Cuffelinks

Five Year Showcase
Chris Cuffe's Top 10

Fifth Anniversary Edition – December 2017

Welcome to the Fifth Anniversary Edition 232

Chris Cuffe's best of the first five years

Five years ago, Chris Cuffe and a few friends established a financial newsletter where market experts share their ideas with an online community. Cuffelinks is now a leading source of expert insights on investing, superannuation and many social and demographic issues.

Our website includes a searchable archive of 1,500 articles from 600 writers, the subscriber base is 22,000 with over 30,000 unique visitors a month who have made three million pageviews. Some of our articles have been read over 30,000 times, and subscribers have made over 5,000 comments.

In this Special Edition, Chris has chosen 10 of his favourites which have stood the test of time:

- Howard Marks on 'Risk and How To Handle It Today' *Howard Marks*
- Where did SMSFs come from, and where are they going? *Paul Keating*
- Why we can't resist tactical asset allocation *Chris Cuffe*
- Hey, what have you got against late 60s babies? *Alex Denham*
- Investing against the herd: resisting emotion *Ashley Owen*
- What real estate agents don't tell you *Graham Hand*
- The world by 2050 *Warwick McKibbin*
- We need to talk about risk *Chris Cuffe*
- A journey through the life of a fixed rate bond *Warren Bird*
- Is there an Uber or Amazon of wealth management? *Graham Hand*

These articles have not been 're-edited' and should be read in the context of the date they were written.

Thanks for coming on the journey with us over the last five years. Thanks also to our sponsors who enable Cuffelinks to be distributed free to subscribers and other readers.

Please share this free ebook with friends and colleagues and encourage them to subscribe to Cuffelinks (also free) for more great insights over coming years.

Graham Hand, Managing Editor

Leisa Bell, Assistant Editor

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Howard Marks on risk and how to handle it today

by Howard Marks, September 15, 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 (see full disclaimer at end).

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.

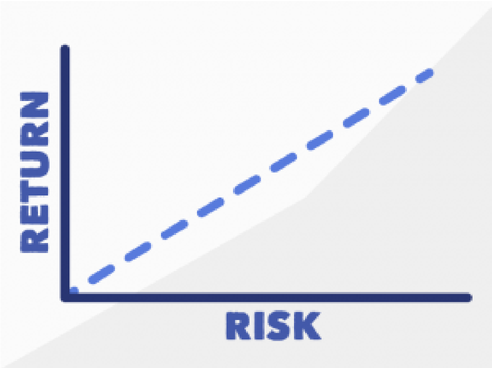
Largely a Matter of Price

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

The Product of Uncertainty Concerning the Future

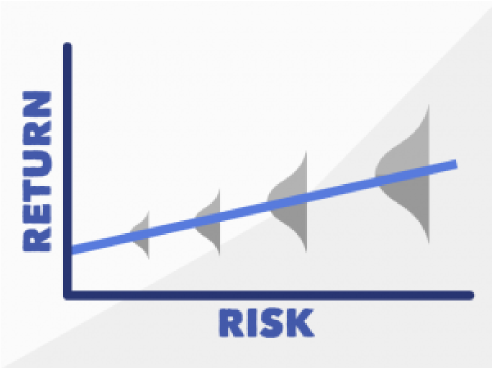
- **"Risk means more things can happen than will happen." – Elroy Dimson**
- It's challenging to come up with an estimate of an investment's expected rate of return.
- It can be much harder to comprehend and describe the entire distribution of possible outcomes around the expected return.

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.

Howard Marks is an investor, writer and co-founder of [Oaktree Capital Management](). He is known in the investment community for his "Oaktree memos" to clients which detail investment strategies and insight into the economy. This article contains information and views as of the date indicated and such information and views are subject to change without notice. Oaktree has no duty or obligation to update the information contained herein. Further, Oaktree makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss. Please see full disclaimer at end of this ebook.

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

by Paul Keating, February 14, 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 <u>not</u> 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.

Why we can’t resist tactical asset allocation

by Chris Cuffe, September 19, 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 'çheap' 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 is co-founder of Cuffelinks; Founder and Portfolio Manager of the charitable trust Third Link Growth Fund; Former Chairman of UniSuper and Chairman of Australian Philanthropic Services. The views expressed are his own. This article provides general information and does not constitute personal advice.

Hey, what have you got against late 60s babies?

By Alex Denham, October 24, 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 Millenniums and Gen Ys for their narcissism, laziness and sense of entitlement.

We are not the Millenniums, 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 Millenniums, 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. Millenniums enjoy!

(Yes, yes I know house prices now make it impossible for Millenniums 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 Millenniums!

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 Millenniums (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.

Investing against the herd: resisting emotion

by Ashley Owen, August 2, 2013

One of the most difficult aspects of investing is learning how to remove emotion from the decision-making process and just focus on the facts. Investors need to resist the temptation to get caught up in the hype of the daily news and noise, and to have the courage to go against the herd if that is what the facts dictate.

