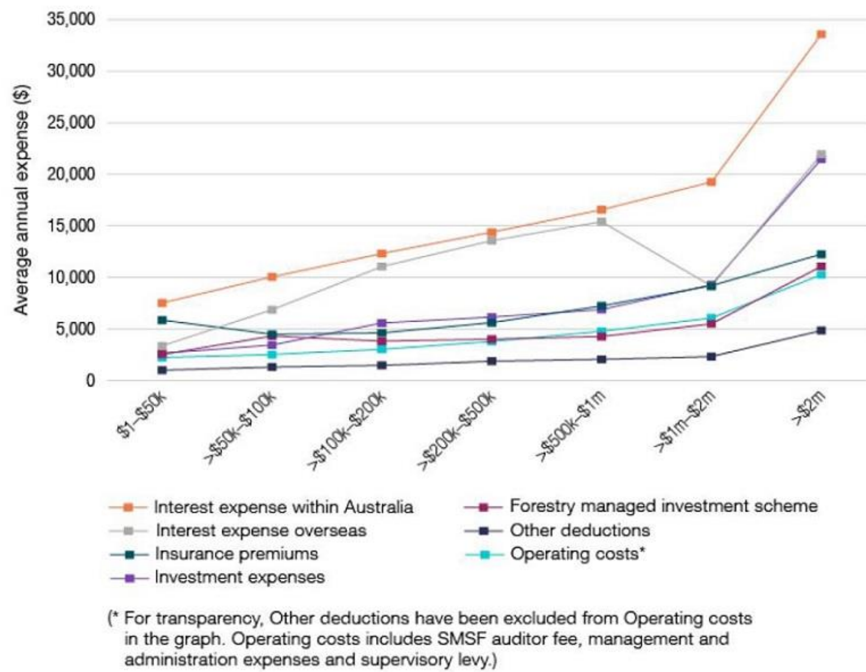


The breakdowns also allow us to determine how much the average and median expenses have been affected by those funds which undertake optional services or incur less common expenses.

The SMSF sector may be wondering how the total average expense cost of $14,879 was calculated for the 2017-18 financial year. Graph 7a below supplied by the ATO provides a visual determination.

Funds with over $2 million had a significant impact on the weighting of the costs allocated to an average figure. In addition, expenses such as investment expenses, insurance and interest were attributed to the average when many SMSFs did not use these services. The spike in these amounts is also quite evident for funds on the higher end of the scale. In particular, interest expense relating to borrowings is an expense aimed at achieving higher investment returns and not an operating expense.

Graph 7a: Average expense by expense type and asset range, 2017–18



(* For transparency, Other deductions have been excluded from Operating costs in the graph. Operating costs includes SMSF auditor fee, management and administration expenses and supervisory levy.)

Greater information can be taken from the following table on median expenses. It details the number of funds which are reporting an expense, as well as a clear breakdown for asset sizes.

Median expenses	$1-$50k	>$50k-$100k	>$100k-$200k	>$200k-$500k	>$500k-$1m	>$1m-$2m	>$2m	All funds	No. of funds reporting this expense
Interest expense within Australia	$764	$10,459	$12,515	$13,401	$13,403	$12,406	$7,394	$12,881	61,652
Interest expense overseas	$48	$4,717	$11,794	$12,407	$9,048	$3,059	$818	$9,453	351
Insurance premiums	$3,271	$3,001	$3,363	$4,175	$5,252	$6,413	$7,909	$4,532	98,821
SMSF auditor fee	$450	$473	$495	$548	$550	$574	$659	$550	347,739
Investment expenses	$149	$711	$3,877	$4,399	$4,880	$6,371	$10,734	$5,311	240,691
Management and admin expenses	$1,107	$1,331	$1,804	$2,341	$2,824	$3,437	$5,048	$2,808	444,961
Forestry MIS	$633	$2,309	$1,848	$2,869	$2,238	$2,889	$3,467	$2,538	353
Supervisory levy	$259	$259	$259	$259	$259	$259	$259	$259	470,415
Other deductions	$285	$386	$513	$473	$277	$259	$259	$317	217,770
Total expenses	$1,871	$2,645	$4,613	$6,855	$7,787	$9,588	$15,814	$7,710	470,415

If we take a fund with a typical establishment balance of between $200,000 and $500,000, only including the typical operating expenses, removing those with investment expenses, insurance, interest, and forestry MIS we can roughly estimate the median operating expense as $3400 for these SMSFs.

