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Connecting investors with ideas

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Contents

ATO to shine spotlight on poor SMSF investment data

Graham Hand

Although SMSFs hold $750 billion of Australia's almost $3 trillion superannuation system, the data on their investment allocations is surprisingly poor. There are two main sources:

1. the Australian Taxation Office (ATO) produces out-of-date reports based on SMSF tax returns, using badly-defined categories (discussed in detail here).

2. industry participants such as SuperConcepts, Class, Sharesight and Investment Trends provide asset allocations based on surveys or data dumps from their own clients.

While some of the attempts by industry are useful, a comprehensive report requires the ATO to improve its categories, and there are signs it wants to head in that direction.

In a talk called 'The Regulator - putting a spotlight on what they're putting a spotlight on' to Chartered Accountants on 21 October 2019, Dana Fleming, the Assistant Commissioner SMSF Segment said the ATO was looking at changing asset categories. For example, 'unlisted trusts' provides no information on the asset class held.

> *"I would love better data and granularity and hope to improve that for ourselves ... so we get better visibility of what people are actually invested in."*

The recent ATO letters

In August 2019, the ATO wrote to 17,700 SMSF trustees about their lack of asset diversification, and it sparked a flurry of activity from members. The ATO said:

> *"… SMSF annual return data indicated these SMSFs may be holding 90% or more of their retirement savings in one asset or a single asset class."*

In 99% of these cases, the SMSF had borrowed money to buy one asset, property. At a time of declining property prices, the concern for retirement savings was justified, but the vast majority of SMSFs do not borrow.

More importantly, another part of the ATO announcement has broader implications. About one-third, or 180,000 SMSFs, invest 90% in a single asset or asset class, and the ATO also said:

"We are concerned that these SMSF trustees may not have given due consideration to diversifying their fund's investments and the risks associated with a lack of diversification when formulating and reviewing their investment strategy."

Legal obligations of all SMSFs

Under superannuation regulations (section 4.09 of the SIS Act), it is a legal requirement for SMSFs to "*review regularly and give effect to an investment strategy",* allowing for:

- Risks, liquidity and likely returns from investments, having regard to cash flow requirements.
- Composition of investments as a whole, avoiding inadequate diversification.
- Ability to discharge existing and prospective liabilities.

SMSFs make up the largest segment of super assets at about 26%, ahead of industry funds at 25% and rapidly dropping behind, retail funds at 22%.

The asset allocations of large funds (excluding SMSFs)

Large funds invest their assets in ways shown in the table, providing a clearer classification than available for SMSFs.

Some highlights include:

- A larger allocation to international shares than Australian listed shares.
- A significant investment in unlisted and alternative assets, such as unlisted property (5%), infrastructure (6%), unlisted equity (4%) and hedge funds.
- A solid defensive cash and fixed interest allocation of 32%, often due to offering 'balanced' funds to their members.

Australia's $160 billion sovereign wealth fund, the Future Fund, gives even more detail. It holds 29% of assets in global equities and only 7% in Australia, and it reports its unlisted investments in private equity, alternatives, infrastructure and timberland.

Asset allocation (funds with more than four members)

Asset class	Amount ($billion)	%
Cash	180	10
Australian fixed interest	233	13
International fixed interest	164	9
Australian listed shares	411	22
Listed property	57	3
Unlisted property	99	5
International shares	448	24
Infrastructure	104	6
Hedge funds	32	2
Unlisted equity	74	4
Other	32	2
Total	**1,838**	**100**

Source: APRA June quarter 2019.

Source: ASFA Statistics

The asset allocation of SMSFs

The ATO quarterly report reports managed funds under one category without separating fixed interest, domestic and global equities. The foreign investment number is only direct equities, not including the holdings of Exchange Traded Funds (ETFs), Listed Investment Companies (LICs) and managed funds in global equities.

There are four alternative sources, each useful but limited by the sample size. Researchers at Investment Trends make broad allocation measurements, while three SMSF service providers (Class Limited, SuperConcepts and Sharesight) reveal what their clients are doing. Class's SMSF asset allocation as at 30 June 2019 is shown in this graphic.

Like the ATO reports, it is difficult to identify the global equity holdings. The listed shares component can be divided into:

Source: Class Limited, SMSF Benchmark Report, June 2019

- Domestic shares, 76.7%
- ETFs, 8.6%
- Debt and hybrid securities, 7.5%
- Other trusts and stapled securities, 7.2%

We know from reports issued by ETF providers that SMSFs have moved rapidly into fixed income investments and global equities in the last year, which is heading in the same direction as the large funds. A wide range of listed opportunities which were not available a couple of years ago, such as infrastructure, securitised assets, corporate credit and global fixed interest, are now available in listed form on the ASX.

SMSF global equity allocation

Many global equity managers like to quote the ATO data on international investments to encourage SMSFs to place more money in their funds. The ATO data shows an allocation of only 1.4% because most global shares are held by SMSFs in local funds. The portfolio tracking software company, Sharesight, estimates 15,500 SMSFs in its sample allocate about 14% to global equities in various vehicles. Checked against SuperConcepts estimates, this figure is far more accurate than the ATO data.

Source: Sharesight, ATO. ATO data is for the quarter ending March 2019, Sharesight is for September 2019.

Meeting the legal obligations of running an SMSF

We know enough about SMSFs to state that the majority have a diversified asset allocation, but as the ATO has said in its letters to trustees, there are many who need to consider whether their investment strategy meets the purpose of providing for retirement.

The main legal requirement is to put an investment strategy in place and to review it regularly in the context of risks, returns and cash flow needs. However, SMSF trustees have significant flexibility in their asset allocation, and if they document their strategy properly, they should be safe from ATO scrutiny, even if their assets are not well diversified. The ATO has no right to decide if an investment strategy is suitable for an SMSF trustee.