Investors who follow the herd invariably end up buying at or near the tops of booms when everybody else is buying and when the media and the so-called ‘experts’ are most euphoric. Then they often end up selling when everybody else is selling, when the media is most pessimistic at the bottom of the busts.

One of Warren Buffett’s simplest but hardest to follow gems of wisdom is to be greedy when others are fearful and to be fearful when others are greedy. This is much easier said than done!

Most investors seek reassurance

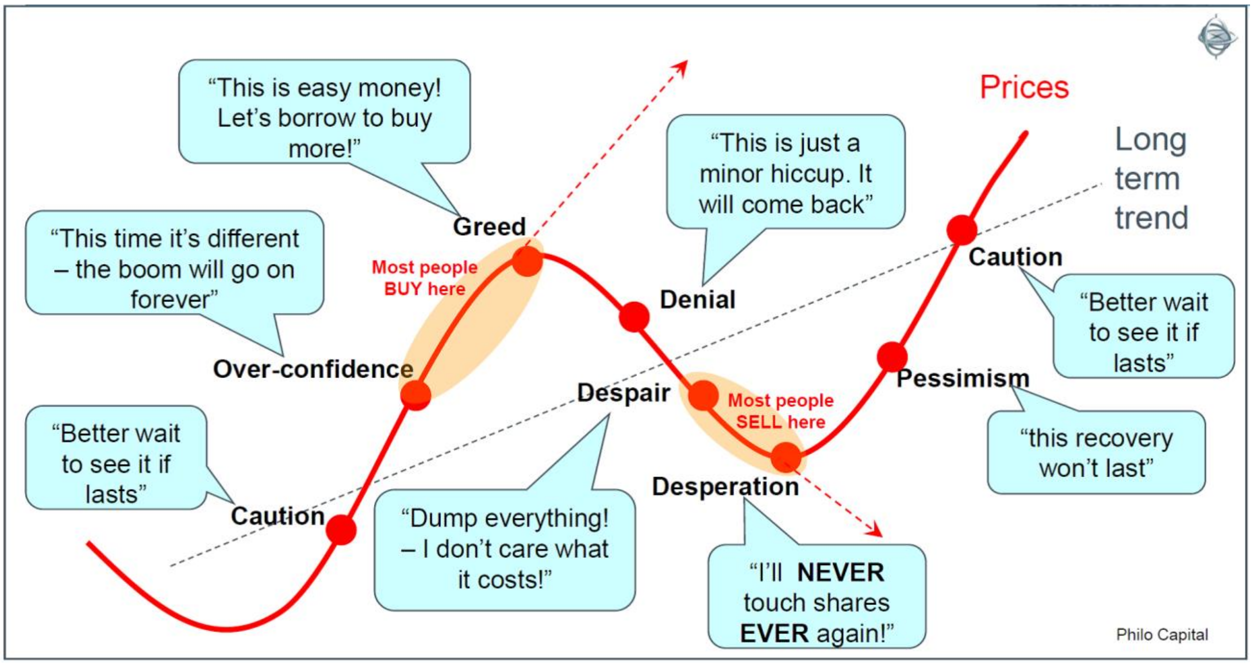
The first step is to learn to ignore the popular media, and especially the so-called financial media, and all the well-meaning advice or hot tips from friends, family and neighbours over the back fence. That is difficult enough, but it is even more difficult to go to the next to step and actually go against the herd and sell in booms and buy in busts. This goes completely against human nature. Humans are social animals who constantly seek reassurance from the herd, and are prone to follow the weight of popular opinion.

As a result, most investors (individuals and institutions) buy high and sell low – ie they are bullish and buy (or worse still, gear up and buy) at or near the tops of booms, and then they are bearish and sell (or worse still, are forced to sell by their margin lender) at or near the bottom of busts.

Two prime examples of this I saw first-hand were the crazy bursts of share buying and gearing up fuelled by the introduction of franking credits in 1987, and a similar crazy burst of share buying and gearing up in the months leading up to the closing of the $1 million super contributions window in June 2007. On both occasions, investors everywhere sold other assets (incurring tax on capital gains) and threw the money at the stock market in the media frenzy, only to see their money halve in value in the crashes that followed immediately after. If they used gearing they lost more than half and many thousands of people were wiped out completely. The extra flood of money and debt accelerated the market rises in 1987 and 2007, and so markets had further to fall when they collapsed.

I have used the following chart hundreds of times in presentations. It always gets a laugh, whether the audience is first time individual investors or experienced fund managers.

They laugh mostly because they know it is true but also because they know that humans are almost powerless to avoid the traps because it happens in every cycle.



Buying more as prices rise

Investors like to see prices (of shares or any other investment) rising. The longer prices keep rising, the more assurance they have that 'this time it's different' and that prices will keep on rising in the future. Often they sit cautiously on the sidelines waiting and watching the market rise for several years before they finally pluck up the courage to take the plunge – inevitably right at the top before the fall.

