“What matters is that investors should consider managers do have limited capacity to maximise returns.”
WILL HAMILTON

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Spread your portfolio to smooth out returns

BRYAN ASHENDEN

My SMSF is heavily concentrated in Australian shares, property and cash. Should I consider other investments?

This kind of concentration is common. Australian Taxation Office statistics show Australian shares, cash and direct property make up a majority of SMSF investments. Australia's love of property is well documented, and cash is often favoured by more conservative investors or those with shorter investment time frames. People also tend to invest in what they know, and Australian shares allow SMSF trustees to invest their retirement savings in familiar companies.

Nevertheless, as an SMSF trustee, you need to understand that asset classes behave differently at different times — some asset classes will rise in value while others fall. If your SMSF is concentrated in only certain assets or has a domestic bias with limited exposure to international markets, it risks being overexposed if these areas of the market fall in value.

Diversifying is a way of spreading risk and can help SMSF trustees to smooth out overall returns in their fund. This could be achieved by spreading investments across different asset classes including cash, fixed interest, shares, and property.

Another way to diversify is across different countries or regions. For example, you could gain access to international shares and fixed income through exchange traded funds listed on the ASX.

If you are seeking a combination of diversification and professional expertise, you may like to consider managed investments. These can invest in a variety of asset classes, including cash, fixed interest, property and shares, with the option to focus on a specific asset class, particular industry, or even a specific country.

Managed investments can provide a level of diversification well beyond the reach of most direct investors. An Australian share fund, for example, could hold shares in dozens of Australian companies and a property fund could hold major assets such as a commercial office block. Instead of you having to select which assets to buy and sell and when to do it, with a managed investment, these decisions are made by professional investment managers. However, you need to be aware that along with the risks associated with individual asset classes, managed investments carry the additional risk that the professional investment managers chosen may not perform as expected.

Your SMSF's investment requirements will change over time as members' ages, priorities, goals and risk appetites change, which means asset allocation should be reviewed at least annually. SMSF investment strategies should also be reviewed if there are any changes to the members of the fund, including the addition of a new member, the death or departure of an existing member, if a member's circumstances change, or if a member retires.

The precise mix of investments that is right for you (or any) SMSF will depend on individual factors, including SMSF members' ages, lifestyle, attitude to risk and personal goals. Before making any investments decisions, you should ensure you understand the benefits and risks of each type of investment you are considering, checking they match your (and other members') goals and risk tolerance and that all tax considerations have been accounted for.

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Dark and stormy cloud of Amazon

The giant's imminent arrival a huge worry for retail investors

ROGER MONTGOMERY

AFP

Amazon is the world's fifth-largest company, luring 5 per cent of all retail spending in the US

Investors in Harvey Norman over the past few weeks have had cause for concern as the company botched its disclosure to the market about what corporate regulator ASIC was — or was not — looking at with respect to its accounting and balance valuations.

But investors in Australia's retailers have much bigger worries as the strategy of the world's most powerful retail group, Amazon, is set to be revealed.

Many might not realise that Amazon floated 20 years ago and now generates about $US4.2 billion ($5.5bn) in profits. At a market capitalisation of $US400bn, it is the world's fifth-largest company, with 5 per cent of all retail spending in America conducted on its e-commerce platform and 50 per cent of all new spending.

With an emphasis on long-term viability of its services overriding short-term profits, and a learn-adapt-grow approach to entering and growing in a country, there is a lot for Australia's retailers to worry about, especially if the rumoured arrival of Amazon in the third quarter eventuates. Amazon has already set up trademarks in Australia and there has been reports it is searching for a distribution site in western Sydney.

But the question is who should be most worried and why?

The answer to that question lies in the experiences of competitors overseas who have had to endure the Amazon juggernaut's emergence and expansion in their countries. In the US, for example, two leading retailers had very different experiences: while the Sports Authority failed following Amazon's expansion, Dick's Sporting Goods has prospered.

To win against Amazon a retailer cannot simply rely on assortment and price. On both of those fronts Amazon will always win hands down thanks to expertise gleaned from experience and massive support from the revenues earned through Amazon Web Services, which is also providing computing power and analytics to the likes of Netflix and the CIA.

If a retailer is slow to take up a comprehensive omni-channel approach including great delivery, they're also in trouble because Amazon offers awarded service via it's logistics.

