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This Week's Top Articles

Being Jon Medved: three decades of start-up investing

Graham Hand

Jon Medved is CEO and Founder of OurCrowd, an Israeli crowd-funding platform that facilitates investors buying into individual companies or a fund of companies in start-up mode. The company has over 1,000 Australian investors. According to Bloomberg Business Week, "OurCrowd is hands down the most successful equity-crowdfunding platform in the world."

Jon is a serial entrepreneur and according to the Washington Post "One of Israel's leading high-tech venture capitalists". NY Times Supplement 'Israel at 60' named Medved as one of the "Top 10 most influential Americans who have impacted Israel". He has invested in about 200 startup companies, helping to bring 20 of them to values in excess of $100 million. Exits include: Shopping.com (acquired by eBay), Compugen (Nasdaq: CGEN), Answers.com (Nasdaq: ANSW, acquired by Summit), Mobile Access (acquired by Corning), Native Networks (acquired by Alcatel), Broadlight (acquired by Broadcom) and Digital Fuel (acquired by VMWare).

I met Jon near his office in Jerusalem for this interview.

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JM: We're a 'next generation crowd-funding or investing platform'. We're trying to allow people to access innovation easily. Innovation is important to everybody. It used to be a creature of the tech or digital world, the 'in-crowd' guys of Silicon Valley, but they integrated technology into their businesses and innovation is now mainstream.

Look at the Apple announcements. I was talking to an 11-year-old kid and he was shaking, talking about how to close apps and how it's ready for AR and machine learning, and yet the talk from Apple was filled with tech speak. I was thinking, "Does the broader audience really understand this now?" We're at a special time in history. Part of it is the excitement of the new. Part of it is fear of losing your job. Part is the fear that your business will be destroyed. And there's a FOMO, a fear of missing out.

GH: And many young people have a massive decision to make. Do they take the safe path on a career which will pay well or do they throw it in for a couple of years and try a start-up?

JM: In Israel, there's an unusual attitude towards risk. We are a risk-embracing culture, almost against our will. Would I rather be at the threat of instant annihilation and have lots of start-ups or would I rather be chilled like

New Zealand. I don’t know. It starts as a global attitude towards risk, and that’s Jews as well as Israelis. Why are there so many Jewish Nobel Prize winners? Why so many wealthy industrialists? Why so many authors? Playwrights, artists? Enemies would say it’s because we don’t play fair. But we also fight among each other, there’s no external conspiracy, our instincts are right below the surface. But if the world is against us, we come together at the last minute.

GH: Is there an influence from the military/industrial complex in Israel?

JM: There is danger on the doorstep, and the army role is a huge part of the startup culture. Every kid has been told from the earliest time, not only are you a special Jewish kid with all the pampering and history behind you and being told you can do anything, but here there’s a different element. You’d better be a tough son-of-a-bitch. We’ll send you to Scout camps, you’ll go overnight on Outward Bound style class outings, and you might not come back. Then you’re going into the army and a lot do extreme stuff, that could include technical units. Kids are told they need to achieve in order to protect the country, and creativity and dreaming are encouraged and failure is not punished.

GH: In your world of identifying startups, this seems to create both opportunities and problems, in that you see hundreds of potential deals a year.

JM: That’s not a problem. As an angel investor, there’s something called ‘The Venture Power Law’. One of 10 will result in 90% of the total return. So if you don’t have at least 10, it’s hard to win, because then you’re playing roulette. So we have multiple funds, although our ratio is much better than 10%. OurCrowd has made about 120 investments, we’ve had 17 exits over the first four years. I hope to have a 20% to 40% hit ratio.

GH: What have you learned from your failures?

JM: There’s nothing more important than the people. Don’t fall in love with the technology too much. If it’s a great idea and a shitty guy, stay away. If it’s a great guy with a shitty idea, change the idea. We met two brilliant guys who came into our office with a stupid idea, back in 1998. We really liked them, we called them back and said we’re not investing in your idea but we have another we’d like you to pursue. We asked them to do a comparison shopping site, gave them $1 million of seed money, and the company ultimately become shopping.com (the url was bought later). Which we sold for US$640 million to eBay.

Next, it’s always going to take longer and more money than expected and you’d better think about that from the start. Keep some powder dry. If you decide you have $100,000 to put into a deal, don’t put it in first go. There’s a huge debate about how much to keep in reserve. For every $1 invested in the early stage, you could need as much as $5 in subsequent funding rounds. What you really want is other people to come in and pay higher and higher share prices. But beware the dreaded ‘down round’, which can corrode your own holdings through dilution.

That’s another thing to learn. While dilution can be bad, notional dilution is actually a good thing. As the cake becomes bigger, it’s difficult for you to maintain the same percentage slice.

GH: Right. 50% of $600 million is a big number.

JM: Exactly. Focus on the growth of the pie and less on your share. It’s a mistake entrepreneurs and other investors make. Focus on total return and your stake in dollar terms rather than building your stake in percentage terms.

But, have enough that if this is the ‘Venture Power’ deal, that it has the impact of covering all your other sins. If you’re going to build a portfolio, you should have some rough parity in the portfolio. If you’re wildly varying your throws, putting $100,000 here and $10,000 there, then it might turn out that the $10,000 is the winner. It won’t cover your sins.

So we do the analysis and then we let people use our platform to build their own portfolio, to buy into these companies the way they buy public stocks, which is unprecedented. You can’t call up your broker at Macquarie and NAB and ask for some startups please. (although we are now partnered with NAB and they are offering OurCrowd funds!)

Have you seen any companies on our website that you like?

