Firstlinks
a Morningstar company

Edition 520, 4 August 2023

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Editorial

Making a mistake is never a pleasant feeling. It's especially the case when it comes to investing. It's often money for which you work hard, save, and it can be lost … forever. And the unpleasant feeling can sit in your gut for a long time.

It has with me. I know that I've tried to gloss over and even erase the memory of market losses. It seems easier that way. The trouble is, like a lot of suppressed memories, they tend to bubble to the surface years later.

There's a better way. It involves perhaps heeding the advice from your grandmother of 'learning from your mistakes'. Yet, how do we best learn from investment failures? Here are four methods that I've found are worth trying:

1. Detach your ego from the mistake

I used to play chess quite a bit and not too long ago I went to a tournament that my friend was playing in. It was a national tournament and most of the country's best players were competing. I happened to walk into a neighbouring room to where the main competition was taking place and observed a teacher going through a chess game on a projector in front of a large audience.

What he was doing was dissecting a game that had been played by two high-ranked players earlier that day. He was pointing out the good and the bad, and the possibilities that players had on each move. Funnily enough, the players who'd competed in the game were in the audience and contributing to the discussion.

It was a collaborative, detached, almost scientific effort. And ultimately it was about how everyone could improve their chess. I later found out that the teacher was a chess grandmaster who'd been Australia's number one player for over 20 years.

A similar story comes from the world of music. Recently I listened to an interview with Rick Rubin, one of the greatest music producers of all time. He's the founder of Def Jam records, and has worked with a plethora of great artists, including the Red Hot Chili Peppers, Johnny Cash, The Beastie Boys, Jay Z, and Adele.

In the interview, Rubin addresses how he gives feedback to a musician when things aren't going to plan, and the song or album isn't what it should be. He describes how important it is to separate the music from the artist:

> *"It's never about the person. If someone takes criticism personally, the game is over. And it's helpful to remove whatever it is we're making from the people making it.*
> *Taking the ego out of all of it is such a key component of allowing the thing to the best thing it can be. If it's about **you**, it's not about **it**."* [bolding added]

Whether it be chess, music, or investments, detaching your ego from a mistake is critical to prevent repeating the same error and improving your investing skills.

2. Avoid hindsight bias

'Harry Hindsight' is a perilous thing. Unlike with chess or music, we don't often have the time or inclination to look at an investment loss straight away. And it can be looking back at an investment that was first made three, five, or even 10 years ago.

In retrospect, mistakes can appear simple and linear. For instance, a management change at the company you invested in may have altered the strategy from one of organic growth to acquisitions, and cultural issues with the takeover targets led to problems that ultimately took their toll on profitability. Or technology may have disrupted your stock to such a degree that it had to pivot into another business which proved unsuccessful. And the list goes on.

It's important though to try to evaluate an investment decision not as it stands today, but as it stood when it was first made. With the example above, could you have foreseen that management would change strategy to pursue acquisitions? Did management give hints of that before you make the decision to invest? Could you have seen back then that slowing yet stable growth would force management into making crucial decisions about future capital allocation and deciding whether to pursue more growth or not?

Often, we don't have the information we have now when we first made the decision to invest. Yet if we're to learn from mistakes, it's crucial to avoid hindsight bias.

It isn't easy. Scientific studies show that people that are aware of hindsight bias fall for it just as much as everyone else!

3. Write it down

Writing, journaling, scribbling, whatever you want to call it, is a form of meditation and reflection. It's a way of structuring your thoughts, doing a thorough analysis, and putting emotions to one side in favour of rationality.

Unsurprisingly, as a writer, I've found this is a helpful method. Not long ago, I wrote about the dumbest investment mistake that I'd ever made. It was uncomfortable, humbling, and even painful, yet it put a full stop on an investment loss that I'd previously just wanted to ignore.

4. Focus on the process

Almost all top athletes have routines. If you look at golf players closely, you'll notice that before they putt, they'll often bend down to observe the slope of the green, they'll go to the opposite side of the hole to view the slope from another angle, they might talk to their caddy, and they prepare their grip on the club in a specific way – and they'll do the same things every single time.

The reason that they have these routines is that when the stakes are high, when the pressure builds, they can rely on these routines to help them focus and relax.

It's not dissimilar in the medical world. In 2001, a critical care specialist at Johns Hopkins Hospital named Peter Pronovost was concerned about the simple errors being made at the hospital that were leading to bad outcomes for patients. He decided to tackle so-called central line infections. These are infections that happens when germs enter the bloodstream via a central line, which is like an intravenous (IV) line.

Pronovost decided to plot out the steps to take to avoid infections when putting in a central line. They weren't complex steps. In fact, they were steps that every doctor would regard as 'no-brainers'.

Pronovost asked all the nurses in ICU to observe the doctors for a month and record how often they carried out each step in the process. In more than a third of cases, the doctors skipped a step.

Then, Pronovost persuaded the hospital to authorize nurses to stop doctors if they saw them skipping a step on the checklist. A year later, the results were dramatic: the line infection rate went from 11% to zero.

Pronovost later noted that the checklist helped doctors with memory recall and clearly set out the minimum necessary steps in a process.

Like golfers and doctors, the best investors have routines and checklists too. Mistakes often happen when they don't strictly follow the process. They might skip a step. Or add a step that's normally not part of the routine.

Individual investors may not have a process at all. And that can be the biggest mistake of all.

James Gruber

In this week's edition...

Graham Hand has joined the throng of Aussies in Europe and he's in a reflective mood. It's 40 years to the month since he and his wife first set foot on the continent as starry-eyed backpackers. He looks at how the trip now is different to back then, both the good and the bad, and offers a few tips on how to save money.

Stephen Mayne has a splendid piece on how Australian companies worth billions of dollars are slipping into private hands at an alarming rate. He explores what's driving the takeover binge, why it's a worry, and what needs to be done to fix the problem.

Ashley Owen says one of the most important, but difficult, aspects of long-term investing is learning to not let day-to-day market chatter and scaremongering media headlines affect your long-term strategies. He explores how simple, diversified portfolios can continue to perform well no matter what the future holds.

Last month, ASIC and APRA slammed superannuation funds for not meeting a new 'retirement income covenant' obligation to better prepare members for retirement. **WTW's Nick Callil** says the regulators' concerns are understandable and he outlines what the funds can do to accelerate their retirement strategies.

Dr. Cameron Murray is puzzled that so many people seem to want both more homeownership *and* more landlords and rental housing. He says basic math suggests that isn't possible. Murray explains why increasing the ratio of homeownership to rental out of the stock of homes means changing ownership patterns, and that means landlords selling on balance.

Private investments are all the rage in funds management circles as they offer new potential products and revenue streams. Yet, for the average investor, are they worth putting money into? **Morningstar's Emory Zink** offers some words of caution.

At times, income from investment funds may include a component of 'tax-deferred distributions'. Due to their complexity, these distributions aren't widely understood. **Cromwell's Michael McLaughlin** offers a helpful guide to how these distributions actually work.

Finally, in this week's White Paper, **Van Eck** suggests a pivot in central bank policy, at the Fed and Reserve Bank, may be some time away, and investors should continue to focus on company balance sheets and cash flow and avoid highly volatile and speculative assets.

Curated by James Gruber and Leisa Bell

40 years on, European travel and we have changed

Graham Hand

In 1983, my wife and I backpacked around Europe for a few months before I started a secondment to a bank in London. Forty years later, we are travelling in France and Spain before heading to a family wedding in Germany.

Of course, we have been to Europe many times over those decades, but when we realised it was 40 years to the month since our first trip, we started reflecting on the changes not only in Europe and travel, but in ourselves. The starry-eyed 25-year-olds are now more worldly-wise 65-year-olds, making it impossible to say which experience was 'better'.

But let's look at how the trips were different, good and bad.

1. (Almost) everything now booked in advance

For many years, every long trip has involved a spreadsheet: dates, transport, hotel, activities, all planned by the day and booked on the internet after much research. Every hotel stay involves numerous checks of booking sites and directly with the hotel to find the best price and room, ensuring the location works for transport and activities.

In 1983, without the internet and mobile phones, we knew a start and end date and a rough direction, but not much else, except something wonderful. The Eurail Youth Pass offered two months of unlimited train and boat travel for a few hundred dollars. It was a ticket to freedom, allowing decisions to be made every day according to whim.

Accommodation was not so easy. Arrive in a new city, armed with '*Europe on $20 a Day*', and search around the train station for a 'pension' or hostel or affordable hotel. If especially lucky in more trusting times, an old lady (who was probably the age we are now!) would approach two clean-looking Australians and offer a room in her house. These turned into some of our best stays, in splendid residences where the owners needed money for living and upkeep.