The updated expense data shines a light on the many optional expenses an SMSF could incur. With these breakdowns, it is clear that previous analysis included expenses such as insurance premiums and interest expenses that were not operational expenses.

We are now able to see a clearer picture of where SMSFs choose to voluntarily incur expenses that members believe provide value to their fund.

Franco Morelli is Policy Manager at the SMSF Association. Part 2 of the analysis of the new data will be published next week.

60/40? Do you have the right mix of shares versus bonds?

Amy C. Arnott

Bonds have been a beautiful thing over the past couple of decades, compounding returns at a decent clip while faithfully filling their traditional role as buffers in down markets. But now that interest rates are close to all-time lows, their future return prospects are much lower.

In this article, I'll explain why investors saving for retirement should consider shifting their asset allocations to lean more heavily on stocks. I'll also run through some of the pros and cons of doing that, especially when it comes to downside risk.

Assumptions needed for planning purposes

We generally avoid making predictions about long-term market returns. But for planning purposes, investors need to use some type of return assumptions instead of just throwing up their hands in the face of unpredictable future returns.

Looking at long-term historical norms is a place to start. Over the past 92 years since 1928, Treasury bonds have averaged annual returns of 5.15%, while medium-quality corporate bonds have returned 7.22%. If you subtract inflation, real returns are 2.17% for Treasuries and 4.22% for corporates.

But it's highly unlikely that bond returns will reach the same level over the next 10 years. The yield on the 10-year Treasury has steadily declined over most of the past 20 years, and the Fed's recent interest-rate cuts have pushed yields down even further, as shown in the chart below.

Exhibit 1: 10-Year U.S. Treasury Yield Over Time

Source: U.S. Treasury/multpl.com. Data at 31 May 2020

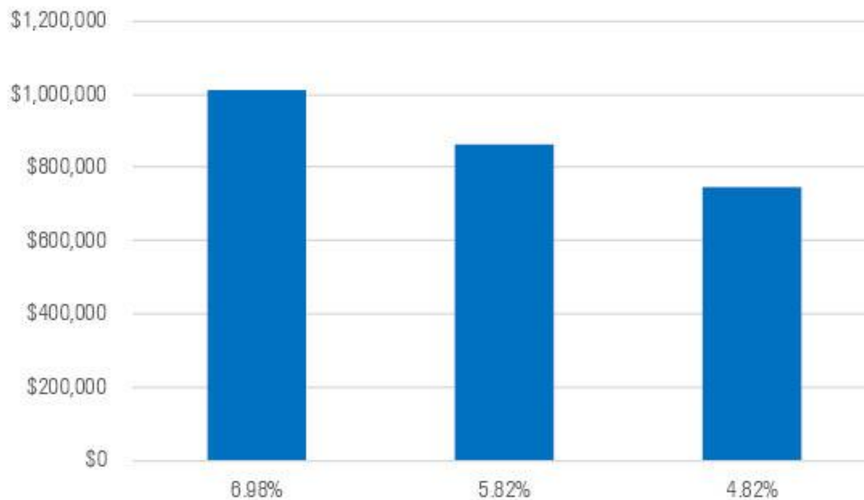
Yield makes up much of the return bond investors earn, so rock-bottom yields suggest future returns are likely to be far lower than in the past, and may not even keep up with inflation. Lower future returns have profound implications for retirement planning. Investors who stick with the same asset-allocation guidelines that worked in the past will likely fall short of their goals.

How should portfolios change?

Take a hypothetical 50-year-old investor who starts with a $300,000 balance invested in a portfolio combining 60% stocks and 40% bonds. If she's able to sock away $500 per month over a 15-year period, the outcome looks pretty good if you assume the same rates of return we've seen over the past 15 years. But if we ratchet down the return assumption for bonds to 1.5% annually, the investor ends up with about $150,000 less, which might translate into a year or two of retirement spending.

