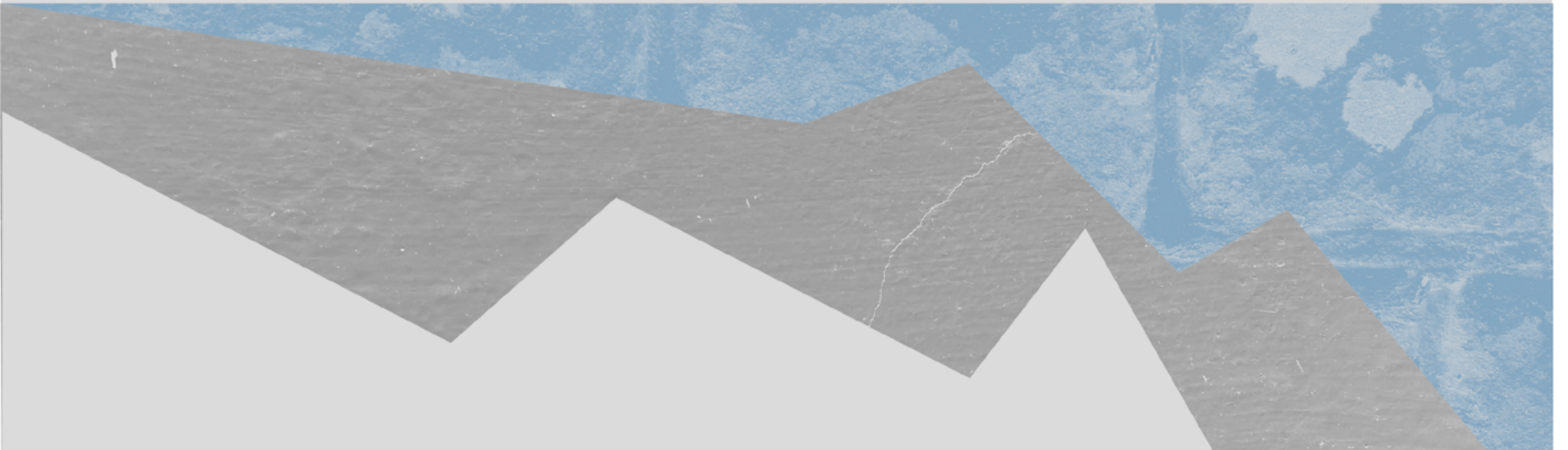




Cuffelinks

Showcase 2014



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Foreword

December 2014

by Chris Cuffe



Welcome to our first ebook, the Cuffelinks Showcase 2014. It is exclusively available to subscribers and rather than pass it around, we ask that you subscribe friends and we will then send it to them. In this way, we continue to grow our community of around 10,000 subscribers.

Our team has scoured through the Cuffelinks archive of over 500 articles, all still available on our website. After a lively debate and some disagreement, we have selected 50 highlights based on originality, popularity and quality of insight. Apologies to any writer who missed out because there were many excellent articles to consider.

Since Cuffelinks started publishing on 8 February 2013, about 150 market professionals have written for us. We have avoided product promotions and jumping on the daily news bandwagon, and focussed instead on enduring stories that give investment insights and valuable opinions.

Many of our articles discuss the challenges of saving for retirement, asset allocation and superannuation policies. The need to educate and inform will intensify with the \$2 trillion in superannuation heading for \$9 trillion by 2040. We have explored at length the significant future stresses from an aging population, changing demographics and tight budget constraints.

My thanks for being part of the Cuffelinks community, especially to those who comment and provide feedback. We know from annual Reader Surveys that we have a highly engaged readership from diverse backgrounds, and we hope you enjoy this selection.

- Chris Cuffe

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www.cuffelinks.com.au



Risk Management

Howard Marks is one of the highest profile asset managers in the US, and he gave special permission for Cuffelinks to reproduce his presentation on risk. Noel Whittaker is Australia's foremost financial adviser, and he shares eight principles he applies to health and wealth. Justin Wood suggests spending guidelines for retirees, while Graham Hand quotes insightful behavioural finance examples from Nobel Prize winner Daniel Kahneman.

Howard Marks on risk and how to handle it today

by Howard Marks

Published 15 September, 2014

Cuffelinks' introduction to Howard Marks, Chairman, Oaktree Capital

Howard Marks established Oaktree Capital in 1995, and is responsible for the firm's adherence to its core investment philosophy. Oaktree manages over US\$90 billion and its mission is to provide highly professional management with a primary emphasis on risk control in a limited number of sophisticated investment specialties. Howard is best known in the global investment community for his 'Oaktree Memos' to clients which detail investment strategies and insights into the economy, and are available on the [Oaktree website](#). In 2011 he published the book *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*.

Howard Marks recently gave the following confidential presentation on risk to selected institutional clients, and Oaktree Capital has given permission for Cuffelinks to share the insights with its readers. The material remains at all times copyright of Oaktree Capital.

Risk Is ...

The Ultimate Test of Investment Skill

- It's not hard to achieve investment return.
- That's especially true when the market rises, which it usually does.
- The real achievement is achieving return with risk under control.
- The key questions when you see a portfolio perform well:
 - Is it just a fair-weather portfolio?
 - How will it hold up if the environment turns hostile?

An Essential Consideration in Assessing Investment Performance

- Return alone tells only part of the story about performance.
- Two investors with the same return didn't necessarily do equally good jobs.
- Their performance has to be viewed in risk-adjusted terms.
- The key question is "How much risk did each one bear?"

Not Volatility

- Academics developing investment theory accepted volatility as the measure of risk. I believe they did this in large part because volatility is readily quantifiable.
- However, few people in the real world consider volatility the key risk.
- Risk premiums aren't demanded in response to volatility.

Not Machinable

- Only volatility is fully quantifiable.
- Nothing can be substituted for volatility in investment theory's calculations.
- But volatility alone isn't a useful measure of risk.

The Probability of Loss

- This is what most people mean when they say "risk."
- This is what people demand compensation for if they are to bear it.

The Probability of Falling Short

- Many investors face a return requirement. The ramifications of failing to achieve that return can be significant.
- Thus the risk of missing opportunities is another important risk.
- Since the requirement is unique to each investor, the probability of failing to reach it is situational, not a risk inherent in the investment or portfolio.

The Likelihood of Being Forced Out at the Bottom

- Many investors claim to be long-term oriented and thus immune to fluctuations.
- But bad-enough declines can make them sell:
 - ▷ because they lose confidence
 - ▷ because they receive margin calls or
 - ▷ because of a need to fund real-world cash requirements.
- Some of the greatest pain in 2008 was felt by investors who had overestimated their ability to withstand volatility.
- **Selling at the bottom – and turning a downward fluctuation into a permanent loss – is the cardinal sin in investing.**

An Investment Consideration; It Should Be Distinguished from Managers' Business Issues

- The possibility of lagging behind a benchmark and of performing worse than others aren't investment risks, but rather competitive/business issues.
- A shortfall in relative performance doesn't necessarily indicate that high risk was borne. It may, for example, result from the application of risk control in an overheating market. Thus it may indicate low risk, not high risk.
- Succumbing to "the tyranny of benchmarks" introduces the risk of allowing others to define desirable behavior for you.
- Eliminating the risk of deviating from a benchmark – as index funds do – may reduce business risk but increase investment risk. **Index fund investors lose money every time their market goes down.**

Unquantifiable In Advance

- Like any judgment regarding the future, the probability of loss can't be anything but a matter of opinion.
- A variety of experts will view it and quantify it differently.

Unquantifiable After the Fact

- A profitable investment may (or may not) have been risky.
 - ▷ Was it a safe investment that was sure to produce a positive outcome?
 - ▷ Or was it a risky investment where the investor got lucky?
- Likewise, a losing investment may not have been risky, just unlucky.
- For the outcome of an investment to be an accurate indicator of its riskiness, return would have to be a function of risk alone. There are too many factors at play for that to be the case.
- **The bottom line: it's impossible to quantify risk, even in hindsight.**
- Thus, in particular, it's impossible to say high-returning portfolios were riskier and low-returning portfolios were safer. In fact, the opposite is often true.

Best Assessed through Subjective Judgment

- Since risk can't be measured, gauging it has to be the province of experts.
- **Imprecise, qualitative, expert opinion about the probability of loss is far more useful than precise but largely irrelevant numbers concerning volatility.**

Counter-Intuitive

- When all traffic controls were removed from the town of Drachten, Holland, traffic flow doubled and fatal accidents fell to zero (*Dylan Grice, Soc. Gen.*).
- "Jill Fredston is a nationally recognized avalanche expert . . . She knows . . . better safety gear can entice climbers to take more risk – making them in fact less safe." (*Pensions & Investments*)
- **Thus the risk of an activity often lies not in the activity itself, but in how the participants approach it.**
- Likewise, the degree of risk present in a market derives more from the behavior of the participants than from the companies, securities and institutions. **Risk is low when investors behave prudently and high when they don't.**
- Prior to the subprime crisis, there had never been a nationwide wave of mortgage defaults. This convinced investors that mortgages were safe. This, in turn, led to a lowering of credit standards and the issuance of mortgages so weak that a nationwide wave of defaults was inevitable.

Perverse

- **The riskiest thing in the world is widespread belief that there's no risk.**
- **A high level of risk consciousness tends to mitigate risk.**
- As an asset declines in price, making people consider it riskier, it becomes less risky.
- As an asset appreciates, making people think more of it, it becomes riskier.
- **This perversity is one of the main things that render most people incapable of understanding risk.**

Hidden and Thus Deceptive

- Even if it contains construction flaws, a house will stand until there's an earthquake.
- Equally, an investment can be risky and still not show losses as long as the environment remains salutary.
- The fact that an investment is susceptible to a serious risk that will occur only infrequently – the “improbable disaster” or “black swan” – can make it appear safer than it really is.
- **The riskiness of an investment becomes apparent only when the investment is tested.**
- **“It's only when the tide goes out that we find out who's been swimming naked.” - Warren Buffett**

Something That Should Be Dealt with Constantly, Not Sporadically

- Risk produces loss when bad things happen; that's when we need risk control.
- But we never know when bad things will happen, and thus when risk control will be needed.
- The right model for investing isn't American football, where one team's defensive squad tries to stop the other's offensive squad for a while, and then they trade places. The right model is soccer, where pretty much the same eleven people have to play both defense and offense all game, and there are few stoppages or substitutions.
- Likewise, in investing no one tells you when to substitute defense for offense, and there are no stoppages during which to do it.
- **Risk control is unnecessary when loss doesn't occur, but that doesn't mean it's a mistake to have it. The best model is automobile insurance: do you regret having had it in a year without an accident?**

Not a Function of Asset Quality

- **A high-quality asset can be priced so high that it's risky.**

Largely a Matter of Price

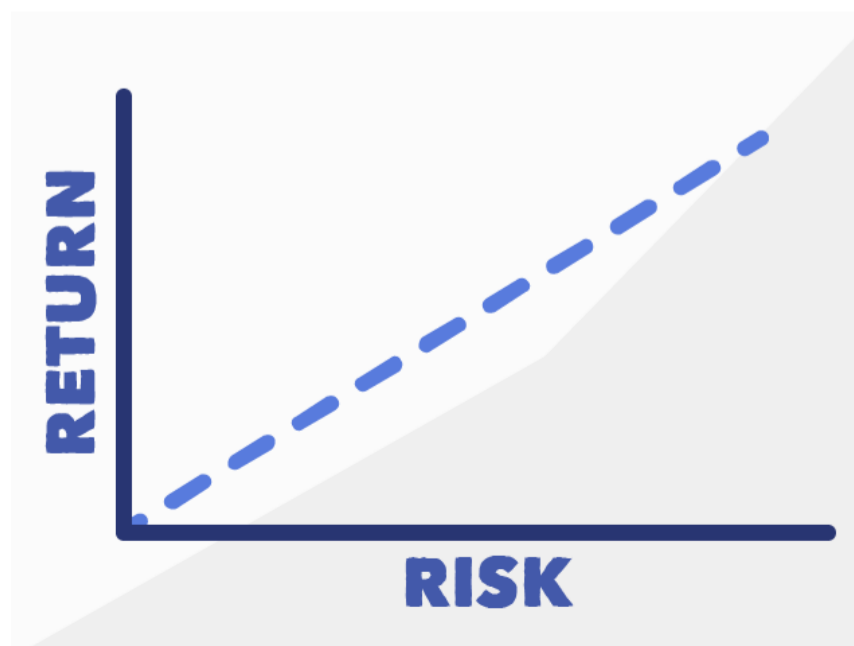
- **A low-quality asset can be cheap enough to be safe.**

The Product of Uncertainty Concerning the Future

- **“Risk means more things can happen than will happen.” – Elroy Dimson**
- It's challenging to come up with an estimate of an investment's expected rate of return.
- It can be much harder to comprehend and describe the entire distribution of possible outcomes around the expected return.

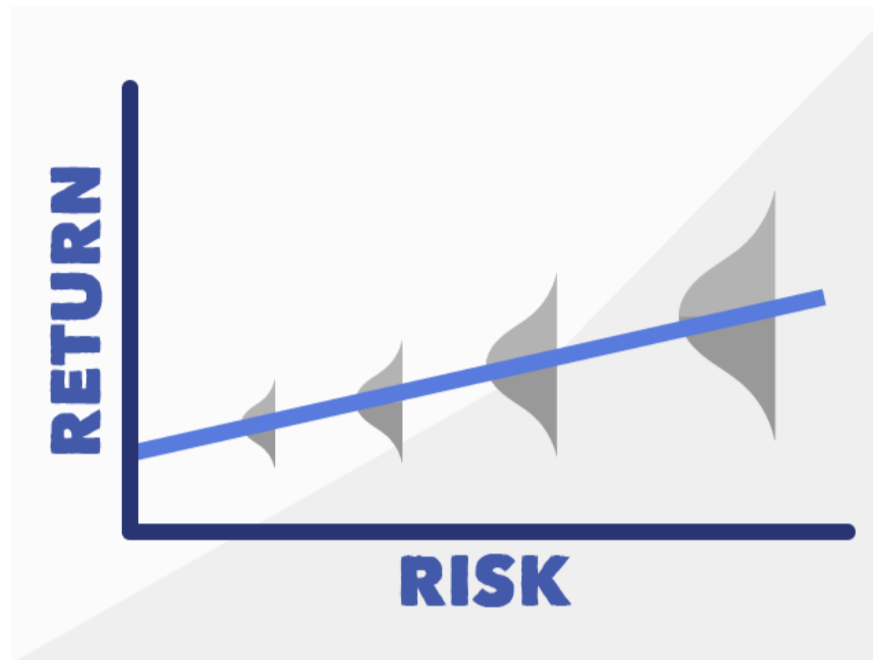
Not a Dependable Source of High Return

- It's true that investments that seem riskier must appear to offer higher returns in order to attract capital.



- However, that's very different from saying "riskier assets produce higher returns" or "the way to make more money is to take more risk." These are traps into which most investors fall, especially in times when things are going well and risk taking is being rewarded.
- **If risky investments could be counted on to produce high returns, they wouldn't be risky.**

Best Thought of in Terms of the Distribution of Possible Outcomes



- As risk increases,
 - ▷ The expected return rises,
 - ▷ The range of possible outcomes becomes wider, and
- The worst outcome worsens and ultimately becomes negative.
- **This is the way to think about the risk/return relationship.**

A Function of Correlation, Not Just Each Asset Taken Individually

- Apart from the riskiness of individual assets, the risk of a portfolio will be a function of how connected the assets' returns are.
- Effective diversification doesn't mean owning different things, but owning things that respond differently to events in the environment.
- Estimating correlation is extremely difficult because of the many fault lines that run through portfolios.

Not Separable from Investment Management

- "Risk managers" are statisticians with little knowledge of underlying assets.
- So-called "risk management" organizes the thought process regarding portfolio risk, but its output isn't any better than its inputs.
- The riskiness of a portfolio is best thought of as the left hand side of its distribution of probable returns; who's most qualified to assess it?
- More people were probably being paid to manage risk in 2005-07 than at any other time in history. And yet the essential ingredients for the greatest crisis in almost 80 years were able to develop.

Capable of Being Borne Intelligently

- You can bear risk prudently if it is:
 - ▷ risk you're aware of,
 - ▷ risk that can be analyzed,
 - ▷ risk that can be diversified, and
 - ▷ risk you're well paid to bear.

Kept Under Control in Superior Portfolios

- Highly skilled investors assemble portfolios that will produce good returns if things go well and resist decline if things go poorly.
- Achieving an above average return with average risk is a significant accomplishment.
- Achieving an average return with below average risk is an equally significant accomplishment, albeit easily overlooked.

- **Assembling a portfolio that incorporates risk control along with the potential for gains is a great accomplishment. But it's a hidden accomplishment most of the time, since risk only turns into loss occasionally . . . when the tide goes out.**

Something to Be Managed and Controlled, Not Avoided

- Risk control is indispensable.
- Risk avoidance is not an appropriate goal in investing.
- "You've got to go out on a limb sometimes because that's where the fruit is." – Will Rogers

The Bottom Line

You shouldn't expect to make money without bearing risk, but you also shouldn't expect to make money just for bearing risk.

Risk is best handled on the basis of accurate subjective judgments on the part of experienced experts emphasizing risk consciousness.

Outstanding investors are outstanding because they have a superior sense for the probability distribution that governs future events, and for whether the potential returns compensate for the risks that lurk in the distribution's negative left-hand tail.



Published 28 February, 2014

This morning I was doing a workout at the gym, something I have been doing for more than 20 years. Keeping your body in good shape and building your finances requires similar strategies, as exactly the same principles apply to each.

Today, in the interests of good health and wealth for us all, I'll share the principles with you.

Rule 1. You must have a concrete goal.

It is as pointless to say "I want to lose a few kilos" as it is to say "I want to have more money in the bank". It is essential to have a specific goal and a timeframe.

Rule 2. Focus on the benefits.

This is what will help you stay on track when the inevitable temptations arise. Shedding a few kilos will certainly improve your health and make you feel better; retiring with a substantial superannuation balance will open up a whole new world of freedom and choice.

Rule 3. It must be a permanent lifestyle change.

Dr Gary Egger of Gutbusters said the word DIET was short for Diabolical Ineffective Expensive Timewaster. Most people who go on a crash diet put all the lost weight back on when the diet inevitably becomes too hard. It's exactly the same with money. Scrimping and saving for a month is pointless. Becoming wealthy is usually the result of a process of managing your money well over the long haul and letting compound interest work its magic.

Rule 4. Understand the 70/30 rule.

Seventy per cent of a successful weight loss program will be attributable to your eating habits, and thirty per cent to exercise. Seventy per cent of building wealth consists of managing your money to spend less than you earn, while the rest of it consists of good asset selection and tax effective strategies.

Rule 5. Don't try to do too much too soon.

The reason most New Year's resolutions fail is that they are normally made in a moment of alcohol-induced euphoria and are not carried through in the harsh light of day. The trick is to start small and build on it. To lose weight you might decide to have two healthy-eating days a week. To get your finances in order you could start with a simple budget coupled with moving your home repayments from monthly to fortnightly.

Rule 6. Expect roadblocks.

There will be times, especially around Christmas, when your budget and your belly will take a battering. By all means, prepare for these occasions to the best of your ability but don't give up if you have a setback. Just treat it as a period of consolidation while you prepare to start moving forward again.

Rule 7. Keep track of your progress but don't do it too often.

Both your weight and your portfolio are going to be bouncing around for the rest of your life, and getting excited or depressed because of a good or bad day can put you on an emotional roller coaster which could lead to impulsive and flawed decisions. As long as you are making steady progress towards your goal you are on the right track.

Rule 8. Mix with people who share your goals.

It's much easier to refuse dessert when nobody else at the table wants it than it is to watch everybody else eating it. It's easier to live within your income if your circle of friends shares your financial aspirations.

The great thing about having a variety of goals is the way you can make them work together. Much of our discretionary spending these days is on food and alcohol, and cutting back on these will save you dollars as well as kilos. It may be difficult at first while you are slowly changing lifelong habits but eventually new habits will form. Then you can enjoy the results.

Noel Whittaker is Australia's foremost financial adviser, a well-known media commentator and international best-selling author, including 'Making Money Made Simple'. He is Adjunct Professor with the Faculty of Business at the Queensland University of Technology. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

Spending guidelines for retirees and endowments

by Justin Wood

Published 6 June, 2013

Most Australians become reasonably comfortable matching annual spending to annual income with some provision for saving throughout their working life. On retirement they face a very different and frightening problem; how to determine spending each year from a pool of savings that must last 20-30 years? The same issue faces endowment funds and charities.

Investment income is typically far more volatile than wage income and the market value of investments can fluctuate substantially. For example, in 2009 many retirees through a combination of spending and falling market prices ended the year with around 20% less savings than at the start of the year. Some decided to cut their spending significantly, while others kept spending at a similar rate in the hope that market values would recover.

One solution is to pass this risk onto someone else through the purchase of an annuity. A life annuity, a defined benefit pension and the taxpayer-funded age pension all offer retirees the opportunity to continue spending from a reasonably stable annual income. However, most retirees currently drawdown their super as an allocated pension or withdraw their super as a lump sum to manage their retirement spending privately in conjunction with the age pension. This article discusses a spending rule that might help those retirees who pursue these options.

Annual spending over the long-term

Not-for-profit entities with endowment savings face a similar problem. How should they determine annual spending over a long horizon when investment income and the market value of assets fluctuate substantially from year-to-year. The Yale University Endowment Fund has developed a spending policy that is a useful model for local endowment funds and also may be useful for retirees.

Under the Yale policy, the target long-term spending rate is 5.25% of the Endowment Fund's market value each year. So if the Fund is worth \$20 billion, the annual target spend is just over \$1 billion. However, in any given year, Endowment spending is determined by:

- * 80% of the previous year's spending, plus
- * 20% of the 5.25% long-term spending rate applied to the market value of the Endowment two years prior
- * The calculated amount is then adjusted for inflation over the prior year
- * A constraint is imposed of at least 4.5% and no more than 6.0% of the market value of the Endowment two years prior.

This combines some spending stability with some responsiveness to changing market conditions.

To quote directly from Yale:

"The Endowment spending policy, which allocates Endowment earnings to operations, balances the competing objectives of providing a stable flow of income to the Operating Budget and protecting the real value of the Endowment over time. The spending policy manages the trade-off between these two objectives by using a long-term target spending rate combined with a smoothing rule, which adjusts spending in any given year gradually in response to changes in Endowment market value." (Yale University Financial Report 2011).

Some comments on the spending policy:

- The target long-term spending rate of 5.25 per cent reflects Yale's past 20-year real return from the fund (the return above inflation) and the fact that Yale University has an indefinite horizon. Retirees may want to deplete their capital over their expected lifetime, or they may want to leave capital as a legacy or retain a buffer for risk management reasons. Also, in the current investment climate, they may not have the same confidence that they can earn as high a long-run real return as Yale has done. These factors will change the target spending rate.
- The adjustment for inflation is designed to maintain the real value of spending and hence, for retirees, implies a similar standard of living in the absence of any adverse changes in the market value of savings.
- The weights of 80% applied to last year's spending and 20% applied to the value of the Endowment gives greater weight to spending stability over adjusting more quickly to financial conditions. Yale started with weights of 70% and 30% and a retiree could choose these weights or others to suit their own circumstances.

There is a big difference between the drawdown rate from a pension account and the retiree's actual spending in retirement. Retiree spending depends upon their total resources both within the superannuation system and those held privately. The drawdown rate from the pension account might be set using the ATO's minimum annual payments for super income streams. The spending policy might use the Yale model to identify spending guidelines.

Few retirees will spend just because a model indicates that this amount can be spent. In reality, the Yale policy is not so much a methodology for determining annual spending, but rather a warning flag when the unavoidable spending requirements of the day – food, survival, medicine etc. – force one beyond the guidelines into depleting one's capital faster than planned. It would be a signal to tighten one's belt.

Lessons for endowments, charities and governments

In Australia, the Benevolent Society Endowment uses a rule similar to Yale's in determining the annual distributions from their Endowment to support new Benevolent Society initiatives. The target real rate is the forecast long-term real rate that the Endowment expects to achieve, after investment management fees, and the weightings are 70/30. This provides a relatively stable annual cash flow to fund initiatives with the expectation of maintaining the real value of the Endowment for future generations. Real Endowment growth is achieved through attracting new capital donations, which will support real spending growth on initiatives.

The Yale model has useful elements for Australian entities with endowment funds, for Private Ancillary Funds (PAF) that are used by families, individuals or companies to establish grant-making foundations and also for self-funded retirees. A smoothed, constrained spending policy may even have some applications for governments balancing annual spending initiatives against a background of volatile tax revenues due to rapidly changing economic circumstances!

Justin Wood is a founding shareholder in Vinva Investment Management and member of the Benevolent Society Endowment Investment Advisory Committee.

So you think you think rationally. Think again

by Graham Hand

Published 26 March, 2013

Nobel Prize winner Daniel Kahneman published *Thinking, Fast and Slow* in 2011, and it shot to the top of bestseller lists. The reviewers often sounded as if Kahneman were reporting on new research or putting out a fresh idea, like a Michael Lewis or Malcolm Gladwell insight. But this did an injustice to Kahneman. His book was nothing less than a summary of a lifetime's work. His Nobel Prize was awarded in 2002, and he traces his work back to 1969 at the Hebrew University of Jerusalem, when he met Amos Tversky. Together, they would bring behavioural finance out of the margin and into the mainstream, such that over 40 years later, it is an accepted part of understanding how investors and markets behave.

But this article is not another review of his book. Rather, Kahneman reports on dozens of studies he and his colleagues have done on how we make decisions, and explains our irrational behaviour. The reader is drawn in to take the tests and judge their own weaknesses in logic, which is why this book can be so humbling to read.

Kahneman divides our thought processes into System 1, which is automatic, effortless and unconscious, but answers questions quickly and gullibly based on intuition. And System 2, which is controlled, deliberate and requiring effort, but often only engages when circumstances require it.

Try these quick questions

So here we go. I've taken 10 examples from Kahneman's book, and I will give the questions first, followed by the answers and a brief explanation. Try not to peep.

1. A bat and a ball cost \$1.10. The bat costs one dollar more than the ball. How much does the ball cost?
2. If it takes 5 machines 5 minutes to make 5 widgets, how long would it take 100 machines to make 100 widgets? Here's a clue: is the answer 100 minutes or 5 minutes?
3. How many animals of each kind did Moses take into the ark?
4. A man has been described by a neighbour as follows: "Steve is very shy and withdrawn, invariably helpful but with very little interest in people or in the world of reality. A meek and tidy soul, he has a need for order and structure, and a passion for detail." Is Steve more likely to be a librarian or a farmer?
5. Consider three possible sequences of boys and girls born in a hospital: BBBGGG, GGGGGG, BGBBGB. Which of these sequences is least likely?
6. Is the height of the tallest redwood in the United State more or less than 1,200 feet? What's your best guess about the height of the tallest redwood?
7. It's a fact that people with a PhD are more likely to subscribe to The New York Times than people who did not go to college. You see a lady reading The New York Times on a New York subway. Which of the following is more likely? a) She has a PhD or b) She does not have a college degree.
8. The most famous and controversial experiment involves a lady called Linda. "Linda is 31 years old, single, outspoken, and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and also participated in antinuclear demonstrations." The question is, which alternative is more probable? a) Linda is a bank teller b) Linda is a bank teller and is active in the feminist movement.
9. What if you were given a choice between the following: a) A gamble with 80% chance to win \$100 and 20% chance to win \$10, or b) A sure payment of \$80. Which would you choose based on your personal preferences? Which would you choose based on the expected value of the outcomes?
10. Consider these two problems:

Problem 1. Which do you choose? Get \$900 for sure or 90% chance to get \$1,000.
Problem 2. Which do you choose? Lose \$900 for sure or 90% chance to lose \$1,000.

What are the logical or rational answers and what is happening in your decision-making?

1. It's difficult to stop the answer 10 cents jumping into your mind. More than 80% of university students give this first intuitive answer. But it's wrong, and Kahneman highlights our failure to check the answer as we simply follow the law of least effort. The correct answer is 5 cents.
2. Again, there is an intuitive response, but the correct response is 5 minutes. Kahneman also reports that students are far more inclined to make a mistake if given the puzzle in normal font, but do better in a small, washed-out font. The cognitive effort of reading the question produces a better result.
3. Very few people detect what is wrong with this question. Look again. Holy Moses! Oh Noah!
4. Most people reply that Steve is more likely to be a librarian than a farmer. But there are at least five times more farmers than librarians in the United States, and the majority of the librarians are women. So it is far less likely that Steve is a librarian.
5. Intuitively, we don't expect a sequence of six girls, but since each event is independent of the one before it, they are all equally likely.
6. When the question is asked like this, the mean estimate given by respondents was 844 feet. But when it is asked like this: "Is the height of the tallest redwood more or less than 180 feet? What's your best guess about the height of the tallest redwood?" ... the mean answer is 282 feet. This 'anchoring' effect has many examples in investing.
7. It's more likely to be the second because far more non graduates ride the subway than PhDs.
8. People think Linda is a very good fit for an active feminist. But the set of feminist bank tellers must be wholly included in the set of bank tellers. Therefore, the probability that Linda is a feminist bank teller must be lower than the probability she is a bank teller. When a possible event is specified in increasingly greater detail, you only lower its probability. People are confusing intuition with the logic of probability. In tests of undergraduates at top universities, 85% to 90% chose the second, incorrect option.
9. Most people dislike risk and almost everyone prefers the sure thing. The expected value of the gamble is \$82 ($0.8 \times 100 + 0.2 \times 10$), which is more than the sure thing. But few people evaluate risks in this way. Most people would choose the sure thing even if it were only \$50.
10. You were probably risk-averse in problem 1, as for the great majority of people, a \$900 gain is much better than a gamble. But then in problem 2, you probably chose the gamble. The thought of losing \$900 encourages you to take the bet. People become risk-seeking when all their options are bad, and you probably dislike losing more than you like winning.

Kahneman hopes his examples improve our ability to identify and understand errors of judgement. If we make mistakes in these simple questions where the logic is obvious, we are likely to be missing critical information or focussing on the wrong issues in many of our investment decisions. Each day, we respond to problems quickly and automatically, giving undue attention to details that stand out easily. Critical information is often ignored. The best investors are those who can hear through the noise.

Graham Hand was General Manager, Capital Markets at Commonwealth Bank; Deputy Treasurer at State Bank of NSW; Managing Director Treasury at NatWest Markets and General Manager, Funding & Alliances at Colonial First State. He is the Editor of Cuffelinks.



Portfolio construction

Chris Cuffe on why we can't resist attempting active asset allocation and trading versus investing, Nobel Prize professors on active versus index management, some problems with the structure of managed funds, and David Bell on avoiding the quick money.

Why we chase the Holy Grail

by Chris Cuffe

Published 19 September, 2014

"We cannot suppress the powerful intuition that what makes sense in hindsight today was predictable yesterday. The illusion that we understand the past fosters overconfidence in our ability to predict the future." Daniel Kahneman, Nobel Prize Winner, in *Thinking, Fast and Slow*.

"The only value of stock forecasters is to make fortune tellers look good." Warren Buffett

"Far more money has been lost by investors preparing for corrections, or in trying to anticipate corrections, than has been lost in corrections themselves." Peter Lynch

Like many people who manage their own portfolios, I actively engage in tactical asset allocation (TAA), despite evidence that it's a waste of effort. TAA is market timing with a fancier name, and usually involves switching from equities to defensive assets and vice versa in anticipation of a major stockmarket move. Unfortunately, nobody rings a bell to tell when this is about to happen, so we all have our own techniques.

I think there are two main reasons why people engage in TAA:

- We think we're good at it.
- The rewards for correct decisions are fantastic.

At an institutional level, many trustees and asset consultants prefer instead to set a static strategic asset allocation, and rebalance back to these set percentages as markets move. They may tolerate some small range either side of a target allocation, but relatively few public super funds in Australia tactically adjust their portfolios significantly the way an individual investor might.

Is TAA a waste of time?

Of course, academics have an expression to describe the belief that you can outguess the market: *illusory superiority*. People overestimate their positive qualities and abilities, and underestimate their weaknesses. Examples quoted in [the research](#) include:

- in surveys of driving safety and skills, 93% of people in the US put themselves in the top 50%
- at the University of Nebraska, 68% of faculty members rate themselves in the top 25% for teaching ability
- at Stanford University, 87% of MBA students rated their academic performance above median
- in a survey attached to the SAT exam in the US (taken by about one million students a year), 70% put themselves above the median on leadership ability, 85% on 'ability to get on well with others' and 25% rated themselves in the top 1%.

There have been many studies showing nobody really knows where markets are going (click this link for an [excellent report on the perils of market timing](#)). In 1994, some US academics analysed over 15,000 market timing calls in 237 investment newsletters over 13 years, and found that over 75% of the newsletters produced negative performance. In 2012, Morningstar compared 210 tactical asset allocation funds with a simple Vanguard 60/40 default fund, and with few exceptions, the tactical funds performed worse, were more volatile and ran as much downside risk as the simple fund.

Even those who have a well-researched and systematic approach to TAA often have a timing problem. It can take years after an asset allocation move to know if it is correct. Any fund manager with an open-ended fund who called the GFC downturn correctly but altered their asset allocation two years early probably lost a lot of funds as the market continued running until 2008.

This was the case for funds who used long term fundamental measures (like Nobel Prize laureate Robert Shiller's 'CAPE' ratio model, and Vanguard founder Jack Bogle's real dividend yield model) to under-weight equities as soon as they became expensive two or three years before the boom ended. They underperformed during the best part of the run up and they lost a lot of clients and funds. To make matters worse, they also lost when they re-entered the market a year too early, when the long term fundamental models said the market was 'cheap' in early 2008, right before the worst part of

the crash in late 2008 with the collapse of Lehman.

And it's difficult for institutions to do TAA with any conviction as they are obsessed with benchmark risk and competitor risk. Public super funds, for example, 'force' themselves to be in most asset classes all the time rather than avoiding some completely from time to time. Over the last year or so, I have heard many institutional investors say Aussie bonds look very expensive at present, yet most have an allocation to them.

Individual SMSFs are much better placed as benchmark and competitor risks are not such a worry, and an SMSF can also take a much longer timeframe to make decisions.

I personally believe it is still worth giving TAA a go and I think I do better than the market at least 51% of the time if I have an adequate long term time frame to work to.

If you could do it well, is TAA really worth it?

Let me show some simple examples of why so many of us strive for the elusive TAA heaven. I will be drawing my data from calendar year statistics in the [Vanguard Australia Asset Class Tool](#), a publicly available source of returns across all asset classes since 1970.

Assume I have \$1,000 to invest, and there are no transaction costs and no tax leakage (these are unrealistic assumptions for many people, but it is needed for simplicity and won't change the message). The measurement period is 10 years from 1 January 2004 to 31 December 2013. The six asset classes chosen for the purposes of this article are:

- Australian shares
- International shares (\$A unhedged)
- Australian property (listed REITs)
- Cash
- Australian bonds
- International bonds (\$A hedged)

1. Unrestricted and perfect asset allocation

The Vanguard table shows which asset class performed best in each calendar year. If I could invest in any asset class without restriction (0% to 100%) and I had a perfect ability to asset allocate and did not care about diversification, then over the 10 year period from 1 January 2004 to 31 December 2013, I would have invested the initial \$1,000 as follows:

1 January 2004, 100% Australian property, for a return over the year of 32.0%
1 January 2005, 100% Australian shares, for a return over the year of 21.0%
Etc, etc, switching between asset classes every year for 10 years.

This perfect approach turns **\$1,000 into \$9,628 after 10 years**, an annual compound growth rate of **25.4%**. And for completeness, the worst allocation would have resulted in \$1,000 turning into \$445 after 10 years.

2. Set 70/30 asset allocation

Most institutions have a 70/30 asset allocation for their key balanced funds. Let's assume, using our six asset classes, the average asset allocation was:

- Australian shares (35%)
- International shares (25%)
- Australian property (10%)
- Cash (5%)
- Australian bonds (15%)
- International bonds (10%)

With \$1,000 invested at the beginning and the above set asset allocation, \$1,000 becomes \$1,962 after 10 years, a compound average growth of 6.98% per annum. This assumes the asset class allocation at the beginning was not rebalanced each year. If the standard asset allocation was rebalanced each year, then \$1,000 turns into \$2,094 after 10 years, a compound return of 7.6% per annum.

3. Allowing tactical asset allocation around the benchmark

Let's now assume institutions are permitted to do tactical asset allocation around the standard asset allocation with ranges as follows:

- Australian shares (35%) – range 25% to 45%
- International shares (25%) – range 15% to 35%
- Australian property (10%) – range 5% to 20%
- Cash (5%) – range 0% to 10%
- Australian bonds (15%) – range 10% to 25%
- International bonds (10%) – range 5% to 20%
- Overall growth assets (70%) – range 50% to 80%

Using TAA discretion and allocating to the best returns, we have 80% growth (shares and property) and 20% (cash and bonds) from 2004 to 2006, then we switch to 50% in 2007 and 2008 (and thereby reduce the impact of the GFC), back up to 65% growth for the 2009 equity recovery, down to 50% growth in slow equity years of 2010 and 2011, and 80% growth since then. While this is far less extreme than the perfect results in example 1 with no diversification, these numbers are within the range assigned to many asset allocators within a balanced fund.

The results? The \$1,000 invested at the beginning turns into \$3,457 after 10 years, a compound annual return of 13.2% per annum. Compared with the above static 70/30 asset allocation that is rebalanced each year, this tactical asset allocation with perfection yields an additional \$3,457 – \$2094 = \$1,363 after 10 years, a significant improvement.

We chase the Holy Grail

In a theoretical extreme, an asset allocator could have turned a \$1 billion fund into \$9.628 billion in 10 years with perfect vision, or a 70/30 balanced fund could have delivered 13.2% per annum instead of 7.6% per annum with excellent TAA. It's little wonder the attraction of trying proves difficult to resist.

And, of course, there's a third reason a lot of us do it. We enjoy it, it gives meaning to our role of managing money, and for many it's a lot more fun than setting and forgetting 70/30 and going to the races. But I'll leave the last word to John Bogle, the Founder of Vanguard:

"Sure it would be great to get out of the stock market at the high and back in at the low, but in 55 years in the business, I not only have never met anybody that knew how to do it, I've never met anybody who had met anybody that knew how to do it."

Chris Cuffe took Colonial First State from a start-up to Australia's largest investment manager during his 14-year tenure. He then became CEO of Challenger Financial Services Group and subsequently CEO of Challenger's Wealth Management business. Chris is now involved in a portfolio of activities including directorships and assisting the non-profit sector. In particular, he is Chairman of UniSuper, Chairman of Australian Philanthropic Services and founding director and portfolio manager of Third Link Growth Fund. In 2007, Chris was inducted into the Australian Fund Manager's RBS Hall of Fame for services to the investment industry.

Index versus active? Nobel Prize professors can't agree

by Graham Hand

Published 1 November, 2013

The 'index versus active' investing debate is one of the oldest arguments in the industry. On one side, researchers point to the legends of the market (think Buffett, Templeton, Lynch, Gross) who have outperformed a market index over long time periods. On the other side, as many brilliant minds point to statistics which show the majority of active managers underperform the index after fees over long time periods, and of course there will be some above average in a sample of thousands – that's how probabilities work in any game of chance.

The professors can't agree, what hope for mere mortals?

The debate had another run this week when the Nobel Prize for Economics was shared by world-renowned professors with opposite views. In one corner is Professor Eugene Fama, who gave us the modern efficient markets theory that share prices incorporate all available information and there are no mispricings to exploit to consistently deliver outperformance. Fama's conclusion in [his paper](#) (with Kenneth French), Luck versus skill in mutual fund performance, was:

“Going forward, we expect that a portfolio of low cost index funds will perform about as well as a portfolio of the top three percentiles of past active winners, and better than the rest of the active fund universe.”

The other Nobel winner, Professor Robert Shiller, says of efficient markets, “the theory makes little sense, except in fairly trivial ways”, and he draws on behavioural science to show the human errors involved in market pricing. He emphasises the extent to which individual investors misperceive and overreact to information.

Outperformance comes in many guises. Rosalind Hewsenian, CIO of a major US charitable trust and an investment consultant from 1985 to 2006, in this [excellent article](#) called ‘Beating the market has become nearly impossible’ (Institutional Investor, 18 September 2013), says:

“Most of my career was dominated by the twin rallies of the stock and bond markets. Alpha was generated by simply tilting risk a little higher than the markets generally and you could outperform.” (Note: alpha is a measure of excess returns).

Most asset managers do not accept such a humble and self-deprecating explanation.

About 80% of securities listed on the ASX are owned by institutional funds, domestic and foreign, each managed by highly qualified and skilled experts. There are thousands of stock pickers and analysts, all educated at the best universities in the world and most with decades of experience. They are the market and they own the index, and some will underperform and some will outperform. A few will look really good, and they will win awards and attract money. But how do we separate skill from chance? For example, the probability of making 60 correct guesses out of 100 coin tosses is about 2.8%. So if we have, say, 100 participants who guess a coin toss every month for 10 years, about three of them will correctly guess 60 out of 100. Are these the celebrated fund managers who have outperformed all the others? Surely, a decade of excellence in coin-tossing proves their added skill. But then what happens next year, on the next set of tosses?

The latest ‘Index Versus Active’ scorecard

So it is opportune that in the same week as the Nobel Prize announcement, the updated SPIVA scorecard was released. This is a tortured abbreviation for the Standard & Poors’ (SP) Index Versus Active (IVA) scorecard. The report is issued semi-annually, the latest for mid-year 2013, and it tracks the performance of actively-managed Australian funds versus their benchmarks, corrected for survivorship bias.

The comparisons of active versus index over only 12 months are not much value. For example, in the year to 30 June 2013, 60% of active Australian equity funds outperformed the S&P/ASX200 Accumulation Index, but in the previous year, 70% underperformed over one year. Longer time periods must be studied.

The results over five years, summarised in the table below, are:

- the index outperformed over 60% of active Australian equity funds, and over three years, 68% of managers lagged their benchmarks
- 82% of small cap Australian equity managers actually outperformed their index. This occurs over all periods studied in the report. There are two reasons usually given why small cap managers consistently outperform their index. First, the index includes many speculative small resources companies with a dream but no decent cash flows, which eventually collapse, and managers often avoid these disasters. Second, small caps are less analysed than ASX100 companies, and it is possible to identify undervalued gems with excellent prospects
- 79% of active international equities underperformed their index, and 88% over three years
- 64% of active Australian bond funds failed to beat their index
- 60% of active Australian A-REIT funds failed to beat their index (and 87% in the last year)
- Only 81% of the asset managers from five years ago still exist.

It’s not much of a scorecard for the millions of hours of number-crunching and company visits by talented active managers. Or are they all so talented that they cannot beat each other?

| Report 1: Percentage of Funds Outperformed by the Index | | | | |
|---|--------------------------------|--------------|----------------|---------------|
| Fund Category | Comparison Index | One-Year (%) | Three-Year (%) | Five-Year (%) |
| Australian Equity General | S&P/ASX 200 Accumulation Index | 36.42 | 67.63 | 60.41 |
| Australian Equity Small Cap | S&P/ASX Small Ordinaries Index | 6.12 | 11.54 | 18.10 |
| International Equity General | MSCI World Ex Australia Index | 75.52 | 88.04 | 78.97 |
| Australian Bonds | UBS Composite Bond Index 0+Y | 37.74 | 67.27 | 64.29 |
| Australian Equity A-REIT | S&P/ASX 200 A-REIT Index | 86.96 | 79.80 | 59.22 |

Source: S&P Dow Jones Indices, Morningstar. Data as of June 30, 2013.

Ironically, S&P believes active management provides a useful role, since the massive amount of research undertaken keeps prices close to fair values and allows index investors to take a free ride without paying the costs. They call this a 'fragile equilibrium', and quoting William F Sharpe:

"Should you index at least some of your portfolio? This is up to you. I only suggest that you consider the option. In the long run, this boring approach can give you more time for more interesting activities such as music, art, literature, sports and so on. And it very well may leave you with more money as well."

It's your call, depending on who and what you know. If you think you can identify the few managers who outperform the index consistently over time, either by research or based on advice, go for it. At least you'll have more fun watching him (it's always a man) explain the variability to the index and why his style did not work last year. If you don't have an opinion, or don't have the time, stick to an index. If there's one thing you can control, it's the cost, and the range of index funds now available allows wide choice to implement most asset allocation strategies.



Published 10 September, 2014

This short series looks at some product shortcomings which could materially affect whether an investment is appropriate. An investor wanting a broad exposure to the market in a single investment has three main alternatives: unlisted managed funds, listed investment companies (LICs) and exchange traded funds (ETFs). We will focus on some weaknesses in each of these three product types. The [first part](#) in the series looked at LICs, and this article goes inside managed funds.

The main problem for unlisted managed funds is that investments are combined with all other money in a pool, and the actions of others in the pool can adversely affect an individual. The 'open-ended' structure requires shares to be bought and sold within the fund as investors come and go. This contrasts with a 'closed-ended' product such as LICs where purchases and sales are made on market with other investors.

In the industry, it's called 'watch your neighbour' – what are other investors in the pool doing?

Examples of unwelcome impacts of pooling

The pooling of investors can have a significant impact on the returns of an individual.