GH: I don’t have the knowledge or time to read and analyse all the information on a particular company. What do I know about face recognition software? I need a fund of endorsed and researched companies, where you have already done the work.

JM: That's your best approach. The OC50 fund of companies gives you huge diversification, you could have four or five 'powerball' returns, no guarantees of course.

GH: Back on the people, how do you determine how resilient a person will be? Nothing goes perfectly and there will be setbacks along the way.

JM: You never know, there's no real test. One good thing in Israel is it's a small place. To check into someone's background, the joke is asking, "Who is your kindergarten teacher and how do we contact them?" Everybody knows each other, we'll find out if this is someone who cuts and runs.

But you can have too much resilience. In this business, the majority of companies will give you an indication in the first couple of years whether it will work or not. The minority who hang in limbo, most will go down, although some come back. And then there are those we call zombies which stay alive forever, the walking dead, but even some of these suddenly come back.

The biggest problem is not so much picking the right market trend, but getting the timing right. Timing is critical. For example, we all know that autonomous driving is coming, but we don't know how fast and how big. When will there be tens of millions of autonomous cars? It's critical for any company selling into that market. If you are off by three or four years, you're gone. Back in the day, I invested in a company in 1998 called iscraper, an internet portal to help builders and planners and designers to move the whole process online.

GH: There's a successful Australian company, Aconex, which does that.

JM: Right. This company iscraper failed miserably, because in 1999, forget it. There were no smartphones, no cloud, the right idea was not ready. The right time for that investment was probably 2005, two years before the iPhone. Remember, these companies are burning money, they're not profitable. Growth is the primary driver, not initial profit. We want triple digit growth, not 10% or 20%. You can't make your money back in this risky business on 20% growth.

When you raise money, you want to cover one to two years of growth. You don't want to raise more than two because then you're taking too much dilution at a lower price. If you're doubling every year, you're four times the size in two years. Running out of money is fatal. You can fix the human problem.

GH: Tell me more about the pitch. You are hearing hundreds of ideas, you're sitting around listening to them all the time. What if you love an idea and your colleagues don't, and vice versa? How do you come together?

JM: Most venture capital firms require unanimity. They say, there are so many deals, if someone has a serious objection, we're not doing it. We work on a majority, but if someone has a serious objection, we double check it. We have a formal investment committee process where we vote, and if there's a significant minority objection, we will sit and reconsider. We don't like a 4-2 vote.

Remember, we have a second level of assessment in our investing process, where external investors essentially decide whether to participate. We might decide to put $2 million into a company, as we put 5% of our own capital in on the same terms as the crowd, and then we take it to the crowd. Sometimes, the crowd will say 'No, thank you."

GH: Although the crowd will significantly trust you.

JM: Generally. And we've knocked back lots of deals which have become great successes. Or some we have tried to get into and missed. The really good deals are not companies that are begging you for money. You are begging to put money into them. If you sit back and wait for people to come to you, you'll miss out.

You start this business with a network of people. In my case, I've been doing this for over three decades. I've made over 200 investments, had dozens of exits, I know thousands of board members and entrepreneurs, so people call me and say, "Look at this." More important, I might hear someone is about to leave who sold his last business to Intel, so how do we talk to him?

GH: How do you ensure your personal preferences don't come into the decision-making, your basic beliefs on what will work or not?

JM: Follow your instincts. Some people will take issue with this, but believe your gut and check it. It's just like love. How many people meet somebody and are not really excited by them, and then fall in love and marry? It happens, but not that often. For most people, there's some kind of chemistry first up. When you sit down and engage, you're either there or you're not. The difference is that most people in love don't do due diligence.

We're always checking but there's an instinct about the person and the idea and the blue sky. It's a noise and signal recognition problem. The more data I collect, the more meetings I attend, the more deals I'm pitched, the stronger the signal on those rare deals we want to do. We do 1% to 2% of the deals we are pitched, 50% or 60% are triaged out before reaching a meeting. We get down to five or six and we talk money and what they are looking for, and you might get one or two or three done. Then we put them up on the site for others to invest in.

GH: Do you have rules about minimum ownership percentage, maximum investment amount, etc?

JM: Our clients can start at $10,000, but with the companies on the platform, our initial throw is typically not less than $1 million, but it could be as much as $20 million. We like to have a healthy minority stake, somewhere between 10% and 25%. Above that, we're edging out other investors as we want to be part of a syndicate. So if the company reaches a $500 million valuation, we have a chance of making $50 million or $100 million for our investors. And we take 20% of the upside, so that might be a $10 million cheque to us when our investors make $50 million. Each year, about 100 Israeli companies will exit private ownership, many in the hundreds of millions, and those are good numbers. You need those home runs to make this stuff work.

Graham Hand is Managing Editor of Cuffelinks. Cuffelinks does not have any sponsorship or business relationship with OurCrowd. This article is general information and does not consider the circumstances of any investor.

How to invest in early-stage tech businesses

Benjamin Chong

With the rise of crowdfunding platforms and the Australian Government's new tax incentives, it's increasingly attractive for private investors to seek the higher risk-adjusted returns in early-stage technology businesses. High-growth, early-stage businesses will drive jobs growth and economic prosperity according to the Australian Venture Capital and Private Equity Association (AVCAL).

What defines a great investment opportunity?

Having started, run and exited technology businesses over the last 20-plus years, we have realised a strong founding team is critical. For investors new to backing technology businesses, it's important to remember the founding teams of great businesses should have the right balance of business, domain, and technical experience, allowing them to create a sustainable competitive advantage with their new and differentiated product or service.