Conversely, when prices are falling it is very easy to succumb to the general market and media pessimism and start believing that prices will keep on falling in future. Investors who bought in the boom hang on grimly, watching the market keep falling, hoping it will miraculously bounce back. Then finally, after all hope is lost and when the media are most pessimistic, they sell out in despair – often right at the bottom just before the rebound.

Individuals follow this pattern because they're humans. Fund managers end up falling into the same trap because the majority of them are index-huggers. In the booms most of them know they shouldn't be buying shares when they are over-priced but they still grit their teeth and keep buying anyway, because they are terrified of falling too far behind the general market index. Likewise, in the busts they know they shouldn't be selling shares cheaply but they have no choice but to sell because they have to meet fund redemptions as investors withdraw their funds in the panic. The end result is the same as for individuals – they buy high and sell low.

The above chart is a fun caricature and we should test the theory that people really are most bullish at the top of booms right before the busts, and they really are most bearish at the bottom of busts right before the market rebounds.

In Part 2 next week, we look at consumer sentiment measures in Australia as an indication of investor optimism. You may be surprised just how closely investors in the real world follow this simple pattern of behaviour in every stock market cycle.

Ashley Owen is Chief Investment Officer at advisory firm [Stanford Brown] and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

What real estate agents don't tell you

by Graham Hand, July 9, 2015

Explore the rear entrance of an apartment hotel or resort that is more than five years old and take a look at the contents of the skips in the lane outside. They are often full of sofas, dining chairs, mattresses and televisions. Seven years earlier, when the proposal for a shiny new building was just a model in a display apartment for off-the-plan sales, hundreds of dreamers signed up to buy apartments. They also agreed to a furniture package for $40,000 to allow the building to operate as a hotel or resort. After years of people on holidays staying in the rooms, jumping on the sofas and leaning back on the chairs, the furniture needs replacing. Over the five years, that's another $8,000 a year of costs to write off for each owner. It's not such a dream now.

A few years later, the apartment will probably need a new bathroom and kitchen. How many years of income will that cost?

If you don't believe a sofa lasts only five years, you've probably never owned one of these short-let apartments. Hundreds of kids and honeymooners and party animals have enjoyed themselves on the furniture while on holiday. Have you ever watched coverage of schoolies week?

The most misleading number in investing

Real estate agents quoting gross yields on residential property are using the most misleading number in investing. The costs associated with residential property consume most of the income, leaving uninformed investors blind to the actual returns until the expenses start to come in. In an era where the professionalism of financial advisers is slammed daily in the media, many property agents get away with poor disclosure without comment.

Obviously, this is not a marginal asset class few people care about. Residential real estate in Australia is worth $5.8 trillion, and it dwarfs listed equities of $1.6 trillion and superannuation of $2 trillion. It accounts for over half of Australia's wealth (see CoreLogic Housing and Economic Market Update, April 2015).

Why are gross versus net yields so important for real estate?

Invest in a term deposit at 3% and you will earn 3%. There are no other costs involved. In equities, the effective yield earned can be better than the quoted dividend rate when imputation credits are added back. But residential property is the opposite. Net yields should be the main focus because expenses are high and unavoidable, even if the property is left empty.

A typical commentary on a real estate 'entertainment' programme goes like this:

"Is this a buy or a sell? It's a one-bedder only 10 kilometres from the centre of Sydney, close to buses, 65 square metres, asking $750,000, would rent for $650 a week."

"Well, the starting point is you don't want to be out of this market," replies the agent confidently. "This place will be worth $50,000 more in a year – that's $1,000 every week. And look, $650 a week is about $35,000 a year, that's a yield of 4.5%. Where can you get that today?"

Can you imagine what ASIC would do to a licensed adviser who spoke like that, or included it in an offer document? Prices do not always rise, and that yield is not available by buying that apartment.

CoreLogic quotes rental rates of 3.7% for 'combined capitals' across Australia, but this number is gross rental yields (for example, see page 7 of above-linked report). It's the number the industry loves to talk about. But even if we put aside stamp duty, legal costs, borrowing costs and vacancies, what about the regular costs of owning a property? These are the ongoing drains on income that are often overlooked. According to a Reserve Bank of Australia Research Paper, 'Is Housing Overvalued' (June 2014), the running costs of long term rental properties are 1.5% per annum, and transaction costs of 7.3% averaged over ten years are 0.7%, giving costs of 2.2% per annum.

That takes the net yield to 1.5% before allowing for repairs and maintenance. Reality is completely different than the real estate brochures and entertainment programmes convey.

How do management rights work?

When a large apartment building is constructed, the lots or units are purchased either by people who want to live in them (owner occupiers) or let them (investors). The 'management rights' to the building are sold by the developer, which gives the manager the right to charge a fee to look after the building and in some circumstances, run a letting scheme. The manager estimates how much income the building can generate when deciding how much to pay for the rights.