1. Capital gains tax liability

When an investor withdraws from a fund, some shares may be sold to meet the redemption, potentially creating a capital gains tax liability. However, the capital gains liability does not go to the departing investor, but is left for those remaining in the fund when distributions are made. This can be a particular problem if many investors leave and few remain. When the fund makes its distribution, a large taxable capital gain liability may fall on the 'last man standing'. In other words, because investors move into and out of managed funds at different points in time, taxation liabilities in respect of gains that benefited past investors may be passed on to subsequent or remaining investors.

2. Loss of franking credits

Franking credits are only paid to investors receiving a distribution, and the value of the franking is not included in the unit price. An investor who departs a managed fund just prior to distribution leaves the full franking behind, and this may be a material part of the entire return. In fact, those in the know can arbitrage the fund if they know a large franking credit exists for a limited number of investors at distribution time. (Note, one fund recently started grossing up its unit prices for franking credits).

3. Managers forced to sell as investors panic

Investors are notorious for selling when the market falls and buying when the market rises. This can be problematic for open-ended funds because portfolio managers may be forced to sell even when they think the market offers excellent

value. If they have to meet redemptions and no new money is coming in, it does not matter what the manager thinks about the market. They become frustrated net sellers at discounts to their own valuations, then as the market recovers and inflows return, they become even more frustrated having to invest at higher prices. While one investor can remain patient, the fund is forced to act due to other investors in the same pool. A closed-end fund does not need to meet redemptions when prices are low nor invest when prices are high.

4. Unrealised gains or losses

There is no allowance in the unit price for unrealised gains and losses in the portfolio, and this can have implications for the future taxation of the fund. Two funds may be otherwise identical but the one with large unrealised gains will give a higher capital gains tax liability to its investors after shares are sold than the one carrying unrealised losses.

5. Suspension of withdrawals

During times of market disruption, such as experienced by mortgage funds during the GFC, the liquidity of the underlying assets may not be sufficient to match the level of redemption requests. The fund manager may have no choice but to suspend redemptions. Managers advise in their PDS something like:

“Any decision whether to process withdrawals will be made in the best interests of investors as a whole. Under abnormal market conditions, some normally liquid assets may become illiquid, and we may restrict or delay withdrawal payments.”

Again, the actions of some investors in panic mode may lead to the suspension of redemptions for the more patient and calm investors, and if the latter need to withdraw for some reason unrelated to the market, their funds might not be available.

6. Converting capital to taxable income

Distributions from a managed fund are based on the number of units that an individual owns on the distribution date in proportion to all units in the fund. The unit price (similar to the price listed on the ASX) of the fund will fall by the amount of the distribution immediately after it is paid. An investor buying units immediately before a distribution may be generating a tax liability without a return on the investment. For example, assume a unit price of \$2 and a 10 cent distribution on 7 July. On 8 July, the unit price falls to \$1.90 and the investor may receive a taxable distribution of 10 cents. Capital has been converted to taxable income due to the timing of the investment.

Your neighbour can bite you

Managed funds are far more complicated than most investors realise, and behind the scenes, trustees often have to deal with problems related to fair treatment between unitholders. The investor who does not know the portfolio's realised and unrealised capital gains, the potential loss of franking credits, the timing of distributions, the inflows and outflows of the fund and the risk of suspension is buying into a world of uncertainty.



Published 25 July, 2014

“Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years.” Warren Buffett

Imagine two portfolio managers, Jack and John, who are both responsible for Australian equity portfolios for large funds management businesses. They both have offices overlooking Sydney Harbour, and are supported by large teams of analysts. John manages three billion, Jack about four billion. For 20 years, both have arrived in the office by 7:30 am to prepare for the first meeting of the day, having already read their emails and checked Bloomberg and Reuters at home. They are well known in the market and are often interviewed on television to give their market views.

They are both Masters of the Universe, and to the casual observer, they seem to be doing the same job. But they have completely different styles.

John markets himself as index agnostic, and he is not active in terms of portfolio turnover. He prefers to hold a relatively concentrated portfolio of less than 25 stocks, backing his judgement and not owning a bit of everything. For the majority of the time, he is happy with the way his portfolio is set, he has a good understanding of the investee companies' long term prospects, and there's usually little which suggests to him that he needs to change his portfolio. On most days he does not do a single trade, although it has taken him the best part of 20 years to learn this discipline. His portfolio turnover is only 15% annually. In the last decade, he has beaten the index by 3% per annum, making him a top quartile manager. As a younger man, he found he was often trading just to look busy, and it was only when he had nothing to prove that he felt confident doing nothing. In fact, he now has time to spend some mornings with his wife, and he tries to amaze her and leave early to cook dinner.

Jack's portfolio includes 70 of the ASX100, with most large companies close to their index weight. He is continually rebalancing back to index, selling companies which have risen and buying companies which have fallen. He has also delivered good results over the last decade, about 2% over the index. He finds outperformance, or alpha, through intimate relationships with the major brokers in town. They tell him whenever they hear anything, and he quickly buys or sells a stock before the story is on the street. He often reverses his trade a few hours later. He rarely claims to have any great insights into a company's long term prospects, but he just stays a step ahead of the market. His portfolio turnover is over 200% a year. He stays close to the screens and phones all day, and demands any broker with news contact him first or face a black ban. He pays handsome brokerage, with the large firms earning \$5 million a year from him. He does not know or care how long he has held any individual stock. He's never home early.

How do you manage your portfolio?

Who do you want to manage your money? If you are a direct investor, where do you stand on active trading? Both Jack and John have their strengths and weaknesses, and in my career, I have worked with both types and they've done well. In reality, most investors are somewhere between these two extremes, with elements of 'buy and hold' and 'trade opportunistically'.

Personally, for my own investing, I'm more in John's camp of 'buy and hold'. In fact, I find it much easier to recommend changes to other people's portfolios than my own. Maybe I'm less emotive when it comes to other people's money and can see other opportunities, but some of the benefits of John's approach include:

- More likely to detach himself from market emotion and not be spooked by short term movements in share prices
- Low turnover means lower costs and he takes advantage of the capital gains tax (CGT) discount on shares held for longer than 12 months
- Smaller portfolio may mean a more intimate knowledge of the investments.

But it's not all plain sailing. A 'buy and hold' strategy may ignore how poorly some sectors and stocks can perform over time, and fails to recognise the need to change at certain points of inflexion. Few if any businesses are immune from challenging conditions. Just ask the executives and investors in companies like Kodak, destroyed by digital processing, or Blockbuster, impaired by online movie downloading.

It's easy to think BHP must have been a good long-term investment, but as Ashley Owen wrote in [Cuffelinks on 24 October 2013](#), its share price in real terms has moved little over 125 years.

"BHP shares peaked at £413 in February 1888 at the top of the late 1880s/early 1890s silver and lead mining boom. That's \$34.70 in today's dollars in real terms after CPI inflation and after accounting for all of the splits and changes in capital structure over the years. People who bought BHP shares at the top of the 1888 mining boom had to wait 75 years for the share price to recover in real terms after inflation. BHP is still only \$36 today as I write this in October 2013, some 125 years later!"

Why do I resist over-trading?

No doubt there were good trading opportunities in BHP along the way, so what other reasons cause me to resist over-trading?

- transaction costs
- the paperwork (which I dread)
- taxation leakage (if I have made a profit)
- loss aversion (if I am carrying an unrealised loss then, rightly or wrongly, I often just want to 'stay in there' to prove it will come good)
- not wanting to become a 'trader' where gains are taxed on income account rather than capital account (although this is a fuzzy piece of tax law)
- not having carry forward losses that gains could be offset against
- the reported experience of traders, who often seem to lose money by being too flighty in their positions and opinions.

I believe taxation leakage is one of the more important considerations when selling a stock. A portfolio manager may be happier to actively trade on behalf of a tax exempt fund (though always watching the 45-day rule to avoid losing franking credits) but should be more hesitant about realising a gain where they are a taxpayer (whether 15%, 30% or 45%). The time value of money paid to the ATO becomes an important calculation.

On the other hand, some experienced fund managers believe tax is a secondary issue, and sell decisions should always be made on investment principles. I understand this view, but I'm not impressed if a portfolio manager generates a capital gain by selling a share after owning it for 11 months and three weeks (and losing the lower CGT concessional rate).

There's no right answer

Investment is more art than science, and I find these trade-offs a real dilemma in practice. Sometimes I think I have *finally* got my portfolio 'set' and then something happens that makes me feel I should change it (yet again!) but deep down this is an uncomfortable move.

I've often thought we need a formula that takes into account our tax rate, our concessional CGT rate, transaction costs, the value of carried forward losses, an estimated valuation on the stock versus its market price (an inexact task at the best of times), etc etc ... and, hey presto, the formula would spit out whether selling is a good strategy. And by the way, this issue applies equally to changing asset allocation as it does to changing securities within a specific asset class.

I personally manage an investment portfolio for a not-for-profit, tax exempt organisation that has nil brokerage fees thanks to the generosity of a community-minded stockbroker. I find myself regularly adjusting the portfolio both in terms of security selection and asset allocation (between Aussie shares, international shares, property, infrastructure and various fixed income securities). I find this rewarding (the portfolio performance has been very good, even if I do say so myself!), but at the same time challenging and somewhat tiring, like I am on a never-ending marathon.

But when it comes to my own personal affairs where I am definitely a taxpayer, until someone gives me a black box to work through the myriad of variables, I am much more of a 'buy and hold' investor, unless I need to sell for cash flow reasons. That said, there have been many times where I have kicked myself for not reducing exposure to particular stocks or asset classes when it looked obvious they were stretched in value.



Published 13 June, 2014

There is no easy way to make money. There are no shortcuts to building your retirement savings. Do not convince yourself otherwise.

This week, the ABC reported on yet another trading programme which appears to have lost lots of money for the people who signed up. The alleged culprit is 21st Century Eminis, which provides financial education and training services on how to become a successful trader. There is little in life that frustrates me more than to see people lose their hard earned savings on get rich quick schemes.

I have long been outspoken on this topic, including making submissions to ASIC and posting public notices on my advisory business website warning against such schemes. Unfortunately you have to be careful about how you word such public notices for various legal reasons. Simply put, whenever you are introduced to a scheme or an investment opportunity which sounds exciting, please repeat: "There is no easy way to make money". If you know a family member or a friend who is considering such an opportunity, say to them with passion: "There is no easy way to make money". It may be one of the most valuable things you ever do for them.

Retail investors are sometimes shown four possible shortcuts to financial success, each having a different path to potential failure.

1. Investment products which turn out to be fraudulent

A great (though 'great' is far from an apt description) example is Astarra (Trio was the trustee) which funnelled investors' money offshore never to be seen again. Worse still, Astarra products were recommended by financial planners. Another example is US-based hedge fund Madoff, the largest investment fraud ever seen.

Fraudulent schemes are highly likely to lose you money. They typically have an elaborate design and structure and the payoffs for a successful fraud can be huge. The Madoff hedge fund fraud is estimated to have cost US\$65 billion. If a fraud is cleverly designed it is extremely hard to identify. Before making any investment, you should undertake a thorough due diligence. If you are considering an investment then seek professional advice. Question the skills of your advisor and make sure the advice is truly independent. Astarra, for example, sponsored financial planning conferences and Madoff supposedly provided access to a network of high profile people.

Commonly, frauds promise outsized returns but some of the recent frauds (including Astarra and Madoff) only targeted good solid returns, thereby avoiding people's fraud radars. Finally, diversify – it sounds simple but unless you are so confident you have identified something truly amazing and unique (which is unlikely), then diversification makes sense. Question your own skills. Are you really someone who can identify the needle in the complex investment haystack?

2. Investment products which involve leverage

The underlying assets of these investments vary but the constant theme is leverage. Infamous examples here include Storm Financial (leveraging up equities, and in some cases leveraging up leveraged equity funds), or investors providing leverage to property businesses (Westpoint, MFS Premium Income Fund, City Pacific and EquitiTrust). Once again many of these investments were recommended by financial planners, possibly swayed by large commissions.

Leverage has its place in the hands of professionals. In theory leverage has a proportionate effect on risk (an investment in a risky asset with a volatility of 10% combined with a 200% exposure to this asset becomes a leveraged investment with 20% volatility). However in practice the risk created by leverage is much more complex because there are many other risks that come with managing a leveraged product such as maintaining the leverage ratio or margin requirement, particularly in periods of market stress when the underlying assets may be volatile and illiquid. For any investment it is important to determine if leverage is used, how much is applied and explore any risks that may result. If this is too complex for you then stay away. Leverage does not always guarantee disaster but it does create greater risk of disaster.

3. Trading programmes and software which fail to deliver

This takes the form of software or training courses that teach you how to become a successful trader, often promising large financial returns and even the potential to give up your day job and become a home-based trader.

With trading programmes (software and education) I maintain a high degree of scepticism. After 17 years in the investment management industry and having visited thousands of investment managers and hedge funds I know it is difficult to develop a set of trading rules guaranteed to perform. If someone did find something special do you really think they are likely to share this with the world? Surely they would either trade their own money or create a hedge fund to earn the associated performance fees. Either of these approaches would also protect their trading secrets.

While there is much debate among academics about whether markets are efficient or not, I work on the basis that markets are broadly efficient. I believe that simple models will fail to generate outsized returns for the risk taken, a point I have proven to myself (and my uni students) many times! Many trading programmes use underlying instruments with embedded leverage such as futures, margin FX and CFD's (contracts-for-difference). These instruments are dangerous in the hands of the uninformed. If you do not understand them then do not touch them.

4. Tax-driven investments

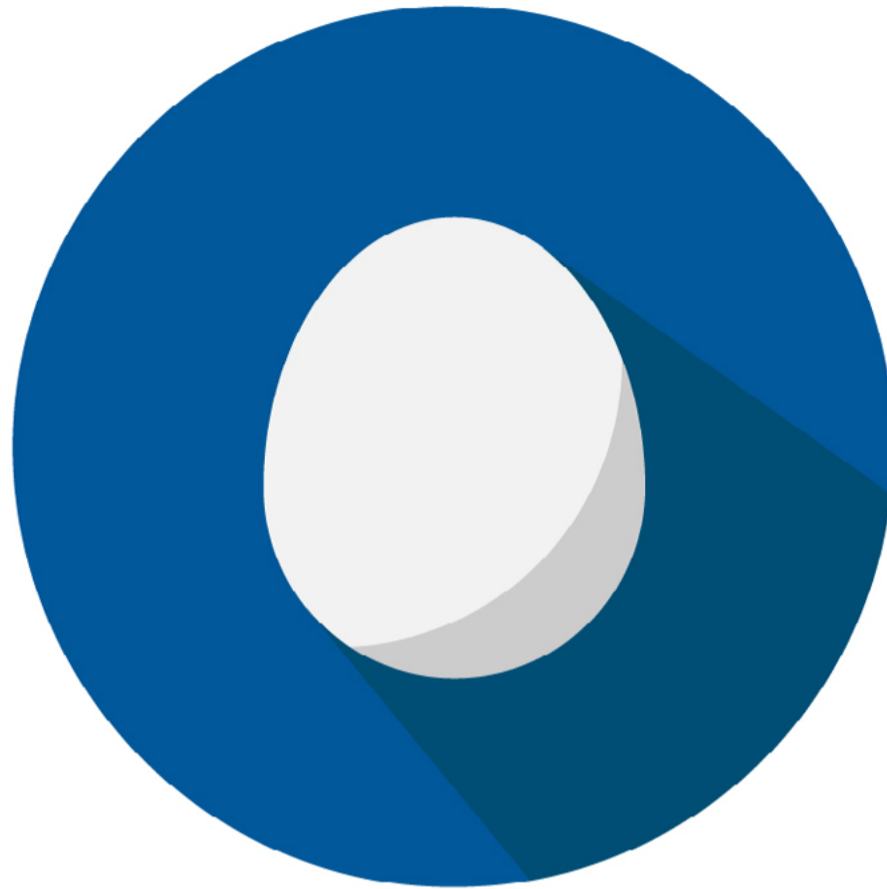
This is where tax benefits are a major driver of the investment outcome. Agriculture schemes, most notably Great Southern and Timbercorp, are the most prominent (read painful) recent experiences.

Tax-driven investing can be complex. The risk is that chasing a tax objective may lead to money being placed with people ill-equipped to handle the day-to-day business of managing the assets and finances of the investment vehicle. If the business activities are mismanaged, then the investment vehicle may not survive to provide any tax benefits at all.

Always be wary of terrible governance practices. Prime Trust is a distressing example where exorbitant payments were made to the founder. While poor governance can exist anywhere there seems to be a greater risk away from mainstream investment opportunities.

I hardly paint a pretty picture for get rich quick schemes. Really, none of this article should be new information. If it is, then you are vulnerable to these risks. If you are presented with an opportunity that looks really exciting, make sure you remind yourself that "There is no easy way to make money".

In July 2014, David will cease his independent consulting and become the Chief Investment Officer at AUSCOAL Super. He teaches the Hedge Funds elective for Macquarie University's Master of Applied Finance.



Superannuation

Former Treasurer and Prime Minister, Hon Paul Keating, explains where our super system came from and where it is going. Australia's first Minister for Superannuation and Corporate Law, Nick Sherry, criticises the complexities of our super system, and Australia's foremost futurist, Phil Ruthven examines the future of super and wealth. Chris Sozou argues insurance should not be in super, while Chris Cuffe takes a look at the state of the wealth management industry.

The most complex super system in the world

by Nick Sherry

Published 16 October, 2014

Over the past 25 years – the last two in particular – I have examined closely, and in some cases worked directly with, a range of defined contribution pension systems around the world. This includes key aspects of their design and operation, particularly in the UK, Hong Kong, Switzerland, Chile, Ireland, Greece (no finalised systems) and Colombia. The analysis includes key benchmarking against a range of countries. Australia is always included.

The Australian strengths are clear and include compulsory, defined contributions; diversified arms-length investment; independent trustee governance; firm prudential oversight; independent dispute tribunal; compensation in the event of theft and fraud and others.

However, on any analysis our system is the most complex compulsory defined contribution system in the world, mainly because of the number of electable options and decision-making choices that can or should be made by an individual.

And I am not referring here to the fund or investment decision or the tax overlay, which receive considerable attention in public policy debate.

Complexity adds to cost

Ideally a system should be simple to understand, so simple that an individual can effectively make decisions themselves, to the extent permitted in a compulsory system. Simplicity matters because complexity is cost and cost reduces a member's return particularly in a defined contribution system.

The costs and various system-wide fee analyses have been highlighted from time to time, for example, in the recent [Grattan Institute Report](#) (although they make some good points, I disagree with parts of their analysis and policy suggestions) and the Cooper Review (which I established as a Minister).

The critical question is what drives this cost? Valid reasons include the lack of a centralised administration hub, the number of funds (related to this is a lack of scale in some cases), the number of investment options, the conflicted fees or commission related to advice and product selling and others.

One key aspect of the Australian system that receives little critical attention is the considerable number and range of electable options and decisions available to the individual. The range of electable options is not available in any other compulsory system.

Examples of our highly complex system

Our super funds include, in addition to the availability of fund and investment selection, such complexities as:

- insurance – TPD (Total and Permanent Disability)
- insurance – salary continuance and unemployment insurance
- consolidation – rolling together multiple accounts
- estate provisions
- early access in a range of defined circumstances.

Furthermore, we have made the area of contributions complicated with:

- salary sacrifice – concessional
- other after tax contributions – non-concessional
- co contributions for low income earners
- splitting of contributions
- children accounts
- transition to retirement at age 55
- spouse contributions

Some other countries may have a few of these options but nowhere near this range of complexity. The newest defined contribution systems in the UK and New Zealand do not have insurance or estate provisions or most of the above.

Australia also has further complexity in the post-retirement space. In addition to allowing lump sum withdrawals (as other defined contribution systems do), there is also a means-tested government pension. No other advanced economy with such an extensive defined contribution system has this provision.

Are we maximising retirement incomes?

This complexity drives up cost in two main areas – administration and advice (or selling depending on your perspective). This is on top of the additional complexity and cost arising as a result of individual fund and investment selection.

It further leads to a fundamental question in a compulsory defined contribution system that is supposed to be for retirement. Is all of this necessary to maximise the retirement income of the individual?

A critical analysis and debate should consider some of the following in an attempt to reduce the complexity:

1. Insurance in super. If contributions are inadequate, why is insurance – particularly disablement and salary continuance – appropriate in super? It diverts resources from retirement income.
2. Estate requirements. Why the need for a parallel and separate system to deal with an individual's super property in the event of death?
3. Transition to retirement at the age of 55? The pension age is 65 going to 70!

Concluding comments

Australia has the most complex defined contribution system in the world, both pre- and post-retirement.

Other countries have undertaken a more careful analysis and considered debate. Certainly, the Australian experience as an early mover has been very helpful to other countries in realising, at least in some areas, what not to do. The main point is to avoid complexity to the extent possible and keep it simple.

Nick Sherry was a member of the Australian Senate from 1990 to 2012, Chair/Deputy of the Senate Superannuation Committee (overseeing the Super Guarantee and SIS Legislation), the first Minister for Superannuation and Corporate Law (responsible for ASIC and the superannuation divisions of APRA and the ATO), Assistant Treasurer and many other roles. He now consults to financial providers, governments and international organisations around the world.

Superannuation and our growing wealth

by Phil Ruthven

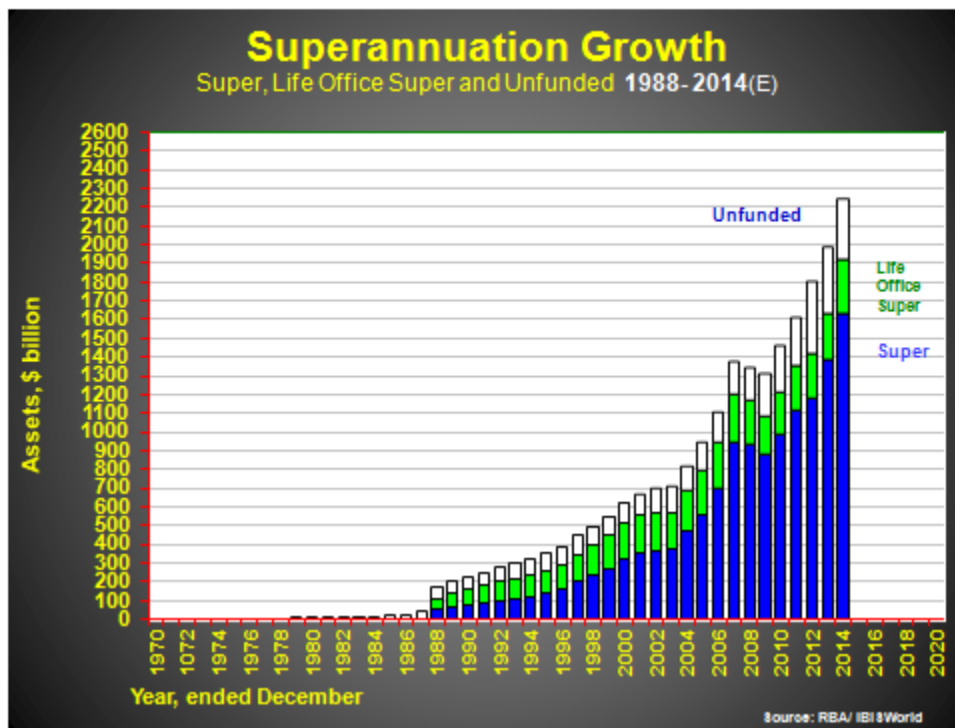
Published 2 October, 2014

Universal superannuation became an embedded component of the savings and wealth accumulation of workers some 21 years ago; a coming-of-age in 2014, so to speak. Only retired, non-working and some self-employed households missed out on the compulsory saving as part of employee's remuneration, although voluntary contributions were to rise as well.

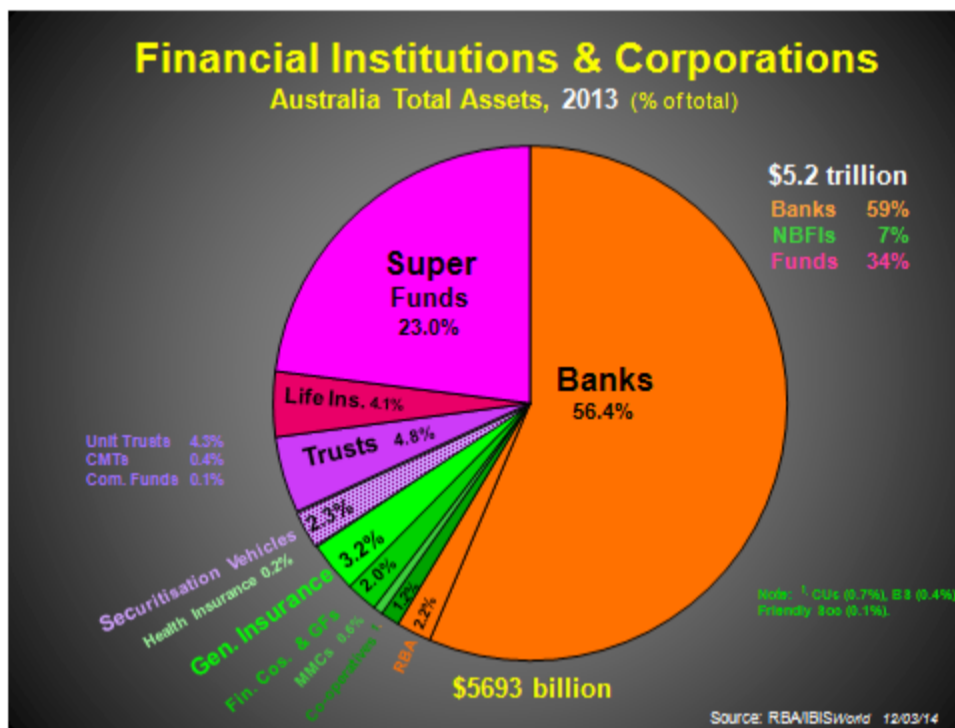
Of course, Life Offices had been offering retirement benefit packages for a long time in the form of *industrial* (weekly payments), *ordinary* (monthly payments) and *superannuation* type policies, of which only the last mentioned is of any significance today.

And government employee retirement benefits had also been around for many decades, usually unfunded, with retirement benefits paid out of current government receipts from taxes and Government Business Enterprises surpluses. That unfunded legacy is with us today, but addressed to some extent by the Howard/Costello Government while it was in office via the Future Fund.

The first chart shows the spectacular growth of superannuation assets, only temporarily reversing for two years during the onset of the GFC.



PR Picture1 031014Assets will pass \$2.2 trillion this year, from less than \$100 billion 30 years ago. They will account for nearly 30% of the total assets of all financial institutions by the end of 2014, with banks diluted from an 80% lion's-share of all assets up to 1940, to around 55% today. Still dominant. The second exhibit provides perspective in this regard.



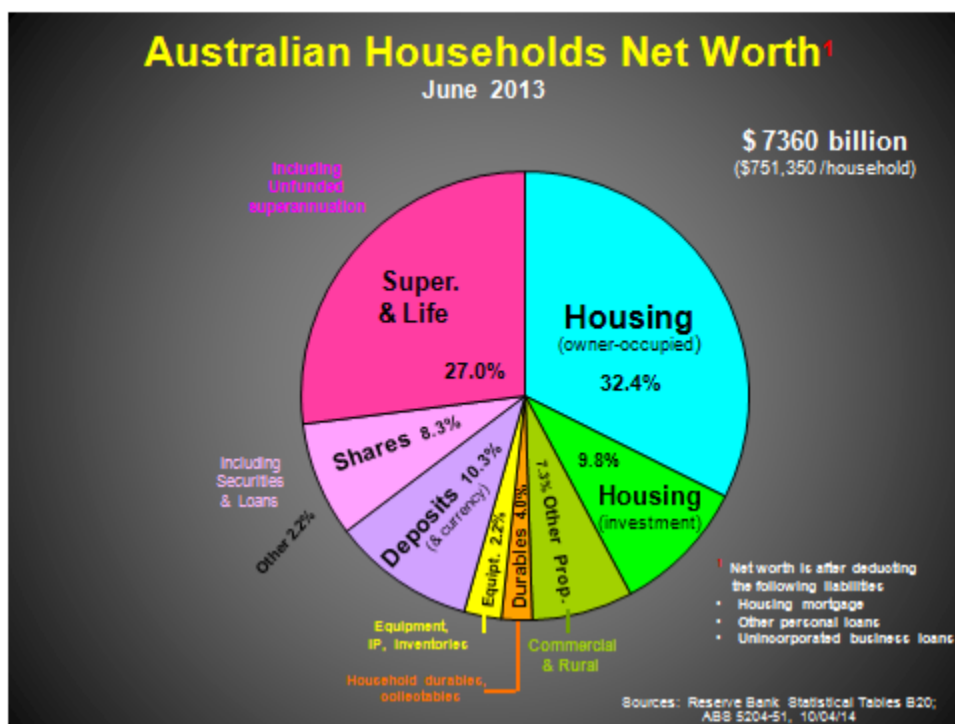
PR Picture2 031014At the end of 2013, approaching half the superannuation assets were in local shares (where they control nearly 60% of the ASX by capitalisation), 17% in overseas assets (including shares), 14% in bonds and other securities, 13% in cash and deposits, and the balance in property and other assets.

Clearly, superannuation has become an important part of household net worth as the third exhibit highlights.

At 27% of average household net worth of \$751,000 in mid-2013, it is well ahead of investment property (16%) and is likely to overtake the value of owner-occupied housing (32%) soon.

Indeed, financial assets in total – including super, shares and deposits – are poised to overtake all hard assets (property, equipment and durables) within a few years. Some 25 years ago, financial assets represented 35% of net worth (including 11.4% in super). By the end of this year, the ratio will be over 50% with 24% in super.

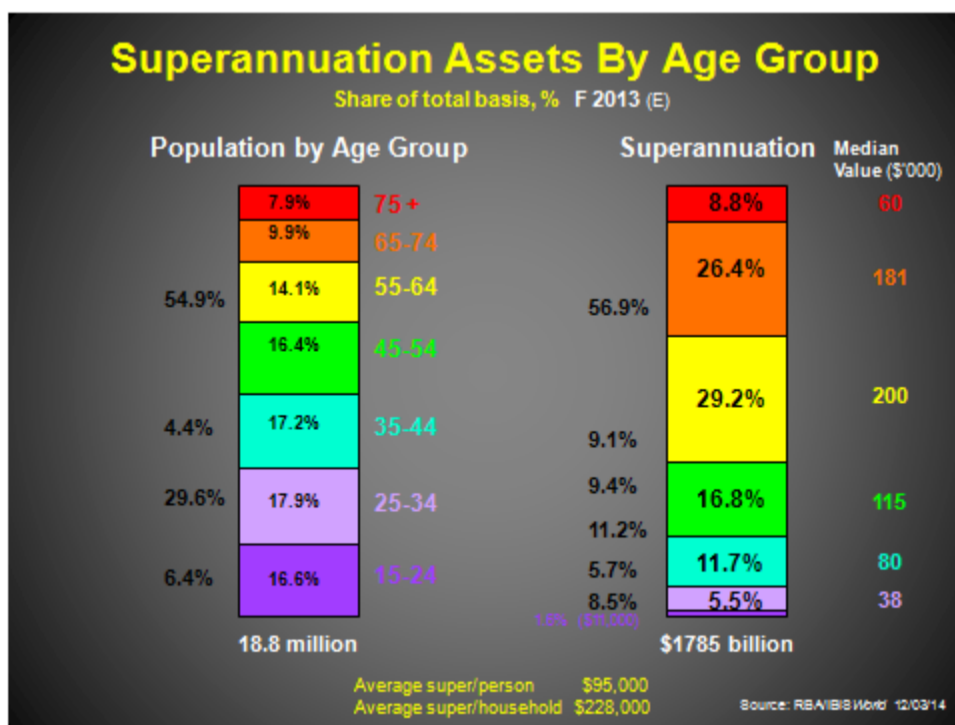
This is a very positive development, as hard assets only yield a modest rental return plus capital gain, and never match the returns from active assets, notably shares.



PR Picture3 031014 So how much super does one need to have to be able to retire independent of the pension and with dignity? Twice as much as the average home, meaning that a home should no longer be regarded as the biggest investment of one's life, as was the claim for much of the post-WWII years (although with a wide diversity of property values, every person's position is unique).

Average household income for the 9 million+ households of the nation will be just over \$150,000 by the end of 2014: yes, surprising as that figure is. It is suggested that retiring on a one-third share of average household income is a desirable goal. In turn, this would suggest a nest egg of around \$830,000 taking out 6% each year and leaving enough to grow the capital in line with inflation.

Currently average super sits at around \$100,000 per person or \$240,000 per household in 2014, but this includes young people and households as well as retired ones. So a look at the differences across age groups is helpful in seeing how close we are to 'dignified retirement' at present, as the final exhibit shows.



PR Picture4 031014 It suggests that recent retirees (aged 65-74) have a median value of super of \$181,000 per person, or around \$360,000 per household, or 40-45% of the 'dignified retirement' level. The even-older households are generally pensioners, with less than \$75,000 per household in super (much of it via Life Offices).

Being averages, a minority of these age groups live comfortably, but most – perhaps over two-thirds – would be living a more abstemious lifestyle.

The younger Baby Boomers are currently the best-off in super, with over \$400,000 per household and the capacity to improve on that level with a continuing working life for a decade or more. Their average could edge up towards 55-60%

of the desirable level if they work long enough. Again, some retirees in this age bracket will easily reach a comfort zone. Generally, only a third or so of Baby Boomers (49-71 years) will retire with their wished-for comfort and dignity.

So, it is not all that salubrious, reminding us that we have a long way to go. It will take at least two generations (of an average of 20 years each) from 1993 to achieve the desired level of comfort for retirees. The Net Generation (12-32 years old) and the youngest of the Gen Xers (33-48 years old) are the first of the retirees likely to be comfortable. In theory, provided they have super and assuming no interim catastrophes and set-backs. But we are on the way, and leading the world.

Phil Ruthven AM is Chairman of IBISWorld.

Does insurance belong in super?

by Christopher Sozou

Published 29 August, 2014

The establishment of the compulsory Superannuation Guarantee was in recognition of the unaffordable nature of the pension system, given the demographic shift that the baby boomers would create in coming decades. It forms a major pillar in Australia's retirement savings framework whereby retirement income is funded by:

1. the safety net of the pension system
2. superannuation savings including voluntary and compulsory contributions
3. personal savings.

After only 20 years, Australia has created a savings pool that is the envy of the world.

Interestingly, there is nothing in the above which addresses insurance needs, yet life and TPD (total and permanent disability) insurance are playing an ever-increasing role in superannuation. There is little written about why insurance was included in the superannuation architecture, but one can envisage the logic went something like this:

- superannuation is a compulsory system and every working Australian should have at least one account
- there is an underinsurance problem in Australia
- we can solve the underinsurance problem if we default insurance in super
- if we try hard enough, we can make a link between life and TPD insurance and retirement income.

Insurance seems to be increasingly important in superannuation, whether it be the large increase in premiums in the last couple of years, or the entire section dedicated to insurance in the Super System Review recommendations (otherwise known as the Cooper Review). ASIC lists insurance as one of six key considerations in picking a super fund, while the acknowledgement of consideration of insurance is mandatory in accepting a super rollover form. For SMSF trustees, it is now mandatory to consider insurance as part of the SMSF's investment strategy. Insurance is well and truly imbedded into the superannuation system.

Yet the question that does not seem to be asked is, "does insurance belong in super?"

The main objective of the super system is to alleviate the pressure on the age pension system. This gives us the 'sole purpose test' which ensures a super fund is maintained to provide benefits to its members upon their retirement (benefits can be released prior to retirement age, but these are only under special circumstances).

Contrary to the sole purpose test, life and TPD insurance provides protection primarily for the current day, whether for a member's family in the event of death or the member themselves in the event of a permanent disability. The Cooper Review's justification for this was that:

"Superannuation funds are generally structured towards financing a period of retirement after a long engagement in the workforce. Fortunately, that is the experience of most members. However, for a significant number of members each year, total and permanent disability (TPD) or premature death mean that they or their dependants need to call on their superannuation savings much earlier and for a longer period than they would have expected. Insurance plays a crucial role in allowing those needs to be met."

This explanation is not a very convincing link but given the noble purpose outlined, it should not be an issue provided that it does not impact the functioning of the superannuation market.

And this is where things get interesting. Superannuation provides for a retirement outcome. The decision on which superannuation fund is the right fund for an individual is in itself a difficult one, considering fees, service quality, investment options, performance and trust in the institution. Insurance on the other hand provides protection for the current day. In selecting an insurance provider, an individual would consider the level of cover, premiums, service quality, policy exclusions and trust in the institution.

The problem with defaulting insurance in super is that it distorts the decision-making process.

For example, an individual may want to change super funds because they are not happy with the features and service levels of the incumbent fund; however their insurance offering is excellent. What decision does the individual make? Do they compromise their retirement outcome due to their present day insurance needs?

Conversely, a member's superannuation fund may experience a large increase in insurance premiums. Does the member change super funds as a result, even if they are happy with all other aspects of their fund?

Both scenarios create difficult decisions for members and more importantly distract from what a superannuation decision should be based on, engaging with members on their desired retirement outcome.

From a super fund's perspective, there is the time, effort and cost invested in managing insurance within the fund, whether negotiating a policy's premium rates, managing data to support the group underwriting process or managing the claims process. All this distracts from the sole purpose of maintaining a superannuation fund for the purpose of providing benefits to its members upon their retirement.

In trying to solve an under-insurance issue, we have added cost and complexity to superannuation for both product providers and members. The further question is, does the social benefit outweigh the additional cost and complexity?

Christopher Sozou is Head of Wealth at Virgin Money.

We're living longer and so should our superannuation

by PJ Keating

Published 23 February, 2013

On 28 November 2012, I delivered the keynote presentation at the Association of Superannuation Funds of Australia (ASFA) conference in Sydney. My presentation focused on the future of superannuation and the retirement system in Australia. This article examines why it might make good sense for the government to be the key provider of a national annuity scheme, to cater for what is now a growing gap in our retirement incomes system as a result of people living longer.

But first, let's look at where scale superannuation came from.

Our retirement income system is built on three pillars:

- the means and asset tested age pension
- compulsory superannuation
- tax-assisted voluntary superannuation.

The big leap forward came with occupational superannuation which morphed into compulsory superannuation with the introduction of the Superannuation Guarantee Charge (SGC) in 1991 and its extension to universality in 1992. That change was a defining one for Australia because few democracies can encourage their workforce to save at least 9% of their wages and even more on top of that voluntarily. But Australia did. And it was my Government that achieved this through the unlikely combination of:

- a centralised wage fixing system
- a formal government policy structure with the workforce (the Accord)
- the Government granting a structural concession for cyclical prudence (wage restraint)
- a supra-boost to productivity coming from a decade of macro and micro-economic policy reform with trend productivity doubling
- affordability for the compulsory SGC paid by employers coming from a sharing of that productivity gain with their employees.

And since then a further 3% of compulsory savings has been approved by the current Government, which will take the compulsory portion up to 12% by July 2019.

This extraordinary combination of events now allows Australians, unlike most citizens of other countries of the world, to bridge the income gap from work, through and into retirement. But it is now clear that the current system does not provide enough because people are living longer now than when my Government created the scheme for them. We built something that took people from age 55 to 75, but these days, if you reach 60, you have a reasonable likelihood of getting to 85. And the numbers continue to change materially with every decade that passes.

So, we have two groups in retirement – a 60 to 80 group and an 80 to 100 group. The 60 to 80 group is all about retirement living and lifestyle, which I think the current superannuation system adequately caters for. But the 80 to 100 (which is technically, the period of life beyond the previous life expectancy) is more about maintenance and disability and less about lifestyle.

I don't believe the current system caters for this. The policy promise of a good retirement cannot be fulfilled with such longevity, and so, the promise has to change.

At the ASFA Conference, I talked about two possible approaches to this problem:

1. People keeping some of their superannuation lump sum, which they generally receive at age 60, until later. This would be achieved by a portion being compulsorily set aside in a deferred annuity – a pre-payment which kicks back in at say 80 or 85 years. This would mean that the compound earnings on say 20-25% of the lump sum would accumulate between say the ages of 60 and 80, to be available on a deferred basis from 80. In essence, a significant proportion of the lump sum would be 'preserved' or 'set aside' for the much later years, including the years of longevity if there are such years. If there are not, the residual value of the deferred annuity would go to the person's estate.
2. An alternative would be for a further 3% of wages (taking us from 12% to 15% in all) to be devoted to health – maintenance, income support and aged care.

While I think the second alternative has the primary merit, I want to examine here the first alternative, but with a twist: the government as the annuity provider.

While I believe that private enterprise has been the appropriate outlet to provide for products and services for our country's compulsory superannuation system (and I have never been in favour of government mega-funds of the European variety), I do think deferred annuity structures are a different kettle of fish. So why do I think there is merit in the government providing a compulsory deferred annuities scheme?

There are a number of reasons:

1. Only governments can bear and pool risk across generations, and as the government also provides the default option, the age pension, it picks itself as the most likely, effective and reliable longevity insurer. Covering oneself for later life and longevity risk is pretty much a classic insurance task, but there is a case for an appropriate government agency to operate such a longevity fund. One thing is clear ... the longevity cohort, the high aged, requires absolute certainty as they have no room or ability to protect themselves.
2. While private enterprises are capable of providing deferred annuity products, they inevitably have to build into their pricing a profit margin as well as a 'regulatory margin' (the need to have a certain amount of assets supporting future promises to clients). As the government does not require either, it is able to offer significantly better deferred annuity rates.
3. The problem with later age, longevity and aged care is that capital markets have difficulty in managing that sort of risk. Private providers of deferred annuities find it problematic to adequately manage asset/liability mismatch meaning more 'regulatory capital' is required, with consequential lower returns to the end annuitants.
4. Albeit somewhat theoretical at this stage, I think the current 'Simple Super' changes underway in our superannuation system as a result of the Cooper Review provide the foundation for the government to play a competent role in the administration of a national and compulsory deferred annuity system. Standardised and systematic data protocols are well advanced and will soon be live, delivering an easy transfer of superannuation data between private enterprise and government.
5. With superannuation account consolidation (also an outworking of the Cooper Review) soon to be a reality, the government (via the ATO) is in the best position to know an individual's total superannuation account balance at age 60 and hence the amount required to be compulsorily set aside for a deferred annuity to kick in at a later date.

6. Through the experience of managing the Future Fund, the government now has a workable precedent for managing assets with a long term perspective, away from the day-to-day business of the government's own balance sheet.

A government-administered, universal, compulsory deferred annuity scheme would be a fully-funded scheme, with the capital provided by the annuitant from a portion of their lump sum superannuation benefit. This would mean that if there was any shortfall in the actual assets set aside and the liability due to the annuitant, the government would fund the gap. However, careful asset management with a long term horizon should ensure that any such shortfall should, over time, be insignificant.

I am still of the view that the compulsory superannuation component should increase further beyond the 12% level. People will recall that in the Budget of 1995, the Treasurer, Ralph Willis, announced that compulsory superannuation would rise from 9% to 15% over time. However, a change of government saw this initiative subsequently reversed, to the detriment of current retirement savings.

If the compulsory superannuation charge was increased from 12% to 15%, it would provide more options to adequately provide for the final phase in life, rather than relying on the age pension.

Hon Paul Keating was Treasurer of Australia between 1983 and 1991 and Prime Minister between 1991 and 1996.

The state of play in the funds management industry

by Chris Cuffe

Published 5 December, 2013

Chris Cuffe spoke recently at the Finsia Leadership Connect dinner, and this is an edited transcript of his speech.

The funds management industry is undergoing consolidation and evolving rapidly, under pressure to provide better service and high returns while cutting costs.

Total Australian superannuation system assets are around \$1.7 trillion – spread between self-managed super funds, industry funds and retail funds – that's around 100% of our GDP. Treasury forecasts suggest that super assets will grow to \$8.6 trillion by 2040, which would represent around 200% of GDP. To reach this level, taking inflation into account, it would require a compound growth rate of about 6 to 7% per annum.

In a recent speech, Paul Keating suggested that the superannuation system returns that we've achieved to date are not going to be repeated in the future. If you have a system that's reached 200% of GDP, it's probably mathematically impossible to have returns of 4–6% above GDP growth. We are likely to see significantly lower returns from our super investments into the future. As Keating points out, perhaps we should be quite satisfied with receiving a long-term return equal to nominal GDP plus 1%.

Fees

Assuming investment returns become materially lower than over the past few decades, the level of fees charged to manage assets will come under increasing focus.

I think we will see a material downward trend in fees which are based on a percentage of funds under management (FUM). This is partly because industry funds are moving towards managing funds in-house due to their obvious economies of scale and consequent cost savings. Most big industry funds in Australia are non-profit (or perhaps better termed 'profit for members'), and they only need to cover the cost of managing money, without trying to incorporate a profit margin. If these funds are growing bigger and need proportionately fewer staff for a given level of FUM, then the fees that a member pays for the management of their money will come down, and I see that as creating downward pressure on the whole industry. Put another way, we see one large segment of the industry that have a fee based on 'cost recovery' rather than a set 'per cent of FUM'.

It is important to also appreciate that most industry funds are now 'public offer', open to anyone to invest in, providing head-on competition to for-profit retail funds.

Similarly, SMSFs don't need a profit margin as they're managing for themselves. While many trustees of SMSFs may continue to use managed funds, many trustees are happy to directly invest. So there's downward pressure from this area as well. The SMSFs will continue to proliferate in my view, but possibly at a slower rate if the costs of having their money managed via external superannuation funds continues to come down.

