Underperformance has a good side

Bad stocks can rise and great stocks sometimes falter

ROGER MONTGOMERY

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Over the long run you'll do just fine investing, at rational prices, in extraordinary businesses. An extraordinary business is one that can retain a meaningful proportion of its profits each year and reinvest those retained profits at an attractive rate.

Think of a bank account with $10 million deposited, earning 20 per cent interest and reinvesting the interest each year; In 10 years there will be $63m in the account. Auction the bank account in a decade's time and you'll do just fine. You can now turn the big auction room, which is the stockmarket, off.

Sure, the risk of a so-called Brexit, China, or the Middle East may all have an impact on prices in the short term, but in the long run, prices cannot help but reflect the increase in the worth of that bank account. And you don't need to be particularly skilled at forecasting the markets or the economy either. Feel free, however, to heed my warnings about house prices.

So why am I telling you this?

Because I need to remember it myself. Inevitably the investing strategy outlined above goes through periods of underperformance — a word I hate. It means the broader market index has done better than my funds at Montgomery. And it means Blind Freddy could have closed his eyes, bought the stockmarket index — with all the rubbish companies that constitute it — and done better than a team of professional, hard-working analysts.

Worse still, it gives ammunition to the promoters of index funds who actually recommend you act like Blind Freddy, close your eyes and just buy the index — an artificial list of big-but-not-good companies that aren't growing and whose prospects are challenged by maturity and disruption.

They ask you to ignore all the facts but have faith that their share prices will just go up.

A step back, however, reveals that the share prices of companies like Telstra, NAB and AMP today are all lower than where they were in 1999. That is 17 years with no capital appreciation.

And what about the index itself? The S&P/ASX 200 is where it was in 2006. So much for claims that the stockmarket always goes up. And so much for the simplistic advice to invest for the long run. The longer you remain invested in mediocre businesses that pay most of their earnings out as a dividend, the more likely your purchasing power is going to be eroded.

Over the past 12 months, the ASX 200 is still down about 12 per cent, even after rising 7 per cent from its February 2016 lows. The recent strength, however, is due to a rally in the materials sector with leveraged mining stocks up by double digits in the week, having already more than doubled since February. Iron ore prices have jumped to $US69 a tonne, from just $US37 a tonne last December.

Having missed the run-up in material stocks, one might wonder whether Montgomery should have been positioned differently. The answer, however, lies not in recent stock price performance but in the long-run economic performance of businesses in the materials sector.

Trying to consistently and correctly predict the relative performance of different sectors, or stock prices themselves, is tantamount to correctly betting on black or red at the casino. It's simply a mug's game. Instead, investors should focus on the business.

BHP is consistently applauded as Australia's resource success story and speculation about the iron ore price bottoming may tempt some investors to believe they should think about buying the stock. But take a quick look at the business and you might wonder why so much attention is paid to BHP at all.

- Ten years ago BHP earned $14 billion on shareholders'/owners' funds of $32.5bn and total borrowings of $12bn.
- After 10 more years in business the company has $84bn of shareholders' funds and $50bn of borrowings, so you would reasonably expect it to also be earning a lot more than it did 10 years ago.
- But BHP, now run by Andrew Mackenzie, is forecast to earn just $1.5bn in 2016, down from $14bn in 2006.

Short-term underperformance makes a fund manager look bad compared with the index but one needs to appreciate such relative performance is inevitable because the prices of good businesses don't always go up and the rubbish that I don't own occasionally does.

And rather than asking whether the iron ore price will continue to rise or reverse, I just ask: are we invested in high-quality businesses? If the answer is yes, we should be delighted when the prices of great quality businesses underperform because it represents opportunity rather than risk.

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Last chance to comply on art and collectibles

MONICA RULE

Unfortunately, while we ponder which rumours may or may not be true about next Tuesday's federal budget, there is no doubt whatever that key changes to superannuation rules for antiques, art, stamps, coins, rare books and other collectables are certain to kick in on July 1 this year.

"Collectables and personal use assets" as defined for superannuation and investment purposes are items such as artwork, jewellery, antiques, wine, cars, recreational boats, memberships of sporting or social clubs, or assets that are ordinarily used or kept mainly for personal use or enjoyment (with the notable exclusion of land).

The "new" law did in fact become effective from July 1, 2010. However, the law allowed SMSFs that already acquired collectables and personal-use assets prior to July 1, 2010 to continue with their existing arrangements. They did not have to comply with the requirements of the law until July 1 this year. And that date is almost upon us.

From July 1, SMSFs that have acquired these types of assets and benefited from the grandfathering arrangements will need to put plans in place to comply with the law.

The law requires that the asset must not be used by or leased to a related party. For example, if prior to July 1, 2010, an SMSF was leasing an artwork to an SMSF member so it could be displayed at the member's home or their business premises, then the lease needs to be terminated by June 30.

The law also stipulates that the asset must not be stored in a private residence of a related party. This means an artwork purchased by an SMSF cannot be stored at the member's home. The artwork can be kept in suitable storage at the member's place of business or anywhere else, provided the member can justify to the ATO that it is the best place to store the art work due to temperature and condition of the room and the storage container.

It cannot just be left hanging on the walls of the member's business for the personal enjoyment of the members or others.