Given the size of Australia's domestic market, hungry founders who have sights set on chasing global markets are also key. Investors should focus on founding teams with the capability to scale their businesses and demonstrate market momentum by high customer acquisition rates and a solid pipeline of deals in negotiation. Assessing the business's current customers and total month on month customer growth is also helpful.

How do you start investing?

High-growth early-stage technology opportunities arise in a number of ways:

Angel investing

Angel investors, typically affluent individuals, provide capital to early-stage businesses in exchange for equity. Since the introduction of the Australian Government's National Innovation and Science Agenda reforms in July 2016, such investors can benefit from a 10-year capital gains tax exemption and a 20% non-refundable carry-forward tax offset on investments. To be eligible for these incentives, an investor must meet the 'sophisticated investor' test under the Corporations Act, or have total investments in qualifying companies under $50,000 for that income year.

Under the scheme, eligible companies must be non-listed and have been incorporated within the last three income years with total assets not exceeding $50 million. They must have less than $1 million in business expenses and income under $200,000. Further criteria include demonstrating potential for high growth and scalability, and addressing a large market with a significant competitive advantage.

While angel investing requires a high level of involvement, the advantages include having greater control over capital and the ability to practically support founders. As an angel investor, the investment process involves sourcing, assessing, negotiating, conducting due diligence and ongoing management of deals. Additionally, angels often support a portfolio business with coaching and mentorship in their areas of expertise.

Joining an angel group is a great way to source deals as it provides an opportunity to not only connect with founders but also seek advice from an experienced network of angel investors. Some examples include Sydney Angels and Melbourne Angels. I've found it helpful to develop my network and learn from those who have previously invested in my areas of interest. Visiting industry specific publications will also keep you in the loop.

Crowd-sourced funding platforms

This year, a new method of investing in early-stage technology businesses has gained Australian Government support: crowd-sourced equity funding (CSEF). CSEF platforms allow investors to invest capital into early-stage private enterprises in the same way they would invest in shares on the ASX, by buying shares in startups and SMEs. Parliament recently passed legislation allowing unlisted public companies to advertise their campaigns on licensed crowdfunding portals and raise up to $5 million a year. Retail investors - those earning less than $250,000 a year and owning less than $2.5 million in assets - are limited to investing $10,000 per company per year.

In September 2017, Treasurer Scott Morrison introduced new CSEF legislation into Parliament, which will permit CSEF platforms to advertise offers from private proprietary companies, allowing the public to invest in a much larger range of businesses. Private companies will soon be able to raise up to $3 million through CSEF platforms before requiring an annual audit of their financial statements. These investments must be made through ASIC-licensed crowdsourcing platforms that can be accessed by both retail and wholesale investors.

The investment process for CSEF investments is similar to angel investments. It involves assessing the prospects of available deals on CSEF platforms, determining if you wish to participate on the published terms, and making the investment.

Indirectly investing through a venture capital fund

If you like the idea of investing in early-stage businesses but don't have the time to be an angel or CSEF investor, consider investing through a venture capital (VC) fund. Reputable funds will follow a structured process similar to the one outlined above. When assessing potential funds, consider the background of the fund's principals, the value proposition to both investee businesses and investors, and their history and track record.

As with angel and CSEF investing, screening the principals of a VC firm is a crucial step before committing to an investment. If the fund focuses on specific sectors, consider whether the principals have relevant technical knowledge to review potential deals and add value to their investments. Some VCs have a founder background, with extensive startup and operational experience. Other VCs have a financial management or investment banking background.

Either way, make sure the VC has personal experience in building or leading their own businesses along with the ability to provide critical feedback to investee businesses. Screening a VC firm also involves reviewing the firm's track record and historical investments, all of which can provide an indication of future performance.

Benjamin Chong is Partner at venture capital firm Right Click Capital, investors in high-growth technology businesses. Right Click Capital also publishes newsletters on investment and M&A activity across internet and technology businesses. This article does not consider the circumstances of any investor.

Fear of missing out trumping fear of loss

Roger Montgomery

In the early 20th century, Argentina was one of the world's wealthiest nations, thanks to an educated workforce and agriculture. But after a litany of economic and financial crises, Latin America's third largest country is not high on the list of places to invest for Australian investors.

Just three years ago it was being sued by investors, while simultaneously trying to avert its second debt default in a decade. Government ineptitude and volatile commodity prices have conspired to plunge millions of citizens into abject poverty.

A brief history of Argentina's economic and financial crises is instructive, because while you may initially wonder what this has to do with you, the market's current attitude to Argentina is vital in understanding where your returns are likely to go.

Impact of disappearing exports

In the 1930's, Argentina was unable to escape the Great Depression as demand for its commodity exports vaporised. With government budgets plunged into deficit and public-sector workers unpaid, the military staged a coup in 1930 against the country's democratically elected president.

Thanks to this precedent, and due to frequent economic disruption, more military leaders led the country than civilians throughout the 20th century, and between 1930 and 1983 presidents averaged only two years in office while the minister for economics was replaced annually.

After a brief period of post-war prosperity, in the early 1950s, commodity prices fell again. The nationalistic president Juan Domingo Peron took possession of British-owned railroads causing foreign investment to dry up. When inflation soared to 40%, real wages collapsed, and strikes following the death of Peron's wife Eva Peron (you may recall the song 'Don't Cry for Me Argentina') caused the country to grind to a halt. The military intervened again.

In the 1970's the military regime was being begged by the constituency to return Peron from exile to the presidency and thanks to memories of the post war prosperity the generals relented. Peron died the following year.

Unsurprisingly, when the country made a former exotic dancer and Peron's third wife his successor, several military and para-military factions struggled for control. In 1976, with inflation at 600% military generals staged another coup.

