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Third Link News

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Death and taxes

Benjamin Franklin, one of America's most influential Founding Fathers once said, 'In this world nothing can be said to be certain, except death and taxes.' However, watching the share market over the last six months has shown me, yet again, that the cycle of markets is as sure as night and day.

The Celebrated Jumping Frog of Calaveras County is an 1865 short story by Mark Twain in which the narrator retells a story he heard from a bartender about a gambler betting on a jumping frog. It was Twain's first great success as a writer, bringing him to national attention. The story includes an immortal line for stockmarket scholars about Twain's favourite theory: 'that no occurrence is sole and solitary, but is merely a repetition of a thing which has happened before, and perhaps often...'

While people often say 'history repeats itself' in cycles, this is never exactly true. Fund manager and Third Link adviser, Kieran Kelly, recently pointed out in a letter to clients, that this was also appreciated by Twain when he wrote, 'History does not repeat itself, but it does rhyme'. Recurrences are due to sometimes subtle and not readily identifiable circumstances. Some of these factors may not be understood while the event is occurring and may only become apparent years later. The reason for the recurrence will often be hotly debated. Nowhere is this better evidenced than in the stockmarket.

Since 1875 there has been some 14 stock market cycles in Australia, where a cycle is defined as a fall in the nominal price index for the broad market of at least 20% from the previous top. The longest of these was from November 1888 to June 1914 (a period of 26 years!) while the shortest of these was from July 1960 to February 1964 (4 years). The current cycle, commencing from the high point of November 2007 to the low point of March 2009 and now rising up again, was the second quickest and steepest fall of all (the worst being 1987) and the recovery in the first 12 months after the bottom was the fastest on record. Four years after it began in March 2009, this recovery is in the middle of the pack compared to past cycles.

Why are stock market cycles, with their 'exaggerated' highs and lows, so predictable? In Kieran Kelly's words (which I fully agree with), the answer is simple. The stock market is a barometer of human emotion and particularly human frailty. It registers them all – fear, greed, lust, paranoia, confusion, panic, herd-mentality, envy and disappointment. It's a big human stew, but the ingredients never change. It comes to the boil at different times but the taste is always the same because people never change. Not really, not even over long periods of time.

The herd always charges off in one direction. Then, just wait, what's that sound you hear? It's the herd charging back again in the opposite direction. When they head off over the hill, what is the only thing you know for sure? That given time you will see them all come thundering back, over that same hill in the direction they first came from. Humans, like jumping frogs and migrating wildebeest, never change.

Below is a must read article, *Demographic insights – living longer with low growth* by Bruce Gregor, an accomplished actuary and demographer. It provides very useful insights into Australia's future in terms of growth prospects, superannuation capital management and the management of retirement incomes.

Thank you for your continuing investment in Third Link Growth Fund. As the Fund now approaches its fifth anniversary, it is heartening to see the fees you pay to us for having your money professionally managed continue to make a difference to others. Since the Fund began in mid 2008, around $1,800,000 has been donated to the charitable sector, with the donations now running at approximately $60,000 per month. If you have not done so already, have a look at the 'Our Charitable Partners' section of the website (www.thirdlink.com.au) to find out more about the charities we support.

Regards

Chris Cuffe,
Founding Director & Portfolio Manager
Third Link Investment Managers Pty Limited

Demographic insights – living longer with low growth

by Bruce Gregor

Australia is at a critical point on three fronts – economic growth prospects, superannuation capital allocation and the management of retirement income. To see how this position has developed we need to look beyond the 2008 GFC and commodities booms and examine longer term demographic changes and their effect on markets. I will examine each aspect in turn and make some comments on what actions could be taken to moderate potential problems.

Economic growth prospects

For too long public policy in Australia has focused on headline (real) GDP growth (rather than GDP per capita). This disregards important changes in demographic composition. For example, over the past 10 years, headline GDP growth was 3%pa while GDP growth per capita was only 1.4%pa (from RBA data to September 2012). This difference is due to the population growing faster than total GDP is growing. As a percent of population, Australia has one of the highest net migration rates of the developed economies. Our population has also maintained a higher headcount than some others because of age longevity.