The decision to store the asset somewhere must be documented and kept for at least 10 years. This can be a done in a trustee minute detailing where the asset is stored and the reason behind the storage.

The asset must be insured in the SMSF's name within seven days of its purchase. If an asset is not currently insured, then the SMSF trustee will need to obtain insurance for the asset by July 1 this year.

> If SMSF trustees want to avoid a penalty, they need to act now.

Finally, if keeping the asset in the SMSF will result in non-compliance with the law, and the SMSF members want to sell the asset to themselves or to a related party, then the members will need to obtain an independent valuation of the asset so that evidence can be provided that the asset was sold at market value.

Now as I said, the law has been in place since July 1, 2010 for new collectables and personal use assets acquired by SMSFs since July 1, 2010 and the grandfathering arrangements for assets acquired by SMSFs prior to July 1, 2010 will be over on July 1 this year.

There isn't much time left to comply.

If SMSF trustees want to avoid paying the potential $1800 penalty for non-compliance with the law, they need to act now.

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Genuine philanthropists stifled as they seek blended financial vehicles to benefit the country

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For those in the know, the funding arms race within both Australian and North American philanthropy has taken interesting turns with new relationships being forged between traditional commercial risk taking and altruistic charitable motivations.

Australian Ultra High Net Worth families in particular have increasingly become frustrated by the rigidity of ATO-recognised Private and Public Ancillary Fund philanthropically approved structures — often referred to as PAFs or PuAFs — and this has seen several seek better outcomes in the jurisdictions of Hong Kong, Israel, Switzerland and importantly, the US.

The interesting turn for northern hemisphere philanthropy has been the rise and nascent acceptance of "blended finance"; which, in essence, sees public, private, corporate and charitable pools of savings co-mingled to achieve altruistic outcomes via commercially driven endeavours.

Australian taxpayers are already contributing to these blended initiatives through our financial support and membership of the IMF, World Bank and ASEAN, to name but a few.

To better understand the new directions contemporary philanthropic trends are heading, it becomes important to recognise that traditional 20th century philanthropy had always perceived "risk" as a discounted factor — in other words, all moneys allocated towards a given cause or project has subsequently been written-down as spent and therefore the risk of returning capital has never needed to be contemplated.

It appears now though that 21st century philanthropy is heading in new directions and Australian UHNW families are paying greater attention to these developments than most simply because their current, domestic options remain so restrictive.

The most recent example of newly blended financial engineering has seen a heated debate in the US surrounding the role of "limited liability company" or "LLC" blended entities and this new approach has been dubbed "Private Capital Philanthropy".

On December 2, 2015, Facebook founder Mark Zuckerberg and his wife, Priscilla Chan, announced they would philanthropically pledge 99 per cent of their Facebook shares and do so through an LLC and not what is traditionally expected, being either a US private foundation, charitable remainder or lead trust.

Given that on the date of this announcement their gift would be in the vicinity of $US50 billion, this sizeable example of private capital philanthropy stoked a fresh debate within Australian philanthropic communities about how else they may also find blended financial options to champion their respective families' charitable missions, personal giving programs and family foundation remits.

The Zuckerbergs' initiative raised poignant questions that resonate for Australians which include:

1. Given that gifting via US LLCs does not constitute a charitable donation for tax purposes, as American law requires a donor to make an outright gift and lose control of donated assets, how would tax deductibility be treated for Australian equivalents?

2. American entrepreneurs are clearly testing new ways that they can dedicate personal assets for causes, while retaining control and flexibility, but will the Australian Taxation Office respect the initiative of Australian entrepreneurs and socially-minded philanthropists as the US IRS appears to have?

3. In the US, LLCs are often used as a part of a broader giving strategy that includes traditional methods such as private foundations, direct donations and donor-advised funds and the question remains, can Australian PAFs, PuAFs and family foundations interact with for-profit structures such as proprietary limited (Pty Ltd) companies in these ways?

4. Even though LLCs do not provide donation tax deductions, they do reassure investors in the donor's company that the donor retains voting control and very importantly are not obliged, as US private foundations are, to spend 5 per cent of their assets annually — this predicament is echoed nearly identically in Australia, especially regarding compulsory minimum annual distributions.

5. Who defines the requirement for "impact" — whether that be social, environmental or scientific — given that the donating parties remain as both commercial and altruistic participants? As is the case with the Zuckerbergs or eBay founders Pierre Omidyar and Laurene Powell Jobs, who also championed LLC giving.

Above all else, the primary frustration for bona fide Australian philanthropists is that, unlike the US, within Australia, this debate is not being allowed to proceed as any notion of ingenuity when it comes to charities and philanthropy is muted before it is allowed to begin — "negative gearing" can be debated to no end but new forms of private capital philanthropy are apparently beyond the pale.

Nonetheless, it has become crystal clear if the government and corporate Australia is rapidly withdrawing from public funding of the arts, charities and educational initiatives between now and 2019, either traditional or private capital philanthropy must play a more compelling role.

Mobilising private capital to generate, not just economic value but also social and environmental value, represents the best strategy for Australia, given the profound societal challenges ahead and the ever-present need to modulate the amount of accepted risk.

Larkin Group is an Ultra High Net Worth wealth team focusing on high-yielding global investments.

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