AUSTRALIAN INVESTORS ASSOCIATION

Investor Update

Monthly updates on investment issues for AIA members

MARCH 2016

Investor Update – March 2016

Welcome to the March Edition of Investor Update. This month Chris Brycki looks at smart beta ETFs and Brian Herd poses the question "Can an Executor challenge a Will", the answer may surprise you. Also in this edition, Graeme Colley and Brett Wright address the issue of insurance in SMSFs. We hope you enjoy.

In this issue

The AIA BLOG is now operational and we invite you have a browse. You can access from any page of our website by simply clicking on the "BLOG" in the top menu.

Should you buy into smart beta ETFs?

Chris Brycki - Stockspot

Smart beta is latest investment trend, marketed as a new way to diversify and reduce risk. But is smart beta really the best way to achieve your investment goals?
It's nearly impossible to read the financial news or an investment newsletter these days without coming across the term "smart beta".

Smart beta – also known as strategic beta, alternative beta, fundamental beta, advanced beta, enhanced beta, and probably a few other names – aims to combine elements of passive index investing and active fund management to deliver the best of both worlds: transparency, broad diversification, and market-beating returns – all at low cost. What more could you ask for?

Upcoming Events

AIA Annual Investors Conference

Featuring some of the most respected names in the financial industry, this conference is not to be missed. Full details will be available shortly and we hope to see you at the Marriott Resort and Spa Surfers Paradise.

Adelaide Information Meeting
2016 update on the LIC Sector
11 April 2016 7.00pm

Brisbane Information Meeting
Alan Hull: The stockmarket from every angle
6 April 2016 1.30pm

Sydney North Shore Group
Ashley Owen
13 April 2016 7.30pm

Gold Coast Information Meeting
Julie Dolan – The here, now & where to of SMSFs
18 April 2016 9.30am

All meetings

But before you throw all of your savings into the latest smart beta product, it's worth digging a bit deeper into what smart beta really is. Smart beta is all about **index construction** which refers to which stocks (or other assets) make up an index and their relative size within that index…
So what exactly is an index?

Indices and index funds
The first share market indices were designed to measure the broad market and serve as a point of comparison for 'active' (stock picking) fund managers. They typically weighted stocks by size – the stocks with the biggest market value made up a larger portion of the index. Examples of size-weighted indices include popular ones you've probably heard of like the the S&P 500 (started in 1957) or S&P ASX/200 (started in 2000).

When John Bogle launched the first index fund in 1975, it was intended as a sensible, low-cost way for individuals to invest into these such indices. The Vanguard 500 Index was not intended to beat the market, but simply ensure investors kept up with the stocks in it.

Over 40 years, Vanguard has now grown into the largest mutual fund manager in the world with over US$3 trillion under management and index investing has become so popular that an entire industry has emerged on the back of it.

Emergence of smart beta
All index funds, by definition, are passive investments. This includes smart beta. There's no fund manager making trading decisions and all buying and selling is done according to a strict set of rules.

However, smart beta indices aim to fix some of the believed shortcomings of weighting investments by market size when building an index. One example is that during a bubble, some shares can make up a larger and larger share of the index, like technology stocks did during the 'tech boom' in the late 1990s, or mining stocks when commodity prices rocketed in 2006-2011. This can cause traditional size-weighted indices to 'overshoot' during booms and busts.

To address this and other similar observations about size-weighted indices, new ways of constructing indices have emerged – with weights determined by different approaches such as dividends, research ratings, simple averages, or consistency of cash flows. This is what's meant by **smart beta**.

