INVESTMENT (LISTED ON AUSTRALIAN STOCK EXCHANGE – ASX)

Direct Equities

Australia has one of the highest levels of equities ownership in the world with 38% of Australian adults owning equities (shares), either directly or through managed funds. Equities are classed as a growth asset as they are essentially linked to the revenues of the company’s business. They appeal to a range of investors because they offer attractive income opportunities and exposure to a broad range of industries and sectors that provide growth and diversity within an investment portfolio.

Research by the Australian Securities Exchange shows that share ownership is increasing across the board among all age groups, incomes and education levels. Below we look at the key reasons equities form the basis for so many portfolios.

Capital gains over the long-term

Historically, equities have provided some of the strongest after-tax investment returns over the long-term. By owning equity in companies with growth potential, investors have the opportunity to benefit from capital gains as the asset grows in value over time. Of course, investors cannot expect the company to pay out all its profits in a form of a dividend as this may come at the risk of future profitability and a lower share price.

A good source of income

The dividend yield on equities is another important source of return. Unlike term deposits, dividends from equities can have inflation built into earnings where companies are able to pass cost increases onto customers.

Highly liquid

Equities are traded on major stock markets around the world. They are highly liquid which means that they can be converted into cash quickly and with minimal impact to the price received. Unlike direct investments, there is relative ease in the transfer of ownership and the movement of equities.

Tax advantages

The after-tax performance of equities is lifted by dividend imputation, a tax benefit not shared by other asset classes. The dividend imputation system allows investors

who have been paid a dividend to take a personal tax credit (franking credit) since the company has already paid tax on the dividend.

Corporate control

Equities come with certain rights including the voting rights to which the investors are entitled. The level of corporate control depends on whether the equity is classed as ‘ordinary’ or ‘preferred’ and on the size of your shareholding.

Ordinary shares represent the majority of shares held by investors. When you own an ordinary share of a company, you usually have one vote per share that entitles you to participate in the election of the board of directors.

Preference shares have fewer rights than ordinary shares, except in one important area – dividends. Companies that issue preference shares usually aim to pay consistent dividends and preference shareholders have first call on dividends. In the event that a company is liquidated, preference shareholders have prior claim to assets over ordinary shareholders. This feature allows the company to raise capital from venture capitalists before it goes public because most venture capital deals are structured as preference shares.

Limited liability

A unique features of owning equities is the notion of limited liability ie when you own equity in a company and in the event that company loses a lawsuit and must pay a large settlement, creditors can’t come after your personal assets. Your liability is limited to the amount invested in the company.

Exchange Traded Funds (ETF's)

What is an ETF?

An exchange-traded fund (ETF) is a listed investment strategy that invests in a basket of securities or other assets. ETFs share many similar characteristics to both stocks and managed investments. They trade close to their net asset value and can be bought and sold on the stock exchange. They tend to trade very close to their net asset value because ETFs are generally structured to allow arbitrage to occur easily if the traded price deviates significantly from underlying value, and issuers use the services of "market makers" to keep this gap as tight as possible.

About ETFs

Key things you should be aware of:

- ETF investing may be suitable to investors that seek low cost exposure to a specific market, sector or strategy
- This strategy may appeal to investors that seek the flexibility of investing in ASX tradeable securities but with broad market diversification
- An appropriate level of diversification may be achieved despite small investible balances
- Relative to passive investing via managed funds, ETFs may enable investors to gain more specific market or sector exposure
- The strategy may appeal to investors that want to minimise the risk of underperformance. Investors have a level of certainty that performance will closely track the strategy or market being replicated
- ETF investing may be suitable to investors that seek greater liquidity than listed investment companies (LICs)
- Possible tax benefits. Passive strategies often have lower levels of turnover than active strategies
- May be suitable to highly efficient markets where alpha is more difficult to achieve or where a client wants to implement a tactical or medium term view.

