Cuffelinks
Connecting investors with ideas

Edition 226, 10 November 2017

This Week's Top Articles

ETFs are not always simple index trackers

Gemma Dale

Exchange traded funds (ETFs) have existed in Australia since 2001, and have grown rapidly in popularity, now exceeding $32 billion in value. Within NAB's online broking platform, nabtrade, which is heavily dominated by retail investors, ASX-listed ETF trades grew at an annual rate of 59% over the last four years, compared to 20% year-on-year growth for other securities. As investors discover the extraordinary range of exchange traded instruments on global markets, their preferences and trading behaviour are starting to shift. While ETFs may offer the world, they may not be just the simple solution to stock selection challenges that many investors expect.

ETF growth and trading characteristics

The growth of ETFs in Australia can be attributed to the successful marketing of three key features: embedded diversification, a passive approach to asset selection and low cost.

Most share investor now loosely conflate ETFs with index investing, and index investing with being an inexpensive way to access a diversified portfolio. This hypothesis is supported by data from the nabtrade portfolio: the four most heavily-traded ETFs on the domestic market over the four years to August 2017 track the ASX300, ASX200, the US Total Market and US S&P500 respectively. The trades placed to acquire these ETFs were substantially larger than trade sizes for most other direct equities. Turnover is also lower, suggesting that investors are happy to buy and hold these instruments as a simple way to access market returns (less a small fee).

The emerging trend in ETF investing is revealed by the ASX-listed ETF with the fifth highest confirmations, the Beta Shares Strong Bear Fund (BBOZ). This product allows investors to take a leveraged short position on the performance of the ASX, generating a 2.0-2.75% return for each 1% fall in the Australian market on a given day. The management costs of the product are 1.38%. This product is neither passive, in the traditional sense of replicating a long-only benchmark, nor inexpensive. It offers an exposure that, prior to the evolution of the ETF market, investors would have had to create utilising Exchange Traded Options.

With the advent of low cost, direct access to international markets, this trend toward more targeted investment selection has grown significantly. nabtrade launched its international trading offer in March 2015. Since that date, domestic investors have traded over 580 individual international ETFs, primarily in the US, and the majority of these do not track the major indices.

Trends in the use of global ETFs

More recently, the top 10 international ETFs traded on the nabtrade platform has included Robotics and Artificial Intelligence, Aerospace and Defence, Biotechnology and Lithium and Battery Technology. As this list demonstrates, investors are using the ETF structure to access sectors and market positions that would otherwise be difficult or impossible to access in Australia. Of the top 20 most traded international ETFs, only one is broad market, long only. The rest offer sector specific, short and/or leveraged options across a range of markets, instruments and commodities. It's a far cry from the low-cost passive image ETFs may conjure.

Investors have now witnessed the second-longest bull run in US equity market history, and with global valuations at elevated levels, it is not surprising that investors are either hedging against a downturn or seeking specific assets which they believe have greater growth potential than the wider market. Inexperienced or naïve investors may wish to pursue the sectors that are currently media and market darlings with a relatively limited understanding of both the underlying sector and the relevant instrument. Over 80% of international ETF trades are buys; most investors are new to buying directly on global markets and choose to hold rather than trade their investments.

Low cost does not equal low risk

A word of caution for those who wish to pursue a theme or strategy that ETFs have only recently made possible. Record low volatility may have led some investors to believe that a passive, low cost strategy is also low risk. ETFs now offer the opportunity to benefit from movements, both positive and negative, in a broad range of assets. This exposure comes with a commensurate cost and risk. Many indices the ETF seeks to replicate were constructed with the express purpose of developing a subsequent ETF, effectively making them active investments. The weightings of the underlying investments may be anything but passive.

None of these factors is fundamentally problematic so long as investors have a full understanding of the risks and costs of their investments. Each ETF must disclose a summary of its investment selection methodology and its fees. At the bare minimum, investors should be confident that their objectives align with those of the ETF manager.

Factors to consider in selecting ETFs

Investors accessing sectors or market via ETFs should consider:

1. *What are your investment objectives?*

All investments are only useful to the extent they help to achieve an overall investment objective. If your overall investment objective is to exceed inflation, your investment selection will look different to someone aiming to exceed a relevant benchmark (e.g. the ASX 200) or achieve a target rate of return to provide for their retirement. A hot topic or market opportunity, however popular or exciting it sounds, has no place in your portfolio if it introduces a level of risk you do not require or are not comfortable with.

2. *What objective is the ETF designed to achieve?*

Traditional long-only benchmark ETFs are designed to generate benchmark returns, less a fee. By definition, these products underperform the benchmark, but due to their low-cost nature, generally by only a small amount. There is little to no risk they will generate significantly lower returns than the overall market unless there is a counterparty event (see Synthetics, below). Newer and more sophisticated offerings can be markedly different. The popular ROBO ETF, for example, is designed to 'provide investors with a liquid, cost-effective and diversified way to gain access to rapidly evolving robotics technology and AI'. Be conscious of short and leveraged ETFs: investors with little or no experience with shorting and leverage may find themselves unprepared for the volatility and potential losses these instruments deliver.