Common smart beta strategies
There are 4 common smart beta approaches to building indices:

- **High dividend strategies** that aim pick stocks with higher dividend yields to boost investor income. *e.g. Vanguard Australian Shares High Yield ETF (VHY)*

- **Other fundamental indices** that focus on measures like sales revenue or free cash flow as a more accurate measure of economic contribution rather than using market capitalisation.
e.g. Russell Australian Value ETF (RVL) or
BetaShares FTSE RAFI Australia 200 ETF (QOZ)

- **Equal weighting** – the simplest form of index construction that just averages an entire universe of stocks, thus giving each stock the same importance.
e.g. Market Vectors Australian Equal Weight ETF (MVW)

- **Low volatility strategies** which target a smoother ride by carefully selecting less risky stocks.
e.g. ANZ/ETFS S&P 500 High Yield Low Volatility Fund (ZYU)

While some of these funds may advertise a new paradigm of investment thinking, they all use fairly transparent, rules-based approaches to prioritise exposure to certain market factors. These factors include style (growth and value), **size** (large, mid, small), or **momentum** (consistency). The challenge for investors is in deciding which factors to want exposure to (if any).

Smart beta bets on market factors
At their core, all smart beta ETFs are taking a bet on certain market factors being more important than others:

- **Low volatility and high dividend** stocks tend to have a bias towards value stocks that have lower growth and more stable earnings since they tend to be less volatile than companies with less predictable profits like mining businesses or biotechnology. However, when investors crowd into low-volatility or high dividend stocks, as they've been doing over the past few years, it can push valuations in some sectors (e.g. telecommunications, utilities, and property) to the point they actually become more risky. This can, perhaps counterintuitively, make low volatility or high dividend strategies dangerous after a period of good returns.

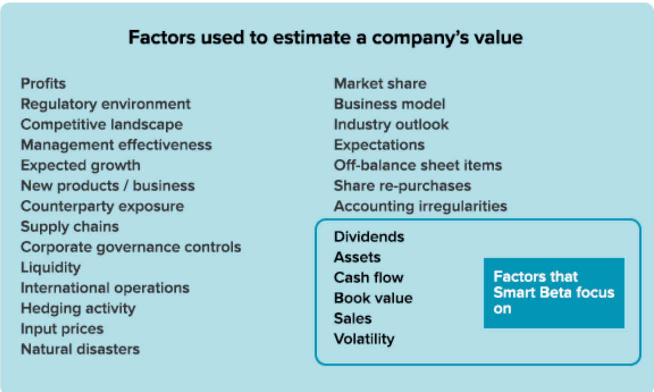
- **Fundamental indices** may use operating cash flow as a better indication of economic size. Analysis shows these approaches have a strong value stock bias as well.

- **An equal weighting methodology** introduces a significant bias towards small companies because the stocks that have a lower market size have the same weight in the index as bigger businesses like Commonwealth Bank (CBA). The portfolio will likely also have a value bias because equal weighting will expand the weight of value stocks, which tend to trade at lower price compared to their profit.

Shortcomings of smart beta

How smart is it really?

By offering enhanced exposure to some factors, like value and size, smart beta strategies must also be de-prioritising other factors. Because current price reflects every factor used by any investor to estimate a company's value, a market-size-weighted index also represents an all-factor approach to investing. On the other hand, smart-beta is essentially taking a bet that a few select factors are more important than an all factor (market value) approach.



Source: Vanguard

Backtesting can give false confidence

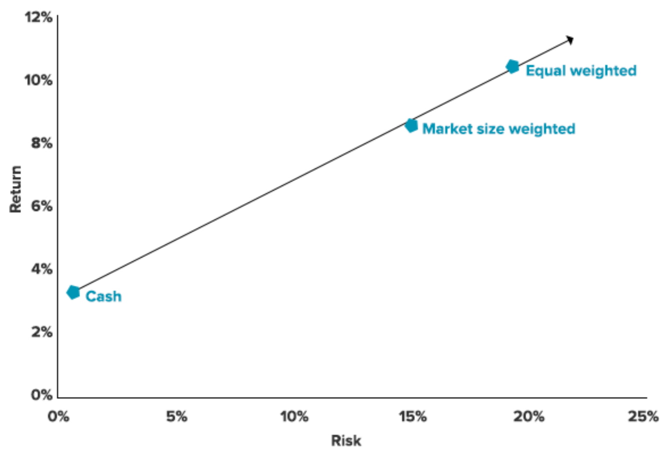
Smart beta strategies are often marketed as being able to 'beat the market'. However the truth is often a lot more murky. Many have only outperformed from backtesting over a select, historical time period which introduces a few significant issues.