But let's at least collect accurate data to assist an informed discussion.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

The 'streaming wars' could penalise viewers

Michael Collins

In 2017, when Netflix was 20 years old, the ad-free on-demand-video or streaming service achieved three milestones. One was that Netflix hit 100 million subscribers worldwide. Another was the streamer earned its first Oscar when *White Helmets* won Best Documentary Short Subject. The third was the company premiered its first blockbuster movie; namely, *Bright* featuring Will Smith.

In that giddy year, legacy free-to-air and balkanised cable TV rivals appeared passé and Prime Video and the like looked like limp competition. Netflix co-founder and CEO Reed Hastings declared the creator of 'binge watching' had even beaten an unobvious competitor. "We actually compete with sleep," Hastings said. "And we are winning."

Succeeding might get harder for Netflix

Even though Netflix has intensified content creation, boosted global subscriptions to 152 million and still dominates the subscription video-on-demand market globally, the company risks losing its dominance in streaming for two reasons.

First, Big Hollywood and another Big Tech company are entering the streaming landscape that in the US already includes Amazon's Prime Video.

Coming soon to streaming are Hollywood icons AT&T's WarnerMedia, Comcast's NBCUniversal and Disney, recently bolstered by its purchase of 21st Century Fox. This trio will arrive with competitively-priced packages, marketing budgets to promote their arrival, libraries of premium content, plans to create compelling programs exclusive to the new services, and intentions to reclaim the popular content they have licensed to Netflix. They enter streaming with an aim to arrest sharply declining viewership of their linear channels (where video content is delivered to a schedule), build direct customer relationships and protect their position as global media giants.

Apple is arriving with US$6 billion to spend on content for its upcoming TV+ service, which is about what Amazon is thought to devote to content on Prime Video that was founded in 2006. While Big Tech lacks content archives, they are wealthy, have huge customer networks and might be willing to loss-lead on streaming to attract and retain more people on their platforms that they monetise in different ways.

The **second** problem for Netflix and streamers such as Australia's Stan relates to content. Four areas of concern stand out:

1. New entrants are claiming back marquee content such as *Friends* and *The Office*.

2. Heightened competition has boosted the value of licensed content, which hampers newer streamers with smaller back catalogues compared with Hollywood rivals.

3. Binge watching hastens the need for fresh content.

4. The last (and a less urgent problem) is that countries are setting local-content rules requiring streamers to invest in local content.

These reasons are pushing the streaming industry to boost content spending. Netflix, for instance, is expected to spend almost US$15 billion in cash on content this year, more than 60% higher than only two years ago.

The heightened competition and rising content costs are bound to transform the streaming TV industry. Smaller stand-alone streaming platforms could struggle as the giants fight to become one of the small number of services to which most households subscribe. Before too long, market share is likely to be more evenly spread across the vertically integrated giants.

The rising problem of multiple subscriptions

But given the way TV viewing works, that scattering of market share is likely to prove a situation where competition leaves consumers worse off. The future facing viewers is likely to be one where many households will need to subscribe to multiple streaming services (on top of traditional pay-TV packages) to see the mix of shows they want – which means paying more all up. They might see ads where none exist now (a de facto price rise). Or they might spend more time planning an app churn that brings them the content they prefer (another hidden cost even if it might be small for the tech savvy).

In short, the period in which viewers could access the right mix of enough programs, including all their favourite shows, at an affordable price on one or two ad-free streaming platforms is ending. Consumers face a fragmented and costlier world of streaming that could remind people of the disjointed and frustrating pre-Netflix era.

For all its streaming stranglehold, Netflix, to be clear, has only about 10% of total viewer screen time in the US. Netflix will hold a healthy, even if shrinking, grip on this fast-growing viewing segment for the foreseeable future because the company owns a rapidly growing stash of content and has the industry's most-honed algorithms to promote content. There is nothing remarkable in the likely trajectory of streaming; a company comes to dominate a new niche and others enter to share the profits. But it is likely to be notable for how market forces can act against the interest of consumers and for how tech can transform industries without fulfilling its initial promise.

Michael Collins is an Investment Specialist at [Magellan Asset Management](), a sponsor of Cuffelinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: https://www.magellangroup.com.au/insights/.

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Five tips for Aussies who live in the US

Noel Whittaker

Whenever baby boomers get together socially two topics will almost certainly come up in the conversation.

The first will be about their ageing parents, and the increasing challenges that come when parents get older, and contemplate a move from the family home to some form of aged care facility.

The second will be about their children, and thanks to the global village that is now our world, you can bet that at least one of those children will be living overseas, possibly in the USA or the UK. A major issue that often arises will be how to handle the tax treatment of a change in residency.

Not born in the USA

I have had experience in both these issues, as I am a co-author with Rachel Lane in the book *Age Care Who Cares*, and my second son James is now a resident of the USA. Take it from me, if you think aged care is complicated, it's a breeze compared to American tax law.

For what follows I'm indebted to Daniel Sparks of Pitcher Partners Sydney who took the time to explain the intricacies that face an Australian who becomes a resident of the USA, based on these five tips.

1. Residency

Generally speaking, you become an American resident for tax purposes the first time you enter the country after receiving your green card. Any child born in America is automatically an American citizen.

But, it isn't necessarily the case that your Australian resident status ends at that time. You would still need to look at Australian principles of tax residency, which can be vague, to work out whether you have become a non-resident for Australian tax purposes.

It is possible you may be resident for tax purposes in both Australia and the US. In that case, you would have to look at the tax treaty to determine whether a tie-breaker test applies to treat you as non-resident from an Australian perspective. This is first based on where your 'permanent home' is but can become complicated if a person has a home in both countries, as is sometimes the case.

It is also possible you became a US resident at an earlier point in time due to the 'substantial presence' test if you were spending significant time there before getting the green card. Often, people move to the US on working visas initially and the green card comes later after they have already lived there a few years.