Of course, there are hundreds of thousands of different schemes in Australia, ranging from small premises run by mum and dad to professional managers (including listed companies) who may pay up to $15 million to manage a large, prestigious building by the beach with great views. The management rights might include running a restaurant, a reception centre, housekeeping, a real estate business as well as the letting and maintenance. Income includes payments from the body corporate, plus owners who enter a letting agreement pay a percentage of the letting charges, say 8% for long term letting and 12% for short term. The vast majority of apartment buyers in a hotel or resort sign up with the manager because there are efficiencies in one person managing the whole building. But what the buyer does not realise is that every change of a light bulb, every adjustment of the remote control, and every time the room is cleaned is a money-making opportunity to recover that $15 million.

Higher income, higher expenses

An apartment costing say $500,000 might rent permanently for $500 a week, but as part of a hotel, $250 night in high season. How can this not be a better deal? Consider these examples of well-established apartments in hotel or resort schemes targeted at short-term letting:

Table 1: Extracts from tax returns for typical short term letting apartments

Type	Estimated Value	Financial Year	Income	Expense	Net income
1 bedroom NSW	$500,000	2013/2014	$62,475	$46,881	$15,594
		2012/2013	$56,248	$40,083	$16,165
2 bedroom QLD	$500,000*	2009/2010	$20,944	$29,684	-$8,739
		2008/2009	$24,740	$31,388	-$6,648
		2007/2008	$26,631	$31,473	-$4,842
3 bedroom QLD	$350,000	2013/2014	$27,946	$28,018	-$72

*Bought in 2004 for $500,000, sold in 2011 for $505,000 (gross before costs).

The expenses from short term letting are far more than permanent, especially costs such as cleaning and replacing equipment. Owning an apartment for short term letting can be an annoying experience of monthly expenses to maintain the apartment to the standard required by the hotel or resort manager. Here is more detail from the tax returns of these apartments:

Table 2: Detailed income and expense returns

Income or Expense	**3 bedroom QLD**	**2 bedroom QLD**	**1 bedroom NSW**
Rents received	$27,946	$20,944	$62,475
Expenses			
Advertising for tenants	$922	$264	$3,124
Body corporate fees	$6,246	$7,309	$8,247
Cleaning	$3,693	$4,099	$15,568
Council rates	$1,458	$3,521	$936
Depreciation on plant	$1,422		$2,123
Insurance	$931		
Property agent fees	$3,689	$8,683	$8,205
Repairs and maintenance	$671	$4,793	
Special building write off	$1,772		
Water charges	$1,666		$694
Linen	$2,419		
Electricity	$1,121	$834	
Total expenses	**$28,018**	**$29,684**	**$46,881**
Net rent	**-$72**	**-$8,739**	**$15,594**

(Tax returns do not use the same categories in every case).

It’s hard to believe a small apartment can incur $47,000 in costs a year. People who put their apartments into these letting pools are probably prepared for some of the same costs as long term rentals, such as strata fees and council rates, but who expects regular costs such as these:

Table 3: Examples of specific expenses in short term letting

Typical Expenses	Amount
Cost of cleaning one-bedder after a one night stay	$73.32 per night
Assist guest to use air conditioner	$13.68
Fixed bath tap and repaired toilet roll holder	$27.35
Fixed oven	$13.68
Dry clean doona	$64.90 regularly
Dry clean blanket	$43.78 per month
Fixed loose dining table	$13.68
New knife	$20.00
Cable TV	$47.85 per month
PABX	$30.53 per month
Replace blown light bulb	$23.36
Fixed DVD player	$13.68
Pest control	$16.50 per quarter
Repaired bed wheel	$13.68
Fixed fridge and reset	$13.68
Dry clean shower curtain	$26.40 per month
Rehooked curtain	$13.68
Fixed leaking toilet	$27.35
Reset microwave oven	$13.68
Television hire	$37.00 per month
Refit towel rail	$54.00

It's a monthly crap shoot. The owner pays $360 a year for the phone system, and could buy the television for a year of hiring fees. The dry cleaning can be $100 a month. The cost of cleaning a one-bedroom apartment after one night is an unbelievable $73. How long does it take to clean a small apartment in a building with 200 such apartments? If you think the management fee should cover the quick visits to the apartment and complaints by guests, read the fine print. There is no way of knowing how often a light bulb is replaced or a bed cover dry cleaned. Who dry cleans a shower curtain every month? That $1 light bulb costs $23 to replace. This is a big money earner for the manager. A guest might stay for one night and after expenses such as booking agent fees, advertising levy, housekeeping and repairs, little is left for the owner. It's not worth the wear and tear on the apartment.

Who cares, capital gains and tax deductions are more important than income

Many investors may consider the income to be a minor part of the expected return, especially if they realise it's only likely to be 1.5%. Residential property prices in Sydney were up 14% in the year to March 2015, so a few dollars in expenses is tolerable (although it was less than 5% per annum for the decade before 2015).

There's a problem here as well with short term letting. Most owner occupiers do not want to live in a building where the majority of other tenants are holiday-makers. These visitors are out to have a good time. They party late at night, crash their suitcases into the lifts and walls, drag their wheels across the floorboards or carpets, return from the beach in their towels and drip on the furniture. The kitchen benches get scratched, the carpet must be cleaned regularly, and equipment is stolen. People who assume guests look after the room in the same way they look after their own home don't know how some people live. A permanent resident living in a building does not want to battle a lift full of suitcases every time they leave their apartment.