Think of an index like a deck of cards. Backtesting lets you shuffle a deck of cards thousands of times until a favourable "shuffle" emerges to match the order you want to show. In essence, backtesting lets the smart beta strategies and ETFs 'stack a deck' of stocks in a way that outperformed the index in the past. But there's no guarantee that the same strategy will work going forward. As a result, many smart beta strategies could have simply worked in the past by chance.

Let's say you rebuilt S&P/ASX 200 but weighted the companies according to the birthday of their CEOs and found that this new index outperformed a size weighted index by 20% over 15 years. This would not be because January-born CEOs are better at managing businesses than December ones. This would just be an example of how you can use a random set of data to prove any hypothesis when backtesting.

What about risk?

Some smart beta strategies have been able to outperform over the long-term, but the differences in return can usually be explained simply by risk. For example, equal-weight indices of stocks do tend to outperform market-size weighted indices over the long-term. However this can be explained entirely due to equal weight taking more risk (due to having more small stocks). On a risk versus return basis, you're no better off owning the equal weight index even though it generated higher returns. Also, there are sometimes lower-cost ways to get the same factor exposure (small companies) and return profile.

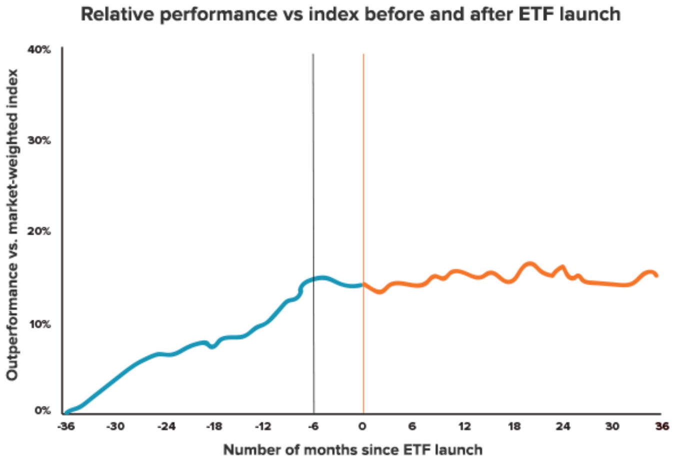


Sources: CRSP US Stock and Index Database, S&P Dow Jones Indexes, Federal Reserve

Smart beta follows in-vogue style trends

It's no coincidence that many of the smart beta funds launched over the past couple of years in Australia have been dividend focused. This is because dividend investment strategies had a great run of performance between 2011 and 2014. ETF issuers know that it's much easier selling strategies that have done well recently than those that haven't since people tend to chase returns.

In fact research has shown that on average, new funds launch about 6 months after the peak in their particular strategy compared to the broad index. This is not a coincidence – the product teams launching new funds usually take about 6 months to get them launched so when they decide to launch a fund it's usually at exactly the point that the particular strategy is showing it's best results compared to benchmarks. Unfortunately, outperformance tends to end soon after smart beta ETFs are launched.



Source: Research Affiliates

Conclusion
Smart beta ETFs give investors the ability to tilt their portfolios towards certain factors that active fund managers have used for years.

But if you're considering investing in an smart beta ETF, it's important to understand that you are actually taking bets on certain market factors beating others. You should be comfortable with what those factor bets are, and why you're taking them.

If you don't understand the bets you're taking and the only reason you're investing in smart beta is backtesting or recent performance, then what you're buying into isn't smart beta as much as it's smart marketing, and that's not smart investing.

As any card player will tell you, reshuffling the deck won't give you better odds of success.

INVESTMENT CONFERENCE OF 2016!

The conference commences 5pm Sunday, 7 August with a keynote presentation "Australia's next growth driver; The rise of the services sectors" by Paul Bloxham.

Sessions continue Monday, Tuesday and conclude at 3.30pm on Wednesday, 10 August, followed by the daily happy hour. In addition to the eight plenary sessions, the conference features a Monday evening Masterclass and five streams plus the morning Sponsor sessions.