Scale benefits

There has been a lot of talk about lower costs arising from mergers and scale benefits with the introduction of MySuper but I'm not completely convinced about that. I've always thought that if you took commissions out of products (e.g. with the FoFA reforms) you would see more competition, and you might not need the MySuper reforms in order to get lower cost products as well. Certainly though, one good aspect of MySuper is making the insurance offering compulsory given the apathetic nature of many people.

But in investment management and superannuation generally, there are both economies of scale and diseconomies of scale. For example, in my view it's very hard to manage an Australian equity portfolio that is larger than \$5–6 billion and can still generate alpha, whereas if you're managing a fixed-interest portfolio, scale is your friend. On the administration side of superannuation, people talk about 'unlimited scale benefits'. I question that. I think you reach a point where you've probably got it to the lowest cost per unit, and from there you plateau or you have diseconomies.

The demise of defined benefits schemes

The demise of defined benefits schemes has been absolutely profound both here and globally, and I contend it has not been a great thing. In the Western World, the accountants forced market movements through the financial statements of the corporates underwriting the schemes. This was untenable for corporates, so DB schemes have been closed and most of the population is now in defined contribution schemes. But the defined contribution system around the world has focused 'the system' way too much on short-term investing, which has led to a lot of problems.

UniSuper has the largest open defined benefits scheme in Australia. The scheme used to share the same pool of assets as their accumulation balanced fund. Some years ago, they separated it and invested it differently, investing on the defined benefits side by matching the liabilities to get the right return, without regard to the rest of the market. Interestingly, each year now, the defined benefits scheme significantly outperforms the defined contributions side.

It is hard to unscramble the egg and create defined benefit schemes again, because no employer or government will want to be the underwriter. But I think the right scheme going forward is a hybrid scheme, where you have something that looks like a defined benefit scheme, but without an underwriter. That is, you have a pooling of risk rather than an underwriter of risk. I think Australia would be much better served by something like that. But ironically, that would mean turning the clock right back to the first funds that we had in Australia and many other parts of the world, which came out of life companies; they had reserves and would manage the highs and lows of the markets by smoothing investor returns.

Accumulation phase versus the retirement income phase

Although the baby boomers are now moving into the retirement stage, annuity funds are not very popular (and never really have been in Australia or overseas). I think the reasons are pretty obvious: the returns offered are unattractive because of the need for a profit margin, the need to price uncertainty and also to hold sufficient regulatory capital. There is also the risk that the commercial organisation isn't going to exist in 20–30 years. There's a problem with matching assets with liabilities in long-term funds where people need a retirement income for 30 years. You can't easily buy a 30-year bond in Australia.

I think the Australian Government is extremely well placed to offer an annuity scheme, whether as principal or as guarantor, and could do so offering far superior rates to commercial operators. This is something that Paul Keating also believes in. In an article he wrote in Cuffelinks earlier this year, he said:

"A government-administered, universal, compulsory deferred annuity scheme would be a fully-funded scheme, with the capital provided by the annuitant from a portion of their lump sum superannuation benefit. This would mean that if there was any shortfall in the actual assets set aside and the liability due to the annuitant, the government would fund the gap. However, careful asset management with a long-term horizon should ensure that any such shortfall should, over time, be insignificant."

To me, this has a lot of appeal and would be a strong encouragement for people to better fund their retirement.

A quick reflection on regulation and risk

Particularly post-GFC, I think the burden of regulation has been excessive and in the super industry we have completely bastardised the term 'risk'. People use it in so many different ways, and it means different things to different people. What's happened is that people have looked at the downturn in investment markets and called that 'risk', and regulators have wanted to put new rules around it. But you can never find the rules to solve investment risk; it's just part of the game. After 30 years in investment markets, as I've learned more and more, I realise I actually know less and less. As time goes on, you figure out that you can't get from A to B any quicker in terms of returns or the time it takes to generate these, but you just learn where the landmines are. The learning in investment management is really about doing things the right way.

This transcript originally appeared in Finsia's INFINANCE magazine, December 2013 edition.



Retirement

Harry Chemay on the 4% withdrawal rule, Kevin O'Sullivan on managing sequencing risk, Jeremy Cooper on longevity risk, Rob Prugue on inflation and spending money and Nicolette Rubinsztein on the search for the post-retirement silver bullet, David Bell counters some claims about Chilean pensions and Bev Durston on reporting retirement incomes.

The 4% rule for retirement withdrawals may be too high

by Harry Chemay

Published 21 March, 2014

An Australian paper on safe withdrawal rates from capital at retirement concludes that over 30 years, a 50/50 portfolio with a withdrawal rate of 4% a year would run out of money about 18% of the time. This is despite the excellent returns from Australian equities over the sample period. The study has important implications for financial planning over long retirement periods.

In contrast to academic work on the accumulation phase of investing, a trifling amount of research has been done on the decumulation phase of investing, where accumulated wealth must be managed to fund retirement needs for potentially 30 years or longer.

Twenty years ago, William Bengen, a practising financial planner with an aeronautical engineering degree, set about calculating the rate at which capital could be drawn for a US retiree with a high probability of the portfolio lasting 30 years. Bengen used US investment return data from 1926 to compute a safe maximum withdrawal rate (which he called SAFEMAX) of 4.15% per annum for a 50/50 portfolio of US shares and bonds. He thus suggested that if a US retiree commenced a systematic withdrawal plan drawing 4% of the initial portfolio value, and thereafter that same dollar amount (adjusted for inflation each year), a 50/50 'balanced' portfolio would last for at least 30 years. Subsequent studies confirmed Bengen's findings, and thus the '4% Rule' was born.

Finsia safe withdrawal rate report

The 4% Rule has come to be the default safe withdrawal rate in retirement planning assumed by planning professionals. It relies on historical data for the US. How safe is it for other countries? A recently released Finsia report seeks to shed light on the matter.

[Finsia's report](#) is the latest contribution in its Retirement Risk Zone initiative, focussing on the risks in the last two decades of work and the first fifteen years of retirement. The report was authored by Professor Michael Drew and Dr Adam Walk of Griffith University.

In an important departure from previous US-centric studies the authors used a global database of real (after inflation) investment returns for 19 countries spanning a period of 112 years. They focussed their analysis on Australia and a selection of other countries representing the quartile performers (Japan 25th, Netherlands 50th and New Zealand 75th) as well as the worst performer, Italy. The table below provides details of these nations (with the US and UK added for comparison):

Real returns for Australia and selected countries; 1900 to 2011

| Ranking (Shares) | Country | Real Share Performance (Annualised %) | Real Bond Performance (Annualised %) | Ranking (Bonds) |
|------------------|----------------|---------------------------------------|--------------------------------------|-----------------|
| 1 | Australia | 7.22 | 1.57 | 9 |
| 3 | United States | 6.19 | 2.01 | 6 |
| 5 | New Zealand | 5.76 | 2.12 | 5 |
| 7 | United Kingdom | 5.20 | 1.52 | 10 |
| 10 | Netherlands | 4.81 | 1.51 | 11 |
| 14 | Japan | 3.62 | -1.06 | 17 |
| 19 | Italy | 1.68 | -1.74 | 18 |

Source: Finsia report (Dimson Marsh Staunton Database)

Drew and Walk used a simulation process to model the probability of portfolio ruin (retirement capital exhausting) for various retirement timeframes, and for various growth/defensive asset allocations. The results for a 30 year retirement for Australia appear below:

| Asset allocation (rebalanced annually, 30 years) | Withdrawal rate as a percentage of initial portfolio value | | | |
|---|--|-------------|-------------|-------------|
| | SAFEMAX100 | SAFEMAX95 | SAFEMAX90 | SAFEMAX50 |
| 100% stocks | 2.74 | 4.20 | 5.13 | 7.63 |
| 75% stocks/20% bonds/5% bills | 2.94 | 4.01 | 4.31 | 6.71 |
| 50% stocks/45% bonds/5% bills | 2.96 | 3.54 | 3.62 | 5.37 |
| 25% stocks/70% bonds/5% bills | 2.45 | 2.69 | 2.85 | 4.11 |
| 95% bonds/5% bills | 1.66 | 1.83 | 2.04 | 5.37 |

The highlighted row indicates that using a 50/50 asset allocation, the Australian safe withdrawal rate is **3.62% p.a.** (real) at a 10% chance of portfolio ruin (SAFEMAX90) over a 30 year retirement.

Whilst Australia has enjoyed the highest equity returns of all 19 nations over the 112 years analysed, its 50/50 SAFEMAX90 real rate of 3.62% p.a. is not the highest. Both NZ (3.97% p.a.) and the Netherlands (3.67% p.a.) had higher safe withdrawal rates, owing to superior risk-adjusted returns from their respective bond markets. The two laggards were Italy with a SAFEMAX90 rate of 1.23% p.a. and Japan with a rate of 0.29% p.a.

What conclusions can be drawn from the report?

The report's authors conclude that there is no 'silver bullet' when it comes to retirement planning. They warn against using the 4% Rule in a deterministic way, instead suggesting that the underlying philosophy of the Rule can be a useful tool in framing retirement conversations and in forming expectations. They note that a retiree couple with a \$1 million starting pension balance would need to draw in excess of 5.6% to generate the ASFA comfortable retiree budget.

Perhaps more importantly, the report suggests that asset-liability management needs to be considered more thoroughly in retirement planning. The authors note that, "The conversation is a difficult one in that, for many investors, their focus is on the asset side ... of the equation, not the liability. We posit that the first challenge in tipping the scales in the retiree's favour is to get the framing right, moving from a 'pot of gold' (asset) mindset to an 'income replacement' focus (liability)."

Scope for future research

Whilst the report is an important step, especially given its Australian context, much more needs to be done to further our understanding of the decumulation phase. The report does not consider, for example, the interaction between personal retirement assets (superannuation), other assets and the age pension. It ignores important personal planning issues such as mortality risk, taxes, franking credits or the bequest motive. Current government statistics indicate that less than 20% of retirees are fully self-funded, and that most Australians will be dependent on some level of government assistance in retirement. With those aged 65 plus estimated to grow in number from the current 3 million to some 4.2 million by 2020, and with pension assets expected to exceed \$1.4 trillion (2011 dollars) by 2026, there is a lot at stake. This report shows that even if the future repeats the excellent past returns, the old 4% Rule is little more than a conversation starter.

Harry Chemay is a Certified Investment Management Analyst, a consultant across both retail and institutional superannuation and Fellow member of FINSIA. He has previously practised as a specialist SMSF advisor, and as an investment consultant to APRA-regulated superannuation funds.

The full study is, "How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective", FINSIA Research Report, Professor Michael Drew and Dr Adam Walk. Available on the FINSIA website.

Sequencing risk and ways to manage it

by Kevin O'Sullivan

Published 6 March, 2013

'Sequencing risk' is the risk of experiencing poor investment performance at the wrong time, typically when the portfolio balance is at its greatest. In Jeremy Cooper's Cuffelinks article last week, he highlighted that "our defined contribution (DC) system was never designed to provide retirement income, but just a lump sum to retire with." In arriving at that lump sum to retire with, fund members must contend with sequencing risk, particularly late in their accumulation phase and early in the decumulation phase.

An example of 'sequencing risk'

When good or bad returns occur can be almost as important as the size of the returns. That is, the sequence of investment returns, not just the average of those accumulated returns, is critical. And unfortunately, no one has come up with an approach to affect or determine, before the fact, the sequence of market returns.

Let's consider two individuals who made net superannuation contributions of \$10,000 per annum over a 20 year period. Let's also assume that, over that 20 year period, the average investment earning rate on the savings of both individuals was identical, say 7% per annum. And finally let's assume that the returns of each individual were identical in years 2 through 19 but individual 1 had a -10% return in year 1 and a +10% return in year 20 and individual 2 had the opposite returns, +10% in year 1 and -10% in year 20.

As individual 2 experienced the significant negative return in the final year, the time at which the balance was the largest (and closest to retirement), his account balance at the end was \$402,634, **\$81,000 lower** than the \$483,636 balance of individual 1 (as individual 1 experienced the significant negative return early on, with a much lesser impact).

This risk of experiencing poor investment performance leading up to or shortly after retirement ranks alongside market risk, inflation risk, longevity risk and liquidity risk as key risks to manage to ensure savings are adequate for sustainable retirement income.

When are individuals most exposed to sequencing risk?

It can be extremely disheartening when poor investment performance comes at a time close to retirement, when an individual's account balance may be close to a desired retirement amount. In addition to the losses, it can lead to actions that the individual would have preferred to avoid – working longer, reducing expenditures, possibly increasing investment risk to achieve higher asset growth. And it may be difficult for a person, once they have retired, to recover from poor investment returns or to buy securities at deflated prices.

The period of greatest risk is typically considered to be the last 10 years of the accumulation phase and the first 10 years of the decumulation phase (although some studies postulate that it begins earlier than 10 years before retirement). The sequence of returns during this period will have a significant impact on the sustainability of a retirement income, leading to an increase in the probability of 'portfolio ruin' post retirement.

Whilst few Australians buy an annuity on retirement, sequencing risk can be even more acute in countries where individuals must purchase an annuity at the time of their retirement. They may also be exposed to buying an annuity at a time when market prices for annuities have increased significantly due to reductions in future yields on securities that insurers use to back the annuities. For example, at present, some lifetime annuities in Australia are priced using a negative implicit real return.

How to mitigate the risk

There's much good research on this topic but no perfect solution to mitigate the risk. And market timing is clearly not a viable option, even if it may have worked for some.

In considering their members' best interests, trustees of large superannuation funds should consider how they can help members to manage sequencing risk. This might include segmenting members based on age and account balance, using target date funds, improving communication of the risk and provision of downside protection for members in the retirement risk zone.

How might individuals mitigate the risk, knowing there is no perfect solution?

- **Reduce the level of investment risk as retirement approaches.** The aim is to lower the chances of significant losses on a retirement nest egg, but when should an individual start to de-risk? What are optimal levels of risk to accept? As most individuals' superannuation savings will remain invested for many years after their retirement, should they de-risk as much as occurs in some target date funds? If they take too little risk they may end up with insufficient retirement income. With too much risk, poor returns can erode their savings and jeopardise the sustainability of their retirement income.
- **Increase the level of diversification in the savings portfolio.** But even with greater diversification, poor performance still can occur. Also, at times of stress in the markets, assets previously considered to be uncorrelated may follow each other down.
- **Buy annuities and/or deferred annuities.** This can address post-retirement sequencing risk but doesn't address pre-retirement sequencing risk. Also the market for annuities in Australia is still relatively small and individuals could be exposed to high annuity prices at time of retirement.
- **Spread contributions more evenly over a working life.** Risk could be more evenly spread if contributions were high initially and decreased as one approaches retirement, but individuals would likely be reluctant to put more money into super when they are younger.
- **Adjust asset allocation over a working life.** Higher exposure to growth assets in the early years than occurs with typical exposure levels by investing mostly in equities (or achieve even higher than 100% exposure using call options or gearing) when younger but switch to less volatile assets when approaching retirement.
- **Keep sufficient assets (about two years of expenditures) in a liquid fund.** This would allow an individual to avoid the need to cash out investments after a significant fall in the markets, before markets have had time to recover. But this does not provide protection from risk on the balance of the portfolio.

And finally, individuals could choose to defer retirement or save more! That is, an individual could target a retirement funded ratio – a Defined Benefit (DB) concept – of greater than 100%, where a target is set greater than expected requirements. This provides a buffer where, faced with one or two years of poor investment performance around retirement, the retiree would have a greater chance of funding the desired post-retirement lifestyle.

Use of a target funded ratio approach could also lead an individual to consider whether it is necessary to take as much risk close to retirement. More employer sponsors of DB funds are doing this as their funded ratios improve towards 100% or more.

To summarise, dealing with sequencing risk is important for people who generally want to save enough to have a retirement income greater than the age pension. Besides considering actions whilst they are approaching retirement or shortly thereafter, individuals need to take some steps at a younger age – start earlier, save more, lower their risk as assets grow, understand their retirement objectives and the consequent saving needs.

Kevin O'Sullivan is Director, Actuarial & Benefits Consulting at Russell Investments and is now CEO at Unisuper.

Your money or your life: what's more certain?

by Jeremy Cooper

Published 30 May, 2014

Death and taxes are the proverbial certainties in life. Life, however, is full of uncertainties, like just how long a recently retired 65-year old will actually live and what the share market is going to do for the first ten years of their retirement.

Using a concept first explored by Moshe Milevsky, it is possible to compare the relative uncertainty around retiree lifespans and equity market returns using Australian data.

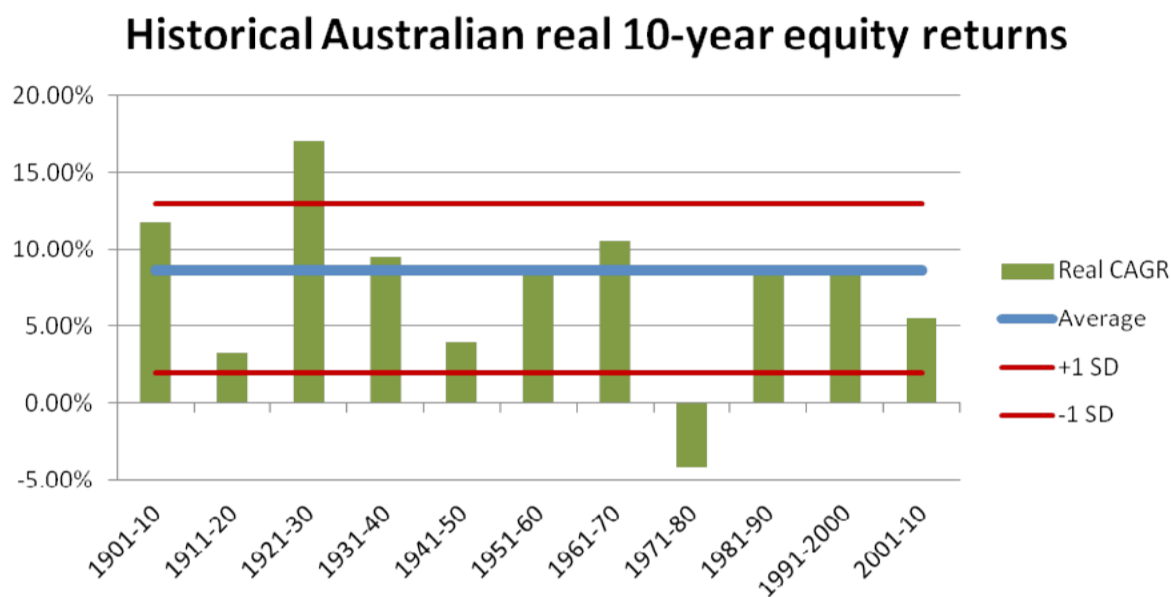
Market uncertainty

Investors are, of course, aware that equity markets are volatile. If a capital sum is invested for a period of time, the amount of capital available at the end of the period will be uncertain. The question is: how uncertain?

This question depends on the investment timeframe. As a rule of thumb, equity markets are volatile in the short term, but over the long run there is some reversion to the mean that partially reduces this volatility. For a retiree, the impact of returns in the first 5–10 years after retirement has a big impact on their capital base. So a 10-year period is an appropriate term to consider in a retirement context.

Data on equity markets from Credit Suisse, based on work by Dimson, Marsh and Staunton, provide the real returns on equities in Australia since 1900, split into 10-year periods. The returns for each decade can be seen in figure 1. These returns include all dividends and are before tax.

Figure 1. Real returns on Australian equities in 10-year periods.JC Chart1 300514



Source: Credit Suisse using data from Dimson, Marsh and Staunton

One way to consider volatility is to look at the variation (standard deviation) from the average outcome (mean). Using Australian equity market returns, the mean real growth can be measured by the 10-year effective compound annual growth rate (CAGR): 8.7%. The volatility in this example is the measure of plus and minus one standard deviation from the mean, which is 13% and 1.9%, respectively.

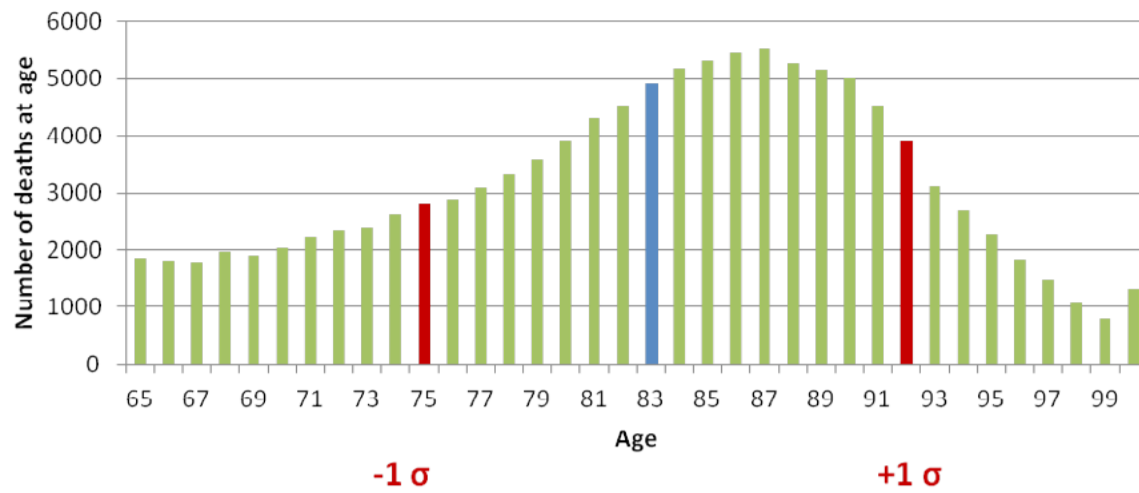
Another way to look at volatility is to use a co-efficient of variation (the ratio of the standard deviation to the mean). Using the same average 10-year Australian example, the co-efficient of variation is 47%.

Life expectancy vs actual lifespans

What about the variation of actual retiree lifespans from average life expectancies? How much certainty can a retiree have about the length of their own life from retirement onwards? The answer to this question might be a surprise for most retirees and their advisers.

In 2012, the most common age at death for someone who was 65 years-of-age or over was 87 (the mode). Despite this, taking the probability of survival from age 65, the mean 'expected' length of life for a 65-year-old was 18.1 years or to age 83. In reality though, very few people live exactly that long. Some live longer and some not as long. The range of actual lifespans around this mean point is represented by a standard deviation of 8.4 years either side of 83, figure 2.

Distribution of actual lifespans for 65 year-old Australians



Source: ABS

For a 65-year-old, it is also possible to measure the volatility as a ratio between the variation of actual lifespans to the average life expectancy. Remarkably, the co-efficient of variation, the range of actual lifespans proportional to the mean, is also 47%. So it turns out that a 65-year-old has to cope with a lot of uncertainty around how long they are actually going to live.

Relative uncertainty

Both equity market returns over 10 years and actual lifespans (versus average life expectancies) for 65-year olds have the same relative level of uncertainty: 47%. While this result is generated through some selective data use, it does highlight that both the equity markets and actual lifespans at retirement are similarly uncertain.

Summary

Longevity risk is not just the risk of living longer and outliving retirement savings. Uncertainty around a retiree's actual lifespan is another, more complex, aspect of longevity risk. Financial models and retirement plans generally revolve around average or expected life expectancies, done so for the sake of convenience. This is a serious industry shortcoming.

Two known retirement uncertainties – a retiree's actual lifespan and the money earned on equity investments (pre-tax investment returns) – have a surprisingly similar dimension. Both forms of uncertainty need to be managed in retirement at the same time. The first step in doing this is to move away from planning for averages. Retirees know that they won't achieve average share market returns and will build a portfolio to adjust for this.

What far fewer retirees will have realised is that they will almost certainly not live to their average life expectancy either.

Jeremy Cooper is Chairman, Retirement Income at Challenger Limited.

Dear friends, colleagues and fellow rockers

by Rob Prugue

Published 4 July, 2013

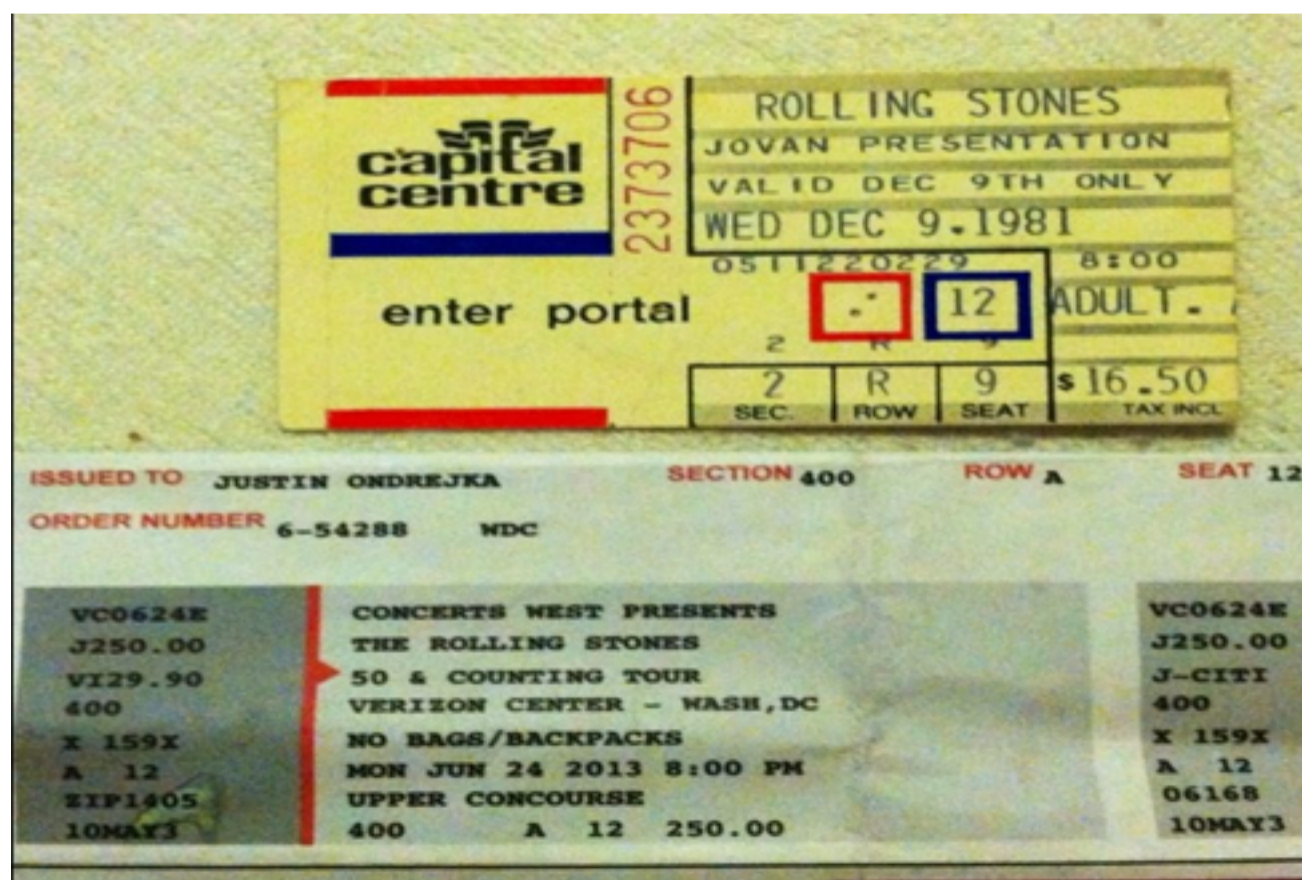
Dear friends, colleagues, and fellow rockers

The quest for stable and inflation protected investment ideas grows as the era of market uncertainty ingrains itself for what looks to be a long and bumpy roller coaster ride. Such tumultuous and volatile market conditions, coupled with capital inadequacy, threatens to impact when baby boomers can retire, if and when they do, and how comfortably they can do so. Increasingly, the luxury and ability to retire at the age of 65 is looking more and more like a distant dream.

Pete Townshend may have once said never to trust anyone over 35, but today at 68 years himself, no doubt he's changed his tune. Actually, it's the rock and roll stars we baby boomers grew up on who are the best examples of working WELL beyond 65. The Rolling Stones, for one, are touring North America this northern hemisphere summer. Not bad given that Mick Jagger himself turns 70 in just one month's time. But for rock lovin' baby boomers wanting to retire in comfort, however, perhaps we're immunizing against the wrong CPI target.

No, am not referring to health care inflation, which is near twice the rate of CPI. Nor am I referring to food inflation, which here too dwarfs the official CPI levels. Rock and roll may never die, but the cost of seeing it is killing us.

Courtesy of a high school friend, who I've happened to share many a rock concert WAY back when with, I received a photo which speaks in volumes to the aforementioned. My friend sent me two ticket stubs: one of last night's Rolling Stones concert in Washington DC; and another of a Rolling Stones concert we both attended was back in 1981. Same rock band, same city, same venue, and very near same seats. Way back in 1981, to see the Rolling Stones would set you back a whole US\$16.50. Today, to see these now septuagenarians rock on stage would set you back US\$250! In 32 years, the price of a Rolling Stones ticket has risen by 15X! I tell you, baby boomers have no chance immunizing their retirement portfolios towards such luxuries.



Consider the following stats. Back in 1981 the average US household weekly gross salary was US\$340, compared to today's gross weekly salary of US\$930. From 1981 through to 2013, the average weekly gross household salary rose by a nominal 1.74% annually. During this same time period, the price of a movie ticket rose nominally by 1.9%, whilst the price of a gallon of petrol rose by 1.5%. The cost of a Rolling Stones ticket, however, rose nominally by 8.6% pa. I wonder what impact this

would have if the statisticians would dare to include the price of Rolling Stones in their CPI calculations?

Perhaps this increase has more to do with demographics than just CPI calculations? Well consider this. The affordability of seeing a movie, or cost of driving to the movie theatre, has not changed much over this 32 year period. But the same cannot be said for Rolling Stones. Back in 1981, seeing the Rolling Stones would only deplete 5% from one's weekly gross salary. Today? Seeing these aging, diamond-stoned rockers deplete a whopping 27% of the average US household income.

Either way you look at it, and to paraphrase the Stones, what a drag it is getting old.

Rob Prugue is Senior Managing Director and Head of Asia Pacific at Lazard Asset Management.

Searching for the post retirement silver bullet

by Nicolette Rubinsztein

Published 24 October, 2014

I confess to being a non-believer in silver bullets in the context of post retirement products. The silver bullet is probably not a product, but good financial advice. However, I also admit that my view on the product silver bullet has changed over the last two years, and I am now more of a believer than I was.

What does our post retirement look like?

Contrary to some commentary this year, our post retirement system is in reasonable shape. According to Rice Warner, 85% of client assets are invested in income streams. Those taking lump sums generally have small balances and appear to be doing sensible things with them, like paying off debt. We have a reasonable array of post retirement products in the retail market (account based pensions, annuities, variable annuities) and the recent [Melbourne Mercer Global Pension Index 2014](#) ranked Australia second in the world.

However, there's a bit that's not great. There are mounting longevity challenges. Mercer's data shows there's a 35% chance that a white collar fund member retiring now will live to 91 if they are a man and 93 if they are a woman.

With 93% of retail money in account based pensions, it's clear that most members have little longevity protection (apart from the age pension). Our exposure to annuities is significantly lower than many other major countries, some of which have more than 50% of their retirement assets in annuities.

Burnt by the GFC, many investors remain risk averse with lower exposure to growth assets, with comments like this being the norm: "More than anything, I want to ensure that my husband and I have financial security and safety for our money ... nothing too risky." This thinking is showing through in spades in both quantitative and qualitative research at Colonial First State.

Even though our system ranked well in the Mercer study, the Global Age Watch Index 2014 ranked Australia behind France, Canada, UK and the US for income security. This measure took into account pension coverage, levels of poverty in retirement (defined as half average earnings) and income replacement for the population over age 65.

It's not surprising that the Financial System Inquiry Interim Report commented, "the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees".

For a while, many believed [variable annuities](#) were the silver bullet. In some ways they can seem to offer the upside of equity markets with the downside protection of a lifetime annuity. With around \$2 trillion of assets invested in them, they have certainly been popular in the US. However, their success has come under a cloud since the GFC, with a number of providers exiting the market due to problems with hedging their exposures. In addition, it is apparent that the factors that have driven their growth in the US are not translatable to the Australian market. Commissions of around 7% are reportedly common and there are tax advantages that are specific to the US. With about \$2.6 billion invested in variable annuities in Australia, there has been some interest, but it's clear they are probably not the silver bullet.

Global changes provide pointers

Three global changes might provide an idea about the worldwide view on the silver bullet.

In 2012, the [OECD Working Party on Private Pensions](#) developed a series of 10 recommendations for the “good design of defined contribution pension plans”. The seventh recommendation was “for the payout phase, encourage annuitisation as a protection against longevity risk ... A combination of programmed withdrawals with a deferred life annuity (e.g. starting payments at the age of 85) that offers protection against inflation could be seen as an appropriate default”.

In addition, the US Government recently made changes to allow 401(k) savings to be invested in deferred annuities, whereas the UK Government removed the compulsory annuitisation. And there are changes happening locally. The Government is looking at deferred annuities, with Treasury having released a detailed discussion paper.

There are also changes in sentiment by financial advisers. Inflows into lifetime annuities increased 35% last year according to Plan for Life, and Zenith recently created a model portfolio for retirement which includes an allocation to annuities. Furthermore, a recent Investment Trends survey showed that 37% of advisers said they would like to use some sort of annuity in the following 12 months (Investment Trends Retirement Income Report 2013).

Using scenario modelling

Our approach to trying to find the silver bullet was to commission Ernst & Young to do some scenario modelling. Their quest was to find what product combination delivered the best outcomes for customers in retirement. They built a stochastic model of the different products that are available in the market – lifetime annuities, deferred annuities, term annuities, variable annuities and account based pensions. There were two key conclusions.

Firstly, the variable annuities didn't model well, mainly because of the high fees and the lack of flexibility in the product design.

Secondly, the 'hybrid' options, where an annuity (lifetime or deferred lifetime) is combined with an account based pension often delivered superior outcomes for members.

Much as I would like to think our modelling delivered unique insights, similar conclusions have been derived elsewhere.

In particular, there is academic work showing that a small allocation to an annuity (say 10-20%) can deliver better outcomes for customers. Indeed, David Bell wrote [an article in Cuffelinks](#) entitled 'Why academics like lifetime annuities' where he commented, “financial models suggest life annuities are beneficial to rational decision-making individuals, yet in Australia the number of life policies purchased remains small.” There is also work by Mercer on behalf of Challenger which has similar findings. Given the OECD roadmap and the US changes, it appears they might have also reached similar conclusions.

Closer to the silver bullet?

It would have been great if I could say that I have discovered a new, sexy, amazing, innovative, silver bullet. Instead, I'm afraid the answer is rather dull. 'Partial annuitisation' with a modest allocation might be as close as we can come to the product silver bullet.

If combining an annuity and an account based pension is the answer, we need to make it easy for advisers to construct, report on and maintain such portfolios on behalf of their clients.

Nicolette Rubinsztein is General Manager, Retirement and Advocacy, Colonial First State. She has been on the Board of The Association of Superannuation Funds of Australia (ASFA) since 2007 and chairs ASFA's Super Systems Design Policy Council.

Grattan and the fuss about Chile's pensions

by David Bell

Published 4 September, 2014

Recent press would have you believe that Chile's pension system is the solution to the perceived cost problems in Australia's superannuation system. This is due to a combination of media sound biting of a report by the Grattan Institute (and subsequently the Financial Services Inquiry) which, while interesting and a motivator for important discussion, is ultimately incomplete, open to alternative interpretations, and in my opinion flawed. The Australian superannuation system is highly complex – there is no silver bullet which takes it to the next level.

Chile's default fund auction system

Chile has a well-regarded pension system. The overall system, which includes the government- provided pension, was ranked 8th out of 18 countries (each selected as having a developed retirement income system) in the 2013 Melbourne Mercer Global Pension Index (Australia ranked 3rd). The FSI highlighted an important feature of their system in its Interim Report:

"Other mechanisms could also be deployed to drive fees down. One example is the approach introduced in Chile in 2008, where — unlike Australia — superannuation contributions of all new members are placed in the same default fund. Default fund management is auctioned on the basis of fees, creating stronger competition between funds for default fund status. Since these arrangements started, the fees charged by successful bidders in Chile have fallen by 65 per cent, although fees on other funds have not fallen to the same degree."

This comment was likely based on a report produced by the Grattan Institute titled, "Super sting: how to stop Australians paying too much for superannuation".

Grattan Institute analysis of Chile's pension system

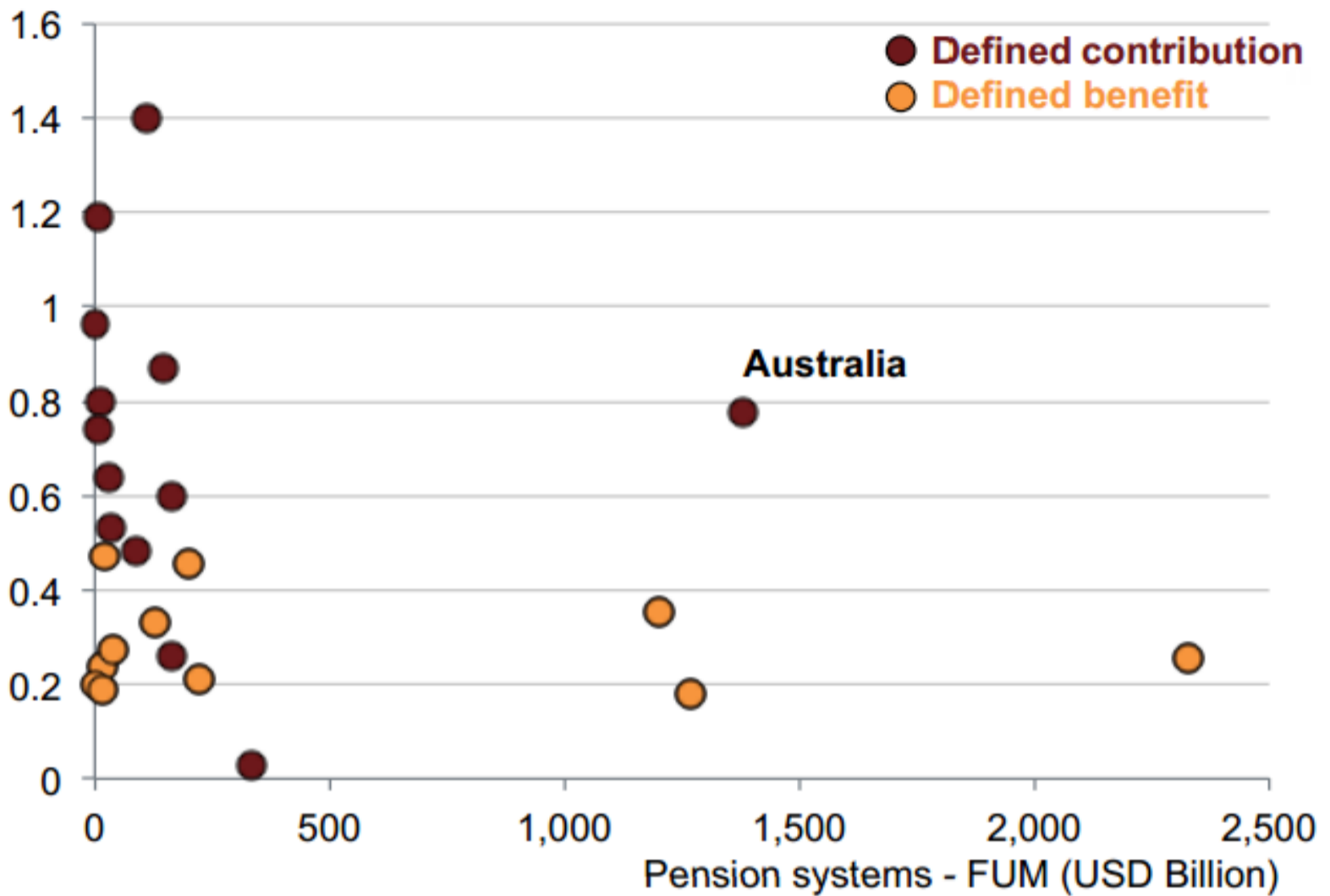
In Chile, workers contribute to approved pension funds, known as AFP's (Administradora de Fondos de Pensiones). Currently there are six AFP's each offering five investment options based on investment risk (simply named funds A, B, C, D and E). The Chilean government implemented a broad range of pension system reforms in 2008, and to address concerns regarding the cost efficiency, the government introduced a tendering process. Every two years, all AFPs tender to be the default fund for new contributing workers. New defaulted fund members cannot leave the directed AFP for two years but can switch investment option. Each option charges the same administration fee. All existing members of the default AFP also have their fees reduced to the new level. Since introduction, the Grattan Institute notes that the successful tenderer fee has fallen 65% to a fee less than 0.20%. This headline number is definitely worthy of attention. Unfortunately AFP's with large memberships have not been winning the tender recently and so the fee reductions have not benefited the majority of the population.

In my opinion the Grattan Institute adopts the view that a certain way to improve performance is to reduce fees. The logic of such a view, also shared by the Super System Cooper Review, is that investment management makes little difference to performance but fee differences make a large difference in performance. To support their view they undertake analysis which shows that:

- Adjusted for system size, Australia's super fund fees are much higher than those in other countries, as demonstrated in the following chart taken from the Grattan report:

Figure 2: Australia's superannuation system expenses exceed others of similar scale

Funded pension expense, per cent of funds under management, annual



Note: Year: 2012 or latest prior to 2012. For the purpose of this chart 'defined benefit' is a system where greater than 60% of assets are in defined benefit plans; others are allocated to defined contribution. The chart includes 22 countries, the US Thrift Savings Plan (the defined contribution fund for US public servants) and the Swedish private pension system. See Appendix 3 for a version of this chart with countries identified.

Source: Thrift Savings Plan (2014), Swedish Pensions Agency (2013), Swedish Pensions Agency (2014a); OECD.Stat (2014a); OECD.Stat (2014b); OECD (2013).

- Outperformance does not persevere (if a fund outperforms in one year there is little continuation of that outperformance in subsequent years). This argument is summarised in the following chart:

Figure 9: Low fees are a better guide to future returns than are previous returns

Subsequent net real annual returns of funds based on previous fees and previous returns. 2006-2013, per cent, annual



| Fees (per cent of assets) | Lowest fees | Top previous net returns | Average fund |
|---------------------------|-------------|--------------------------|--------------|
| | 0.64% | 0.85% | 1.38% |

Note: In each year in the sample from 2006 to 2011, three sets of funds are compiled. The first are the 10 per cent of funds with the lowest fees. The second are the 10 per cent whose historical returns (for history back to 2004) are highest. The third is all funds. The orange bars indicate the average of the subsequent returns for all decision years.

Source: Grattan analysis of APRA (2014a) & SuperRatings (2014).

- Fees are high because of the failure of account-holders and employers to put sufficient pressure on super funds to reduce fees.
- Super funds seek to differentiate by providing a range of product features and services, rather than focus on fee reduction.
- MySuper will not result in substantial fee reductions.

To reduce fees the Grattan report proposes a two-part solution:

1. Select default funds in a fee-based tender (similar to the Chilean process).
2. Encourage a more active choice program through the Australian Tax Office hosting a 'choice platform' which compares an individual's current fund to that of the default fund (tender winner), and allow an opportunity to instantly switch to the default fund.

(As a side note, the Chilean experience of tendering is not viewed as a universal success. In 2013 a special committee of the Senate approved a range of measures including creating a publicly-administered alternative to the current privately operated system. This is in response to concern that the tendering process has not delivered population-wide benefits).