3. *Is the ETF replicating a benchmark or actively managed, or some combination of the two?*

A passive strategy describes the process of replicating an existing benchmark. It is a basket of securities at 'market weight'. For example, the S&P500 is universally familiar and many competing managers offer S&P500 ETFs. Investors can be confident their investments will deliver to their benchmark. At the other end of the spectrum, the popular Blackstone Group Unit Trust ETF is a hedge fund, which by definition is actively managed and does not track a benchmark or index. Other ETFs may use a rules-based approach to investing, or use a new or more sophisticated benchmark. In many cases, this can amount to active management. The ROBO ETF described above, for example, seeks to 'provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the ROBOGlobal® Robotics and Automation Index'. This index is created and maintained by ROBOGlobal, the creator of the ROBO ETF. Given the relatively recent emergence of this field it is not surprising that no traditional index existed, but where the manager both creates and replicates an index. Investors should take care to understand how that index is constructed and take a deeper look at the underlying investments than they may need to do with a more widely recognised benchmark.

4. What are the underlying investments of the fund?

With more sophisticated ETFs, the investor should undertake a due diligence on the investment strategy and underlying investments of the product to ensure they have a full understanding of the investment they are making. Each ETF provider publishes a fund summary, a prospectus and a summary prospectus, as well as plenty of information on their websites to assist investors in understanding their portfolios. The popular Lithium and Battery Tech ETF, for example, has a hosted webinar on lithium on its website, along with videos and white papers for prospective investors. Investors should look at the underlying companies in the portfolio, where they are domiciled, their returns and prospects and so on. An investor may believe themselves to have made a relatively vanilla investment, although the underlying portfolio may be volatile or highly speculative.

5. Is the product 'real' or synthetic?

A synthetic ETF is one which does not purchase the underlying index securities on behalf of the investor, but instead guarantees the return of that benchmark by using derivatives or other instruments to execute an agreement between the ETF and a counterparty. There is a risk that the counterparty (usually an investment bank) may default, called counterparty risk, and the investor is left with nothing, as they are not entitled to any underlying securities. Much has been written on this subject and it does not apply to most commonly purchased ETFs, especially in Australia, however investors should ensure they are aware of this issue before they consider any investment.

6. How much does it cost?

ETFs are generally perceived to be an inexpensive way to access a basket of securities or pooled investments. As the products on offer become increasingly diverse and sophisticated, this is often no longer the case. The fees for popular sector-based ETFs are sometimes in excess of 1%, which may bring them closer to (and in some cases, exceed) the fees charged by active fund managers. While cost should not be the primary driver of any investment, cost fundamentally impacts the net return (a fact which the ETF industry has successfully impressed upon investors who have used them to purchase traditional indices). Some of these fees may be justified given the complexity of the underlying portfolio, but for others, the price may result in suboptimal returns to the investor.

This list is not exhaustive, but the trend toward sector-specific and targeted instruments offers investors an unprecedented opportunity to invest or trade according to their convictions. However, a misunderstanding of the structure in which the assets are housed may result in more risk than investors appreciate.

Gemma Dale is Director, SMSF & Investor Behaviour at nabtrade, a sponsor of Cuffelinks. nabtrade offers free independent research on each ETF available via its platform, both domestic and international. This article is general information and does not consider the circumstances of any investor.

What NAB's announcement really means

Roger Montgomery

National Australia Bank's (NAB) recent profit announcement would have been another uneventful example of a large Australian corporate meeting the market's expectations, but for one big announcement. Some 6,000 people or fully 17% of the company's workforce will lose their jobs over the next three years due to automation, artificial intelligence and robots, with 2,000 people coming in to execute those goals.

Banks are 'reshaping'

NAB's cash profit was up 2.5% to a record $6.6 billion. The Net Interest Margin was a little better than expected and the non-interest income worse. What surprised the market was the announcement that costs are expected to grow by 5-8% in 2018 and won't fall again until 2020 due to investment in programmes designed to cut costs by $1 billion per annum by 2020. Those programmes include 'significantly reshaping' the workforce by freeing nearly a sixth of the workforce from their daily obligations.

According to John Maynard Keynes, technological unemployment is the product of:

"… our discovery of means of economising the use of labour outrunning the pace at which we can find new uses for labour".

Technological unemployment – the kind Keynes warned about in 1933 - just hit middle Australia in the guts again, but it is not the product of computers and Artificial Intelligence. Indeed, Queen Elizabeth I railed against it in 1589, when she denied William Lee a patent for his stocking frame knitting machine because it would:

"… *assuredly bring [my subjects] to ruin by depriving them of employment, thus making them beggars".*

Sadly, Queen Elizabeth I is today unavailable to defend 6,000 NAB employees from the same fate. The announcement raises some important questions.

The **first** is whether our politicians are actually qualified or incentivised to navigate our country through the tempest that has only just begun.