This year our conference is titled "Volatily, Risk & Reward; Strategies for an uncertain world".

Early Booking Special

No need to pay the full amount now!
2 options:

Book by 31st May and pay $100 non-refundable deposit and pay the balance by 8th July, or

Pay the full amount by 31st May if you wish

You receive:

Free entry to the Monday evening Masterclass - "Analysing companies and understanding annual reports" together with a light supper (bookings after 31st May pay $33, if not booked out as numbers are limited to 200), and
Go into the draw to WIN 3 NIGHTS ACCOMMODATION in an 'Ocean View' room at the Marriott during the conference.

Can an Executor challenge a Will?

Brian Herd – CRH Law Partner

The short answer is yes and they often do. Read on.

When you make somebody the 'Executor' of your Will, you send a number of subliminal messages to them:

1. You are the person/s I know and trust to perform this important role when I die;

And, as required by the law:

2. Your job is to do what my Will says; and

3. Your job is also to uphold or defend what it says even if it is challenged.

There is an understandable and prevailing bewilderment in the community about how it is that you can make a Will and yet the Courts can overturn it or change it. Indeed, this is happening more and more if you believe all the statistics about the number of challenges to Wills being filed in our courts. There is no doubt that it is a growth area in legal practice.

While there is a limited range of people who can challenge a Will, generally, they are an existing beneficiary in a Will who challenges the Will wanting more from the estate than what they were given. Alternatively, it could be someone who expected to be a beneficiary but missed out completely. Usually both types of challengers are adult children contesting their parent's Will.

As well, the last surviving parent's Will usually provides that all, or some, of the children are beneficiaries and all, or some, of the same children are the Executor/s of the Will. They get given two hats to wear in the Will. So, given the expectations of the parent in appointing their children as Executors (set out above) and the legal duty of those executors to uphold the terms of the Will, what happens if one of those executors wants to challenge their parent's Will?

As indicated above, the answer is clear – they can. However, it is the implication of such a challenge on their role as an Executor that is even more interesting – can you be a Challenger and an Executor at the same time?

Common sense would tell you that that is, at best, uncomfortable and at worst, a raging conflict of interest. The law and common sense are not often on the same page but on this occasion they are. If an Executor ever found themselves in such a position, they would be well advised, if not required, to give up their Executor's role in order to pursue their challenge.

BRIAN HERD: Recognised as one of the leading experts in Australia on elder law, aged care, retirement, estate planning and disability and a regular author, broadcaster and popular presenter on many elder law subjects and issues.

AIA Membership REFER A FRIEND

Regardless of age or present level of wealth, the AIA can assist with education and information to make better investment decisions.

If a friend or relative joins as a result of your recommendation, both of you will receive **an additional three months free membership**. Simply write your name and member number on the back of the referral card. This is our way of saying thank you for your recommendation.

We also draw your attention to a new membership category, Student. Full time students under the age of 30 are welcome to join the association at the discounted rate of 50% off regular membership and no joining fee.

The AIA Board

SMSFs and insurance – how much do you need?

Graeme Colley & Brett Wright

It is interesting to know that most Australians would not hesitate to insure their car, but when it comes to their own lives they are reluctant to take out life insurance. Research undertaken by the Australian Securities and Investment Commission has confirmed underinsurance is a significant life insurance problem in Australia. The work undertaken found that up to 60 percent of families with dependants had insufficient life insurance to financially care for the family for greater than 12 months should the main breadwinner die.

For those who have a self-managed superannuation fund (SMSF) one requirement is for the fund trustees under Regulation 4.09 of the SIS legislation is to consider whether insurance should be held on the lives of fund members. This is to be reviewed regularly which means at least once a year according to the regulators.

Like most of us, many trustees find insurance confusing as the types of policy and level of cover differ significantly. They seek information from their advisers as to the type of insurance that is appropriate and how the amount of cover is calculated. This should take into account the whole circumstances of the individual and their immediate family or business.

There is a limit to the type of insurance cover that can be provided in superannuation. These rules were tightened from mid-2011 to ensure the type of cover was consistent with the superannuation conditions of release. That is, any cover is to be limited to death, terminal illness, total and permanent disability and temporary disability such as sickness and accident.