Moreover, the Amazon Prime services that offers free two-day delivery is a very attractive alternative to waiting in queues at understaffed bricks-and-mortar locations. According to a recent Harris poll, Amazon is held in higher esteem than any other company by Americans.

Amazon will launch without needing to get all things right. They learn from the experience very quickly, adapt and react fast thanks to unimaginable data and analytics and then proceed to grow. With the financial muscle to weather any storm, it is comfortable putting long-term viability in terms of offering consistent service above short-term profitability. For incumbent retailers that means margin compression.

Five retailers in Amazon's sights

Stock code	FY22 online channel share	*Amazon high impact* EBIT FY22 relative to no Amazon scenario	*Amazon low impact* EBIT FY22 relative to no Amazon scenario
JBH	Consumer electronics 34%	▼ -33%	▼ -14%
HVN	Consumer electronics 34%	▼ -9%	▼ -3%
SUL	Auto 20%, sports 25%	▼ -32%	▼ -19%
MYR	Clothing and home 25%	▼ -55%	▼ -18%
PMV	Clothing 25%	▼ -22%	▼ -13%

Source: Credit Suisse

A recent report from Credit Suisse completed a theoretical impact study on what Amazon's arrival might do to the business of five leading listed retailers — JB Hi-Fi, Harvey Norman, Super Retail (owner of Supercheap Auto and Ray's Outdoors), Myer and Premier Investments (owner of Peter Alexander, Smiggle.)

The 'death spiral' of price competition

Amazon's pricing policy is what justifiably worries most retailers. Margins for retailers of the same product vary by as much as 1000 basis points (10 per cent) and using Amazon's automated pricing engine, and analysis of trends and online product searches, they select the products selling well and set prices to match the lowest price offered by a reputable seller or alternatively they pitch prices just below those of rivals.

For example if the lowest price offered is $100, Amazon will set prices at $99 or $95. But remember, free delivery too.

So what happened when Amazon took off in the US? Sports Authority was once the largest chain of its kind in the US but filed for chapter 11 bankruptcy on March 2 last year.

Ask an Amazon exec why the company failed and they might say it was simply a matter of trying to compete on assortment and price with an undifferentiated brand and product. Sports Authority was also said to have been offering a mundane shopper experience, and a private label that was not well received by consumers.

That puts Australian retailers who sell third-party brands on notice. It should also be pointed out that consumers lost trust in the Sports Authority brand due to arguably poorly executed advertising tactics.

And that latter point suggests those who rely on promising "cheapest" in their ads might find they cannot continue to make that claim in an Amazon world.

Competing on price with Amazon enters a company into an "automated" pricing death spiral that Amazon will always win.

It is better to take the lessons of the failed Sports Authority and the relatively more successful (to date) Dick's Sporting Goods and invest in a better experience in-store for customers, including store fitout and training staff to be experts.

Retailers need to focus on specialty brands that don't want their product on Amazon and are therefore unattainable there for consumers. Retailers need to build consumer trust and/or be hyper focused on local markets. Offering in-store pick-up and advice is something Amazon cannot do well. Dick's Sporting Goods provides expert advice on sporting equipment that needs customisation like golf clubs that need shortening or bicycles that need fitting or archery equipment that requires stringing. It also deals with heavy and bulky items that Amazon doesn't want to ship, such as gun safes and canoes.

> Amazon will launch without needing to get all things right. They learn quickly

It is immediately obvious that these markets tend to be niche. Separately, there are a large number of retailers that simply won't be able to compete as Amazon focuses the initial phase of its rollout on household appliances such as mixers and coffee pots.

Amazon has been said to initially focus on media and digital products to help it understand the product velocity, web traffic and search preferences of its target market. It then expands into highly consumable items and small packages with higher price points such as electronics before moving into products that are frequently purchased or with high repetition before moving towards bulkier items like lawnmowers and TVs and finally grocery items.

For Australian retailers like Harvey Norman, JB Hi-Fi and the supermarket-style retailers of Target, Big W and Kmart, where a large portion of revenue is from undifferentiated consumables that can be bundled into small packages and shipped quickly, Amazon represents a cloud service of the dark and stormy kind.

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Huge merged funds on the rise but focus should stay on performance, not management size

WILL HAMILTON

It hasn't happened in Australia yet but an important dimension of the rising level of takeover activity across markets is the creation of some seriously large fund management groups.

Already about 1 per cent of global fund management groups control no less than 45 per cent of fund management assets.

In Britain, recent proposals for mergers of fund management companies such as Standard Life and Aberdeen, and Janus and Henderson have reignited a debate about funds management companies and their relative size.