If we look at a country like Japan that has negligible migration but now has the most aged population in the developed world, its latest 10 year GDP growth rate and per capita GPD growth rate are equal at about 0.7%pa (OECD 2011). Due to low fertility and an extreme age structure, Japan is now producing negative annual population change.

At the present time Australia's ageing structure is at an amber light stage with 14% of total population aged 65 and over. Japan reached this level in 1995 and is now at 24%. My population projections using ABS mid-range assumptions show that Australians aged 65 plus will be 24% of the population in 2055. If Australian migration is reduced to zero, the 24% figure will be reached 20 years earlier in 2035.

The most significant economic effect of ageing at these levels is reduced domestic demand from household spending. Ignoring the short term surface ripples of mining cycles and financial volatility, my view is that demographically-driven domestic demand in Australia over the next 10 years will generate significantly lower growth in GDP per capita. This has little to do with supply side issues like labour productivity – it is pure demand-driven demographics.

I then looked at external factors and the long-term global investment markets outlook. The best recent examination of this, by Elroy Dimson and his team at London Business School, has just been published in the 2013 Credit Suisse Investment Returns Year Book. Their conclusion for future average returns in major investment markets over the next 20 to 30 years is for 3 to 3.5% pa real equity market returns and for about 0.5% pa real return from bonds. This compares to the period since 1980 to date which averaged just over 6%pa real return in both equities and bonds.

In summary, economic text books and investment models based on the last 30 years are likely to be of little worth in charting Australia's course over the next 30 years.

Superannuation capital allocation

Superannuation assets were valued at $1,500 billion as at September 2012 – almost identical to both annual GDP and the value of the ASX-listed shares. The majority of superannuation assets (excluding a shrinking defined benefit component) can be allocated (and after age 60, spent) at the whim of households. These assets were compulsorily acquired by superannuation guarantee contributions or involuntarily accumulated in conjunction with salaried employment.

I believe that, to date, the job of administering and investing these assets with current major funds has been superior to putting them into federal government consolidated revenue. However, it seems to me we have reached a stage where some mandated investment allocation of part of these funds (say 30%) should be directed to balancing out adverse economic effects of ageing demographics.

How this directed investment is done needs more debate. It should not be too difficult to devise a scheme of targeted infrastructure development bonds and longevity reinsurance bonds backed by government guarantees (like we now have for bank deposits and flood and terrorist reinsurance). Left as they are, super assets will force up prices for domestic listed investments which will then offer lower long term returns than are currently priced in.

Management of retirement income

Most people arrive at the end of full-time work having had someone else worry about how their pay reaches their bank account. Few are well prepared to manage this task when retirement arrives.

Whilst the $1,500 billion in superannuation assets is a big item, it is very unevenly distributed. About 60% of this 'belongs' to a well-endowed 20% of the population (SMSFs, public servants and military super). The majority of people retiring over the next 20 years will have modest balances. When we overlay this with the future low growth world and the variability of prospective life expectancy, retirement income planning is really an impossible mission, despite the best efforts of financial planners.

One way to make this money go further is to 'recycle' part of what is left when retirees die, for the benefit of the surviving retired population. There are two established ways of doing this. The best way is by compulsory lifetime annuitisation of part of superannuation at retirement. A less popular way of recycling is by applying a rate of death duties on super. ■

> *'Left as they are, super assets will force up prices for domestic listed investments…'*

Bruce Gregor is one of Australia's leading authorities on financial demographics. For further writings by Bruce on similar topics, see his website www.findem.com.au

Portfolio Update

The objective of the Third Link Growth Fund is to provide an investment in Australian listed shares. To achieve this, the Fund extensively invests in other managed investment funds run by professional third party investment managers.

As at the end of March 2012 the portfolio was invested as shown in the table.