But many times, the finding of a room after a long train journey was a slog, and without review services such as TripAdvisor, always a gamble. While today's review services are inconsistent, there's less chance of a dud.

Which is better? Hands down, knowing exactly where the good hotel is and already booked. It's not a time for spontaneity. A prior check on Google Street View shows where to walk as we step out of the train station, and into a quality room quickly.

2. The single currency

The euro was launched on 1 January 1999 and the change to common coins and bank notes took three years to 2002. It is a welcome improvement in European travel convenience, and no doubt was one of the driving forces behind the expected efficiency of one currency across many major countries in the European Union (but not all).

In 1983, changing currency in every country, and then making sure not too much was leftover before leaving, was a logistical exercise. The most common way to carry currency was travellers' cheques, and with the nascent adoption of credit cards, nearly all payments were in cash. The late 1980s was a boom period for adoption of travel loyalty cards, but The Platinum Card was not introduced by American Express until 1984.

So a big plus now is using one currency in all major mainland Europe countries. A few hundred euros was all the cash needed for a month of travel, and in Spain and France especially, even small purchases of a few euro were done by card or phone.

3. Minimising the exchange rate cost

While carrying a physical credit card is useful, it usually stays in the pocket, as nearly all payments are made by a swipe of a mobile phone. Here is a valuable improvement in technology, but it's not only the convenience of everything, including a great camera, on the mobile phone.

One of the last bastions of little competition, especially among the banks and financial institutions who are the major issuers of credit and travel cards, is retail foreign exchange. The 'no commissions' claim is meaningless, especially at bureaus de change, as the spread between the wholesale rates and retail rates is at least 3%, and usually more at the bureaus in airports and popular tourist spots. If travelling business class, staying in good hotels and eating well, 3% could add $1,000 or more on a $30,000 trip.

Our go-to payment method for this entire month was the Wise Visa card with euros stored on the account in advance (there is no commercial arrangement here, and no doubt there are competitors with similar offers, and any reader is welcome to add a comment to this article about any genuinely good product).

The Wise card offers wholesale exchange rates with a transaction fee of only 0.46%. For example, if A$1,000 is converted to euros using the Wise app when the wholesale exchange rate is 0.6, €600 is received less a fee of $4.60. This compares with say 3% or $30 with most banks, and worse at ATMs. On arrival in Paris, we needed some cash, and the exchange rate was 0.54 plus a €3 fee. Although we changed only a small amount, paying an extra 6% to travel around should be avoided. We topped up the Wise card as needed with quick transfers between our Australian bank account and Wise.

4. Communication

In 1983, we queued at Amex offices to collect letters from home. We waited in line at post offices to make expensive reverse charge phone calls lasting only a few minutes. We wrote 'aerogrammes' regularly as the only way to stay in touch, and those documents now record precious memories.

These days, it's all mobile phones, and Wi-Fi is good in hotels and most eating places. One downside of the heavy reliance on the phone is the agony if it is lost. I took my previous phone as a backup but I'm old enough to need a printed copy of all bookings for reassurance. I'm also in the uncomfortable habit of checking where my phone is a hundred times a day. I use the PPWW system to check I have the essentials with me – Phone, Passport, Wallet, Wife (oops, wrong order).

But what about mobile access without Wi-Fi? Our mobile provider is Telstra in Australia, and their global roaming cost is $10 a day with 1GB data. For both of us, that would cost $600 for a month.

In previous years, the solution was to buy a sim card on arrival in a city, but that involved finding the right store, changing the sim card and hoping it all worked with a new phone number.

The advent of the e-sim allows access to cheaper services loaded before leaving Australia. We used Airalo which offers a Europe regional e-sim covering 39 countries. Connection to the e-sim is downloaded directly to the phone via their app, activated on arrival in Europe. The cost for 30 days and 3GB is US$13 or 5GB for US$20. Larger downloads can be done on Wi-Fi in hotels and top up is easy if more data is required. Airalo is nominated on the phone as the 'primary' provider and moves the usual ISP to 'secondary'. It proved a reliable and cheap way to retain internet, maps, and WhatsApp access at all times.

Another great development is Google Translate to read signs or menus by choosing the camera option to give an English translation. No more wondering about the vast choices on the long menu.

5. Rental cars

Renting cars has become more complicated, and not only because the range of cars is almost infinite with many more companies. I'm reminded of the work of Barry Schwartz on *The Paradox of Choice*. Annoyingly, selecting a particular car is almost impossible as every company can supply a 'comparable car'.

The good side is that Europe offers a wonderful motorway system, and long distances favour diesel cars, which frequently give a range of 1,000 kilometres or more as they sip fuel in top gear. It's easy to average 120km/hour even for Australians not as familiar with fast driving as Europeans, who fly past at speeds approaching 200km/hour. A daunting 500 kilometres journey can be completed in four to five hours without breaking the speed rules.

(Rental car companies know how much fuel expenses can be saved on diesel and offer a 'diesel guarantee' for an extra charge when booking a car).

But tolls are everywhere and expensive. One toll in Spain after a good drive on a motorway was €27, or almost $50. Keep a physical credit card handy as waving an expensive iPhone out of the car window is an accident waiting to happen.

A major complication involves the level of insurance with the rental car company. My usual credit card provides travel insurance including coverage for rental cars, and I rely on that, but some people just want to hand back the car and not bother about the consequences of any damage, so they take out full insurances with the rental company. Fine, but it's a big cost and the rental car company always gives the hard sell on *"We'll charge you the excess and you'll need to fight it out with your own insurer"* so it's my guess they make heaps out of the insurance.

For example, to reduce the $1,500 excess to zero costs $65 a day, and there are all types of other choices, such as 'Windscreen, glass, lights and tyres' at $28 a day, 'personal accident' at $41 a day, roadside assistance at $39 a day, cross-border fee of $31, additional driver fee of $41, even a navigation cost of $43 a day when everyone has maps on their phone. We connected to the car's Apple CarPlay for no cost. If any domestic insurer can find a way to extend normal Australian car insurance to an overseas trip, it would be a great product.

6. Comfort and convenience

The big difference between the youths of 1983 and the journeyed of 2023 is the ability and willingness to pay for comfort. Travel involves a fair amount of effort and inconvenience and is likely to become less appealing as the years roll by, so take a chunk out of the kids' inheritance and do it with a bit of style, if it's affordable.

We all have different thresholds in the many facets of travel. For me, good accommodation in great locations is worth paying for, and I appreciated the room overlooking the Guggenheim in Bilbao, the Paradores hotel built inside an ancient castle on the water at Hondaribbia near San Sebastian, and the East Side accommodation

facing the Spree River and the Berlin Wall, decorated by artists in the longest gallery in the world. Memories worth paying for. And I'm not schlepping at the back of a plane for 24 hours, hoping to arrive in one piece.

But I don't need to be picked up by a limo, I don't need to eat under Michelin stars every night (although the $1,000 lunch at three-star Arzak was a worthwhile special event), I'm fine with Hop-On-Hop-Off tours rather than a personal guide, and public transport can be a great way to see a city. Assembling a dinner of cheeses, meats, bread and wine to eat by a river is every bit as good now as 40 years ago.

In 1983, we stayed in youth hotels for a few dollars, sometimes 12 people to a room, we walked a lot, and rooms in pensions were inexpensive with shared facilities. We often chose the cheapest form of transport. Comfort didn't matter so much at the time but it sure as hell does now.

And crucially, we slowed the pace this time. In 1983, we packed the days and nights and moved on. In 2023, we spent longer in one place, with more down time and even a snooze in the afternoon. It can be difficult to give yourself permission for a day off when you're in a major European city with much to see, but we relaxed into it better.

7. The economy

Staying in the booming cities of Barcelona or Bilbao or Hamburg or Berlin or Paris or Cologne in the height of summer is no guide to how the European economy is faring overall. Inflation has hit Australian prices but Europe feels more expensive than ever. Joining the queues to spend heaps of euros makes it look as if Europe is thriving and must be a great place to invest, although it barely rates in the portfolios of most Australians.

The vibrant activity in the big cities is misleading as Europe overall is not doing well economically. The Wall Street Journal of 17 June 2023 ran the following headline, and the article discusses economic stagflation, poor demographics due to an ageing population, little urge for innovation and technology, insufficient migration and a population that values free time over long work hours. As the recent elections in Spain confirm, in addition to results in Italy and Germany, politics is becoming hostage to extremes. The lessons of dependence on Russia for energy have not been learned as there is massive reliance on China for raw material supplies, such as 100% of rare earth elements, 97% of magnesium and 79% of lithium. It does not bode well for a European carbon-free future and desire to avoid reliance on oil.