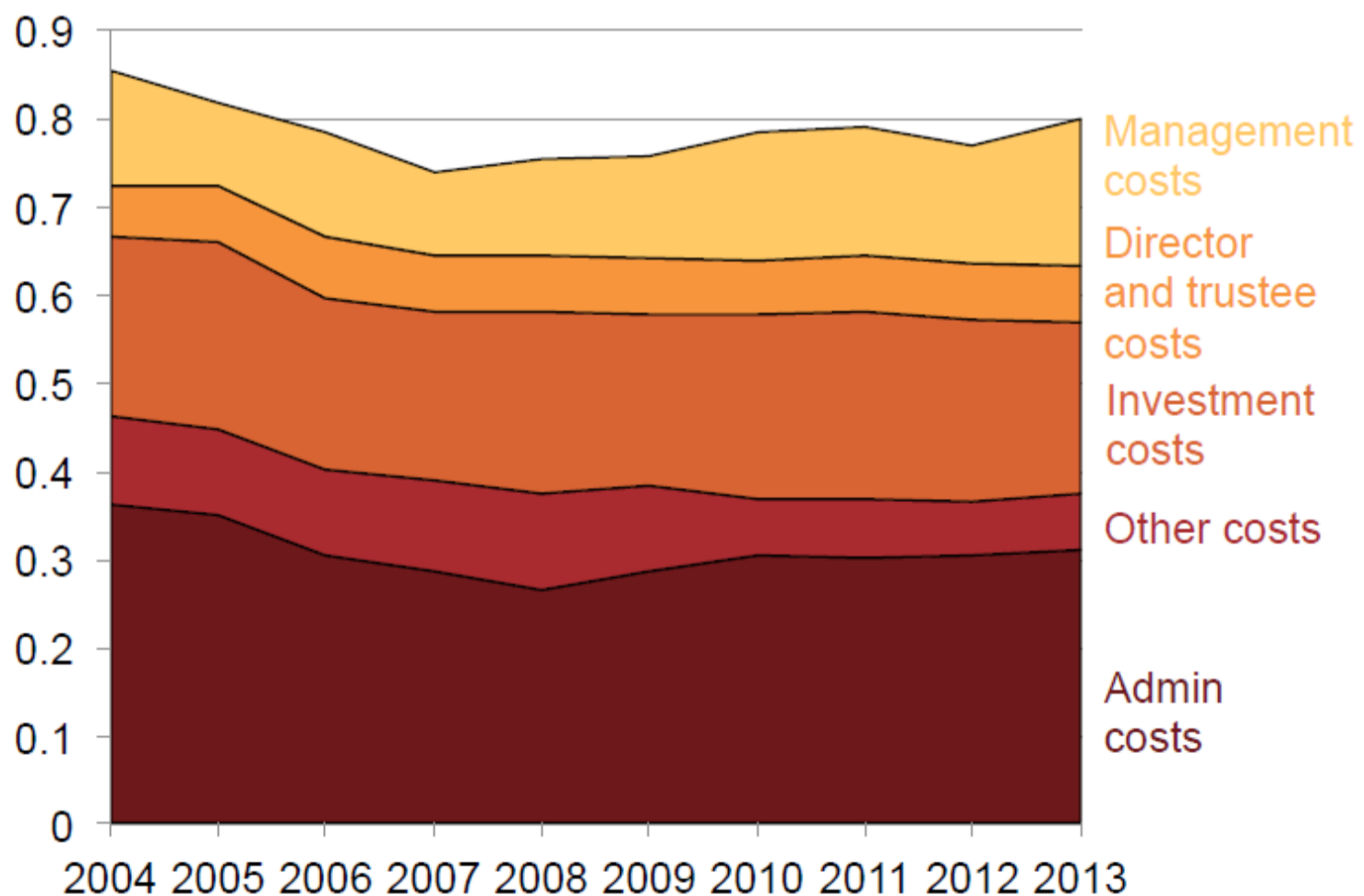
The Grattan Institute deserves commendation for producing some analysis and venturing some opinions which should, at the least, require self-reflection amongst super fund providers. Ultimately I disagree with their views and believe that their proposal would fail if implemented. Understandably there will be differences in opinion when a report is produced by people who are not directly involved in the superannuation industry (the three principal contributors are from an economics / academic background). While sometimes great industry innovations are generated by those from outside an industry, I don't think we have a plausible game-changer in this case.

I make a number of points in response to the Grattan Institute:

- Global cost comparisons have historically been difficult because every country's retirement income system has a unique structure providing different features and services. Some services are provided or subsidised by governments. A simple chart (the first one above) as provided Grattan does not tell the full story (but clearly raises important questions).
- The assessment of active management skill is flawed, most notably in the statistical tests applied against the objectives of the system. Super funds focus on long term performance and ultimately retirement outcomes, yet the statistical testing by the Grattan Institute focuses on the perseverance of short term performance. I question the relevance of this statistical test, especially when the large differential in fees observed in the early 2000's no longer exists. Perhaps the short term test is conducted because it is more difficult to test longer term performance, as a much lengthier set of data is required. The key question is whether quality active management applied in well constructed portfolios will improve a fund member's long term retirement outcome. This doesn't just mean higher returns; it could also mean reduced risk. Surely the debate on active management needs to be a broad and forward-looking one. Based on the flawed construction of many passive indices, evidence of costly behavioural biases, and my own personal experiences of the impact of high quality active management on the return and risk outcomes of a portfolio, I believe that active management does have potential benefits. Surely super funds should have the choice about whether and how much they incorporate active management, rather than have that choice regulated away.
- The report fails to address the issue of where cost reductions can be derived, rather alluding to the potential for cost savings similar to that experienced in Chile. Yet the Grattan report itself provides a useful chart on this very issue:

Figure 23: Fund expense ratio has changed little; some components have varied

Superannuation fund expenses, 2004-13
Per cent of funds under management,



Note: Expenses exclude commissions, and trading costs such as buy-sell spreads. Costs are weighted by funds under management. APRA regulated funds only - excludes SMSF and some public sector funds.

Source: APRA (2014b).

Based on this chart, from which areas can cost reduction be derived? It appears that investment costs are already quite low at circa 0.20%. Even if we assume a more conservative (higher number) for investment costs, we can see that the impact of a shift to passive management will deliver far lower benefits to those achieved in Chile. Indeed we can see that administrative costs alone are higher than the total fee for Chile's last AFP tender!

- Finally, recommendations need to have a high chance of succeeding in practice. In this case success should be measured as system cost reduction. Undoubtedly the creation of a super choice platform would be a costly exercise. It is debatable how much choice would actually take place given the disengagement of many and the alignment of workers to their industry super fund. It would also not surprise to see funds increase advertising expenditure around tax return time – another cost to members with no investment return benefit.

Complexity of our super system

Cost is a crucial issue on which regulators and the industry need to maintain constant focus, but I believe the cost debate has many nuances to it. Does the system as it stands provide too many services and features? What is the economic cost of the substantial choice provided to Australians? What is the cost versus benefit of the substantial regulatory requirements placed on super funds? Which areas of the cost structure (as per the third chart) have the greatest potential for cost reduction? Unfortunately given the complexity of our system, a simple solution is unlikely to succeed; rather an ongoing collection of micro reforms, combined with ongoing fund merger activities, will lead to system cost reduction.

A final comment on the active management debate: in my opinion the investment management industry is experiencing a period of unprecedented dynamic change. The focus on member lifecycle outcomes, post-retirement solutions, the balanced versus lifecycle debate, smart beta and minimum volatility investments, represent just a small number of the current challenges, or opportunities, depending on your view. The lens through which performance outcomes are assessed needs to be refined further. It is those from within the industry which need to provide greater leadership in this area. From here we can then justify the sensible use of active management strategies.

David Bell is Chief Investment Officer at AUSCOAL Super. He is also working towards a PhD at University of NSW.



Published 2 May, 2014

Over the past 20 years, I have been managing a variety of government and industry superannuation and pension funds in Australia, Singapore and the UK. Returning to Australia last year after a seven year contract in the UK, I have noted some shortcomings in the way information about superannuation is reported to individuals.

The Australian superannuation system has an excellent reputation as one of the most successful for ensuring the majority of the workforce automatically makes some provision for their retirement. Many countries have subsequently adopted some of these features into their own systems including the UK which implemented its form of Defined Contribution (DC) pensions, known as 'Auto-Enrolment' in 2012.

The early adoption by Australia of a DC system more than 20 years ago was a masterstroke of strategic vision and demographic awareness. In implementing DC, it allowed the private sector, the Federal Government and the individual states and territories to largely eliminate any link of retirement incomes with workers' final salary defined benefits (DB). According to APRA, the DB-only component of the super industry was only \$70 billion as at June 2013 – a mere 4% of the asset base.

But one of the unfortunate consequences of moving to a DC system is that superannuation has become detached from any link to an income that the individual can expect in retirement.

Losing the link to salary

The original idea of a 'final salary' or DB pension scheme was simple for an individual to understand: the level of income in retirement would be linked to the salary they were earning whilst contributing to the scheme. There were technicalities about contribution rates, which salary (final or career average) would be paid and how overtime and other variable uplifts would be treated, but the basic notion had clarity and was easy to communicate.

In Australia, only a limited number of employers ever offered DB income streams. The market here generally had a 'lump sum at retirement' model which I believe is far inferior to an income stream. Contrast this with the benefit in the UK where a worker who had contributed to their pension beyond 20 years could expect to receive roughly two-thirds of their salary by way of a pension income after retirement. This income would typically be indexed to the cost of living and would last for the entire life of the worker. Whilst the provision of income in retirement was the responsibility of the employer, the individual always had a guideline for the level of income in retirement.

Under the current DC system in Australia there is no link with the projected income that a worker can expect to receive in retirement. All of the risks of achieving an adequate retirement income have been successfully passed onto the worker. These risks include, but are not limited to:

- longevity risk – how long will the individual live and need the income
- adequacy risk – building an adequate pool of savings to cover the income needed
- investment risk – the investment strategy adopted for the rest of their life
- drawdown risk – how much to draw on the pool of savings once the individual retires
- inflation risk – how to keep pace with any rise in the cost of living in retirement
- healthcare risk – what health care needs the individual may have in retirement
- provision for after-death – how much to leave and how to manage this.

The responsibilities of the individual under a DC system are daunting.

The need to report projected income from superannuation

At present there is limited free advice available to individual workers to assist them with these DC risks. Some employers provide independent financial advice, and most super funds provide some level of free advice but this often focuses solely on their own funds. Most individuals are not equipped with the right information from their super funds to make the best informed decision.

Super funds should provide improved reporting to aid members to make decisions about retirement. Each individual receives an annual statement showing their current superannuation accumulation balance. What is missing is the projected retirement income (in real terms, adjusted for inflation) compared to their current salary. In the DC world, inflation risk rests with the employee, and they need to know the value of their savings in current dollars.

Behavioural finance concludes that people feel content with a much smaller accumulated total than they actually need. As soon as an accumulated balance gets close to a multiple of salary (say three times average salary at \$150,000) or close to the cost of the average property in Australia (say ten times average salary at \$500,000) then individuals 'feel' wealthy and no longer focus on saving more.

This is inappropriate because these sums will not provide – even for a worker on average salary – sufficient income in retirement to live at the same level of comfort as when they were earning their salary. The salary-linked reporting provides the right information, despite the fact that it may not be a pleasing message for most workers.

Sound assumptions are required to prevent this being used purely as a marketing exercise. Good practice would be to establish a set of assumptions (i.e. on asset growth rates, retirement age, inflation) for use by every super Fund across the industry so that the projected income number is comparable across funds. In the UK for example, the Pension Regulator sets the assumptions for these comparisons and each annual pension statement has to show an expected income per annum assuming growth rates of 3%, 5% and 7% of the assets until retirement.

It is very useful for a 40 year old Australian who still has time to save more for retirement to be told that their projected income will be only 15% of their current salary adjusted for inflation. They have time to take corrective action, if financially possible.

Given that contributions are related to salary it seems strange that the accumulation pot size is given so much importance. The objective of the DC saving scheme is to produce an **income in retirement** for individual workers. A sceptic might suggest that super funds do not want to tell their members this vital piece of information lest they receive poor member feedback, or worse, cause members to switch to another fund. This can be addressed by using agreed industry-wide assumptions which are sanctioned by the regulator, APRA. But not giving this vital piece of information as early on as possible is letting the clients down.

[Link to the employer's remuneration policy](#)

Another hidden corollary of the current compulsory DC system is that employers have now 'switched off' from using pensions as a positive tool in their remuneration policy. Before compulsory superannuation, quality employers would use higher superannuation benefits as a method of enticing quality employees to work for them and to retain the loyalty of their existing staff.

Nowadays in Australia the opposite might be true – that superannuation might actually become a negative for remuneration policy. Since it is compulsory, superannuation is not considered a variable component of remuneration policy. And the requirement for incremental increases in superannuation contributions over time may actually 'backfire' on employees. A worker may feel they lose out because a potential wage increase may instead be allocated towards a mandated super payment. In this way real wage cuts are likely as superannuation contributions gradually increase.

Summary

The Australian super system has set the standard for governments to reduce their reliance on social security pension provision. But the individual worker has assumed significant responsibilities for the total management of their income from retirement to grave. Most individuals are relatively unaided and without the necessary reporting tools to correctly interpret data and make decisions. I find it startling that even today, most super funds do not report to their members a projected income in retirement.

Bev Durston has over 25 years' experience of implementing investment solutions for pension funds, sovereign wealth funds and fund managers. She recently relocated to Sydney and founded an advisory business for institutional clients, Edgehaven Pty Ltd. Bev has a first class Banking and International Finance degree from CASS in London, and a Masters of Applied Finance from Macquarie University.



SMSF management

Hon Paul Keating on where SMSFs came from and future asset allocation, Andrew Bloore on putting the 'self' into self managed super, Monica Rule on binding death nominations and Graham Hand on property spruikers targeting SMSFs.

Where did SMSFs come from, and where are they going?

by PJ Keating

Published 14 February, 2013

When we laid the foundations for the current superannuation system in the 1991 Budget, I never expected Self Managed Super Funds (SMSFs) to become the largest segment of super. They were almost an afterthought added to the legislation as a replacement for defined benefit schemes.

This is the second article which draws on my talk to ASFA in November 2012, and it examines why SMSFs have become so popular.

In 1992, my Government introduced the Superannuation Guarantee Charge (SGC), with major extensions in coverage for working Australians who previously had no easy access to super. It came from the sea change in the economy and society produced by the co-operative political model adopted in 1983, with a productivity basis for improvements in living standards, and superannuation as a form of distribution of those improved living standards. The co-operative model induced and produced a massive increment to real wealth.

Employer contributions to superannuation rose from 4% of salaries in 1992-93 to 9% by 2002-2003. I wanted to reduce the future reliance on the age pension, and over time, give ordinary people a better retirement. Back in the 1980s, only wealthy people were in the stock market, but I felt mums and dads should be able to share in the bounty of the wealth of the nation. Owning a home was fine but they needed more. And through superannuation funds, everyone is now in it, and it's been good for both investors and the nation. We have created a \$1.5 trillion pool of capital, and many super members have accumulated significant balances which they want to manage themselves.

It was not generally so initially. In 1992, employers mainly made the decision about which fund an employee's super contributions would be invested in, usually a so-called default fund. This approach was intended to keep the system simple, affordable and understandable. Each year, the employee would see the contributions and the gradually-building balance, without the employee having to take any action. It also kept the accumulations out of the hands of government bureaucracy.

The wealth would address the growing economic problem of an ageing workforce, and realign the mix between capital and labour through labour contribution to real capital growth. Very few countries have developed an adequate retirement income system with no 'false promise' in such a universal way, leaving the age pension – an income and asset tested pension – as an anti-destitution payment, which ceases when the recipient dies.

So the SGC was not introduced as a welfare measure to supplement the incomes of the low paid. It was principally designed for Middle Australia, those earning \$65,000 to \$130,000 a year, or one to two times average weekly ordinary time earnings (AWOTE). This is not to say that those on 50% or 75% of AWOTE should not benefit equitably from the superannuation provisions. They should. But for Middle Australia, the SGC and salary sacrifice was and is the way forward.

At an SGC of 12% and tax arrangements as now, someone on one to two times AWOTE plus adequate salary sacrifice limits should be able to secure a replacement rate in retirement income of around 70% over a 35 year working life.

That was the basic design, and achieving those targets did not require a lot of risk-taking in the investments. If compound annual returns reflected nominal GDP plus say 1%, the system would be doing well. Indeed, the Treasury forecast of system assets growing from \$1.4 trillion today to \$8.6 trillion in 2040 represents a compound annual growth rate of around 6.7%.

I mention this to provide context commentary on the rapid growth of SMSFs. As a general statement, I believe people's expectations as to rates of fund returns are too high. The Australian superannuation system is both large in world terms and large in absolute terms. Not only is it forecast to grow to \$8.6 trillion by 2040, but currently, the system stands at over 100% of GDP and will mature nearer to 200% of GDP. It is simply too large in aggregate to consistently return high single or double digit returns.

I am certain expectations as to returns and the search for yield have done two things:

- managers have adopted a higher risk profile in portfolios, and
- lower returns than expected have soured expectations, encouraging more people to take the initiative and manage their own assets, including taking on the trustee role when setting up an SMSF.

Returns on APRA-regulated funds averaged 3.8% over the 10 years to 2011, notwithstanding volatility from the unprecedented growth in equities and investment markets between 2002 and 2008, juxtaposed against the impact of the GFC. Over the same period the average cash rate was 5.2% and the average GDP growth 3.1%.

These results indicate that significant risk was taken by superannuation managers to secure returns in line with the relatively risk-free government cash rate. Importantly, these risks were taken on by managers who had limited direct exposure to losses – losses ultimately borne by superannuation beneficiaries. However, if the funds did return a significant amount, those same fund managers are often entitled to performance fees! And these fees are generally calibrated to annual returns rather than long term returns required to fund a retirement income.

I believe returns expectations are inflated and those expectations lead to incentives to drive higher fees for managers, but at much higher risks, as was the case between 2002 and 2011. We only have to look at asset allocations. At December 2011, total Australian super assets were weighted:

- 50% to equities
- 18% to fixed income
- 24% to cash and term deposits
- and the rest across other asset classes including property.

By contrast, the average weighting of OECD country pension assets was:

- 18% to equities
- 55% to fixed income
- 11% to cash and term deposits
- and the rest to other asset classes including property.

So, Australia is 2.5 times more heavily weighted into equities and relatively underweight in other asset classes. We are disproportionately weighted into the most volatile and unstable asset class.

The question is – how does this weighting work to deliver the key objective of the system? 60% of total superannuation assets are held by investors over the age of 50. A large proportion of these assets should be moving towards less risky, more stable asset classes, protecting capital ahead of the retirement phase. When we reach the point where outflows are increasingly matching inflows, the weighting to equities needs to be rectified. As the system matures, a real capital adequacy risk may start to develop, which will need to be seriously monitored by the government.

SMSFs currently represent almost 32% of system assets, a pool of \$475 billion, and growing strongly. As I said earlier, generally this group has unrealistic expectations as to how much is a good return. Single digit returns sour their enthusiasm for managed funds. They think they can do better themselves. Some sophisticated investors probably can, but how many self managers have the required level of investment expertise? And by investment expertise, I do not mean falling prey to financial advisers. Notwithstanding the costs of setting up a SMSF, you need something like \$600,000 of assets to make the decision to self manage a better relative fee proposition to management by larger managed funds.

But the main issue gets back to investment skills. How many SMSF investors are competent in matters of asset allocation and general investment savvy? This becomes a real problem for the SMSF system and its deliverability as it occupies an increasingly higher proportion of overall system assets.

For systemic prudential reasons, investment in stable asset classes, such as government bonds or higher rated corporate bonds, could be desirable for SMSFs. That is, perhaps some form of minimum investment will be required which is mandated to mitigate downside risks. As the system reaches the tipping point, where inflows are increasingly being matched by outflows, it will need to be monitored for capital adequacy risk.

Hon Paul Keating was Treasurer of Australia between 1983 and 1991 and Prime Minister between 1991 and 1996.

SMSF property spruikers on borrowed time

by Graham Hand

Published 31 August, 2013

Most of the one million SMSF members have not read their 70 page trust deed, but every deed says something like: *The Trustees must ensure that each investment strategy is appropriate at all times for Members of the Fund.* The thousands of people attending property seminars aimed directly at SMSFs have additional risks to consider that are rarely, if ever, mentioned during the presentations. ASIC is watching how the industry's gatekeepers behave.

For example, is it appropriate to use high leverage to invest in a single, illiquid asset worth many times more than the SMSF itself? Or in pension phase, how will minimum pension payments be met if the property is untenanted? And where will the money come from for major repairs if all the funds are in the property?

It was welcome that Peter Kell, ASIC Commissioner in charge of the SMSF taskforce, recently spoke at the CPA Conference, and attempted to clarify the requirements for property purchased through an SMSF. To quote him:

"In the past you may have seen ASIC comment that we do not regulate direct property investment. This is the case except where the investment is made through an SMSF. Let me be very clear – a person requires an AFS licence if they recommend that an existing or proposed member of an SMSF purchase a property through their SMSF. This is because the vehicle through which the underlying investment is made is an SMSF and an interest in an SMSF is a financial product."

Then he issued this request (my underlining): "Where you see examples of unlicensed SMSF advice, please let us know."

So we should give Peter and ASIC our stories.

Attending an SMSF property seminar

There are many property companies and real estate agents running seminars targeting SMSFs. The property agents issue emails to people who have visited one of their displays or responded to an advertisement. To quote from an email from one of the largest real estate companies in Australia:

"Worried you won't have enough when you retire? Find out how you can utilise your existing superannuation to buy your next investment property. The presentation will provide insight into SMSFs and how they can help you create a brighter future for you and your family. According to the ATO's most recent SMSF bulletin, 3,000 SMSFs are being established every month, that's 100 daily and around 4 every hour!"

The seminar is held in the offices of the real estate company, and each session is packed. On the night I attend, extra lounge chairs are brought into the room, and it is standing room only at the back (near the bar). The clients are of all ages, including some surprisingly young couples. The real estate agent welcomes the crowd, says he will talk about some specific properties later, and then introduces the main speaker. We are told it's an amazing presentation that will blow us all away.

The main speaker is from an SMSF administrator. He's got quite a patter. First he tells us, "Those in the front row may need an umbrella. I tend to spit a lot". I look at the real estate man to see if he is cringing in embarrassment, but he thinks it's very funny. Then we're told some surprising statistics. We don't need much super to buy a \$1 million property. 72% of SMSFs plan to buy property at some stage, and 92% of them plan to borrow. 86% of people prefer property to equities. In the near future, \$500 billion will move into property from SMSFs, and one-third of all property will be bought by an SMSF. He tells us he has a telescope that can see into 2020, when we will be printing human organs to put into the body. And this telescope tells him there will be \$3 trillion in super and the market capitalisation of the ASX will be only \$2 trillion. The balance must find a home. In fact, the government introduced borrowing in super to encourage purchases of property. So this is going to be an LRBA night. That's Limited Resource Borrowing Arrangement, because that's how SMSFs buy property.

We are told there is a financial planner at the back of the room who any of us can talk to later.

The presentation makes the following points:

1. Using property, you can take control, diversify and stop managed funds and market fluctuations affecting your families (sic) financial future.

In fact, it couldn't be less diversified. Residential property is one single, illiquid investment. How is it diversified? Because the rent covers the interest expense on the loan, leaving money for other assets. Oh, that's fine then.

2. There's an ability to use leverage in super that cannot be accessed through 'normal' superannuation.

What is this, 'abnormal superannuation'? It is possible to leverage into other assets in super, although maybe not to the extent possible in property.

3. Use your limited super as a deposit.

The transaction example uses \$140,000 of superannuation ("maybe take it out of an industry fund") to buy a property for \$500,000. Then when you sell it for \$1 million ten years later when you are 'only' 55, you will be in pension phase where there is no capital gains tax. No mention that it might not suit you to enter a 'transition to retirement' pension for other reasons, or that for many in the room, the pension age is 60 and not 55.

It gets even better. If you don't have enough money in super but you have equity in your house, you can borrow against your house and lend the money to your SMSF under an LRBA.

4. You can reduce the purchase price of the investment property by 40% using concessional tax superannuation compared to after-tax salary for loan repayment.

The 'reduced purchase price' comes from the tax-effectiveness of superannuation, not property. Every investment is 40% lower on this basis, plus the fact that there is a \$25,000 a year limit on concession contributions. That's not much for a property deposit.

5. If you don't have enough money for a deposit, four people can pool their money to fast track to wealth, allowing increased exposure to property assets.

So now someone with a really small amount in super, plus three of their friends, can leverage into property.

And on it goes. The numbers are wonderful. The money that buys the property does not incur any income tax, and there's no capital gain on sale. Only an SMSF allows you to avoid tax like this, it is 'below the tax line'. You would be ridiculous to buy property outside an SMSF, because for your \$140,000 deposit, you need to earn \$261,682. It's so much cheaper in the SMSF. You save \$514,429 over the life of the property investment.

The structure can be put together for a fee of \$7,995 for the complete package of legal work setting up the SMSF, establishing the trust deed plus independent legal financial (sic) advice. When you check their website, where they promote their services to real estate agents, you see the 'wholesale price' is \$5,000. The rest is the agent's commission. In fact, allowing for referral fees and insurance premiums, an agent can earn \$5,700 on an average SMSF package attached to a property.

It's been quite a spiel, and the property agent is welcomed back to the microphone to offer a "grab bag of gold nuggets". These are various property developments around Sydney. And at the end, the financial adviser offers his services to anyone who wants to talk about SMSF strategies.

What does the licencing process seek to achieve?

Is that what the licencing process intends, that as long as there is a licenced adviser in the room, everything is fine? To quote again from Peter Kell: "a person requires an AFS licence if they recommend that an existing or proposed member of an SMSF purchase a property through their SMSF." At what stage is the licence required and when does the financial advice begin?

It's an irresistible combination for a marketing person based on four massive numbers: \$4 trillion in residential housing, \$1.5 trillion in superannuation, \$500 billion in SMSFs and one million trustees, many of whom are far more comfortable with bricks and mortar than they are with shares and bonds. Throw in an ability to borrow in the SMSF and an industry that has never taken a backward step in seizing an opportunity, and residential property in self-managed super has become part of every real estate agent's kit bag.

This regulatory environment is confusing many participants. The Mortgage and Finance Association of Australia (MFAA) recently launched a training programme to improve the skills of their brokers when dealing with SMSFs. The Property

Investment Professionals of Australia (PIPA) recently said accountants, financial planners and mortgage brokers were tentative about who could legally lead SMSF trustees through the property investment process.

High-profile financial adviser and author, Noel Whittaker, is currently collecting stories about victims of property spruikers. He reports in his latest newsletter that just one firm of property marketers was making 22,000 cold calls a week. He has many stories of people losing money from property investments, and although not specifically targeted at SMSFs, no doubt this product is part of the spruiking.

When borrowing was allowed by SMSFs in 2007, did the regulators expect an industry to develop that encouraged leverage of four times the value of a superannuation balance? Superannuation has tax advantages to encourage people to save for the years when they cannot earn an income. Let's hope Australia does not have a property price fall anywhere near the size of countries like the United States and Ireland, or a lot of retail superannuation money will be lost.

At least the SMSF trust deed also has provisions to cover member insanity.

Putting the 'self' into self managed super

by Andrew Bloore

Published 18 March, 2013

I am often asked, "Where should my SMSF invest?", and the answer is always the same ... it depends on what you want it to do. An SMSF can hold any allowable (ie non personal use) asset in any currency anywhere in the world, giving significant investment flexibility to your fund.

I encourage people to focus on the investment strategy, and recent changes to the law require regular reviews of an SMSF's investment strategy. Another common question is, "Should I just set my strategy really wide so I don't have to worry about it?", and my answer is always NO. Investment strategies are not compliance documents, and 0 – 100% in every asset class is not an investment strategy, it's a waste of time. It's important to know when your fund is not performing the way you want it to, and a good investment strategy will assist you. You set the mandate and if you're outside that range, you should know about it. Then you can decide if you have to change your strategy or if you need to change your investments. Make your fund work for you by setting a meaningful strategy and then monitor it.

The Superannuation Industry (Supervision) Act is very helpful. It might not be the most exciting read but the Act helps you through the decisions. For example, it has the 'sole purpose section', Section 62, which is a broad direction to start you thinking about the purpose of your super.

The Act says that super is for:

- your retirement
- you before retirement if you are no longer able to work
- your family if you die.

So consider where to invest with these points in mind. First, your retirement. Work out when you want to retire and what that means to you. Then you can work backwards to determine what you need to do today to achieve it. Next, super is there if you are no longer able to work, so what if that happens tomorrow? If you don't have enough assets in the fund, insurance will help. Another of the recent changes to super is a requirement to determine if you (or any member) need insurance. Finally, in the event of your death, where do you want your assets to go? Your family. The Act is designed with your best interests in mind.

This leads to three basic questions before working out what to invest in. What do you need? When do you need it? Who do you want it to go to on your death? The outcome of this clarity of goals leads to your investment strategy and your estate planning.

I often see wills that force all the assets out of the fund into a testamentary trust and then pay them to family members from there. This can be really tax and financially detrimental. Why take something out of a nil tax entity and put it in the hands of a marginal tax payer unless you have no other choice? Show me in your will where it says you want the Tax Office to be a beneficiary under your estate. A little planning goes a long way here.

When you have set your goals, strategy and estate plan, you need to decide exactly what to invest in. This requires a combination of professional advice and making up your own mind. An investment adviser should get to know you and the level of risk you are comfortable with. This is not static and is different for each person. What I think is low risk you might think is very risky. The key is finding a comfort level. If you lie awake at night worrying about your investments then they are too risky for you. Good advisers will help you through this.

There are traps along the way as there are so many things that an SMSF can do. You can get carried away by trying to double your assets overnight but in the real world that is like betting on red or black at the casino. Not a smart way of strategically achieving the goals you set for yourself. Your fund can borrow and this may be a good way to build your retirement assets, but you are adding to the risk. The implications of getting it wrong are significant and you must follow the rules exactly.

Everyone is different so you need to make it your fund and design it just for yourself and your dependents. That's the importance of self in self managed super, since it's about you and your family's future. Get to know your fund a lot more intimately.

Andrew Bloore is Chief Executive Officer of SuperIQ, a leading provider of administrative services for SMSFs.

The will power of binding death nominations

by Monica Rule

Published 2 October, 2014

There have been many articles in the media on disputes between SMSF trustees who are members of the same family. Judging by the outcomes, my recommendation is to put formal arrangements in place if you want your wishes to be respected in the event of your death.

Contrary to popular belief, superannuation assets do not automatically form part of a person's estate pursuant to a will. If you want your superannuation to be distributed as part of your estate, you will need to check the wording of the Trust Deed and create a binding death benefit nomination (BDBN).

The way superannuation savings will be paid from an SMSF, in the event of death, is based on the SMSF's Trust Deed. As well as stating how your benefits can be received by you while you're alive, it should spell out how they will be distributed when you die.

The complication with SMSFs is that under superannuation law, it is not compulsory for an SMSF to have a BDBN. Without it, the surviving members in your SMSF determine who your benefit will be paid to. This may not be a problem if there is only you and your spouse and both want each other as beneficiaries. But what if you want some or all of your superannuation to go to your children?

As the BDBN is not compulsory, there are no restrictions on what it can contain. Normally a BDBN needs to be witnessed by two individuals who are not beneficiaries to the estate. It also needs to be updated every three years for it to remain valid, but even here there are exceptions. The SMSF Trust Deed can spell out under what terms a BDBN will be accepted. For example, it can offer a BDBN that does not have to be updated on a regular basis (a non-lapsing binding nomination) or does not need to be witnessed by two people. A non-lapsing nomination remains valid until the member changes it or revokes it. Please talk to a lawyer on what you should put in your Trust Deed as well as in a BDBN.

The two court decisions described below show how disputes were resolved both with and without a BDBN.

Ioppolo & Hesford v Conti [2013] WASC 389

Mr and Mrs Conti were trustees of their SMSF but were estranged. Mrs Conti made a will stating her superannuation entitlements were to go to her four children and expressly stated she did not want any of it to go to her estranged husband. She did not have a BDBN. The terms of their Trust Deed were that in the absence of a BDBN, the surviving trustee could use their discretion to pay the benefit. Mr Conti paid Mrs Conti's benefit to himself. Mrs Conti's children took action against their father. The court ruled in Mr Conti's favour as he acted within the requirements of the trust deed. Mrs Conti's will carried no weight in the court's decision.

Wooster v Morris [2013] VSC 934

Mr Morris and his second wife were trustees of their SMSF. Mr Morris made a BDBN in March 2008 in favour of his daughters from his first marriage. Mr Morris died in February 2010. Mrs Morris decided that the BDBN was not binding and paid herself all of Mr Morris' superannuation entitlement. The daughters took action against her. The court found in favour of the daughters, but because Mrs Morris controlled the SMSF, it took many years for Mr Morris' daughters to claim their benefit and their court costs. Unfortunately Mrs Morris died and her estate filed for bankruptcy which consequently left the daughters with a large shortfall in their entitlements.

In conclusion, the correct wording in both an SMSF's Trust Deed and a BDBN are critical to ensure that your wishes are carried out in timely manner.

Monica Rule worked for the Australian Taxation Office for 28 years, is a SMSF Specialist Advisor, and is the author of The Self Managed Super Handbook, recently released in its fourth edition.



Financial advice

Noel Whittaker on FoFA shortcomings, Chris Cuffe on what financial advice is worth paying for, David Bell on whether clients understand advisers, Jonathan Rochford on resetting the fee debate between fund managers and investors and Andrew Gale on post-retirement planning.

FoFA is not in anyone's best interests now

by Noel Whittaker

Published 27 November, 2014

In 2006 Westpoint, a mortgage trust offering returns of 12% per annum, went belly up leaving their investors with nothing. In 2008 Opes Prime collapsed, resulting in further losses, followed a few months later by the demise of Townsville-based Storm Financial which caused thousands of Australians to lose their life savings. Subsequent investigations revealed that Storm had been charging entry fees of up to 10%, and that Westpoint had been paying a 10% commission to advisers who recommended them.

Naturally, disasters of this scale made headlines, and gave vested interests the opportunity to bag the financial advice industry in general. The paradox is that the actions of these three companies were far removed from the operations of the average financial adviser.

Westpoint was a mortgage trust that got caught in the development business, Opes Prime was a margin lender with shonky documentation, and Storm had a one-size-fits-all model which resulted in many of their clients being over-gearred.

The desire to 'do something'

Be that as it may, the cries for somebody to 'do something' resulted in the Ripoll Inquiry, which was charged with the responsibility of recommending reforms to the financial system so these disasters could never happen again.

The final report was released in November 2009, and its recommendations were introduced to parliament by the Labor Government, with the title FoFA – Future of Financial Advice. Despite the best intentions of the members of the Ripoll Committee, who are good people, FoFA has been a disaster. It has created layer upon layer of red tape, yet has done little to protect the investor.

The cost of implementing FoFA, which will ultimately be borne by the consumer, was estimated in 2009 at \$700 million, with annual costs of \$375 million. Given the raft of paperwork since, it's fair to say that FoFA has cost well over a billion dollars.

Following representations from the financial planning industry, and as part of their programme of eliminating red tape, the current Coalition Government attempted to wind back part of the FoFA 'reforms'. The changes appeared to be on track until the last minute when Senators Lambie and Muir took us back to square one.

It is ironic that the complaints from the Timbercorp investor who had lost money were the catalyst for the change of heart, yet it has been reported that, in that specific case, the intermediary had been an accountant, not a financial adviser.

Ill-informed views

Given the adversarial nature of politics and the argy-bargy between industry funds and other players in financial services, we have been subjected to an unprecedented amount of ill-informed hysteria.

Opt-in is a classic example. The original FoFA rules contained an opt-in provision which required financial advisers to contact their clients at least once every two years for clients to confirm in writing that they wished to stay with their present arrangements, and were happy to continue to pay asset-based fees.

The requirement is pointless. Clients are already provided with details of fees in the original Statement of Advice, as well as in their annual fee disclosure statements AND in their regular product statements. Furthermore, they are not locked-in, as they could be with a telephone or pay TV contract. They are free to opt-out at any stage without penalty.

National Seniors have been running a scare campaign claiming that their members will be seriously disadvantaged if the government scraps the opt-in rules. National Seniors would be better off using their precious resources on an education campaign.

Are they trying to say their members are so naïve that they don't talk to their financial planner at least once every two

years, and they're not capable of reading a simple statement of fees being charged?

Australia is sinking under a weight of unnecessary and onerous compliance. Almost weekly, I receive large documents from people such as my accountant, insurance agent, bank and stockbroker providing information which I don't need, and will never read, because it's now the law. There is still a feeling among bureaucrats that the only way to protect a consumer is to require bigger and bigger amounts of paperwork in the interests of 'disclosure'. The practical effect is a load of unnecessary work on the good guys who have to churn it out, and even more confusion for the consumer who is handed reams of paperwork they are most unlikely to read.

The overreach of 'best interests duty'

A major stumbling block is the requirement that the financial adviser must act in the 'best interests' of their clients. This would seem to be stating the obvious because one could reasonably expect that your lawyer, doctor, dentist and every other person you dealt with would have an obligation to act in your best interests. My legal friends tell me this is not the case. People who contract with you have a duty of care and if they fail on this duty of care, an action can be taken for negligence.

The introduction of the new term of 'best interests' opens up a new area of law. [The regulations](#) require that an adviser act in the best interests of clients, provide appropriate advice, warn the client if the advice is based on incomplete or inaccurate information, and prioritise the client's interests.

In an attempt to get around the problems with the definition of best interests, there is provision for an adviser to put themselves into a 'safe harbour'. To be protected by 'safe harbour' rules, the adviser must:

1. Identify the objectives, financial situation and needs of the client
2. Identify the subject matter of the advice sought
3. Identify the objectives, financial situation and needs of the client that would reasonably be considered relevant
4. Make reasonable enquiries if it is apparent that the information provided by the client is incomplete or inaccurate
5. Assess whether they have the expertise to provide the advice sought. If not decline to give advice
6. Conduct a reasonable investigation into the financial products that might achieve the client's objective
7. Base all judgements on the client's relevant circumstances.

Now here's the rub! As well as all the foregoing, there is a final 'catch-all' point, that the adviser is also required to take "any other step that ... would reasonably be regarded as being in the best interests of the client." (Corporations Act 2001, Section 961B (g)). Yes, we are back to square one.

To help in clarifying my own thinking, I spent an hour with a senior legal figure to discuss FoFA in depth. Raising an eyebrow he chuckled, "This is so vague I could drive a cart through it."

He also opined out that it encouraged advisers to think in terms of tick-the-box – in other words, to focus on and spend time box-ticking in lieu of ethics.

FoFA was well-intentioned, but the grim reality is that it now costs a financial advisory firm at least \$2500 to open a file and prepare a Statement of Advice for potential clients. This means that the lowest paid in the community, those who need advice the most, have been priced out of the market.

And while all this has been going on the property spruikers, the real villains in the 'advice' space, are left free to carry on their rapacious trade. Apparently, regulating the property market stays in the too hard basket.

Noel Whittaker is the author of [Making Money Made Simple](#) and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. His website is www.noelwhittaker.com.au.

What financial advice is worth paying for

by Chris Cuffe

Published 13 February, 2013

The S&P/ASX200 price index peaked in October 2007 at 6851, a remarkable 2.5 times its level five years earlier, in March 2003, of only 2693. The long bull market had started after 'the recession we had to have' in 1990, and for at least 15 years, financial planners could factor handsome ongoing returns from equity allocations into Statements of Advice.

The market index is now about 5000, 27% below its peak, and it is apparent that the strong market prior to the GFC disguised many shortcomings. As Jack Bogle, the highly respected founder of the Vanguard Group, said, "Never confuse skill with luck, especially during a bull market."

With lower absolute returns from investment markets after the GFC, many market participants (including the funds management industry that I have operated within for the past 30 years) have faced greater scrutiny and criticism, and they will need to work harder and smarter in future to earn their keep.

This article focuses on financial planning and examines the elements of financial advice that are most valuable for clients.

Financial planning has grown rapidly in recent decades, with current estimates of 17,000 planners across Australia. The increase from a small base has been fuelled by:

- relatively complex tax and social security laws, especially concerning retirement planning
- the compulsory superannuation system
- a low interest rate environment causing investors to search for growth, where returns were attractive
- intergenerational transfer of wealth
- opening up of investment markets to 'the man in the street' as a consequence of more knowledge, media coverage, financial advertisements and high profile sharemarket listings (such as AMP, Telstra, CBA, GIO, Qantas, TAB, Woolworths, NRMA).

Prior to 2007, most investors who followed a planner's advice would have been reasonably happy with the results. Advice fees, traditionally a percentage of the assets invested, were a relatively small proportion of the returns generated, and many financial planners received a handsome income. Happy investor ... happy financial planner ... happy, growing industry.

But times have changed. To quote another legendary American investor, Warren Buffett, "It's only when the tide goes out that you learn who's been swimming naked."

Increasingly, investors are asking whether the fees paid, either directly or indirectly, to financial planners represent value for money, or indeed whether they need a financial planner at all. No doubt some planners feel this is unfair because returns rise and fall and this is not necessarily a valid reason to either criticise or praise a planner or their fees. Markets move quite independently of what a financial planner says or does.

But the poor returns prior to the 2012 rally were not the cause of the changes required in the financial planning profession, merely the catalyst.

So the question is: what type of financial advice is worth paying significant fees for?

Access to a wide variety of asset classes can be gained by anyone, regardless of whether they consult a financial planner. This is particularly the case today with a plethora of investment platforms, educational material, managed funds with low minimum balances and easy access to everything listed on the ASX through cheap online broking. Access to investments is not a planner's competitive advantage, perhaps with some exceptions in the rarefied world of exclusive, private banking.

Similarly, the ability of a planner to select the best investment managers, and create an expected superior performance, is often overstated. In any case, this role is carried out by independent specialist research houses who give managers 'star' ratings for their investment skills. Advisers can access these services, and will develop familiarity and preference for

certain managers, but last year's league table winner is often next year's laggard. In fact, most money is made or lost each year from being in or out of a particular asset class, not from who is managing the money within the asset class.

What about the planner's role in selecting the correct *short-term* asset allocations? Again, history has shown us that it is virtually impossible for anyone to predict the winning asset class in any particular year. Peter Lynch, famed former investment manager with the Fidelity Group, has stated about market timers, "... they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."

Further, Jack Bogle's summary of market timing was less pithy but equally precise, "In 30 years in this business, I do not know anybody who has done it successfully and consistently, nor anybody who knows anybody who has done it successfully and consistently. Indeed, my impression is that trying to do market timing is likely not only not to add value to your investment program but to be counterproductive."

It is not that knowledge of expected *long-term* returns from various asset classes is irrelevant and of no value to a client. It is important for a planner to advise what proportion of a client's money should be invested in each asset class, with a 'through-the-cycle' perspective. But this should not result in regular switching, even as a yearly exercise, because of the volatility of different asset class returns over short time frames and the impossible exercise of predicting this with certainty.

The role of combining a client's investments together into a single, easy to comprehend report, showing consolidated performance, transactions, market values, income receipts, calculators, tax implications and so on was once a significant value-add of a planner. This is now done by administration platforms or software solutions which are increasingly 'all-inclusive', and available directly to the investor. Administration services and reporting tools have become a low value commodity. The adviser has a role to play in ensuring the correct platform is selected for the skills, experience and financial resources of the client, but it is part of the outfit to play the game, not the game itself.

There is some value in all the above, especially in the establishment phase of a plan, but what should be the greater focus of high quality, value-adding financial planning?

Simply stated, the value in good financial planning is understanding a client's needs and setting and adhering to a realistic long-term strategy to achieve a desired outcome for that client. Doing this with first rate client service and a strong projection of trust and professionalism are the keys to success. It requires knowledge and skill, and is a lot more complicated than pontificating about the short-term merits of a particular manager, asset class or stock.

Setting strategy requires a good understanding of many aspects of personal finance, including:

- taxation laws, particularly those relating to capital gains tax and superannuation
- social security rules
- expected long-term returns and volatility from various asset classes
- estate planning
- asset and income protection
- the role of trusts, companies and partnerships
- personal budgeting
- family law, especially where assets require splitting
- structured philanthropy

This knowledge is worth paying for. Until investors understand the true value in financial planning, the relationship between financial planners and their clients will often become dysfunctional when markets are producing poor returns. The industry needs to move clients away from gauging success by the return appearing on their yearly investment statement, and much more towards the overall strategy.

A financial planner requires reward for execution and adherence to a sound, personalised strategy. Where the fee between a financial planner and an investor is fair and reasonable and sustainable value is being delivered, there is no justification for the criticism of fees during periods of poor returns. However, if the 'sale' by a planner to a client was all about sexy, quick investment returns, then the investor has every reason to complain about fees when investment returns are poor. This is not financial planning. This is speculating.

The financial planning industry must continue to advance into a mature profession that the public understands and properly values. We can look forward to such changes with enthusiasm. Good financial planning advice is an extremely valuable service and increasingly essential as the general population continues to age and the compulsory superannuation system works its way through a full life cycle.

Do clients understand what advisers are saying?

by David Bell

Published 29 November, 2013

Financial literacy levels in Australia and around the world are low, but it may be eye-opening to learn just how low they are. It's an important issue for financial advice. There's no point providing a 70 page Statement of Advice if the client does not understand the basic concepts in there.

How is financial literacy measured? Annamaria Lusardi and Olivia Mitchell (from Dartmouth College and Wharton School, University of Pennsylvania) have led the development of financial literacy survey designs. There are two assessments most commonly used – a basic and an advanced literacy test. Here are the 'Australianised' versions of these tests (created by Bateman and research partners*). Answers can be found at the end of this article.

Test 1 – basic financial numeracy

1. Numeracy/interest rate: Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow? (Answers: a. More than \$102; b. Exactly \$102; c. Less than \$102; d. Do not know; e. Refuse to answer.)
2. Compound interest: Suppose you had \$100 in a savings account and the interest rate is 20% per year and you never withdraw money or interest payments. After 5 years, how much would you have on this account in total? (Answers: a. More than \$200; b. Exactly \$200; c. Less than \$200; d. Do not know; e. Refuse to answer.)
3. Inflation: Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account? (Answers: a. More than today; b. Exactly the same; c. Less than today; d. Do not know; e. Refuse to answer.)
4. Time value of money: Assume a friend inherits \$10,000 today and his sibling inherits \$10,000 three years from now. In three years, who is richer because of the inheritance? (Answers: a. My friend; b. His sibling; c. They are equally rich; d. Do not know; e. Refuse to answer.)
5. Money illusion: Suppose that in the year 2020, your income has doubled and prices of all goods have doubled too. In 2020, how much will you be able to buy with your income? (Answers: a. More than today; b. Exactly the same; c. Less than today; d. Do not know; e. Refuse to answer.)

