> A quick glance at the performance of the ASX 200 over the past decade will reveal why you don't want to be invested in that index.
> ROGER MONTGOMERY, MONTGOMERY FUND

Index investing just for dummies

ROGER MONTGOMERY

Here's a handy one-liner for the marketing team at any index fund: "Most active fund managers underperform the index". This is, however, an unmitigated exaggeration and when it is applied liberally, along with the promise of diversification and low costs, the arguments are the pitchfork used by index managers to collect funds and fees from unsuspecting Australian investors.

As the path of least resistance ensnares more unsuspecting investors, index-tracking strategies increase their share of assets, and according to Morningstar, passive funds now account for a third of US mutual fund assets, up from a quarter just three years ago.

In Australia, ASX-listed ETFs are at a record high of over $17 billion and according to a January 2015 Australian ETF Review, ETF trading activity also broke the record for the largest month-on-month gain in funds under management as growth reached $955 million. More than 180,000 investors are expected to have adopted the structures by the end of calendar 2015. The number of financial advisers employing ETFs has reached the record level of 7000. (Exchange traded funds act like index funds and hold a basket of shares that mirrors an index, such as the ASX 200. An ETF is simply a version of an index fund where the product itself is listed on the stock exchange.)

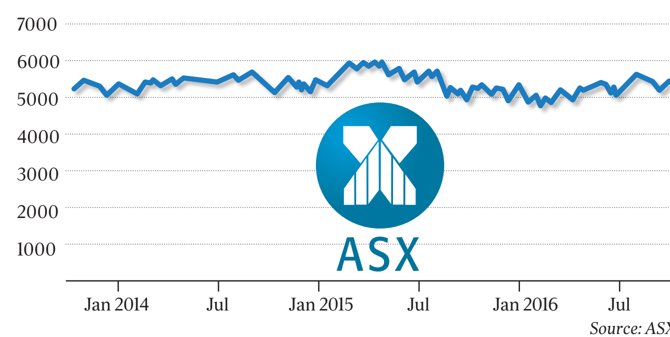
The popularity of index investing, especially in Australia is unwarranted, and that's leaving aside the argument that index investing, by definition, guarantees average returns. Index investing, especially when directed to market capitalisation-weighted equity indices (the bigger the share market capitalisation, the bigger the share of the index fund), is simply dumb investing.

Know your stuff

When Warren Buffett recommended index investing to the masses, he made the point that it suits the "know-nothing investor". That is, the investor who has no interest in understanding a business or valuing it.

If you are reading this article, you are not a know-nothing investor. And if you are an adviser, your clients are relying on you and paying you to be a "know-something investor".

ASX 200 going nowhere fast



Source: ASX

Here's three key reasons why index investing is dumb with a simple example based on the oil stock Exxon first articulated by one of our analysts, Daniel Wu.

- The *Financial Times* recently published a column on ETFs pointing out that ExxonMobil, the largest US oil company, is included not only in S&P index products, but in a variety of specialist ETFs for active beta, momentum, dividend growth, deep value, quality and total earnings.
- Between Q2 2013 and Q2 2016, Exxon had a revenue decline of 46 per cent, EPS decline of 74 per cent and a debt increase of 129 per cent.
- All of the above led to a share price increase of 4 per cent.

In other words, the popularity of index funds and their ilk has caused a $US360 billion ($470bn) market cap company with a weaker balance sheet, in a structurally challenged industry, that has lost half its revenue and three quarters of its earnings, to now be more valuable than it was three years ago.

While exchange-traded and index funds have been heralded as one of the most important financial innovations during the past decade, promoters fail to warn investors of their limitations and dangers.

As the Exxon example demonstrates, while index investing grows in popularity, so does the blind purchase and sale of large baskets of shares with no regard for their underlying fundamentals. How such an approach to equity investing can be recommended to an investor requires careful examination. Most dangerously, as index investing grows in popularity so too does the divergence between stock prices and fundamental values.

Index investors face:

- The risk of permanent capital impairment;
- Enhanced prospects of increased volatility, and
- The certainty of average performance.

More frequent periods of greater divergence between price and fundamental value will occur as the popularity of index investing increases, and in those periods, active managers have the opportunity to make much larger returns for their clients.

As index investing grows in size so does the ability for marginalised active managers to outperform. The argument that passive beats active — the reason for the migration to passive forms of investing — weakens.