WORLD | EUROPE

Europeans Are Becoming Poorer. 'Yes, We're All Worse Off.'

An aging population that values its free time set the stage for economic stagnation. Then came Covid-19 and Russia's war in Ukraine.

Reuters ran the following two days later.

World · Business · Markets · Sustainability · More

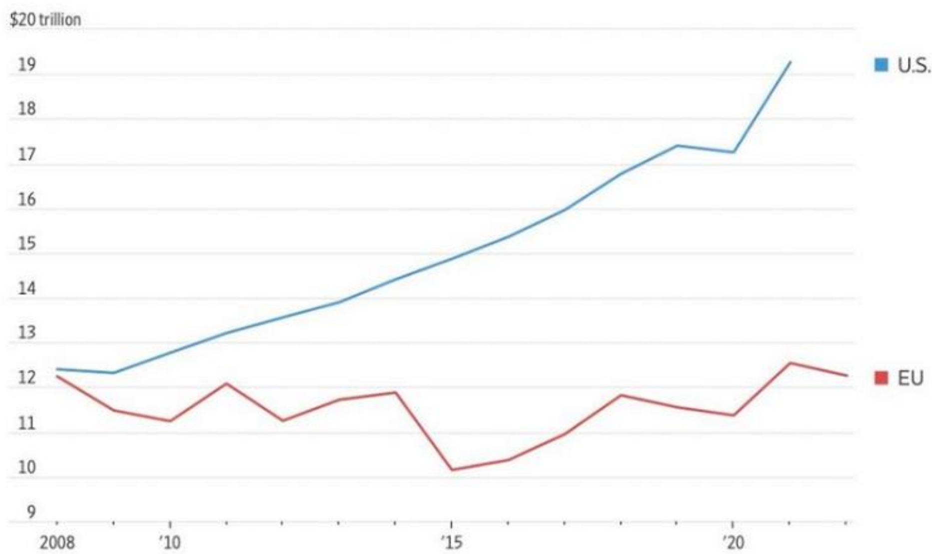
Environment

Germany debates need for siesta and cold footbaths amid sizzling temperatures

By Sarah Marsh and Rachel More

July 19, 2023 2:13 PM GMT+2 · Updated 19 hours ago

Nobody in the US, Australia or Asia, for example, would dream of imposing a siesta. Final consumption expenditure (spending on goods and services to satisfy individual needs or the collective needs of the community) was similar in Europe and the US in 2008, but Europe has since stagnated while the US is up over 50%.



Retiring overseas

According to The Australian, almost 10,000 Australians retire overseas each year, attracted by numerous benefits:

> *"Whether those Australians are drawn to the lower cost of living, quality of life, or just a change of view, there's a lot to be excited about international living."*

The article details many possibilities, including in Spain where we have just visited:

"One of the preferred retirement locations for our friends over in the United Kingdom, Spain is increasing in popularity with Aussie retirees too. With thousands of kilometres of coastline, Spain rivals Australia as a retirement destination for retirees seeking world class access to the ocean and sea. There's even a national park or two for the explorers.

> *Retiring overseas to Spain is another attractive European option for Australians, particularly given it is one of the 31 countries Australia has a bilateral social security agreement with, meaning you can access your pension from there. Given the lower cost of living, retirement looks like a dream in Alicante or Bilbao, or even the more metropolitan cities of Madrid and Barcelona."*

Lower cost of living in Bilbao and Barcelona? Quality of life? Not based on our experience. Friends have just returned from Greece and were shocked by the prices. Of course, travel expenditure is not a good guide to how the general population spends, but at an exchange rate of 0.55 to 0.6, it's almost double the amount of Aussie dollars for every euro. The quick lunch that looks a reasonable €30 is a comparable $50. We told ourselves to think dollars equals euros but that's not a fair comparison in considering retirement's "*lower cost of living".*

It's all very well for someone from rainy Manchester or Leeds or Birmingham to move to sunny Spain for a better retirement in the warmth, but it's hardly a motivation for most Australians. And despite what the article says, sitting around a Spanish or Italian or Greek village all day, away from friends and family, would drive many Australian retirees stir-crazy. It's sounds ideal but the beach taverna can quickly become tiresome. Do your research and give it a short try before making a commitment as it's tough to top the lifestyle of Australia.

Experiencing versus remembering

The Eiffel Tower looks the same although security is much tighter. The monuments of Barcelona and Berlin have been there for hundreds of years, and they haven't changed in 40 years, although more of Gaudi's amazing Sagrada Familia Basilica is finished. The astonishing cathedral in Cologne took 632 years to build so decades mean little. It's still a pleasure to walk the old parts of great cities, sit by their rivers and ports, enjoy the differences.

The biggest travel change is the way technology has made the experience easier, as Google maps beat paper maps hands down, and payments and communications and translating are light years ahead.

But there are the same hassles nobody talks about when they rave about their holidays. Travel to and from airports and train stations requires careful planning and checking. Packing every few days and carting luggage around is irksome. Deciding where to eat is tricky and time-consuming, and reviews can be misleading. Avoiding the common tourist traps takes effort, and many European cities are known as pickpocket targets.

I long ago accepted that my 'remembering' of holidays is better than my 'experiencing'. Nobel Laureate Daniel Kahneman of behavioural economics fame describes how the 'experiencing self' and the 'remembering self' are totally different and poorly correlated. He offers this thought experiment in his bestseller *Thinking Fast and Slow*:

> *"Imagine that you are considering several options for your next vacation and you reach a decision. You now learn that at the end of the vacation all your pictures and video will vanish. Furthermore, you will take an amnesic drug that will wipe out all the memories of the vacation. Would you still choose the same vacation? Would you be willing to pay as much for it?"*

I look back on our travel experiences with fondness, especially when my wife compiles a photobook of highlights. But at the time of the actual trip, the experience is often tiring and not one jolly event after another. It's as if travel is an investment in the future, a stock of good memories to spice up conversation and imagination.

This 2023 trip is too close to rank with the one 40 years ago. European travel as a 25-year-old was a unique adventure for sights and senses. For those suffering European FOMO when travellers return … remember, we only talk about the good bits, and Australia is a great place to live and travel. Retire overseas? Not a chance.

Graham Hand is Editor-At-Large for Firstlinks. This article is general information.

The sharemarket of deathly hollows

Stephen Mayne

After 38 years as a public company, vitamins group Blackmores recently fell into Japanese hands when more than 96.85% of voting stock supported Kirin's attractive $95 a share $1.8 billion takeover bid.

Sadly, this isn't a new phenomenon. The past four years has delivered an unprecedented splurge of takeovers of ASX listed companies which has coincided with an unprecedented drought of big floats, leading to a hollowing out of the ASX lists.

The 29 substantial public takeovers completed over this period have included the following ASX listed companies:

Afterpay, ALE Property Group, Ausnet Services, Automotive Holdings, Aveo, Blackmores, Bellamy's, Bingo, Coca Cola Amatil, Crown Resorts, Dulux, Galaxy Resources, Healthscope, Infigen Energy, CIMIC, Milton, MYOB, Nearmap, Oil Search, OZ Minerals, Pendal, Slater & Gordon, Spark Infrastructure, Sydney Airport, Tassal, Uniti Group, Village Roadshow, Vocus Communications and Western Areas.

List-less

The total equity value of these companies exceeded $100 billion, as can be seen from this comprehensive but quite shocking list of 163 companies which were once capitalised at more than $1 billion on the ASX but are no longer listed today, whether it be from takeover or collapse.

The ASX admits we've got a problem re-stocking the public company shelves. A spokesman said:

> *IPOs are cyclical and we are at the bottom of the cycle right now. It's the slowest it's been in a decade. However, this is not unique to ASX. It's a global phenomenon as a result of uncertain investor sentiment due to geopolitical issues, but more importantly inflation and the impact on monetary policy – where will rates go and what will be the impact on economies? Compared with our global peers, we do a lot of IPOs, and while numbers are significantly down this year, historically we have listed around 130 new companies annually.*

Takeover targets

In addition to the Blackmores exit, the pipeline of upcoming takeovers is also looking ominous with the following major deals announced but not yet approved by shareholders:

Costa Group: floated by the Costa family and its US private equity partner Paine in 2015 and then Paine has returned with an indicative $1.6 billion offer announced earlier this month.