Other things you should know

- Most ETFs employ a passive strategy – performance seeks to match (pre fees) but not outperform an underlying benchmark or index
- Passive investing employs a constant strategy, irrespective of market valuations. Passive strategies were buyers of the Japanese and the Tech bubbles

- The 'buy and hold' approach to investing must be balanced with the medium term outlook for the asset class
- Some ETFs gain market exposure via derivatives or swaps. In these instances, counterparty risk is introduced and this should be considered. Derivatives exposure may also see performance differ to the physical asset class being referenced
- ETF investing in international assets may be unhedged – performance will therefore be a function of market movements and currency
- May not be suitable for some investor types. ETF investing may be more costly than managed fund investments where a regular savings plan is required
- Some commodity linked ETFs may not offer the capital gains taxation (CGT) discount for assets held for more than 12 months
- It is still wise to always check Net Asset Value before transacting. If you are wanting to trade large volumes in any approved ETF, if the liquidity showing on the ASX bid and offer is not sufficient to execute without moving price away from NTA significantly, this can often be addressed by calling the ETF issuer. The ETF issuers can usually instruct the appointed market makers to tighten the bids on market so larger lines of securities can be traded closer to NTA. It is in the best interests of issuers to co-operate in this manner, as they generally wish to build up the volume traded in their products.

We split instruments into two classifications: Broad Asset Class (Core) ETFs and Sector Specific (Satellite) ETFs.

Our list of recommended ETFs is based on a qualitative assessment of the structural characteristics of instruments. This includes cost / fees, liquidity / quality of the underlying market maker and tracking error. This utilises the internal resources of the Twilight Investment Committee as well as insights provided by our preferred research providers.

Broad approval is only for those ETFs that invest in physical assets rather than swaps. The latter grouping introduces counterparty risk, which is often ignored or misunderstood.

Core ETFs

Core ETFs are suitable instruments to act as a primary allocation to a core asset class such as Australian or Global Equities.

These ETFs offer a sufficient level of diversification to achieve the primary investment objectives sought when allocating to a specific asset class. For example, an ETF that invests in the ASX200 is suitable as a primary allocation to Australian Equities as per the FPW Asset Allocation Methodology. On the other hand, an ETF that tracks a single sector such as energy or financials is unlikely to be suitable. These instruments would instead be classified as Satellite ETFs.

Core ETFs also typically provide the highest level of liquidity.

Satellite ETFs

Satellite ETFs provide exposure to a strategy that is less representative of a core asset class. These strategies can behave much differently in terms of performance to the broader underlying asset class invested in. For example, the performance of the iShares Japan ETF can vary substantially to the MSCI World Index or broader global equities asset class. In this instance, the ETF will generally be unsuitable as a core international equities allocation and should instead complement a diversified international equities strategy.

Exchange Traded Bonds (XTB's)

XTB's offer access to the performance and benefits of corporate bonds, which are normally not available directly for all investors. XTBs are securities traded on the ASX. They bring together the predictable income and capital stability of corporate bonds, with the transparency and liquidity of the ASX market.

Fixed income investments generally provide investors with more secure and stable investments than equity, property or other growth orientated and therefore more risky investments.

A very common form of fixed income investment is a bond. The Australian government, state governments and many of Australia's largest companies borrow money by issuing bonds.

If a company wants to borrow money for a number of years it can do so in one of two ways; it may borrow from a bank, or the company can issue corporate bonds.

Bonds are basically IOUs with the returns to investors determined by two factors:
The face value that is paid when the bond matures
and the steady stream of income paid over the life of the bond defined by the coupon

Key features

Corporate bonds are not all alike. Their key features which can differ from one bond to another include:

The Bond Issuer

Companies can vary in their financial strength, depending on the business they are in and how much money they have already borrowed.

The Face Value

This is the nominal value of the bond, which the company promises to pay when it matures.

The Coupon

This is the annual income that is paid to investors, expressed as a percentage of the Face Value. When bonds first existed in paper, investors would detach the coupon for that payment and take it to the company's bank to receive payment.

These income payments are usually paid semi-annually or quarterly and occur on set dates. This means bonds allow investors to accurately plan when and how much income they will receive from their investments.

Fixed or floating coupon bonds

The asset class that includes bonds is 'Fixed Income'.

It is true that many bonds have a coupon that is fixed. However, some have a 'floating' coupon pegged to an industry benchmark and offer investors a fixed margin above that benchmark.

