EQUITY

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The growing likelihood of a reflation economic model and its implications

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FROM THE CEO

By John Cowling

Writing this letter each month is an interesting exercise as it forces me to consider what issues are likely to be current when Equity is published and distributed to members. In last month's issue Damien Klassen, in connection with his article on extreme valuations reached in the Gamestop short selling saga[1] said, "Weird stuff is going to keep happening". ..."When markets are no longer based on capitalism, but propped up on government and central bank support, then the biggest risk remains policy error in response to one of these tests".

Everywhere we look at the moment we can see promoters who are appearing with novel investments offering either spectacular capital growth or high yields. Last time this happened in a big way was just prior to the GFC.

Every financial bubble is accompanied by a variety of risky fads whose aim is to separate investors (both retail and professional) from their money. It's worse in the USA where the latest fad is special purpose acquisition companies (SPACs).

A SPAC, also known as a "blank check company", is a shell corporation listed on a US stock exchange with the sole purpose of acquiring a private company, thereby making it public. This approach has the advantage to the promoter of avoiding the traditional initial public offering processes and approvals. That's a "red flag" in itself.

According to the US SEC, "A SPAC is created specifically to pool funds in order to finance a merger or acquisition opportunity within a set timeframe. The opportunity usually has yet to be identified". Another red flag if ever I saw one.

According to Bloomberg "the pace of money raising from SPACs has far exceeded the heydays of traditional IPOs during the dot-com era. In terms of dollars, SPAC issuance has been running at a clip of US$28 billion a month." Now the red flags are wildly fluttering.

For comparison, IPO capital raised in Australia in 2020 was just $5.3 billion, but the market value of new listings, including IPOs, spin-offs, direct and dual listings, was up 148% year-on-year at $35.7 billion.

The ASX has ruled out jumping on the SPACs bandwagon sweeping through Wall Street, despite concerns that this could force Australian technology companies to list offshore. The ASX is no stranger to the phenomenon, having put a lid on "cash box companies" in the late 1980s, prohibiting listings where cash is more than 50% of the assets and requiring a commitment as to how the cash will be spent. No policy failure here.

So, in Australia, we haven't seen the same rush to IPOs as in the US, and recently we have seen banks and other blue chips recovering while growth stocks take a breather.

In fact, the four of the largest new listings of 2020 were relatively conservative businesses:

- TPG Telecom's (ASX: TPG) $16 billion merger with Vodafone Hutchison Australia and the listing of TPG Telecom as the combined group.
- Iluka Resources' (ASX: ILU) $2.3 billion demerger of its iron-ore royalties' business, Deterra Royalties.
- Magellan Global Fund's (ASX: MGF) $2.3 billion listing of closed class units.
- GrainCorp's (ASX: GNC) billion-dollar spin-off of United Malt Group (ASX: UMG).

Just over a year ago, in February 2020, the ASX launched the S&P/ASX All Technology Index with a market capitalisation of $100 billion and 46 members. One year later the market capitalisation of the index has grown to $170 billion, with the average daily turnover of the constituents making up $850 million of the local market.

Today, the ASX has over 30 listed technology companies with valuations greater than $1 billion market capitalisation, compared to 10 companies five years ago. Therefore, there are plenty of Australian technology stocks to consider or, if you prefer, an ETF for diversification there is BetaShares S&P/ASX Australian Technology ETF (ASX: ATEC). This new ETF tracks the technology index and has seen its price increase over the year from $14.85 in March 2020 to $20.96 today (8 March 2021), a gain of 41%. This shows the confidence investors have in high priced Australian tech stocks such as Afterpay, Xero, Altium and SEEK.

But increasingly worrying to me is the increasing household and government debt. Yes, the additional credit is driving economic activity, but what happens when interest rates start to rise?

As always, our US cousins take things to extremes with their government debt levels and it has been calculated if interest rates returned to pre-2008 levels (around 5%) then corporate profits there would drop in half. Unlikely, but never say never.

Talking about speculative asset values! Last September we ran a series of webinars on Bitcoin to help members better understand this phenomenon. It was trading at around $15,000. A member called me a week ago saying it had now passed $60,000 and they didn't know what to do. My instinct (not financial advice) says sell enough to pay back your original investment then sit back and enjoy the free ride. It's sure to be bumpy.

As Warren Buffett's business partner, Charlie Munger said: said bitcoin reminded him of an old Oscar Wilde quote about fox hunting: "the pursuit of the uneatable by the unspeakable".

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[1] Damien Klassen "Six less*ons from* the Gamestop saga" p 8, February/March 2021 Equity.

The times they are a-changing — again

By Rudi Filapek-Vandyck, Editor FNArena

It has been a while since a corporate results season in Australia was mostly about corporate performances. The last time this happened was, according to my memories, February 2018.

Back then, investors weren't so sure whether strong share price performances for companies (including Altium and Appen) could be maintained, but their financial market updates proved the doubters wrong.

Every subsequent season since has been overshadowed by macro forces, albeit to different degrees and mostly through attempts to rotate away from "quality and growth" into "banks, value and cyclicals".

The February 2021 season has proved different. That oft attempted but seldom sustainable market rotation into banks, miners and energy producers is by now five months old, and it has been solidified throughout the month with investors unambiguously showing their preference for share market laggards that stand to benefit from the rollout of vaccines globally and the re-opening of regional and international borders.

At times it was almost heartbreaking to observe how strong performances from COVID winners would receive no reward, at best, while for companies such as Webjet and Flight Centre, it almost didn't matter what financial results were being released as investors are keeping their attention firmly focused on the fact that global borders will re-open, exact timing unknown.

This year's grand debate: bonds

In 2021, the return of broad-based optimism about the economic recovery ahead has started to translate into higher bond yields which, in turn, have looped back into a weakening US dollar (stronger AUD) and a universal approval for investors to again start accumulating shares in small mining companies, banks, oil and gas producers, steel, construction and building materials, contractors and mining services providers, and other industrial cyclicals.

The sharp rise in bond yields was the big shadow hanging over February this year. Not only did it provide too big a headwind for most COVID beneficiaries, it also reignited market debate whether unprecedented stimulus and government support programs are heralding the return of consumer price inflation, which would justify even higher bond yields.

Central bankers joined the debate. They said: "No, it doesn't." The alternative view is that bond yields fell in 2020 because of the global pandemic, and as market optimism grows those yields are simply pricing out the virus impact.

On the first Monday of March, the RBA used its money printing power to put a halt to what risked becoming an unruly trend that could well grow beyond control. More intervention from central banks worldwide might well be in store.

Whether it settles this debate once and for all is highly unlikely, but if the temperature on bond markets cools down, which would be the prime target for central banks the world over, then at least equity investors can start focusing again on corporate earnings, balance sheets, quality of business models, structural trends and valuations.

For investors, maybe the key challenge is to find a portfolio balance between direct winners from higher bond yields and this year's economic recovery, and those robust business models that might be temporarily out of favour, because they performed so well in the past, and whose runway for growth continues to be supported by new structural mega-trends and tectonic shifts into tomorrow's technology-driven new economic reality.

Certainly, a less dominant theme of rising bond yields will more easily allow companies such as ResMed, Xero, Charter Hall and Altium to regain a firmer footing, and thus investors' attention.

Reporting season: the stats

At the micro-level, i.e, corporate results, the February reporting season has already been declared "the best in 20 years", and FNArena's data and statistics certainly support such a bold statement.

Out of the 346 companies monitored over the month, 163 or 47% beat expectations, while only 44 companies delivered an unambiguous disappointment for an ultra-low miss rate of 12.7%.

Earnings forecasts have risen throughout the month for prospective growth of 15%, led by the banks and iron ore miners. Usually, forecasts on balance fall during reporting seasons.

The average individual target price increase was 4.95%, while all 346 targets in aggregate rose by 6.24%.

Of equal importance for many income-oriented investors, dividends are recovering much quicker than profits (dividends also fell much deeper last year), and with the prospect of ongoing big payouts from iron ore miners and banks, market strategists at J.P. Morgan recently declared a "super cycle in dividends" awaits the Australian share market over the coming three years.

Small cap tech under pressure

Having said all of the above, there is no denying a rather large number of highly popular, highly valued, strongly growing businesses have come up short these past few weeks, which has weighed upon share prices irrespective of bond market shenanigans.

The aforementioned Altium is one of them, but we can easily add a2 Milk, Appen, Nanosonics, and many of the smaller cap technology sweethearts, including Aerometrex, Bravura Solutions, Catapult Group, Infomedia, ResApp Health, Temple & Webster, and others.