So, the secondary market sales of these apartments are usually not to owner occupiers, and the building gradually becomes dominated by short term lets. The major buying force that pushes up the price of real estate, the person buying their dream home, is not in the market. The premises are also subject to intense wear and tear, and the foyers are full of holiday brochures and bags and screaming children and people waiting to check in or out. So these apartments are worth less than in owner occupied buildings. Investors ask to see the net return after five years, the tired furniture and dirty carpet, and the income yield is not enough to create demand unless the price is relatively low. In many locations, these apartments in hotel schemes are the cheapest in town. It's no surprise the two-bedder listed above made a large capital loss after expenses (stamp duty, agent's fees, legal fees) despite seven years of ownership.

At least the loss is a tax deduction, able to be offset against other income. But buying an asset to create a loss and a tax deduction is a strange way to build wealth. Many investors talk about the 'tax deduction benefits' as if that is a good aim in itself. The only reason it's a tax deduction is because it's a loss.

OK, but at least I can holiday there

How about justifying the purchase by using the apartment once a year for a holiday? Forget it. The time of the year when the rent is the best is also when the owner wants to use it. Don't confuse an investment with a lifestyle decision such as a holiday. Anyone who wants a week in a resort should pay for a week in a resort, not a year of problems owning the place.

Graham Hand is Managing Editor of Cuffelinks and is now onto his third sofa in an investment property. This article is for general educational purposes about a specific market segment, and individuals should obtain their own professional advice.

The world by 2050

By Warwick McKibbin, March 12, 2015

Australia is an island, but what happens in the world economy matters a great deal to what happens in the Australian economy. We don't know what the world will look like in 2050, but that doesn't mean we shouldn't think about it and plan for different future scenarios. We do know a few things, and one of these is that demographics is destiny – almost. Demographics drives economic growth, both within Australia and globally, but it's not everything. Economic growth also comes from productivity growth and capital accumulation, including investments in private and infrastructure capital and human capital.

Demographic change

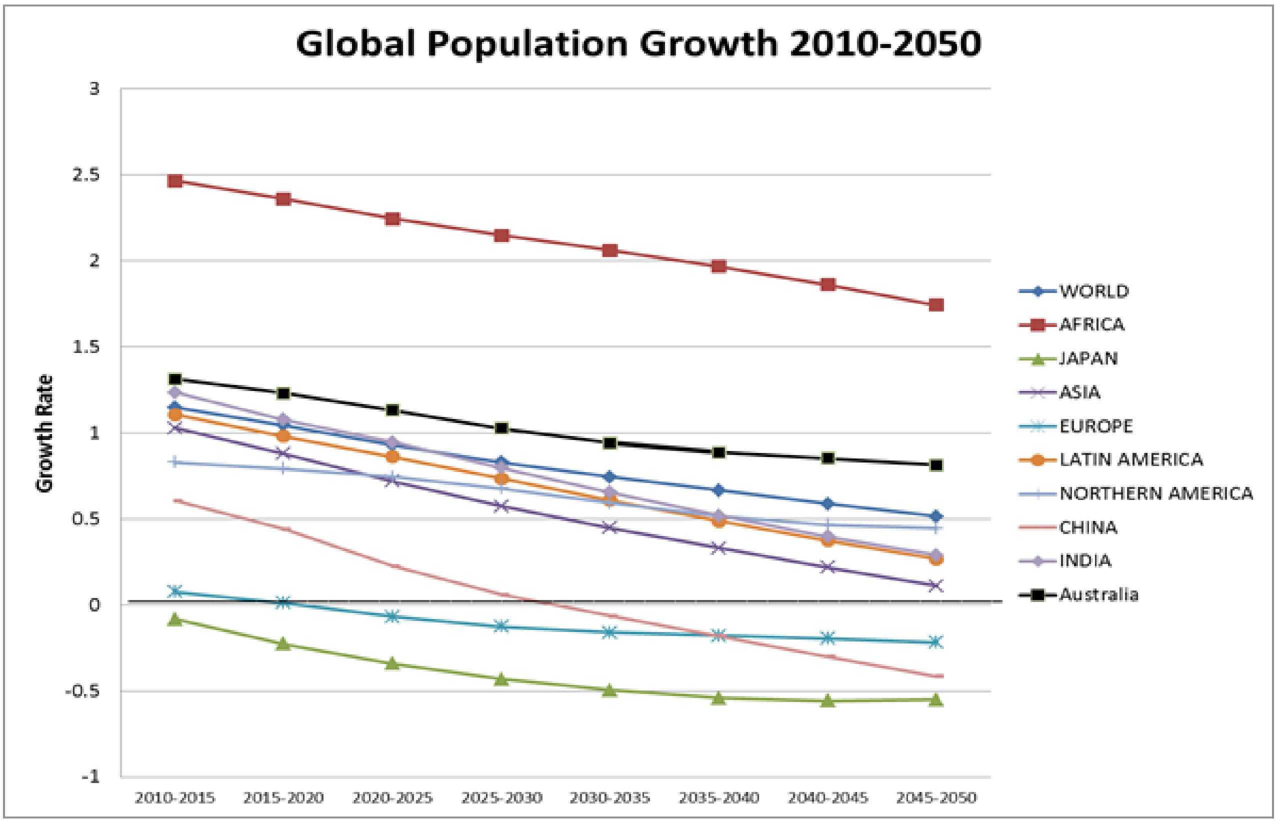
A key insight from thinking about future scenarios of the world to 2050 for the design of a retirement system is that the system needs to be flexible and be able to adapt as new events unfold. A system needs to be sustainable and withstand the volatility and uncertainty that the world faces. Understanding the demographics is a good place to start but productivity growth is just as important, especially in the retirement income space.