2. Superannuation

Daniel tells me that you will be required to advise the IRS every year the balance of your superannuation fund in Australia, and potentially pay America income tax on any gain in value, even if that value is unrealised. If the value has fallen because of market fluctuations, there is no deduction for the reduction in that value. This is particularly onerous because you will be paying income tax at American marginal rates, on earnings in your super fund which have already been taxed at 15% per annum.

3. Investments such as property and managed funds

When you become a non-resident for Australian tax purposes, you have two choices with your investments. The first option is to let a notional realisation happen for capital gains tax purposes and pay capital gains tax in Australia on that gain to date.

The assets then become part of your American tax affairs, and all income and capital gains need to be declared on your American tax return. If you keep assets such as Australian shares, you will need to advise the share registry you are now a non-resident - they will deduct tax from your Australian distributions at the normal non-resident rate.

Alternatively, you can keep the assets and pay capital gains tax when you dispose of them, while still including the income in your American tax return. The problem with doing this is that the capital gains tax discount of 50% slowly erodes, because no discount is allowed for non-residents.

I understand that there is a specific US/Australia tax treaty clause that might solve the 'deferred CGT' issue. It essentially says that if you defer CGT for Australian purposes, then US will tax the whole capital gain and Australia will not tax any of it. However, this only works if you are a US resident at the time of the sale. It wouldn't work if you moved to a third country before selling the assets, or moved back to Australia, in which case Australia taxes the gain but you lose some of the CGT discount.

4. Gifts to the American resident

It is common for parents to give money to their children for help with living expenses, and possibly to help in buying a house. If these gifts exceed $US100,000 in a year the child is required to fill in Form 3520. In normal circumstances this would have no tax consequences, except that failure to report a foreign gift may result in a penalty of up to 25% of the unreported amount.

5. Inheritances

A bequest is similar to a gift and once again Form 3520 has to be completed. There may be Australian capital gains tax payable in the estate of the deceased, but if the beneficiary is a non-resident the capital gain cannot be rolled forward as it can be if you are a resident. In some circumstances a capital gain might be rolled forward if the asset is 'taxable Australian property' (eg. Real estate situated in Australia). Obviously it is critical when making a will to distinguish between non-resident beneficiaries and resident beneficiaries.

It can become complicated

What I have written is just a short summary of the complexity faced by Australians who become American residents. It also highlights the importance of getting expert advice sooner rather than later. It's much easier to keep the car out of a bog than try to dig it out when the wheels are deep in mud.

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OFFER: *Newly revised and updated, Making Money Made Simple will be available from October 2019. Any two books for only $49.99 with free shipping within Australia. View two-book bundles.*

Managing risk using asset diversification

William Gormly

Employing a strategic asset allocation (SAA) can minimise the overall level of portfolio risk for a given level of return. The investment strategy sets target weights to the asset classes in a portfolio. Weightings are primarily allocated based on the investment objective, time horizon and, most importantly, the risk tolerance of the investor.

Combining uncorrelated assets

Support for SAA is provided by the fundamental benefit of portfolio diversification. Combining a group of assets that are less than perfectly correlated can reduce the overall risk of a portfolio for a required rate of return. The main theory, known as Modern Portfolio Theory, was pioneered by Harry Markowitz for which he was later awarded a Nobel Prize (for Graham hand's interviews with Mr Markowitz, see here and here).

It is centered on the notion that the return of an asset should not be viewed in isolation but assessed on its contribution to the overall portfolio risk and return. The portfolios that provide the highest return for a defined level of risk fall on what is called the efficient frontier. This combination of assets is deemed to have greater diversification and be less susceptible to nonsystematic risk.

To illustrate the risk and return benefits of a SAA in a portfolio, 10 year back-tested data has been provided for three portfolios with different risk profiles: Conservative, Balanced and High Growth.

The portfolio asset weightings have been based on the corresponding BetaShares ETF Model Portfolios of the same risk profiles. This example is provided for information purposes only and is not intended to reflect the actual performance of the model portfolios they have been based on. Risk profiles of each model portfolio are produced in accordance with the Australian Prudential Regulation Authority's (APRA) standard risk measure.

In Figure 2, we have calculated the performance over a period of 10 years ending 30 September 2019, with monthly rebalancing back to the target SAA weights. Broad market cap weighted total return indices are used to generate asset class returns, focusing on indices that are commonly tracked by ETFs.

Figure 2 illustrates that each of the portfolios can be seen as 'optimal portfolios' that broadly fall on the efficient frontier. Compared to a portfolio of solely Australian Equity, the 'High Growth' portfolio provided a higher 10-year return and lower risk whilst having a monthly return correlation of 92.4%.

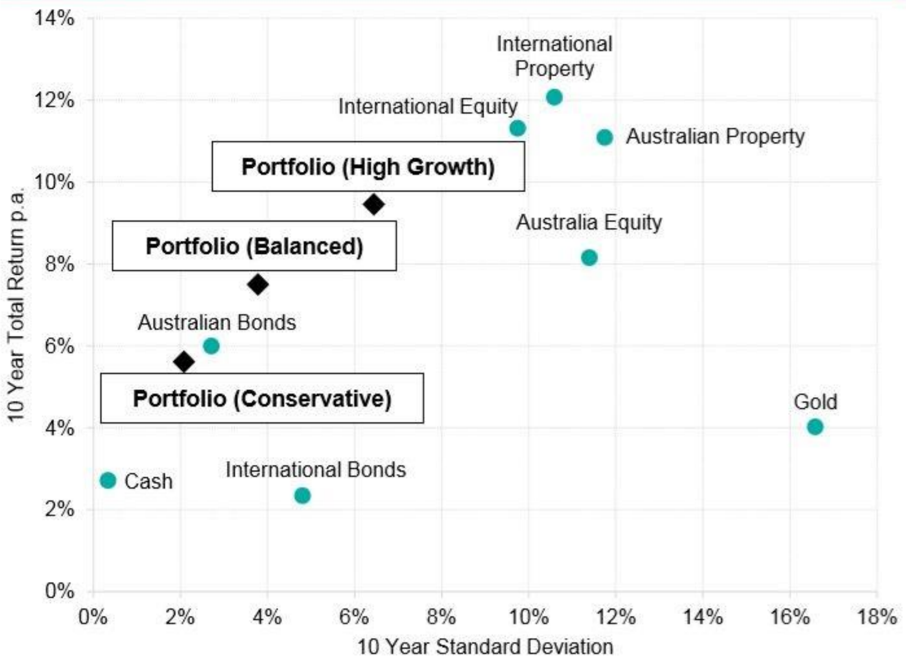
A 100% weighting towards Australian Equity would have been a sub-optimal portfolio and an inefficient investment strategy over the 10 years. This highlights the importance of asset diversification in a portfolio and the long-term risk versus return benefits it can provide.