Invocare: the death industry giant has agreed to an indicative offer by US private equity firm TPG at $13 a share or $2.2 billion in total and we're just awaiting the completion of due diligence.

Newcrest Mining: the biggest remaining ASX-listed gold miner has signed a binding agreement to be taken over by Denver-based US giant Newmont in an all-scrip offer valued at $29 billion which will go to a vote once the usual 300-page scheme book is finalised.

Origin Energy: signed a 142 page binding agreement way back on March 27 to sell itself for $18.7 billion to Canadian giant Brookfield and its US partner MidOcean Energy for $8.91 a share with a shareholder vote due later this year. This is a bit embarrassing given that the board knocked back BG Group's $15.50 a share offer way back in August 2008. If you're going to sell off the farm, at least maximise the price.

United Malt: was only spun out of Graincorp in 2020 but is being snapped up by Soufflet Group**,** a private French company controlled by the Soufflet family which has offered $5 a share or $1.5 billion in total.

So, what's left to buy and sell?

Once you've digested this surprisingly long list of 163 departed $1 billion-plus companies have a look at this list tracking what's left in the form of the current "top 150 companies" which were listed in *The Australian's* weekend edition on Saturday.

At face value, it should be re-assuring that the 150th company, 4WD outfit ARB, has a healthy market capitalisation of $2.49 billion.

However, *The Australian's* list is not what it seems.

For starters, it includes ten New Zealand companies, such as Infratil, Auckland Airport, Fisher & Paykel and Meridian Energy. Well, at least their assets aren't too far away, unlike others on the list such as Zimplats Holdings, which has a big platinum operation in Zimbabwe, or Champion Iron which only operates mines in Quebec.

For some reason, *The Australian* doesn't list News Corp, even though it has a secondary listing on the ASX and substantial assets here.

However, *The Australian* has included six ETFs listed in their top 150, such as the Vanguard Australian Shares Index which comes in at number 40 with a market capitalisation of $12.39 billion. Are ETFs even "companies"? When all they do is invest in other companies or asset classes?

Why is this happening?

There are a number of factors behind this hollowing out of the ASX. The first is our general inability to develop successful Australian head-quartered multi-national companies like Computershare, CSL, Macquarie, QBE and Wisetech.

Then there is our open-door policy for takeovers, which is arguably more liberal than other country, with the possible exception of the UK. As this list of more than 320 foreign companies turning over $200 million-plus in the Australian market shows, an increasingly large chunk of the Australian economy is foreign-owned.

Big Super on the rise

The next issue is the growing tendency for our big industry super funds to take public companies private. Vocus Communications, Sydney Airport and ALE Property Group were all snapped up by industry funds over the past three years.

Standby for more of this with toll road company Atlas Arteria expecting a bid soon from Industry Funds Management (IFM) which has already amassed a 23% stake on market.

Foreign trade buyers have also been active over the past four years with Nippon Paint buying Dulux, Canadian fish giant Cooke Inc buying Tassal and the French purchase of United Malt.

And then there is private equity

However, it is private equity which is the biggest driver, having taken out dozens of companies over the years, with many more in prospect.

And imagine if all of their prospective bids had proceeded. Surviving ASX100 companies like Ramsay Healthcare, Treasury Wine Estates and Santos have all rebuffed private equity bids in recent years.\

Too much power

The final problem is weak competition laws in Australia which have seen far too many takeovers approved, creating excessive domestic market power for the predators.

For instance, Howard Smith traded as a public company for 143 years until Wesfarmers was allowed to buy it for $2.7 billion in 2001. This eliminated its main Bunnings competitor, the BBC hardware chain, and made life hard for the remaining independents. Even Woolworths couldn't compete with its failed Masters venture.

If you read through the 'disappeared companies list' you'll see countless other examples. For instance, buried inside the privatised Commonwealth Bank is three former state banks – BankWest, State Bank of Victoria and State Bank of NSW – along with former mutual Colonial. No wonder CBA is a super profitable behemoth, making it takeover proof forever and a day.

A watchdog regrets

In his farewell February 2022 speech as Australian Competition and Consumer Commission boss, Rod Sims told the National Press Club that he regrets the power imbalance between big and small businesses in Australia, including the plight of farmers battling to get reasonable terms out of supermarket giants.

It's a problem which is being exacerbated by the current startling run of ASX takeovers and the lack of viable scaled new competitors emerging to compete.

Stephen Mayne is a Walkley Award winning journalist, shareholder activist, former City of Melbourne councillor, former spin-doctor for Jeff Kennett's Victorian Liberal Government, current City of Manningham councillor, founder of Crikey and publisher of The Mayne Report. This article was first published by Michael West Media.

The BIG picture: portfolios perform for the passive and patient

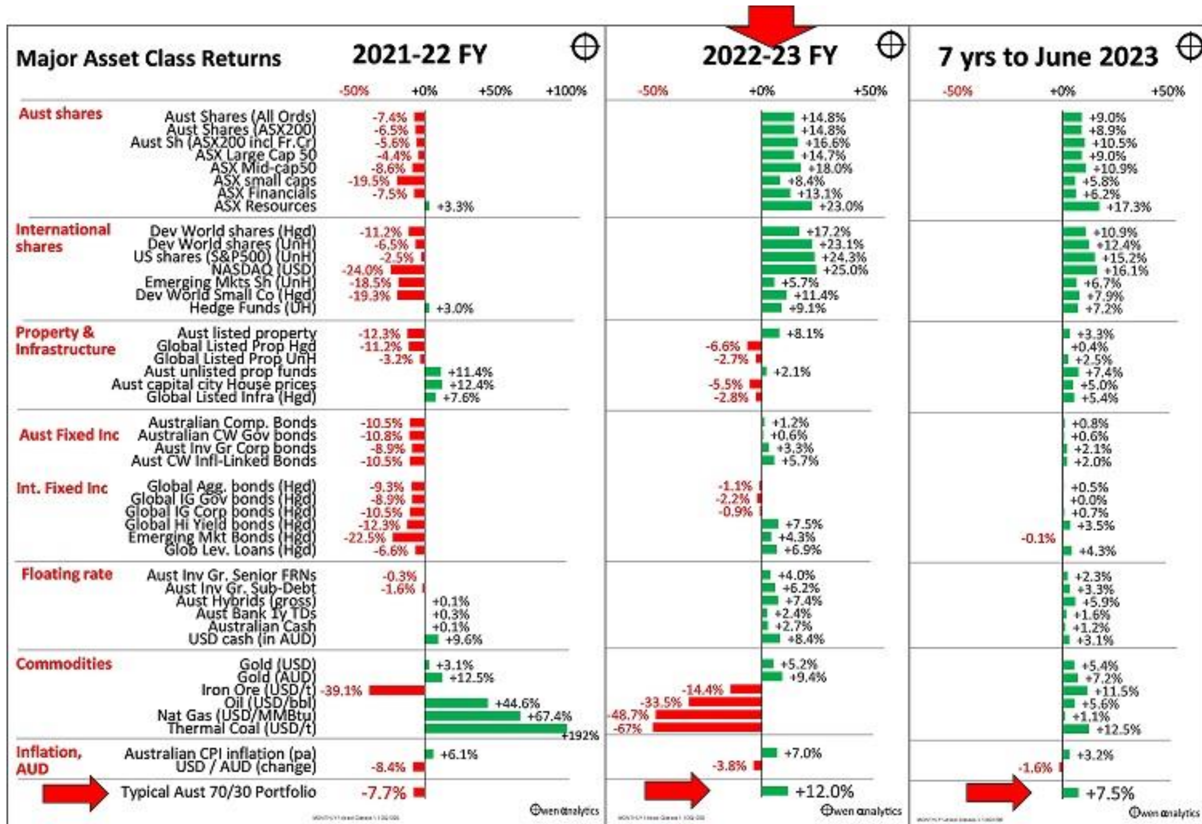
Ashley Owen

One of the most important, but difficult, aspects of long-term investing is learning to not let day-to-day market chatter and scaremongering media headlines affect your long-term strategies. Although I keep a close eye on financial markets daily (mainly to respond to a daily email inbox full of panicking punters), I look at my own long-term portfolio only once or twice per year, typically during the January break, and at financial year-end.

Looking through the day-to-day volatility and market chatter, the charts below show returns from the main asset classes for the 2022-23 financial year (middle chart), plus some other related data (commodities prices, inflation, exchange rate – in the lower section).

In the upper two sections of the middle chart, we see that in the 2022-23 financial year to June, share markets posted double-digit gains (with the best gains in recession-plagued Europe), while real estate markets (including housing) were hurt by rising interest rates, and bonds were more or less flat.