Many readers may recall the invasion of the Falkland Islands, a British colony, in 1982 with Argentina losing the brief war to the British. After the loss and human rights abuses during a war known as the 'Dirty War', the military was disgraced and democracy returned to Argentina, seemingly permanently, in the 1980's.

Political and economic stability don't go together

But political stability has not lead to economic stability. An expansion of government offices under president Raul Alfonsin, caused public sector wages to grow exponentially. Meanwhile, lax tax collection systems saw only one tenth of 1% of the population of 30 million Argentines paying income taxes. The consequential impact on the government's budget and foreign investment saw inflation reach an unprecedented 5,000%. With rioters clearing out supermarkets, Alfonsin handed the presidency over to his elected successor, Carlos Menem, almost six months early.

According to many reports, Menem spent the 1990s attracting foreign investment, selling off loss-making state enterprises and cutting import tariffs. Inflation fell to single digits, and Argentina became the International Monetary Fund's (IMF) poster child for free-market reform.

By the turn of the Millennium and Menem's departure however, corruption was rife and Asia, Brazil and Russia's financial crises saw foreign investment flee emerging markets like Argentina. Maintaining Menem's Peso peg to the US dollar was impossible and, unable to print money, the government borrowed heavily.

In 2001 the country declared the largest sovereign debt default in history and a depression followed. In terms of income, over 50% of Argentines were 'poor', as were seven of every 10 Argentine children at the depth of the crisis in 2002.

In 2003, economic growth returned to an average rate of 9% for five years. GDP exceeded pre-crisis levels by 2005, and Argentina resumed repayments on defaulted bonds. By 2010, 93% of bonds were brought out of default through a second debt restructuring. According to most reports, bondholders who participated in the restructuring have been paid punctually and have seen the value of their bonds rise. In 2006 Argentina repaid its IMF loans in full. In 2016 Argentina came out of the default when the new government decided to repay the country's debt, finally paying the full amount owed to litigious hedge funds.

Argentina is a country where economic instability is normal and locals will tell you another 'crisis' is underway or on the way. The country however has experienced its best run of growth since the post war boom thanks to high prices for commodities, due largely to demand from China.

Foreign investment returned in 2016, but the Peso has slipped to fresh record lows in recent months as government spending on social welfare programs, current account deficits and printing of new money has again fuelled one of the world's highest inflation rates at 20% per annum.

Ok, so now you know something about Argentina going back nearly 90 years. What does it have to do with you? Well, just a few months ago Argentina joined Mexico, Ireland and the U.K. in issuing a 100-year bond. Only 12 months after it emerged from its most recent default the bond issued was massively oversubscribed, such is the desire for yield by global investors.

Another default in Argentina?

According to Reuters, Argentina received $9.75 billion in orders for the 100-year bonds and sold $2.75 billion at a final yield of 7.9% with a 7.125% cash coupon. That's just 5% more than what investors are willing to lend at to the US government.

A reasonable question to ask is: do you think, inflation, higher interest rates or a default might happen in Argentina in the next 100 years? If the answer is yes, and that's what the history lesson was for, then investors who hold this bond will have to endure capital losses at some point, while receiving a yield that is insufficient to compensate them for the risk.

When share market investors, including Australian investors paying high price to earnings (P/E) ratios of above 18 times, suggest high P/Es are appropriate given low interest rates, they are playing the same relative value game as the Argentinian bond investors. You can only accept paying a very high P/E if you also accept very low prospective returns.

The Argentinian bond issue, which coincides with Ivory Coast and Senegal offering 16-year bonds at 6.25%, Greek 5-year bonds at 4.63%, Iraq 5-year bonds at 6.75% and Ukraine 10-year bonds yielding 7.3%, suggests the market is at it again. It fears missing out more than it fears losing money.

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Check the Centrelink rules before gifting

Liam Shorte

'Gifting assets' before applying for a pension often will not increase the age pension. The gifting and deprivation rules prevent you from giving away assets or income over a certain level in order to increase age pension and allowance entitlements. For Centrelink and Department of Veteran's Affairs (DVA) purposes, gifts made in excess of certain amounts are treated as an asset and subject to the deeming provisions for a period of five years from disposal.

What is considered a gift for Centrelink purposes?

For deprivation provisions to apply, a person disposes of an asset or income when they engage in a course of conduct that destroys, disposes of or diminishes the value of their assets or income, without receiving adequate financial consideration in exchange for the asset or income.

Adequate financial consideration can be accepted when the amount received reasonably equates to the market value of the asset. It may be necessary to obtain an independent market valuation to support your estimated value or transferred value or Centrelink may use their own resources to do so.

Deprivation also applies where the asset gifted does not actually count under the assets test. For example, unless the 'granny flat' provisions apply, deprivation is assessed if a person does not receive adequate financial consideration when they:

- Transfer the legal title of their principal home to another person, or
- Buy a new principal home in another person's name.

What are the gifting limits?

The gifting rules ***do not prevent a person from making a gift*** to another person, but cap the amount by which a gift will reduce a person's assessable income and assets, thereby increasing social security entitlements.

There are two gifting limits as follows:

1. A person or a couple can dispose of assets of up to $10,000 each financial year. This $10,000 limit applies to a single person or to the combined amounts gifted by a couple, and
2. An additional disposal limit of $30,000 over a five-financial-years rolling period.

The $10,000 and $30,000 limits apply together, meaning that assets can be gifted up to $10,000 per financial year without penalty, but without exceeding the gifting free limit of $30,000 in a rolling five-year period.

What happens if the gifting limits are exceeded?