The benefits of having insurance through super are:
- Insurance inside super can be cheaper due to the bulk buying power of funds. These days that can include SMSFs.
- Automatic cover may be available under some policies as there may be no medical examinations required.
- Super policies may include total and permanent disability insurance (TPD) and income protection insurance.
- Tax effective, as the premiums paid out of super contributions may generate a direct tax deduction to the fund.
- Premiums may be deducted from super contributions which may be tax deductible to an individual or employer.

The shortcomings of insurance in super are:
- The amount of insurance cover could be less than the amount required.
- A superannuation fund is unable to purchase trauma insurance under the current rules.
- Premiums paid from super contributions provide less money to invest. This may impact on the amount members will have available at retirement or on meeting another condition of release.
- Most income protection policies inside super provide benefits for a limited time, usually up to two years.
- Delays may occur in life insurance claims being met as the amount may be paid initially to the fund then be distributed to the beneficiaries. This may result in a lengthy and frustrating process.
- Members should exercise the option of completing a binding death benefit beneficiary nomination to be certain any life insurance payout goes to those intended by the member.
- Non-financial dependents for tax purposes may be liable to pay tax on the death benefit received. If the same benefit were paid from a policy held outside of superannuation it would be tax free if received by the same person.

Calculating the amount of insurance cover for members of an SMSF will be different for every person and depend on their personal circumstances, such as age, health, income, expenses and domestic situation.

To determine the amount of insurance required there are four main financial needs to be taken into consideration if death, TPD or temporary incapacity were to happen to the member. The amount required could be based on the:

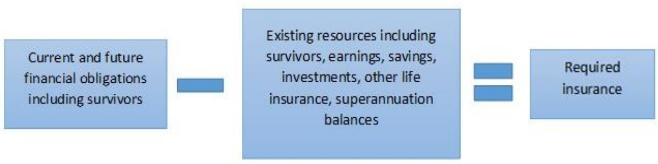
1. Personal needs of the member – Mortgage/debts, family living expenses, potential medical costs, carers expenses, school fees or any other personal need or estate planning provision important to that person.

2. Cash flow needs of the fund – If a member is temporarily incapacitated by a sickness or an accident and is not making contributions (or not paying rent for a members business property owned by the fund), the fund needs enough cash flow to meet operating expenses, investment expenses, loan repayments, investment strategy objectives and benefit payments such as pensions to other members.

3. Liquidity needs of the fund – If the fund holds mostly illiquid assets (non-cash assets such as property), to prevent a forced sale of the assets when a lump sum death or TPD benefit payment needs to be made, it is possible to use insurance as a strategy for providing cash that can be used for benefit payments to exiting members and their beneficiaries.

4. Debt/liability needs of the fund – Insurance can also be used as a strategy for eliminating the debt and liabilities a fund holds upon death or TPD of a member, which helps to protect the assets and provides a greater benefit to the continuing member(s) and the exiting member or beneficiaries.

The following formula is a guide to calculating the amount of insurance required:



Is insurance affordable?

It is possible to insure for everything at a cost; however, to be practical most people do not have insurance cover for every possible outcome and accept the risk to a certain level themselves.

Funding large amounts of premiums from super can impact significantly on a member's balance in the fund. The flipside is that not having adequate insurance in place could leave the member or members in financial hardship if they suffer an insurable event before reaching retirement age or as they continue as a fund member during their retirement.

Another side to considering the affordability of insurance is the depth of the benefits provided and the pricing of the premiums. The old saying is so true, "It is not cheap if you cannot claim on it", meaning it is important to ensure you put in place quality insurance policies that will pay in the circumstances intended by the trustees at the time the policy was taken out.

There are hundreds of insurance policies to choose from, with the quality of benefits, features and definitions within each contract varying substantially. This can be influenced by whether the policy being held either inside or outside of superannuation.

When considering insurances the fund can hold for the members, qualified professionals such as those with a full or limited licence will be able to assist in selecting appropriate insurances available through SMSFs, or other insurances such as Trauma and Own Occupation TPD which are required to be taken outside super. This would depend on the terms of the licence authorised by the licensee.