During a time when share market laggards — from the banks to Western Areas, and from Lynas Rare Earths to Telstra — proved they are still worth investor attention, as long as the economic recovery remains on schedule, many of the former can-do-no-wrong share market darlings revealed some of their own vulnerabilities and weaknesses.

No doubt, for some investors this has further galvanised their appetite for more cyclicals and less quality, defensives and growth, but one needs to keep in mind the theme of backing last year's COVID victims will run its course at some point, while central banks remain convinced there is no sign of sustainable inflation on the horizon.

The major failures

Every reporting season opens up a list of major failures, and this time AGL Energy delivered one of the eye-catching, negative performances.

AGL's share price has been in decline for over four years as the power network operator and electricity generator struggles to combine old world coal fired power stations with new world renewables and the need for more grid flexibility. It is but an existential dilemma for all to witness; one that is unlikely to be resolved by simply separating out the dirty coal operations.

In the same vein, Unibail-Rodamco-Westfield might be the proud owner of several of the highest quality shopping malls around the world, but burdened by too much debt, lockdowns, the shift to online and the threat of ongoing asset devaluations, management's task of manufacturing a successful transformation is not being made any easier, irrespective of this year's recovery.

Another one of February's spectacular disappointments was delivered by machine learning and artificial intelligence data and services provider, Appen.

While the need for such data and services will remain high in the years ahead, Appen's small base of key customers seems to have injected more price competition among suppliers and Appen, valued as a high growth company with sheer unlimited potential, has felt the repercussions through a gigantic share price devaluation, with ongoing risk for further negative surprises.

Investors equally did not respond in kind when Coles Group suggested it had to invest more to future-proof the business, while growth might temporarily turn negative when compared to last year's big boost from COVID lockdowns.

The supermarket operator might as well have rung the bell for last year's COVID beneficiaries in general, which are facing tough comparables to beat in 2021. The opposite remains the case for last year's laggards, including the banks, who managed to crown themselves as the “super-duper come back kids” in February, with ongoing promise of higher dividends, and even special payouts, as the recovery materialises.

February stand-outs

Banks, materials (ex-mining), insurance and retailers enjoyed the strongest forecast upgrades over the season.

Analysts believe the first three will continue to benefit from improving global growth and vaccines, while retailers might face headwinds due to vaccines and spending being redirected back to services, which explains some of the hesitant share price movements post results.

If it wasn't for the acceleration in bond market sell-offs (yields rallying higher), investors might have enjoyed stronger and longer-lasting share price responses to match February's above-average outcome.

At the same time, it's good to remind ourselves expectations were low across the board and many businesses responded to last year's challenge by cutting back on expenses, including capex in many cases, while also enjoying extraordinary support through rent relief and the Federal Government's Jobkeeper program.

The December quarter business indicators in Australia, released immediately after the February season, revealed company profits fell sharply by -6.6% as government stimulus payments ceased.

Even though some economists had pencilled in a potentially worse outcome, this extra data insight can serve as an unofficial warning to investors that this is by no means a time to allow complacency to creep in, with or without ultra-volatile bond markets.

Rudi Filapek-Vandyck is the founder/Editor of FNArena, an online service providing impartial analysis and proprietary tools for self-researching investors at www.fnarena.com

Members of ASA can enjoy a one-month free trial by sending an email to info@fnarena.com and put ASA benefit in the subject line.

The growing likelihood of a reflation economic model and its implications

By G Parkes, Editor of Lonsec's The SMSF Investor

One of the most common phrases in the investment landscape in the past few months has been the “reflation trade”. Indeed, for some time now our portfolio strategy pieces have been centred around how the high frequency economic data has been changing to reflect a growing likelihood of the reflation economic regime being predominant in late 2020 / first half of 2021 for most of the world, and the most likely result for asset class performance.

However, the term “reflation” can be confusing for investors not used to industry terminology, and generally leads investors to ask: “What exactly is reflation, is it the same as inflation, and what are the investment implications?” It’s also instructive to see how products like ETFs and managed funds have performed through this time.

So, what is reflation?

Reflation can generally be thought of as the upswing of the economic cycle where both growth and inflation are accelerating. This generally (but not always) comes after a period of deflation where both growth and inflation were decelerating (such as in recessions).

A classic case of deflation was during the COVID pandemic of 2020. Economic growth rates fell heavily as large swathes of the global economy were shut down, with the accompanying downward price shocks. This is classic deflation, with both growth and inflation decelerating.

However, as both fiscal and monetary policy makers went big with extreme counter measures such as zero interest rates, massive asset purchases and liquidity injections, and huge fiscal stimulus measures, the recovery got going, and after a few wobbles in September and October really cranked into gear late in 2020. The removal of uncertainty with the resolution of the US presidential election helped confidence, however the big pivot point was the COVID vaccine efficacy results. All of a sudden, the overhang of the then “still bad” COVID case numbers was able to be looked through, towards a more normal world, helped by steadily improving data. And so, in early November 2020 the reflation trade really got going in earnest.

Is reflation the same as inflation?

Although they sound very similar, inflation is not reflation. Inflation only measures how the prices of goods and services are changing. The Consumer Price Index is well known, which measures how much the prices of a basket of goods and services changes each year. This is known as the annual inflation rate. Whilst this is a very important data point, it is only one half of the equation. Reflation needs both GDP growth and inflation to be accelerating. It is this combination that markets react to.

What does it mean for investors?

Different combinations of growth and inflation have historically provided very specific outcomes for investment markets. If you can become familiar with them, then investment markets start to make a lot more sense, rather than seeming random and chaotic.

Historically, reflation tends to be good for commodities and shares. However, within the share market, there is a wide dispersion. It tends to favour cyclical sectors such as financials, energy, and resources, and generally higher beta (higher risk) stocks such as small cap stocks.

On the flip side, reflation is generally accompanied by rising interest rates in the bond market (such as the benchmark 10-year Government bond yield) due to rising inflation and a better growth outlook, which is exactly what has been happening recently. This provides a headwind for assets like fixed rate bonds, bond funds and ETFs with significant duration or interest

Classic Reflation since early November 2020: Commodities up, shares up, bond yields up rate sensitivity, gold, and interest rate sensitive shares (the so called "bond proxies") such as REITs, utilities, and infrastructure. (Having said that, there is no doubt that COVID-specific issues have also caused significant distortions to sector performance this past year, and so interest rate sensitivity is not the only factor at play for these sub-sectors).

How has this affected ETF and managed fund performance?

Big macro factors such as rising bond yields play a significant role in the performance of managed funds and exchange traded funds (ETFs). This is due to the fact that these diversified products tend to be a way to gain exposure to an entire asset class, sub-sector or investment theme. Therefore, understanding the macro forces at work behind the scenes is important to be able to contextualise performance. Just because a product has a bad one-month or one-year performance, does not mean it's a bad investment. It all depends on the context, and the background factors.

Let's look at a few examples using fixed interest ETFs to illustrate this point.

On the ASX, there are about 40 ETFs that are listed as being in the "fixed interest" asset class. Now, most of these ETFs are quite sensitive to the direction of bond yields. In other words, if interest rates go down, their prices go up, and vice-versa. The most important interest rate gauge to keep an eye on is the US 10-year treasury yield, and also for Australian investors the Aussie 10-year Commonwealth Government bond yield. As can be seen in the graph above, both of these have been rising steadily since November, and really caught fire in February. When we look at our ETF performance tables, here are the one-month and one-year performances of two popular fixed interest index ETFs (all returns in the table below are as at 28/02/2021).

ETF	One month return	One year return
Vanguard Australian Fixed Interest Index ETF	-3.47%	-2.76%
Vanguard International Fixed Interest Index ETF	-2.56%	-1.80%

Negative returns across both time frames. Does that mean they are bad investments?

No, it doesn't. Both of these ETFs invest based on a fixed interest index, and are sensitive to movements in bond yields. The negative performance is simply a reflection of those rising yields, which is an expected outcome in the "reflation" regime where growth and inflation are accelerating. In the middle of 2020 during the COVID pandemic and plunging bond yields, it was the opposite with these same ETFs posting great returns. The moral of the story here is don't just look at returns and pass judgement. Put those performance numbers in the context of what the ETF or fund actually does, and the macro environment we have been in.