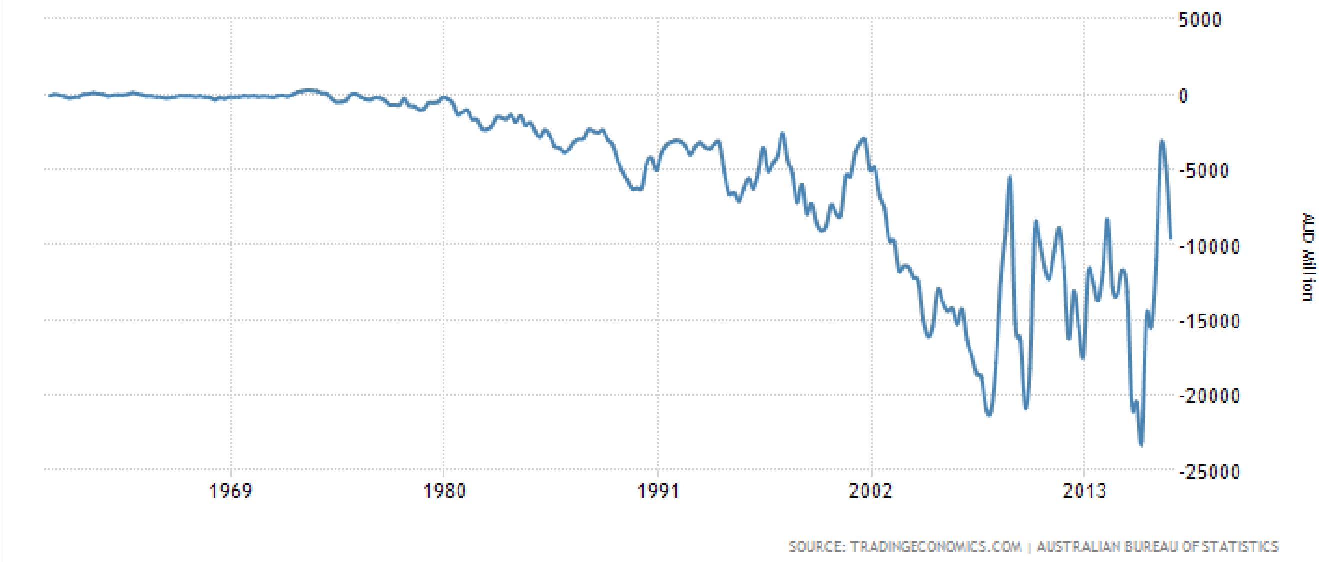
The **second** is whether the current crop of parents or other advisers have thought sufficiently about whether they're providing sound career advice to their children?

And **third**, what, if anything, should we be doing about the societal and economic forces that render large swathes of people unemployable? We don't have space to tackle the third question here, but we can consider the first two.

Let's not concede on our world trade

As the chart below reveals, for an inconceivably long and relevant period, Australia's Balance of Payments (BoP) current account has been in deficit, and a generally worsening trend is evident. The current account records a country's monetary transactions (trade, net income and current transfers) with the rest of the world.

Australia current account ($A millions)



The extended period of deficits, which reflects the cost of our imports far exceeding the revenue from our exports, leads many politicians in Canberra to claim our current account deficit is 'structural'. Indeed, former Federal Trade Minister Andrew Robb told me precisely this.

To label the BoP current account deficit 'structural' is to resign our country to serfdom.

That is not as extreme as it sounds. We cannot forever continue to spend more on our imports than we earn from our exports unless we fund it by borrowing or selling off the farm. Eventually, our foreign lenders - who partially fund our profligacy - won't want our IOU's and they'll demand our property. Were this to occur on a broad scale, and before deciding to default on our debts, we would render ourselves serfs to foreign landlords.

Exporting eight to ten metric tons of iron ore to pay for one imported iPhone is not sustainable. Our spending on iPhones may not change but we should earn more from exporting finished, branded and highly-prized goods and services to fund that spending.

Of course, with no present solution to the problem, the sale of our prime agricultural properties and businesses to foreign owners is painted by our politicians as a 'necessity'. According to Canberra's logic, we 'need' the investment foreign acquirers because they bring innovation and advanced technology that improves employment opportunities for Australians. By owning the innovation we'd broaden the opportunities for our labour force.

The wool is being pulled over our eyes. The truth is we 'need' to sell our property to fund our spending.

NAB's decision shows Australia at a crossroads

More worrying is NAB's announcement demonstrates that the next phase of investment by corporates will be in automation and will detract from jobs rather than create them. And NAB is a domestic business. How much more ruthless would the 'investment' be if we hand control to foreign owners?

All that's required is to give market forces the opportunity to determine what we are good at and where we can add value. We need a tax environment that incentivises enterprising entrepreneurs to start up, and stay, in Australia. NAB's announcement is a reminder that Canberra needs to speed up its development of policies that will ensure John Maynard Keynes is wrong, that technological unemployment is not left to a foreign boardroom.

Of course, Canberra's policy track record - from car manufacturing and energy to the NBN - hardly inspires confidence. With so much to do, it's disconcerting, if not embarrassing, to witness Canberra's focus on same-sex marriage and outing dual citizens.

In the past technological unemployment replaced routine intensive occupations, hollowing out middle-income jobs in manufacturing and clerical services, such as in-bound call receptionists and toll collectors, and forcing labour into low-income service roles. In many former manufacturing states of the US, for example, middle-income manufacturing has been replaced by low-income labour. These people now work in servicing the 140 million square feet of additional mega warehouses built to facilitate the doubling of e-commerce sales in the US, from $142 billion to $291 billion since 2010. Where once computerisation was confined to routine manufacturing and service roles, rapid advances in technology, including data mining, machine vision and AI, will render a much wider range of roles redundant.

