INTERNATIONAL SHARE FUNDS – PART 1

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At Logical we believe the manner in which your strategic investment plan is constructed is vitally important. It needs to be aligned to achieving your long-term objectives, consistent with your preferences and risk tolerance, grounded in reality and robust through varying market cycles.

A key to achieving your long-term objective is to 'diversify intelligently' and provide you with access to 'best of breed' investments. In order to do this, we need to fully understand the underlying characteristics and differences between the investments in your portfolio. It is only then that we can truly understand the risks in your portfolio and build a portfolio that should meet your long-term objectives.

This is the first in a two-part series of articles that analyses the characteristics and differences of professional international share funds (unlisted) in your portfolio.

The aim of the first part of this two-part series is to provide you with a better understanding of the underlying characteristics of the international shares component of an investment portfolio. This includes the following:

- Provide a guide as to what a unitised international share fund is and what are the key characteristics and differences between those available; and
- Implications for clients.

The second part of this two-part series will examine the key characteristics of three international share funds that Logical considers 'best of breed', correlate very well together (Antipodes Global Fund, Magellan Global Fund and Franklin Global Growth Fund) and lastly how to diversify these international share managers 'intelligently'.

What is an International Share Trust?

An international share trust is a unit trust that pools the money of many individual investors. This pool is managed by the responsible entity. It is used to buy a range of shares from various global markets, according to the investment objective of each particular fund. The investment objective of each fund is shown in the relevant product disclosure statement.

In other words, an international equity unit trust is an investment vehicle that enables the investor to spread risk by pooling their money with that of other investors. This money is then invested by a team of investment specialists in a range of international listed companies which will be more varied than a small investor could achieve on their own.

Key Characteristics of International Share Funds

Some of the specific differences between international share funds include:

1. Investment Objective

While all funds aim to achieve long term capital growth, the funds will aim for different levels of outperformance from the underlying international market (often represented by a benchmark such as the MSCI All World [excluding Australia Net Reinvestment of dividend]). More active funds will look for a higher level of outperformance. Others aim to achieve returns without reference to the underlying market, that is, the fund may have an 'absolute' return objective.

2. Investment Style

International share funds will also vary in their investment styles. The 'style' of a fund manager refers to the way they choose stocks from their investment universe. Fund managers generally may be classified either as Value, Growth or Neutral based on their stock selection process. For example, value managers favour companies that they believe are undervalued as to their 'intrinsic value' relative to their current share price and growth managers favour companies with higher growth or earnings prospects than the market average. Generally, different styles perform better at different periods of the economic cycle. The style will also have an impact on the consistency of returns when compared with the benchmark.

3. Volatility of total returns - Portfolio Tracking Error

Most international share funds will track an underlying market benchmark, the most common being the MSCI World ex-Australia NR. The degree to which the portfolio deviates from the benchmark is measured by the tracking error. Funds with a high tracking error are more active in their stock selection; the stocks in the portfolio will differ significantly to the stocks in the underlying index. Funds with a high tracking error may underperform (or outperform) the market significantly over extended periods of time. They are therefore more 'risky' than less 'active funds.' Index managers (often in the form of exchange traded funds or ETFs) have a very low tracking error by definition. It is worth noting that in technical terms the tracking error is a measure of the degree to which a fund's returns differ from the benchmark, whereas the standard deviation measures the consistency of the absolute level of returns.

4. Market Capitalisation bias

International share funds may also vary in terms of their investable universe. The range of company size in the MSCI World ex-Australia index goes from 'small caps' to 'mega caps'. Mega cap companies comprise 75.3% of the index, large cap 22.7% and small cap 1.9%. The top ten stocks in the index comprise 9.6% of the index. Fund performance can be affected by the market capitalisation segment to which a particular fund is biased.

5. Number of stocks held in the portfolio

International share funds may also vary in the number of stocks held. This can vary from a highly concentrated portfolio of between 20 and 75 stocks to a highly diversified portfolio of over 500 stocks. The greater the concentration of the portfolio the more volatile a fund's performance may be.

6. Volatility of Income

Distributions (income) from international funds are comprised of dividends and other foreign income and realised gains/profits less realised capital losses. In contrast to Australian share funds, the dividend component of the distributions is likely to be much smaller, often less than 2-3% p.a. Therefore, in a falling market, where realised capital losses exceed capital gains, distributions can be reduced to close to zero. For this reason, international share funds should not be relied upon to provide income in the short term. For more details see Logical Financial Management Newsletter June 2016 – Income Distributions from Unit Trusts.

7. Taxation Consideration

An Australian resident taxpayer is liable to pay Australian income tax on foreign income earned from overseas investments held by a unit trust. Foreign income includes dividends, interest income and realised capital gains that have been taxed in the foreign country. Realised capital gains which have not been taxed in the source country are not classified as foreign income. As the bulk of distributions from international funds are untaxed, realised capital gains, a minimal amount is expected to represent foreign income.

8. Currency Hedging

An international share portfolio has uncertain (risky) return associated with it, as is the case with an Australian share portfolio. The difference between the two is that the international portfolio has an extra layer of risk arising from the movement in the Australian dollar against the other currencies used in the portfolio. For more details see Logical Financial Management Newsletter July 2015 – Impact of a Falling Dollar.