Figure 1 - Indicative asset portfolio weights

	Portfolio		
Asset	**Conservative**	**Balanced**	**High Growth**
Australia Equity	10%	25%	45%
International Equity	5%	20%	35%
Australian Property	3%	3%	5%
International Property	3%	3%	5%
Australian Bonds	40%	30%	3%
International Bonds	15%	10%	3%
Gold	5%	5%	5%
Cash	20%	5%	0%
Total	**100%**	**100%**	**100%**

SOURCE: BELL POTTER RESEARCH. INFORMATION PURPOSES ONLY

Figure 2 - Risk v return



SOURCE: BLOOMBERG, BELL POTTER RESEARCH. INFORMATION PURPOSES ONLY

Correlations in returns between different asset classes are also relevant in building a portfolio. Figure 3 shows a 10-year correlation matrix, including the blended portfolios described above. It's notable that even a 'balanced' portfolio has a high correlation to equities.

Figure 3 - 10 year asset return correlation matrix

Correlation Matrix	Australia Equity	International Equity	Australian Property	International Property	Australian Bonds	International Bonds	Gold	Cash	Portfolio (Conservative)	Portfolio (Balanced)	Portfolio (High Growth)
Australia Equity	1.000										
International Equity	0.521	1.000									
Australian Property	0.614	0.320	1.000								
International Property	0.435	0.578	0.639	1.000							
Australian Bonds	-0.204	-0.112	0.274	0.285	1.000						
International Bonds	0.156	-0.224	0.242	0.010	0.319	1.000					
Gold	0.032	-0.234	0.132	-0.148	0.218	0.553	1.000				
Cash	-0.082	-0.127	-0.031	-0.017	0.168	0.057	0.078	1.000			
Portfolio (Conservative)	0.604	0.318	0.715	0.536	0.519	0.630	0.525	0.070	1.000		
Portfolio (Balanced)	0.881	0.707	0.707	0.631	0.109	0.276	0.196	-0.054	0.829	1.000	
Portfolio (High Growth)	0.924	0.780	0.654	0.615	-0.102	0.096	0.034	-0.098	0.667	0.968	1.000

SOURCE: BLOOMBERG, BELL POTTER RESEARCH. DATA AS AT 30 SEPTEMBER 2019

The results also show the higher returns come with greater 'risk', measured by the standard deviation. These are the classic trade offs expected under Modern Portfolio Theory.

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Firstlinks provides regular reports on LICs trading at discounts and premiums in the Education Centre.

Six common estate planning errors

Kirsten Lynn

A generation ago, estate planning consisted of a simple 'his and hers' will. It was 'everything to each other and then to the children'. But times have changed, such as:

- We are generally much wealthier
- Our financial worlds are increasingly complex with SMSFs, family and testamentary trusts, Powers of Attorney and company structures
- We live longer
- We divorce and re-partner more frequently
- The prices of property and schooling have exploded
- We often have dual incomes and we build wealth separately.

Some common questions we are asked

But it's not just demographics, longevity and housing that has changed. At Stanford Brown, in our experience working over many years with affluent families, we have seen a significant shift in the philosophy of wealth transfer.

> "*How will our plans impact the lives and aspirations of our children and grandchildren?*", ask our clients, echoing Warren Buffet's now-famous insight that he wished to leave his children enough money so that they would feel they could do anything, but not so much that they could do nothing.

> "*Will our plans help to preserve family bonds when we're gone*," they ask, "*or will it all end up in the courts?*" Ultimately, they wonder, "*how can our plans contribute to the long-term benefit of our family and the legacy we wish to leave?*"

Here, we highlight six of the more common mistakes when couples, particularly those from blended families, make plans to pass on their wealth.

Six potential mistakes in wealth transfer planning

1. Don't expect a perfect solution

One of the most confronting realisations when succession planning for a blended family is that you will rarely get what you want. State-based family provision legislation, and the added reach of notional estate provisions in NSW, require that you look after certain family members more than you may wish.

If an eligible family member makes a claim, the courts can intrude into your private arrangements and substitute their decision for yours. Yes, you could move to Queensland to avoid the NSW laws, as one lawyer quipped, but a pragmatic approach is essential.

2. Don't assume you have to die first

Many believe the greatest gift they can give their children is their grandchildren's education. They don't wait until they die to give this gift.

We encourage our clients to think first about the purpose of their life savings. They should provide not only food and shelter, but pleasure and fulfilment too. Many have created wealth well beyond their own personal needs and choose to help their children when it is most needed or make a philanthropic gift or teaching a child the responsibilities of being a steward of family wealth.

Of course, we often see that living longer brings an increased likelihood that you won't always be able to make decisions for yourself. Do you want to take the risk that you and only you can keep your world spinning on its axis? We have helped too many widows and widowers facing the unravelling of complex structures that their partner managed.

3. Don't rush the selection of your succession planning team

You need the right people at the wheel of your estate planning. You can scour the map, indicate the destination and mark out the best route, but what about the roadworks, the other drivers, the inclement weather? You cannot predict or control those factors. You have to trust in the wisdom and skills of the people you have appointed to act for you after you die or can no longer make your own decisions. And there are many appointments to make – Executors, Trustees, Guardians, Attorneys and Beneficiaries to name but a few.