Consider for a moment that as recently as 2004, Levy and Murnane, in their book *The New Division of Labour*, noted the challenges associated with replicating human perception. They used the example of driving in traffic as being 'insusceptible' to automation and specifically noted that making a left hand turn in front of oncoming traffic would be difficult for an algorithm to replicate judiciously. Just six years after that book was penned, Google announced it had successfully modified a Toyota to be fully autonomous.

Falling computing prices will ensure that cognitive and problem-solving skills are relatively productive, and a polarisation in the labour market should follow. Some of the big changes to the employment landscape will include transportation and logistics as the cost of sensors makes augmentation of vehicles cost-effective.

Elsewhere, algorithms will enter sectors reliant on storing and accessing information. Office and administrative support roles will be threatened. Meanwhile, personal and household robotic technology is advancing rapidly and the comparative advantage of human mobility and dexterity is diminishing. This will threaten a proportion of low paid jobs sending wages down.

Finally, for our purposes, but by no means final, prefabrication will permit more of the construction process to be conducted in controlled environments reducing error rates and injury, while robots that can assemble on-site are already being demonstrated.

NAB's announcement of 6,000 job losses represents the tip of the iceberg while simultaneously bringing the reality of the shift in the employment landscape home. And for investors, navigating this change will be no less challenging.

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Banks reporting season Scorecard 2017

Hugh Dive

Over the last 10 days, the major Australian banks have reported their financial results for 2017, with collective annual profits of $31.5 billion. In comparison to the May reporting season (which saw the surprise introduction of a 0.06% levy on the liabilities and $50 billion wiped off the bank's collective market capitalisation), the results were mostly in line with expectations. A key feature in the last round was how efficiently the financial impact of this 'game-changing' levy or tax was passed onto borrowers.

Our reporting season awards

This article examines the common themes emerging, differentiates between the banks and hands out our reporting season awards to the financial intermediaries that grease the wheels of Australian capitalism.

Reporting season scorecard November 2017

Code	Share Price	Cash earnings growth	Dividend growth	Net interest margin (reported)	Impairment charge as % of loans	Capital Ratio	Return on Equity	Forward PE Ratio	Forward dividend yield	2017 total return	Summary of 2017 result
WBC	$ 32.64	3.0%	0.0%	2.10%	0.13%	10.6%	13.8%	13.4	5.8%	3.0%	Pros: Very low bad debts, expanding margin and growing Tier 1 capital Cons: Higher costs
ANZ	$ 30.02	7.6%	0.0%	1.99%	0.21%	10.6%	11.9%	13.1	5.4%	1.3%	Pros: Capital stronger and bad debts falling Cons: Costs up and markets income down due to lower volatility
NAB	$ 31.70	2.5%	0.0%	1.88%	0.15%	10.1%	14.0%	13.1	6.3%	6.6%	Pros: Solid result, margins up, bad debts down and loan growth ahead of expectations Cons: Aggressive cost head count reduction will come at a cost of $500-$800M
CBA - 1st Quarter 2018	$ 78.20	6.0%	2.1%	2.11%	0.11%	10.8%	16.0%	13.7	5.6%	0.1%	Pros: All round solid set of results Cons: Costs elevated from investment spend

Source: Company reports, IRESS, Atlas Funds Management

- **Cash earnings growth.** Across the sector profit growth was generally in-line with the credit growth in the overall Australian economy. ANZ reported headline profit growth of 7.6% after backing out the impact of the sale of the bank's Asian retail businesses, Esanda and property gains from 2016. The growth across the sector was achieved by improving economic conditions and lower bad debts. All banks reported lower trading income due to decreased volatility over the year. During periods of higher market volatility, the banks can boost their income by both selling more foreign exchange and interest rate derivative contracts to their clients. However, they can also generate trading income by using their large balance sheet reserves to trade securities on the global markets.

ANZ
Gold Star

- **Angry on costs.** Reducing costs featured prominently in the plans of bank CEOs for the upcoming year, with much discussion about branch closures and headcount reductions. The removal of ATM bank charges and the migration of transactional banking from the physical bank branch to the internet is likely to deliver an efficiency dividend to the banks. NAB took the most aggressive stance, announcing that the bank will reduce its workforce by 6,000 employees due to business simplification and increasing automation. However, this will come at a cost with NAB expecting to book a restructuring charge of between $500-$800 million in 2018 and increases in investment spend by $1.5 billion. They may also be a 'political' price.

National Australia Bank
Gold Star

- **Bad debt charges still very low.** One of the key themes across the four major banks and indeed the biggest driver of earnings growth over the last few years has been the ongoing decline in bad debts. Falling bad debts boost bank profitability, as loans are priced assuming that a certain percentage of borrowers will be unable to repay and that the outstanding loan amount is greater than the collateral eventually recovered. Bad debts fell further in 2017, as some previously stressed or non-performing loans were paid off or returned to making interest payments, primarily due to a buoyant East Coast property market and higher commodity prices. CBA gets the gold star with a very small impairment charge in first quarter 2018 courtesy of their higher weight to housing loans in their loan book. Historically home loans attract the lowest level of defaults.