If the gifting limits are breached, the amount in excess of the gifting limit is considered to be a deprived asset of the person and/or their spouse. The gift is assessable as an asset for five anniversary years from the date of gifting, and subjected to deeming under the income test. After the expiration of the five-year period, the deprived amount is neither considered to be a person's asset nor deemed.

Example 1: Single pensioner – gifts not impacted by deprivation rules

Sally, a single pensioner, has financial assets valued at $275,000. She has decided to gift some money to her son to improve his financial situation. Her plan for gifting is as follows:

Financial year	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Amount gifted	$6,000	$6,000	$6,000	$6,000	$6,000	$6,000

With this gifting plan, Sally is not affected by either gifting rule. This is because she has kept under the $10,000 in a single year rule and also within the $30,000 per rolling five-year period.

Example 2: Single pension – gifts impacted by one gifting rule

Peter is eligible for the age pension. He has given away the following amounts:

Financial year	Amount gifted	Deprived asset assessed using the $10,000 in a financial year free area rule	Deprived asset assessed using the $30,000 five-year free area rule
2017/18	$33,000	$23,000	$0
2018/19	$2,000	$0	$0

In this case, $23,000 of the $33,000 given away in 2017/18 exceeds the gifting limit (the first limit of $10,000) for that financial year, so it will continue to be treated as an asset and subject to deeming for five years. In 2018/19, while gifts totalling $35,000 have been made, no deprived asset is assessed under the five-year rule after taking into account the deprived assets already assessed, i.e. $33,000 + $2,000 – $23,000 = $12,000, which is less than the relevant limit of $30,000.

Example 3: Couple impacted by both gifting rules

Ted and Alice are eligible for the age pension. They give away the following amounts:

Financial year	Amount gifted	Deprived asset assessed using the $10,000 in a financial year free area rule	Deprived asset assessed using the $30,000 five-year free area rule
2017/18	$10,000	$0	$0
2018/19	$13,000	$3,000	$0
2019/20	$10,000	$0	$0
2020/21	$10,000	$0	$10,000
2021/22		Any gifts in 2014/15 will be assessed as deprived assets under the five-year rule	

In this case, $3,000 of the $13,000 given away in 2018/19 exceeds the gifting limit for that year, so it will continue to be treated as an asset and subject to deeming for five years. The $10,000 given away in 2020/21 exceeds the $30,000 limit for the five-year period commencing on 1 July 2017, so it will also continue to be treated as an asset and subject to deeming for five years.

Are some gifts exempt from the rules?

Certain gifts can be made without triggering the gifting provisions. Broadly speaking, these include:

- Assets transferred between the members of a couple, such as where a person who has reached age pension age withdraws money from their superannuation and contributes it to a superannuation account in the name of the spouse who has not yet reached age pension age.
- Certain gifts made by a family member or a certain close relative to a Special Disability Trust.
- Assets given or construction costs paid for a 'granny flat' interest.

Trying to be too smart by gifting prior to claim

Any amounts gifted in the five years prior to accessing the age pension or other allowance **are** also subject to the gifting rules

Deprivation provisions do not apply when a person has disposed of an asset within the five years prior to accessing the Age Pension or other allowance but could not reasonably have expected to become qualified for payment. For example, a person qualifies for a social security entitlement after unexpected death of a partner or job loss.

Liam Shorte is a specialist SMSF advisor and Director of Verante Financial Planning. This article contains general information only and does not address the circumstances of any individual. You should seek professional personal financial advice before acting.

Why instos don't invest in residential housing

Hugh Dive

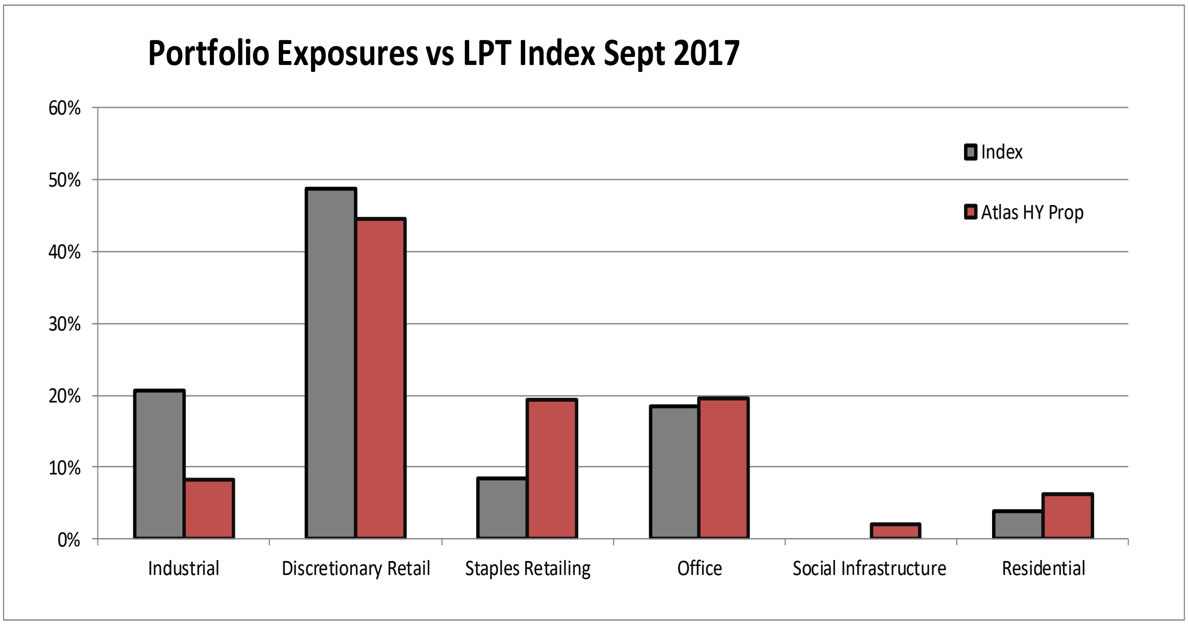
One of the misconceptions investors have is that the $123 billion listed property index is primarily exposed to residential real estate. In fact, only 4% of the value of the index is trusts exposed to residential property. Further, this exposure primarily comes from developers selling finished apartments or home and land packages, not from actually owning housing real estate that is rented out.