Test 2 – advanced financial numeracy

1. Individual shares: Buying shares in a single company usually provides a safer return than buying units in a managed share fund (Answers: a. True, b. False, c. Do not know, d. Refuse to answer)
2. Shares versus bonds: Shares are normally riskier than bonds (Answers: a. True, b. False, c. Do not know, d. Refuse to answer)
3. Diversification: When an investor spreads his money across different assets the risk of losing money... (Answers: a. Increases, b. Decreases, c. Stays the same, d. Do not know, e. Refuse to answer)

Lusardi and Mitchell subsequently identified the three underlined questions as most significant for a shorter test which is known as the 'financial literacy instrument'. It is used in academic studies around the world and in government body surveys in the US.

Table 1 shows the survey results for basic financial literacy for Australia and the US.

| | 1. Numeracy / interest rate | 2. Compound interest | 3. Inflation | 4. Time value of money | 5. Money illusion | All Five Correct |
|-----------|-----------------------------|----------------------|--------------|------------------------|-------------------|------------------|
| Australia | 88.4% | 71.8% | 78.4% | 54.9% | 86.7% | 36.5% |
| US | 91.8% | 69.0% | 87.1% | 73.8% | 78.4% | 43.8% |

Table 1: Basic financial literacy results: Australia: Bateman et al (2011)*, US: Lusardi & Mitchell (2009)

In addition, Julie Agnew and research partners (2013)** performed the shorter financial literacy instrument test across a survey group of over 1,000 Australians. They found that only 43% achieved three correct answers.

Most industry participants should find the basic financial literacy questions quite simple, so the numbers in the final column of Table 1 should be alarming. Only 36.5% of Australian participants answered all five questions correctly, especially since the academic literature indicates that people with higher levels of financial literacy are more likely to plan for retirement.

There are many areas where the industry could make use of financial literacy tests, such as:

- At a financial planning level: When assessing risk tolerance do financial planners also assess financial literacy? Financial literacy levels may distort risk tolerance assessments used across industry. Should risk tolerance be independent of financial literacy (ie a true measure of our tolerance for risk)? Does the way that advice is delivered take into account financial people's level of financial literacy?
- For SMSF's: Are people capable of being effective trustees of their own SMSF if they do not have basic levels of financial literacy? Is there a way that basic financial literacy assessment can be included in a checklist on whether it is appropriate for someone to establish an SMSF?
- For institutional super funds: Should there be a basic financial literacy requirement for trustees of super funds? While the diversity of skill arguments across trustees are well made, surely a minimum level of financial knowledge should be a pre-requisite.

The results of this research are worrying. As an industry we have to be careful to understand that financial literacy levels of non-industry participants may fail to even reach basic levels. The way that we communicate complex information is very important and an ongoing challenge for regulators, product manufacturers and financial planners.

Answers:

Basic financial literacy: 1 – a, 2 – a, 3 – c, 4 – a, 5 – b

Sophisticated financial literacy: 1 – b, 2 – a, 3 – b

* Hazel Bateman, Christine Eckert, John Geweke, Jordan Louviere, Susan Thorp and Stephen Satchell

** Julie Agnew, Hazel Bateman and Susan Thorp

David Bell is Chief Investment Officer at AUSCOAL Super. He is also working towards a PhD at University of NSW.

The great fee debate: resetting manager and investor expectations

by Jonathan Rochford

Published 8 August, 2014

The recent push by the SEC in the United States and ASIC in Australia for greater transparency on asset management fees has reignited the debate about what is fair and reasonable. Managers are cast as greedy and investors are portrayed as ungrateful and focussed more on fees than on total returns. The battlelines have shifted for some in Australia with the introduction of MySuper, which adds to the pressure to reduce the total fees paid by fund members. Having been on both sides at different times in my career, I believe I can comment on the reasonable expectations each side should have.

Factors in picking a manager

I'll first touch on three key factors when picking a manager: integrity, outperforming a relevant benchmark, and taking a small share of the outperformance.

The first is often accepted as a given, but clients of Bernie Madoff found this assumption can be financially fatal. A portfolio can recover from underperformance of an unskilled and honest manager, but not from a complete capital loss. This applies equally when taking advice from accountants and financial planners who recommend products, with many pre-crisis timber schemes and mezzanine mortgage funds in Australia relying on extraordinary commissions to drum up sales.

The second criteria superficially can appear to be simple. The trick comes when a manager compares itself to an irrelevant

benchmark such as an investment grade bond index for an unrestricted bond fund or an overnight cash rate for an absolute return strategy. One recent study found that private equity earns around half its total performance from using leverage and from timing its entry and exit points (multiple expansion), thus muddying the comparison with a vanilla equity index. Some asset classes have much easier benchmarks to beat than others. For instance relatively few large cap managers materially outperform their index after fees yet almost all small cap managers do.

The last factor is where this debate really takes off. Once you've found an honest manager who you think is likely to outperform in the long term, how do you fairly reward that manager? What's the right split between the base management fee and the performance component?

I'll focus first on resetting manager expectations before moving on to investor expectations in Part 2 of this paper.

Resetting manager expectations

In my time acting as an institutional investor a number of things commonly frustrated me:

1. Where I thought the manager was being paid way too much to get out of bed, and then took a decent chunk of any outperformance as well. Why are managers entitled to be paid so much merely for fund raising not for raising the value of my capital?
2. Where I believed the manager was acting for their financial interest rather than giving investors a choice of what would best suit them. How can a manager pretend that something is unequivocally the best thing for me when they are clearly conflicted?
3. Where I didn't know what was happening with the investments and then faced stonewalling or hostility when I asked for information. Was the manager hiding something?

These situations and many conversations along the way shaped what I think about what managers should expect.

Managers are not entitled to a million dollar lifestyle until their clients are richly rewarded. If you can't beat a relevant index in the long term you are wasting an investor's time and money.

When I see managers charging 1% or more in management fees on multi-billion dollar portfolios I see that as excessive and unjustified. The cost of salaries for good people, decent systems and modest office space simply doesn't require it. Some managers seem to believe that being able to craft a nice story about their investment process including a pretty slide pack means that they are doing their job. For investors to benefit, managers need to be rewarded for performance not presentation.

Investors are entitled to 90% of the outperformance over the index

This one is partly economics and partly conscience. Having done the calculations before setting up an asset management business I believe a 90/10 split well-rewards managers who outperform. But it is also a matter of conscience and I note that many managers will see 80/20 or 70/30 as the fair split. For the vast majority of managers, they are easily replaceable with another manager of equivalent or better skill, including index managers. Even in bullish markets when there is much capital around looking for an investment home, the demand/supply balance ultimately rests with investors.

Fees should be easy to explain and transparent

The recent SEC reviews of US private equity managers has highlighted the chutzpah of many managers in charging underhanded fees and the indolence of many investors in allowing the situation to exist unchecked. Managers should be able to fully explain their fees in one page or less. A standard base and performance fee model should suit almost all manager/investor relationships, with the incentive then placed onto the manager to minimise their costs of doing business. Where a specific additional service is required, this should be subject to investor sign-off.

Investors are always entitled to know where their money is and why it has been invested there

If a manager truly believes they have the recipe for a secret sauce and that revealing their positions will divulge the recipe, then that must be something everyone signs up to on day one. At least quarterly, managers should sit down with their investors and tell them where they see their sector positioned. I suspect many managers don't do this as they fear being exposed as not having anything meaningful to say, or that an honest conversation might result in their investors recognising that other sectors present better risk and return prospects.

Investors are entitled to know the risk and return prospects and be given a choice to change

Whether it is has come about by bad experience or is simply an irrational fear, many managers are not able to say to their clients that their sector is not offering great value at a particular time. I've recently attended a number of presentations where US high yield debt managers have put forward the thesis that other cycles have made further gains from this point so investors should remain invested for now. Stripping away the hyperbole, their message could be rephrased "historically

markets have become more overvalued than they are now so be greedy and squeeze the last few percent of gains out of this cycle." This is short term, self-serving advice. Managers should trust investors that if they offer to give some cash back now when prices are high, they'll be first in line to receive more capital when prices are lower and the prospects for performance fees are much higher.

Managers need to accept that investors may have valid fee or liquidity constraints that rule them out

I cringe when I hear the whining of some managers that investors should ignore fee, liquidity or return targets, often mandated by regulation. Why should an investor change their business model or lobby government for a change in regulation so that a private equity manager can earn high fees? Why should venture capital or agriculture managers be entitled to special treatment if historical returns don't point to their sector outperforming in the future? Why should an investor take greenfield infrastructure risk because it is good for the economy rather than a good risk and return proposition? If a manager isn't able to put forward a convincing case of future outperformance and appropriate fees they shouldn't complain about investors passing on their 'opportunity'. They should be looking to either change their business model or to pitch to other investors who have different views and constraints.

Managers should start changing their business models now to reflect a lower fee future

Managers need to start reducing their standards in their salaries, offices, flights, accommodation, entertainment and use of professional services ahead of a sea change in fee levels in the next decade. More large investors are increasing their index positions as they accept that the few managers that can materially outperform an index would be swamped if given a meaningful allocation of the investor's total capital. An Australian superannuation fund told me that their cost of adding another dollar to an index equity product was 0.01% per annum. That's increasingly what managers are competing against. Without the ability to survive in a lower fee environment, managers must excel in either performance or marketing, or accept that they are in a dying business.

Jonathan Rochford is a Portfolio Manager at Narrow Road Capital. Narrow Road Capital advises on and invests in various credit securities. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

A better approach to post-retirement planning

by Andrew Gale

Published 21 November, 2013

The post-retirement sector is large and growing rapidly, and financial advice processes need to be more sophisticated to deal with potential problems such as sequencing risk and longevity risk. What I will call 'Post-Retirement Optimised Portfolios (PROPs)', based on stochastic modelling, should be part of the solution.

In the [March 8, 2013 issue of Cuffelinks](#), I wrote, "Growth in the post-retirement population over the next 20 years is mind-boggling, with different five year age groups (e.g. 65-70, 70-75, etc.) growing between 60% and 100% between 2010 and 2030. There will be major growth in the age 65-70 segment over the next five years as the first wave of 'boomers' reaches retirement. We need much greater sophistication in post-retirement advice and investment solutions, including the use of investment scenarios or stochastic modelling in building optimised portfolios. This poses particular challenges for product and advice providers."

Based on the latest Deloitte Superannuation Report, Australia's post-retirement sector is forecast to grow from \$333 billion as at 30 June 2013 to \$1.4 trillion in 2033. Over \$800 billion of the 2033 assets is forecast to be in SMSFs as the baby boom bulge transition into post-retirement.

Changing the post-retirement emphasis

Let's start by recognising the post-retirement issues we want to address:

- sequencing and longevity risks are acknowledged, but without solutions
- debate is too product-orientated
- deterministic rather than stochastic planning.

There is much debate about conservative versus growth-oriented asset allocations for retirees in the post-retirement phase. This often rests on assumptions regarding the equity risk premium, and the arguments put forward tend to be too simplistic.

There is now much greater discussion regarding sequencing risk and longevity risk, which is encouraging. However, we still lack sufficient advice solutions and portfolio construction tools to deal with these risks.

Too often the debate about post-retirement solutions revolves around product – for example, the relative merits and demerits of annuities and deferred annuities – rather than a focus on advice solutions and portfolio construction, with products only being considered following that process.

Retirees with less than say \$250,000 in financial assets (including super) at retirement will have a significant reliance on the age pension. This largely addresses sequencing and longevity risks for this group. Some retirees will also rely on scoped advice or simple retirement calculators, with all their shortcomings.

People with over \$3 million in financial assets, including super, at retirement should also be relatively well-placed to weather sequencing and longevity risks, providing of course they do not practice an overly lavish lifestyle.

This article is primarily directed at those with financial assets at retirement in the \$250,000 to \$3 million range, and those receiving comprehensive financial advice. A common approach to post-retirement financial advice for these people is risk profiling, cash flow modelling, high level asset allocation, portfolio construction, and product selection.

My concern is that existing processes for cash flow modelling tend to be based on deterministic approaches. That is, determining a fixed expectation of investment returns corresponding to the asset allocation, and conducting future cash flow modelling based on this expected return.

Volatility of returns and the impact of the order of returns (sequencing risk) tend not to be well incorporated. Longevity risk tends to be dealt with in a rudimentary way by assuming living to average life expectancy, sometimes complemented by basic scenario analysis where we assess 'how long the money will last' at various ages of death.

The problem is that deterministic models only consider an expected outcome and do not consider the range of possible outcomes that retirees may experience. This is valuable information for the planner to consider, to communicate with their client and to be used as a basis for plan design.

On average, deterministic predictions will have approximately a 50% success rate, meaning that there is a 50% likelihood that a retiree would have experienced their expected planned retirement outcome, with some left over as an estate, and a 50% likelihood that the retiree would exhaust their retirement accumulation and have to accept a lower level of consumption in retirement. Is a '50% right' plan good enough? Even with cash or contingency reserves of up to twice the targeted annual income draw to deal with sequencing risks, the percentage likelihood of a deterministic based plan being 'right' will only be marginally improved.

A proposed approach

We need a stochastic approach rather than a deterministic approach.

A stochastic approach simply considers variability in outcomes by allowing for variation in the inputs which go into the forecasting model. This can be done using mathematical techniques where one derives a distribution of outcomes. The other, more common approach, uses simulation techniques, producing many simulations which are aggregated into a picture of the range of outcomes.

A stochastic approach uses many different sources of variability which affect outcomes. Examples include returns, risks and correlations between asset classes, and factors which affect mortality outcomes (systemic piece (longevity risk) and the idiosyncratic piece (that individuals may experience a different outcome to the population expectation)). The amount of detail can be significant when one incorporates products (allocated pensions, life annuities, variable annuities, reverse mortgages), direct investments in the various key asset categories, and the age pension (with means testing and indexation) and various taxes.

The broad approach to the construction of a Post-Retirement Optimised Portfolio (PROP) would be as follows:

1. Retiree client to force rank their retirement objectives (see below).
2. Input key information into the modelling engine, including current assets and allocation, targeted income and capital cash flow requirements, risk profile, age, force rankings, etc.
3. Perform stochastic runs to produce the many simulations (typically thousands), using random number generators to model many different outcomes, and difference sequences of returns.
4. Review the results of the stochastic model, including the likelihood of meeting the various force ranked post retirement objectives.
5. Adjust inputs to better match achievement of the highest ranked post retirement objectives.

Post-retirement objectives

The three key post-retirement objectives are:

- a capital or estate goal – i.e. to have a certain amount of capital preserved at various future ages, either to cover aged care costs, health costs, or targeted estates for beneficiaries
- income goals
- goals regarding tolerance for variability in income.

Clients will need to rank what is most important to them.

A key output from the simulations is the construction of an optimised portfolio with asset allocations (including direct investments) which seek to fulfil the ranked objectives. A simpler version is the consideration of say 4-10 alternative portfolio constructions, and using the simulations to assess which constitutes a 'best fit' with the ranked objectives.

The outputs from the stochastic modelling will show the full range and extremities of future financial asset holdings and income levels, allowing for different sequences of returns and the risk of outliving the assets.

An optimised portfolio would show the probability of fulfilling the various objectives. For example, it may show that a retiree has an 85% chance of achieving the capital or estate goal at the age of 87 based on an income of \$55,000 per annum, indexed to inflation from retirement.

If this client has chosen the capital goal as their most important objective, they may find this outcome unacceptable. They can then recalibrate the inputs to produce a result which more closely fits their force ranked objectives. For example, this may require some increase in their appetite for variability of income. Or a small reduction in targeted income requirements, from \$55,000 to \$50,000, can significantly increase the likelihood of achieving the capital goal.

This approach enables well informed trade-off decisions. Typically this would be presented in a visual format to increase client understanding.

It is not unusual for such optimised portfolios to have a 'bedrock' source of income, which may generate 20-40% of post-retirement income. This could include social security, annuities or an equity release product. Such sources of income also have a low degree of correlation with returns from other financial investments. This PROP approach would also be able to demonstrate where deferred annuities may be appropriate.

Current developments and an appeal for action

Some entities are developing this capability, including Deloitte US, Mercer and Count Financial, and investment research house Lonsec and global actuarial firm Milliman. This paper is a high-level overview and I would love to hear from you if you have been pursuing similar endeavours. It can be refined for factors such as the different phases of post-retirement (active, passive and impaired) and funding future health and aged care costs.

The wealth industry needs to deliver superior post-retirement solutions, including:

- more research on this topic, such as the work by the Actuaries Institute's Retirement Incomes Research Group
- greater innovation and commercial initiative, as mentioned above
- large wealth management institutions and advice firms embracing these more sophisticated post retirement approaches
- advisers encouraging their licensee to pursue this more sophisticated approach.

Hopefully, as these approaches are adopted, it will be possible to integrate such modelling with mainstream financial planning software platforms.

Andrew Gale is co-owner and Executive Director at Chase Corporate Advisory and a board director for the SMSF Professionals Association of Australia (SPAA). The views expressed in this article are personal views and are not made on behalf of either Chase Corporate Advisory or SPAA.



Equities investing

Lessons from Warren Buffett, Ashley Owen on 10 years of the mining boom and why economic growth does not drive stock market returns, Graham Hand on understanding how performance fees affect returns, Roger Montgomery studies Ben Graham, a look at how gearing drives equity returns and Chris Stott on discounts and premiums in Listed Investment Companies.

Ten lessons from Warren Buffett's 2013 shareholder letter

by Graham Hand

Published 7 March, 2014

Each year since 1965, Warren Buffett has written a newsletter to Berkshire Hathaway shareholders, and the [2013 letter](#) was released last weekend. In that time, Buffett has produced an annual compounded gain of 19.7%, turning USD19 into USD134,973. Wow, the power of compounding over 49 years!

In Buffett's words, here are some highlights (only the headings are mine):

1. Irrational herd mentality is bad, fear is good

Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments ... Indeed, tumbling markets can be helpful to the true investor if he has cash available when prices get far out of line with values. A climate of fear is your friend when investing; a euphoric world is your enemy.

2. Focus on earnings and productivity

Focus on the future productivity of the asset you are considering. If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on. No one has the ability to evaluate every investment possibility. But omniscience isn't necessary; you only need to understand the actions you undertake.

3. Worrying about price fluctuations is speculating not investing

If you instead focus on the prospective price change of a contemplated purchase, you are speculating. There is nothing improper about that. I know, however, that I am unable to speculate successfully, and I am skeptical of those who claim sustained success at doing so. Half of all coin-flippers will win their first toss; none of those winners has an expectation of profit if he continues to play the game. And the fact that a given asset has appreciated in the recent past is never a reason to buy it.

Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard. If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays.

4. Ignore macro opinions or the political environment

Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: "You don't know how easy this game is until you get into that broadcasting booth.") In the 54 years we have worked together, we have never foregone an attractive purchase because of the macro or political environment, or the views of other people. In fact, these subjects never come up when we make decisions.

5. Don't need to own 100% of a great business

At Berkshire, we much prefer owning a non-controlling but substantial portion of a wonderful company to owning 100% of a so-so business; it's better to have a partial interest in the Hope diamond than to own all of a rhinestone ... Woody Allen stated the general idea when he said: "The advantage of being bi-sexual is that it doubles your chances for a date on Saturday night." Similarly, our appetite for either operating businesses or passive investments doubles our chances of finding sensible uses for our endless gusher of cash.

6. The best opportunities are in the United States

Charlie and I have always considered a 'bet' on ever-rising U.S. prosperity to be very close to a sure thing. Indeed, who has ever benefited during the past 237 years by betting against America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. And the dynamism embedded in our market economy will continue to work its magic. America's best days lie ahead ... Though we invest abroad as well, the mother lode of opportunity resides in America.

7. Non-professional investors will do well indexing

You don't need to be an expert in order to achieve satisfactory investment returns. But if you aren't, you must recognize your limitations and follow a course certain to work reasonably well. Keep things simple and don't swing for the fences. When promised quick profits, respond with a quick 'no.'

Most investors, of course, have not made the study of business prospects a priority in their lives. If wise, they will conclude that they do not know enough about specific businesses to predict their future earning power. I have good news for these non-professionals: The typical investor doesn't need this skill. In aggregate, American business has done wonderfully over time and will continue to do so (though, most assuredly, in unpredictable fits and starts) ... A low-cost S&P 500 index fund will achieve this goal.

My money, I should add, is where my mouth is: What I advise here is essentially identical to certain instructions I've laid out in my will. One bequest provides that cash will be delivered to a trustee for my wife's benefit. (I have to use cash for individual bequests, because all of my Berkshire shares will be fully distributed to certain philanthropic organizations over the ten years following the closing of my estate.) My advice to the trustee could not be more simple: Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors – whether pension funds, institutions or individuals – who employ high-fee managers.

8. Don't sell when the news is bad

The main danger is that the timid or beginning investor will enter the market at a time of extreme exuberance and then become disillusioned when paper losses occur. (Remember the late Barton Biggs' observation: "A bull market is like sex. It feels best just before it ends.") The antidote to that kind of mistiming is for an investor to accumulate shares over a long period and never to sell when the news is bad and stocks are well off their highs. Following those rules, the 'know-nothing' investor who both diversifies and keeps his costs minimal is virtually certain to get satisfactory results. Indeed, the unsophisticated investor who is realistic about his shortcomings is likely to obtain better long-term results than the knowledgeable professional who is blind to even a single weakness.

9. A public pension crisis is coming in the United States

Local and state financial problems are accelerating, in large part because public entities promised pensions they couldn't afford. Citizens and public officials typically under-appreciated the gigantic financial tapeworm that was born when promises were made that conflicted with a willingness to fund them. Unfortunately, pension mathematics today remain a mystery to most Americans.

During the next decade, you will read a lot of news – bad news – about public pension plans. I hope my memo (reproduced in his report) is helpful to you in understanding the necessity for prompt remedial action where problems exist.

10. 50 years of Berkshire Hathaway

Next year's letter will review our 50 years at Berkshire and speculate a bit about the next 50.

My personal perspective on 10 years of the mining boom

by Ashley Owen

Published 24 October, 2013

This year marks the 10-year anniversary and the conclusion of my big plunge into mining stocks. Starting in September 2003, I bought into about a dozen mostly speculative mining and mining-related stocks, to add to my existing BHP holding.

Great speculative mining booms occur about once every 30 years or so in Australia. Before the 2000s boom, the last big one was in the late 1960s. I will probably be old or long gone before the next big speculative mining boom comes along, and so it was good to experience one first hand.

Buying into hope and hype

Following China's entry into the World Trade Organisation in 2001, it took me two years to bring myself to buy mining stocks because of my fundamental dislike of their business model. Digging up rocks and loading them onto the nearest ship while other people in other countries use their brains to turn our rocks into useful things, then buying those useful things back at a thousandfold mark-up with money borrowed from foreigners, seems to me like a dumb idea. That's Australia's main export business model. Add to that the potentially enormous costs of remediating the giant holes in the ground and the environmental issues that are left behind.

So it took me two years to bring myself to buy rock diggers and, worse still, speculative explorers that hadn't even found rocks to dig up yet. I also bought several mining services companies with the idea that they would benefit from a possible mining boom even if the mining companies themselves didn't make money, as almost all miners don't.

Let's be clear. It was not investing, it was speculating, as most of the companies I bought had little or no revenues. Some had little more than hope and hype. It was a gamble that China would hold together politically after the 1989 Tiananmen Square crisis and not go down one of many disastrous paths it had taken before – like the 'Great Leap Forward' in the late 1950s or the 'Cultural Revolution' in the late 1960s to mid-1970s. It was a gamble that the handover of power from Jiang Zemin and Zhu Rongji to the new team of Hu Jintao and Wen Jiabao would be smooth and untroubled.

It was a gamble that the Chinese economy and social fabric would survive the massive banking insolvencies after the bad debt binges in the 1990s. It was a gamble that mining commodities prices would somehow arise from their slumber after going nowhere during the 1980s and 1990s (and indeed falling in real terms over the past century). It was a gamble that China could successfully undertake what would turn out to be the biggest construction boom in the entire history of human existence.

It was also a gamble because I knew the history of mining booms and busts in Australia and I knew of the extraordinarily high failure rate of Australian mining stocks.

Miners and explorers – the great Aussie gamble

Australians love a gamble and one of their favourite ways to have a punt has been on mining stocks. From the early days of the first stock exchanges in the Australian colonies right up to the present day, the majority of stocks listed on Australian stock exchanges have always been mining stocks (or explorers actually). The vast majority of them have never produced a cent in profits nor paid a cent in dividends.

Australians have always been happy to punt on the stock they discover for 1 or 2 cents per share, hoping it will shoot up to \$100. There are very few ways in which an ordinary worker can hope to turn a small bet into a fortune – the lotteries, the pokies, the races, and mining stocks. Dot com stocks had their day in the sun in the late 1990s, but the prospect of making a fortune with mining stocks has been around for nearly 200 years since the first copper mine boom in Kapunda and Burra in South Australia, well before the gold rush in Victoria.

In every mining boom, hundreds of new companies are hastily thrown together to harvest money from the pockets of 'investors' (ie punters) caught up in the mining fever. Unfortunately most of the money raised in every mining boom has been lost – either pocketed by promoters, siphoned off by brokers, or simply wasted looking for minerals that are either

never found or are found in too low grade to mine profitably.

In every boom the vast majority of mining companies run out of money and collapse, leaving only a small number that survive and sometimes prosper.

Western Mining

One very rare example of success (but only for those investors who got the timing right through the various phases of its life) was Western Mining. It was one of the hundreds of new gold stocks floated in the 1930s gold boom, and one of the few to survive more than a few years.

Western Mining was funded by a group of London investors in 1933 to explore for gold in WA in the gold price boom triggered by the Sterling and US dollar devaluations against gold in the depression. It found commercial grades of gold in Kalgoorlie and then moved progressively into other minerals, including bauxite in the 1950s, nickel in the 1960s, uranium, oil & gas, phosphates, copper, and finally back to gold.

Western Mining was rare in that it managed to make enough money out of several of these booms, and the management then had the unusual foresight and courage to recognise when each boom was over and then to move on in search of the next one. It was a hot gold stock in the 1930s gold boom, a hot bauxite stock in the late 1950s, it was the original hot nickel stock in the late 1960s nickel boom even before Poseidon. Western Mining's discovery of nickel at Lake Lefroy near Kalgoorlie in 1966 kicked off a wild nickel boom. Then it reverted to being a hot gold stock (or rather lukewarm by that time) in the late 1970s gold boom.

Western Mining's share price hit a peak of \$19 per share in 1969. The late 1960s nickel boom collapsed in the early 1970s, the late 1970s gold boom collapsed in the early 1980s, and the prices of all commodities including gold, oil and industrial metals fell heavily in the 1990s. Even at the top of the gold bubble in early 1980, WMC only reached \$3.50 per share. It reached a peak of \$12 at the top of the 1987 stock market boom, but it then collapsed by 84% to just \$1.92 in the October 1987 crash.

In 2002 the company was split into WMC Resources, which was taken over by BHP Billiton for \$7.85 in cash – a loss of more than 50% for those who bought in the late 1968s boom, and that's before inflation. The remainder was renamed Alumina, which is still listed today and worth around \$1 per share. Those investors who bought Western Mining shares its heyday in the late 1960s mining frenzy are still waiting to get their money back after 45 years! It had a great run, and fortunes were made in each of the booms, but the trick is to get out when prices are high and not hang on in the forlorn hope that 'this time it's different'.

Western Mining was very rare in that it survived as long as it did. BHP is another example but it diversified into several other industries beyond mining for much of its life, which included manufacturing behind high protective barriers until they were dismantled in the 1980s and 1990.

BHP shares peaked at £413 in February 1888 at the top of the late 1880s/early 1890s silver and lead mining boom. That's \$34.70 in today's dollars in real terms after CPI inflation and after accounting for all of the splits and changes in capital structure over the years. People who bought BHP shares at the top of the 1888 mining boom had to wait 75 years for the share price to recover in real terms after inflation. BHP is still only \$36 today as I write this in October 2013, some 125 years later!

These then are the reasons why it took me two years to finally bring myself to buy mining stocks in 2003, when you almost couldn't give away mining stocks, they were so unpopular.

Selling decisions

Making buy decisions is hard enough, but I find what and when to sell even harder. Fortunately several of the stocks I bought were taken over in the 2007-08 mining boom and so those decisions were made for me. Others I sold in the boom because of the crazy prices offered, and I finally sold the remainder this year (although I retain BHP and Rio Tinto shares).

Ten years was a great run and the gamble paid off. There was a lot of luck involved. Most stocks went through the roof, but that's what happens in a speculative bubble. You use the money you can afford to lose. My best stock was Fortescue Metals (FMG), which was little more than hope and hype when I bought in September 2003 for 27 cents per share (or 2.7 cents adjusted for the 10:1 split in December 2007). I had seen Fortescue founder Andrew Forrest take shareholders for a wild ride in Anaconda Nickel in the 1990s (from a safe distance, not as a shareholder) so I knew it was going to be a rollercoaster ride in Fortescue. The difference was that prospects for iron ore in the 2000s looked a whole lot brighter than nickel did in the 1990s (nickel prices halved in the 1990s), so I bought some shares. I sold most of the shares in 2007-08 and the rest recently.

My returns from several of the companies could have been significantly higher had it not been for some selling errors. I sold some too early and others too late, although it helps that they were bought in the early stages of the boom.

Speculating versus investing

There is still money to be made in mining stocks, but it is generally not at the speculative end of the market. Mining booms generally occur in three stages. First there is a commodity price surge when speculative explorers tend to do best – but only if they find something, or at least report that they find something. This was in 2003-2007. This first phase is usually triggered by a rise in demand (this time China) and also by the fact that mining investment had been virtually non-existent during the previous couple of decades since the last boom during which the low commodities prices from the last glut of production made exploration and development uneconomic.

The second stage is a construction boom, when engineering and mining services companies tend to do well. This was during 2006 to around 2010-11.

Finally, there is a production boom and the companies that prosper are the lowest cost producers, usually large scale and diversified. Commodity prices fall as supply increases when new mines start producing, costs rise, the higher cost producers get squeezed but the lowest cost miners prosper. Most of the holes in the ground end up being abandoned, boarded up or flooded with water.

I still hold shares in BHP and Rio Tinto, which are low cost, high volume producers that are likely to survive even if commodity prices fall, as they are likely to do as new supply comes on stream in the coming years. They are held as parts of well-diversified, long term, multi-asset class portfolios.

It is one thing to reminisce about speculative booms but they are few and far between, and the trick is to get in early when they are deeply unpopular. Never buy into the hype at the top of the boom – that is when you should be thinking about selling, not buying.

In the meantime investors need to be very careful with their long term wealth and this requires investing prudently, not gambling or speculating. Speculating is fine if done with money you can afford to lose, and kept well away from long term portfolios. Speculating is for buying beach houses, boats and Bentleys. If it doesn't work out it doesn't matter. On the other hand, long term portfolios are what investors and their families are going to have to rely on for the rest of their lives, and that calls for 'investing', which means sensible diversification and disciplined risk management.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

Watch the performance of performance fees

by Graham Hand

Published 5 December, 2013

Many investors take a cursory look at the performance fee when investing in managed funds or Listed Investment Companies (LICs), perhaps figuring that a high fee is a good problem to have. It must mean the fund manager has delivered outstanding performance. It's a reward for excellence, and we share the spoils together, right?

Not always. There is no market standard for performance fees, and it pays to know how a fund will reward its manager. The most common performance fee is 15 to 20% of the excess return above the benchmark plus the base management fee. Therefore, with an average base management fee for Australian equities of about 0.9% (which is paid regardless of performance), a performance fee often starts to accrue if the fund outperforms the benchmark plus 0.9%.

But it doesn't always work like that. For example, there are Australian equity funds with performance fees calculated over the cash rates. In the last 12 months, the ASX200 is up 22%, while the cash rate is 2.5%. Even if the fund manager only achieves the index, a 20% performance fee will generate a payment of 20% X (22%-2.5%) which equals an eye-popping 3.9%, usually on top of a base management fee.

This reduces the index return from 22% to 18.1% less the management fee and expenses. That's probably more than the investor is earning on the cash allocation elsewhere in the portfolio.

MySuper rules on performance fees

There have previously been no rules or guidelines issued by regulators on performance fees, so it was good to see some clarity from the [Stronger Super Review](#). It's a useful guide to what to look for, and many current fees breach this model. MySuper products are allowed to charge performance fees on the following terms:

- a reduced base fee that reflects the potential gains the investment manager receives from performance based fees, taking into account any fee cap
- measurement of performance on an after-tax (where possible) and after-costs basis
- an appropriate benchmark and hurdle for the asset class reflecting the risks of the actual investments
- an appropriate testing period
- provisions for the adjustment of the performance based fee to recoup any prior or subsequent underperformance (for example, high water marks, clawbacks, vesting arrangements and rolling testing periods).

Key findings from Morningstar study

In 2011, Morningstar studied 82 investment strategies in large cap Australian share funds, and found 18 employed some form of additional performance charge, as reported in this [White Paper](#). They found that even the fund managers themselves often misunderstood their own fee calculations.

Their key findings have a significant overlap with the MySuper rules, plus:

- The headline performance fee is just one aspect which should be considered. The management fee has the potential to be much more costly.
- Absolute fee structures – those not linked to an appropriate equities-related benchmark – would have proven extremely costly to investors over the previous 10 years.
- Any performance hurdle employed should at least cover the base management fee, to avoid investors paying additional fees for potentially sub-par returns.
- Fund managers which have the ability to reset their high watermarks have the potential to act against investors' best interests.
- Fund managers typically crystallise their performance fees over too short a period, creating the potential for a shorter-term mindset which is inconsistent with their stated longer-term goals.

High water marks

Performance fees should only be paid once the manager has recovered previous underperformance (either relative to an index or in absolute terms, depending on the incentive structure). This test in the performance fee calculation is called a 'high water mark' because the previous high level of the fund must be reached before the performance fee kicks in.

For example, assume the market index is up 10% in the first year, while a fund is up only 5%. Then in the second year, the index is up 10% again, and the fund rises a healthy 15%. Ideally, there should be no performance fee in the second year, because the manager has delivered index performance over two years (ignoring the impact of the base fee, which should make the hurdle for performance fees even higher). The high water mark established at the end of the first year needs to be recovered.

But here is an opportunity for a new investor which became highly attractive after many funds underperformed during the GFC. If an investor enters the fund in the second year in the above example, there will be no performance fee paid despite that investor experiencing an above-market 5% return. There is a negative accrual in the performance fee calculation from the year before. If the fund is one where the base fee is lower due to the performance fee, the investor can achieve active returns for modest fees if the timing is right. It should be possible to ask any fund manager for a list of funds with negative performance fee accruals.

However, this also demonstrates a weakness of pooled unit trust structures which Individually Managed Account-type products are designed to avoid. Performance fees in a unit trust must be calculated at the trust level as a whole, not by investor. The negative accrual from prior losses is shared with future investors in a pool, resulting in a return to paying performance fees earlier.

Vast variety of performance fees

Even within a single Product Disclosure Statement of a platform provider, the performance fee section shows amazing diversity, including non-compliance with the MySuper rules laid out above (and hence, these are not eligible to be My

Super funds). Take as an example the PDS of Colonial First State's FirstChoice Wholesale platform, available here (fee section on page 9). The variations include performance fees that are calculated:

- before management fees*
- after management fees*
- over zero – commonly used for hedge funds or 'absolute return funds' which do not have a market index (or beta) exposure
- over the cash rate
- over the bank bill rate
- over an equity market index such as the S&P/ASX300 Accumulation Index or MSCI World
- inclusive of franking credits and overseas withholding tax
- with a variation from 10% to a mouth-watering 25% of the 'excess return'.

*An example of the difference is: assume a fund has a management fee of 1%, delivers 2% above its benchmark, and a performance fee of 20%. If the performance fee is calculated 'before management fees', it is $20\% \times 2\%$ equals 0.40%. If it is 'after management fees', it is $20\% \times (2\% - 1\%)$ or 0.20%. Easy to overlook, but costs an extra 0.20% in fees.

Performance fees make an extraordinary difference to the economics of running a funds management business. A rule of thumb is that a fund manager might expect the base management fees to cover the costs of opening the doors, while the performance fees deliver the profits, shared in large measure with staff. For example, the listed Australian company K2 Asset Management with around \$750 million in funds under management had a good year in 2013, earning \$24.3 million in performance fees compared with only \$124,000 the year before.

Here are two examples of different approaches in the Listed Investment Company (LIC) space:

1. Flagship Investments Limited is an Australian equity fund which aims to be at least 90% invested. Its performance fee is 15% of the amount by which its net performance (after all costs) exceeds the bank bill rate. On first look, this seems unreasonable, as a long-only equity fund is measuring itself against a cash index. But the mitigating feature is there is no fixed management fee, and the manager provides administrative services without charge. This approach pays off handsomely for the manager in good equity market, then he relies on his own resources in flat or down years. An investor can decide if this is fair.
2. Sandon Capital is a new Australian equity LIC currently in the IPO stage. Its performance fee will be 20% above the one month bank bill rate, plus a base fee of 1.25% per annum. Again, on first blush, it looks expensive. However, this is not a normal long-only fund, it is an activist fund. It will invest in shares where the manager will advocate for change to unlock value, and may often be substantially in cash. Again, the investor can decide if this is fair.

These two funds illustrate the unique circumstances behind many performance fees.

In summary, the ideal performance fees will be measured against an appropriate benchmark after allowing for the fixed management fee, be subject to a high water mark and have some trade off with a lower base fee. But there may be particular circumstances related to the way money is managed which justify a deviation from this formula.

Ben Graham's three most enduring principles

by Roger Montgomery

Published 12 September, 2013

Benjamin Graham was the father of security analysis and the intellectual Dean of Wall Street. I believe Graham was many things, including the father of the many ratios we take for granted in our work as analysts, portfolio managers and investment officers. Perhaps controversially, I also believe he may not have reached some of his conclusions had he access to a computer that allowed him to properly test his ideas.

Having said that, there are many things that Ben said that not only made sense but made significant contributions to investment thinking. And despite the absence of a computer, Graham observed several characteristics of the market that the advent of modern computing has only served to reinforce.

For those grateful for executive summaries, here follows mine on the three most significant contributions Ben Graham made to the body of work on investing.

By understanding, testing and implementing the approaches that flow from a study of Graham's principles, I believe any investor will benefit not only in terms of returns but also in terms of risk mitigation. In Part 2 next week, we will display anecdotal evidence of their truth with graphics using modern computing and the techniques of the development team at Scaffold.com.

Lesson One

The first of Graham's significant contributions is his Mr. Market allegory, introduced in 1949. Mr. Market is of course a fictitious character, created to demonstrate the bipolar nature of the market.

Here is an excerpt from a speech made by Warren Buffett about Ben Graham on the subject:

"You should imagine market quotations as coming from a remarkably accommodating fellow named Mr Market who is your partner in a private business. Without fail, Mr Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains...

Mr Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow.

Transactions are strictly at your option...But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr Market is there to serve you, not to guide you.

It is his pocketbook, not his wisdom that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence."

The implications of this little story cannot be understated. What Graham is saying is that there is a legitimate alternative to the Efficient Market Theory as a model of the way the market behaves and works. He said this before EMT became the cornerstone of every financial services firm that cared about "biggering and biggering and BIGGERING."

Another significant implication is that as investors we should be less focused on price as our guide as we should on value. This challenges the validity of many streams of financial study that have as their root, the price of securities. Think about all the PHD papers and other academic studies that uncover relationships, or validate the power of explanatory variables, but whose concluding evidences are merely price, or some derivative of price. If prices in the short run are determined by those who are merely selling to renovate the bathroom or by events in Syria – events that have no impact on the number of \$2 buckets being sold by The Reject Shop – what 'value' can we place on them?

Lesson Two

The **second** great lesson Ben Graham taught gave us the three most important words in value investing; margin of safety. In engineering the margin of safety is the strength of the material minus the anticipated stress. Building materials that are far stronger than that required to survive the anticipated stress ensures a degree of comfort.

When it comes to investing, the margin of safety is the estimated value of a share minus the price. The greater the margin of safety, the greater the degree of comfort and more importantly, the greater the expected return. If the price is what we pay, and the value what we receive, then the lower the price we pay, the higher the return.

Lesson Three

Despite the high profile of these enduring two lessons, I believe there is a third observation of Graham's, which is equally important. Fascinatingly, with the benefit of computers, we can also demonstrate that Graham was spot on.

Graham was paraphrased by Buffett in 1993:

"In the short run the market is a voting machine – reflecting a voter-registration test that requires only money, not intelligence or emotional stability – but in the long run, the market is a weighing machine."

What Graham described is something that, as both a private and professional investor, I have observed myself; in the short

term, the market is a popularity contest – prices often diverge significantly from that which is justified by the economic performance of the business. But in the long term, prices eventually converge with intrinsic values, which themselves follow business performance.

Next week, we will compare intrinsic value and share prices for some major Australian stocks to illustrate Ben Graham's enduring principles.

Roger Montgomery is the founder and Chief Investment Officer at The Montgomery Fund.

The returns to expect from gearing into shares

by Graham Hand

Published 7 March, 2013

Never stand between a product promoter and a bucket of cash. The sharemarket has a good rally after falling for most of 2011 and the first half of 2012, and market commentary quickly turns to how much further it can run in 2013. Suddenly, the focus switches away from dowdy capital protection, since it's too painful to sit in cash at 4% when the market delivers 20% in 2012 and then 5% in January 2013 and, to make it worse, another 5% in February 2013.

And then come the inevitable noises, in a market that swings more than an unlocked gate in a storm – what about a bit of gearing. If the market is rising, and funding costs are low, let's have more of the action.

Before any investor takes this step, regardless of whether it is appropriate in a world which has done little to address its fundamental problems, there is one question a potential borrower should ask: *how well must the market perform for a geared portfolio to perform better than a normal, ungeared portfolio?* Or put a different way, if the market index rises or falls 10%, how much will a geared strategy change in value?

Surely, that's easy. If I borrow \$100,000 to add to my own \$100,000 and invest \$200,000, don't I simply double the return? And if the market is down 5%, then my return will be down 10%. I can live with that risk, so let's have a chat with my nearest margin loan provider.

Sorry, the returns don't work like that.

First, let's take a look at the recent history of margin lending in Australia.

| <u>At end of</u> | <u>Total</u> | <u>Value of security</u> | <u>Number of clients</u> |
|------------------|------------------|--------------------------|--------------------------|
| | <u>\$million</u> | <u>\$million</u> | <u>thousands</u> |
| Dec-2004 | 15,524 | 35,031 | 134 |
| Dec-2005 | 20,827 | 47,721 | 147 |
| Dec-2006 | 30,823 | 68,194 | 193 |
| Dec-2007 | 41,589 | 93,193 | 248 |
| Dec-2008 | 23,440 | 45,537 | 233 |
| Dec-2009 | 21,608 | 60,045 | 260 |
| Dec-2010 | 19,240 | 57,412 | 232 |
| Dec-2011 | 15,078 | 44,316 | 209 |
| Dec-2012 | 12,235 | 43,142 | 182 |

At the market's peak, a quarter of a million Australians borrowed \$41 billion secured against \$93 billion of shares, and this is only one part of the equity gearing market. There is also an unknown amount of drawings against the equity in home loans, internally geared share funds, and other products such as instalment warrants. And when investors do not fully understand the risks, a scandal such as Storm Financial is created, where the Townsville-based adviser had 13,000 clients

with \$4 billion invested, much of it borrowed by people without the means to repay.

With exquisite timing, SMSFs became allowed to borrow in September 2007. The market peaked in November 2007, so it was probably a blessing that more SMSFs were not caught by the GFC falls. There is not yet much evidence that SMSFs are increasing gearing into equity markets. For example, SMSF administrator, Multiport, issues an SMSF Investment Patterns Survey, and in December 2012, reported only a small increase in the number of financial asset loans. In fact, the average loan size decreased from \$96,000 in June 2012 to only \$76,000 in the latest Survey.

Borrowing to invest will increase if market remains strong

While gearing into shares is less popular than it used to be, it is still a massive industry with healthy margins, and if the market continues to rise, the product providers will be out banging the drum again. More media stories will appear on the benefits of gearing, especially targeting the one million trustees of SMSFs. So is gearing into shares likely to be worthwhile on a returns basis?

According to interest rate website www.ratecity.com.au, there are currently 68 margin lending loans available in Australia, with rates ranging from 7.65% to 8.13%. The cash rate is currently 3% and the yield curve is relatively flat, so these loans carry healthy lending margins of up to 5%. If a borrower chooses a protected equity loan, which includes option protection against falling markets, the interest rate can be 10% or more, depending on the loan to valuation ratio.

It is usually cheaper to borrow against the value of a property, and home equity loan rates are currently around 6%. The borrower must be comfortable exposing the family home in this way.

Another way to gear into the sharemarket is by using internally geared share funds, especially popular with SMSFs given the administration complexity of other forms of borrowing. These funds simply build the debt into fund structure. For example, a fund geared at 60% will take \$10,000 from an investor and borrow another \$15,000 to invest \$25,000 on behalf of the unitholder (\$15,000/\$25,000=60%). The interest cost is significantly lower than in margin lending because these funds borrow in wholesale markets, currently at around 5% or less. However, management fees are charged on the gross assets (including the borrowed amount), so geared funds gross up the fees handsomely. Nice work if you can get it.