Who will make health, lifestyle and medical decisions for you if you cannot? What about financial decisions? After your death, who will carry out the terms of your will? Wills are complex and your Executor can be sued if they do a poor job. If you set up a trust in your will, known as a testamentary trust, who will manage it and who will make sure they are doing a good job?

These are hard decisions. How do your family dynamics play out? If you appoint multiple people to a role, can they have competing interests and still work together productively? If in doubt, do you consider adding in an independent tie breaker? But what about those extra costs!

4. Don't assume everyone wants an equal slice of the pie

We have found it far more common than you might think for couples to have their first frank discussion about wealth transfer with us and their lawyer. That's when it clicks that they don't agree on how to transfer ownership and control and they have different expectations of how the other will provide for them. *"You might re-marry if I die? Really? I didn't expect to hear that!"*

Not all will-makers choose to leave the home to their partner or to treat all their children equally. Beneficiaries will have different needs and expectations. You may not know if you don't ask. They may surprise you and open up alternatives strategies to explore, like selling the family home or giving different gifts at different times. You may wish to leave your children an equal share, but your investment banker daughter may have different cash flow needs to your teacher son.

Whilst it's a deeply personal decision, we are seeing a growing trend for couples to tell their children about their estate plans and involve them earlier in philanthropy or family trusts.

5. Don't tie your beneficiaries together in financial knots

Adult children with parents still together are more likely to receive their inheritance from their longer-living parent, while adult children in blended families are more likely to receive a portion of their inheritance earlier.

However, we have seen examples where the will-maker tried to share the assets. The partner is allowed to live in the home and spend the income of the trust, but ultimate ownership passes to the will-maker's children after the partner dies. It can work, but the beneficiaries can also feel that it is ruling from the grave and it can damage family relationships.

Would each party have accepted a different arrangement that gave them potentially less money, but sooner and with fewer restrictions? Not everything in estate planning is about maximising the after-tax dollars. Freedom from the control of one's parents can also be highly prized!

6. Don't assume your family will never be blended

It's understandable that the main sticking point in your estate planning as a parent is guardianship of your young children in the event of both parents' early deaths. But it's mercifully rare for both parents to die simultaneously. Far more likely is that you will divorce and re-partner.

In our experience, couples, both old and young, are increasingly acknowledging this prospect and planning for the protection of their wealth, even if their marriage is great and they are healthy. We urge our dual income professional clients who have built assets before marriage and who are well insured not to skimp on their estate planning.

If you do not have a testamentary trust, ask your estate planning lawyer why it's not right for you. Spoiler alert: it's appropriate far more often than you would think. Your beneficiaries can choose not to go ahead with the trust, but they cannot wind back the clock and get one if you didn't ask the right question.

Kirsten Lynn is an ex-lawyer and now financial adviser at Stanford Brown. She specialises in working with families, particularly blended families, on planning to protect and pass on their wealth. This article is general information and does not consider the circumstances of any individual. The article is taken from a two-part series, 'How To Leave Wealth To Your Kids Without Ruining Them' and 'How To Leave Wealth To Your Blended Family Without Ruining Them'.

Japan diary: Getting up to speed on infrastructure

Trent Koch

Japanese passenger rail volumes remain solid with the Rugby World Cup and Tokyo Olympics providing continued support. Japan's proposed 500km/h Maglev train between Tokyo and Osaka represents another example of the country's world leading infrastructure. Gas utilities in Japan face growing competition but we believe market concerns are overdone and value is there for patient investors. We invest in Japan today for its quality infrastructure assets, attractive valuations, under geared balance sheets and increasing focus on shareholder returns.

Japan never ceases to impress

I recently returned from a trip to Japan where I met with more than 20 infrastructure companies including passenger rails, airports, gas and electric utilities and renewable energy companies. I also spent time with government officials, customers and suppliers to gain additional perspectives on these companies' businesses.

I have been travelling to Japan for many years now. The country never ceases to impress. The food, the people, the language, the cleanliness, the bright lights and shops, the enduring traditions and unique culture.

Japan enjoys some of the most advanced and well-maintained infrastructure on the planet (ranking 5th out of 140 countries in the 2018 World Economic Forum Global Competitiveness Report). The country is famous for its high-speed bullet trains ('shinkansen'), which have been serving the country for more than 50 years and are renowned for their blistering speed and 'to the second' punctual service.

The country's aging and declining population represents a structural headwind that puts pressure on corporate earnings. Many Japanese companies have been forced to look overseas for growth, and the country is enthusiastically embracing tourism.

This trip reinforced my view that Japan is now increasingly opening itself up to the world. Where once it was rare to hear any language other than Japanese spoken on the street, now it happens constantly.