  Gold Star

- **Dividend growth stalled but may return.** Across the sector dividend growth has essentially stopped, with CBA providing the only increase of 9 cents over 2016. With relatively benign profit growth, a bank can either increase dividends to shareholders or retain profits to build capital (thereby protecting banks against financial shocks), but not both. In the recent set of results the banks have held dividends steady to boost their Tier 1 capital ratios. Additionally, dividend growth has been limited as the banks have absorbed the impact of the additional shares issued in late 2015 to boost capital.

  Gold Star

  Looking ahead, there may be some capacity to increase dividends (especially from ANZ and CBA after asset sales), as the rebuild of bank capital to APRA's standards is largely complete. The major Australian banks in aggregate are currently sitting on a grossed-up yield (including franking credits) of 8.2%.

- **Net interest margins in aggregate increased** in 2017, despite the imposition of the major bank levy. This was attributed to lower funding costs and repricing of existing loans to higher rates. In response to regulator concerns about an over-heated residential property market and in particular the growth in *interest-only* loans to property investors, the banks have repriced these loans higher than those repaying both *principal and interest*. For example, Westpac's currently charges 6.3% on an interest-only loan to an investor, which contrasts to the 4.4% being charged to owner occupiers paying both principal and interest. This has had the impact of boosting bank net interest margins.

  Gold Star
  Australian banking oligopoly

  One of the key things we looked at closely during this results season was signs of expanding net interest margin ((Interest Received - Interest Paid) divided by Average Invested Assets), and this was apparent even after allowing for May's levy.

- **Total returns.** In 2017, NAB has been the top performing bank, benefitting from delivering cleaner results after it jettisoned its UK issues with spin-off of the Clydesdale Bank and Yorkshire Bank. CBA has been the worst performing bank as it faces both the imminent retirement of its CEO and the uncertainty around possible fines from foreign regulators for not complying with anti-money laundering laws. This has resulted in CBA losing the market premium rating that it has enjoyed for a number of years over the other banks.

  National Australia Bank
  Gold Star

Our final take

What to do with the Australian banks is one of the major questions facing all investors. The Australian banks have been successful over the past few years in generating record profits, benefiting from lower competition from non-bank lenders and record low bad debts. Looking ahead it is not easy to see how the banks can deliver earnings growth above the low single digits in an environment of low credit growth, increased regulatory scrutiny and the sale of some of their insurance and wealth management divisions.

Competition amongst the big four banks is likely to increase, as for the first time since 1987 (NAB's purchase of Clydesdale Bank) we have no Australian banks distracted by foreign adventures, with all four focused on the Australian market. However, looking around the Australian market the banks look relatively cheap, are well capitalised and unlike other income stocks such as Telstra should have little difficulty in maintaining their high fully franked dividends.

Hugh Dive is Chief Investment Officer of Atlas Fund Management. This article is general information and does not consider the circumstances of any investor.

See also: KPMG's *Major Australian Banks Full Year 2017 Results Analysis*, and EY's *Australian major banks' full year results 2017*.

25 questions to ask your financial adviser

Jonathan Hoyle

Today, one the most respected of all the professions are the medics. Yet it wasn't always thus. Contrary to popular belief, *'Primum, non nocere'* - *'first, do no harm'* does not appear in the Hippocratic Oath - it is, in fact, attributed to Thomas Inman, as recently as 1860. That same year a doctor by the name of Oliver Wendell Holmes famously remarked that *"If the whole material medica, as now used, could be sunk to the bottom of the sea, it would be all the better for mankind—and all the worse for the fishes."*

In 1987, when Stanford Brown was founded, few would have mourned if the entire financial planning profession were sunk to the bottom of the ocean, as a visit to your friendly neighbourhood planner could be seriously harmful to your financial health. You were likely to emerge as the proud owner of an egregiously expensive insurance policy or a fancy investment scheme such as a macadamia nut plantation, with fees and commissions layered more intricately than an onion.

However, that was then. And the times are a changing. Financial advice as a profession is finally coming of age. But where to start? There are more than 20,000 licensed financial advisers in Australia. How does one sort the wheat from the chaff; the Bernie Madoffs from the Warren Buffets? We would recommend commencing your search with this helpful pamphlet, entitled '[Questions To Ask Your Financial Adviser'] compiled by our industry regulator, ASIC.

"I retire on Friday and I haven't saved a dime. Here's your chance to become a legend!"

A more critical (and controversial) article was recently penned by Jason Zweig, a financial columnist for the Wall Street Journal, entitled 'The 19 Questions To Ask Your Financial Adviser'. Here we look at each of his questions and adapt for the Australian market. It won't guarantee you a good adviser, but it will reduce the odds of a dud.

1. Are you always a fiduciary, and will you state that in writing?

Not a problem for Australia's financial planners as we are required, by law, to act in the best interests of our clients.