For example a floating coupon bond may track the Bank Bill Swap Rate (BBSW) and offer investors 0.75% above this rate. In this case the coupon would be BBSW + 0.75%.

Note: In general, a riskier company will issue bonds that have a higher coupon than a less risky company.

Term to maturity (or tenor)

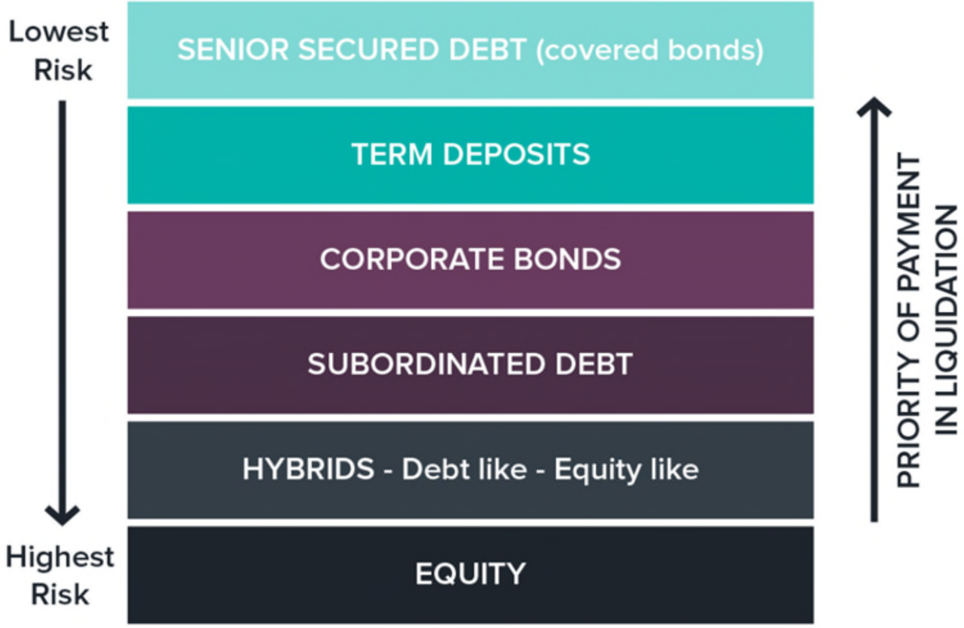
This is the length of time from the bond being issued until its maturity, when the face value and the final coupon are paid to investors.

Capital structure ranking

When you invest in a company, it is important to understand where you sit in the capital structure. In the event the company gets into financial trouble, some bonds will be paid out before others and before shareholders.

XTBs cover senior corporate bonds which sit above subordinated bonds, which are above hybrid securities then equities. The lower the ranking in the capital structure a security is, the higher the risk and potential reward associated with that security.

An important practical and day-to-day implication of where senior and subordinated bonds, hybrids and shares sit in the capital ranking of a company is the price stability or volatility of the security in the market. Senior bond prices/yields are generally far less volatile than securities below them in the structure such as shares and hybrids. This is important when it comes to the stability of a diversified portfolio.


CAPITAL STRUCTURE OF A BANK
Lowest Risk
Highest Risk
SENIOR SECURED DEBT (covered bonds)
TERM DEPOSITS
CORPORATE BONDS
SUBORDINATED DEBT
HYBRIDS - Debt like - Equity like
EQUITY
PRIORITY OF PAYMENT IN LIQUIDATION

Listed Investment Companies (LIC's)

What is a Listed Investment Company?

A listed investment company (LIC) is a close-end collective investment scheme similar to an investment trust. Instead of regularly issuing new shares or cancel shares as investors join and leave the fund, investors buy and sell to each other on ASX and as such are traded as other securities on the Australian stock exchange.

Advantages

- Listed Investment Companies are a closed end investment, meaning that management do not have to worry about people withdrawing funds. If people wish to exit the investment they can simply sell their shares, without affecting the amount of funds under management. This allows for management to take a more long term approach to investing if deemed favourable
- Traditional LICs employ a buy and hold strategy which can result in tax advantages (for example Australia's system of paying capital gains tax on only half of capital gains if an asset is held for 12 months). This strategy also amounts to lower costs for LICs and traditionally lower fees. However, contemporary LICs often take a more active approach to portfolio management
- LICs provide a lot of diversification for investors, while often targeting specific markets
- LICs must comply with transparency and governance regulation imposed by the Australian Stock Exchange.