Even those projections might be too aggressive because they assume equity returns stay at the same level over the next 15 years. With a more conservative assumption of 7% nominal returns for stocks, the ending balance would total about $264,000 less.

Exhibit 2: Potential Savings Gap



Source: Author's calculations. Return assumptions are based on weighted returns for a 60/40 portfolio. Assumes a starting balance of $300,000 plus $500 monthly investments over a 15-year horizon. Date as at 31 May 2020.

Stocks to the rescue

Of course, the safest way to improve a long-term portfolio's prospects is to boost contributions (or reduce withdrawals, if you're retired). But a higher equity allocation could help fill some of the gap.

If we shift to an 80/20 mix and stick with the more conservative return assumptions, the ending balance gets a bit closer to the original level, reaching $870,000. Even shifting to a 90/10 mix (which would be more aggressive than the typical target-date fund with a 15-year time horizon) doesn't quite get the ending balance back up to the original level. It would reach about $939,000 instead of more than $1 million.

How much is too much?

Of course, higher equity allocations come at a cost. As shown in the table (exhibit 3, next page), there's a direct relationship between equity exposure and risk.

The standard deviation (a measure of risk) for a portfolio combining 80% stocks and 20% bonds is about 34% higher than the traditional 60/40 asset mix.

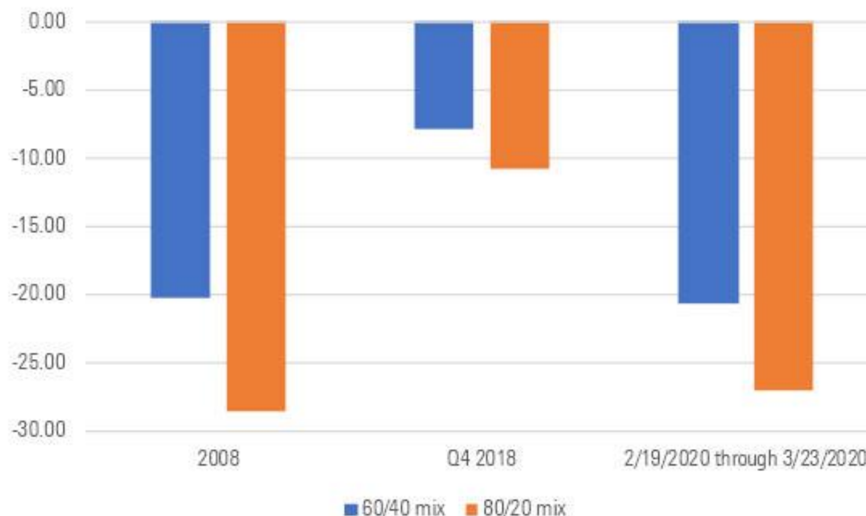
Looking at performance during previous market downturns (exhibit 4, next page) is another way to gut-check your risk tolerance before making any shifts to your asset allocation. For example, in the COVID-19 correction from 19 February to 23 March 2020, a portfolio with an 80% equity weighting would have lost about 27%, compared with a 21% loss for a portfolio with a 60% equity stake (using the US data).

Exhibit 3: Risk/Return Trade-offs for Different Asset Mixes

	Annualized						
	Total Ret YTD	Total Ret 3 Yrs	Total Ret 5 Yrs	Total Ret 10 Yrs	Total Ret 15 Yrs	Sharpe Ratio 3 Yr (Mo-End) USD	Std Dev 3 Yr (Mo-End) USD
BBgBarc US Agg Bond TR USD	5.47	5.07	3.94	3.92	4.39	1.01	3.28
50/50 mix	0.25	7.94	7.08	8.70	6.97	0.74	8.46
60/40 mix	-0.76	8.42	7.63	9.55	7.33	0.68	10.07
70/30 mix	-1.84	8.93	8.24	10.52	7.77	0.64	11.77
80/20 mix	-2.88	9.38	8.79	11.41	8.12	0.61	13.47
90/10 mix	-3.93	9.82	9.33	12.29	8.43	0.58	15.19
S&P 500 TR USD	-4.97	10.23	9.86	13.15	8.70	0.56	16.94

Source: Morningstar Direct. Data through 5/31/20.