2. Does anybody else ever pay you to advise me and, if so, do you earn more to recommend certain products or services?

Since 2013 it has been illegal to receive payment from the managers of funds recommended by a financial adviser. However, the vast majority of advisers receive payments from the insurance products they recommend. A conflict of interest, for sure, but mitigated by the fact that from January 2018, advisers will receive the same commissions from insurers, and volume bonuses for channelling business to one particular insurer have been outlawed.

3. Do you participate in any sales contests or award programs creating incentives to favour particular vendors?

Should be a no. Red flag if otherwise.

4. Will you itemise all your fees and expenses in writing?

Absolutely. Insist on this. It's also the law.

5. Are your fees negotiable?

We believe (quite strongly) that fees should *not* be negotiable. Clients should be charged by the same methodology. Existing clients should not subsidise new clients (unlike certain cable TV providers we could mention), nor should those with superior negotiating skills receive favourable terms.

6. Will you consider charging by the hour or retainer instead of an annual fee based on my assets?

Depends on the job you want done. Yes, for specific project work; but not for ongoing advice. Hourly charging encourages inefficiency. Nearly all advisers will increase their fees in line with the assets to manage. But the relationship should not be linear - managing $2m is not twice as involved or complex as managing $1 million.

7. Can you tell me about your conflicts of interest, orally and in writing?

Of course. These must be disclosed orally and in writing.

8. Do you earn fees as adviser to a private fund or other investments that you may recommend to clients?

Some advisers are developing their own in-house sector funds. For example, the Acme Financial Adviser Australian Share Fund. This creates a conflict of interest. Focus on those who have a broad Approved Product List (APL) to recommend only the best-in-breed and most fee-competitive funds.

9. Do you pay referral fees to generate new clients?

Many advisers pay referral fees to lawyers and accountants to refer new clients. Provided this is fully disclosed, there is no conflict. It's more an issue for the referrer than the adviser.

10. Do you focus solely on investment management, or do you also advise on taxes, estates and retirement, budgeting and debt management, and insurance?

Some advice firms offer all these functions in-house, but the vast majority work with other professionals (such as estate planning lawyers and accountants). No issue, again provided all relationships are disclosed.

11. Do you earn fees for referring clients to specialists like estate attorneys or insurance agents?

A repeat of Q9.

12. What is your investment philosophy?

A five-word question but a lengthy answer. Not all are the same. This is one of the most important questions you need to ask if the principal job you are looking for is money management.

13. Do you believe in technical analysis or market timing?

Those advisers that repeat the mantra 'it's all about time in the market' are not really providing investment advice. Try telling a Japanese equity investor from the late 1980s that it's all about 'time in the market'. Since the 1987 crash, US equities have returned a whopping 11% per annum whilst Japanese equities have returned a derisory 0.5%. Advice firms should have long-term views (the short term is almost impossible to predict) on asset classes. Otherwise, what are you paying for?

14. Do you believe you can beat the market?

See above. It's all about the long term. As Mark Twain might have said 'markets don't repeat but they do rhyme.'

15. How often do you trade?

We all know the stockbroking model is largely discredited. Large turnover means large trading fees and taxes. At SB, we adopt Warren Buffet's maxim that *"the cornerstone of our investment strategy is lethargy, bordering on sloth."*

16. How do you report investment performance?

This can be a major differentiator between advice firms. All investment returns (after fees) should be available at any time over any period. And they should also be benchmarked. Worry if you are told that 'we don't benchmark.' To paraphrase Trotsky, *"you may not be interested in benchmarking, but benchmarking is very much interested in you."*

17. Which professional credentials do you have, and what are their requirements?

The CFP is the gold standard in the US and here in Australia. It doesn't guarantee great advice, but it reduces the odds of engaging a dud. Make sure to ask for the qualifications of the Investment Committee too. The Chartered Financial Analyst (CFA) is the undisputed certificate of excellence for portfolio analysis.

18. After inflation, taxes and fees, what is a reasonable estimated return on my portfolio over the long term?

Your adviser should be able to provide you with past returns (for a given level of risk) and conservative estimates of future returns. Returns will likely vary from inflation plus 3-6%, depending on the level of risk in the portfolio. Anyone promising you double-digit returns is either a fool or a crook.

19. Who manages your money?

See also Q17. Financial advisers are not money managers. They are not trained to do this. Look for a professional Investment Committee run by an experienced CFA.

We would also add five of our own to Mr. Zweig's comprehensive list.

20. How do I exit this relationship if I don't like it?

There should be no lock-ins. Financial advice firms are not mobile phone companies. Account portability is essential.

21. Who owns your business?

Most advice firms are owned by a handful of individuals. Be wary of those with institutional ownership, especially when those institutions also manufacture financial products. Massive conflicts of interest.

22. Who provides your licence (AFSL) to operate?

You might prefer those firms who have their own licence. But there are plenty of shoddy independent operators, and there are plenty of excellent advice firms who are licensed by a major financial institution. Not all that helpful. The one key advantage of being self-licensed is that these firms are free to recommend a broader universe of funds and insurance products. If you are meeting with a firm licensed by a bank, ask them what percentage of their clients' funds or insurance contracts are placed with related entities. This should tell you all you need to know.