The calculation which many geared investors overlook

In order for a geared strategy to be worthwhile, the ungeared (or market) return must be enough to cover the interest cost plus any management costs and fees. The formula is:

$$\text{Geared Return} = \frac{(\text{Ungeared Return} - \text{Gross Fees}) - (\text{Gearing Ratio} \times \text{Interest Cost})}{(1 - \text{Gearing Ratio})}$$

The gearing ratio is the amount of debt as a proportion of total assets, so if an investor puts in \$40 and borrows \$60, the gearing ratio is 60%. Obviously, interest is only paid on the borrowed amount, so the lower the gearing, the less the impact of the loan rate. This calculation ignores the fact that income may be taxable and expenses may be deductible.

A typical example of a geared share fund will have an interest cost of 5%, a gearing ratio of 60% and fees on the gross assets of the fund of 1%. Assume the normal accumulation index (price plus dividends) rises 10% over a year. The Geared Return will be 15%, being 9% return after fees (10%-1%), less the interest cost (60% of 5% is 3%), leaving 6% net return, divided by the 40% equity put in by the investor, to give 15% (6%/0.4).

If the market is flat, the Geared Return would be -10%, being the cost of 1% in fees and 3% interest, divided by the capital of 40% to give -10% (Note that these examples consider total returns, including price, dividends and franking credits, so 'flat market' means prices have fallen enough to offset the dividends and franking).

If the index falls 10%, the 'loss' on the investor's capital is a whopping 35%

This is where the asymmetry of returns can shock investors. How can the loss be 35% when the market is down only 10%? It does not seem intuitively correct. It's the effect of costs plus the 250% gearing.

Consider the exact dollars. An investor puts in \$100,000 and borrows \$150,000 to invest \$250,000. The portfolio is down 10% or \$25,000. The fund charges 1% on gross assets or \$2,500 and the interest cost is \$7,500 (even at a low rate of 5%). That's a loss of \$35,000 or 35%.

By the same reasoning, many investors with margin loans in 2007 lost 100%, even when gearing ratios were lower. They put in \$100,000 and borrowed \$100,000, and then their shares fell in value by 50%. Their loss was not 50%, it was 100%. All their capital was gone.

Here are the geared returns on a typical geared share fund for various levels of (ungeared) market performance (the same calculations apply to any form of gearing).

| Accumulation Index (Ungeared) | Geared Return | Gearing Ratio (debt/assets) | Gross Asset Fee | Interest Cost |
|--|----------------------|--|------------------------|----------------------|
| -20% | -60% | 60% | 1% | 5% |
| -10% | -35% | 60% | 1% | 5% |
| 0% | -10% | 60% | 1% | 5% |
| 5% | 2.5% | 60% | 1% | 5% |
| 10% | 15% | 60% | 1% | 5% |
| 20% | 40% | 60% | 1% | 5% |

A margin loan invested on the ASX in, say, cheaper Exchange Traded Funds (ETFs) may save on the asset management fee, but the borrowing cost is likely to be up to 8%, making the above geared returns even worse. For example, if the market loses 10%, an investor with a margin loan at 8% would lose 37%. The 'break even' level – the amount the index needs to rise for a geared strategy to give the same return as ungeared – is about 6.7%.

It's also noteworthy in the above example that the market can rise 5% and the geared investment rises only 2.5%. So it's not true to say that 'gearing enhances market rises', because the market rise must be enough to offset the fees and interest cost before gearing is an 'enhancement'.

But these numbers also explain why geared funds top the performance lists whenever the market rallies strongly. For example, the geared funds of market leaders Colonial First State and Perpetual are both up around 50% in the last year.

A geared investor needs high risk tolerance

Gearing is not for the fainthearted, especially when many believe single-digit returns will become more the norm. A gearing ratio of 60% will give an investment with 250% of the volatility of the standard equity index.

Of course, the same as above applies to any geared investment, including buying the family home. Residential owners are blessed by not having daily market valuations, so they do not realise when their geared exposure has made a massive loss. Plus they tend to consider property investment longer term, especially the house they live in.

This leads to the type of mindset you need to gear into equities. It is for the highly risk tolerant and based on a long term strategy, because short term losses can be severe. Unless one of the simple geared products is chosen, borrowing within super is complex and expensive, and an SMSF may not be the best structure to learn whether you have the risk tolerance.

So next time a salesman calls promoting an equity loan, ask him a simple question: "If the market is down only 10%, how much will I lose?" When he shrugs his shoulders, show him the answer.

Economic growth does not drive stock market returns

by Ashley Owen

Published 4 July, 2013

This is one of the many examples of a widely-held and seemingly logical belief about how investment markets work, that is in fact the opposite of what actually happens in real life.

In every city in every major country across the world, floors full of well-meaning (and expensive) economists, fund managers and analysts spend their lives assessing the outlooks for economic growth rates in the hope that it somehow translates into stock market returns. Whenever the World Bank, the IMF, OECD, central banks, or a major investment bank comes out with its latest economic forecasts, investors everywhere naturally try to understand what it may mean for share prices.

Good economic growth should be good for share prices, and low economic growth (or even worse, recessions) should be bad for share prices, right? Well, wrong actually. Most of the time, it's the opposite in real life.

The 'top down' approach

There are many approaches to forming views about the outlook for share prices and whole stock markets. One of the main traditional and widely used approaches is the 'top down' method. This starts with the global economic outlook and then the outlooks for regions, countries, sectors, industries, and then individual companies.

It is all based on the quite logical assumption that economic growth drives (or is caused by, or at least coincides with) company earnings growth, and that earnings drive stock prices. Or at least expectations of economic growth and expectations of earnings drive stock prices. Or perhaps even that expectations of likely changes in economic growth rates drive stock prices directly.

Of course there are many links between economies and company earnings. After all, what makes up the 'economy' is individuals, firms and governments receiving and spending money; buying, selling, exporting and importing goods and services; saving, investing, borrowing, employing people, etc. – and listed companies are involved in almost all stages of these activities that make up the economy. So it would make sense that increases or decreases in economic activity should affect listed company earnings and share prices.

The problem is that none of these assumptions hold true very often. In fact in most years and in most countries the opposite is the case.

There is no exploitable statistical relationship between economic growth rates and stock market returns, either at a global level or in individual countries, or indeed individual companies. We will look at the global picture first, since economies are highly interconnected and stock markets are also highly correlated.

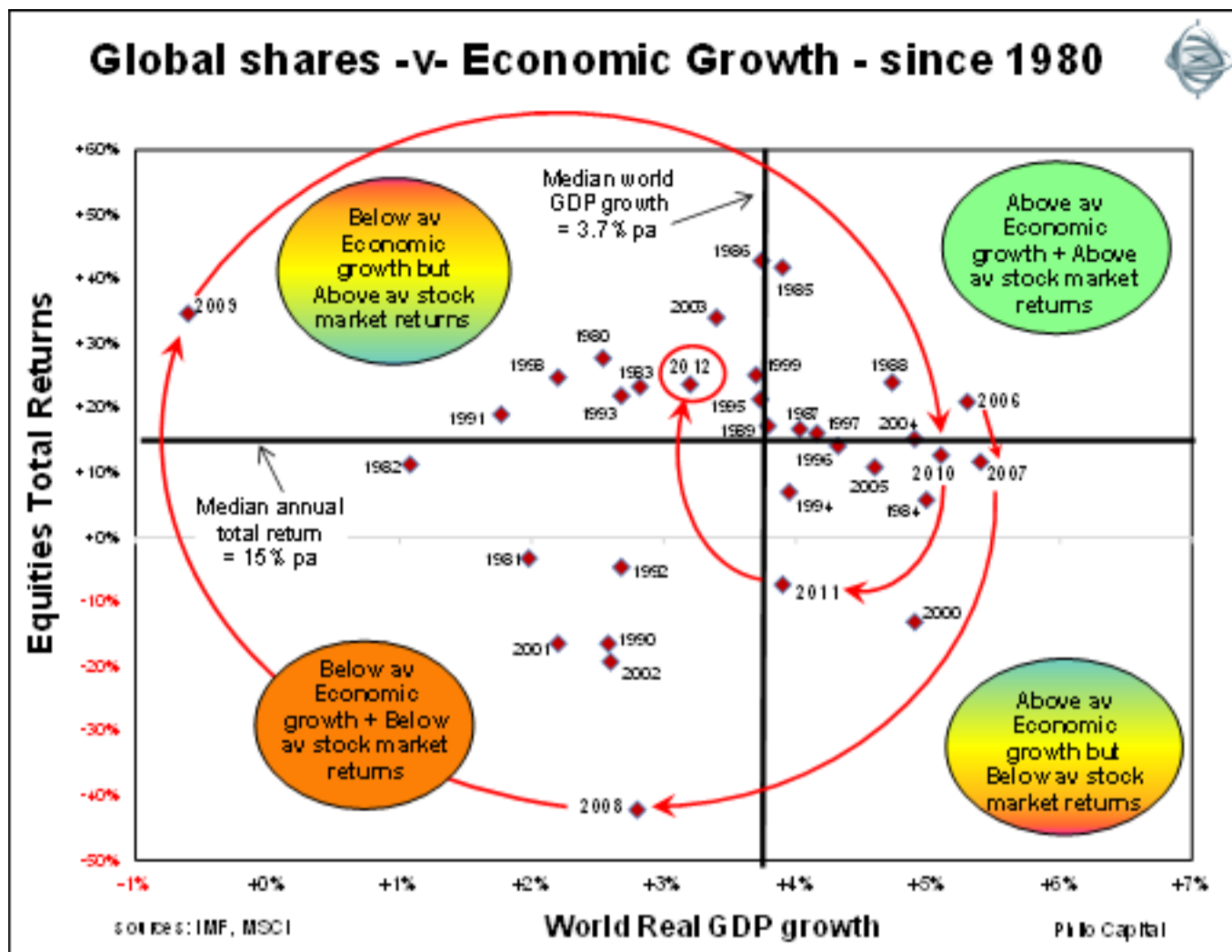
Global economic growth versus global equities returns

Only rarely do above average world economic growth rates coincide with, cause or result from, above average stock market returns. In only 2 years in the past 32 years since 1980 has this been the case – 1988 and 2006.

Likewise, in only 5 years have below average world economic growth rates coincided with, caused or resulted from, below average stock market returns – 1981, 1990, 1992, 2001 & 2002.

In fact at least half of the time when economic growth was above average, stock market returns were below average, and at least half of the time when economic growth was below average (including in global recessions), stock market returns were above average.

This can be seen in the following chart of world real GDP growth and world stock market total returns (ie price changes plus dividends) for each year since 1980:



If economic growth rates coincided with, caused or resulted from, or somehow translated into stock market returns then most years would be in either the top right segment (above average economic growth + above average stock market returns) or in the lower left segment (below average economic growth + below average stock market returns). But in real life this has not been the case.

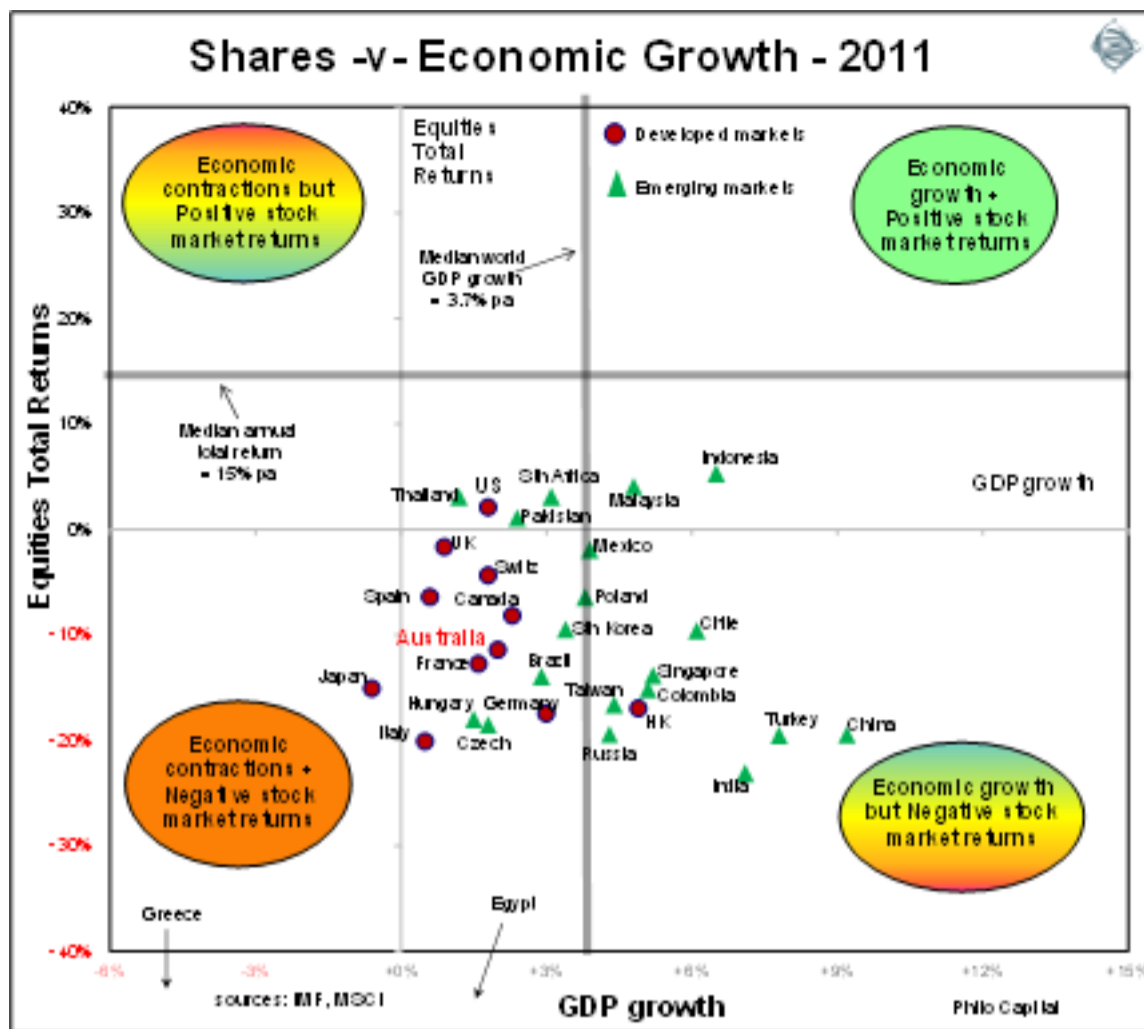
For example 2012 was similar to several other years in the recent past – when economic growth was below average but stock market returns were above average. This followed 2011 when economic growth was above average (3.9% compared to a 30 year average of 3.7%) but stock market returns were very poor and well below average.

Going back further, in 2009 world economic growth contracted in the deepest global recession since the 1930s depression, but shares had a great year in 2009 and the world stock market index was up by 29%!

Individual countries

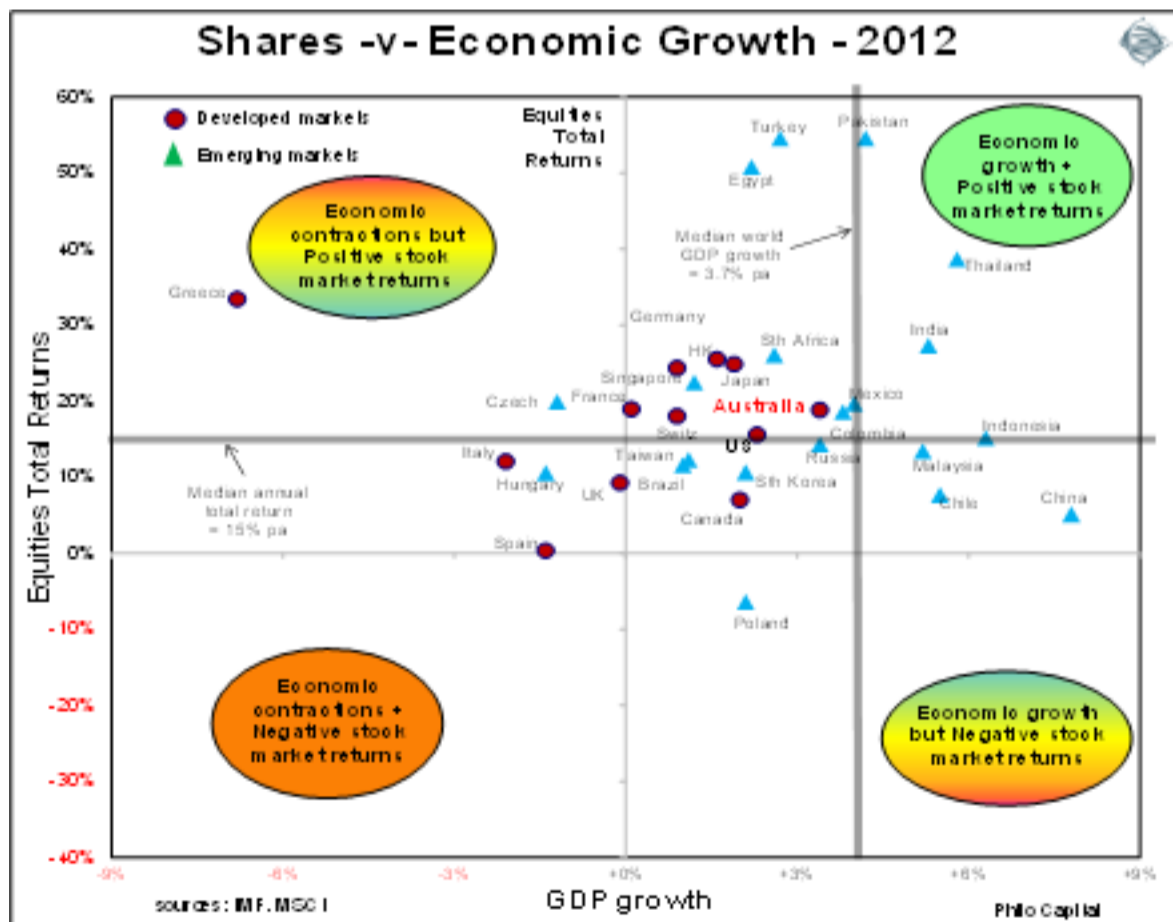
There is a similar story when looking at cross sectional returns in individual countries in any particular year.

For example, in 2011 economies almost everywhere grew (except Japan with its tsunami/nuclear crisis), overall global growth was above its long term average, and earnings and dividends grew strongly in most of the major countries. But almost all stock markets were down heavily that year, despite the good growth in economies, earnings and dividends.



In 2011 the highest growth economies (China, India, Turkey) had the worst stock market returns. Of those very few major stock markets that had positive total returns in 2011, only Indonesia posted price gains. In the others (US, Thailand, Pakistan and South Africa) the broad market price index fell, but the addition of dividends helped them just scrape into positive total return territory, while Malaysia was flat.

Then in 2012 the situation reversed. Economic growth rates were lower and earnings growth stopped or fell in most countries (including in most of the big markets), but stock markets in almost every country boomed.



Nearly all stock markets were up for the year while economic growth was patchy. US growth was sub-trend, and Europe drifted in and out of recession, with significant contractions in the PIIGS, and yet share prices rocketed up almost everywhere.

Conversely, the highest economic growth rate was in China, which once again had one of the worst stock market returns. The worst economy was Greece, which had one of the best performing stock markets that year (up 33% plus dividends!).

(2012 was one of those very rare years when every asset class did well – shares, commercial property, every type of bond market – government, corporate, high yield, emerging market and inflation-linked, and even gold was up 6%. These great returns across every asset class were achieved despite rolling recessions and high unemployment in the developed markets, slowing growth in the BRIC markets, escalating currency wars, rising political and social unrest across the world, troubling military tensions in north Asia, plus the odd nuclear scare thrown in for good measure from Iran and North Korea).

The relationship between economic growth and stock market returns is so perverse that the regular economic outlook statements from the World Bank and the IMF have almost become contrary indicators. Whenever they lower their global growth outlooks it is usually followed by good returns, and vice versa.

There are examples of this everywhere. Every time US Fed Chairman Ben Bernanke declared that the US economy was so weak it had to be put on life support (in the form of QE-1, QE-2, Operation Twist, QE-3, QE-4, etc) investors rejoiced and stock and bond markets in the US and around the world boomed. But in late May 2013, when suggested that the US economy is strengthening to the point where it can now be taken off life support, stock and bond markets fell heavily in the US and everywhere else as investors panicked and ran for the exits. The last thing investors want is a strong economy!

Closer to home, last week the Australian stock market just finished its best financial year since the pre-GFC boom (with total returns of 21% for the 12 months to June 2013), despite aggregate earnings falling over the year. Earnings for the Australian market peaked in the 2010-11 financial year, and since then total earnings have fallen by 8% but total returns have gained 12%. We will look at the relationship between economic growth, earnings and share prices for Australia in more detail in future articles.

In conclusion, links between economic growth, company earnings and share prices are not as simple and as straightforward as assuming that higher (or lower) economic growth leads to higher (or lower) share prices. Like most things in life, timing is everything, but that's another story for another day.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

Why LICs trade at premiums or discounts

by Chris Stott

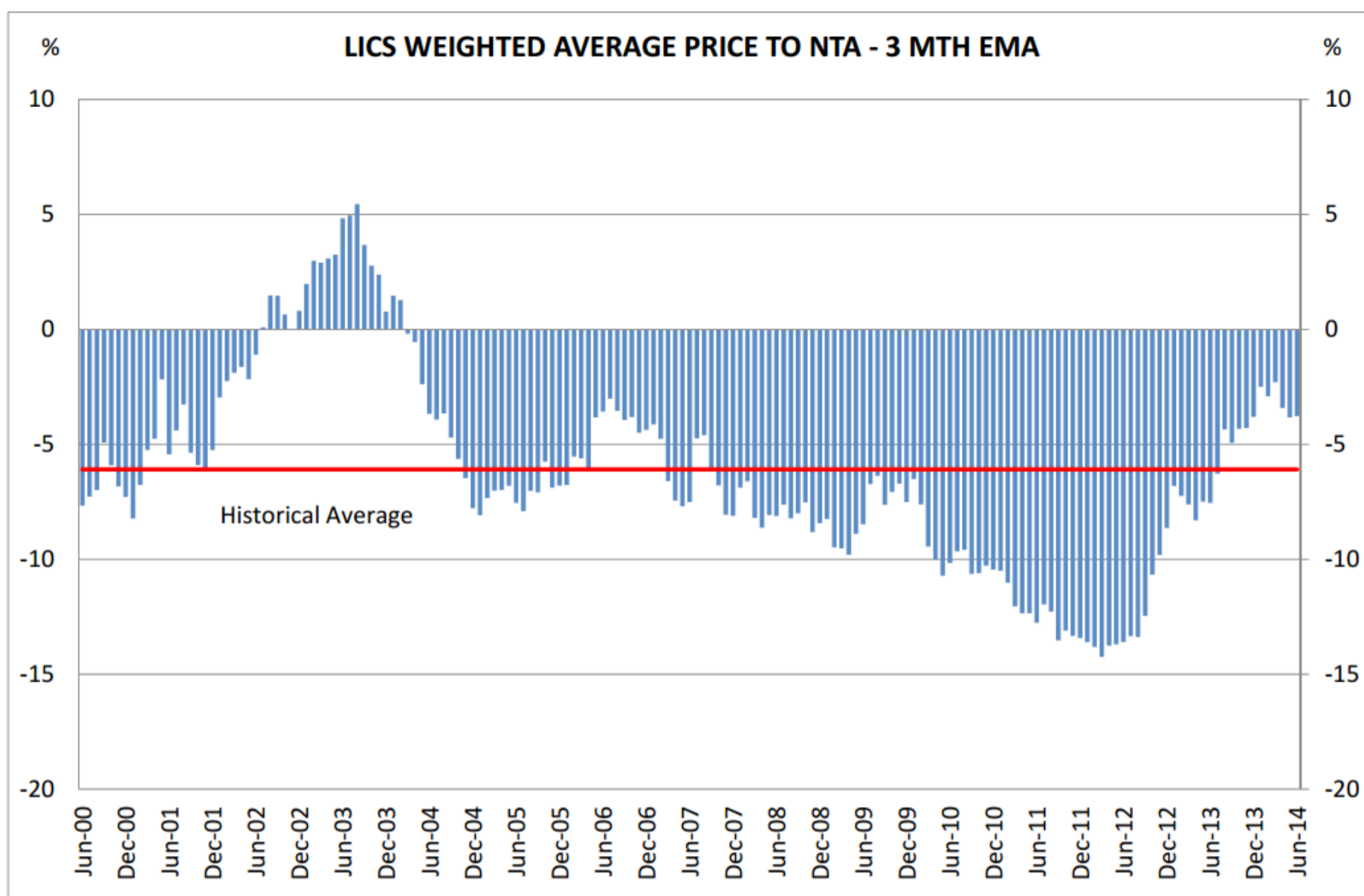
Published 16 October, 2014

With a surge of Listed Investment Companies (LICs) coming to market recently in Australia, there are now over 60 LICs listed on the ASX with a combined market capitalisation of more \$25 billion – up 15.1% over the last 12 months and a remarkable 52.1% over the last 24 months. A key feature of this investment vehicle is that, unlike unlisted managed funds, it can trade at a premium or a discount to its underlying asset value. Over the last ten years, Australian LICs have traded at an average discount to net tangible assets (NTA) of 6%. Today the median discount is 4%, with some LICs trading at significant premiums to NTA including Djerriwarrh Investments Limited (ASX:DJW) and WAM Active Limited (ASX:WAA) with share price premiums of 24.0% and 34.0% respectively (as at 10 October 2014).

Increasing profile of LICs

This trend of reducing price discounts has been driven by a number of factors including the increased popularity of LICs following the introduction last year of the FOFA (Future of Financial Advice) reforms banning upfront and trailing commissions payable by other managed funds to investment advisers and financial planners. This development helped raise the profile of LICs and their benefits. In addition, while valuations of LICs traditionally focused on their discount/premium to NTA, in their 'hunt for yield' investors are now more focused on fully franked dividends, an important feature of LICs.

In this article, I look at the factors that may cause an individual LIC to trade at a premium or a discount to its NTA.



Source: Patersons '[Listed Investment Companies](#)' Quantitative Research report – 27 June 2014

Trading at a discount to NTA

There are a number of reasons why a LIC may trade at a discount to its NTA including:

- Poor investment portfolio performance, or for newer LICs, having no established past performance.
- Lack of fully franked dividends, a poor track record of paying them, or a perceived inability by the market to pay fully franked dividends in the future.
- Ineffective marketing and communications resulting in the failure of the LIC to raise its profile amongst prospective investors or build an understanding relationship with existing shareholders.

The consequences for a LIC and its shareholders when it consistently trades at a discount to its NTA are generally negative.

Shareholders are likely to become disgruntled, particularly if they bought their shares when the LIC was trading at or around its NTA. Consider a shareholder who bought when the underlying assets were worth \$1.00 per share which later trade at 80c each. Trading at a discount means a LIC's ability to raise capital is constrained and its growth is stunted. The LIC may then be forced into a share buyback or to undertake other capital management initiatives. Attempts to grow by raising capital at a discount are often highly dilutive to existing shareholders, further exacerbating or causing shareholder frustration. As a publicly listed company, disgruntled shareholders have the ability to call for the company to be wound-up, as with India Equities Fund Ltd (ASX: INE) and Van Eyk Three Pillars (ASX: VTP) in recent years.

Over time, if shares consistently trade at a discount, it can attract agitators or activists to the share register who may take a short term approach to their investment. For example, during the GFC, investors Weiss and Carousel Capital took positions in discounted LICs and then cashed-out as soon as they were trading closer to their NTA.

However, this does provide upside for prospective investors who want the opportunity to gain exposure to the LIC's underlying securities for less than their value. Also, investors can exploit occasions where a LIC's shares trade at a discount to its NTA, creating the potential for some gain.

Trading at a premium to NTA

In our view, there are some common factors that contribute to a LIC trading at a premium to its underlying asset value including:

- Experienced management – in recent years, newer LICs have traded at discounts (or more significant discounts) than their older counterparts, such as AFIC (ASX: AFI), founded in 1927, and Argo Investments (ASX: ARG), founded in 1946, suggesting investors value companies with long term experience trading through various market cycles.
- Solid investment portfolio performance – a track record of consistently good performance of the LIC's investment portfolio in absolute or relative terms to a benchmark.
- Stream of dividends – the LIC's track record of paying a regular stream of fully franked dividends over time.
- Effective marketing and communications initiatives that raise the profile and improve the reputation of the LIC and its manager. For example, investor presentations, regular market updates and media appearances.

For a LIC trading at a premium to its NTA, its ability to raise capital in order to grow the company is enhanced. Over the last year, we have seen numerous LICs raise capital through placements (in addition to Share Purchase Plans and Dividend Reinvestment Plans) such as Cadence Capital (ASX: CDM) and WAM Capital Limited (ASX: WAM). Last calendar year, almost \$1 billion was raised by LICs (including Initial Public Offerings) – a record for the sector.

Existing shareholders generally welcome an increase in the value of the shares relative to the LIC's assets as it increases the value of their investment. For example, a shareholder may have bought their shares when the LIC's underlying assets were worth \$1.00 per share and they later trade at \$1.20 per share. In the shorter term, this may translate into larger than usual gains, however, this is often short-lived with history showing that LICs normally return to trade at or around their NTA. The downside is for prospective investors who must pay in excess of the value of a LIC's NTA.

In general, the premium to NTA trend has contributed to attracting considerable capital to the LIC sector over the past year with more LICs listing in the last 12 months than over the previous decade.

Chris Stott is Chief Investment Officer at Wilson Asset Management. His views are general in nature and readers should seek their own professional advice before making any financial decisions. Wilson Asset Management is a major manager of LICs.



Property investing

Adrian Harrington on the many dimensions of property investing, Roger Montgomery on how property fails simple valuation tests and Graham Hand on how 'fear of missing out' not yields is driving property prices.

A guide to real estate investing strategies

by Adrian Harrington

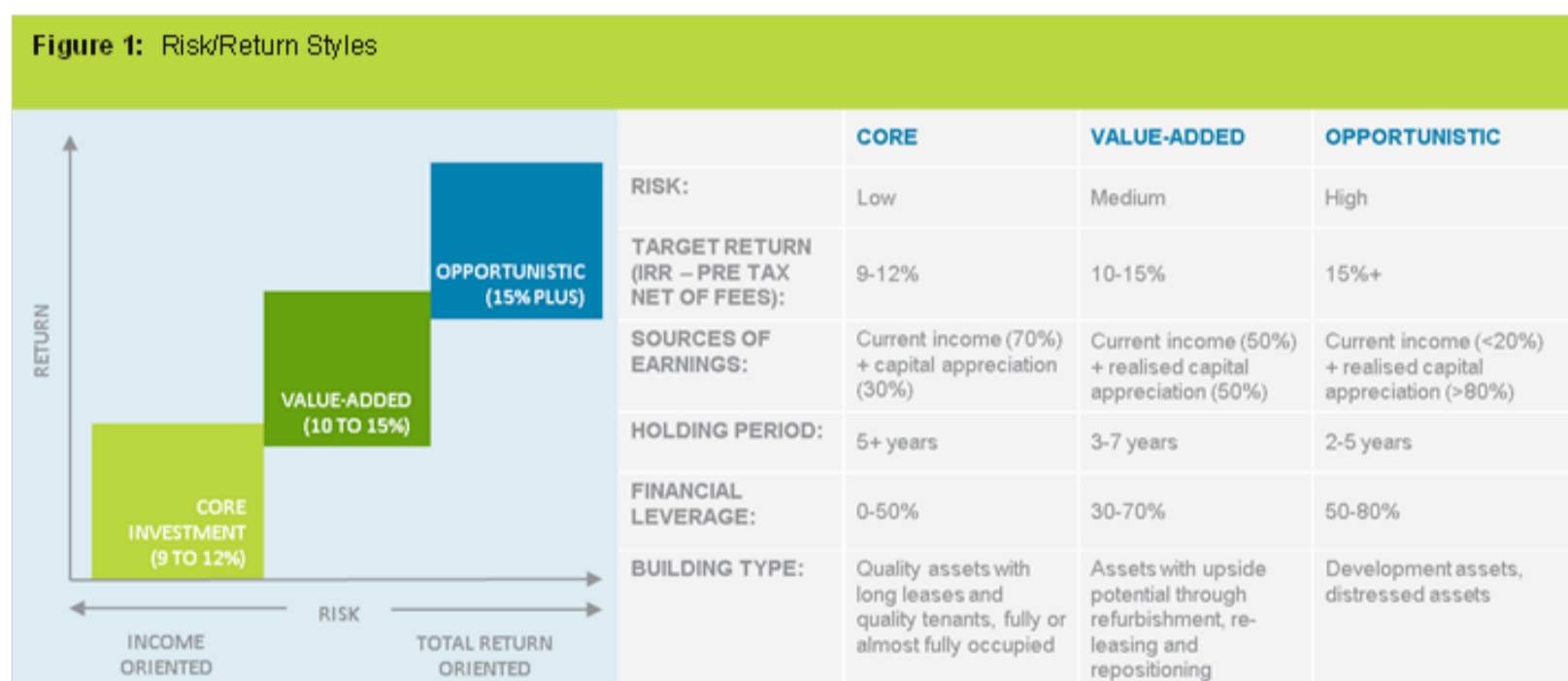
Published 14 August, 2014

Securitisation and the increased sophistication of the real estate industry have led to new ways to repackage property assets to create a broader menu of investment opportunities. However, the risk, return and liquidity attributes of these investments vary greatly.

This paper provides an overview of different real estate investment strategies based on three risk-return styles (core, value-added and opportunistic) and four quadrants of real estate investing, based on whether they are equity or debt and traded in the public (listed) or private markets.

Risk – return styles

Figure 1 shows three key risk-return styles for real estate investing: core, value-added and opportunistic.



Core real estate investing is buying assets that are well located, leased to quality tenants and funded with modest levels of leverage. Such investments typically target 9%-12% p.a. total returns with the objective of providing investors with secure income plus modest capital appreciation. The income component typically represents a significant majority (circa 70%) of the expected total return. Examples of core investments include CBD office buildings, retail centres and industrial warehouses.

The ability to significantly enhance the value of core real estate is limited compared to value-added and opportunistic investment strategies. Core assets generally require little or no short-term capital expenditure other than normal repairs and maintenance.

However, core investing does not mean passive management. Active management of core assets can add value through initiatives such as improving lease profiles and reducing building operating costs. Core real estate tends to be held for the long-term, typically five years or more. Leverage is generally below 50%.

In recent years, real estate related social infrastructure such as child care centres, medical centres and student accommodation have increasingly been considered as legitimate core investments. There are both listed and unlisted real estate funds focusing specifically on these sectors such as the Folkestone Education Trust, the Generation Healthcare REIT and the unlisted Australian Unity Healthcare Fund.

Value-added investing engages in active strategies to create value in the underlying real estate investments through refurbishment, re-development or leasing-up of vacant space. A value-added strategy typically targets 'secondary' assets which for various reasons have depressed levels of income or the value has deteriorated over time relative to the broader market. Through hands on 'active management' there is a focus on increasing an asset's income and hence capital value. Value-added real estate investments will therefore appeal to investors seeking enhanced returns in exchange for higher levels of asset operating risk. These investments target returns between 10%-15% p.a. and typically use modest to high levels of leverage of between 30% and 70%. They have a hold period of between three and seven years, although often at the shorter end, as the successful execution of the strategy will depend on picking the right time in the real estate cycle to exploit the opportunity.

Opportunistic investing targets a range of higher risk strategies such as real estate development, highly leveraged financing or transactions involving 'turnaround' potential (often known as distressed investing), investments with complicated financial structures (including mezzanine debt) or emerging market investments. The focus is on capital appreciation, with the returns typically back-ended and achieved through a sale or completion of a development, often with little income along the way.

Such strategies usually use higher levels of leverage between 50% and 80% and typically target returns of 15% p.a. plus.

Opportunistic strategies require specialised investment and management expertise due to their complexity and to mitigate the higher risk. Investors tend to be sophisticated and well capitalised with a higher risk appetite than core or value-added investors. Opportunistic investing looks at relatively short-term hold periods, in many cases less than three years. The key is to expeditiously exit the investment as the strategy is executed and value maximised.

Value-added and opportunistic investing is not simply the use of high levels of leverage. They require careful analysis of the real estate cycle and market trends to take advantage of dislocations and mispricing in the market.

Four quadrant investing

Four quadrant investing refers to the classification of real estate investing across four financial markets – public and private, debt and equity – as shown in Figure 2.



The most common forms of private market in Australia, other than directly owning a building, are unlisted real estate funds or unlisted syndicates which typically own one asset such as an office building or retail centre and have a fixed term of between five and seven years. These investments are traded in the private market, and between purchase and sale, values are derived from private valuations. Such assets are relatively illiquid compared with the public markets.

Public equity refers to investments in real estate investment trusts (A-REITs) or real estate companies whose securities or shares are traded on a stock exchange such as the ASX. The A-REIT market is the most liquid and transparent of the four quadrant markets, and currently comprises 50 A-REITs with a market capitalisation in excess of \$97 billion. There are another 29 real estate-related securities that are classified by S&P/ASX as real estate managers and developers.

Private debt represents investments in direct real estate loans or in funds that hold mortgages on real estate, such as mortgage trusts. The loans may be first mortgages (senior debt) or second ranking subordinated loans such as mezzanine loans. Typically, the investor or lender will receive periodic interest payments from the borrower and a security charge against the property in the form of a mortgage. At the end of the mortgage term, the investor or lender will receive the

balance of the mortgage principal. This type of real estate investing is similar to investing in bonds that are held to maturity. Public debt represents real estate debt instruments such as commercial mortgage back securities (CMBS) which are traded in the public market or unsecured debt (corporate bonds) issued by A-REITs and real estate companies. Access to investing in the public real estate debt market in Australia is almost exclusively limited to institutional or 'wholesale' investors.

The four quadrant model of investing emphasises the links between real estate and the capital markets. The income from each of these investments relies on the performance of the underlying real estate despite the fact that the pricing, the risk and the liquidity will depend on which part of the spectrum (debt or equity) the investment occurs and whether it is traded in the public or private market.

Conclusion

Whilst the menu of real estate investment opportunities has increased, not all investment styles and strategies across the four quadrants are suitable for all investors. Most investors in real estate will focus on core real estate strategies and will typically invest in the quadrant that best suits their liquidity requirements. If liquidity is an important factor, an investment in public equity such as A-REITs may be a more viable investment alternative than private real estate either directly or through an unlisted fund or syndicate.

Given the different markets and risk profiles, pricing anomalies in the short term may occur across the three investment styles and four quadrants. A more sophisticated investor may take advantage of these pricing arbitrages and move across the three styles or allocate between the four quadrants according to where they expect to achieve the best relative risk-adjusted returns at different points in the real estate cycle.

Adrian Harrington is Head of Funds Management at Folkestone, an ASX-listed (ASX Code: FLK) real estate funds manager and developer. Folkestone Funds Management offers real estate funds to private clients and select institutional investors.

Residential investment property fails simple valuation test

by Roger Montgomery

Published 10 October, 2013

The Herengracht Canal in Amsterdam has been a favoured strip of real estate in the city since the 1620s. The Herengracht House Index, constructed by finance professor Piet Eichholz of Maastricht University, tracks house prices in the area over a 380 year period – commencing with the Dutch 'Golden Age'. Over that time, real (i.e. inflation adjusted) house prices have only doubled, which corresponds to an annual average price increase of something like 0.1%. This would indicate that despite short-term rises and falls, prices roughly follow inflation.

Valuing like other financial assets

What could this mean for investors in the Australian residential property market? It may have looked like an attractive option recently. Auction clearance rates have been healthy, but rising prices have prompted media commentary on a possible housing 'bubble'. What do we find if we apply value-investing principles?

We'll start by assuming that residential property, at least the investment kind, derives its value in the same way as other financial assets – by producing cash flows – and obeys the same fundamental financial laws.

Since property income is fairly predictable, the valuation exercise should be straightforward. We just need three numbers:

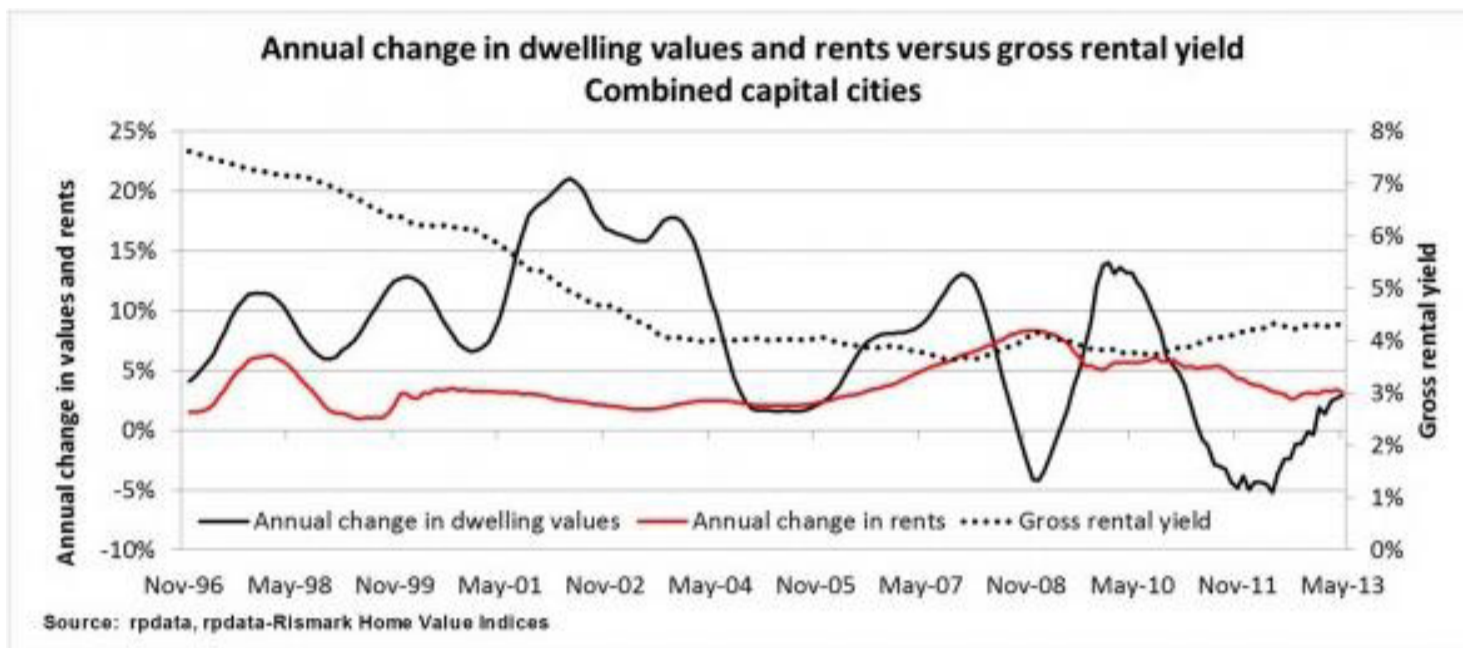
- discount rate, or rate of return required by an investor
- net rental income generated
- long-term rental growth rate

We can plug these values into a simple formula that will calculate the present value of the cashflows into perpetuity, following the same principles used to value a business.

A discount rate reflects the rate of return an investor needs to compensate them for the risk of investing in a particular asset. A good way to estimate it might be to start with the 10-year government bond rate (a proxy for the rate that applies when there is no risk, currently around 4% p.a.), and add a risk premium.

In the case of equities, the risk premium is commonly thought to be around 5-6%. I think a case can be made for a lower risk premium for property, given that it has a more stable profile, but we should also consider that property is a much less liquid asset than equities, and investors should demand some compensation for this. For the sake of argument, let's choose a risk premium of 4%. This gives us a required rate of return of around 8%.

Net rental yield is the next piece of information we need. The chart below, published by RP Data, shows a current gross rental yield for Australian capital cities of around 4.3% p.a.



To calculate a net rental yield, subtract all the expenses that an investor must incur in generating the gross rent, including property management fees, maintenance, insurance etc. A reasonable estimate may be around 1.0%, which gets us to a net rental yield of 4.3% – 1.0% = 3.3%.

The final number required is the long term growth rate in rents. As shown in the chart above, a figure just above 3% p.a. may be a reasonable estimate. Let's assume 3.2%.

Combining these numbers into a valuation can be done as follows: divide the annual rent earned on a property by a divisor, which is calculated by subtracting the long term growth rate from the discount rate, as set out below.

$$\text{Value} = \text{Net Rent p.a.} / (\text{Discount Rate} - \text{Growth Rate})$$

This is the formula for calculating the present value of a stream of cash flow that grows at a fixed rate in perpetuity. If a property generates \$20,000 per year of net rent, we would calculate its value as $\$20,000 / (8\% - 3.2\%)$ or $\$20,000 / 4.8\%$, equal to around \$416,667.

If that property can be bought today at a net yield of 3.3%, it would imply that the market price of the property today is $\$20,000 / 3.3\% = \$606,061$. This is significantly higher than our valuation of \$416,667. On the basis of the discount rate and long term growth rate we assumed, buying property on a net rental yield of 3.3% appears hard to justify.

Continuing assumption of capital growth

Over the past three decades, there has been a fourfold increase in Australia's indebtedness as a percentage of annual disposable income, to 150%, as well as massive growth in property prices. Together with the above analysis, these facts indicate that the same level of growth is not sustainable. If this is correct, it may pay to be cautious about buying on the basis of a continuation of assumed capital growth.