Sensible investing

And keep in mind that it isn't true that most managers underperform their benchmarks after fees. In Australia the vast majority of active small cap managers beat their index. Their index is full of junior mining exploration companies that lose money or dilute, with frequent capital raisings, the ownership of the company for incumbent shareholders. Simply exclude those companies from a portfolio, buy the rest, and hey presto, you're beating the index over the long run!

Poor quality companies aren't the exclusive domain of small cap indices. There are rubbish companies in every index. Market cap-weighted indices are constructed by aggregating the performance of companies invariably based on their size or on what they do. They aren't selected because they are highly profitable at what they do. And they aren't selected because they are expected to produce strong share price performances over the long term for their investors.

A quick glance at the performance of the ASX 200 over the past decade will reveal why you don't want to be invested in that index.

Indices were not originally designed as investments but simply as a measure of the market's activity. A cap-weighted index is not constructed with the intention of producing a solid long-term return for investors. It's not hard to find an active manager beating the index over long stretches of time. Go find one and eschew dumb index investing.

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Five ways to maximise your super before new rules kick in

GLENDA KORPORAAL

With the federal government's draft legislation on the proposed changes to superannuation now released to the market, there is no time to wait for people approaching retirement who want to boost their superannuation.

Peter Hogan, technical director of the Self Managed Superannuation Fund Association, says there are five points which should be on the "to do" list for people wanting to maximise the potential opportunities in super in the current financial year before the tougher changes come into effect on July 1, 2017.

Maximise concessions

With the proposed cuts in the concessional super caps, employees in particular have to act now if they want to take advantage of higher salary sacrifice opportunities available this financial year.

At the moment, people 49 and over can put as much as $35,000 in a year into their super on a concessional basis (including the compulsory 9.5 per cent super guarantee contributions). The figures goes down to $25,000 a year for people of all ages from July 1.

Hogan points out that it is mostly people over 50 who are in this situation, with few free cash to boost their super before retirement. For employees, the salary sacrifice contributions have to be taken out of their regular pay. It is not practical to do a lump sum in the last minute.

So those wanting to boost their salary sacrificing to take advantage of the higher caps have to start making the changes at their pay office as soon as possible.

Post-tax contributions

The current financial year also provides a one-off opportunity for people with extra cash, maybe from a one-off windfall, inheritance or sale of an asset — to put as much as $540,000 into their super from post-tax assets.

Treasurer Scott Morrison's backflip on the $500,000 lifetime cap on post-tax contributions has given a reprieve to some KYM SMITH

A backflip by Treasurer Scott Morrison on the May budget announcement of a $500,000 lifetime cap on post-tax contributions has provided a reprieve for some people who may have been organising their affairs to do this.

"The old laws still apply until June 30," Hogan says.

This allows people to put in $180,000 a year in post-tax contributions, which can also be made in a lump sum of up to three years' worth, or $540,000 (bringing forward contributions for two years).

The new caps

From July 1 the post-tax super contribution cap goes down from $180,000 a year to $100,000. And when the total amount in super hits $1.6 million, no more post-tax contributions can be made at all.

People will still be able to make three years' worth of contributions in one year (a maximum of $300,000 from July 1 with no more for the next two financial years).

But, as Hogan points out, the combination of the significantly lower annual cap and the impact of the $1.6m maximum represents a significant cutback from what has been allowed in the past.

> Employees have to act now if they want to take advantage of higher salary sacrifice opportunities

Review tax situation

People in pension mode, with super funds of more than $1.6m, will be hit by the changes to come into effect from July 1, 2017. From that date, assets above $1.6m will have to be moved back into accumulation mode where earnings are taxed at 15 per cent.

This raises questions for funds with unrealised capital gains such as shares. At the moment these assets can be sold tax- free when the funds is in pension mode so capital gains are not an issue.

But with a maximum of $1.6m allowed to be in the tax-free fund as of July 1, trustees of self-managed super funds might want to review their portfolio for capital gains tax implications.

(The actual amount in the tax-free fund can go up and down with the market from July 1. The $1.6m is the total lifetime amount which can be moved or tipped into a tax free fund.)

The Tax Office frowns on transactions which deliberately sell and buy the same shares to wash out the capital gains tax liabilities. But for people with funds of $1.6m or more who may be feeling some assets are richly priced, it could be time to take some profits and reinvest them elsewhere.