Figure 1 shows UN projections of population growth around the world. There is a wide range of assumptions underlying demographic projections, so these are not certain but a reasonable estimate for thinking about the future. At the lowest part of the graph is Japan, which is already shrinking. The line above that is Europe, which is also disappearing demographically. These two historically key drivers of the world economy are shrinking demographically. It is clear from Figure 1 that all lines are trending down, so while the world economy is expected to be growing, it will do so less quickly over future decades.

Changing demographics changes the rates of return on various assets. The stronger the world grows, the more likely the return on capital will be high, as well as returns on a wide range of asset classes. Now focus on China, third from the bottom. China shrinks very quickly and follows Europe and Japan into negative population growth within the next 10 to 15 years. This is mostly due to the one child policy in China. Relying on China for Australia's growth over the next 30 or 40 years will not be coming from the demographics, but it may be driven by productivity growth. Australia's demographic trend compares favourably with the other major countries.

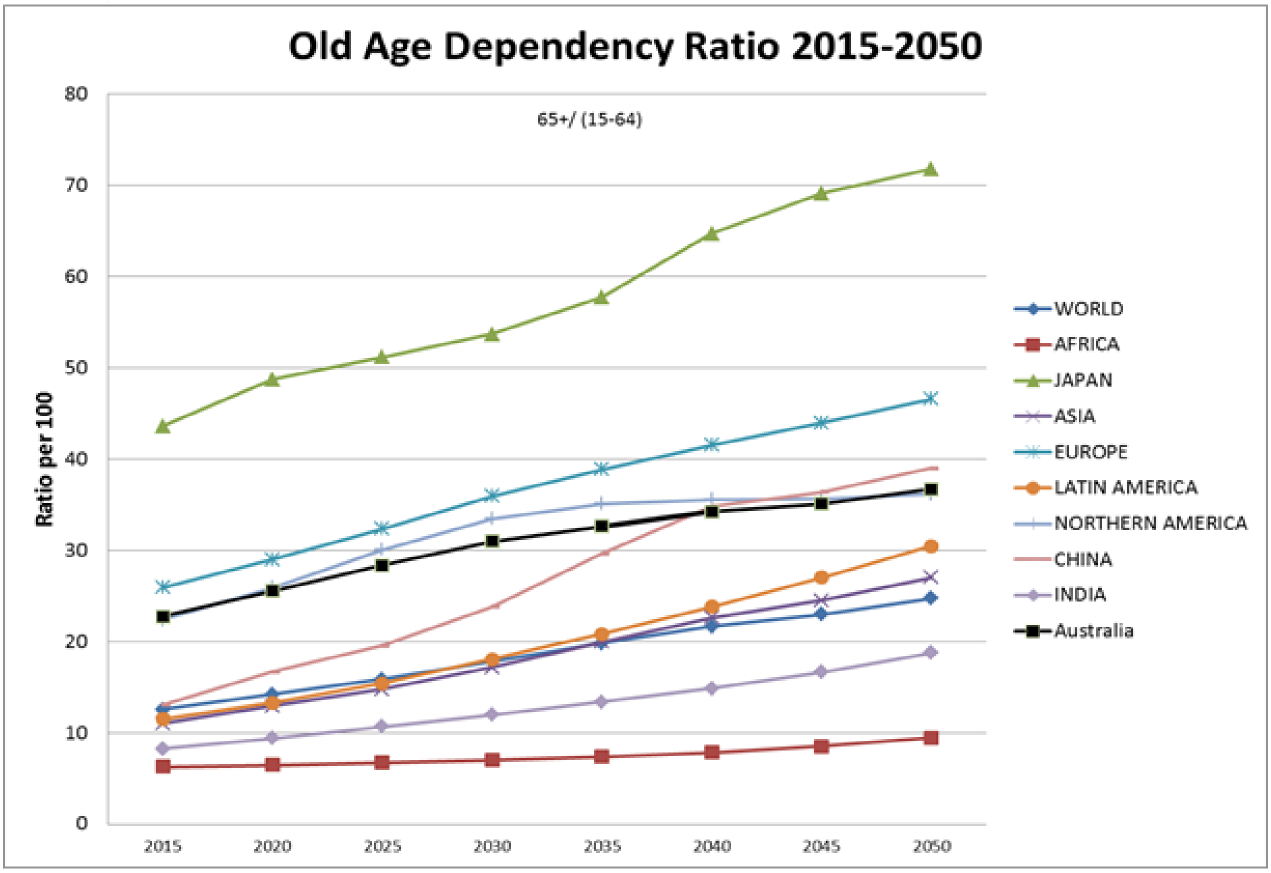
Another issue that matters from a superannuation and retirement point of view is what happens to the old age dependency ratio. This is the ratio of people aged 65 and above divided by the number of people between 15 and 64 (as a measure of working age population). These measures are not a good guide of actual dependency in the sense that people will have to work longer, as the people who will be in the 15-64 age cohort will not be