Of course, the conclusions you reach with this approach depend on the assumptions you put into it, and the purpose here is not to argue that property is overpriced. Rather, it is to set out a framework that allows some basic assumptions to be converted into a fundamental value. By doing this, you can decide for yourself whether there is long term value to be gained.

Roger Montgomery is the Chief Investment Officer at The Montgomery Fund, and author of the bestseller, 'Value.able'.

'FOMO' is driving residential property prices, not yields

by Graham Hand

Published 3 October, 2013

There's a confluence of events boosting Australian property prices, especially in Sydney, but none is more pervasive than the Fear Of Missing Out (FOMO). All investment markets are driven by sentiment, and when it's impossible to pick up a newspaper without the latest story on 85% auction clearance rates and smashing of reserve prices, potential buyers change their mindset. They may have trudged from one open house to another in 2012, waiting for the no-compromise property, but now they are jumping in before prices rise further. According to RP Data-Rismark, prices in Sydney were up 5.2% in the September 2013 quarter and 10% since the start of the year, multiple times the rise in average weekly earnings.

A common technique used to promote properties is to quote the gross yield. Purchase price \$700,000, rent \$700 a week, that's \$36,400 a year or 5.2%. Even better, many inner-city apartments can become part of a short-term apartment letting scheme, like a long-stay hotel. Room rates might be as high as \$300 a night during a major event, \$200 at other times. That's double the weekly rent of a lease. It's a no-brainer.

It's only when the off-the-plan property settles a year later, or time comes to select an agent and a decent tenant, that many investors face a harsh reality check. The costs are always greater than expected.

The confluence which is creating the competitive forces behind FOMO includes:

- various first-home buyer schemes and stamp duty exemptions
- investors moving money out of cash and term deposits into the growth asset class they believe they understand and is not volatile
- Asian buyers, especially Chinese who are restricted in owning property in their own country. Asians love property and Australia is seen as more stable than Europe or the United States. They often have children studying here
- SMSFs are the new players, and although the amounts are not high in absolute terms (only about 3% of SMSF assets are residential property and three-quarters of property assets are commercial), it's a new competitive influence
- other residential property investors (local non-super) who have regained confidence at a time when unemployment remains low and financing has never been cheaper.

But let's take a look at the harsh reality check facing many of these exuberant buyers, considering the costs of purchase and owning an apartment with either short-term or long-term rents:

1. Stamp duty. Stamp duty varies from state to state at about 3-4%. On a \$700,000 property in New South Wales, stamp duty is about \$27,000. Imagine transaction costs of that amount in the share market. The efficient allocation of equity capital and efficient trading would be compromised.
2. Legal costs, loan establishment fees, valuations, building inspections, etc. Let's call it \$5,000.
3. Mandatory furniture package for short-term rentals. Need to set a high standard for someone paying up to \$300 a night, so full package for a 2 bedroom serviced apartment say \$40,000.
4. Apartment leasing agent. Between 6% and 15% of gross income depending on the type of leasing plan.
5. Body corporate administration fees. These are often deliberately understated during the selling period, but there are four killers to watch for: 24 hour concierge, swimming pools, lifts and gymnasiums. Then there's gardening, fire services, cleaning. A decent building and apartment will cost at least \$2,000 a quarter to maintain all these services. No point paying a million for an apartment and not maintaining the building.
6. Body corporate sinking fund. Again, depends on what is agreed by the body corporate but set for future major capital expenditures, such as repairs or repainting the entire building. Say another \$1,000 per annum.
7. Council rates. Although charged on the 'unimproved capital value' of an apartment rather than the land value of a house, it could easily be \$2,000 a year on a \$700,000 apartment.
8. Water, electricity, gas. Usually paid by the tenant on a longer lease but by the owner in a short term apartment scheme, rising rapidly and maybe another \$2,000 a year.
9. Vacancy. Long-term leases allow 4 weeks a year, short-term depends on the success of the managing agent or apartment scheme operator. May need to discount rates to compete, especially in winter. Assume short-term occupancy is healthy at 75%.
10. Apartment cleaning. A 2-bedroom apartment leased for a few days might cost \$120 to clean, giving an annual cleaning bill of over \$10,000 (assuming apartment rented for 270 nights a year for 3 nights each time, that's 90

cleans). There's no choice to clean it yourself, it's all part of the apartment scheme.

11. Travel agent's commission. Short terms pay online services such as wotif.com 10% of the rental, and similar for travel agents. Assume paid on half of rentals.
12. Replacement of furniture and equipment. The short-term agent will say that the apartment looks tired and needs a complete refit. Not all tenants are neat, tidy and careful. Some will have raucous parties, kick a door, smash a vase. After a few years, the sofa will be disgusting, the carpet filthy and the mattress stuffed. Expect to replace the furniture at least every five years, and probably the entire kitchen and bathroom every 10 to 15 years. Everything in the apartment will need replacing regularly, plus painting and air conditioning. Cost per annum, say \$10,000 (ignored in the table below to avoid double-counting with original cost).
13. All the other stuff. Where do we stop! There's a linen fee, pay TV, PABX, credit card fees, advertising, insurance and postage fee. The agent charges \$20 to replace a light bulb, \$15 to adjust the TV, \$200 to fix the dishwasher, using tradesmen who have a far closer relationship with the agent or building manager than the owner. The apartment will be better maintained than the owner's home. Call it \$2,000 a year on short-term leasing.

At this point, faced with all these costs, administration and paperwork, the apartment owner draws on two sources of comfort: tax savings and capital gains.

First, tax savings. If the property is negatively geared, there is a deduction against other assessable income. Other costs make the tax deduction even higher. What many owners fail to recognise is negative gearing is a polite way of saying 'loss'. A loss is still a loss, even if tax reduces the size of it. Furthermore, tax is paid in an SMSF at only 15% in accumulation stage or nil in pension phase, so the tax savings are far less than a high marginal tax-paying individual.

Second, capital gain. It is irrelevant to someone buying today that prices are up 10% this year. All that matters is the future. Buy an apartment for \$700,000 and sell it for \$750,000 a year later and there won't be much left over to pay for all the hassle. It costs most of the gain to buy, finance, repair and keep it. It's easy to believe that property prices are one-way traffic, but Sydney has only just recovered in real terms the prices from 2004. That's almost a decade with no real growth. It's as convincing to make a case for prices falling in years to come – rising interest rates, increasing unemployment, historically high price-to-rent ratios – as it is to bank on capital gains.

Table 1. Illustrative returns from a 2-bedroom apartment

| Cost item | Up front cost | Annual short-term | Annual long-term |
|--|----------------------|--------------------------|-------------------------|
| Purchase price | \$700,000 | | |
| Stamp duty | \$27,000 | | |
| Legal, inspections, etc | \$5,000 | | |
| Furniture package (only for short-term rental) | \$40,000 | | |
| Rental income (short-term 365 X \$180 X 75%, long-term 48 X \$700) | | +\$49,275 | +\$33,600 |
| Apartment leasing agent (Gross rental X 13% or 7%) | | -\$6,406 | -\$2,352 |
| Body corporate administration fee | | -\$8,000 | -\$8,000 |
| Sinking fund fee | | -\$1,000 | -\$1,000 |
| Council rates | | -\$2,000 | -\$2,000 |
| Water, electricity, gas services | | -\$2,000 | - |
| Apartment cleaning (short-term, assume 90 times pa) | | -\$10,800 | - |
| Travel agent/online commissions, 10% on 50% of rent | | -\$2,464 | - |
| Other costs (linen, pay TV, maintenance and repairs) | | -\$2,000 | -\$1,000 |
| Purchase cost short-term | \$772,000 | | |
| Purchase cost long-term | \$732,000 | | |
| Net income (ignoring interest cost on loans) | | \$14,606 | \$19,248 |
| Net income/purchase cost | | 1.9% | 2.6% |

Ignores tax and depreciation effects which vary by buyers, including land tax.

Of course, any of these assumptions can be varied (including using lower rents and higher costs), but the net rental income from residential investment, ignoring interest costs, is around 2% to 2.5%. Rents do rise over time, but not much in real terms, and so do costs.

There's a decent chance the day the apartment is bought, when the thrill of owning a property is matched by dreams of income and capital gains, is the highlight of the investment. After the calculations, paperwork and administration are done, taking phone calls from agents saying the toilet needs fixing quickly becomes tiresome.

Like any investment, residential property must be the right asset bought at the right price and the right time, not anywhere based on the need to get into the market quickly due to FOMO. It might be that the recent price rises have already delivered the best returns for some time.



Fixed interest investing

Warren Bird explains the risk that term deposit investors did not understand plus taking credit risk in fixed interest investing, and Ashley Owen gives a short history lesson on banks and government debt.

Term deposit investors did not understand the risk

by Warren Bird

Published 19 June, 2013

Investors in term deposits (TDs) have taken a significant risk!

As interest rates have fallen, TD rates have declined sharply as well. Therefore, people who expected TDs to give them a reliable income stream are facing a challenging time. How has this come about? What lessons can be learned about risk management from this experience?

Relatively few investors have the comfort of holding TDs that will continue to earn 5.5 – 6.0% for a few more years. This rate or better could have been locked in until around 2016 by investing in 5 year deposits. In fact, Westpac was still offering 8% for 5 years in 2010, a deposit that does not mature until 2015. However, over 90% of all TDs have been taken out for no longer than 12 months. The rates being earned by most investors have fallen nearer to 4% or less.

This presents investors with a significant decision. Do they keep rolling into new six month rates and accept the sharp drop in income? Do they move into a longer maturity, where rates of 4.5% or more are still on offer? Or do they shift into higher risk, but potentially higher returning, assets?

Duration risk ignored

In effect, the majority of investors who have moved into TDs have created portfolios that have short duration. In fact, they have been positioned very short. The duration of the average TD holding seems to be around 0.5 year. That is at least 4 years shorter than the typical managed bond fund, and a similar amount shorter than a 5 year maturity TD would have been.

Some readers might not be familiar with the term 'duration', and it's not a word often used in relation to TDs. Readers who have heard the term probably understand that it has something to do with bond price volatility. But since the value of a TD doesn't fluctuate, how can an investor be said to have taken a duration position by holding TDs in their portfolio? And what does it have to do with reinvestment risk?

Yes, it's true that duration is a measure of how much a bond's price changes when its market yield changes. As market yields change, long duration bond prices fluctuate more than short duration bond prices. But duration is also relevant to one of the most important drivers of the longer term returns that a fixed interest and/or TD portfolio will deliver. The key is to understand why the word used for 'bond price sensitivity' is one that also means 'length of time'.

Fixed interest investing is a series of cash flows

The link is as follows. Both bonds and TDs are a series of cash flows: regular interest payments and a maturity payment. The term to maturity is very important, but it isn't the full story. At its heart, duration is a measure of the weighted average time for the payment of all the asset's cash flows, not just the last one at the final maturity date. A bond or TD maturing in X years' time has a duration that is less than X because the regular cash flows that are paid before the final maturity date are taken into account.

Therefore, an investor who owns a short duration asset, whether it's called a bond or a TD, receives all the cash flows from that security more quickly than if they owned a long duration asset. This exposes them to more significant reinvestment risk. They have to deal with the fact that their investment has become cash sooner than if they'd taken a longer position.

This risk cuts both ways, of course. If someone invests in a longer term bond/TD, then yields in the market fall, they are 'happy'. They have locked in a higher rate than is now available. They don't have to reinvest at those lower rates for a longer period of time than if they'd only made a short term investment. On the other hand, if after they invest the market makes higher yielding options available, they are 'sad'. They won't be able to take advantage of the higher rates until much later, missing the extra income along the way.

Some investors have intentionally positioned themselves short over the past few years. They chose to have cash available around now as they expected rates would be higher. In their case they have, as it turned out, made a wrong call on the economy and interest rates. They will be disappointed, but it was intentional on their part to take the risk.

However, I suspect that many investors were unaware of this issue. They may have thought that by owning short term TDs instead of equities their income was protected from future fluctuations. In reality they were actually exposed to significant risk.

When rates fall, short duration strategies result in lower total returns than longer term positions. This shows up quickly in a bond fund by its return being below its index or a competitor's longer duration portfolio. But it also shows up in the fact that cash flows have to be reinvested at lower rates sooner and the total return in the medium term ends up quite a bit lower.

'Duration' is one of the jargon terms used by fixed interest managers and it may be tempting to regard the word as just technical mumbo-jumbo best left to the experts. However, the duration of your income portfolio is a significant driver of your longer term investment outcomes, whether you are in a bond fund, own direct fixed interest securities or hold TDs.

While duration creates capital price volatility in assets that are marked to market, it also drives the length of time for which current interest rates will be paid. If the goal of an investor is simply to avoid capital volatility, then short bonds or TDs are ideal. But if the investor's income needs are paramount, then the real question to ask is whether you have locked in a decent rate for long enough. How soon will you be faced with the reinvestment decision?

Whether you invest in bonds or TDs, being intentional about the duration of your portfolio is more likely to deliver investment outcomes that meet your objectives than ignoring it.

Technical note

The link between this way of thinking about duration and the more common reference to bond volatility is that, when bond prices change, it is essentially the market's way of measuring the quantum of 'happiness' and 'sadness' from changing market yields that I mentioned in the article. An example should clarify what I mean.

If you invest \$10,000 in a five year bond (or TD) paying 4% annually you will be paid \$400 a year interest. This is \$2,000 in total over the five years. The duration of this asset is 4.45.

Yields then fall in the market to 3%. Your investment is now earning \$100 a year more in interest payments than someone entering the market at the lower rate. In nominal terms, that's a total of \$500 of 'excess' interest earnings over the life of the investment. When each of the \$100 amounts is valued using 3% as the discount rate, this works out at \$458. This is the amount by which the value of your asset increases, a capital gain of 4.6% of the \$10,000 outlay that you made.

What about a rise in yields? If after you've locked in 4% the market moves to 5%, you will earn \$100 a year less than a new investor is able to do. Your bond is revalued downwards by the NPV of those amounts, or \$433 – a capital loss of 4.3%.

In neither case have you really 'made' or 'lost' money. At maturity your bond or TD will still repay the \$10,000 in capital that you paid for it. The mark-to-market is simply measuring your good fortune or bad luck in regard to the interest payments you are receiving compared with what's subsequently available.

If you invested only for one year, the price changes will be much smaller than these. This is because either the extra interest or the shortfall that you've locked in is only for that shorter time period and is thus a smaller amount.

The point of all this is that the reason duration is relevant to bond price volatility is because when you value the interest income you are earning compared with current market rates, the time period over which you are earning that income is a major factor in the valuation. If you invest at a high interest rate, but only for a short time period, then you will only earn that rate for a short time period. The value of your investment won't fluctuate much, but you will have to reinvest your cash flows relatively quickly. You are thus exposed to market fluctuations and over the longer term your investment outcome will be affected.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management, and is now an External Member of the GESB Board Investment Committee and a consultant and writer on fixed interest, including for KangaNews. He has since been appointed CEO/Executive Director of the Uniting Church Treasury and Investments Division.

Give this risk the credit it deserves

by Warren Bird

Published 5 September, 2013

I find it ironic that the fixed interest risk that most people fear is market risk. The fact that when yields go up, bond prices fall seems to scare many investors.

It shouldn't.

The risk that bond investors should be most concerned about is credit risk. Only a credit failure can result in the permanent loss of capital and, potentially, a significant negative hit to a portfolio's total return.

Market risk does not produce a permanent loss of capital. When yields rise there is an initial fall in the mark to market capital value of bonds, but higher yields result in increasing returns over time. I've written about this over the years ([including in past articles in Cuffelinks](#)), so I won't become sidetracked by it again now.

Rather, this article discusses what credit risk and credit ratings are. In part 2, I will turn to the question of how credit risk can be managed so that it doesn't wipe you out. The good news is that, although credit risk is the more serious investment risk in my view, it can also be managed so that the risks are well worth taking.

What is credit risk?

The credit quality of a borrower is the likelihood that they will fail to honour their obligations to make timely payment of interest and principal. The world is an uncertain place and no bond issuer – be they a company or a government – has a 100% guarantee of never failing to pay.

There are a lot of factors that determine a bond issuer's credit quality. There are financial factors, such as the amount of leverage an issuer has on its balance sheet. Issuers with low leverage have a stronger capacity to meet their debt obligations than highly leveraged issuers with low interest cover ratios.

The management strategy of the issuer is important. For example, strong risk management policies reduce credit risk, as does a clear and robust governance framework.

Finally, the industry in which a business operates is an influence on credit quality. Some industries are relatively stable, while others are volatile; some have a small number of well-established participants, while others are much more open to new start-ups taking market share from existing players.

What are credit ratings?

One of the most commonly used tools in credit risk analysis is credit ratings. Most people have heard of ratings, even if only when our politicians talk proudly of how the government still has a 'triple A' rating.

There are many different ratings scales that can be used, but the table below provides an overview of the ratings framework used by most agencies and credit analysts. In this framework, AAA ratings are assigned to borrowers with an 'extremely strong' capacity to pay. As the capacity diminishes the rating moves to AA, then A, then into the B's.

| Rating band | Risk description | Corporate examples | Default rate* |
|-------------|--|---|---------------|
| AAA | Capacity to pay is extremely strong | Johnson & Johnson, Microsoft | < 1% |
| AA | Capacity is very strong | CBA; Toyota; Nestle; Shell; Colgate | 1.5% |
| A | Strong capacity, but some susceptibility to changed circumstances | Boeing; Coca Cola Amatil; Telstra; Wesfarmers | 2.5% |
| BBB | Adequate capacity, but adverse changes likely to weaken capacity | Alcoa; Nissan; Kellogg; Toshiba | 5% |
| BB | Currently has capacity, but would face major uncertainties if adverse business or economic conditions unfold | Ford; GM; Fortescue; Goodyear | 20% |
| B | Currently has capacity, but likely to be impaired if adverse conditions unfold | American Airlines; Nokia; Levi Strauss; Wendy's | 40% |
| CCC, CC, C | Currently vulnerable or highly vulnerable to non-payment of obligations | Clear Channel | 60% |

*historical average % of issuers rated in the band that default within 10 years, based on Moody's and S&P data.

It's important to understand that credit ratings are subjective opinions about an issuer's credit quality. They are an analyst's view, after considering the sort of factors mentioned above, of the issuer. Different analysts can have different views and there is no absolute right or wrong rating.

Also, ratings aren't set in stone. As economic and business conditions unfold, some issuers improve and may receive a credit upgrade, while others deteriorate and may be downgraded. In recent years, Wesfarmers has moved from BBB to AA, while Nokia has been downgraded from BB to B.

As a guide to the likelihood of default, ratings are more of a relative guide than an absolute probability. For one thing, the average default rates shown in the table above mask a great degree of variance year to year. Years like 2008 and 2009 saw above average defaults across the spectrum of ratings, while in many years there are very few.

What are credit ratings not?

Finally, ratings are not an indication of the probability of losing capital if there is a default. Some debt investments have a high probability of default, but are secured against tangible and liquid assets that can be sold so that investors recover some of their capital. Others have a strong credit risk rating, but if a default occurs the recovery rate may be quite low.

It's also important to appreciate one thing they are not. Ratings are not investment recommendations. They are an input, but don't provide sufficient information to make a decision about whether to invest or not. This works both ways. AAA rated bonds are safe, but may be poor investments if they are paying a very low yield or if the recovery rate if there is a default is very low. On the other hand, while the credit risk of BB and B rated bonds (sometimes unhelpfully called 'junk bonds') is high, they are often excellent investments because of their high yields and reasonable recovery rates if there is a default.

The returns you make from investing in fixed interest are a combination of the interest you receive and capital losses from defaults. A high-yielding portfolio may provide an investor with as much as 3 or 4% above low risk portfolios like cash or term deposits. But if you experience a default or two you can easily lose more than 3 or 4%. This can wipe out the extra income you had hoped to receive.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management until February 2013. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest, including for KangaNews. He has since been appointed CEO/Executive Director of the Uniting Church Treasury and Investments Division.

A short history lesson on banks and government debt

by Ashley Owen

Published 19 July, 2013

The current European government debt crisis has seen the media full of stories about the 'unprecedented' government defaults and 'unimaginable' bank failures. The big banks have been designated 'too big to fail' as governments rush in to prop them up using taxpayers' money, and the bankers keep their jobs and their bonuses.

Recent events have many historical precedents

Fascinating though the current events are, they are hardly new. Not much changes – even across thousands of years. For example in the year 1345 AD, defaults on government debts caused the collapse of the Italian banking industry which financed trade and commerce across the whole of Europe.

Wind the clock back a further 1,000 years to the collapse of the Roman Empire in the 4th century AD, the result of a combination of factors including imperial over-stretch and a breakdown in the monetary system and society following rampant inflation from excessive money printing to finance wars and the expanding government. The collapse of the empire, and the monetary system that supported it, plunged Europe into the Dark Ages – a thousand years of barter and feudalism, without an effective financial system to oil the wheels of trade and commerce.

After 1,000 years of economic stagnation following the collapse of the Roman Empire, the Italian city states led the re-birth of the European Renaissance, and Florence emerged as the centre of European trade and commerce, underpinned by its widely trusted gold coin, the florin, first minted in 1252. By the early 1300s two great banking groups in Northern Italy, the Bardi and the Peruzzi, had come to dominate the European banking industry, lending to businesses and governments all over Europe.

One of the biggest borrowers was England, which needed funds to finance its wars against France. The debt pile kept mounting up until finally in 1345 the English government finances collapsed under the weight of debt. The English Crown (Edward III) defaulted on its loans of 600,000 gold florins from the Bardi and 900,000 florins from the Peruzzi. As these debts were in a hard currency backed by gold and not England's soft paper money, England could not simply print more currency to repay the loans. The English default bankrupted both the Bardi and the Peruzzi banking groups, triggering the collapse of the whole of the Florentine banking system due to counterparty holdings with all of the other banks.

The bankruptcy of the Italian and European banking system was a painful but necessary process – debts were written off, shareholders were wiped out, depositors lost their savings, bankers lost their jobs, their fortunes and their standing in society, and businesses across Europe were starved of capital and failed. But lessons were learned, and it cleared the way for a new breed of much stronger, better managed banks, led by the Medici, that went on to prosper and underpin the tremendous economic, social, political and cultural revival of Europe in the centuries that followed.

Little has changed in all these years. Governments are still the largest borrowers from banks, and they are still defaulting on their debts. Britain's most recent default (these days quaintly called 'restructure') was its humiliating bailout by the IMF in 1976. Even before Greece's shock default and restructure last year, Greece had been in eight separate debt restructure cycles lasting a total of 92 years out of the 181 years since its independence. Virtually every country (including Australia in 1932) has defaulted on its government debts at one time or another.

Banks again holding piles of government debt

In the latest government debt crisis, banks are once again using their power to pressure governments into bailing them out by propping them up with citizens' taxes and future pensions, and again the bankers keep their massive salaries and bonuses.

These days banks are geared at more than 20 to 1 (even the new Basel 3 rules will only require a leverage ratio of 3% equity to total assets, ie 33:1 gearing), meaning that a decline in value of its assets of only a few percent would render a bank insolvent. European banks are grimly clutching onto huge piles of government debt they know are worth significantly less than their face value. Governments are terrified of the idea of banks failing because the widespread loss of public savings

could easily trigger public revolt and perhaps revolution that would end the incumbent politicians' privileged lifestyles.

The end game is inevitable in the long term – the end of the current greatly flawed banking system riddled with moral hazard and distorted incentives. But the end of that system will probably require large scale default and collapse of major banks, where shareholders are wiped out, bankers lose their jobs, their fortunes and their reputations, and businesses are starved of capital, but where lessons are learned and the decks are cleared in order for new, stronger, better managed banks to emerge in their place.

In Japan after the 1990 collapse of the debt-fuelled asset bubble, it took seven years for the government to recognise the problem, another five years to start to fix it, and the job is still only half done more than 20 years later.

In China following the 1983 li gai shui reforms and the 1984 bo gai dai reforms, the five big state-owned banks went on a wild lending binge from 1985 to 1993, lending vast amounts of money to provincial governments and state owned enterprises to fund politically motivated, uneconomic projects. That credit bubble collapsed in 1993 in a mountain of bad debts that rendered all of the major banks insolvent and the government was forced to recapitalise them. The economy collapsed and unemployment soared, but what did the government do to kick start the economy and find people jobs? It forced the same banks to lend to the same loss-making state owned enterprises for even more unprofitable, politically motivated projects. The result was the same – another pile of bad debts, insolvent banks and more recapitalisations in 1998, and then again in 2004. Then since 2009, those same big banks have been at it again, shovelling vast amounts of credit to the same provincial governments and the same state owned enterprises to fund even more politically motivated and uneconomic projects. No lessons learned there.

In the current crisis it looks as if Europe is heading the same way as Japan. Governments are still in denial, trying to prop up the existing system with taxpayers' money. Unlike in China, European taxpayers have votes and so the road to reform is littered with endless cul-de-sacs of compromise and side deals. Progress is being slowed even further by the need to get 17 different countries to agree to every tiny step of the way.

The United States was much quicker to eliminate the bad banks, restructure and recapitalise the survivors, but still same old managers are pocketing massive salaries and bonuses, and the surviving banks are bigger and more complex than ever before. Bankers' lobby groups still have an unhealthy influence in Washington, watering down and delaying any real reforms.

(I was a lending manager at Citibank in the early 1980s when the global Chairman of Citibank, Walt Wriston, declared that "Governments can't go broke!" – right before Mexico and 15 other Latin American countries defaulted on their debts. Citibank was the biggest lender in the great Latin American debt binge but Wriston was able to use his political power and scare tactics to get the US government to use taxpayers' money to bail Citibank out – and not for the first or last time!)

Bank bail outs continue ... for now

The end game is still many years away it seems. Politicians are still in the pockets of the banks, bowing to their will and bailing them out. The 'too big to fail' banks are now bigger than ever. One day politicians will have the courage to stand up to the banks and allow countries to default, and allow banks to fail. In some countries it may be triggered by popular uprisings that replace the existing governments and political parties, and we are seeing this trend gather pace in southern Europe. Bepe Grillo came very close in Italy earlier this year. People everywhere are coming to realise that simply replacing the government with the opposition doesn't solve the problem.

Only with the end of the current flawed system will there be a birth of a new financial system that is strong, flexible and responsive enough to fuel the next great stage of economic growth and prosperity.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund..



Interviews with the famous and other good stuff

Editor, Graham Hand, has interviewed many famous investment legends for Cuffelinks, including Harry Markowitz, Burton Malkiel, Elroy Dimson and Rob Arnott. Plus Ashley Owen gives an historical perspective on gold prices, Jack Gray delivers two of his gems on trust in financial services and poetry for investors, Graham Hand examines why the public hates us, and Alex Denham suffers as a late 60's baby.

Elroy Dimson on investing, expectations and truth in numbers

by Graham Hand

Published 13 June, 2014

Elroy Dimson is a Finance Professor at Cambridge University, Professor Emeritus at the London Business School, Chairman of the FTSE Advisory Board and Chairman of the Strategy Council of the Norwegian Government Pension Fund. With his co-authors, he is the world's leading authority on the history of financial markets. His Global Investment Returns Yearbook, produced annually with Paul Marsh and Mike Staunton, gathers data across major asset classes for 25 countries (including Australia) over 114 years, and is often quoted as the definitive source of market information.

I met Elroy Dimson at the 2014 Research Affiliates Advisory Panel at Laguna Beach, California.

When Elroy Dimson presents a paper or consults to clients in New York, he tries to be back home in London the same or the next day, often without needing a hotel room. Some of his meetings with the Norwegian Pension Fund are held at Heathrow or Oslo Airport. He is acutely aware that his highest profile work, the Yearbook, is taking up more of his time each year. Dimson is one of those people who needs 25 hours in every day.

Real return expectations

The obvious question for someone who analyses thousands of data points across 25 countries each year is what should an investor learn from reading the Yearbook. For example, it reports that US equities have never delivered negative real returns in any 20 year period. Does this mean a long term investor with a 30 to 40 year horizon should be invested almost all in equities?

Dimson does not encourage this view. He agrees that if you look at the statistics since 1900, the minimum holding period to be confident of a non-negative real return for US equities is 17 years. But the average for European countries is between 40 and 50 years, and he advises not to extrapolate from the past US experience, as the US may not be superior to most other countries in the future. Looking forward, with real bond rates around zero and an equity risk premium of maybe 3 to 3.5% and a 60/40 asset allocation, the overall return will be 2% real before fees. This is well under the expectations of most people.

He says expectations of returns have come down, and now many 'thinking people' believe a 3 to 4% real return is a more sustainable level for equities. By 'thinking people' he means consultants and asset managers who are honest with their clients, not worried that the client will think the consultant is failing to help achieve return objectives. Or that the next consultant or manager pitching 30 minutes later will be more optimistic and win the business.

Most investors need to accept and manage with these lower returns. Some endowments are supported by gifts, so maybe it matters less for a higher education institution or a charity funded by a flag day, but others who have to exist on what they earn need to manage it very carefully.

Asset allocation and rebalancing

Dimson has strong views on so-called tactical asset allocation. He says there is no evidence that market timing works. But he is in favour of countercyclical investing, in other words, buying when the mass of investors need to sell. When equity markets have declined, for example, insurance companies are faced with solvency margin implications, which means they can't do their ordinary insurance business. If they don't have the right balance sheet, they are forced to sell their risky assets. It makes sense for longer term, long horizon, low liability funds to move in the other direction.

The most difficult part of a rebalancing, such as buying stocks when markets are still falling, is going against what most others are doing. Dimson says it's very important when buying on weakness and selling on strength to have a long term strategy that stops knee-jerking. He quotes a British insurance company which during a heavy market fall announced a strategy of buying cheap. They were loading up on equities as prices fell, but then had to reverse their actions to maintain their solvency margin. Likewise, family offices, institutional investors or sovereign wealth funds must be able to maintain the strategy, because the worst of all is to knee-jerk and end up in a big mess. The Norwegians don't fall into that trap because they have a disciplined approach to strategy.

The truth in the numbers

Dimson is most often referenced for his long term data work, but the Yearbook has become more than simply an accurate source of financial markets numbers:

“Occasionally we do venture into expressing strong opinions, but quite often, we try to let the data speak for itself. We don't make such strong statements as people who make a living from forecasting. Most frequently, we are listening to what we think are current concerns. We have to form a judgement by about September each year on what will be the hottest issue in February the following year, and then we do the research. We try to capture what many people believe, and we can then let the data confirm or reject the story.

“When it became clear that expected returns were lower, we wrote extensively about that. We also analysed historical data to see if equities might save you from low interest rates. History reveals that income oriented equity strategies have had a long-term total return that has been superior to growth oriented strategies. There, we were a bit more forceful.

“Some market beliefs are not well-founded. The work we did earlier this year on emerging markets addressed the belief that emerging markets outperform, but there's no compelling evidence one way or the other. Some investors who follow our work closely have ended up having much the same percentage in emerging markets, Europe, North America, and the rest of the world.

“We've also looked at country rotation strategies. People have said if you're invested internationally, you should avoid countries with weak currencies. You don't want gains on a national stock market to be offset by weak currencies. But we find you get a higher long-term reward from the equity markets of countries that have experienced prior currency weakness.

“Some believed if you buy countries with strong economic growth, you'd be rewarded. We thought this was implausible, and our evidence is clear. If you buy the common stocks of countries that have low economic growth, the subsequent performance is on average better. The extra risk is rewarded.”

Financial markets commonly feed on urban myths and generalisations, but Dimson finds truth in the numbers. He likes nothing more than testing a market perception that has gained credibility, using long-term data to evaluate it – and quite often, to shoot it down. And then he's off to track down someone who has the data on the 26th country to add to the investment return series, or to tweak the accuracy of last year's numbers. It's a project which will never end.

Harry Markowitz on investing until 100

by Graham Hand

Published 6 June, 2014

This discussion with Harry Markowitz took place at the Research Affiliates Advisory Panel Conference, Laguna Beach, California, 30 May 2014.

Markowitz's pioneering work on portfolio management was first conceived in 1950 and appeared as Portfolio Selection in 1952. It proposed investors should act according to the expected return and risk along an efficient frontier, and became known as Modern Portfolio Theory. Markowitz won the Nobel Prize for Economic Sciences in 1990. He now divides his time between teaching and consulting, and he is co-founder of GuidedChoice, a managed account provider and investment adviser.

The traffic between San Diego and Laguna Beach has been heavy all day, and Harry Markowitz is running a few minutes late for his meeting with me. I am about to meet one of the legends of the wealth management industry, and he starts by apologising for his long journey. He's nearly 87 years-of-age and no longer nimble on his feet, and yet it's soon apparent that the mind is as sharp as the young economist who studied with Milton Friedman. Every second sentence is still a wise crack. He's in the middle of writing four volumes on 'Risk-Return Analysis: the Theory and Practice of Rational Investing', and is contracted to deliver the final volume in 2019, “So I have to live until at least then”, he says.

Markowitz identifies the development of databases and ability to model expected outcomes as the major recent improvements in his portfolio construction work. Given a set of investments with forward-looking returns and defined risks, portfolio theory will show an efficient frontier for the investor. This principle has guided asset allocation and diversification for the 64 years since his original ideas. Says Markowitz, "I lit a small match to the kindling, then came the forest fire."

Markowitz tells me he has a wall in his office dominated by a cork board, and on it, a large graph shows returns over time from various asset classes. It shows \$1 placed in small cap stocks in 1900 growing to \$12,000, while the bond line has reached \$150. I asked whether this shows that for anyone with a long-term investment horizon, their portfolio should be heavily dominated by equities, maybe even 100%. He said he is asked this asset allocation question all the time. His advice is different to a waitress in a coffee shop versus a well-informed investor with good professional advice. He tells the waitress to go 50/50, a mix of growth from a broad stock fund and security from bank deposits, because she cannot tolerate the volatility of a 100% equity portfolio. But an educated investor with good advice should take their current portfolio mix, find the most efficient frontier, then simulate possible future outcomes focusing on income expectations. The investor can then better judge whether the portfolio is the right mix to achieve the end goals.

Markowitz believes active stock selection is for a few highly skilled people who usually find returns not from stock-picking on the market, but by participation in private placements. He cites Warren Buffett and David Swensen (of Yale University) as consistently delivering excess returns but mainly because of the private deals they are offered and their ability to value them. Otherwise, outperformance is not worth chasing.

His own portfolio is currently equally weighted municipal bonds and equities, the latter with an emphasis on small caps and emerging markets, but with a stable core of blue chips. This is because he feels so many stocks are overvalued at the moment, and his portfolio is also influenced by his age. "I want enough bonds that if I die, and the equity market goes to zero, my wife will have enough capital and income to live well." His current objective is to reach 100 without appearing on the right-hand column of *The Wall Street Journal*, with the heading "Harry Markowitz f*cked up".

He is a great believer in rebalancing, and this is one reason why a cash reserve is always required. As equity markets rise, shares should be sold to retain the same proportional asset allocation mix. This provides a natural protection from overvalued stocks. He recalled working with a major Fortune 500 client in November 2008, after the rapid stock market fall, allocating more to equities in a rebalancing exercise. This has subsequently paid off handsomely. But it was scary at the time, and as the market continued to fall, he thought if he keeps allocating more to equities at this rate, the whole place will be owned by him and Buffett. He likes the expression 'volatility capture' for this process, which is why there is a role for bonds as part of the reallocation mix.

I was still curious why a person with good savings at age of say 40, and strong income flows, would not invest 100% in equities, given their long term outperformance versus cash or banks. He said, "They may think their income is assured, but then may hit a rough patch and need to sell equities at the worst moment." He highlighted that many people have jobs which are also heavily exposed to the strength of the economy, and that they should also "diversify their own job and other income sources". He suggests investors should not become too smart, using leverage and unusual investments, and not try to become rich overnight.

He is also keen on using simulation to determine possible future outcomes. In his financial advice business, GuidedChoice, and especially in their new work on GuidedSpending, they ask clients to define an upper band of future income requirements, which might be say \$50,000. Clients then define a 'scrape through' amount, such as \$30,000. Simulations are done based on variables such as living longer and market returns "to capture the essence of the spending problem". Clients can vary scenarios to see the outcomes. The most common consequence of the process is that people save more, often dramatically and commonly 50% or more. While the technology behind the scenes is complex in this modelling, it is presented in ways the client can easily understand. But he dislikes mechanical rules such as taking 4% from the portfolio each year. "Why should someone who is 90 only take 4% if they want to spend more?" he says.

I ask him how a fund with investors aged from 16 to 90 should allocate its assets. "It's like a family," he responds. "There is a trade off in a family structure between paying for the education of the children, versus the future retirement of the parents. All families make these 'social choices', and so must the fund. Their decisions may not be ideal for the 16 year old or the 90 year old but everyone makes these choices in life".

And one of Markowitz's choices is to keep working as hard as ever. "I enjoy this, and what else would I do all day?" He now dedicates every Friday to writing to ensure he meets his deadlines, spends every Thursday afternoon at GuidedChoice where he consults to their institutional clients, and he maintains a heavy teaching and advising schedule. If his health allows it, he'll still be doing it when he's 100, and that right hand column of *The Wall Street Journal* will be singing his praises.

The Burton Malkiel Interview

by Graham Hand

Published 23 May, 2013

For full background on Burton Malkiel and examples of his recent work, see [this Cuffelinks article](#).

Graham Hand: Thanks for signing my copy of *Random Walk*. Note it is the sixth edition from 1996 so I didn't just buy it for you to sign. And your book's now into its 10th edition.

Burt Malkiel: And I'm about to start working on the 11th edition.

GH: Can you tell me what's changed in investing over the decades since the first edition?

BM: What's changed is that the first edition, there were no index funds. First edition was in 1973, the first index fund was in 1976. It is meant to be an investment guide, and there have been dramatic changes in the kinds of instruments available to investors.

There are three major things I do in different editions. One, the new instruments available. For example, more recent editions have featured ETFs. Two, the changing regulations like tax laws facing investors. Then finally, the academic research over the period. Two things I will put in the 11th edition are the low volatility products available, and I think that option writing is interesting. I have some colleagues who have done fascinating research that they can replicate the hedge fund index and get 300 to 400 extra basis points by writing puts. You're basically selling insurance.

You know, in the early days when I said "Just go and buy index funds", I had a reviewer say in *Business Week*, "This is the biggest load of garbage", so I keep saying, "I said go buy index funds, did it work?" and every time I look at the last four or five years, yes it did work. The book has changed a great deal, but the basic message hasn't changed, even if the advice on what to use has changed.

GH: If I look at some of the criticisms of the book, where people say there are some managers who have had long-term success outperforming the market, but as I read your book, you acknowledge this. For example, in my edition it says, "I walk a middle road. I believe that investors might reconsider their faith in professional advisers, but I am not as ready as many of my academic colleagues to damn the entire field. While it is abundantly clear that the pros do not consistently beat the averages, I must admit that there are exceptions to the rule of the efficient market. Well, a few." So you're not just an efficient markets person.

BM: And that was actually another change. I'm not saying you should necessarily index everything, but there's enough evidence in favour of it, the core of your portfolio ought to be indexed, and then if you want to trial something active around the edges, you do so with much less risk. But just remember, there is this distribution of returns (Burt draws a normal bell curve, then a vertical line near the y-axis representing 1% fees) and if there were no fees, half would be above and half would be below. If you can get the market return, the typical active manager will be 1% less than the market. You're much more likely to be on the negative side of the distribution with active managers. But you can definitely try it.

I will also be writing about financial repression in the next edition (GH comment: this is where the government interferes with free market operation). I would not buy a bond index fund today.

GH: It's really interesting to hear that because if we focus on asset allocation rather than manager selection, how do you feel about the various investing models that are recommended to retail clients, say invest 70/30 and stick with that.

BM: There's no question that in my advice to the Princeton widows, they want to be able to draw some income out without having to sell all the time. They want to do it easily. I don't want them to get their income from a US bond portfolio, they should get it from emerging markets bonds where there's no financial repression, or in dividend growth stocks, which takes me back to a low volatility strategy. This is asset allocation, but I don't feel badly about doing it. If there's somebody in retirement who wants income, yes, I don't want them to buy Google and Facebook, I want them to buy a particular type of stock, but that's fine.

GH: And you also don't want them to buy a bond yielding 1%.

BM: Exactly, because I think they're going to get killed.

GH: So in that situation, the so-called lifecycle funds with an increasing allocation to the bond market ...

BM: I don't like them, that's another thing going into the next edition. I've been a director of Vanguard, I'm on the Vanguard International board now, but I don't like lifecycle funds because at the end, they're putting 80% into precisely the securities that I think are going to give people an enormous amount of trouble.

GH: Let's turn to Wealthfront, which looks like it's gaining some good momentum.

BM: It's amazing. As I said in the panel discussion, I'm not sure about a lot of things, the only thing I'm absolutely sure about is that the lower the fee I pay, the more there'll be for me. So what we do at Wealthfront is we're using the lowest cost ETFs, we are also charging a wrap fee for doing the asset allocation of 25 basis points. So it's kind of 'Vanguardising', if you wish, the advice business. I have been with them since the end of 2012 and they've got \$210 million of assets from almost nothing in that time. They are doing this using a lot of technology – we're not going to hold your hand, you can't do that for this price – and the marketing is done through e-invites, the clients are from places like Google and Facebook and Salesforce and they are happy to be serviced online. I don't think my Princeton widows would be comfortable with this approach, and if you want to pay more for advice, fine if there's someone who will hold your hand.

GH: I assume there's some process of risk assessment.

BM: Yes, we use some of the expertise from behavioural finance people, [Meir Statman](#) was one who helped us design the questionnaire so it's not simply age. That's too simple, people are all different. There are people for whom a very aggressive portfolio makes them sick to the stomach when it goes down.

GH: They can't sleep at night.

BM: More than that. They can't sleep at night, but one of the things we know about the mistakes people make is that they're more likely to sell when the market falls. They can't take any more. When people try to time the market, they usually get in at the top and get out at the bottom. You see it with mutual fund flows, you see it with pension funds. Are we doing it perfectly, probably not, this is not an easy thing to do. We have added people who know something about survey techniques, people who know behavioural finance, we get the questionnaire filled out and then we put people in particular buckets.

Just to give you an idea, I'm a client, and given my age, they had me in a safer portfolio than I wanted to be, and I said you can't just do it with age because I'm not investing for myself, I'm investing for my grandchildren. It's the horizon of the people you are investing for.

GH: Given your comments about low bond rates, if someone profiled as conservative, where do they go?

BM: As I said, the bonds we are using are bonds from countries not engaged in financial repression, have younger demographics, have reasonable interest rates, low debt and better fiscal balance. I am the Chief Investment Officer and I design these things for exactly the reasons we discussed earlier.

Let me tell you the other things we can do. We do rebalancing with an automatic formula, and for taxable accounts, we do tax loss harvesting. Let's say you've got a US equity position, and the equity has gone down. We'll sell the Vanguard ETF and buy the Schwab ETF, it is essentially the same thing but it's not a wash sale when you do it that way, and take the tax loss, and particularly for the clients we have now, they can use the tax loss because their portfolios might be 98% in Facebook stock which they will be taxed on. This works well.

GH: One last question. You said recently, "We should be modest about what we actually know." Do you have any feeling of disappointment about progress we've made in investing. If I were a surgeon or a pianist, after 35 years, I'd be very good.

BM: I think the reason we have not made much progress is that it is probably one of the most overpaid professions there is. It's an inefficiency, with investment professionals paid regardless of the results. I've been an educator, and I just try my best in everything I do. I went to Wealthfront because I like the idea of doing good for humanity and I get paid in stock and I might do well financially at the same time. The real problem with us making enough progress in our industry is the misaligned incentives. But now, at least there's a lot of competition in ETFs and fees have been driven down to close to zero.

The Harry Markowitz Interview: Retail financial advice

by Graham Hand

Published 16 May, 2013

This is the second part of my interview with one of the fathers of the wealth management industry, the 1990 Nobel Prize Winner, **Harry Markowitz**. His [Modern Portfolio Theory](#) ideas are still taught in universities and business schools. In Part 2, we discussed his retail financial advice business, GuidedChoice. He is co-founder and Chief Architect, including designing the software analytics for the investment solution and heading the Investment Committee. Part 1 of the interview on portfolio selection is [here](#).

Graham Hand: Can we talk about you do with GuidedChoice? I'm especially interested in how you advise people, how you manage asset allocation and issues such as longevity risk.

Harry Markowitz: What we do is Monte Carlo analysis to get a probability distribution of how well you will do if you invest in a certain way, and save a certain amount of money. You're familiar with [Gary Brinson's writings](#) on asset allocation?

GH: Where 90% of your returns come from asset allocation, not manager selection.

HM: Yes. The important thing about Gary Brinson's work, which has persuaded trillions of dollars of funds to do this top down analysis, is where you first decide to be on an efficient frontier at the asset price level. Then you figure out where you should invest, you might consider the managers to use or ETFs. The beauty of that is that people who have no ability to pick stocks can still get good advice.

We do this top down analysis, for all our clients, we do forward-looking estimates of variances and covariances. We don't reestimate values very often because we use long-dated series. A few years back we said we've got to reduce our forward-looking estimates on fixed income because we're obviously in a low rate environment, but we don't change equity estimates very often. We are doing principal component analysis of the factors, but it's not completely mechanical. When it's finished, we take all the asset classes with estimated expected return on one axis and estimated standard deviation on the other axis.