Exhibit 4: Performance in Previous Market Downturns



Source: Morningstar Direct. Data as of 31 May 2020.

Conclusion on the right allocation

Ultimately, the 'right' asset allocation is incredibly personal. Risk tolerance is a key input, but so is risk capacity, the amount of risk you can take given your proximity to needing to spend from your savings. If you're within a few years of retirement, having an allocation to safer assets like cash and bonds won't just lower your portfolio's volatility; it will help ensure that you don't have to invade your equity assets when they're down.

At the same time, low bond yields don't bode well for future returns. That suggests overweighting bonds is apt to reduce returns, and may result in a shortfall for investors who allocate too much to them in the name of safety.

Investors will likely need to pursue multiple strategies to help address the potential savings gap. Significantly increasing pre-retirement savings and reducing planned spending can improve your odds of success.

But if you're willing to take on additional risk—and confident that you won't be tempted to sell during market drawdowns—increasing your equity exposure can help fill part of the shortfall.

Amy C. Arnott, CFA, is Director of Securities Analysis for Morningstar. This article is general information and does not consider the circumstances of any investor.

Is it time for a social impact credit system?

Dr. Paul Mazzola

As the Covid-19 pandemic persists, the universal public health system continues to be stretched and the longevity of the subsequent global economic crisis remains uncertain. The consequential social impact is far reaching, exacerbating problems of poverty, mental health, social dislocation, domestic violence, and potentially crime, and the level of unemployment continues to rise.

The long-term social costs could be disastrous. As the economy continues to deteriorate, what happens to the low socio-economic segment of our community? Will economic resuscitation relegate social benefit programs? And what happens to climate change action? Will it continue to be the victim of political jostling or forgotten altogether?

It seems that all sectors of the economy are distressed. The government is fiscally exhausted, and the household sector is facing various challenges including increasing unemployment and already historically high levels of debt, which now stands around 120% of GDP. Furthermore, the small-to-medium-sized business sector is facing a decline in consumer sentiment, a raft of closures and a spike in potential bankruptcies.

Where do social and environmental causes turn to for support?

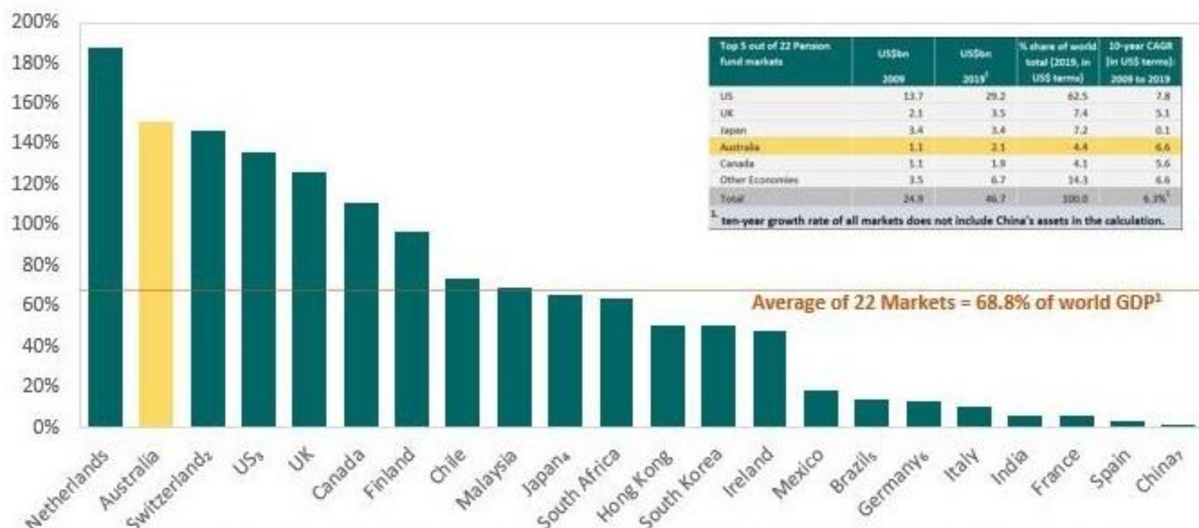
Is investment management our white knight?