23. Who is your Ideal Client?

If the response sounds like 'anyone with a pulse', it might be best to move on. Advisers are increasingly specialising. This is a good thing!

24. Can you provide me with testimonials of clients in a similar situation?

Always ask for this. We would recommend checking out a website called Adviser Ratings. It contains testimonials from the adviser's clients and a rating. It's a bit like Trip Adviser. Also ask for ASIC's Adviser Register. This will tell you if your new adviser has been up to any skulduggery in the past.

25. What do you read or watch to keep up-to-date?

Markets constantly evolve and advisers should read serious financial journalism written by experts, not only popular press and media. Of course, Cuffelinks should be on the list.

Choosing your financial adviser is a significant decision. We suggest asking people in your life whose financial opinions you respect. These might be your accountant or an educated friend. And meet plenty of advisers during your due diligence. A good adviser adds value. They really do. We hope this list will help you in your search. Good luck!

Jonathan Hoyle is Chief Executive Officer at Stanford Brown. This article is general information and does not address the circumstances of any individual.

Three crucial mistakes about life expectancy

Don Ezra

I've found that many people have a vague idea about how long life expectancy is, and that it is typically underestimated. It's an important subject, because if you're going to plan to make your assets last a lifetime, you need to make some estimate about how long that lifetime may be.

Why do so many people misunderstand it? Is it the arithmetic or the concept? Let's take a look. (Spoiler alert: the arithmetic is simple.)

Let me make three points about life expectancy.

1. Most people misunderstand the arithmetic.

Even if they have heard that in some country (call it Country A) life expectancy at birth is 80 years, they don't understand that if they have reached the age of 65, the average person can expect to live more than another 15 years (in fact, probably more like 20 years). Here's how the arithmetic works:

Suppose I asked you for the average of the numbers from 0 to 100. It's not a trick question. It's simple arithmetic. You know the answer is 50.

Now suppose we leave out the lower numbers and determine the average of the numbers from 40 to 100? Obviously, it'll be higher; in fact, the average now rises to 70.

It's similar with life expectancy.

Suppose we encountered a peculiar population of 100 people in which one person dies before the first birthday, one dies between ages 1 and 2, and so on, the last one dying between 99 and 100.

What would be the average age at death? Again, not a trick question: it's 50. Half the people will live longer than that, half won't reach it.

Now suppose we leave out all of those who die before age 40, leaving us with a smaller group. The average age at death of this smaller group is 70. Half of those alive at age 40 will live longer than that, half won't reach it.

So, what does this tell us about the life expectancy of this peculiar population?

It tells us two things. First, at birth, if we don't know which person we're talking about, all we can talk about is the average, and for the average person, then, the life expectancy is 50 years. Second, if we consider only those who have survived until age 40, and again we don't know which individual we're talking about, their average age at death is 70. Their *future* life expectancy, once they've reached 40, is another 30 years, because that's what 'life expectancy' means: it's the average number of *future* years to be lived by the average member of a well-defined group.

Notice that the people in the second group (those who have survived to age 40) are also members of the first group (the entire population). But the two groups are not the same, even though they contain some identical members. The second group excludes those who have already died before 40; that makes it a different group, and a longer-lived group. So, if we are to define life expectancy, it's important to define the group we're talking about very clearly.

OK, now let's go back to Country A, and interpret those numbers.

The numbers tell us two things. First, if you include the entire population, the average age at death is expected to be 80. Second, if you exclude those who have already died before age 65, and include only those who survive past that age, their average age at death is higher than 80; in this case it's around 85. And that's why the future life expectancy of someone in Country A who has already survived to age 65 (a smaller group) is a further 20 years, not the 15 years that people often misunderstand it to be.

Life expectancy tables vary by gender (typically, the life expectancy of a female is longer than that of a male), by country, by race – all kinds of factors, in addition to age. You may find a website with a calculator that helps you to estimate your future life expectancy. If your health isn't average (it may be better or worse), your doctor may be able to help.

2. Averages disguise the unpredictability

Talking about the average conceals the fact that, for any individual, the actual date of death is uncertain. For most people, until they're near death, their specific future life expectancy is still pretty much unpredictable.

When you make financial plans about the future, *it's important to take this unpredictability into account*. There are many ways to do so, the subjects of future posts.

3. The longer life expectancy of one member of a couple

More specifically, how long before the *second* death of the couple. Techies call this the 'joint and last survivor' life expectancy. It's important because it's necessary to provide for the longer-lived member of a couple, whichever one that may turn out to be.

Suppose there's a couple whose individual future life expectancies, at some point in time, are roughly 15 years and 20 years. How long until the second death?

Most people say: well, after 15 years you expect one to die, and after 20 years the second one will die; so, it's 20 years to the second death, right?

It actually turns out to be a little more complicated than that. I won't go into the arithmetic. I'll just tell you why the expected time to the second death is *longer* than 20 years.

The one with the longer expectancy has a 50/50 chance of living longer than 20 years. The one with the shorter expectancy has *some* chance (though much less than 50/50) of living longer than 20 years. Between them, they have a bit *more* than a 50/50 chance. And so for the couple together, *the average expectancy to the second death is longer than the longer of the two individual life expectancies*.