Let's look at a couple of other fixed interest ETFs, this time active ETFs with a different strategy:

ETF	One month return	One year return
ActiveX Ardea Real Outcome Bond Fund	+0.27%	+4.36%
ActiveX Kapstream Absolute Return Income Fund	+0.03%	+4.93%

This time, we have positive returns in February even though rates rose strongly and many bond ETFs and funds suffered, and quite strong one-year returns. The reason is that these ETFs have an underlying strategy that is very specific, very active, and not reliant on bond yields falling to obtain a return.

Does this mean that these ETFs are superior to the index ETFs we looked at above? No, not necessarily. They are just different, and are often blended together in portfolios to have exposure to either outcome.

In mid-2020, when index bond funds were flying high due to plunging interest rates, these active ETFs would have looked mundane and viewed as "underperformers". Not so now. See how it changes, based on how the underlying strategy of the fund meshes with the macro backdrop. In December 2020, we actually highlighted the Ardea Real Outcome Bond Fund as a fixed interest "Investment Idea" for our members, for the very reason that rising bond yields (and our forecast of that continuing) was a headwind for regular index-based bond funds and ETFs, and that this fund did not have that issue due to its strategy.

The bottom line

The bottom line in all of the above is that investment markets move to a rhythm, dictated by the business cycle. If you can understand where we are in that business cycle and what is happening at the macro level (what we call the Portfolio Strategy piece) and combine it with understanding what a company, ETF, or managed fund actually does (what we call the Investment Research piece), then you give yourself every chance of successfully navigating your way through financial markets to accomplish your investment goals.

Graham Parkes is a macro analyst, and the editor of Lonsec's The SMSF Investor.

Cleaner energy bringing greater returns

By Leo Armati and Pablo Berrutti, Altiorem


Society's values on energy production have changed drastically in the last 100 years. Burning fossil fuels has allowed companies, countries and empires to prosper and create booming global economies. However, through an increased understanding of environmental and health impacts, and changes in technology and societal values, people are today looking for cleaner, environmentally friendly and socially responsible ways of generating energy. As well as this, investment into this area has boomed due to the feasibility of the projects and their way of generating not only green energy, but financial returns.

The shift in energy production can be attributable to a range of factors. In recent years, the cost of producing power from gas has significantly increased the wholesale price of power, however the growth in renewable energy has seen prices fall overall by an average of 7.1% between 2019-20 and 2021-22.[1] Climate and health issues have also been a major concern for consumers and investors as societal values have changed. It is proven that burning of fossil fuels pollutes the air and negatively affects human health, with WHO stating 91% of the world's population breathes air that exceeds guideline limits in terms of levels of pollutants.[2] With this in mind, investors now want to allocate capital to gain both a financial and social return on investment (ROI). Examples include Atlassian founder Mike Cannon-Brookes backing the large-scale renewable project called Sun Cable and high-profile Fortescue boss Andrew "Twiggy" Forrest's dual support for green steel and Sun Cable.

Unbeknown to some, these more efficient and ethical technologies are also producing greater investment returns for shareholders than traditional global energy companies. A June 2020 report by the Imperial College Business School in London and the International Energy Agency[3] explored risk and return for renewable energy companies in the US, UK and Europe and found that listed renewable energy portfolios have outperformed fossil fuel portfolios over the last decade and were less volatile. Importantly, the report found that performance of renewable energy portfolios has significantly improved over the last five years while volatility has decreased.

While this past performance is encouraging, investment is about the future. In this regard the Inevitable Policy Response Report[4] paints a picture of a potentially disruptive transition from fossil fuels to renewable energy as countries seek to catch up for lost time and climate impacts worsen. Their scenario sees coal phased out by 2040 and two thirds of all electricity generated by wind and solar by 2050. These timescales matter given new energy infrastructure assets must operate for decades to deliver expected rates of return.

Another related and important transition is to electric vehicles, which outside of Australia has shown significant growth with leading car manufacturers committing to 100% battery powered product ranges and phase-out plans for internal combustion engine (ICE) vehicles in countries like the Netherlands, Denmark, France and Ireland. This is in part because the European Union's CO^2 targets for 2021 require EV and hybrid vehicle volumes to double.[5] The combination of renewable energy, which has already become cheaper than fossil fuels in most countries, and electric vehicles, which are expected to be competitive with internal combustion engines in the next few years, point to the twin disruptions of transport and energy that could result in significant pain for shareholders facing stranded fossil fuel assets and underfunded remediation liabilities.

A broader cleantech shift means that renewable energy and transport are not the only areas for opportunity when it comes to the transition to a low carbon economy. The Deloitte Australia CleanTech Index (DACT) comprises 90 companies listed on the Australian Securities Exchange which are included in sub-indexes involved with clean technologies ranging from waste and water to smart grids and green buildings. While many are smaller companies which can carry higher risk, the index achieved a 31.8% gain[6] in the year to February 2021, outperforming the ASX 200 which was 1.5% lower. This was the seventh consecutive year the index has outperformed the market. Over five years the index has delivered a 117.1% gain vs a 32.2% gain for the market. This positive performance reflects the significant growth of cleantech, however, like any investment, there are risks and not all companies in any sector will be good investments. Investor due diligence is always important.

As Australia is one of the world's biggest exporters of coal and gas, our economy and the share price returns of fossil fuel companies face significant risks. A green and prosperous future will require a substitute for the loss in export revenue. Sun Cable aims to become the first exporter of green energy, utilising solar energy in Australia to be exported by submarine cable to the Indo-Pacific region. As cleantech and renewable energy companies mature, there is a risk of flight if Australia does not have a supportive environment for their growth. It is important for all Australian shareholders, including millions of Australians through their superannuation funds, that these opportunities are available domestically.

As we start 2021, it is a good time for all shareholders to assess their portfolios' exposure to the great shifts and trends which will shape global economies in the years ahead. Many may be left uncomfortable by what they find. E

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1 *Australian Energy Market Commission, 2018 Residential Electricity Price Trends, https://www.cleanenergycouncil.org.au/consumers/electricity-prices.*

2 World Health Organisation, Air Pollution, https://www.who.int/health-topics/air-pollution#tab=tab_1

3 https://imperialcollegelondon.app.box.com/s/f1r832z4apqypw0fakk1k4ya5w30961g

4 *https://altiorem.org/reseach/the-inevitable-policy-response-preparing-financial-markets-for-climate-related-policy-regulatory-risks/*

5 *https://www.citivelocity.com/citigps/electric-vehicle-transition/*

6 *https://altiorem.org/reseach/deloitte-australia-cleantech-dact-index/*
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CEO remuneration: We need a rethink…

By Dr N Sultana, Associate Professor, School of Accounting, Economics and Finance, Curtin University

Over the past several decades, CEO pay has increased substantially globally, including in Australia. In 2019, the highest paid CEO in Australia was paid $37,760,000, a number 420 times higher than average Australian salaries, with a daily rate over $100,000. According to the most recent figures from the Australian Bureau of Statistics, the average weekly earnings for Australian adults who work full time is $1,634 — a figure which equates to $84,968 per year. If you take the median figure instead of the mean, the comparison is even more alarming.

From the Australian corporate collapses in 2002, the Global Financial Crisis 2007-2009 and the more recent Banking Royal Commission (BRC) Inquiry 2019, the underlying reasons for corporate failures have been identified as greed and associated financial incentives. In 2004, responding to public concerns and to protect the national economy from corporate greed, Australia was one of the first countries to impose a number of changes to enhance corporate governance practices and transparency in the setting of executive compensation. Following the UK, the Australian Government introduced its "say-on-pay legislation". This non-binding vote on remuneration reporting provided a new communication channel between shareholders and boards regarding remuneration issues. Aside from the non-binding vote, listed firms are also required to include a separate audited remuneration report in their annual reports, disclosing the total remuneration and the individual components of remuneration for each director and executive and a comprehensive description of the remuneration policy adopted by the firm.

However, the non-binding shareholder votes were mostly ignored by firms given the absence of any adverse consequences for them, leading inevitably to a series of more corporate scandals. Subsequently, the Rudd Government's efforts led to the issuance of a binding shareholder vote on remuneration reports, commonly known as the "two-strikes rule", which became effective from July 1, 2011. According to this rule, if a quarter of the eligible voters or more vote against a remuneration report for two consecutive annual general meetings, the board of directors may be replaced[1] with the exception of the CEO. Despite these regulatory initiatives, we continue to see corporate misbehaviour resulting in the BRC Inquiry 2019. Excessive compensation was again a significant theme from BRC findings in the financial sector.