AUSTRALIAN EQUITIES			
General:			
JBWere Individually Managed Account	21.2%		
Bennelong Ex-20 Australian Equities Fund	9.8%		
Cooper Investors Australian Equities Fund	11.1%		
Goldman Sachs Premier Australian Equities Fund	5.6%		
Montgomery [Private] Fund	9.5%		
Paradice Mid Cap Fund	11.3%	68.5%	
Small Caps:			
Aberdeen Australian Small Companies Fund	6.3%		
Eley Griffiths Group Small Companies Fund	2.3%		
Pengana Emerging Companies Fund	12.8%	21.4%	
Other:			
Tasman Market Neutral Fund (managed by Regal Funds Management)	8.0%	8.0%	
			97.9%
CASH & CASH EQUIVALENTS			
Colonial First State Wholesale Premium Cash Enhanced Fund		1.4%	
Custody Account & Other		0.7%	
			2.1%
TOTAL			100.0%

The figures shown against each Australian equities fund listed above do not 'look through' each fund and strip out any cash component.

Over the last six months the changes to the portfolio have been as follows:

- we redeemed our holding in the Solaris High Alpha Fund, in which we had been invested for around 4.5 years;
- we invested for the first time in the Goldman Sachs Premier Australian Equities Fund;
- we added to our investments in the JBWere Individually Managed Account and the Aberdeen Classic Series Australian Small Companies Fund; and
- the Fund paid a distribution of income to investors in early January 2013 in respect of the six months ended 31 December 2012.

As at the end of March 2013 the Third Link Growth Fund stood at $53.5m in size. During the last six months we received $2.5m in new applications and processed redemptions totalling $1.4m.

A description of each of the fund managers we invest with, including their funds listed in the table adjacent, can be found on our website at www.thirdlink.com.au(see the section "Fund Managers We Invest With"). Each of these managers rebate their management fees and performance fees which apply to the investment of Third Link Growth Fund in their respective fund. This effectively means they are managing the assets of Third Link Growth Fund for free. It is through this extraordinary generosity, together with that of other service providers (all listed on the Fund website), that Third Link is able to make sizeable donations to the charitable sector without diluting the returns to investors from the Fund. ■

Fund Performance

The objective of the Third Link Growth Fund is to provide an investment in Australian listed shares, with the aim of outperforming the S&P/ASX 300 Accumulation Index[1] after fees over rolling five year periods.

	three months	six months	one year	two years	three years	Since inception (June 2008)[4]
Third Link Growth Fund	+9.2%	+16.1%	+19.6%	+9.1% pa	+8.7% pa	+7.5% pa
Fund performance relative to its benchmark[3]	+1.2%	+0.7%	+0.4%	-0.6% pa	+0.9% pa	+3.8% pa
S&P/ASX 300 Accumulation Index[1]	+8.0%	+15.4%	+19.2%	+5.7% pa	+5.0% pa	1.7% pa

Returns are calculated after fees have been deducted and assuming reinvestment of distributions. No allowance is made for tax.

The benefits of franking credits from dividends received have been ignored.

Before February 2012 the objective of the Fund was to provide a diversified growth-oriented investment with a bias at most times to Australian listed shares, with the aim of outperforming the returns of the Morningstar Multi-Sector Growth Market Index[2] after fees over rolling five year periods. As such, the performance of the S&P/ASX 300 Accumulation Index in the table above for two years and longer has been shown for illustrative purposes only.

The Fund has produced a very satisfactory performance over the last six months, with a return of +16.1% after fees. All months except March 2013 showed positive results, making the period one of the best for many years. In particular, excellent returns were achieved by the Fund's holdings in the Pengana Emerging Companies Fund, Montgomery [Private] Fund, Bennelong ex-20 Australian Equities Fund, and the JBWere portfolio managed by Frank Macindoe, which all achieved returns well in excess of the S&P/ASX 300 Accumulation Index during the six month period.

Even more pleasing is the one year performance of +19.6% after fees, particularly in the context of cash on deposit over the same period yielding just +3.6%.

As we observed in the last couple of our six monthly newsletters, the Australian share market still appears to have favourable winds that are likely to provide attractive returns over the near term for the following reasons:

- Australian interest rates still appear to be on a downward trend, though the Reserve Bank seems to have hit the pause button for the time being while it assesses the impact of past interest rate falls that are still working their way through the system;
- The stubbornly high Australian dollar is forcing many companies to become more efficient (which will provide a double benefit if the Australian dollar falls);
- Corporates continue to have strong balance sheets and the recent reporting season was the first time in approximately 3 years that the results were slightly ahead of expectations;
- Stock market valuations are not stretched (and still below their long term trend);
- Dividends are still attractive (particularly compared to bond yields); and
- Australia's sovereign debt levels are not excessive.