Last month, Mirvac announced they would be bringing Australia's first major build-to-rent apartment development to market in a move that could potentially address housing affordability issues. The question is why have institutional investors shied away from investing in residential developments, unlike in the US and the

UK where this sector is a growing part of the listed property indices? Indeed, in the US, the residential sector accounts for around 25% of the $US2 trillion in institutional property investment, placing the sector just behind office.

Residential property has attracted little interest from institutions because retail investors have an investment edge. The chart below shows the property exposures of the S&P/ASX 200 A-REIT index by sector in September 2017. The residential exposure of $4.7 billion is dwarfed by the value of the discretionary retail ($59 billion), industrial ($25 billion), and office ($22 billion).

Listed property by sector exposure



Source: Atlas Funds Management, index versus Atlas High Yield Property Fund.

Three structural reasons for retail investors dominating residential

Whilst the smaller transaction size of buying a two-bedroom apartment is attractive to retail investors compared with an industrial warehouse or an office tower which may be valued in the tens to hundreds of millions, there are three structural reasons why retail investors dominate residential property investment.

1. Capital gains tax breaks for home owners 'crowds out' corporates

Although the domestic rental sector exists in listed property trusts (LPTs) in the US and Europe, in Australia the tax-free status of capital gains for owner-occupiers selling their primary dwelling has had the effect of bidding up the purchase prices of residential real estate. For example, when a company generates a $500,000 capital gain from selling an apartment, they would be liable to pay approximately $108,000 in capital gains tax, whereas the owner-occupier pays no tax on the capital gains made on a similar investment. This discrepancy in the tax treatment encourages owner-occupiers to pay more for the same real estate assets and contributes to low yields.

2. Negative gearing

Similarly, individual retail investors benefit from the generous tax treatment in Australia that allows them to negatively gear properties. There are three types of gearing depending on the income earned from an investment property: positive, neutral and negative. A property is negatively geared when the rental return is less than the interest repayments and outgoings, placing the investor in a position of losing income on an annual basis. Under Australian tax law, investors can offset the cost of owning the property (including the interest paid on a loan) against other assessable income. This incentivises individual high-taxpaying investors to buy a property at a price where it is cash flow negative and maximise their near-term tax returns and bet on capital gains. Whilst companies and property trusts can also access taxation benefits from borrowing to buy real estate assets, a rich doctor on a top marginal tax rate of 47% has a stronger incentive to raise their paddle at an auction.

3. Yields on residential property too low

At current prices, the yields that residential property offer are not very attractive for listed vehicles. At the moment, the S&P/ASX 200 A-REIT index offers an average yield of 5%. This is higher than yields from investing in residential property. SQM Research reported that the implied **gross** rental yield for a 3-bedroom house in Sydney was 3% with a 2-bedroom apartment yielding 4% in July 2017. After borrowing costs, council rates, insurance, and maintenance capex, the net yield is estimated to average around 1%. With listed property investors focused on yield receiving on average ~ 5% from property trusts investing in office towers and shopping centres, such a low yield would only be accepted if it was offset by high and certain capital gains.

Mirvac's new 'build to rent' fund

In August 2017, Mirvac announced its intention to develop a 'build to rent' fund with assets based initially in Sydney. This fund is likely to target institutional investors rather than retail, who generally already have a significant exposure to residential real estate. This looks to be an opportunity for Mirvac to access both development profit (profit margin +25% in FY17) and also an ongoing funds management fee on the completed assets. However, we would be surprised to see much of Mirvac's own capital invested in the fund. In 2017 Mirvac generated an 18% return on the $1.8 billion of capital invested in its residential development business (ROIC). Mathematically it is hard to see how investing in their own finished product will generate returns higher than the trust's average cost of capital.

Our take

Whilst the residential sector is a large part of the stock of Australian real estate assets, without significant taxation concessions it is hard to see this sector garnering much interest from institutional investors, especially for income-focused investors. We see that the majority of returns over the next 12 months will come from distributions and income from writing call options over existing holdings, rather than spectacular capital gains.

Hugh Dive is Chief Investment Officer of Atlas Fund Management.

Is your portfolio playing 20/20 or test cricket?

Andrew Martin

Following the footy finals, sporting eyes will turn to the upcoming summer of cricket, which this year features the Ashes. To win a game of test cricket, a team requires experience, discipline, patience and consistency over extended periods. It involves knowing when to play and when to leave, when to attack and when to defend. Similar traits are required when it comes to successfully managing a portfolio of investments for the long term.

This summer will also feature an increase in the number of 20/20 games, with a focus on short term excitement through increased risk taking. The comparison of cricket and investing is appropriate. The skills required to generate consistent long-term returns look very like that of test cricket, yet investors are often drawn to riskier approaches. As cricket historians well know, Don Bradman only hit six 6's in his entire test career, yet holds the highest batting average on record.