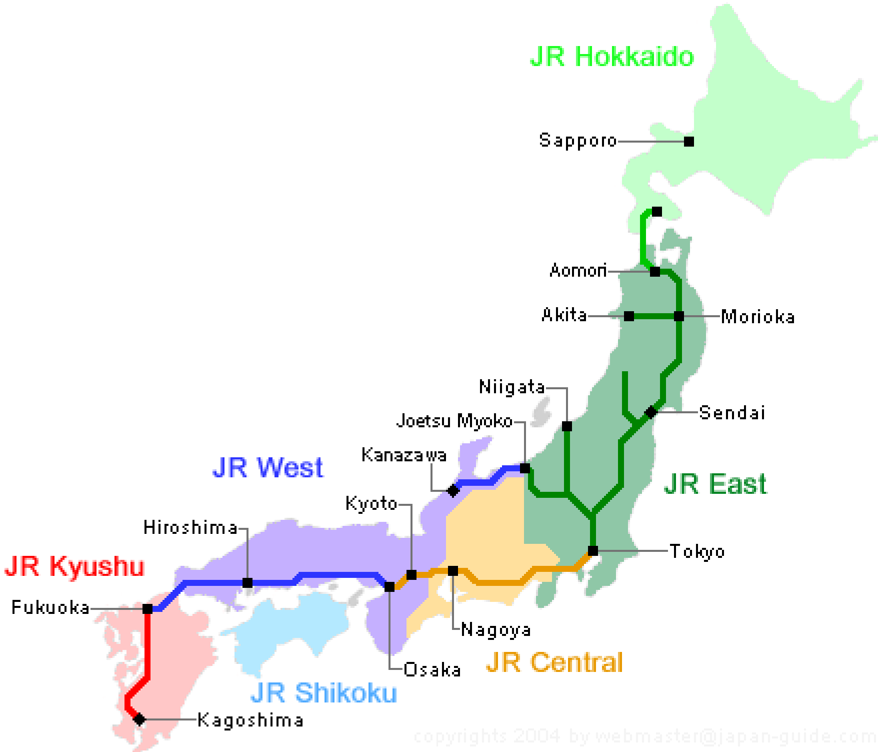
Japanese Rail: nobody does it better

Japan's passenger rail network is the busiest in the world, carrying almost 30% of global rail passengers, more than all of Europe combined.

Map of Japan's Passenger Rail Network

Japan's rail network was privatised in 1987 when six passenger rail companies were created with JR East, JR Central and JR West being the three largest. We like Japanese passenger rail companies for their high barriers to entry, strong free cash flow and predictable earnings.

JR Central is the owner and operator of the world's busiest high-speed railway line today. Every year, JR Central transports more than 150 million people along the 515km route between Tokyo and Osaka. This train line is a cash cow for the company producing over Y1 trillion yen ($US900 million) in revenue per year.



Source: Japan Rail Guide

In 2014, JR Central started construction on a Y9 trillion (US$84 billion) Maglev project. At over 500km/h, it will be the fastest bullet train in the world with a speed almost twice that of the current shinkansen.

The first part of the project will connect Shinagawa Station in Tokyo to Nagoya in 2027 and will cover the distance of 286km in 40 minutes (instead of 86 minutes today). Over 85% of the line will be underground passing under urban cities and mountainous terrain. The line will then be extended by 153km to Osaka with plans for this to be open by 2037. Once complete, commuters will be able to travel from Tokyo to Osaka in just 67 minutes, rather than the 142 minutes it takes today.

Some days you really love your job

Whilst in Japan, I attended the JR Central Investor day. The highlight of the day (in fact the year …) was an opportunity to take a test ride on the 42km track which has been constructed to test their new driverless Maglev trains.

Japanese companies have been slow to adopt corporate governance best practice but they are moving in the right direction. This investor day was another example of the improvements being made.

Excitement had been building all week at the prospect of travelling on what will be the fastest train in the world (by some margin) when it opens in 2027. I had assured my wife that it was safe and my kids that I would take plenty of photos and videos. It did not disappoint.

The train quickly accelerates with superconducting magnets and propulsion coils pushing the train forward. At around 150km/h, the train suddenly levitates 10cm off the ground and the ride becomes smooth. As the speed increases, the stability increases. Managements view is there is no risk of derailment, an important consideration in such an earthquake prone country.

Within a minute, we were travelling over 400km/h. It was at this stage that the noise started to increase. I would compare it to the noise you might hear when flying at altitude on an aeroplane. The company is aware of this issue and is confident they can reduce this noise ahead of the opening in 2027.

We eventually reached a speed of 500km/h, faster than any train on the planet (the fastest train in the world today is in China at around 420km/h). We stayed at this speed for over 2 minutes, an experience I will never forget.

JR Central's share price has materially underperformed the index and its peers over the last six months on concerns the Maglev project may come in late and over budget. Spending the day with management gave me confidence that these investor concerns look overdone and that at below 10x PE these risks are reflected in the company's current valuation multiples.

Growth optionality in property for JR East

JR East, the largest of the JR companies, carries more than 6.5 billion (yes billion) passengers per year on its 12,300 trains. For context, Amtrak, the largest passenger rail network in the US, carries just 31 million passengers per year. JR East services the Greater Tokyo region and its population of over 35 million people. Tokyo remains the one area in Japan where the population continues to grow each year.

Whilst in Tokyo, I was given a 1-on-1 tour of JR East's Y500 billion (US$4.6 billion) Shinagawa redevelopment project. Shinagawa is the last major land parcel to be developed in Greater Tokyo. The redevelopment site covers almost 14 hectares and will include seven new buildings (scheduled to open between 2024 and 2027) plus a new railway station (Takanawa Gateway Station) that will open in time for the Tokyo Olympics.

Digital image of the new Takanawa Gateway Station and three of the seven new Shinagawa buildings