Hogan points out that the federal government is proposing to provide some one-off capital gains tax relief for people in pension mode who will be hit by the changes from July 1, 2017.

For people with funds in pension mode, who have to move assets above $1.6m back into accumulation mode, the government is allowing a traditional arrangement where people can elect to do this at cost basis, which is the market value as of June 30.

Transition phase

This financial year is still a good year to use transition to retirement strategies where they suit an individual's circumstances for people over 56 who are still working. But the attractiveness of TTR from a tax point of view cuts out from July 1.

From July 1 a TTR arrangement could still be used to allow someone cutting back on their work to pull some money out of super ahead of their retirement. But those seeking to use TTR for its tax benefits will be disappointed from July.

People approaching retirement need to start thinking now about how to position themselves.

The wages of sin: shares rise faster than S&P 500

STIRLING LARKIN

There remains good money to be made across global markets this year despite the fact that we face a world of low numbers.

These numbers include interest rates hovering near zero — 40 per cent of the world's sovereign debt is in negative yield territory — while earnings expansion, economic growth and inflation are near record lows around the world.

This is now being accepted as indicative of what we should expect over the rest of this decade.

What has also become evident more recently is that global investors need to remain flexible while at the same time avoiding one-way bets — this is not an easy task.

What this has also meant for the ultra high net worth community is that as well as remaining flexible, liquidity and redemption of capital must remain high priorities when considering continuing strategies that embrace the search for yield.

There are important reasons why this high priority matters more to UHNW investors than to other Australian investment communities.

With traditional allocations, such as equities and corporate bonds, likely to offer low returns, Australian UHNW investors have, over the past three months, been presented with a greater number of allocations within a broad category referred to as "alternatives".

With no agreed definitive definition of what constitutes an alternative, these presented opportunities have widely ranged from property developers recycling real estate assets to international private banks packaging liquid alternatives for investors with fungible wealth in excess of $US20 million ($26m).

Liquid alts are a rapidly growing subcategory within asset management.

They seek to combine many of the characteristics of hedge funds — which usually offer monthly redemption of capital terms — with daily liquid unit pricing structures.

Liquid alts have been pitched as an alternative investment exposure that achieves returns with a lower correlation to equities and bonds, while at the same time purporting to offer investors similar redemption characteristics to that of shares.

Of course, for all Australian investment communities considering global alternative investments, lucrative options remain in the higher risk investment categories, which include:

- Exchange-traded funds and US mutual funds facing companies within the ISE "Sindex".

This index represents sin stocks that collectively represent sectors including alcohol, gaming, marijuana and tobacco. Since the nadir of the global financial crisis, it is up 325 per cent, double that of the S&P 500 over the same horizon. The Spirited Funds and Whiskey + Spirits ETF (WSKY: US) was launched this week in New York.

- US MLP, or master limited partnership funds, which in essence tactically invest across US shale, gas and energy assets. This specific US investment structure enjoys tax benefits of a limited partnership with the liquidity of publicly traded securities but can only qualify for these if they generate at least 90 per cent of their income from "qualifying sources". These include only those activities related to the production, processing and transportation of oil, natural gas and coal in the US.

With the quest for yield driving MLP fund inflows higher during the first half of 2016 than all flows of 2015, there has been a noticeable uptick in talks with investors seeking yield.

MLPs have screened more attractively given relative underperformance versus US utilities, REITs and telcos. In play this month was SemGroup Corp (SEMG: US), which announced it had completed the acquisition of all of the outstanding common units publicly held of its underlying MLP, Rose Rock Midstream (previously RRMS: US).

Remembering to avoid taking one-way bets, the investment philosophy global investors must embrace is not to try to find hedges for certain things going on but to remain focused on finding returns that make sense to them.

For many this has meant avoiding blind allocations to US or Australian equities, without thinking deeply about which areas could display growth or value.

One of the things that has gone missing is that equity markets have not been very highly correlated over the past year. The S&P 500 went up 5 per cent while European markets went down by about 8 per cent.

Accepting that it has not been growth markets that are highly correlated but rather sovereign debt markets, it was interesting to note that there was nothing about Brexit that should have driven down bond yields in the US or in Australia — but that is exactly what happened.

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Sindex trouncing S&P 500 since 2008

SIN INDEX
SPF INDEX
3500
3000
2500
2000
1500
1000
500
2010 2011 2012 2013 2014 2015 2016

Source: Bloomberg

THE AUSTRALIAN
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