Disadvantages

- Owners of shares in listed companies must ride out the volatility of the share price which can divert from net tangible assets per share as the market digests related news
- Dividends from LICs are paid out as management see fit (as opposed to mandatory distribution of all surplus funds as in unlisted managed funds.

We split these instruments into two classifications:

Core LICs: These instruments offer appropriate liquidity and diversification and are therefore suitable to act as a primary allocation to a core asset class such as Australian or Global Equities

Satellite LICs: These instruments offer lower levels of liquidity and / or employ a unique investment mandate and are therefore more suitable as a satellite strategy

Our research is based on a qualitative review of the structural characteristics of instruments, including the underlying investment mandate, quality of investment house, liquidity & FUM, cost and research ratings.

Core LICs

Core LICs are suitable instruments to act as a primary allocation to a core asset class such as Australian or Global Equities. These LICs offer a sufficient level of diversification to achieve the primary investment objectives sought when allocating to a specific asset class. For example, an LIC that invests primarily in the ASX50 is suitable as a primary allocation to Australian Equities as per our Methodology.

On the other hand, a LIC that tracks a single segment of the market such as the small cap sector is unlikely to be suitable. These instruments would instead be classified as Satellite LICs.

Core LICs tend to be established investment strategies, with seasoned investment teams, large FUM and offer higher levels of liquidity. We would therefore expect the performance of these LICs to more closely track the underlying return on the investments held.

We believe that this is important in the LIC sector given the lack of a market maker or arbitrage mechanism. The performance of LICs in general – especially those with low levels of liquidity – can and often do differ substantially to the underlying value of assets. This can occur for extended periods of time.

Despite generally higher levels of liquidity, there is no guarantee that the performance of Core LICs will match the return generated by the underlying value of assets.

Satellite LICs

Satellite LICs provide exposure to a strategy or asset class that is less representative of a core asset class and / or offer lower levels of liquidity.

These strategies can therefore behave very differently in terms of performance to the underlying asset class invested in.

Lower levels of liquidity may also see Satellite LICs trade at larger discounts to their underlying value of assets.

Note: From time to time, some LICs issue listed options to existing shareholders. These are typically long dated and their existence can make it difficult to know how badly new investors will get diluted until closer to the maturity date. Advisers should check for the existence of such options and be cognisant of their dilutive impact before buying any given LIC.

Listed Income Securities

What is a Listed Income Security?

Listed Income securities are ASX traded instruments which have both debt and equity characteristics (also known as listed hybrid income securities).

In the capital structure they are usually senior to common equity but rank behind other obligations e.g. deposits, debentures, senior and subordinated secured debt, senior and subordinated unsecured debt, etc.

Many hybrids take the form of preference shares, and in practice their seniority to common equity usually manifests in the form of a fixed or floating coupon which must be paid before any dividends are paid to common equity holders.

A key feature of listed hybrids are the call and maturity dates – these make the securities somewhat bond-like, however there are many other variables such as legal structure, security specific covenants/conditions, and low historic recovery rates which make these instruments quite different to a plain vanilla bond.

Listed hybrid securities are of varying quality and come with many and varied terms and conditions. There are significant differences between listed hybrids issued before and after 1 January 2013.

There are four key differences between "new style" and "old style" securities:

1. Non-viability clause

Any new subordinated debt or Additional Tier 1 (AT1) security issued after 1 January 2013 must include a non-viability clause. This is the predominant change under Basel III rules for capital securities and states that if the regulator, at its sole discretion, believes an issuer/bank is at the point of "non-viability", then they can require that any capital securities with the requisite terms in the documentation be written off (the default position) or converted to equity (if the issuer is listed and this is requested by the issuer at the time of structuring the deal).

The point of "non-viability" is not defined. In layman's terms it is when the regulator deems the issuer to be sailing too close to the wind but that may be on capital grounds or liquidity or even due to a high balance of non-performing loans. The trigger here is at the regulator's sole discretion (but would be assumed to be at a lower Common Equity Tier 1 ratio CET1 less than 5.125%). One probable trigger

point would be a government equity injection or similar state support to an ailing bank, something that occurred with many big name banks in Europe in the GFC such as RBS, Lloyds and ING.