The sentiment of the BRC was echoed by the Australian Prudential Regulatory Authority (APRA) in April 2018 when APRA targeted executive bonuses in the Australian banking industry, with the CEO of APRA saying that "carrots are large but the sticks are brittle" for senior executives in banks. How bank CEOs and their senior executives are paid is an underlying theme of the Royal Commission hearings along with the key question of how financial incentives drive behaviour and create conflicts with a duty to serve the interests of stakeholders.

Although the inquiry only focused on the financial sector, the issue is relevant across all industries. Following the BRC, the dissatisfaction from shareholders was evident, with a series of backlashes over executive pay for all major banks, including the NAB, CBA, ANZ and Westpac. More than 88 per cent of shareholders rejected the executive remuneration at NAB's AGM — well over the 25 per cent threshold required to trigger a first strike against NAB's board. All other major banks also faced a similar situation where CEO pay was rejected by shareholders with a first strike. Even during the BRC inquiry, CEOs across all industries continued to get high bonuses, suggesting that there is a culture of entitlement whereby supposedly "at-risk pay is not very risky at all" as suggested by the CEO of Australian Council of Superannuation Investors (ACSI). A recent report by ACSI also suggests that CEO's pay structure is mainly focused on meeting financial targets, e.g, increased share price and rapid growth of firms in which CEOs are getting bonuses for meeting targets but experiencing no penalties for missing targets — an issue consistently raised by regulators and investors. Additionally, CEOs are not held properly accountable as they are being paid bonuses for just doing their jobs, when in fact, such bonusses should be paid only if there is outstanding performance from the CEO. Also, long term performance, which adds to true firm growth, needs to be the main focus rather than just meeting yearly targets. These issues consequently raise questions about the leadership of boards.

To help boards monitor CEO's pay and performance, in 2010, the ASX Corporate Governance Council introduced Principle 8, which requires boards to form a sub-committee called the remuneration committee, whose primary responsibility is to monitor how executive remuneration is packaged, focusing on pay for performance. It has been more than 10 years since these guidelines have been introduced, but CEO pay continues to soar remarkably.

It is long overdue for Australian boards to genuinely address community concerns on executive remuneration. If the pay culture/approach is not changed internally by firms/boards, there will be greater regulations and intervention by government. The US and UK governments are already taking action by announcing requirements for large companies to disclose the ratio of their CEO pay compared to their average (UK) or median (US) worker pay. It is only matter of time before Australia will follow this lead. It really is better to voluntarily and genuinely embark on a change in the way CEOs and senior managers are renumerated.

[1] *After receiving the second strike, if 50 per cent or more of the shareholders vote in favour of a board re-election resolution, the directors must stand for re-election during an extraordinary general meeting to be held within 90 days.*

Commercial property offers attractive yields

By Adrian Harrington Head of Capital and Product Development, Charter Hall

Over the past 12 months, the spread of the coronavirus has tested the world's health and financial systems in unprecedented ways.

Australia, due in part to its geography (an island nation) and the outstanding efforts of our government and health officials, has weathered the COVID-19 storm well.

The Federal Government and RBA both responded decisively to provide much-needed support to the economy. The RBA recently acknowledged that Australia's economic recovery is well underway. In the absence of a renewed widespread outbreak, near-term projections for economic growth have been upgraded. The Australian Government now forecasts Real GDP to grow by 4.25% in 2021, following a fall of 2.25% in 2020.

What does this mean for Australian commercial property?

Property market stabilising but divergence in returns

Whilst Australia's major commercial property markets have stabilised, rolling 12-month total returns have diverged significantly by sector.

According to the PCA/MSCI Direct Property Index, the best performing sector in the 12 months to December 2020 was industrial (13.9%) followed by office (4.7%) and retail (-10.1%) (Figure 1).

It was a similar story in the listed sector, although the magnitude of the returns amongst the REIT sectors was even wider, in part due to the liquidity that REITs provide, making it easier for investors to trade in and out when COVID-19 hit.

Industrial A-REITs were the best performer — up 41.2% — followed by office REITs (-15.9%) and retail REITs (-23.5%). The retail REIT return was impacted by discretionary retail mall REITs as concerns around retailer viability, on-line retailing growth and forced closures during lockdowns all weighed on the sector.

Office sector

Much has been written about the future of the office market sector. The key question is whether COVID-19 is creating a long-term structural change or it's just another cyclical event.

Charter Hall's view is that this is another example of a cyclical correction, and whilst there will be some changes to the way companies operate and the amount of space they occupy in the short-term, the physical office is far from dead.

Undoubtedly, some organisations will need to adjust their workplace strategies to provide greater flexibility for their employees. But our tenants are telling us that the office environment is essential in stimulating productivity, maintaining culture, managing risk and driving innovation.

There will no doubt be a flight to quality by tenants. Landlords who can adapt to their tenants' needs, and provide a high level of technology and amenity to ensure that the office provides an enjoyable, healthy and productive environment, will be best placed to attract and retain tenants.

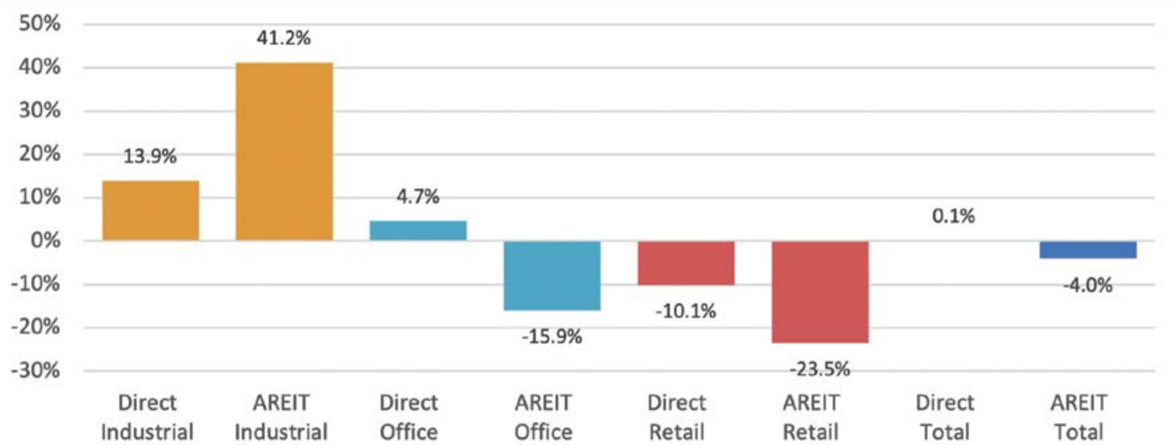
Industrial sector

Demand for industrial space is expected to remain strong, supported by the ongoing growth in online retailing, the continued quest for efficiencies in supply chains, and the rebound in the economy.

Despite the COVID-19 related interruptions, national leasing volumes reached 2.86 million sqm in 2020 — the highest level on record.

Investment volumes over the past 12-months totalled $5.2 billion, and 2021 is expected to be another record year. Institutions generally remain underweight to the sector and recognise the attractive long-term, resilient returns that are available from industrial property.

Figure 1: Direct vs listed property: total returns 12 months to 31 December 2020



Source: Property Council of Australia/MSCI Australia All Property Index and S&P/ASX300 AREIT Accumulation Index

Retail sector

The acceleration of online retailing during COVID-19 has further disrupted the retail landscape. Australia Post reported in December 2020 that online sales were up 34.9% year-on-year, and there was a 21.3% increase in the number of households shopping online.

Retailers are having to invest significantly in their online capabilities, while their store and logistics networks are being integrated as part of the drive to create an efficient omni-channel presence.

While retailers and the larger retail centres were being challenged prior to COVID-19, this has been accentuated by the increase in penetration of online retailing and changing shopping patterns. The next few years won't be any easier. Vacancies will remain elevated, while the rebasing of rents still have some way to go, and a lack of buyers will see values remain under pressure.

The convenience end of the retail spectrum was exceptionally strong during COVID-19, driven by the essential role they played in providing non-discretionary items and consumers preferring to shop closer to home. Despite supermarket sales normalising post the COVID-19 spike, the outlook for convenience retail centres is positive. Strong investor demand from both private and institutional investors should see a further re-rating of convenience centres in the year ahead.

Outlook

Australia enters 2021 well-positioned, although there is no doubt that the impacts of COVID-19 will continue to be felt for some time.