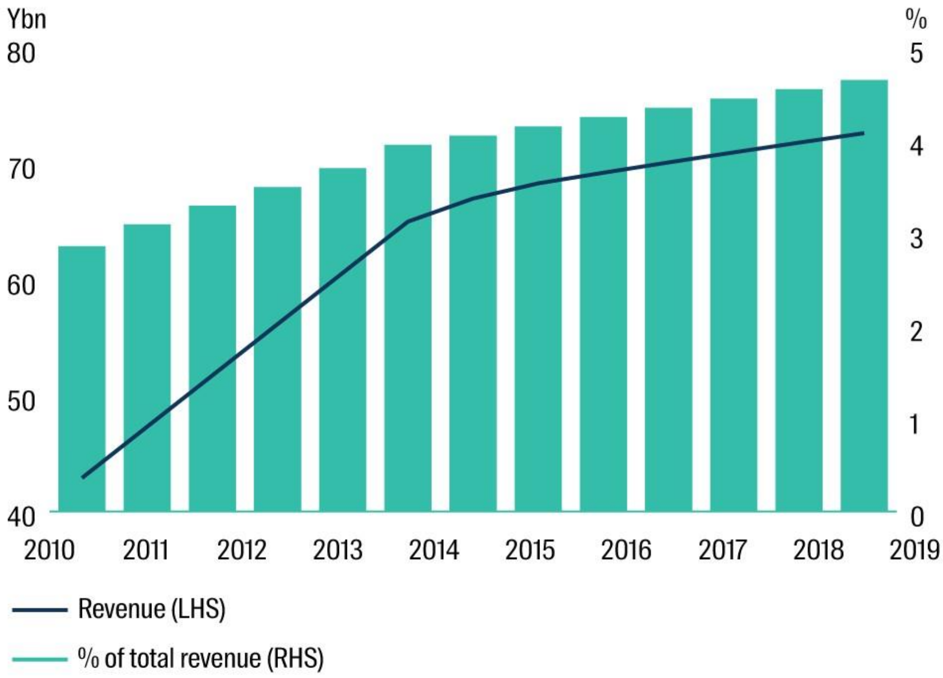
Source: JR East

Shinagawa is located just 12 minutes from Haneda International Airport and will be the location of JR Central's Maglev Shinagawa station, which is due to open in 2027. At 8x EV/EBITDA and 1.2x Price/Book, I believe the market is underestimating the value of JR East's property assets and that the stock will re-rate in the coming years as investors realise the growth optionality offered by this and other redevelopment projects.

Inbound tourism playing out for JR West

We started investing in JR West mid-2018 following a period of material stock price underperformance. The market was concerned about structural headwinds for their commuter train network and volumes had been weak on their shinkansen network. But on the ground due diligence and a close monitoring of inbound tourism numbers confirmed that a strong tourism story was playing out in Japan, in particular in the Kansai region. JR West owns much of the passenger rail network in this region and is well positioned to benefit from an increase in tourist numbers.

JR West – Inbound tourist revenue (as % total revenue)



Source: First Sentier Investments, Company reports.

We invested in JR West for its attractive valuation, underleveraged balance sheet, increased focus on shareholder returns and inbound tourism story. The stock has rebounded considerably in the last 12 months causing us to trim our position in recent months.

In-bound tourism story to continue

Whilst in Osaka, I was also given a tour of Yumeshima Island precinct. Yumeshima is an artificial island, which once complete will cover an area of 390 hectares. It will be the venue for the Osaka 2025 World Expo and is the proposed venue for Osaka's Integrated Resorts bid later this year. Japan is looking to follow the example of Singapore and Macau in opening its first Integrated Resort – large-scale entertainment complexes that combine casinos with hotels, restaurants, conference centres and retail spaces. Three venues are likely to be chosen, with Osaka and Yokohama (near Tokyo) the two favoured cities.

Spending time with Osaka government officials and seeing the development taking place (over 90% of the island has already been reclaimed) confirmed the strong inbound tourism story that is likely to continue in Japan for many years to come.

Japan's energy reliance

A country with limited natural resources, Japan imports over 90% of its energy needs. As it recovered from World War II and its economy rapidly expanded, it became hugely dependent on fossil fuel imports, notably oil from the Middle East. The oil crisis of 1973 brought this commodity reliance into focus and the country shifted its energy policy rapidly towards nuclear. By 2010, nuclear made up 30% of the energy mix with forecasts for it to reach 50% by 2030.

In March 2011, an earthquake and tsunami caused widespread devastation on Japan's east coast, including a meltdown at the Fukushima Daiichi Nuclear Power Plant. This event changed Japan's energy future forever. Japan had 54 nuclear reactors operating at the time but within a year, this had been reduced to zero. Today, more than eight years later, just nine nuclear reactors have reopened. Nuclear power remains a deeply contentious issue within Japan with many people opposed to their reopening.

Nuclear can play an important role in producing low carbon emitting electricity. We just think it is too risky when positioned on perhaps the most earthquake prone country on the planet. We screen out the Japanese electric utilities from our 'core infrastructure' universe owing to their highly volatile earnings and reliance on nuclear energy to generate power.

Liberalisation of gas and electricity markets

Japan's gas retail market was liberalised in April 2017, allowing new entrants to enter a market previously dominated by the big three city gas suppliers - Tokyo Gas, Osaka Gas and Toho Gas. It followed the liberalisation of Japan's electricity market a year prior. Gas companies are now free to enter the electricity market, and vice versa.

Tokyo Gas confirmed that competition remains keen in the Tokyo region with electricity provider **Tokyo Electric Power (TEPCO)** winning 80% of the 1.1 million gas customers lost to date. However, Tokyo Gas has been able to offset lost gas customers with a larger increase in new electricity customers. Tokyo Gas is targeting 2.4 million electricity customers this year, which they look likely to achieve. We believe the market has over reacted to competition concerns and that Tokyo Gas are well positioned to increase its net customer numbers over coming years. The company has a strong balance sheet, and has been increasing its dividend and buying back stock in recent years.

Competition has been even fiercer in the Kansai region in which **Osaka Gas** operates. Electricity provider **Kansai Electric Power (KEPCO)** have led a very aggressive marketing and pricing campaign to win new customers. Whilst this strategy has won them new customers, they continue to lose money in their gas business. I met with KEPCO at their Osaka head office where management confirmed a recent change of strategy, with a focus on profits not volumes going forward. This change should benefit competitor Osaka Gas in the near term.

Similar to Tokyo Gas, we think the market has overreacted to competition concerns and that Osaka Gas remains well placed to grow earnings from current levels, particularly with overseas projects such as Freeport LNG in the US coming online this year.

Osaka Gas: safety first

Whilst in Osaka, I did a tour of Osaka Gas's largest Liquefied Natural Gas (LNG) Terminal. The Senboku LNG Terminals are located 40 minutes south of Osaka City. They account for 70% of Osaka Gas's overall gas supply and 7% of Japan's total gas supply. Whilst the terminals are clearly aging (Terminal 1 was built in 1971 and Terminal 2 in 1977), what stood out was the huge emphasis placed on safety.