Two groups still have ammunition to spare: the corporate and institutional investment management sectors. The Australian Bureau of Statistics shows that the institutional investment management industry in Australia has funds under management of almost $4 trillion. According to the Willis Towers Watson Global Pensions Asset Study 2020, the superannuation sector is the largest within the industry and finished 2019 with the world's fourth-largest superannuation market.

Before the onset of the Covid-19 pandemic, Australia also experienced one of the highest growth rates of superannuation fund assets in the world. Assets rose to 151% of GDP in 2019, representing an increase from 110% a decade ago, and a compound annual growth rate of 9.2% between 2009 and 2019. Fast, long-term growth rates have now created the second-highest superannuation asset to GDP ratio among the world's 22 major superannuation (pension) markets.

Global Pension Assets

% of GDP ratio[1]



Top 5 out of 22 Pension fund markets	US$bn 2009	US$bn 2019[1]	% share of world total (2019, in US$ terms)	10-year CAGR (in US$ terms) 2009 to 2019
US	13.7	29.2	62.5	7.8
UK	2.1	3.5	7.4	5.1
Japan	3.4	3.4	7.2	0.1
Australia	1.1	2.1	4.4	6.6
Canada	1.1	1.9	4.1	5.6
Other Economies	3.5	6.7	14.3	6.6
Total	24.9	46.7	100.0	6.3%[1]

[1] ten-year growth rate of all markets does not include China's assets in the calculation.

1. The Assets/GDP ratio for individual markets are calculated in local currency terms, and the total; **Note** that the ratio of total pension assets to GDP declined from 2016 with the addition of China. China's pension assets represent 1.5% of total GDP; 2. Only includes autonomous pension funds. Does not consider insurance companies assets; 3. Only Includes IRAs (Individual retirement accounts); 4. Does not include the unfunded benefit obligation of corporate pension plans (account receivables); 5. Only Includes pension assets from closed entities; 6. Only includes pension assets for company pension schemes; 7. Only includes Enterprise Annuity assets.

Sources: Willis Towers Watson, Thinking Ahead Institute and secondary sources, Global Pension Funds Assets Study 2020 (Released @20 February 2020); Austrade

How can our white knights rescue us?

An increase in asset allocation to Social Impact Investing (SII) is a possible solution. SII is defined as the type of investing that generates positive financial and social change. SII is differentiated from traditional investing by its intent and measurement so that both financial and social returns (impact) can be identified. Impact Investing Australia, an independent not for profit organisation, which serves as the operating entity of the Australian Advisory Board on Impact Investing (AAB), suggests that the market in Australia will reach $32 billion by 2022—although acknowledges that precise figures are difficult to determine. Nevertheless, this is dwarfed by the Australian ethical investment market, which has over $630 billion of assets under management.

An obvious application of SII is as a co-investment strategy between government and private sector organisations. Through a variety of agreed social investment activities, government could enhance social welfare outcomes and generate efficiencies. A co-investment strategy is a productive means for government to enhance economic outcomes through the multiplier effect. The alleviation of poverty and potential reduction in unemployment translates into higher consumption, taxation revenue and GDP growth.

Moreover, supplemental social benefits will accrue. One of the challenges in the growth of the SII market is the greater level of uncertainty of returns. So how can we incentivise SII? The answer can be found in the development of a universally accepted and applied social impact credit system.

Social impact credit system

The social impact credit system is one that is designed to attribute value to investments that generate a positive impact to society. It assigns a score for each SII, taking into account the nature and amount of the investment. Scores, otherwise known as credits, can be publicised by the investor thereby promoting their own corporate social responsibility (CSR) and perpetuating a ‘good corporate citizen’ perception.

It is a model that allows comparisons between organisations and incentivises social investing, volunteering and gifting in society. Ultimately, the concept of routinely incorporating CSR considerations into investment decisions could find its way into corporate mission statements, investment mandates and strategy and policy documents. This would engender a way of doing business that considers social as well as financial outcomes in investment decision-making frameworks.