Continued low-interest rates and the desire for yield will further enhance the attractiveness of property in a diversified portfolio, especially those assets offering long leases and high-quality tenant covenants. We continue to see real assets, particularly property, as a surrogate for traditional fixed income, given the demand for income-producing assets against a backdrop of historically low global interest rates.

Despite expectations of lower rental growth in some sectors, commercial property risk premiums look attractive even though absolute yields are at their lows. Nationally, the average yield for CBD office is 5.23%, industrial is 5.18% and retail is 6.1%; all looking extremely attractive relative to the 10-year bond yield of 1.4% and the cash rate of 0.1%.

Over the next year, we expect industrial and long lease sectors to continue to significantly outperform, followed by convenience-based shopping centres and office, with discretionary retail shopping malls lagging well behind. E

Adrian Harrington is Head of Capital and Product Development at Charter Hall.

Understanding LIC and LIT performance

By Angus Gluskie, Chairman, the Listed Investment Companies and Trusts Association

It is clearly important for investors, advisers and researchers to understand how an investment has performed. It is also useful to be able to accurately compare and contrast the performance of differing investments.

As an investor, I have always considered the two most important performance reporting measures to be the underlying investment return of the entity (before tax and expenses) and the total expense ratio.

- The first of these, the before tax and expense investment return, provides insight into how well the underlying investment assets have performed. It can be accurately compared against benchmark indices which are also before-tax and expense measures.
- The second, the total expense ratio, provides a clear measure of the cost of managing the investment vehicle. Naturally, it is important that this measure captures all costs, and not just some of them.

I prefer to see these two items reported separately, as it provides greater insight when interpreting performance. For example, it is clearly useful to be able to understand and differentiate between the skill level of differing fund managers and, separately, to consider the merit of the cost structure.

Additionally, differentiating these two components highlights that "index" returns are a theoretical before-cost measure. If an investor seeks to actually invest in an index equivalent, that will come at the cost of investing in the securities making up the index and at the management cost of administering the investment fund.

Net asset value returns for trusts, including LITs

For untaxed entities such as listed investment trusts (LITs), ETFs or unlisted managed funds, the combination of the underlying investment return (before expenses) and the total expense ratio, will equate to the investment return that can be determined from the net asset value (and income distributions) per unit.

Net asset value returns for LICs

Listed investment companies (LICs), however, are taxpaying entities which pay company tax on unfranked income and realised capital gains, and which provide for tax on unrealised capital gains.

Based on current ASX listing rules, the post-tax net asset value of a LIC is after both the payment and provision of tax. The pre-tax net asset value of a LIC is before the provision, but after the payment of tax.

Continued - Understanding LIC and LIT performance

Currently, quoted investment returns based on these "pre-tax" and "post-tax" net asset values for LICs accordingly represent after-tax returns and are not comparable to normal benchmark indices or to the returns of a trust, managed fund or ETF.

Returns based on share price movements (and distributions)

Returns based on LIC and LIT share price movements are the product of multiple factors:

(a) the underlying asset return net of expenses;

(b) tax paid or provided (if a LIC); and

(c) movements in the premium or discount of share prices to asset backing.

While this measure provides some useful insight into the influence of the premium/discount movement in supplementing returns for an investor, this measure should also be understood for LICs as an after-tax return and is not comparable to a before-tax index.

Clearer net asset values and share price returns for LICs in the future?

Looking to the future, a more useful approach would be for LICs to quote a net asset value that is before all provisions for tax (whether current or deferred), and also to quote the amount of tax paid/provided for each month. Not only would this represent a truer asset backing, but this would also enable the accurate calculation of investment returns (after expenses) on the same comparable basis as LITs, ETFs and managed funds.

With regard to returns based on share price movements (and distributions), it would appear constructive for these to be grossed up for franking credits attached to the distribution. Returns so calculated would truly represent a total return achieved by the investor, and would be comparable across LICS, LITs, ETFs and managed funds (assuming their returns are similarly gross of franking).

Angus Gluskie is Chairman of the Listed Investment Companies and Trusts Association (LICAT).

For more information or to speak to LICAT directly, please contact: Guy McKanna on 0430 355 985, or guy@honner.com.au.

LICAT is a non-profit organisation that seeks to represent the interests of the Australian closed-end listed investment company and trust industry on behalf of the 700,000 share and unitholders who choose to invest in the sector.

Active vs passive ETFs observations

By Matt Gaden, Head of Australia, Janus Henderson Investors

Investing in listed investment securities is becoming increasingly popular amongst Australian investors. Along with listed investment companies (LICs) and listed investment trusts (LITs), the new exchange traded funds (ETFs) — whether active or passive in nature — have been making their debut in the Australian marketplace with increasing frequency for a number of years now, with little sign of slowing down.

There are a number of reasons for the increasing popularity of ETFs, including low cost, convenience and accessibility to a wide variety of investments. So before examining the differences between an active ETF and a passive ETF, it is worth exploring the features and benefits that are common to both.

Exchange traded funds (ETFs) are investment funds that can be bought and sold on a securities exchange, in much the same way as shares are bought and sold on an exchange. As with any investment, investors should always be aware that the value of an ETF can go up or down.

ETFs can offer investors exposure to a range of asset classes, including Australian or global shares, commodities, property, fixed income, alternatives and cash. The main benefit that we have seen many investors enjoy from investing in ETFs is probably the convenience of having access to a diversified portfolio of investments all within a single trade. ETFs are then required to perform disclosure of their holdings, so an investor has complete transparency of what they're invested in within their ETF portfolio.

ETFs operate using a trust structure, which provides certain investor protections that investing in company shares may not. They are structured in a way referred to as "open ended" investments, which simply means that the number of units on issue is not fixed but can increase or decrease in response to supply and demand from investors.

Many of the features that shareholders would be familiar with when investing in stocks are also consistent with the features of investing in ETFs. Similar to the way a company issues shares to its equity holders, an ETF issues units to its investors, with each unit representing an equal share of the portfolio of assets held by the ETF.

Unlike LICs or LITs, where units/shares can only be bought at the initial offering (or in certain instances if the LIC or LIT decides to issue new units/shares in time), units in ETFs can be bought and sold on an exchange at any time, just like common shares.

This means that investors don't need to try to "time" when they buy or sell units in an ETF, they can do it as best suits their needs.

ETFs trade, clear and settle in a very similar way to regular shares. And just like companies, use a three-letter "ticker" code to identify their shares, ETFs are identified by a three- or four-character ticker code, which can incorporate either letters, numbers or a combination of both. By-and-large, newer ETFs use the four character format, so our newest active ETF at Janus Henderson trades under the ticker code 'TACT' for example.

The price at which an ETF is trading is likewise displayed in much the same way as a common share — pricing is displayed live on the exchange throughout the day. ETFs, whether they're passive or active, are designed to trade at a price that is close to their underlying net asset value (NAV), which means that the price an investor pays should closely reflect the underlying assets of the ETF.

And finally, generally speaking, ETFs (whether passive or active in nature) have no predetermined minimum investment amount, so are equally accessible by those with a little or a lot to invest.

So what then are the differences between a passive ETF and an active ETF?

In essence, passive ETFs aim to follow a benchmark or index as closely as possible and will go up and down in value in line with the index they are tracking. An investor will generally receive the same returns as the market, minus fees.

Active ETFs, on the other hand, are for investors who prefer an active investing strategy and want their investments to actively try to outperform the market or index. This means that they allow investors to access the skills of managers who are trying to outperform the index and deliver alpha for their portfolios.

Active ETFs operate in a similar way to managed funds, in that they are professionally managed by an investment manager who makes active decisions about what to invest in. However, unlike managed funds, there are no lengthy application forms, as units in an active ETF are bought or sold through either an online trading account or via a licenced stockbroker or adviser.

Because they do not try to mirror an index, active ETFs also have the ability to make determinations based on environmental, social or governance (ESG) criteria about which investments to hold. This is a key advantage of active ETFs, in their ability to hold less, more of, or not any of, certain companies or issuers. Ultimately, this represents a unique advantage over passive ETFs in that active ETFs have the ability to align more closely with an investor's preferences.

In comparison, passive ETFs generally have to hold the entire index, and in set proportions, and do not have this ability to exclude companies or issuers, irrespective of an investor's preferences or concerns over environmental, social or governance factors.