Figure 1: Global Population Growth



Source: UN Population Projection 2012 Revision, Medium Fertility

Figure 2: Old Age Dependency



Source: UN Population Projection 2012 Revision, Medium Fertility

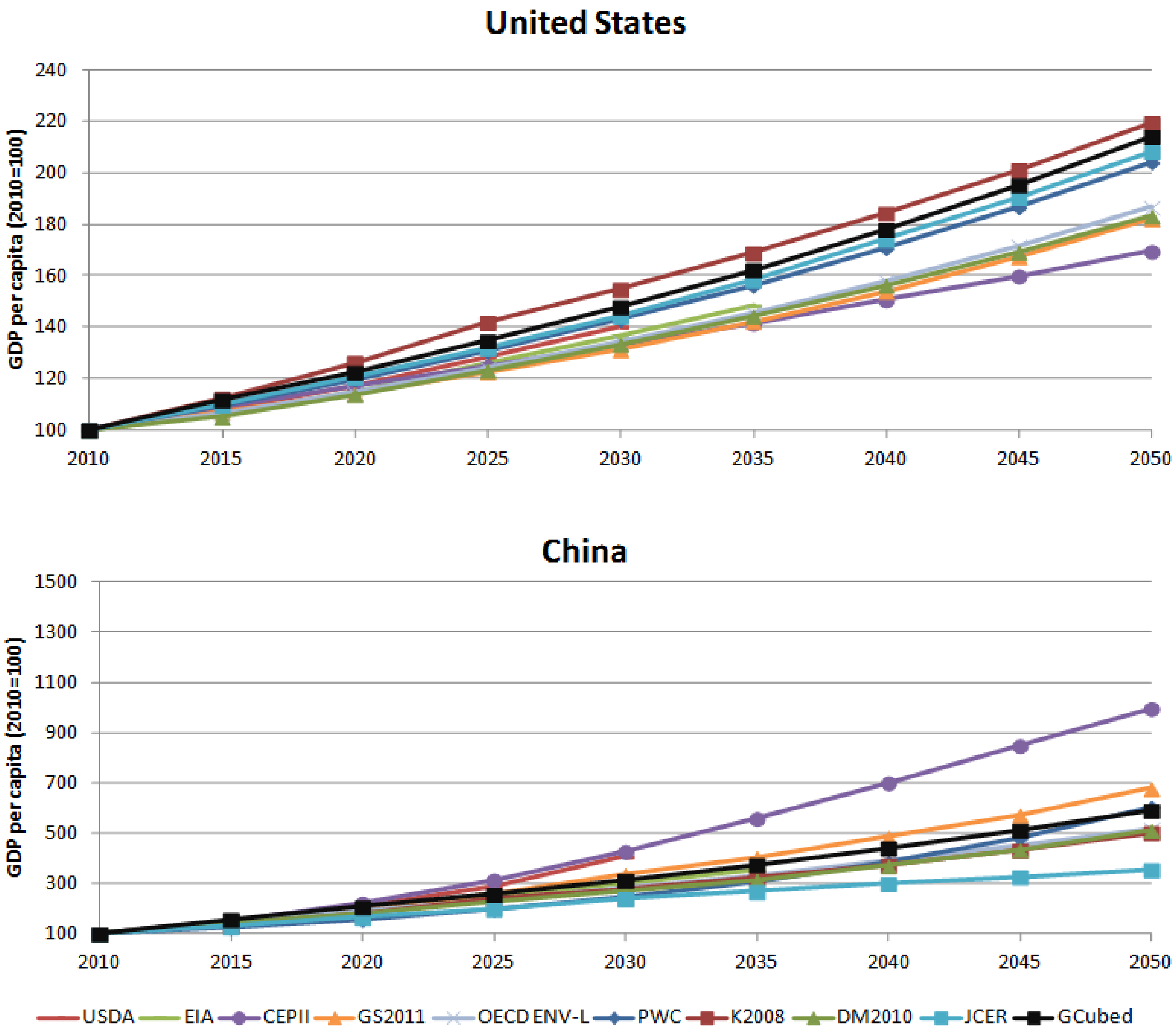
financially able to support this scale of dependency. Already in Japan, for every 100 people of working age there are 44 people over 65. By 2050, it will be 70 older people per 100 workers. This will be very difficult to finance across the world.