It is notable that returns on all asset classes were much better in 2022-23 than in the prior (2021-22) financial year, despite the fact that 2022-23 was the year of high inflation, aggressive interest rate hikes, quantitative tightening, crises in US regional banks and Switzerland, global slowdown fears, recessions in Europe, and declining global profits.



Diversified portfolios

The bottom line on each chart shows returns on a typical Australian diversified '70/30' portfolio (70% 'growth' and 30% 'defensive' assets, which is in line with most large Super fund 'Growth' options, and also commonly their 'default' funds). In our hypothetical 70/30 portfolio, the 'growth' side has an even mix of Australian and international shares, with 50% currency hedging.

The 'defensive' side has Australian and international fixed income (bonds), plus 5% allocation to 1-year bank TDs, and 5% in cash, to negate 'sequencing risk' - ie a couple of years of living expenses in cash and short-term TDs so we don't need to sell assets when asset prices are down.

These are just the basic asset classes, and each can be bought at very low cost by ordinary investors using ASX-listed ETFs, and/or unlisted passive index funds.

This is just a passive portfolio with no fiddling, no active funds, and no chasing hot fads. Just a boring mix of rather boring, low-cost, passive index ETFs/funds. (The returns discussed below are before fees, so the after-fee returns from passive funds/ETFs would be an average of around 0.2% lower).

In 2022-23 (middle chart), this standard passive diversified portfolio returned a very healthy 12% for the year, despite the doom and gloom of war in Europe, inflation, rate hikes, Chinese slowdown, recession in Europe, etc. If your long-term portfolio did not achieve these returns, ask your fund or portfolio manager for a detailed explanation of why.

The good returns in 2022-3 more than made up for the -8% negative return on the same portfolio for the prior financial year (left chart). The portfolio returned +21% in the 2020-21 financial year but was dead flat in 2019-20.

CPI+4% pa return target achieved over 7 years

These are long term portfolios, so we need to look beyond just annual returns. As this is a 'growth' portfolio with 70% in shares, we need to take at least a seven-year view. Average annual returns over the past seven years to June 2023 shows a sea of green across all asset classes, with modest positive returns across the board, although it is notable that all asset classes returned a little below their long-term historical averages.

Even with below average returns, our boring passive diversified 70/30 portfolio would have returned a respectable average annual return of 7.5% per year (less a fraction for passive index fund fees). This was more than 4% above the average inflation rate over the period (3.2% pa).

Why do we focus on a 'CPI+4%' total return goal? If a portfolio is able to generate long term average total returns after fees of CPI+4% pa, and holds enough cash to handle sequencing risk so we can avoid selling assets to fund withdrawals when prices are low, then it can allow a withdrawal rate of 4% of capital (4% is where the minimum withdrawal rate from super pension accounts start), and allow both the cash withdrawals, and the remaining capital after withdrawals, to keep growing to keep pace with inflation (ie. withdrawals and capital value maintain their real values) over time.

Over the past seven years, our boring diversified portfolio of passive index funds exceeded the critical CPI+4% target returns, despite the global pandemic lockdowns, the sharpest and deepest economic recessions in every country since the 1930s Great Depression, the turbulent Trump years, trade wars, war in Europe, 'Brexit', political turmoil and fragmentation across the world, the worst inflation spikes in 40 years, various banking crises, numerous corporate bankruptcies, and a host of other things to scare off investors.

Seven years ago, nobody could have predicted that events would turn out to be as bad as they did, but simple, diversified portfolios did just fine through it all!

That is the past, of course, but we are interested in the future. Although the future is unknowable, we can assume that future events will probably be just as interesting and challenging as the past, but we can also suggest that a simple diversified portfolio of low-cost funds will continue to have a good chance of generating the required returns we need in the long term.

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How super funds can better help with retirement planning

Nick Callil

APRA and ASIC's review of the implementation of the retirement income covenant (RIC) had a clear message: super funds need to do better. The report found that "overall, there was a lack of progress and insufficient urgency from [funds] in embracing the retirement income covenant to improve members' retirement outcomes."

The regulators' concern is understandable. While there were only a few months between the deadline for funds to publish their RIC strategies (June 2022) and interviews for the review, retirement has long been a high-profile area. Any superannuation industry conference or Board strategy day agenda will include retirement strategy as a key topic. The regulators have been pressing trustees towards action (albeit without 'teeth') for many years. And from a commercial perspective, funds are well aware of the hundreds of thousands of members, and billions of dollars, at stake for those who 'win' the retirement game, and the potential penalties for those who fall behind.

Barriers to progress

Many reasons for the slow progress have been well canvassed. For years, funds used the small share of overall fund assets in retirement as a reason for treading slowly. That rationale has disappeared, with the retirement phase share of APRA-regulated fund assets now at 26% and projected to reach 35% by 2032.

Funds believe they are constrained by law from providing more guidance or soft defaults for members in retirement. The Quality of Advice Review seeks to address these constraints, though the Government's response could take years to be formulated and legislated.

And yet, there is progress being made, even if it is not as visible as the regulators would prefer. An example of this is the establishment by several leading funds of a 'chief of retirement' role, focused on developing the fund's overall retirement strategy.

Such appointments are surely a powerful statement of a fund's commitment to escalating its retirement thinking. In many cases, the role is at a senior executive level, sitting alongside other 'heads of' including investment, member experience, technology, ensuring that the incumbent has a seat at the table when key decisions are made, and resources allocated.

Beyond the 'chief of retirement' appointment, however, a deeper question emerges: how does the fund organise its people and resources to develop and implement effective retirement solutions? Which functions within the organisation – often long established – fall under the retirement 'segment', and which are better designated as 'whole of fund' functions? How do existing member touchpoints and service propositions need to evolve to meet the retirement challenge? In short – what does 'retirement' mean, in an organisational sense?

A changing landscape

Even as recently as 15 years ago, funds were much simpler organisations. The predominantly outsourced resourcing model that had existed for decades was still largely intact. Growth, fund mergers and internalisation have led to the mega-funds of today, with hundreds of employees and assets in the hundreds of billions.

As fund organisations have grown, the various business functions (such as investment, operations, technology, member servicing, advice) have become more clearly delineated, with the potential for siloing and even cultural differences between these different functions emerging. Despite these inevitable frictions, the more separate operation of these functions has allowed for a clearer purpose and greater accountability for each at a senior level.

Within this framework, the natural home for the 'retirement' segment is not obvious. It does not sit neatly within, or on top of, any of the existing functions. Retirement is a 'whole of enterprise' initiative requiring input from virtually all the existing business functions, together with new thinking and resources. How to organise these parts into a successful retirement 'segment' is therefore complex, requiring a reimagination of a fund's current retirement proposition. This task remains a work in progress in most funds.

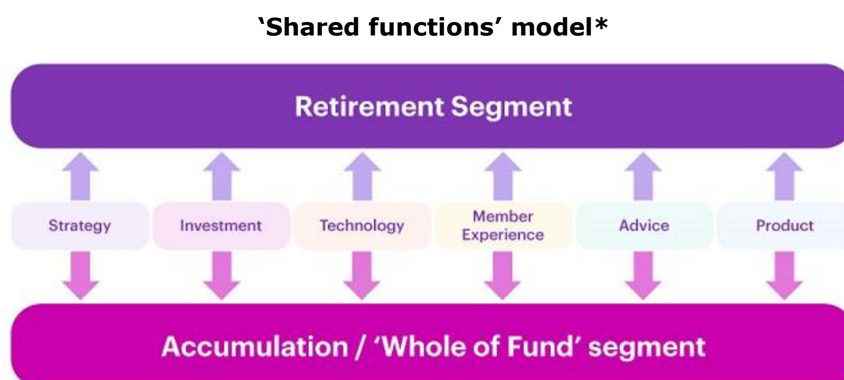
Retirement segment models

Let's consider two potential models that could be used to organise the retirement segment:

- 'Shared functions' model – where the various business functions remain 'independent' and service the retirement segment as needed, while also retaining their existing role in servicing the fund's operations (including both operations attributable to the 'accumulation phase', and operations which relate to the fund as a whole).
- 'Dedicated functions' model – where business functions are established under each segment (retirement or accumulation/whole of fund) as required, with the focus of the service dedicated to that particular segment of the business.

These are depicted (in simplified format) below.