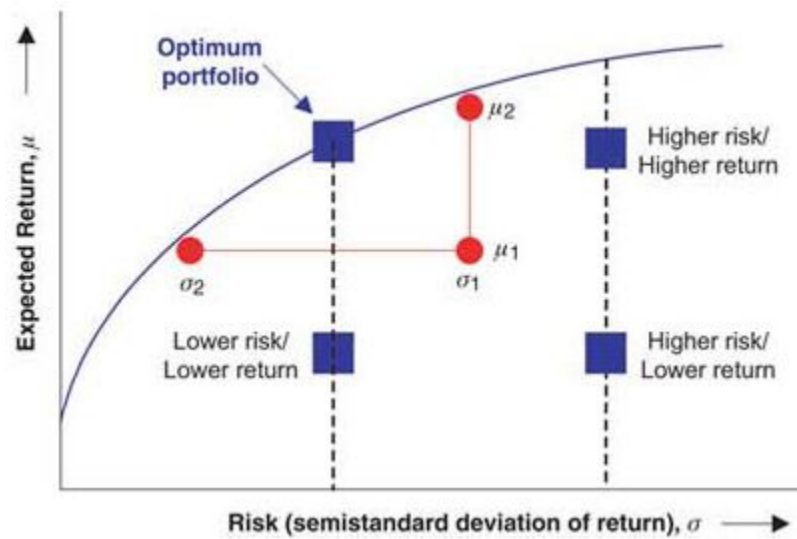
For everybody, we generate an efficient frontier at the asset class level, and we pick off 7 portfolios, number 7 being the riskiest, 1 being the most cautious. Then for specific plans, which have allowed investments, we have a separate optimisation which tries to figure out what are the real investible securities permitted by particular plans in order to match these asset classes. We take into account tracking error, expense ratio, historical alphas. For each participant, we receive a lot of data from their company, and we ask questions like, "When do you plan to retire?"

GH: So there's a type of online questionnaire that the individual fills in? I'm wondering how you work out the client's risk appetite.

HM: Yes, it's interactive online, but we do not ask whether you sky dive. We look at what you already have in your portfolio, assess your current risk level, and we propose to you a portfolio. Then we show you the consequences of changing from your current one to a proposed portfolio. We show you three points on the probability distribution of how much you can spend in current dollars when you retire – in a weak market, an average market and a strong market. You can fiddle with it, you can go up the frontier, or you can save more.

GH: You have these 7 asset class portfolios with different risks, how does someone decide?

HM: You're a client, you've told us when you want to retire, you've said at what rate you are willing to save, told us whether you have a spouse, we can see your existing portfolio. We show you a portfolio which has a similar risk level but maybe a bit more return, and we show you three points off the probability distribution showing the rate you can spend when you retire. You might not want Risk Class 4, so they try 5, and we go back and forth.



Source: [GuidedChoice website](#).

As an aside, you should read a paper I wrote called [The Early History of Portfolio Theory 1600-1960](#). I chose 1960 because that was when Bill Sharpe knocked at my door and asked what he should do his dissertation on. And 1600 is when *The Merchant of Venice* was written and Antonio said, "My ventures are not in one bottom trusted, nor to one place; nor is my whole estate, upon the fortune of this present year." Shakespeare knew about diversification.

GH: So portfolio diversification had already happened by 1600. How far have we come since then?

HM: Well, now we know how to measure covariance. We know diversification will eliminate risks if they're uncorrelated, but not if they're correlated.

Another thing I should say is that GuidedChoice now has another product, GuidedSpending, which has to do with how fast you can spend in retirement. We assume your spending rate will depend how well you do in the market, and we ask you for two consumption levels: upper level where you can put away any surplus for a rainy day, and a lower level where you have to see if you can hold out for a while. Depending on how you set your levels, plus all the other factors, we assign a probability distribution on the rate at which you can spend when you retire. For any time pattern of consumption, we assign a utility based on the average consumption you can achieve.

GH: But how do you plan for how long a person is going to live?

HM: Currently, we assume you will drop dead precisely 10 years after your actuarial time, but I have been promised some day we will have a stochastic model.

GH: So you use actuarial life tables. What do you think about the basic default savings plans, such as the 60/40 model or lifecycle funds with more allocated to the defensive asset over time?

HM: The problem with 60/40, it's a little chicken for people early on, it's not right for everybody. 90/10 might be best for a young person. The problem with lifecycle is I'm 85 and I have more in equities than I've ever had, but I have a wealth level that means I am many standard deviations away from not being able to eat.

GH: So you need to consider your income-earning ability and other factors, not just your age.

HM: You need to look at the probability distribution of what they can spend, what they can earn, how long they will be employed. Our models will always be grossly inadequate because there are more things on heaven and earth than we can ever capture in our models. We have to do the best we can but we get a lot closer than 60/40 for everybody.

GH: What do you think of the merits of Tactical Asset Allocation where someone takes a view on the market and changes the asset allocation?

HM: There's my official view and my unofficial view. My official view is that nobody seems to be very good at picking the market. But it does seem plausible that when price earnings ratios are historically high, we should lean towards less to equities. In my own funds in 2007, I sold my ETFs, I didn't get out of equities completely, and I went back in in December 2008 expecting a January effect. Which came in March. On some occasions, it has merit. But if someone reads a weekly newsletter about whether you should be betting up or down this time, going in and out, you'll lose money on average over the long run. There's a wonderful behavioural finance guy, [Terrance Odean](#), who studies the track records of individual investors, and he finds both active and passive investors gross roughly what the market makes, the active do worst due to brokerage.

You know, I'm writing another book, in 4 volumes, first is already at the publishers, McGraw-Hill. The next volume is due March 2015, then 2017, then 2019.

Rob Arnott seeks many happy returns

by Graham Hand

Published 5 December, 2014

Rob Arnott is Chairman and CEO of Research Affiliates, LLC and a pioneer in asset allocation techniques and smart beta investing, especially fundamentally-weighted indexes and strategies. He is a former Chairman of First Quadrant, and has published over 100 articles. He edited the Financial Analysts Journal from 2002 to 2006, and received the William F Sharpe Lifetime Achievement Award in 2013.

We first met in 2007 when I was responsible for alliances at Colonial First State, and we brought fundamental indexing (sometimes called 'RAFI') to Australia with the establishment of Realindex Investments, which now manages about \$10 billion. An ASX-listed RAFI fund is also offered in ETF form by BetaShares.

Smart beta and fundamental indexing

Smart beta investment strategies are now so common that it's hard to believe that only a decade ago, they were considered little more than a quirky idea. The first fund established in the US using fundamental indexing is about to celebrate its 10th anniversary, and after the first, other managed funds and ETFs were quickly rolled out across the world. So with all these 'many happy returns' coming up soon, it was a good time to ask where it all started.

"I'd long had a view that cap weighted investing was peculiar. The more expensive a company becomes, the bigger its weight in the index. It tends to put most money into companies that are popular, that have high multiples, that have a strong momentum. Why should we earn a stronger equity risk premium on those companies? I thought we needed an index based on sales or book value, but I never pursued it."

"Then in the aftermath of the tech boom in 2001, George Keane was sitting on the Board of the State of New York, and was horrified because they had a large chunk in an S&P500 index fund, which had 4% of its money in Cisco, a company priced at about \$25 million per employee, a stupendous valuation. Could a company with 25,000 employees be worth that? It has to achieve some remarkable things. He watched in horror as these stratospheric tech valuations came back down to earth, so he approached a few people to talk about a better way to index. He was thinking something like a mid-cap value, but I thought, instead of looking for niche categories, maybe we ought to revisit the way we index. So we tested sales weighting, using the 500 largest companies with investment weighted by sales. I was stunned that going back 30 years, it beat the S&P500 by 2.5% a year. I realised we were on to something big."

Arnott then tested using index weightings based on profits, book value, dividends, even the number of employees, and they all outperformed cap weighted indexing over long periods. He argues it is because they sever the link with price. If you weight by fundamentals you are achieving economic representation of the broad macro economy. He tested it for 23 countries and found it worked in all but two of them.

Arnott published the results, but initially, the antipathy of academics and the indexing community was palpable. The lack of academic curiosity in particular took him by surprise, and defending their turf, there was animosity from cap weighting businesses. He now believes the notion that it adds value relative to cap weighting is accepted in some circles as obvious, although critics say it's just another form of active management and is not really indexing.

He is happy with that. "Absolutely they say that, and relative to cap weighting, it's an active strategy. I like to turn it around. Relative to the macro economy, fundamental indexing is neutral, cap weighting is active. It depends how you see the world. The market is making all kinds of wild bets. It's making a huge bet for Twitter and a huge bet against British Petroleum."

Tactical asset allocation and mean reversion

Arnott is also portfolio manager for PIMCO's All Asset Fund. In this role, he makes tactical allocation decisions across dozens of asset categories, but how does he allocate?

"The world has a lot of asset classes to choose from. The notion of picking market peaks and troughs is naïve, nobody can do it. In the long run, valuation matters tremendously, but in the short run, the flow of capital matters more. The flow of capital is profoundly difficult to anticipate, and central bank interventions create disruptions to market valuations. For

those who are patient and contrarian and willing to do what's uncomfortable, the rewards can be great.

"Suppose you have a company in your portfolio that is recognised as a market leader all over the world, no serious impediments to its growth, the third largest market capitalisation on the planet, which implies it will be the third largest source of profits in the world. It's called Google. Then we suggest you should get rid of it and switch to a basket of Ukrainian bank stocks, some of which could go to zero. Is a fund manager who does that likely to be applauded or fired? But if you did 20 trades of that sort, collectively they'd probably do well. It's uncomfortable, but markets don't reward comfort."

Arnott is highly systematic. The more valuations move away from historic norms, the more comfortable he is in taking a larger position. The portfolio is not switched straight into a large position but a process of averaging in commences based on valuation signals. Over time, the position is expected to benefit as prices revert to the mean.

"For example, the Schiller valuation of US stocks today is 26 times earnings, the Schiller for Emerging Markets is 15 times earnings. Well, people are scared of EM, and the US is a haven. There's a flight to safety and the US\$ is strong, while there are many political problems in EM economies. OK, I get all of that. But the valuations are better in EM, and based on fundamentals, the earnings multiple is only 11."

Demographic change

Arnott also writes and speaks widely on demographic change, especially the aging population and lack of tax revenues to pay for services such as health and pensions. He believes we are living in a fool's paradise where governments overspend but are unwilling to raise the money to pay the bills.

"I think intergenerational conflict is inevitable. It will become politically explosive. The baby boomers will say they paid taxes into the system and are entitled to take money out, but it's not like an insurance policy. These are transfer programmes, they are not a prepaid annuity programme. Our politicians have lied to us. I think the problems will happen in the next 10 years. Roughly six years from now, the majority of baby boomers will have retired. Baby boomers and our parents were no longer the majority of the voting population as of 2009, and will be outnumbered 2 to 1 by 2020. Baby boomers will have less power at the ballot box. But there's also a fairness issue. We're expecting our grandchildren to take care of us when we have more money than them."

I pointed out to him that in Australia, the family home is exempt from asset tests for pensions, and a couple can have a million dollars plus an expensive home and still be eligible for a part-pension. He believes such thresholds must fall in coming years, and at some point, politicians will address the family home exclusion. It will be argued on fairness grounds and neither party will defend the baby boomers.

Perceptions of the wealth management industry

Following a Research Affiliates' conference earlier this year, I wrote [this report](#) on the criticisms of our industry from many of the speakers. Active managers are not worth the fees, we don't know how to value companies, asset consultants don't add value. Should we be disappointed with what our industry has achieved?

Arnott does not try to defend Wall Street. "As a business, we have asked where has our industry failed the end clients. Once in a while we ask what's going wrong. I'm not cynical enough to think our industry is deliberately nefarious but there are a lot of paths of least resistance, people trying to make money in convenient ways. Not necessarily what's the best way to help clients succeed. Our industry attracts a lot of people who ask what can I do that can be sold for a premium price, that hopefully make money for clients but hopefully more money for me. That's why Jack Bogle's insights on indexing were such a revelation."

I asked if part of the reason we are in this position is that our industry is dealing with human emotions, individual reactions and behavioural characteristics, and it's almost impossible to know how the market will react to events. Unlike a surgeon who cuts into a body and each one looks basically the same.

"A surgeon operates under the Hippocratic Oath of keeping clients from harm. If your customers die, you're not going to have a career very long. In investment management, a lot of people don't have the institutional equivalent of the Hippocratic Oath."

As our industry seeks to improve its professional standards and build trust with the public, it's worth looking at an extract from the Oath:

"I will apply dietetic measures for the benefit of the sick according to my ability and judgment; I will keep them from harm and injustice ... I will neither give a deadly drug to anybody who asked for it, nor will I make a suggestion to this effect ... Whatever houses I may visit, I will come for the benefit of the sick, remaining free of all intentional injustice ... If I fulfill this oath and do not violate it, may it be granted to me to enjoy life and art, being honored with fame among all men for all time to come; if I transgress it and swear falsely, may the opposite of all this be my lot."

There's something fundamentally good about that.

An historical (not hysterical) look at gold

by Ashley Owen

Published 2 May, 2013

Around the world in the last two weeks, people have rushed retail stores to buy physical gold. Perth Mint has reported sales are at their highest level in five years, and they traded over the weekend to cope with demand. People are queuing across Asian cities in panic-like conditions, while the US mint has been forced to cancel sales of its gold coins. Buyers are responding to the rapid price fall to USD1,322 per ounce in mid-April, the lowest level for two years.

What is most extraordinary is that retail investors usually react to rapid market falls in the opposite way. When equity prices drop, investors usually panic from fear it will fall further. Inflows to managed funds are always at their strongest when the market is at its peak, and outflows at their highest when markets bottom. But something else is happening with gold.



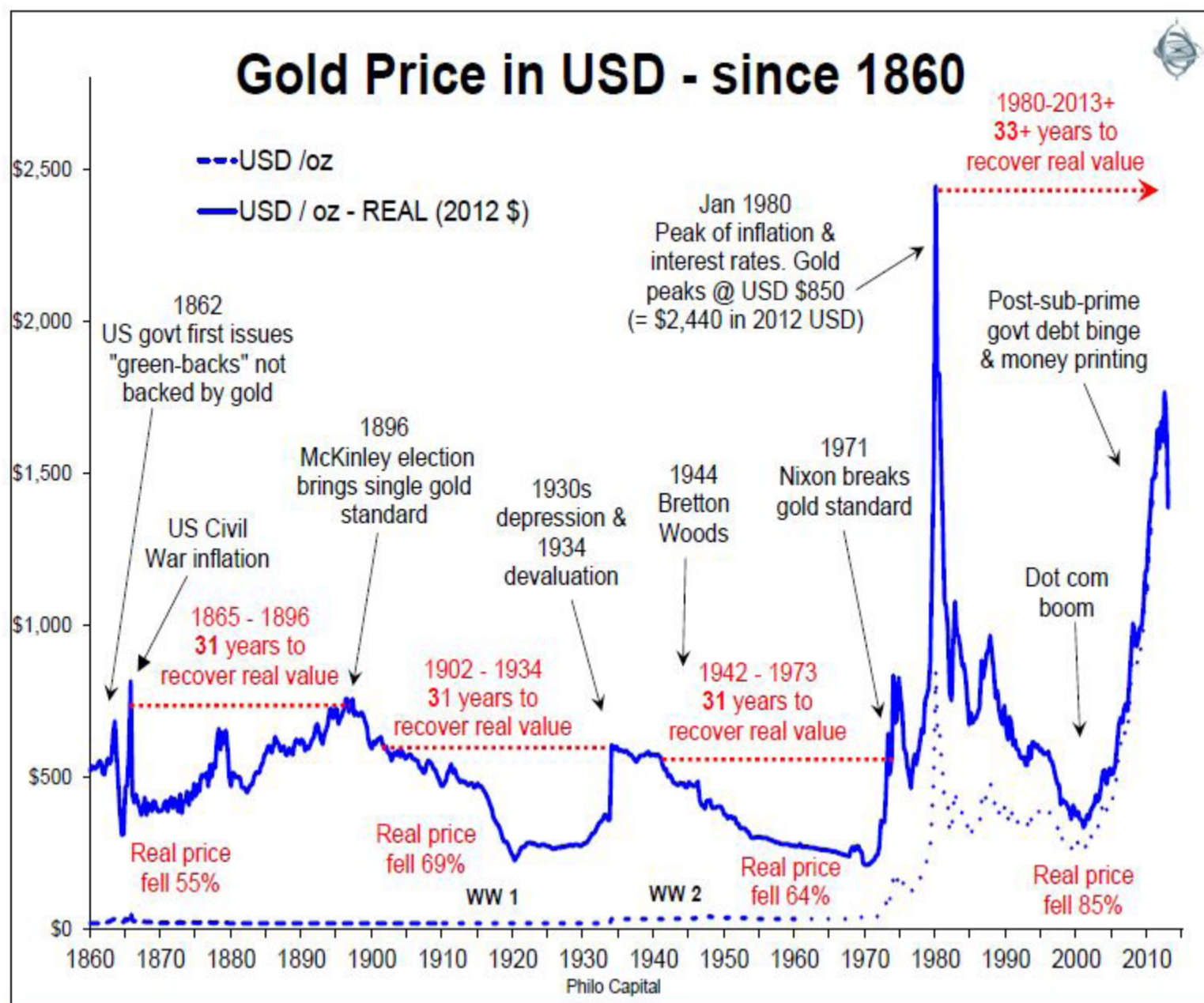
Source: Compiled by Grant Williams of Mauldin Economics from various public sources.

A brief look at gold price history

Most of the time over history, one ounce of gold has been able to buy items worth the equivalent of around USD500 in today's dollars adjusted for inflation. It has done so for much of the past 2,500 years through many societies. Occasionally the gold price (when measured in paper currencies) surges when paper currencies devalue, but it then falls back again in real terms. If bought below its long run level, gold can provide a hedge against the devaluation of paper, but if bought above the level it is speculation, not 'investing'. It is not a matter of whether gold represents a store of value or some other safe haven characteristic. For an investor, it is only worth buying when it is cheap.

The gold price reached USD1,900 per ounce on 5 September 2011 in the midst of the US debt ceiling and credit downgrade crises. Since then it has fallen by more than 20%, including a 10% fall on 15 April 2013, triggered by fears that Cyprus and the PIIGS may have to sell their gold reserves to repay debts.

Gold may shoot up to USD4,000 or USD5,000 in one of two scenarios: (a) an extreme left wing outcome resulting in runaway US inflation leading to a breakdown of society; or (b) an extreme right wing scenario with a Tea Party-led Republican government bringing back the gold standard. These scenarios look remote. People who bought gold in the last bubble in 1979-80 are still waiting to get their money back in real terms after inflation 33 years later.



Investors cannot consider gold without also thinking about currencies and inflation, as the three are inextricably linked. Long term holding of gold makes sense as an inflation hedge or as a store of value if bought at or below the long term price around which it has oscillated for thousands of years. However, if paper currencies collapse, the nominal value of gold expressed in paper money terms can rise dramatically. So gold has most appeal if the investor's home currency is about to experience massive hyper-inflation which destroys the value of paper money, which is unlikely in Australia in the near future. Or since the price of gold is expressed in USD terms, any expected rapid destruction in the value of a home currency may merit purchases of gold.

Of course, profits from short term trading are always possible as a more speculative bet, but long term portfolios are designed to look after long term needs, such as producing income and protecting wealth.

A copy of our comprehensive 2012 study of gold can be found [here](#).

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.

Nixon's Mum

by Jack Gray

Published 13 March, 2013

The financial services industry is untrustworthy ... that's how people see it.

A survey of over 3,000 people across 60 countries found that only a third believe their 'primary investment contact' acts in their best interests. Only a third! Of course we'd be startled if as many as a third believed their used car dealer acted in their best interests but ironically we in finance and investing need to be trusted more than do used car dealers. Not only is a car dealer's past performance likely to be a reliable guide to future performance, but used cars can be tested for quality by identifiably independent experts, and one can insure against the risk of lemons.

None of this holds in financial services where the confluence of informational asymmetry and intrinsic uncertainty means quality can never be tested. For instance, half a century of data is famously needed to be confident that skill rather than luck best explained a manager's outperformance. All we have had is trust, yet the 'market' for trust has failed; demand is increasing while supply is decreasing. The World Values Survey asked people in Britain 'can most people be trusted?' In 1959, 57% answered 'yes', but by 2000 that had collapsed to 31%.

Trust in the entire financial system has been battered by financial crises and bruised by Madoff-style schemes, both of which are too readily dismissed by the few-rotten-apples metaphor designed to comfort us, to distance us from corruption. Yet we all played a part in small but insidious ways. For instance we eternally qualify with the ubiquitous 'little', as in 'we underperformed a little', the strategy 'failed to hedge a little', and the one we all fear, 'this might hurt a little.' Weasel words undermine trust inch by inch. Let's say it like it is. Some language goes further than merely undermining trust. Some destroys it. Listen to private bankers striving to increase their 'share of wallet.'

Trust might be cautiously restored if people see ethical behaviour as the norm, if they see us in the business behaving ethically. Some argue we shouldn't try, that ethics inhibits success in commerce, and that it's too onerous. But where trust is a crucial ingredient of 'getting to yes', ethical behaviour is more likely to enhance success. And it isn't too onerous. Just the opposite because society's response to poor ethical standards is more regulation. Now that's onerous.

Trust in financial services could be re-kindled if we practised two easily-stated pragmatic principles.

The Oedipus Principle. In commercial dealings always act and behave as you would in dealing (at arms' length) with your mother. We may have complex relationships with our mothers, but most would neither take unfair advantage of them nor mislead them in commercial dealings. We wouldn't lie to them, even though as children we all did.

The Nixon Principle. In commercial dealings always tell the truth, tell it quickly, and tell nothing but the truth. The adverb quickly is crucial. The longer you delay telling clients about screw-ups or misleading statements, the harder it is to come clean and the greater the suspicion of a cover-up, which when discovered permanently destroys trust. Judgement is needed in deciding whether to tell the whole truth. Sometimes not telling the whole truth can be ethical, as might be the case if a long-short equity hedge fund named its shorts. Almost never are ethical decisions black-and-white, but blurring is no excuse for not exercising ethical judgement.

All principles of government, investment, commerce and ethics are easy to live by in normal times. Our commitment to them is only tested when we're under extreme pressure, and we mostly fail. Suppose your child urgently needs a life-saving operation which you can fund via a sale that is far more likely to close quickly if you don't alert the buyer to a half-buried escape clause that applies to a guarantee. Will you still hold to the principles of Oedipus and Nixon?

To embed trust in commerce we also need to exorcise the neo-liberal economic rationalist agenda that preaches selfishness as a virtue and justifies it on the grounds that the invisible hand will serve the common interest. Adam Smith knew the limits to his profound and beautiful metaphor; he warned that free markets ineluctably result in collusion and corruption. Financial markets, being "demons of our own design" must be regulated ... wisely. Unfortunately wisdom is in short supply. Would you trust a seller of mortgages regulated by ASIC's requirement that a credit contract be merely 'not unsuitable' for the purchaser? That's but a slight nudge ahead of caveat emptor. 'Most suited' or 'the best', but 'not unsuitable'?

Exorcism must be brought to bear on Milton Friedman's rationalist view that a firm's sole social responsibility is to make (legal) profits. Friedman is doubly wrong. First, a firm's aim should be to produce goods and services of sufficient quality that people will want to purchase them. Profit is a consequence of production rather than the aim. Once profit becomes the aim, as it has on Wall Street, unethical behaviour becomes readily accepted and resources are directed to accounting trickery rather than to production. Profit as the aim allowed Wall Street to legally sell 'No-Doc No Income No Job' negative amortisation mortgages to poor unemployed people (and then to blame them.) Second, were Friedman right, companies would be the only institution in society whose sole constraint is to obey the law. We rightly expect more than that from our schools, our governments, our hospitals, and from each other. We expect them and us to behave considerately, reasonably, ethically – high standards we all fall short of from time-to-time.

Dr Jack Gray is a Director at the Paul Woolley Centre for Capital Market Dysfunctionalities, Faculty of Business, University of Technology, Sydney, and was recently voted one of the Top 10 most influential academics in the world for institutional investing.

Poetry for investors

by Jack Gray

Published 16 May, 2014

In the heady 1960s, students demanded an injection of culture into the narrow training of economists, engineers and other technocrats. Courses such as Poetry for Physicists flourished as part of a utopian vision that humanities would sensitise future leaders, a vision whose minimal expectation was that technocrats will at least have read a novel.

Even by that low standard the movement failed as almost none took it seriously, neither physics students nor their teachers nor administrators. And today in a world where that ugly notion 'relevance' dominates institutions of supposed higher learning, the gap between the two cultures, the technical and the humanities, has widened, such as reported [here](#).

Today, unfortunately, Finance is the prime path to financial success, a path that values culture even less than did engineering 50 years ago. One investment professional proudly declared his studied ignorance of any history because what happened in the past is "*boring, irrelevant and would clutter my mind.*" Pity he hadn't listened to the Roman orator and writer Cicero (106-43 BCE) who understood the incipient dangers of historical ignorance, "*To not know what happened before you were born is to be a child forever.*"

I hesitate to promote poetry on the grounds of relevance, nonetheless the following poetic statements do offer insights and provocations that can make for wiser investors. Hear how poetically the German thinker Wolfgang Goethe (1749-1832) hints at our (investment) biases, "*We know for certain only when we know little. With knowledge, doubt increases.*" The notoriously difficult American/English poet T S Elliot (1888-1965) further captured the epistemological challenges investors face: "*Where is the wisdom we have lost in knowledge? Where is the knowledge we have lost in information?*"

The English sometime poet G K Chesterton (1874-1936) does seem to appreciate investing's central challenge, as evident by the sting in the tail, "*the real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest type of trouble is that it is nearly reasonable, but not quite. ... It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.*"

With greater specificity the Russian Boris Pasternak (1890-1960) also warned of over-emphasising rigour, processes and (risk) measures, "*what is laid down, ordered, factual, is never enough to embrace the whole truth: life always spills over the rim of every cup.*"

In a not dissimilar vein the prolific Greek C P Cavafy's (1863-1933) poem Things Ended reminds us of the limits and dangers of stress-testing,

*"Engulfed by fear and suspicion,
mind agitated, eyes alarmed
we try desperately to invent ways out,
plan how to avoid the obvious danger
that threatens us so terribly.
Yet we're mistaken, that's not the danger ahead:*

*the news was wrong
(or we didn't hear it, or didn't get it right).
Another disaster, one we never imagined,
suddenly, violently descends upon us,
and finding us unprepared – there's no time now –
sweeps us away."*

Herding, that most human of responses, offers a false sense of protection from those "dangers ahead". To be like others is the default strategy of (almost) all managers, consultants and super funds, and one that ineluctably results in following fashion. The wonderfully cynical Irish poet Oscar Wilde (1854-1900), captured the inherent short-termism in that behaviour through his aphorism, "fashion is a form of ugliness so intolerable we have to alter it every six months."

To avoid excessive herding requires sometimes choosing the road less travelled, as did the American poet Robert Frost (1874-1963) in his beautifully lyrical (almost) eponymous poem,

*Two roads diverged in a yellow wood,
And sorry I could not travel both
And be one traveler, long I stood
And looked down one as far as I could
To where it bent in the undergrowth;*

*Then took the other, as just as fair,
And having perhaps the better claim
Because it was grassy and wanted wear,
Though as for that the passing there
Had worn them really about the same,*

*And both that morning equally lay
In leaves no step had trodden black.
Oh, I kept the first for another day!
Yet knowing how way leads on to way
I doubted if I should ever come back.*

*I shall be telling this with a sigh
Somewhere ages and ages hence:
Two roads diverged in a wood, and I,
I took the one less traveled by,
And that has made all the difference.*

And when that path less travelled does lead to success (as surely it sometimes must) and when we then suffer from hubris (as surely we will) we should be reminded of the fate of Ozymandias (as surely we won't) so powerfully captured by the absurdly young English poet Percy Bysshe Shelley (1792-1822),

*"I met a traveller from an antique land
who said: `Two vast and trunkless legs of stone
Stand in the desert. Near them, on the sand,
Half sunk, a shattered visage lies, whose frown,
And wrinkled lip, and sneer of cold command,
Tell that its sculptor well those passions read
Which yet survive, stamped on these lifeless things,
The hand that mocked them and the heart that fed.
And on the pedestal these words appear —
"My name is Ozymandias, king of kings:
Look on my works, ye Mighty, and despair!"
Nothing beside remains. Round the decay
Of that colossal wreck, boundless and bare
The lone and level sands stretch far away."*

Perhaps in some small way poetry can help us transcend the accusation, "what do they of investing know who only of investing know?"

Dr Jack Gray is a Director at the Paul Woolley Centre for Capital Market Dysfunctionalities, Faculty of Business, University of Technology, Sydney, and was recently voted one of the Top 10 most influential academics in the world for institutional investing.

Does the public hate us?

by Graham Hand

Published 17 July, 2014

Published in 2001, my book [Naked Among Cannibals](#) examined how banks had fallen from revered to reviled within a couple of decades. Over the subsequent few years, the finance industry seemed to be gradually winning back the trust of the public, with market research showing improving customer satisfaction and better ratings for 'ethics and honesty'. But events relating to Storm Financial, Westpoint, Opes Prime, Trio Capital and most recently, CBA's advice business, have been setbacks to this progress. The watering down of FOFA is a rich source of rancour for major bank critics.

A few weeks ago, I attended a meeting where two Nobel Laureates debated why the public hates the finance industry. Then this week, David Murray's [Financial System Inquiry](#) highlighted major shortcomings in Australian wealth management. The former CEO of CBA, who bought Colonial First State to create the largest fund manager in the country, was expected to be kind to the major banks, but he criticised the industry on many fronts. The Interim Report says in various sections:

"A trend in the wealth management sector is towards more vertical integration. Although this can provide some benefits to members of superannuation funds, the degree of cross-selling of services may reduce competitive pressures and contribute to higher costs in the sector."

"The quality of personal advice is an ongoing problem ... ASIC shadow shopping exercises indicate that consumers often receive poor-quality advice. This poor-quality advice mainly relates to two factors, the:

- *Relatively low minimum competence requirements that apply to advisers*
- *Influence of conflicted remuneration arrangements*

The price of personal advice has often been hidden by opaque price structures and indirect payments."

"The operating costs of Australia's superannuation funds are among the highest in the Organisation for Economic Co-operation and Development (OECD), and the Super System Review concluded superannuation fees were "too high". The Grattan Institute estimates fees have consumed more than a quarter of returns since 2004."

"It is very difficult for the superannuation system as a whole to beat the market over the long run within an asset class, although it is possible for an individual fund to do so. As Nobel Laureate William Sharpe noted:

'Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs.'"

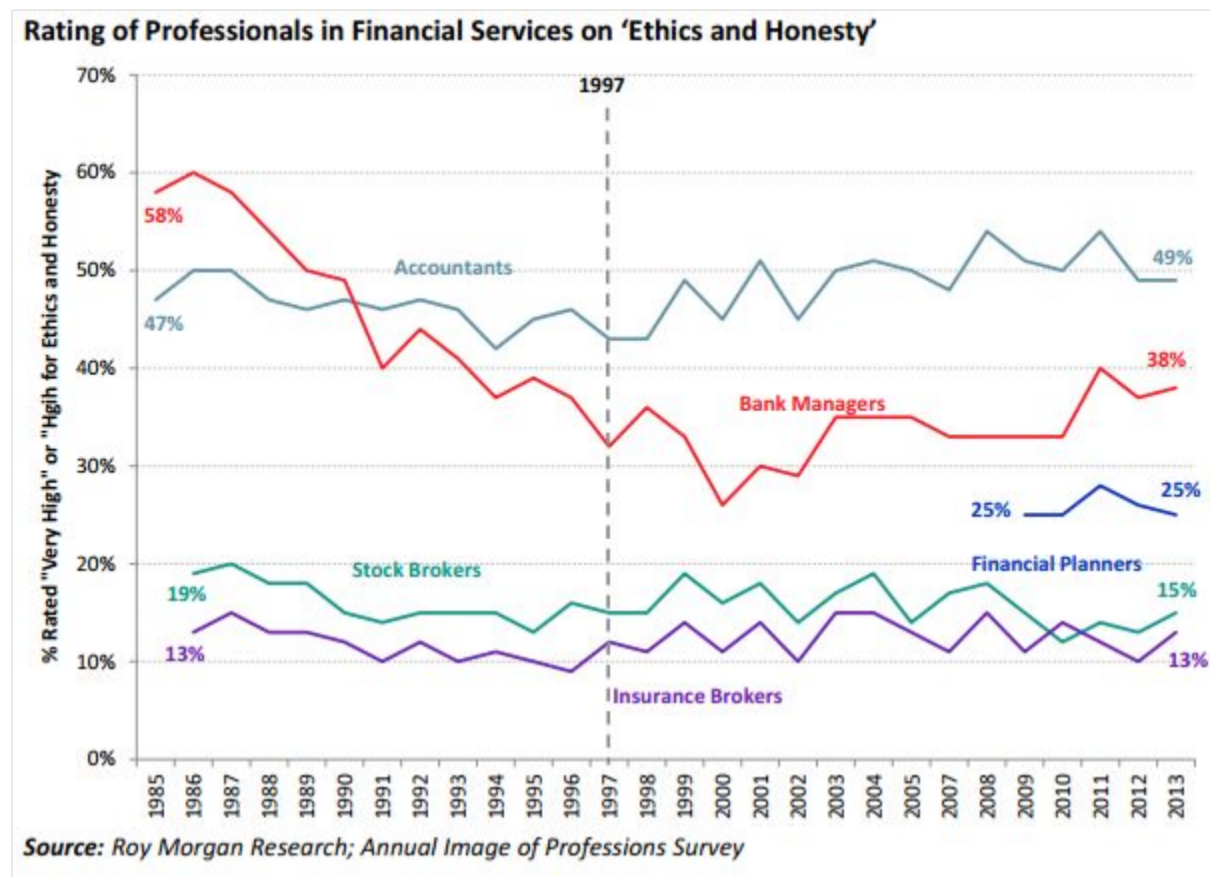
Far from easing the pressure on the major banks, David Murray has delivered more setbacks, especially to the legitimacy of the revisions to FOFA.

The image of financial services professionals in Australia

Roy Morgan Research has tracked the [image of financial services professionals](#) since 1985, and reports:

"Unfortunately, very few Australians trust professionals in the financial services industry, rating them consistently poorly for 'ethics and honesty'. Not exactly the best foundation for a successful working relationship, is it?"

For 'ethics and honesty', only 25% of Australians rate financial planners as 'very high' or 'high', and it's even worse for stockbrokers (15%) and insurance brokers (13%). The once-trusted bank manager scores only 38%, down from a healthy 58% in 1985, as shown below:



How did the Nobel Laureates explain the hatred?

At the 2014 Research Affiliates Advisory Panel at Laguna Beach in California, the first session was hosted by their Chairman, Rob Arnott, in discussion with two Nobel Laureates, Harry Markowitz and Vernon Smith. The topic was "Why Does Main Street Hate Wall Street?", or more prosaically, "Why does the public hate us?"

Harry took it gently. He thought it was mainly a lack of education, and we need to tell the public about the importance of financial intermediation for the functioning of a market economy. But digging deeper, Vernon Smith pointed out that what Adam Smith wrote in his 1776 *The Wealth of Nations* is often mistakenly quoted to justify self-interested market behaviour. Adam Smith described his system of natural liberty thus:

"Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interests in his own way."

But Vernon said this can only be understood in the context of Adam Smith's 1759 Book, *The Theory of Moral Sentiments*. While people have a right to be 'self-loving', part of their maturation is to learn rules of conduct that are 'other-regarding'. Greed is controlled through socialisation.

"He must humble the arrogance of his self-love and bring it down to something which other men can go along with ... we must become the impartial spectators of our own character and conduct."

Vernon believes our industry is guilty of 'crony capitalism' based on privilege. We gamble with other people's money, offer them returns we don't know we can deliver, charge hefty fees, take the profits but pass the losses to the taxpayer. Rob echoed the views on cronyism. Consider the recent US bailouts of the most prestigious names on Wall Street. Politically-connected banks were protected, and within months, their executives were paying themselves massive bonuses, and it has continued since. As Chris Brightman, Chief Investment Officer at Research Affiliates, said in his summary:

"Much of our industry is a deadweight loss to society, and the public is justified in its disdain."

Asset consultants cannot pick outperforming managers

On the second day, we heard from Tim Jenkinson of the Said Business School at the University of Oxford. His subject was, *"Do Investment Consultants Pick Winners?"*. Institutional investors (not uneducated retail) managing hundreds of billions of client money hire asset consultants like Mercer, Towers Watson, Russell and Cambridge Associates to help with fund manager selection. Jenkinson and his team quote statistics which show 94% of 'plan sponsors' employ an asset consultant. These are supposed to be 'the smartest guys in the room'. They tell our biggest investors where to allocate their money. What is the main conclusion of the paper?

“In sum, however, the analysis finds no evidence that the recommendations of the investment consultants for these U.S. equity products enabled investors to outperform their benchmarks or generate alpha.” (Cuffelinks will write a comprehensive review of this study in a future edition).

Why do institutions bother with asset consultants when the managers they pick usually underperform? Well, it's a 'hand-holding service', it protects against 'headline risk', and plan sponsors probably don't even realise how inaccurate the recommendations are. Highly paid executives pay other highly paid executives to protect their backsides, without much idea whether value is being added. This process even has a name – deflection – which is the opportunity to fire someone else so that the institution or its executives are not fired. It's perhaps the most important service that asset consultants perform.

What about the theories and the academics?

If that's the real world of investing, what do theoretical models say about capital market prices? Brad Cornell, Professor of Financial Economics at California Institute of Technology (among many distinguished roles) told us that at best we can put a wide range around possible prices, and our models have basic flaws which render them of little practical use. Then Ivo Welch, Distinguished Professor of Finance and Economics at UCLA, said we should have little if any confidence in capital asset pricing models for predicting future returns. Yet these models play a major role in company valuations, M&A activity and defining flows of billions of dollars of capital. We use the models in business schools for capital budgeting and investment plans, but they have negligible predictive capacity. Chris Brightman again:

“Our clients and business partners pay us to be experts. They want to believe that we know more than we can. We are tempted to allow or even encourage this faith. Overconfidence is necessary for our business success ... Not only is there much we don't know, but also some of what we know isn't true”.

At the equivalent conference last year, [I interviewed Burton Malkiel](#), renowned author of *A Random Walk Down Wall Street*. I asked him whether he feels any sense of disappointment at the state of the investment management industry. He replied:

“I think the reason we have not made much progress is that it is probably one of the most overpaid professions there is. It's an inefficiency, with investment professionals paid regardless of the results. The real problem with us making enough progress in our industry is the misaligned incentives.”

Where does this leave us?

Notwithstanding our shortcomings, Rob Arnott said he likes to think that our industry does add value relative to what most investors would do without our 'help'. Investors would be undiversified and would typically chase every fad and bubble that comes along. Indeed, the reason that contrarian investing often does add value is that the aforementioned lemmings are common in the marketplace, and likely always will be. It is the job of advisers and educators to encourage a longer term perspective.

In the face of the CBA's apology for the behaviour of many of its advisers and the additional compensation payments it now faces, we might expect widespread industry remorse. However, what we actually have is a public argument about the merits of a Best Interests Duty, the definition of conflicted remuneration, the reason we don't need opt-in for fees, and defence of the vertical integration model.

Back at Laguna Beach in California, we drank fine wine, we appreciated the art in the galleries, we ate great food from the kitchens of the luxurious Montage Hotel, and we basked in the sunshine overlooking the Pacific Ocean. Then we jetted back to our well-paid and prestigious jobs all over the world.

William J. Bernstein, author of several classic books on investing, calls us 'talented chameleons' that populate the financial professions. He tells his readers,

“The investment industry wants to make you poor and stupid.”

That's why at least some of the public hates us.

Hey, what have you got against late 60s babies?

by Alex Denham

Published 24 October, 2014

I was born at the end of 1969. A proud Gen Xer who just last week danced in the lounge room with my old school buddies to every 80s song we could think of, belting out the lyrics without missing a beat.

I love that I'm a late 60s baby, even if only just. It was a time of The Beatles, revolutions, Woodstock, the moon landing, the call to give peace a chance, women's liberation, colour television, To Kill a Mockingbird. It was, in all, a very cool time to be born.

We are not the Baby Boomers, the rigid and hard-working, world-changing, now ageing generation that loves to spend their time judging and tsk-tsking the younger folk, mostly the Millennials and Gen Ys for their narcissism, laziness and sense of entitlement.

We are not the Millennials, who – like the Baby Boomers before them with whom they battle today – are intent on saving the world one online campaign (the Obama 'Facebook election') or viral meme (ALS ice bucket challenge) at a time. So what that they are too impatient to work up the ranks, they have other tools at their disposal, and they're not afraid to use them.

With half as many Gen Xers as there are both Baby Boomers and Millennials, our generation is characterised by being pragmatic and independent, adaptable to change, the latchkey children of divorced and working parents. Gen X doesn't get involved in the 'you think you've got it bad' battle, we are too busy over-parenting our children to make up for our deprived and lonely childhoods (cue violins) and creating little companies like Google, Twitter and Amazon.

Why do we get hit with every adverse change?

And so it is with discomfort that I raise this whinge-fest observation. As pragmatic as my stereotype demands I be, I'm getting a niggling feeling that someone out there has it in for us late 60s babies. We just seem to keep getting hit by changing government policy, and not in a good way. Too old for this, too young for that.

First there was free university education. From 1974 to 1988, those sneaky Boomers (and the very early Gen Xers) enjoyed free university education for the only period in Australian history. That's right, as the Baby Boomers entered their university years, for the first and only time in history it became free.

Then, just when I was leaving school, in comes HECs and the cost of university education has increased sharply since. Now I don't disagree with HECs, it has its merits, however it was so perfectly timed to affect me. And of course, many of us will have children at university when the federal government's contribution to degree costs will reduce, so if I want to pay for my 4 year old's degree, [I'd best get saving now](#).

Then there's the First Home Owner Grant (FHOG) scheme introduced on 1 July 2000 to offset the effect of the GST on home ownership. When you're scraping your pennies together to afford a deposit, mortgage insurance and stamp duty, \$7,000 helps (the equivalent of \$10,000 today). I was almost 31 at the time, and like many of my friends in their late 20s, had bought my first teeny tiny flat the year before at age 29. No FHOG for me, I bought too early. Millennials enjoy!

(Yes, yes I know house prices now make it impossible for Millennials to ever get in the market, I get that, but right now this is my rant.)

Cheap housing for us? Hardly. The Housing Price Index started its upswing in the late 80s (as the late 60s kids entered the workforce) and continues today. No cheap housing in sight for us – that was the Baby Boomers boom.

I waited and waited for paid maternity leave until, at the ripe old age of 40, I caved and had my first and only child in 2010 (ok, I admit that wasn't what I was waiting for). Less than a year later, on 1 January 2011, in came Australia's first national Paid Parental Leave scheme. Missed out by a whisker again, all yours Millennials!

And what's yet to come?

Now in our mid 40s (ugh), we slowly turn our minds to the possibility that retirement is somewhere on the distant horizon. Of course, I can't get to my superannuation benefits until age 60 where my Baby Boomer friends are accessing theirs at 55, and now my Age Pension age has gone up to 70, with the real value of future Age Pension payments set to reduce by the changing indexation.

It had to happen, but here are we late 60s kids once again taking one for the team. Good heavens, is this personal?! Am I just imagining this pattern of policy changes directly aimed at hitting us?

Ok, compulsory super came in reasonably early in our working lives, I'll acknowledge that, and it's been a good thing. There's no way I'd have had the discipline to put into it what I have now – home ownership, school fees and holidays are much more fun.

But Super Guarantee started in 1992 at a measly 3% of salary, and it wasn't at a 9% rate until 2002, by which time I'd already been working in some form or another for 15 years. It's the Millennials (and later the Alphas) who will reap the full benefit of the Superannuation Guarantee system.

Australia's superannuation system is currently remarkably generous and flexible. Payments from super are tax-free for anyone over 60, and there's no restriction as to how it is taken. No compulsory pension, once it's released you can do whatever you like with it. There's always pressure on the government of the day to attack this.

"Tax haven for the wealthy!", "Middle class welfare!", "Inequitable and unsustainable!"

You can bet – knowing my luck – that as those pesky, over-populated Baby Boomers swamp the age pension system by blowing their tax-free super benefits on holidays and their huge houses they refuse to sell, in will come compulsory lifetime pensions or annuities, capital gains tax on assets backing super pensions, caps on tax concessional superannuation benefits, the end of dividend imputation, the return of death duties and who knows what else.

You watch, it will happen. And these new measures will come into effect somewhere around 2030 just as – you guessed it – we late 60s kids retire.

Just saying.

Alex Denham was Head of Technical Services at Challenger Financial Services and she is now Senior Adviser at Dartnall Advisers.

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The image features a central white circle containing the Cuffelinks logo and website URL. The logo consists of two interlocking circles, one blue and one grey, followed by the word 'Cuffelinks' in a bold, blue, sans-serif font. Below the logo is the website address 'www.cuffelinks.com.au' in a smaller, blue, sans-serif font. The background is a collage of blue-toned images: a close-up of water ripples, a field of tall grasses, and a close-up of green leaves, all partially obscured by white geometric shapes (triangles and a circle).