9. Short selling of stock or indices

In some cases, investment managers have the ability to short sell specific stocks or indices as part of their investment strategy. This strategy will be employed for risk mitigation or wealth acceleration purposes, or a combination of both. The investment manager will profit if the price of the stock or share decreases and vice versa.

Implications for Clients

Simply, the international share fund characteristics are used to build your international share portfolio.

Let's use an example.

Step 1: What does the client want from their international share component of the portfolio?

The client needs to focus on long-term capital growth and is prepared to have negative returns in the short to medium term and no focus on income.

Step 2: Consider which mix of international share fund characteristics will achieve the objectives.

For this client, it is important to look to achieve a mix of international share funds which have the following international share characteristics:

- Investment style diversification;
- An allocation to high tracking error funds;
- Diversification of market cap bias;
- Sufficient currency hedging capability;
- Concentrated (low number of stocks) portfolio.

It is important to understand the underlying characteristics and differences between the investments in your portfolio (e.g. international shares) if your long-term objectives are to be achieved. Are the specific fund characteristics relevant to your objectives? For example, a high-risk portfolio would consist of funds with style diversity, exposure to small and mid-capitalisation stocks, low number of stocks in the fund and funds that have a high tracking error (risk). It would not consist of a fund that tracks the global benchmark (e.g. index fund manager) and has over 500 stocks in their portfolio.

In next month's edition, we will issue the second part of this two-part series on International Share Funds.

DRAFT SUPER LEGISLATION

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The government has now released a second round of draft legislation amending some of the original budget measures that were announced in May 2016. The drafts are open for public consultation until the 10th of October. Legislation is expected to be introduced into Parliament before the end of this year.

The following summarises the main super changes that are now proposed.

Transfer Balance Cap

- If an individual breaches their transfer balance cap, the ATO will direct their pension fund to withdraw or roll back to accumulation phase the amount of the excess (including notional earnings). The individual will also be liable for 'excess transfer balance tax' on the earnings to neutralise the benefit received from having excess capital in the tax-free retirement phase.
- The transfer balance account will operate in a similar way to a general account ledger or bank account. Amounts transferred by an individual to the retirement phase will give rise to a credit in their transfer balance account. Certain transfers out of the retirement phase give rise to a debit in their transfer balance account.
- Transition to Retirement Income Streams will not be classified as retirement phase income streams and therefore will not be added to an individual's transfer balance account.
- The value of a reversionary superannuation income stream at the time the reversionary beneficiary becomes entitled to the income stream is added to the beneficiaries' transfer balance account.
- Children who receive a superannuation income stream from a deceased parent will be subject to modifications to reduce the impact on the child's future retirement benefit entitlements.
- The value of lifetime pensions and other defined benefit income streams will be counted towards an individual's transfer balance cap. Excess transfer balance tax will not be imposed for a breach of the transfer balance that relates to certain defined benefit income streams, but the income received from these pensions will be subject to additional income tax.
- Transitional rules apply to transfer balance cap breaches of less than $100,000 that occur on 30 June 2017. Such breaches will not give rise to notional earnings or an excess transfer balance tax liability if they are rectified within 60 days.

Non-Concessional Contributions

(These are after tax contributions or personal contributions.)

The $500,000 lifetime cap on non-concessional contributions will not proceed. Instead, the yearly non-concessional contribution cap will be reduced to $100,000 (currently $180,000). The three-year bring-forward can still be utilised for persons under age 65, allowing a person to contribute a lump sum of $300,000 without penalty, but only until the $1.6m transfer balance cap is reached.

Concessional Contributions

(These are pre-tax contributions i.e. salary sacrifice, employer SG, and personal contributions where a personal tax deduction has been claimed.)

The concessional contributions cap is proposed to reduce to $25,000 p.a. for everyone regardless of age, starting 1 July 2017.

Individuals who have total super balances less than $500,000 who do not fully utilise the concessional cap each year and carry forward the unused cap on a rolling five-year basis. This has been delayed to come into effect from 1 July 2018.

From 1 July 2017, the additional 15% contributions tax (also called Division 293 tax) on concessional contributions will apply where an individual's income is over $250,000 (currently $300,000).

Other Proposed Changes

- The work test requirements for those over age 65 will remain in place.
- From 1 July 2017, the spouse contribution tax offset is proposed to be available if the receiving spouse has income up to $37,000 (currently $10,800). The maximum offset is 18% on the first $3,000 i.e. a maximum is $540.
- A Low-Income Superannuation Tax Offset (LISTO) will be reintroduced from 1 July 2017 for individuals with adjusted taxable income up to $37,000 per annum. The LISTO is a refund of contributions tax paid on Concessional Contributions and is capped at $500 per annum. It will be paid into the person's superannuation account as a non-

refundable tax offset. This new measure will replace the low-income superannuation contribution (LISC) when it is abolished from 30 June 2017.

- Everyone under the age of 75 will be able to claim a tax deduction for personal super contributions made from 1 July 2017.
- Anti-detriment payments (a refund of contributions tax paid on a super death benefit) will cease from 1 July 2017.
- As already mentioned, from 1 July 2017, a maximum rate of 15% tax will be applied to the earnings in a transition to retirement (TTR) pension.

As stated above, these changes are still in draft and have not yet been legislated. There is still the potential for further amendments; however, industry consensus is that any further changes are now likely to be minor. We will continue to keep you updated over the coming weeks and months.

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