In summary

Overall, ETFs have evolved from an investment vehicle used solely to build passive portfolios to being an efficient, transparent and convenient means for investors to implement active investment strategies via exchange-quoted structures. And while there is a place in the market for both passive and active ETF strategies, with the growing number of active managers looking to launch ETF's which often replicate their "best of breed" unlisted fund strategies, it is an opportunity for investors to access these strategies in a more convenient and flexible product structure.

A note on terminology: As a way of distinguishing between active and passive ETFs, active ETFs are also sometimes referred to as exchange traded managed funds (ETMFs).

At a glance: active versus passive ETFs

	Active ETFs	Passive ETFs
Availability	Listed on an exchange, such as ASX or Chi-X	Listed on an exchange, such as ASX or Chi-X
Structure	- Trust structure - Open ended - Issues units	- Trust structure - Open ended - Issues units
Identified by	A three- or four-character ticker code. Newer funds will have four characters	A three- or four-character ticker code. Newer funds will have four characters
Liquidity	- Units can be bought or sold at any time - Market makers provide liquidity	- Units can be bought or sold at any time - Market makers provide liquidity
Pricing	Pricing displayed live on the exchange	Pricing displayed live on the exchange
Management style	Actively managed	Passively managed; often designed to mirror or replicate a specific market index
Returns	Investors may receive returns higher or lower than the market	Investors generally receive market returns, minus fees
Disclosure	All holdings disclosed, often with up to two months lag time	Typically, a daily basket of holdings are disclosed
Minimum investment	No minimum	No minimum
Trades	Generally trades close to the NAV	Generally trades close to the NAV
Application process	- Online purchase via a trading account, or - Through a licenced broker or adviser	- Online purchase via a trading account, or - Through a licenced broker or adviser

Matt Gaden, Head of Australia, Janus Henderson Investors

An extraordinary scam that is netting millions

By Romano Sala Tenna, Position, Katana Asset Management

In my 30 years following markets, I've seen a lot of scams. But the current one is the most dangerous yet, and people we know and care about are going to lose money unless we warn them.

Two weeks ago, a Melbourne-based friend emailed me. His closest friend's 68-year-old mother, who happens to be disabled from a stroke, had recently inherited $300,000. Using www.compare-investments.com.au, they checked for a rate better than the 0.4% on offer at the bank.

After completing an enquiry form, they were soon emailed a "prospectus" from a global bank. This offered 4.56% for one year, 5.49% for two years right up to 9.21% per annum for 10 years.

My friend asked me what I thought. The 23-page prospectus looked professional and completely consistent, with genuine documents from the global bank in question. But as I later discovered, key pieces of information were doctored, including the phone number, email address and, of course, the bond rates.

As I read the prospectus, my first impression was that the rates looked really good! Good, but not ludicrously high to raise my suspicions. And with the apparent backing of a big bank brand, it seemed like an option worth considering.

But timing is everything in the markets. And fortunately for my friend (and unfortunately for the scammers), literally 24 hours beforehand, I had received an email from the head of fixed interest at Bell Potter Securities warning of high yield bond scams.

An exchange of emails confirmed that this was indeed a scam.

If this unfortunate lady had proceeded, her application form and 100-point identification check would have provided the scammers with all the information they needed to steal her identity. Worse still, if she had transferred money, it would have been directed to a false bank account and then very quickly skimmed offshore; never to be returned.

I'm not too proud to admit that, if not for that email the day before, I would not have realised this was a scam. And if a professional money manager doesn't immediately recognise an investment scam, what hope is there for the average citizen?

Most scams are easy to spot ...

Such scams usually have one or more of the following traits:

- dubious introduction — often cold calling or spam;
- unbelievable returns;
- capital guarantees;
- unknown brands and amateur marketing materials (often with poor grammar and typos);
- off-shore contacts — commonly from Hong Kong or Eastern Europe— my favourite one last year was a "financial adviser" in Estonia offering a special deal only to close associates, to which I was graciously included despite having never met him; and
- deadlines — pressure to act quickly or miss out — this last trait is perhaps the most tell-tale of all scams.

... But not this one

Several factors, alongside the impressive but "realistic" returns — especially over one- and two-year terms — further suggested the authenticity of this scam, including:

- the brand was a tier-one globally recognised bank;
- the marketing materials were professional and consistent;
- the pathway to the scam — via a comparison site — appeared legitimate;
- the capital guarantee was in fact there, but not immediately obvious; and
- the contact details were for a Sydney CBD number.

As an aside, when I phoned that number it went through to an after-hours voice recording. But earlier in the week I actually got through to a lady with an Australian accent, who definitely did not work for a tier-1 global bank!

We are in an especially dangerous time for scams, and it is not just because of the pervasive reach of technology. The even bigger issue currently is that because cash rates are so low, many mums and dads — who have often only ever used bank deposits — are now looking elsewhere.

Scammers are becoming increasingly clever and more resourceful, and it has never been quicker or easier to enact a scam than it is today. This scam was certainly deceptive, but you can bet even more sophisticated scams are close behind. We need to ensure that those most vulnerable are not defrauded.

(Note: Nomura, Citi and IFM Investors are three firms that have now put out statements acknowledging that their brand has been hijacked.)

Three simple steps to protect savings — yours or others

I think most scams can be avoided if the would-be victim follows three simple steps:

1. **Never feel rushed** — take your time and independently verify the offer. If you're pressured to act quickly, it's almost certainly a scam
2. **Only use a licensed financial adviser** — and check every financial decision with them. We are blessed in this country that we have a strong regulatory framework that licenses and monitors financial advisers; you can check to see if someone is registered at https://moneysmart.gov.au/financial-advice/financial-advisers-register.

3. Watch for above-average returns or a capital guarantee — every scam must offer something that you can't get elsewhere, or you won't take the bait. Even this scam offered rates (on the five- and 10-year bonds) that in hindsight were too far above market. It also offered a capital guarantee, which only very specialised institutions can do, and only on low-risk, low-return products.

Further steps if you have time

There are some additional things to look for:

- The ACCC runs the Scamwatch website, which provides information to consumers and small businesses on how to recognise, avoid and report scams. Among other reasons, I recommend this website because it highlights the breadth and depth of scams operating. However, it can take time to update. For example, this current scam has been operating for several weeks and is still not listed on the website.
- Check the purported issuer's website for any alerts about imposter scams, and check the contact details, branding and current offers. Once again, don't rely solely on this.

As a final point, take the time to report any scams to Scamwatch. The short time it takes to fill out the form may very well save someone else's life savings.

Please warn anyone you care about

I have been following financial markets for 30 years, and this scam passed *my* radar. If a seasoned market follower can be fooled, then anyone can. Our only defence is to warn those we care about.

Romano Sala Tenna is a Portfolio Manager at Katana Asset Management. www.katanaasset.com.

Active investment management – 20-year review

By Mark Knight*

The Mercer Australian Large Cap Share Performance Survey for the 20 years to end December 2020 shows that the S&P/ASX 300 (All Ords before 1/4/2000) returned 8.1% a year on a compound basis. Of the 27 active strategies in the survey, 26 beat the market with a median result of 9.4% pa, compounding at a very respectable 1.3% pa above the market.

The upper quartile compounded at 10.5% pa, beating the market by 2.4% pa. Even the lower quartile mark of 8.8% pa outperformed the broader market. These results do not include the effect of franking and are shown on a before fees basis.

Over a 20-year timeframe, investing $10,000 at a median return of 9.4% pa produces a balance of $60,304.

If, rather, one invested in an index fund or market ETF and received a before fees return of 8.1% pa, the final balance would amount to a far lower $47,480.

For comparison, Ausbil Australian Active Equity Fund has delivered a 20-year compound return of 10.3% pa (gross of fees) turning $10,000 into $115,231. Since inception in 1997, the same Fund has delivered a compound return of 11.0% a year, an excess return of 2.9% pa (gross of fees).

See chart below

Compared to the large-cap segment of the market, the small-cap sector of the market is arguably less efficient (lower levels of information), with less broker coverage and therefore affords relatively greater opportunity for alpha generation over the long run. The data bears this out in a stark fashion.

The Mercer Australian Small Cap (ex 100) Share Performance Survey for the 20 years to end December 2020 shows that the S&P/ASX Small Ords returned 6.5% pa on a compound basis. Of the 11 strategies in the survey, all of them beat the market with a median result of 13.2% pa, compounding at a very respectable 6.7% pa above the market.

The upper quartile compounded at 13.8% pa, beating the market by 7.3% pa. Even the lower quartile mark of 12.4% pa outperformed the broader market by 5.9% pa.