In Australia, last week's productivity commission report leans heavily on small funds to consolidate in order to give better value to consumers ... this may well see bigger funds emerge in the future.

What's more, there are also signs that takeover activity in funds management may also be ready to roll — there are reports that CBA will sell its $6 billion fund manager Colonial First State.

In case of the Standard Life and Aberdeen proposal, it has been interesting to see the reaction of the many British and overseas consultants who have put investment in these funds on hold. Parts of the market are waiting to see how the merged group — with combined funds under management (FUM) of £660 billion ($1.08 trillion) — will take shape.

No doubt they will look at which fund managers depart, what cost savings might be delivered and, notably, the potential fund outflows.

Such mergers have led to a focus on the size of funds management itself, as funds merge to escape being trapped in a "mid tier", while small versus large becomes the trend.

However, my view is that the debate has gone off course. It should not be about the size of a funds management organisation, but about the size of a fund. That is what is important to investors.

Let me give a good example. Blackrock is the largest funds management company in the world with $US5 trillion of FUM ($6.5 trillion). It launched the boutique style Blackrock Concentrated Industrial Share Fund a year ago run by Charlie Lanchester and Madeleine Beaumont, with a targeted cap on FUM capacity of $3bn.

If you look at the list of top-performing funds in Australia as rated by Zenith, in calendar year 2016 you will see names such as The Allan Gray Australia Equity Fund, Dimensional Australian Share Fund, and the Lazard Select Australian Equity Fund. In the mid-cap space are Investors Mutual Future Leaders Fund, Paradice Australian Mid-Cap Fund, and the Aberdeen Ex-20 Australian Equities.

Interestingly, the top performance in both categories has come from firms that are dedicated specialised asset management firms as opposed to investment banks or commercial banks with an asset management division.

I put the reason for this down to focus, and excellence in approach, as opposed to scale. Last year in these pages, I wrote a column on my concerns with listed investment companies (LICs).

One of the reasons I am critical of asset managers for pursuing these strategies is that they are often a funds under management grab, and therefore a revenue grab, as opposed to being about a focus and excellence in approach combined with a focus on capacity of FUM, even though some of the names mentioned above run LICs.

Better-performing fund managers recognise that as their FUM grow, to maintain outperformance they need to close off a fund to new investments as SmallCo recently did in late January.

> Blackrock is the largest funds management company in the world with $US5 trillion ($6.5 trillion) of FUM

In its September 2016 report, Propinquity advisers in New York made the point that independent decision making is revered in the investment management industry.

Among the 1 per cent that control almost half the world's fund management assets, Propinquity classifies these 634 funds (out of a universe of >65,000) as mega funds being those funds with at least $US5bn in FUM.

Mega fund managers

Since the global financial crisis we have seen mega funds grow by a multiple of 1.7 times against the industry-wide average of 1.6 times, and equities as an asset class having the slowest growth of 1.5 times, decreasing from 68.5 per cent of the equity pool to 57.3 per cent.

In the domestic context, Propinquity data shows Australia is under-represented in the mega fund pool with 0.3 per cent of mega fund assets and 2.5 per cent of non-mega fund assets (US is 82.9 per cent of mega fund assets and 30.4 per cent of non-mega fund assets).

This data represents all asset classes but does illustrate the lower mega fund concentration based in Australia.

The focus is on mega funds because, as Propinquity notes, they highlight the difference between the quality and volume of flows.

Quality they define as those assets, "which are invested based on a substantially robust due diligence process and therefore understanding and intellectual commitment to the investment strategies characteristics, philosophy and process".

The opposite of quality is what Propinquity refers to as situations when a fund gets to autoflow, such as when a fund has more than 36 months of investment history in perpetuating flows.

In our domestic context, this is like being approved on retail platforms — and the automatic flow that can come from this as a result.

Automatic flow, unlike quality flow, in many cases is less knowledgeable, less seasoned, less patient and in the event of poor performance or a pullback in market performance, these assets can be the first to leave hence the last-in first-out or "LIFO" pattern that can occur.

What matters is that investors should consider managers do have limited capacity to maximise returns — and we will see further consolidation among asset managers as they attempt to move out of the middle.

Looking for dedicated funds management businesses with a focus on excellence and a discipline on their capacity chasing high-quality FUM is a good way of thinking about fund manager selection.

It's not about how big they are or blindly chasing past performance.

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