'Shared functions' model*



'Dedicated functions' model*

** The business functions shown are illustrative and are not intended to be comprehensive, or representative of any particular fund*

Each model has its strengths and weaknesses – for example, a 'shared functions' model allows the new retirement segment to remain lean and focused, minimising organisational complexity while drawing on functional resources only as needed. On the other hand, getting the required level of focus and priority from those resources may be a challenge.

Conversely, the 'dedicated functions' model enables the development of functions specialising in retirement. A retirement investment function, for example, could explore those aspects of investing specifically relevant to the retirement phase and how the investment component of any retirement solution would be designed. A downside of this model, however, is the more complex organisational structure and the scope for costly duplication of resources.

There is no single 'right' model. A fund's existing resources and structure may well point to a more sensible approach to be taken, at least in the medium term.

In future, it is even possible that the retirement segment of large funds will become separate entities, focusing on managing money safely, getting closer to their members and continually developing innovative solutions for delivering retirement incomes. Accumulation phase entities would remain focused on scale and investing assets for long term growth.

While such a model might be decades away (if it emerges at all), it is an interesting one to consider as the industry matures, and retirement phase assets become more dominant. Meanwhile, funds will need to reimagine their existing structures, and formulate an operating model that allows them to accelerate the development and implementation of their retirement strategies as the pressure from regulators, and competitors, continues to grow.

Nick Callil is Head of Retirement Solutions, Australia at WTW. This article contains general information only and does not take into account your particular objectives, financial circumstances or needs.

Landlords selling equals first homeowners buying

Cameron Murray

Oh no, landlords will sell their dwellings. This is terrible news for renters!

If I hear this nonsense one more time…

A housing math lesson

There are about 10.8 million dwellings in Australia and we add about 160,000 new dwellings to the stock each year.

Of those 10.8 million homes, about 3.6 million are owned by landlords and rented in the private market. The rest are owned by homeowners or are public housing.

If landlords never sell, there will always be at least 3.6 million private rental homes, even if the stock of homes increases over time.

The most extreme way to increase homeownership without landlords selling is if only first-home buyers bought all the new homes. You could even call this approach an 'investor ban on new housing', which is something that people think is very bad.

Let's go through this scenario. In ten years, if the recent level of new housing construction continues, there will be about 12.4 million dwellings in Australia. But there will always still be those same 3.6 million dwellings owned by landlords that exist today.

So the best we can do is go from 66% to 72% homeownership over a decade, assuming an investor ban on new homes has no effect on how many new homes are built.

It is rarely noted that landlords not buying new homes, or landlords selling existing homes, both have the same effect of shifting the pattern of ownership. They are equivalent ways to shift the composition of ownership of the housing stock.

This would be much more obvious if we lived in a world where one person owned all the dwellings — the way to increase homeownership in this world is for this one owner to sell some of their dwellings to renters. But the maths doesn't change because there are millions of landlords.

To boost homeownership back to its 71% peak level that Australia saw in the early 1970s would require over 500,000 landlord sales in net terms — whether that is landlords not buying new homes or selling their existing homes.

That's about a year's worth of normal turnover (sales) in the housing market. It would take nearly a million of these landlord sales to get us to 75% homeownership.

The private rental sector constantly changes

It is also worth remembering that property owners buy and sell rental dwellings all the time. Dwellings often change from owner-occupied to rental, or vice-versa, even without a sale, when homeowners move in and out of a property they own.

Only about half of the dwellings in the private rental sector (PRS) are still being rented five years later, as the below table from this report shows. The rest have been sold to owner-occupiers, or their owners have moved in, or they have been redeveloped and not rented.

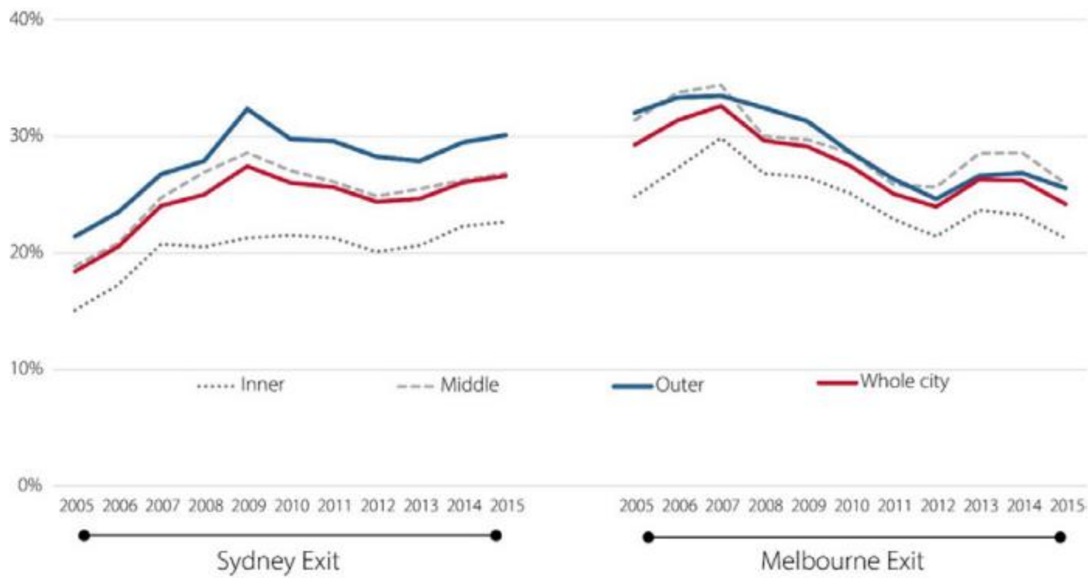
Table 1: Properties no longer in the PRS, Sydney and Melbourne, 2000–20

	First observed			
No longer in the PRS	Q1 2000 %	Q1 2005 %	Q1 2010 %	Q1 2015 %
Sydney				
5 years later	31.7	53.8	63.2	54.7
10 years later	43.7	68.6	77.7	
15 years later	48.6	75.3		
20 years later	54.0			
Melbourne				
5 years later	42.4	49.3	49.3	51.4
10 years later	51.8	58.4	65.4	
15 years later	56.6	66.8		
20 years later	65.4			

Source: The authors' calculations, based on special request NSW and Victorian rental bonds data.

In fact, about a quarter of rental dwellings are removed from the rental stock when a tenant leaves, as the below charts show.

Figure 4: Proportion of bond refunds that are for properties exiting the PRS, Sydney and Melbourne, 2005–15



Source: The authors' calculations, based on special request NSW and Victorian rental bonds data.

Every year, a huge number of homes also enter the rental market. The below charts show that in Sydney, the share of new rental bonds for dwellings that have never been rented before has been rising from about 25% of total new tenancies to 35%, while for Melbourne the churn into the rental market has been consistently higher than that.

Figure 3: Proportion of new bonds lodged that are for properties entering the PRS, Sydney and Melbourne 2005–15

Source: The authors' calculations, based on special request NSW and Victorian rental bonds data

But what about renters?

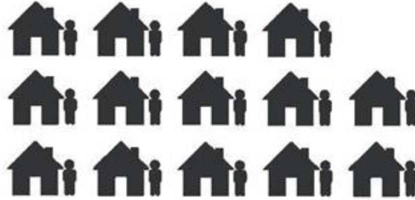
None of this ownership churn affects the supply, or stock, of dwellings. This is because a former renter who buys a home is now also no longer a renter — it's a minus one from the supply *and* a minus one from the demand for rental housing, as the below diagram describes.

Before

Private rented sector

There are around **5m** private rented homes in England, housing around 5m households.

Owner-occupied sector



There are **14m** owner-occupied homes.

What would happen if tenancy reforms caused some landlords to sell up?

Let's say the private rented sector shrinks by **1 million** homes.

Those homes do not just disappear: if they are not sold to other landlords, they must be sold to owner-occupiers.

While the supply of rented homes shrinks, the missing **1m** homes are now owner-occupied...

...which means that there are **1m** more households in owner-occupation, who are no longer demanding rented homes.

After

Private rented sector

Owner-occupied sector

Following this transition there would be **4 million** private rented homes housing **4 million** households and **15 million** owner occupied homes. Supply still balances demand so there is no impact on rents.