Industry has struggled with the reporting of their social impact, whether through their annual reports or other media due to two major issues.

Firstly, there is the complexity and ambiguity relating to some measurement methodologies, many of which utilise subjective data.

Secondly, there is disagreement as to the preferred model. The absence of a simple universal measurement methodology accepted and used by all corporations, hinders comparisons between entities and discourages its application.

A unique social credit system has recently been established in China that suits its cultural and political system. The difference is that it is targeted at individuals instead of corporations. The Chinese system rewards individuals’ positive moral behaviour with credit points and applies negative points for anti-social behaviour. This system is unique to China and in no way reflects the proposed system for Australia. However, the common theme between the two systems is its intended influence over behaviour.

The measurement problem

Resistance to SII from the corporate sector has largely stemmed from the deficiencies and variability of various impact measurements. Effective impact measurement is essential in the corporate setting, where accountability and efficient allocation of resources is an institutional practice. A sound measurement model not only assists investors but is helpful for investees by aiding them to assess their own performance in meeting targeted social goals and use results to inform engagement in future projects.

According to a UK study in 2011, Gibbon and Dey favour a measure known as social return on investment (SROI) which accommodates key characteristics of simplicity and clarity. The ‘SROI ratio’, simply calculates a quantitative ‘return’ on a notional dollar of investment. The appeal of this measure is its bias towards quantitative factors that are well understood by industry. The model relies less on subjective factors, which use ‘financial proxies’ to quantify ‘soft outcomes’. It would seem logical for any research for a measurement methodology to consider a linkage to social development goals (SDGs) to satisfy the universal call to action to end poverty, protect the planet, and ensure that all people enjoy peace and prosperity by 2030.

A comprehensive study in 2017 by Rawhouser, Cummings, and Newbert in the *Journal of Entrepreneurship, Theory and Practice* found that standards for measuring an organisation's social impact are fragmented and underdeveloped. Therefore, they obfuscate a clear understanding of trends and best practices regarding their conceptualisation and measurement. One important observation is the need to devote resources to the collection of new data sources in order for social impact research to progress quickly.

A call to arms

The progress of research in the development of a universal measurement model to advance the acceptance of a social impact credit system should be facilitated by a concerted effort between government, academia and the corporate institutional investment management sectors. An independently controlled administrator is recommended to gather and centralise data, monitor social impact credit measurement, and compile and publish scores.

Only with a consensual approach can a universal measurement model be accepted by the SII community. This is a call to arms for a champion to further this cause.

Dr. Paul Mazzola is a lecturer in banking and finance in the Faculty of Business at the University of Wollongong. The author wishes to thank Mr Greg Peel, Mindhive, for his insightful contributions to this article.

Media worth consuming - June 2020

Jonathan Rochford

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

Finance

Close to half of US retail tenants didn't pay rent in April and May, kicking off a cascade of financial problems. As default notices from American landlords fly out the door, corporate bankruptcies soar. Rating agencies had given leeway to corporates in recent years, now they are set for a wave of catch up downgrades. The SEC has blocked bankrupt Hertz from selling almost certainly worthless shares to naive retail investors. US energy stocks are seeing wild trading in the lead up to filing for bankruptcy.

Chinese investors are taking losses on wealth management products and they aren't happy. China's banks are being pressured to make low rate loans to SMEs. German company Wirecard announced that its auditors couldn't find €1.9 billion in cash it claimed to have and then its CEO was hit with a massive margin call. EY keeps getting caught auditing dodgy companies and attacking internal whistleblowers.

Ray Dalio has gone from "cash is trash" to being concerned about a "lost decade" for equity investors. New research shows that US private equity returns aren't beating a comparable index, but they are creating an extraordinary stream of fees for managers and their advisors. A profile of the Silicon Valley billionaire who loves to point out the stupidity inherent in many investment firms. The revenge motivated buyout of StubHub right before lockdowns began will go down as one of the worst business deals ever. The author of the book "Bailout Nation" successfully applied for a government bailout for his business.