The landscape for traditional active fund managers is changing leading to increasing levels of active risk being taken. So, it is important to measure the level of consistency or a portfolio's 'batting average' to ensure risk is taken at the right time, and not just for risk's sake.

Conviction with consistency

The rise of passive investing along with ETFs is disrupting active management globally. The response in Australia from these pressures appears to focus on taking more risk, to 'prove' a differentiation to the index.

To demonstrate this effect, Figure 1 shows the Australian universe of long-only actively managed funds taken from the Mercer Australian Shares Long Only Survey as at June 2007. Figure 2 shows the same survey, 10 years later at June 2017. Funds are ranked by return (y-axis) and level of active risk (tracking error (x-axis)).

Figure 1: Source Mercer Survey June 2007

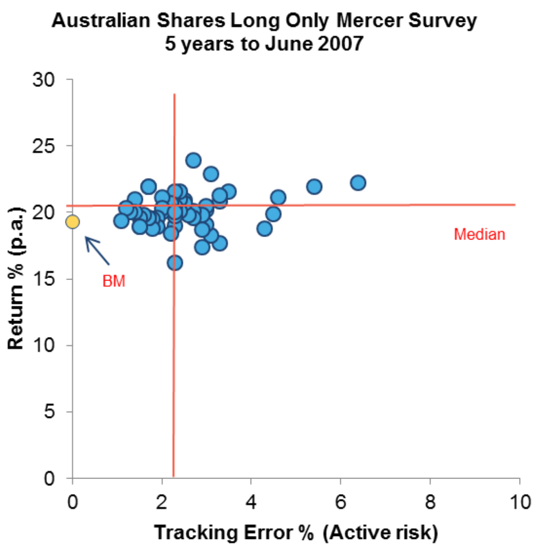
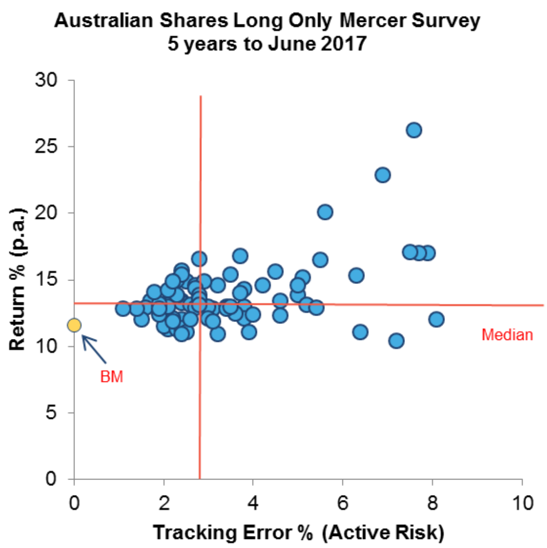


Figure 2: Source Mercer Survey June 2017



In 2007, only 20% of long only funds recorded a tracking error (active risk score) greater than 3%. Ten years on, 45% of active managers in the survey are taking on active risk above 3%. Managers appear to be responding to the pressure to deviate returns away from benchmark.

For higher 'risk' mangers with higher tracking error above the median (shown in figure 2), there is material dispersion in performance for the same level of risk. On average there appears minimal additional return for some very high levels of risk.

Relevancy of active risk

Active risk can be increased in a portfolio in a number of ways: greater concentration via a reduction in the number of stocks held, large sector tilts, unconstrained cash positions and holding companies which have different risk profiles to the benchmark.

Increasing active risk in a portfolio can result in spectacular differentiated short-term returns. However, the increased risk can lead to greater drawdowns (losses) and prolonged periods of underperformance as well. To continue the cricket analogy, a six, six, four in 20/20 is often quickly followed by a 'W' in the wrong column. True, we need to take some risk to get returns, but sometimes risk just equals risk.

Investors should consider approaches that can balance the higher returns expected of a more concentrated portfolio with the level of risk or volatility needed to achieve those returns. Good portfolio management is far less about **how much** risk you take and more about knowing **when** to take the risk

Consistency in return prevents large behavioural biases of buying a star performer right at the top of a cycle or losing faith in the approach just at the wrong time. A consistent return series is also more practical for an adviser managing a large client base with multiple investment time horizons.

Ways to measure portfolio consistency and skill

The following are some techniques to monitor the consistency of an investment portfolio over rolling or extended periods rather than short term point in time periods, used in conjunction with analysis of the investment rationale behind the outcome:

1. **Batting average** is the total months a portfolio has outperformed divided by the total number of months in a given period. For example, if a portfolio has outperformed six months over a year it has a batting average of 50%. Consistency of batting average over time results in a smoother return series.
2. **Hit rate** shows the number of correct individual stock decisions as a percentage of the total number of manager decisions. Maintaining a consistent hit rate over 50% indicates solid investment skill.

3. **Win/loss ratio** is a comparison of the alpha generated from the good decisions with the alpha lost from poor decisions. For example, 0.75% excess return in outperforming months versus 0.70% excess loss in underperforming months leads to a ratio of 107%. Sustaining a positive win/loss over extended periods indicates consistency and skill.

4. **Information ratio (IR)** takes the excess return divided by the active risk i.e. how much return you can achieve for each unit of risk taken. An IR that can consistently remain above 0.5 is seen as a good risk return outcome. Anything consistently above 0.75 implies a high level of skill.

Risk matters

Risk management is central to successful funds management. Using a long-term approach with a level of consistency in returns provides comfort that investors will achieve their objective, irrespective of timing. It may not be as exciting as a 20/20 match, but will provide a superior risk-adjusted return over the longer term, help avoid succumbing to behavioural biases and ensure a smoother ride to your destination.