During the past 10 years in particular, there has been a proliferation of micro-cap strategies that utilise the S&P/ASX Emerging Companies index as their benchmark. For the 10 years ending December 2020, the Mercer Survey indicated a peer group median compound return of 14.5% pa versus 1.7% pa for the benchmark.

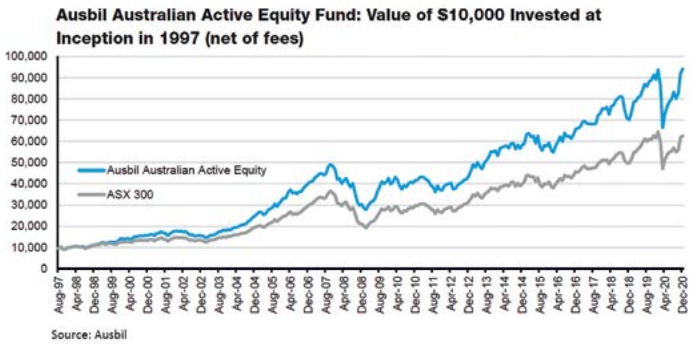
Given the evidence, the role for patient, active investing in Australian equity portfolios is proven and compelling.

Coping with sequence risk

Reducing share exposure either after the commencement of a correction or during the period of recovery, will interfere with compound growth and be detrimental to capital accumulation. However, after the worst corrections, history shows that share values may take several years to return to their starting value.

During the famous stock market crash of 1987, the S&P 500 collapsed by 28.5% and took 398 trading days to recover. The global financial crisis that extended across the second half of 2007 and 2008 caused the S&P 500 to depreciate by 56.8% and recovery took 1,022 trading days.

So, while an 80% to 100% exposure to equities will make sense for many investors, the retiree is in different circumstances given the absence of working income, the reliance on investment income and the consequent vulnerability to so called sequencing risk. It will therefore make sense to retain at least 3 to 5 years of income in defensive assets so as to allow growth assets to recover after substantial downside movements. Further, low volatility and absolute return equity strategies may be utilised alongside traditional, long only shares to moderate this downside risk.



ESG: an additional source of active investment returns

Fundamental, proprietary research of course provides the insights that allow active managers to create a capital return beyond the return of the market sector in which they invest. This research is both qualitative and quantitative and, traditionally, has focused on the financial aspects of corporate performance. It is now increasingly common for the same managers to also investigate the target companies approach to the environment, society and corporate governance (ESG), alongside its financial aspects, for a fuller view of the earnings risks and opportunities.

The fuller the view, the greater the likelihood of excess returns on a risk-adjusted basis over time. Proper ESG integration will also insist on extensive engagement and advocacy with the interaction between fund manager and company manager encouraging corporate behaviour that is both responsible and sustainable. Issues such as climate change and modern slavery are topical. An index or index tracker is unable to do this work. As is the case with valuations, the index is ‘blind’, without any ability to use thoughtfulness and intellect to produce superior outcomes over time, or to actively reduce risks obvious or not.

The effect of fees

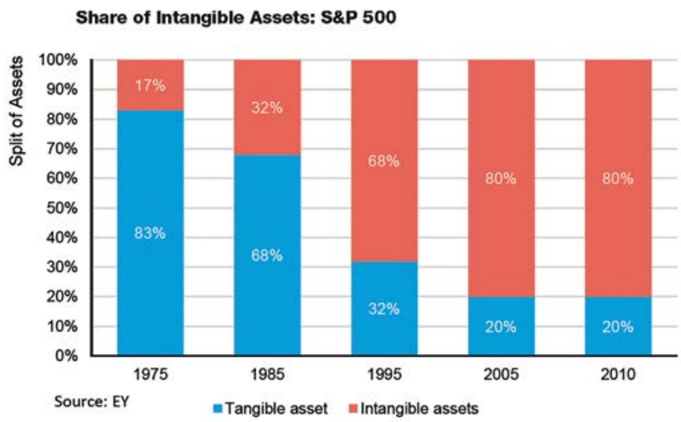
Given the vast array of available investment strategies and vehicles it is difficult to generalise about the average level of investment management fees and what level is and isn’t reasonable. Investors should remain considered in this area because the compounding effect of fees can genuinely interfere with long-term growth objectives.

It is also important to distinguish between investment, administration and advice fees. Only investment management fees should be attributed to investment portfolios and included in net fee calculations. To enjoy the benefits of an active approach, investors should ensure that excess returns are expected to well exceed fees on a rolling long-term basis.

“Patience is bitter, but its fruit is sweet”

In response to the economic malaise presented by the pandemic the federal government expanded the superannuation hardship provisions allowing savers including young adults to withdraw up to $20,000 from their retirement accounts. The government is expected to implement the “Your Super, Your Future” reforms from July 1st 2021 and MySuper products will be subject to an annual performance test based on a comparison with conventional market indices.

Underperforming funds will be listed as underperforming on the YourSuper comparison tool until their performance improves. The reforms present the real risk that super fund trustees will minimise their exposure to active investing rather than suffer the potential for public ignominy during those inevitable periods when the fund return profile and relevant indices depart from one another.



Einstein is reputed to have claimed that, “Compound interest is the eighth wonder of the world. He who understands it, earns it…he who doesn’t…pays it”.

Whether government legislation, regulation, advice or investor behaviour, any cause for impatience around access to capital or the lengthy incubation period necessary to produce valuable active returns, will only serve to interfere with our industry’s capacity to deliver that which our customers desire most – the ability to develop an independent financial confidence that will go the distance. After 45 years across a typical working career, who would deny them? E

** Mark Knight is Head of Distribution at Ausbil Investment Management*

A short notice on the COVID-19 public health event, and how it can impact investments

Given the currently evolving issues around the Coronavirus (or Covid-19) globally, which has officially been designated a pandemic by the World Health Organisation, we wish to notify that, as with many firms, business may be disrupted. A public health crisis, pandemic, epidemic or outbreak of a contagious disease, such as the recent outbreak of Coronavirus (or Covid-19) in Australia, Italy, China, South Korea, the United States and other countries, could have an adverse impact on global, national and local economies, which in turn could negatively impact investment returns in any of Ausbil Investment Management Limited’s registered managed investment schemes (the Funds). Disruptions to commercial activity relating to the imposition of quarantines or travel restrictions (or more generally, an inability on behalf of authorities to contain this pandemic) may adversely impact any investment, including by delaying or causing supply chain disruptions or by causing staffing shortages. The outbreak of Coronavirus has contributed to, and may continue to contribute to, volatility in financial markets. The impact of a public health crisis such as the Coronavirus (or any future pandemic, epidemic or outbreak of a contagious disease) is difficult to predict, which presents material uncertainty and risk with respect to any investment or fund performance.

Understanding LICs: key features and investment strategy

Perpetual Asset Management Australia

Introduction

Investors in equity listed investment companies (LICs) who stayed the course over 2020 have generally ridden out turbulent markets successfully, with these investment vehicles showing they can be good contributors to a robust, diversified investment portfolio. This article examines the structure and strategy behind LICs and considers some of the benefits and risks involved.

What are LICs?

Australian retail investors who are interested in an efficient way to invest in a diversified portfolio of assets managed by a professional investment team should consider the merits of investing in a LIC. Unlike traditional managed funds, investors can buy and sell LICs in the same way other securities on the ASX are traded. A key feature of a LIC is the closed-end structure, which means the investment manager has a fixed amount of capital to invest, as the number of shares issued to investors and capital raised is fixed. The ability of LICs to raise capital from thousands of investors at a single point in time differentiates this structure from ETFs and unlisted managed funds, where investors may apply and redeem units at any time.

Know what you are investing in

As with all investment decisions, investors should do their homework before buying into a LIC. This means knowing what underlying assets you will be getting exposure to and understanding the investment strategy. For example, an investor seeking exposure to both Australian and global shares might consider the Perpetual Equity Investment Company (PIC), which provides access to a concentrated portfolio of Australian and global listed securities. A LIC's performance is generally measured by the performance of the portfolio. Investment performance may be calculated on the growth of net tangible assets (NTA) (based on the performance of underlying assets) and assuming dividends are reinvested. A LIC's performance can also be measured by total shareholder return, which is based on the growth in share price of the LIC assuming any dividends are reinvested. It is therefore possible for the share price of the LIC to trade at a premium or discount to the NTA. Investors should note that while LICs traditionally hold a portfolio of shares, other asset classes such as fixed income are becoming increasingly common.