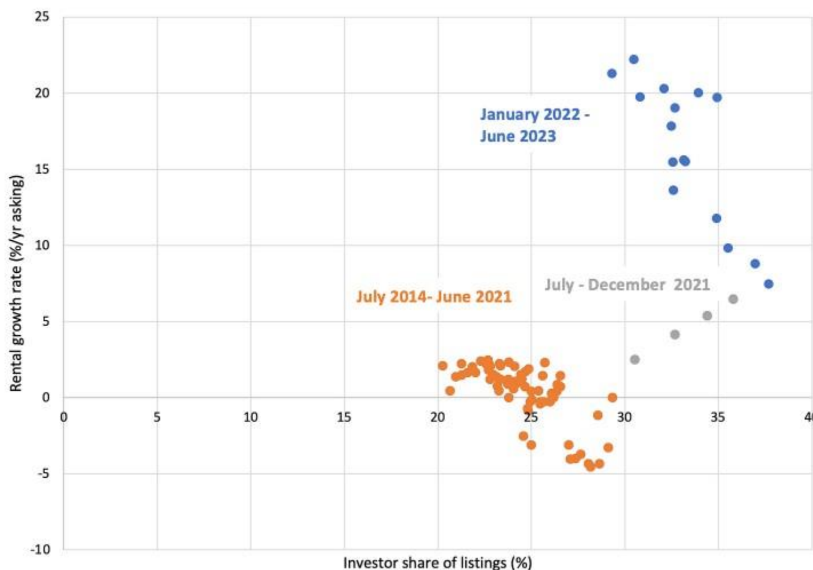
Even if a first home buyer creates a newly formed household, coming from previous homeowning households and not directly from the rental sector (like young adults moving out of a family home), this still removes the demand for housing from those people, regardless of where they would have alternatively been housed.

If you don't believe this housing math, we can directly check whether landlord sales as a share of all sales is predictive of rental increases using the chart below, where I have matched CoreLogic data on landlords (investors) as a share of new sale listings and SQM Research data on asking rents for Australia's capital cities.

Until mid-2021, the relationship was negative — a higher proportion of landlord sales was related to lower rental growth. Perhaps that's because investors sell more when rents are falling.

After a clear cyclical change in the second half of 2021, the same negative relationship is there in the last two years of data.

Overall, this data doesn't provide any evidence for the idea that more landlords selling is related to higher rents. Which is exactly what we would expect based on the simple housing math I discussed above.



It should be a puzzle that so many people can't do this simple math and seem to want both more homeownership *and* more landlords and rental housing. Sure, build more homes. But increasing the ratio of homeownership to rental out of the stock of homes means changing ownership patterns, and that means landlords selling on balance.

Dr Cameron Murray is an Economist and co-author of the Book [Game of Mates](). Subscribe to his written work at [Fresheconomicthinking.substack.com](). This article is general information.

Do private investments belong in a diversified portfolio?

Emory Zink

In our recently published 2023 Diversification Landscape report, we took a deep dive into how different asset classes performed in the past couple of years, how correlations between them have changed, and what those changes mean for investors and financial advisors trying to build well-diversified portfolios.

In contrast to most securities, which are typically traded on an exchange and valued according to rules established by financial regulators, private investments involve lending money to an endeavor for a dedicated period of time with the hope of (but no guarantee of) enticing future cash flows. In the case of venture capital, it means providing resources for the incubation and development of an idea into a durable business; the probability of failure is high but so, too, are the potential returns if the investment gains traction.

Private equity typically refers to a more developed version of venture capital, where early-stage investment in a company that eventually goes through an IPO on a stock exchange may result in attractive upside. Private credit is when investors loan directly to companies that want to avoid the broader capital markets, typically for more favorable covenants than would be available otherwise. Leveraged buyouts, real estate, and real assets—all of these also exist under the umbrella of private investments.

And as varied as these private investments are, they share a number of structural characteristics. The first is illiquidity. Once an investment is made, those assets are committed for a significant period of time (often years) before the expectation of a return, in theory giving the management team the space that it needs to make a go of the endeavor. The second is a high barrier to investment entry, given comparatively large commitment minimums and high fees relative to those of marketable public securities. The third is complex reporting. Private investments rely heavily on discretion when valuing assets, particularly in the early years when there isn't a market precedent. The industry standard for private company valuation is an internal rate of return, or IRR, that is calculated on a delay and can be easily manipulated, rather than the absolute return easily derived for securities that must transparently mark to market daily.

As a whole, these defining structural characteristics mean that private investments aren't scrutinized publicly and on a periodic schedule. Instead, they use built-in patience to give the investments the greatest probability of success. As a result, the pace and magnitude of returns differ from marketable public securities, and that contributes to a perception of portfolio diversification, but in practice, many of these private investments are simply leveraged versions of existing equity and fixed-income market dynamics.

Recent performance trends

With data beginning in 2016, the quarterly IRRs reported by PitchBook represent the general experience of each of these private investment sectors; other indexes cited represent quarterly total returns.

In the wake of the pandemic panic (first-quarter 2020), when the Morningstar US Market Index lost 20.61%, venture capital, private equity, and secondaries (a type of investment that purchases an existing interest in a company from a private equity company) also suffered losses, but they were much more modest at 1.1%, 8.1%, and 2.5%, respectively. Aided by their illiquid structures and delayed reporting, these results don't as easily reflect of-the-moment market temperament in pricing. Then, as markets roared in 2021, those same investment sectors benefited from the accompanying euphoria and rock-bottom financing rates. The one-year trailing IRRs for all three private sectors exceeded 40% in nearly every quarter that calendar year (secondaries was the exception, with 19.6% in the first quarter); venture capital reached 72% in the second quarter of 2021. Still, private investments remain susceptible to general business sentiment, and as inflation indicators picked up and anxiety over rising rates took hold, results for the first two quarters of 2022 reflected greater valuation caution. First-quarter IRRs for private equity and secondaries were modestly positive, at 1.3% and 2.6%, but venture capital's IRR lost 5.0%. Second-quarter IRRs were lower; secondaries eked out a positive 1.5%, but private equity and venture capital lost 2.4% and 8.2%, respectively.

3-year correlation matrix: Private investments

	1	2	3	4	5	6	7	8
1 Morningstar US Market	1.00							
2 Fund of Funds	0.57	1.00						
3 Private Debt	0.77	0.74	1.00					
4 Private Equity	0.80	0.80	0.89	1.00				
5 Real Assets	0.52	0.47	0.80	0.65	1.00			
6 Real Estate	0.12	0.27	0.51	0.39	0.72	1.00		
7 Secondaries	0.30	0.80	0.68	0.55	0.62	0.65	1.00	
8 Venture Capital	0.71	0.89	0.68	0.83	0.31	0.12	0.57	1.00

0.76 to 1.00
0.51 to 0.75
0.26 to 0.50
0.01 to 0.25
0.00 to –0.24
–0.25 to –0.49
–0.50 to –0.74
–0.75 to –1.00

Sources: PitchBook and Morningstar Direct. Correlations are based on internal rates of return for all but the Morningstar US Market Index, which is based on total returns. Quarterly data as of June 30, 2022.

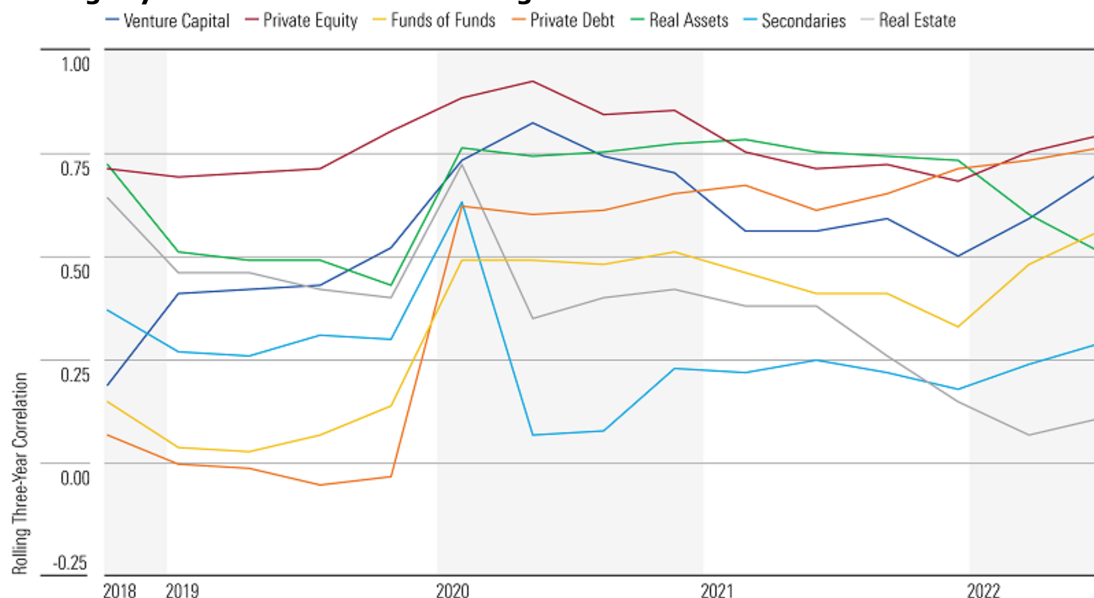
The rolling three-year correlations, reported quarterly, between the private investment sectors and the Morningstar US Market Index vary wildly and reflect volatility potential. By definition, many of these private sectors are early-stage equities. For example, the rolling three-year correlation of private equity ranged from 0.69 (at the end of 2021's bull market) to 0.93 (in the wake of the pandemic panic stress). Only private debt exhibited a negative rolling three-year correlation—in 2019's last two quarters—and that was extremely modest. From the first quarter of 2020 through the second quarter of 2022, the private debt correlations were in far greater sympathy with U.S. equities and ranged from 0.61 to 0.77.