It is also the role of trustees and their advisers to ensure that SMSF trustees do not contravene regulations relating to cross insurance strategies, which the ATO has confirmed are not acceptable from 1 July 2014 onwards. In addition, an eye should be kept over buy/sell arrangements to ensure they are not outside the ATO's interpretation in ATOID 2015/10 in regard to the sole purpose test and the provision of financial assistance to members or their relatives.

In summary, as part of the fund's investment strategy and the members estate planning, it is important for SMSF trustees to plan for and implement strategies that deal with a member's unexpected death, terminal illness, permanent disability, sickness or accident, while also taking into account the:

- Potential financial losses associated with not having insurance, versus the financial protection of having it in place. This not only includes insurance in the superannuation but also held externally to superannuation.

- Cost of insurance premiums over time being debited from the member balances, versus the cost of having insufficient funds available if no insurances are in place when unexpected death or disability occurs.
- Benefit of having some life insurance rather than none, but wise to know exactly what that insurance will or won't pay and in what circumstances, whether it is through the super fund or held externally.

Graeme Colley is director of technical and professional standards at the SMSF Association.
Brett Wright is a director and responsible manager of the SMSF Life Insurance Reviews online compliance platform

PRE CONFERENCE WORKSHOP

THINK OUTSIDE THE SQUARE – IF NOT SHARES THEN WHAT?

Have you asked yourself "What else can I invest in?" This workshop may be what you are looking for.

Alternative Investments represent different approaches to investing across a variety of markets and asset classes. It is the unique mix of underlying risk factors that determine how individual investments are expected to perform relative to traditional asset classes.

Alternative strategies are increasingly used by institutional investors to help achieve both return and diversification goals, so if the "big guns" are taking advantage of this type of investing, maybe there is something in it for you.

WORKSHOP PROGRAM

1.00 - 1.45pm Unlisted mortgage funds
1.45 - 2.30pm Infrastructure
2.30 - 3.00pm AFTERNOON TEA
3.00 - 3.45pm Instalment warrants
3.45 - 4.30pm Technology
Full details available on website

OUR GOLD SPONSORS

TRILOGY FUNDS

Cromwell PROPERTY GROUP

SORNEM PRIVATE WEALTH

K2 Asset Management

VectorVest Australia

BetaShares

OUR SILVER SPONSORS

Investor Centre

HUNTER HALL Ethical Managed Funds

FIIG The fixed income experts

OUR BRONZE SPONSORS

lincoln Intelligent sharemarket solutions

BGL.

Superfund Partners

CBG CAPITAL

Rate%Setter

SUPPORTERS

self managed super

Educated Investor Financial Bookshop

OUR DINNER SPONSOR

Super Concepts

*AIA CONFERENCE MASTERCLASS

WHAT SMART INVESTORS LOOK FOR IN A COMPANY'S ANNUAL REPORT

A company's annual report is an ocean of information for investors. From financial figures to salaries of directors and chief executive officers, it has all the information an investor is likely to need. It also gives an account of how the company has performed in the preceding year and throws light on its future plans.

While the most searched figures in annual reports are sales, net profit, operating profit and the different financial ratios, there are a lot of other important points that are ignored by all but the most seasoned investors, and which can tell a lot about a company.

Presented by Sornem Private Wealth - This year the Masterclass will take a look at how to read and interpret an Annual Report, how to work out if a company's risk outlook is changing and the warning signs that most investors miss.

**Numbers stricIty limited to 200. The Early Booking Offer includes admission for free. Outside of this, the cost is $33 and admission will depend on availability. Light supper included.*

2016 AIA CONFERENCE DESTINATION

Marriott Resort and Spa
156 Ferny Avenue
Surfers Paradise 4217
Ph 1800 809 090

SURFERS PARADISE
RESORT & SPA
Marriott

Australian Investors Association Ltd
PO Box 1208
Oxenford QLD 4210
Tel 1300 555 061
Fax 07 5573 7319
Email aia@investors.asn.au
Web www.investors.asn.au