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Harnessing the upside and risks of small caps

Matthew Booker and Adam Lund

Global equity managers have been lining up to create Listed Investment Companies (LICs) recently, but small caps have been underrepresented. While there are pros and cons associated with any investment structure, some of the new breed of LICs benefit from managers absorbing listing costs. In addition, the number and scale of offerings has meant a significant improvement in secondary market liquidity.

LIC structure has benefits … and some risks

Why is the LIC structure appealing, often as the listed alternative to a managed fund?

- LICs are closed-ended. Once listed, the LIC doesn't have the cash flow pressures of a managed fund, which must keep cash on hand to manage applications and redemptions. As a result, the frictional cost (direct and indirect costs of executing transactions) is typically lower.
- Freed of the requirement to keep cash on hand, the manager can be fully invested and focus on investment fundamentals without worrying about cash flow.
- LICs are companies. Distributions are paid as fully franked dividends, generally a tax benefit for investors. It can also retain earnings whereas a unit trust must pay out all income including capital gains.
- LICs are transparent. Investors have a better look-through at managers' holdings than in a managed fund.

On the other hand there are risks and potential drawbacks:

- Market timing is important for an LIC, because once listed, it cannot raise new funds without going back to the market. If all the proceeds of the initial public offering (IPO) are invested on listing, and the market falls soon afterwards, it can be difficult to re-balance the portfolio without raising new funds.

The best way to mitigate this risk is to choose an experienced manager with a track record of managing the intricacies of the LIC structure. Managing market-timing risk, for example, could mean extending the trade horizon to deploy capital after listing, rather than investing fully in the short term. In our view, six months is an appropriate time to take to invest capital in order to offset market-timing risk.

- Dividends can only be paid out of retained profits, and it takes time to generate profits and dividends. In some cases investing in an unlisted trust could see earlier distributions to investors. Over time these differences are likely to decrease.
- LICs may be popular but small caps are less represented than large cap equities. The small cap segment of LICs lacks diversity and scale, and some are sub-scale and have traditionally traded at a discount to Net Tangible Assets. As a result, they have not attracted the breadth of investors necessary to maintain liquidity and keep spreads narrow post-listing, which has curtailed further investor demand.

Investment opportunities in small caps

At the same time, at the small end of the market, the opportunity for growth is higher. The small cap market tends to be less efficient and the companies not as well researched as large caps. Specialist managers who understand the sector have an advantage.

Blackmores, A2 Milk, Domino's Pizza and Dulux group were once small caps with strong potential. Investors who identified their potential early did well.

Growth aside, some apparently unlovable small caps are turnaround opportunities. In smaller businesses, management teams can have a greater material impact on overall performance.

Success in small caps requires an intimate knowledge of what makes small and medium businesses thrive or fail. For example:

- Smaller companies tend to be more leveraged to economic growth and changes in the economic climate, which means they can be more volatile with greater price dispersion.
- Returns from small caps are more dispersed. Over the past 12 months, the dispersion of returns for the top 100 stocks on the ASX was -61% to 98%, whereas small caps ranged from -65% to 1,000%. The aim is to reduce risk by buying companies whose cash flow can support gearing levels or avoid companies where gearing is high.
- Free cash flow is the make or break number for a small business. Cash flow is the life-blood and key driver of value for any business, small or large, but for small businesses cash flow is arguably more important. It is essential that small companies can self-fund through the cycle, so when a downturn hits they are not reliant on third party funding to survive. The 'dot.com' bust was a stark illustration of how a great idea can be worthless when the market loses confidence in the business model and it is unable to fund through that window due its cash burn. The current market is exhibiting similar characteristics.
- The small caps sector is larger of companies by number and more diverse when compared with the larger cap space. Research coverage is sporadic and of lesser quality, and therefore it's more important to have specialists in this field.

Managing risk is key for small caps

There's no such thing as a free lunch in finance. With the potential for strong performance comes potentially higher risk. This is certainly true of small caps, which is why managing risk is of the utmost importance. Sounds simple, but what does it really mean, and how does a small cap manager do it?

Put simply, look at risk first, return second, and this comes back to cash flow. Free cash flow generation through the full business cycle is crucial. We also prefer companies to have low balance sheet gearing to protect against potential downturns.

Valuation matters. We forecast the cash flows and calculate a discounted value of every company we invest in. We look for a margin of safety relative to this valuation. We're often buying companies at an inflection point, many times in non-consensus situations.

Small caps have much to offer as complimentary to portfolios which are heavily biased to the major banks and a handful of blue chips. Small companies often have a growth potential that is underappreciated by the market for transient reasons. However, their fragmented liquidity, wider spreads and greater volatility mean that for most investors, there are also pitfalls.

Matthew Booker is Portfolio Manager, and Adam Lund is an analyst and trader at Spheria Asset Management. This article is general information and does not consider the circumstances of any investor.

Additionally, on our website this week

For those who print this newsletter and do not visit the website, there are two additional items worth noting.

First, we have launched a new podcast series with Livewire Markets, called 'Inside Investing'.

Second, since Alex Denham's article last week was so popular, we have republished some of the personal reader comments which add important new insights to the aged care problem.