Andrew Martin is Principal and Portfolio Manager at Alphinity Investment Management, a boutique fund manager in alliance with Fidante Partners. Fidante is a sponsor of Cuffelinks.

Goldilocks economy is keeping the bears at bay

Miles Staude

Pick up a newspaper today and it is hard to find many reasons to be cheery. North Korea and ISIS take turns in frightening us for our lives. Brexit and Trump take turns in frightening us for our livelihoods. Most financial commentators are fixated on predicting how soon it will be until the next bear market hits shares.

Recognise the synchronised upswing

It is unfortunate then, that one of the better good news stories of recent years has received less attention than it deserves. Since mid-2016, a string of consistently good economic data from around the world has shown the global economy is in a period of synchronised upswing. In the US, economic growth annualised at a rate of 3.1% in the second quarter of this year, well ahead of market expectations, while Europe and Japan both recorded annualised growth rates of 2.5% during the same period. For mature developed market economies, such growth rates are positively zippy.

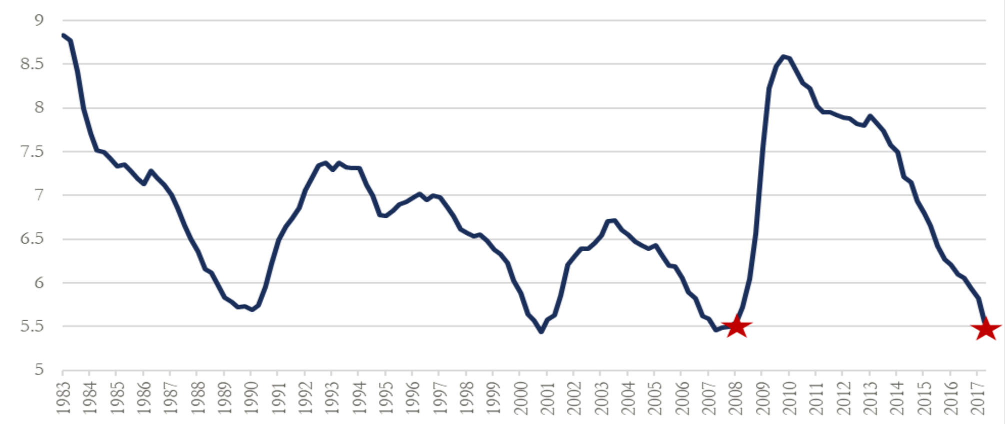
An equally important driver of above-trend global growth has been developments in China. Not that Chinese growth rates have been accelerating, but rather Chinese growth has (once again) not slowed down as forecast. The Chinese economy grew by 6.9% in the second quarter of 2017, the same rate of growth as the first quarter and the equal fastest pace of expansion since September 2015. Chinese growth rates are considerably ahead of its government's own 2017 growth forecast of 'around 6.5%'. A year ago, markets (and the Chinese government) were predicting a meaningful slowdown during 2017 as the government tackled excess credit creation and forced closures in industries with excess capacity. So far, predictions that these actions would weigh heavily on economic activity have proven to be incorrect, or at least premature.

The IMF, in its most recent review of the global economic outlook, forecasts the global economy to expand by 3.5% in 2017 and 3.6% in 2018. This would represent the fastest pace for global growth since 2014 and 2011 respectively. It would also seem that there is room for meaningful upside to the IMF's 2018 figures; as they are predicated on Chinese growth falling to 6.2%, a significant slowdown from the current rate of activity.

Where's the inflation and unemployment?

What is remarkable about this upswing in global economic activity is that it is occurring at a time of both benign inflation and, on some measures, close to record low unemployment. The OECD average unemployment rate fell to 5.6% during June 2017, its lowest level since March 2008 (see chart below).

Exhibit 1: OECD Unemployment Rates 1983-2017



Source: OECD

However, considerable spare capacity remains in the labour force. Workforce participation levels have fallen substantially in key economies like the US, with large swathes of potential workers falling out of the labour market following years of difficult economic conditions. This dynamic means that, despite the low headline unemployment rates, wage growth in developed market economies remains anaemic. The accelerating global economy is pulling workers back into the labour market instead of giving the existing workforce a pay rise. This lack of labour market pricing power is one of the key contributors to inflation remaining *too low* for most major economies. The three most important central banks, the Fed, ECB and BOJ, are all engaged in unprecedented monetary easing programs designed in large part to push inflation rates higher.

Strength feeding profitability

A combination of accelerating global growth, benign inflation and ultra-easy monetary conditions (real interest rates in the US, the Euro area and Japan all remain negative) has created a Goldilocks environment for equity markets. Corporate profitability is the chief beneficiary of accelerating growth in an environment of negative real interest rates and limited wage pressure.

Yet despite the positive economic backdrop, much of the commentary about equity markets today is anchored around one key worry – how long it has been since the last big correction, nearly a decade since the last. It is also true that share markets do not turn on some preordained cycle. They price in the market's best estimate of future corporate earnings. In large part, the reason that share markets continue to make new highs today is that the global economy is in unusually rude health, and that, for now, corporate profitability stands to be the biggest beneficiary from this upswing.

While this is good news for investors, it is better news for large parts of the population removed from the workforce following years of sub-par economic growth. 'Falling labour market slack' is an economist's way of saying that, nine years on from the crisis, many marginalised members of society are finally able to find work. Surely one of the better news stories of recent years.

Miles Staude is Portfolio Manager at the Global Value Fund (ASX:GVF), which he manages from London. This article is the opinion of the writer and does not consider the circumstances of any individual. The title of this piece apes a famous economic article written in 1992 by David Shulman, a senior economist at UCLA.