Relative to other asset classes, the range of correlations across private investments differ dramatically from quarter to quarter, and rather than reflect reality, these are products of the structural characteristics of the asset class outlined above. Still, within private investments, venture capital and private equity are more correlated with marketable equities than private credit, and all three of these typically exhibit higher correlations to U.S. equities than real assets and real estate, which have strong niche underlying market factors that shape those markets.

Long-term trends

Over the long term, the structure of private investments means those revenue streams will look different from those of marketable securities, which more swiftly reflect adjustments to market sentiment in their pricing. This enhances diversification in a theoretical way, but investors who seek private options should remain alert to the risks unique to their underlying investment. Venture capital and private equity, for example, are leveraged and concentrated equity investments by their very structure. Through longer periods, the potential for those investments is tied to many of the same factors that lift and drag on public equity markets.

Rolling 3-year correlations vs. Morningstar US market index: Private investments



Sources: PitchBook and Morningstar Direct. Correlations are based on internal rates of return for all but the Morningstar US Market Index, which is based on total returns. Quarterly data as of June 30, 2022.

The quarterly rolling three-year correlations between these private investments and the Morningstar US Market Index have reached high points, unsurprisingly given that the investments are, by definition in many instances, equities. But these correlations can swiftly shift. For example, while private equity exhibited a 0.89 correlation with U.S. equities in the first quarter of 2020, that number declined to 0.69 by the last quarter of 2021.

Portfolio implications

While private investments remain a potential source for differentiated (though mostly delayed and leveraged) equitylike return streams, their structure merits caution for individual investors. The investment can easily fall apart without access to the highest-quality endeavours with well-resourced teams to manage those projects. This is potentially devastating given that the assets are committed for long periods of time with little recourse if something goes wrong. And while large institutional portfolios with unlimited time horizons and the ability to easily replenish funds may find private investments attractive, an individual investor without those benefits can more practically create diversification with other, more liquid and government-regulated asset classes.

Emory Zink is an associate director, global multi-asset and alternative funds, for Morningstar Research Services LLC, a wholly owned subsidiary of Morningstar, Inc. Firstlinks is owned by Morningstar. This article is general information and does not consider the circumstances of any investor. This article was originally published by Morningstar and has been edited slightly to suit an Australian audience.

A guide to tax-deferred distributions

Michael McLaughlin

Property real estate income funds can be an attractive investment for those people seeking a reliable source of regular income. Most of this income comes from rent earned on the fund's underlying properties and, as rent is usually paid monthly, a property fund is able to pay distributions monthly or quarterly, which is an advantage for an investor's personal cash flow. At times, some of the income from property funds may include a component of 'tax-deferred distributions'.

Though due to their complexity, tax-deferred distributions are rarely understood by anyone outside professional investor or tax specialist circles.

Tax-deferred distributions occur when a fund's cash distributable income is higher than its net taxable income. This difference arises due to the trust's ability to claim tax deductions for certain items – such as tax decline in value on plant and equipment; capital allowances on the building structure; interest and costs during construction or refurbishment periods; and the tax amortisation of the costs of raising equity.

In tax technical terms, tax-deferred amounts can give rise to distributions from property trusts of 'other non-attributable amounts' for trusts that have elected to be Attribution Managed Investment Trusts (AMITs) and 'tax deferred' components in non-AMITs – all referred to as tax-deferred distributions in this article.

Tax-deferred distributions are generally non-taxable when received by investors. Instead, these amounts are applied as a reduction to the tax cost base of the investor's investment in the property fund, which is relevant when calculating any Capital Gains Tax (CGT) liability upon disposal of the investment units or once the tax cost base has been reduced to nil. Therefore, any tax liability in relation to these amounts is 'deferred', typically until the sale or redemption of an investor's units in the fund when CGT may arise.

At its simplest, tax deferral works as follows: suppose a trust earns rental income of $100 and has building allowance deductions of $20. Then the net taxable income is $80, which is distributed to unitholders to be included in their taxable income. The remaining $20 of cash is distributed to the unitholders too, but for tax purposes it is regarded as a reduction in cost base of the units invested in the fund by the unitholder.

So long as the accumulated tax-deferred income is less than the investor's acquisition cost, the tax is generally able to be deferred. If tax-deferred amounts have reduced the cost base to zero – that is, if the investor has received total tax-deferred distributions at least equal to the original cost of the investment – then any excess must be declared as a capital gain in the year it is received.

Capital gains are distributed by a trust only when the trust sells capital assets at a tax profit. These gains are then subject to tax in the investor's hands, the same as other gains. Alternatively, investors are taxed on any capital gains, including any accumulated tax-deferred distributions, when they dispose of their units in a trust or the trust is wound up.

Benefits

An incidental benefit of tax-deferred distributions for investors is the 'deferral' of tax until a CGT event, such as when the sale of your units or the wind-up of the trust, triggers a CGT liability.

Tax-deferred distributions reduce the investor's cost base for CGT purposes, thereby increasing the CGT gain upon realisation. If the investor holds the units for more than twelve months, they may be able to significantly reduce the tax payable by applying the 50% discount for individuals, or by the one-third discount for superannuation funds.

Tax-deferred distributions may also be reinvested until such time as a CGT event occurs. The compounding benefit from reinvesting these distributions can be significant over time.

Case Study

The case study below shows the effect of tax-deferred distributions for an investor on the top marginal tax rate (assumed to be 45%). The case study compares a hypothetical $100,000 investment into an interest-paying investment earning 5% per annum with a property investment paying 5% distributions.

	Interest Investment ($100,000 initial investment)			XYZ Investment ($100,000 initial investment)			Difference
Year	**Interest**	**Tax Payable**	**Net Income**	**Distribution**	**Tax Payable**	**Net Income**	
Year 1	$5,000	$2,250	$2,750	$5,000	-	$5,000	$2,250
Year 2	$5,000	$2,250	$2,750	$5,000	-	$5,000	$2,250
Year 3	$5,000	$2,250	$2,750	$5,000	-	$5,000	$2,250
Year 4	$0	$0	$0	-	$3,375	-$3,375	-$3,375
TOTAL	**$15,000**	**$6,750**	**$8,250**	**$15,000**	**$3,375**	**$11,625**	**$3,375**

As you can see, an investor on a marginal tax rate of 45% and entitled to a 50% CGT discount makes a tax saving of $3,375.

Capital gain = $100,000 capital redemption, less reduced cost base of $85,000 ($100,000 initial investment less $15,000 tax-deferred distributions = $85,000) = $15,000 capital gain. Tax payable = $15,000 x 45% x 50% = $3,375. The tax payable does not take into consideration any Medicare Levy surcharge.

1. Assumptions used in the case study:
2. An individual investor invests $100,000 into XYZ Investment (for example, an unlisted property trust) in Year 1 at a cost of $1.00 per unit (XYZ Investment).
3. The XYZ Investment is redeemed in Year 4 (i.e., after three years) at a unit price of $1.00.
   No allowance has been made for any potential capital gain or loss from unit price increases or decreases during the period the investment is held. This would also have CGT implications.
4. Distributions from XYZ Investment are 100% tax-deferred for the full period of the investment (in order to illustrate the potential savings).
5. XYZ Investment distributes 5.0 cents per unit, per annum.
6. The investor does not have any capital losses available to offset gains.

Michael McLaughlin is Head of Tax at Cromwell Property Group. Cromwell Funds Management is a sponsor of Firstlinks. This article is not intended to provide investment or financial advice or to act as any sort of offer or disclosure document. It has been prepared without taking into account any investor's objectives, financial situation or needs. Any potential investor should make their own independent enquiries, and talk to their professional advisers, before making investment decisions.

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