Calpers is adding leverage to its portfolio as it doesn't think it can hit a 7% return target without it. Politicians have been pressing pension plan board members not to lower return assumptions. Distressed companies are using weak debt covenants to compel bondholders to take losses. Lenders pressuring companies can be good for operational efficiency and corporate governance. Well performing European banks are opting to leave existing hybrids outstanding rather than replace them with higher yielding new issues. Japan's Norinchukin Bank, who owns 10% of the US CLO market, announced it is pulling back its investments in the sector.

Politics and culture

A non-white University of California academic rebutted the narrative that underpins the Black Lives Matter movement. Black Lives Matter protestors are defacing monuments of people who opposed slavery. Lebron James is called out for his inconsistency in supporting black rights but rejecting rights for Hong Kong citizens. When the nicest country in the world has a problem with the Chinese Communist Party, it shows that the

problem is the CCP. The LA Galaxy soccer team forced a player to apologise and then still sacked him after his wife posted unsavoury comments on social media.

The arguments that America has too many prisons and not enough police. The failure to prosecute violent and lethal actions by American police shows why qualified immunity has to go. Deaths of innocent people show why "no knock" police raids need to be eliminated. In some US states, there's a very different set of laws for police officers who commit crimes often allowing them to escape punishment. What do people want when they call to "defund the police"?

A television reporter and crew were arrested for reporting on the Minnesota riots but promptly released after complaints were made to the state's governor. An ESPN journalist encouraged rioters to burn buildings then got upset when rioters attacked his neighbourhood. American businesses have to hire their own security or arm themselves as police forces have failed to stop looters. A Philadelphia newspaper editor was ousted after using the headline "buildings matter too" to respond to looters and arsonists. The American press is destroying itself over insanely trivial matters.

Economics and work

As the Federal Reserve has forced interest rates down, Americans have responded by saving more. Negative interest rates have been proven to harm growth, with the reasons for that quite straightforward. If you are going to use quantitative easing to finance deficits, at least use it to lower taxes as that is proven to create economic growth.

The Federal Reserve has front run treasury issuance pushing asset prices up, but that will reverse unless they print a lot more money. The Fed is pushing ahead with buying investment grade-rated corporate bonds, even though the sector was doing fine without it. With a lot of help from the Fed, high yield bonds are making a comeback. The Fed has openly confirmed it has no concerns with creating asset price bubbles. The hilarious Robin Williams comparison of junkies and markets addicted to central bank liquidity.

There's a long road ahead for those trying to issue joint EU debt with four countries holding back, knowing that some recipient countries are likely to waste the funds provided. The EU is steam rolling through several economic taboos with its pandemic bailout debt. The ECB lent €1.3 trillion to banks at negative interest rates, with cheap funding encouraging banks to load up on sovereign debt.

Up to 68% of Americans receiving unemployment payments are receiving more than when they were working. Failed economists are claiming that looting is good for the economy. Keynesian economics is on its death bed. The back and forth arguments about modern monetary theory. The US government has a spending problem, driven by the soaring cost of social programs over the past 80 years. The growth in the US money supply looks like Argentina. Zimbabwe is experiencing hyperinflation, again.

Miscellaneous

70% of Sweden's Covid-19 deaths were in nursing homes with the deceased having had an average life expectancy of less than a year. A Seattle man left hospital after 60 days of treatment for Covid-19 with a $1.1 million bill. The science on how people transmit Covid-19 is becoming a lot clearer, helping guide ways to slow the spread. There's tens of thousands of people willing to risk infection with Covid-19 as part of helping to develop a vaccine.

A 20-year-old amateur share trader committed suicide after seeing a -$730,165 balance on his account, an amount which is expected to have vastly overstated the eventual outcome from his options trading. Swiss police detained and took mugshots of an eight year old boy for trying to use toy money at a local store. Planes flying with few passengers are having unusual safety issues. In the 1990s Pepsi caused riots when it failed to payout $32 billion after it messed up a competition in the Philippines. Ageing wind farms can become far more productive with new turbines. A park in Oregon has been named after the time that the town blew up a dead whale.

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

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