Benefits of LICs

Angus Gluskie, Chair of the Listed Investment Company and Trust Association (LICAT), argues that closed-end funds provide unique advantages to investors, the broader economy and the financial markets system.

"The efficiency and stability of their closed-end structure coupled with the corporate governance disciplines of ASX listing have proven to be far more durable than many other investment structures," he said.

LICs are popular investment choices amongst retail investors in Australia due to the array of benefits they offer. One of the key features of the LIC structure is the ability to pay franked dividends. Because of their corporate structure, a LIC is able to retain earnings and reinvest them into the portfolio or pay dividends out of profits. Where a LIC can build up both its profits and its franking credit balance, it can provide the opportunity for the board of the LIC to declare consistent dividend amounts to investors over time. In an environment of market volatility and low interest rates, LICs may offer a stable stream of franked dividends, which can be particularly appealing to investors seeking reliable and tax-effective income.

Another advantage of LICs is to assist investors in diversifying their portfolios across asset classes, sectors and geographies that otherwise could be difficult to access. For example, there are LICs that cover international shares, emerging markets, specific sectors, corporate bonds, government and semi-government bonds. Done well, the LIC strategy has the potential to provide the best of both worlds: active management that lifts returns and a consistent income stream that can make a big difference to portfolio returns over a long investment horizon.

Risks of LICs

The LIC sector was affected when global share markets fell in March 2020 as a result of COVID-19 led volatility, but have since recovered in line with the broader Australian equity market. As LICs are closed-ended, the share price of the LIC is determined by the demand and supply of the market with a range of factors including investor sentiment or performance leading to the share price trading at a discount or premium to the value of their underlying assets. LICs may be affected by market volatility experienced by its underlying investments and may not be frequently traded. Therefore, investors may find it hard to sell when required.

Jason Hunt, Perpetual Investment Management Ltd, www.perpetual.com.au.

Investing in ETFs
— interview with David Bassanese, BetaShares

Exchange traded funds (ETFs) have become an increasingly popular and easy way for investors both new and old to maintain a diversified portfolio that concentrates on an index or a particular asset class. The ETF tracks performance against the index or asset class and provides returns based on this after the deduction of fees. An ETF is like a mutual fund, but it is traded throughout the day and not just when markets are close at the end of the day. ETFs are traded on a stock exchange, the same way as other shares.

As with any and every investment product, ETFs come with their own selection of risks and, as investors, it is key that we are aware of these risks. An upcoming issue will explore some of the risks associated with ETFs and what investors might want to keep in mind before investing.

ASA spoke to David Bassanese, chief economist at BetaShares, one of Australia's leading ETF providers.

ASA: How can you measure ETF performance and what should you keep in mind when considering this?

DB: For ETFs traded on the ASX, one key metric is "tracking error", or how well the ETF's net asset value (NAV) tracks the performance of the underlying index (such as the S&P/ASX 200) it is supposed to follow. Typically, this tracking error tends to be very low as ETFs hold baskets of securities or other assets that very closely resemble (if not match perfectly) the basket of securities tracked by the relevant index. Where this matching is less than perfect, however, which is usually due to the costs involved, some tracking error may be evident over time.

Other important considerations include the level of liquidity at the best bid or offer prices in the market and the closeness or tightness of the bid-off spreads themselves. Two ETFs that aim to provide similar exposure to a certain investment benchmark may nonetheless differ in the extent to which they are actively traded and supported by market makers on a daily basis, which in turn could affect how easily an investor can trade in size at the best bid and offer prices currently available on the market. In general, however, all investors should be able to trade in desired amounts at prices close to the NAV, even if in some rare cases (e.g. very larger orders) that may involve contacting the ETF provider to ensure market makers provide the required liquidity.

Of course, you could also evaluate an ETF on the extent to which its NAV, and hence market price, moves over time — but investors need to remember that index tracking ETFs generally aim to match the relevant index's performance, not beat it.

ASA: When markets do strange things like the recent GameStop shift, we were reminded again of how risky markets are and how manipulation can affect investors. Considering ETFs are based on asset classes or indices, how would a GameStop-like event affect ETFs?

DB: Due to its open-ended structure, an ETF's market price tends to closely follow its NAV, which in turn reflects the market price of the underlying securities it holds. If one of the shares in the ETF's portfolio experiences significant price movements, as GameStop did recently, that will naturally be reflected in the NAV of the ETF, and hence its market price. This will occur regardless of whether those stock price movements are a result of market manipulation or other forces.

Having said that, one of the benefits of ETFs is the more diversified exposure they offer, which reduces the impact of any one stock's price movement on its overall NAV and market value.

Short selling can have an impact on any security's price if the level of short selling is reasonably large compared to the overall market value of the securities and typical levels of trading.

While ETFS can be short sold, just like an ordinary share, a big difference is that the level of short selling in the former typically would not be expected to be large enough to affect the individual price of any or all of the very diverse range of underlying securities it holds, and hence the ETF's NAV and market price on any sustained basis. That's because ETFs typically have very diversified exposure across a number of securities, which in their own right trade on liquid markets.

Of course, while the act of short selling — or subsequent short covering — over a very short time period might occasionally cause an ETF to briefly trade below or above its NAV, such mispricing should generally be fleeting, as professional market makers in the ETF can quickly arbitrage away any differences by buying or selling ETFs units in exchange for baskets of the underlying securities it holds.

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03 Women Over 55


04 Digital Communication

01 ASA welcomes new team member

Please join us in extending a warm welcome to **Stephanie Backhouse**. Stephanie joins the national office having just graduated from her internship program with the ASA. Events and webinar organiser **Kristine Nunez** takes maternity leave in April and Stephanie will be taking over from Kristine. We wish Kristine the best of luck and look forward to welcoming Stephanie as a full-time member of ASA.

02 Changes to ASA's board

Since 2020, ASA has been through significant changes in terms of board composition and arrangement. In 2020, Andrew Kearnan and Steven Mabb joined the ASA board while David Fletcher stepped down from his role of company secretary and board member. In the same year, Peter Rae was appointed ASA's deputy chair while Alison Buxton, chair of the remuneration and nominations committee has resigned from her position.

Ms Buxton, who has also been serving as CEO of Confoil while remaining a member of ASA's board, reluctantly stepped down from her role after concluding that ASA would be better served by a director who could dedicate more of their time to the organisation.

In February 2021, the ASA board appointed two new directors – Michael Jackson and Lelde Smits.

Michael Jackson has over 30 years' experience as a director, company secretary and corporate executive. His experience includes setting strategy, managing risk and structuring, negotiating and implementing complex projects and contracts. He has experience in both the private sector and government.

Lelde Smits is an experienced finance journalist and advisor to ASX listed companies with more than 10 years of experience as a communications and governance professional working to drive economic empowerment in our community. Following a career as a broadcast finance journalist in Australia, Ms Lelde relocated to Wall Street to work as the New York foreign correspondent for the *Australian Financial Review*'s digital division and a markets reporter inside the New York Stock Exchange for an independent media company in New York. Returning to Sydney, Ms Lelde co-founded investor and media relations consultancy, The Capital Network.

03 ASA launches education program geared towards women

Women at or over the age of 55 have been identified as one of the critical groups most at risk of homelessness in their later years. A number of factors contribute to this issue, not the least of them being the considerable gap between a woman's earning and saving potential when compared to their male counterparts. One of the ways in which women can bridge this gap is through developing better financial awareness and ability. In 2019, ASA partnered with the ECSTRA Foundation to engage in a series of workshops held across Australian cities and towns that concentrated on developing financial skills for older women who wanted to be in greater control of their finances and investing. Stemming from these workshops, ASA has now launched a new program to enable women to take charge of their financial futures. Visit the ASA website for more information and to access free information developed in collaboration with Felicity Cooper of Cooper Wealth Management. The resources available as a part of this program are available to ASA members and non-members free of charge in case you feel there are women you may know who might benefit from such insights.

04 ASA meetings and events to be communicated digitally

As Australia hopefully emerges from the COVID-19 pandemic with vaccination programs having kicked off in every state in the country, it is likely that physical member meetings will resume shortly. It has been decided that *Equity* magazine will concentrate more on providing educational content and information, and members who may have been used to finding details of their local meetings through the magazine will have to rely on their emails or the ASA website for this information. Please make sure you visit and check the ASA website, and supply us with an up-to-date email address in order to receive regular updates of your monthly meetings and any other upcoming ASA activities and events. E