The non-viability clause is only contained in new issues conducted from 1 January 2013 onwards. This means that in the event it is triggered, such “new style” issues would be converted to equity (or written off) whereas “old style” subordinated debt and even Tier 1 hybrid issues that do not have such a clause could not be converted. This would effectively make the “old style” securities senior in ranking. While this will only exist for the period that both “old style” and “new style” capital securities exist, it is an important and very relevant additional risk.

2. Contingent capital conversion clause (CoCo)

All AT1 securities (and some subordinated debt issues conducted off shore) also come with a mandatory conversion to equity where the CET1 ratio falls below a pre-determined (or contingent) level as set in the issue documentation. In the case of Australian bank AT1 securities, this has always been set at a CET1 of 5.125%, however some issues conducted by European banks have seen 7.0% and 8.0% trigger levels.

All such securities are by definition contingent convertible (or “CoCo”) capital securities as they have the potential to be converted to equity or written off. The typical structure in Australia has been for an automatic conversion to equity, subject to a “maximum conversion number” that would see investors face a capital loss when the share price has fallen in excess of 80% between issue date and conversion date.

3. Step-up clause

New Basel III rules also explicitly prevent the use of step-up margins on any new regulatory capital instrument such as subordinated debt or AT1 securities. Step-up clauses were seen to be “incentives to call” by the Basel Committee and have been outlawed.

"Old style" step-up securities issued before the change in capital rules have been given grandfathering relief to still count towards the capital calculations (albeit on a reducing basis) however only until the first call date, after that date their contribution to capital immediately falls to zero. Further, APRA has previously stated "outstanding non-complying instruments [read step-up securities] will be required to be phased-out no later than their first available call date, where one exists".

The existence of a step-up clause is an important differentiation in a subordinated debt (or Tier 1 hybrid) security. It is a typical feature of "old style" securities and, given the treatment under the revised Basel III and APRA capital rules, provides a strong incentive for the issuer to call at first opportunity. No such incentive exists for "new style" subordinated debt and further, the lack of such a clause is a movement towards economic-based call decisions.

4. Expectation of call

One of the key thrusts of the new Basel III (and APRA) capital rules is to remove any indication to the market that a capital security is intended to be called at first opportunity. Rather, regulators want issuers to make each call decision on the economic merits of cost versus benefit (i.e. is it cheaper to call and re-issue another similar security and if not the issuer should not exercise their call option).

By removing "incentives to redeem" (including step-up clauses) from the structure of newly issued capital securities, the issuers are being forced by regulators to use an economic rationale for the call decision. Further, investors will no longer be able to rely on reputational grounds for expectation of call at first opportunity. Issuers have been very careful in their marketing of new issues to ensure they do not give investors the expectation that "new style" subordinated debt or AT1 securities will be called at first opportunity.

APRA has even suggested that if an issuer was to request its approval to call a capital security with the intention to replace it with a new issue with a similar structure but at a higher margin, it would decline the request.

It is anticipated that once the “old style” securities, particularly step-up securities, no longer exist in the market that the long held expectation of call at first opportunity will change. Basel III and APRA are pushing for a market where both the issuers and investors expect callable securities to be called only when it is economic for the issuer to do so. We believe the market will make this transition over the next two to three years.

All subordinated debt and AT1 securities issued by banks since 1 January 2013 come with a number of added risks, including the potential for securities to be converted to equity or written off. The existence of these additional risks and in particular the difficulty in assessing or hedging against the subjective “point of non-viability” greatly reduces the attractiveness to the wholesale (or over the counter bond) market.

The market has developed such that the retail ASX listed market has become the preferred home for the higher risk but higher return AT1 securities, many of which are expected to convert to equity rather than being redeemed for cash.

All things being equal, “new style” Basel III-complaint capital securities are higher risk than the “old style” securities issued pre-1 January 2013 however “new style” securities typically trade at a higher credit margin.

Investors should ensure they are aware of these additional risks and assess whether they are being paid sufficient return to compensate.

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