The key wildcard though continues to be the possibility of a further softening in China's growth (on which we are so reliant now for our own flow-on prosperity) and further financial system shocks coming out of some of the highly indebted European countries.

1 The S&P/ASX 300 Accumulation Index covers the largest 300 shares listed on the Australian market. Being an accumulation index, it measures changes in both the value and income of the shares.

2 The Morningstar Multi-Sector Growth Market Index is compiled by Morningstar Australasia Pty Ltd (Morningstar), a unit of Morningstar, Inc. Morningstar construct this index by reviewing the asset allocation of Australian fund managers who operate multi-sector funds and have between 61 per cent and 80 per cent of their assets in growth sectors (typically defined as equity and property asset classes) with the balance in cash and fixed income securities.

3 As mentioned above, the benchmark up until the end of January 2012 was the Morningstar Multi-Sector Growth Market Index and from February 2012 onwards the benchmark was the S&P/ASX 300 Accumulation Index.

4 The Third Link Growth Fund was established on 12 March 2008 (though it was not open for investment until 10 April 2008, being the date of the first PDS). Up until the end of May 2008 it was a requirement that application monies received into the Fund were kept on deposit as the unit price was held at $1.00. This restriction was removed from the beginning of June 2008, at which time the Fund was free to invest in accordance with its objective. The performance figures shown in this column are expressed as annual compound returns.

Motivating young Australian students

Beacon Foundation

Beacon Foundation is one of our partner charities. Their mission is to influence the attitudes and culture of Australians so that each young person develops an independent will to achieve personal success through gainful activities for themselves and their community.

At a time in Australia's development when skills shortages rank highly on the national agenda, youth disengagement and unemployment remain at unacceptably high levels. At the end of August 2012, teenage unemployment in Australia was 15.5%. That means over 120,000 15-19 year olds were looking for work.

87,000 students helped since 2001

Beacon's purpose is to prevent young Australians leaving secondary school from moving into unproductive or insecure pathways, becoming marginalised or dropping out. Founded in 1988 in Tasmania, today it's an independent, national not-for-profit organisation. Since 2001 around 87,000 students have completed their program. Beacon currently operates in 127 schools with 13,000 disadvantaged students currently completing their program. Beacon typically works with 15-16 year olds, in communities where intergenerational welfare dependence is prevalent, education has little perceived value or there are low expectations for the future.

Impressive results

Over the years, Beacon has achieved some impressive results that help young people to thrive, not just survive.

- After completing the Beacon program, young people have above average levels of retention, employment and engagement.
- The percentage of young people likely to go onto insecure or unclear pathways was halved from 30% to less than 13%.
- Beacon students are over five times less likely to be disengaged from full time education, training or employment after Year 10 than the national average for 16 year olds.
- The unemployment rate for Beacon students post Year 10 is five times lower than the national unemployment rate for 16 year olds.

The charity delivers an impressive social return on investment of 11:1 – for every $1 invested, around $11 of social value is created.

A 'whole of community' approach

Beacon uses a 'whole of community' approach to build capacity and harness existing assets to give young people a better understanding of the world of work. It establishes direct relationships with schools and has a strong track record of connecting schools and business. While students are part of the education system, they can create for themselves a clear post-school pathway to employment, further education or training. Beacon has also forged strong links among parents, schools, industry and the community to provide students with mentor role models, work experience and opportunities for employment. This 'whole of community' effort provides a meaningful response to the issue of youth unemployment or under-employment. Participating students also sign a charter, publicly pledging their commitment to further education, employment or training.

Scott Harris, CEO of Beacon, says: 'At the centre of its work, and the heart of Beacon, is the power of relationships; through these relationships with Australians who have the capacity, skills and resources to help, young people are connected with and supported by the whole community, and inspired and motivated to aim higher and strive to reach their personal potential.' ■