It was interesting to see the additional safety measures that were put in place post the Fukushima disaster in 2011. Whilst that earthquake did not hit this region, tsunami barrier walls have been built around key units, and all vehicles are now kept in secured areas that are fenced off from key facilities and equipment (to avoid them crashing into units in the event of a tsunami).

Conclusion

Japan is easy to travel around – online ticket bookings, signs in English, fast and efficient infrastructure - and the country is opening itself up to the world like never before.

Investors have historically been frustrated by Japan's poor corporate governance and structurally challenged demographics. However, for long-term investors, Japan provides a way of gaining exposure to high quality infrastructure assets trading at attractive multiples.

We invest in Japan today for its quality infrastructure assets, attractive valuations, under geared balance sheets and increased focus on shareholder returns. Our strategy is overweight Japan via holdings in key assets such as **JR East, JR Central, Tokyo Gas & Osaka Gas**.

Trent Koch is a Portfolio Manager at First Sentier Investors (Australia) Ltd, a sponsor of Firstlinks. This material contains general information only. It is not intended to provide you with financial product advice and does not take into account your objectives, financial situation or needs.

Designing a world-class post-retirement system

Deborah Ralston

In September 2019, Treasurer Josh Frydenberg announced the Retirement Income Review, with a public consultation paper to be released in November 2019 and a final report to the Government by June 2020. One of the three panel members is Dr Deborah Ralston, who in her previous roles, has written several articles for Firstlinks.

As a general guide to what Dr Ralston may be thinking, we republish an article from 2013. At the time, she was Executive Director of the Australian Centre for Financial Studies (ACFS), which published the Pension Index in conjunction with Mercer. We have often republished past articles by leading authors such as Paul Keating and Chris Cuffe, accepting that their thoughts may have developed further, but to share their insights again.

ACFS is now the Monash Centre for Financial Studies, which is part of Monash Business School. Coincidentally, the 2019 Melbourne Mercer Global Pension Index has just been released, linked here, ranking Australia third in the world, behind only The Netherlands and Denmark as we were six years ago.

Here is Dr Ralston's article from 2013.

The release of the latest Melbourne Mercer Global Pension Index earlier this month once again confirmed Australia as having a world class retirement system, coming in third out of 20 countries behind Denmark and The Netherlands.

But read past the rankings in this comprehensive 74-page report and there is a strong warning about the risks facing Australian retirees in the post-retirement or decumulation phase. This is an area that was largely overlooked as our system evolved from employer-sponsored, defined benefit schemes to defined contribution arrangements. To date, most of the focus has been on the accumulation phase of superannuation, but that's changing as more baby boomers enter retirement.

Onus has shifted to the individual

In the past, employees lucky enough to be in a defined benefit scheme (and the majority weren't) were guaranteed a retirement pension traditionally linked to their years of service and salary. But with the advent of compulsory superannuation in 1992 and defined contribution schemes, the onus shifted to the individual to be responsible for their retirement income.

What do these retirees seek? The report identifies the ongoing financial needs of retirees as a 'trilemma' which includes:

- good investment returns and investment choice
- protection from myriad risks – including investment, sequencing (poor returns immediately before or after retirement), longevity, inflation, expenditure and time (or interest rate), counterparty and liquidity (remember, behavioural finance risk shows individuals are far more sensitive to losses than gains, a characteristic particularly pertinent to retirees)
- access to some capital during retirement to cover unexpected expenditures, such as medical.

Quite obviously, this combination of different needs facing individuals over the course of their retirement means there is no ideal solution. Even an indexed annuity will not meet every individual's varying financial needs during their different stages of retirement.

This is indeed a complex problem and the best solution for any individual will depend on a range of factors including their total wealth, health and likely longevity, required standard of living, access to the age pension, etc. At the same time, the needs of individuals must be balanced with the public interest so that clear incentives are in place to encourage personal responsibility and avoid over-reliance on the public purse.

Features of a world-class portfolio for retirees

For the industry, legislators and administrators, how to solve the trilemma will be *the* issue in the coming years. So what's required? The industry needs to provide the right products for an income stream – a portfolio of products that meet individual needs. This portfolio should include features such as:

- limited access to the lump sum on retirement
- some access to capital to allow to meet unexpected expenses
- in the early stages of retirement, an income product to provide adequacy and security
- a pooled insurance-type product to provide longevity protection for later years
- a structure that allows for phased retirement as people continue to work part time.

People need to be educated about retirement, in particular the need to focus on consumption and not investment; it is a quite different phase to the accumulation stage. Research shows that people are typically happier in retirement, but in the immediate years preceding it worry about what will happen and, significantly, often fail to plan for it. The onus has to be on superannuation funds to invest more resources in educating their members about retirement – to literally change their mindsets.

For this to happen the government of the day has to articulate the main objectives of the retirement income system (including the role of the pension). It's an issue that will encompass social, economic and tax policies and will require strong leadership, coupled with an energetic public debate, to ensure we get the policy architecture right.

Ideally, while the issue can't be ignored, any policy changes regarding post-retirement income for DC funds will involve an inclusive public debate and a gradual introduction to allow those affected to adjust their expectations and make long-term plans.

Australia has an enormous opportunity to build a world-class decumulation system that gives individuals security and flexibility in retirement. But it will not be easy. The media furore and public angst that preceded the Labor Government's April 5 statement this year when changes to the tax laws governing superannuation were being mooted highlights the political difficulties. But the longer we delay this debate, the harder it will get – politically, socially and economically.

At the time of writing this article in 2013, Professor Deborah Ralston was Executive Director of the Australian Centre for Financial Studies (now Monash Centre for Financial Studies, which is part of Monash Business School). It publishes the Global Pension Index in conjunction with Mercer. Prior to her appointment on the panel for the Retirement Income Review, Dr Ralston was Chair of the SMSF Association.