In Figure 2, Australia is the black line. Again, Australia's situation is better than many other countries, and this relative position makes a difference to how we might adjust.

China's economy bigger than the US

Many people have thought about the future to 2050 using large global economic models and assumptions about demographics and possible productivity growth rates. Key assumptions are how far countries are behind the technology frontier and how quickly they will close that gap. There are many different scenarios that generate very different outcomes by 2050. For example, Figure 3 shows you what the United States and China are projected to look like using many different global economic models (including my own G-Cubed model). In Figure 3 GDP per capita from each model is normalized to an index of 100 in 2010. These projections are in per capita terms, so they are the outcomes or productivity growth and capital accumulation netting out the demographic effects outlined above.

Figure 3: Survey Projections of Real GDP per Capita Growth for the US and China



Source: Stegman and McKibbin (2013) "Long Term Projections of the World Economy: A Review" CAMA working paper 14/2013

Figure 3 illustrates the great deal of uncertainty in projecting to 2050. Under a wide range of assumptions, these projections suggest that the US economy in per capita terms will be between 170% and 220% bigger than it is today. That's a big expansion in an economy that is on the technological frontier. The uncertainty is even larger for China, with the models suggesting that China will be between 300% and 950% larger than today in per capita terms by 2050. When multiplied by the population, it is clear that China is expected to be substantially larger than the US.

Focussing on the relative size of income per capita in the emerging markets in the same sets of studies, there's an enormous difference in outcomes. But for example, the French model (CEPII) has China at 80% of US GDP per head by 2050. That's an amazing catch up in productivity and capital accumulation when you consider China is currently 20% of US levels. Clearly even with an unfavourable demographic future in China, it is expected that the amount of productivity catch up and physical capital accumulation may be substantial and enable China to grow in per capita as well as in absolute terms.

World economy will be vastly different

Put all this together and the world economy is expected to be a vastly different place in scale and composition by 2050. Emerging markets will likely be a very large share of the global economy. This is good news, because the rates of return in emerging markets, if robust economic structures are put in place, will drive economic activity to these areas and generate wealth globally even under a scenario of stagnation in advanced economies.

These models give us important insights rather than reliable forecasts. One key issue is that given productivity gaps and the potential for catch-up, particularly in emerging economies, there is still potentially a lot of economic growth in the world economy, but it may not be in the traditional regions. In fact, in the scenario of the 'great stagnation' where there is a long period of low economic growth in advanced economies, this certainly need not be true for the emerging world. What will matter is the extent that emerging countries can catch up to the productivity frontier that already exists.

Productivity growth in Australia is a key issue for Australia's future prosperity and the sustainability of retirement systems. Australia has good demographics relative to many other countries which is an advantage. But also important is tapping into trade and investment opportunities in emerging economies, especially in the Asia-Pacific region. China is only part of the story of Australia's future as the rest of the emerging economies may well dominate the global economy by 2050.

Professor Warwick McKibbin is a former Reserve Bank Board member and is Director, Centre for Applied Macroeconomic Analysis, Crawford School of Public Policy, ANU. He is internationally renowned for his contributions to global economic modelling. Professor McKibbin has published more than 200 academic papers as well as being a regular commentator in the popular press. He was awarded the Centenary medal in 2003 "For Service to Australian Society through Economic Policy and Tertiary Education". His website is www.sensiblepolicy.com.

We need to talk about risk

by Chris Cuffe, June 27, 2013

After nearly 30 years in the investment management industry I can say without hesitation that the thing that irks me most is the use of the word 'risk' and what it actually is. In my view it is the most misused and 'glossed over' of all the plethora of investment jargon that exists.

The word 'risk' is a bit like the word 'love'. It has multiple meanings depending on who is using the word and in what context. You can *love* your dog; you can *love* your sister; you can *love* your child; you can *love* football; you can *love* your wife or husband. These uses of the word *love* all evoke different feelings and they each have a completely different connotation and context. And so it is with the word 'risk'.

One of the better definitions of risk I have seen comes from Elroy Dimson, Emeritus Professor of Finance at the London Business School:

"Risk means more things can happen than will happen."

In the superannuation investment industry people seem to talk about risk as though it means the same thing to all people. But it clearly does not. Risk is very different in the eyes of the client (the person with the superannuation account) versus the investment manager versus the regulator.

Let’s look at each.

The person with the superannuation account

My 24-year-old son has a superannuation account with a major industry fund. When I talk to him about risk and what matters concerning his account his answer is straight forward:

- when he contributed to the fund he wanted to know the money arrived safely (aka no one ran off with it)
- whenever he receives a statement he wants to be confident the information shown is correct (aka there is integrity in the underlying data systems)
- when he wants to access his money in future years he knows it will be there (aka the institution is credible and reliable and not a ‘fly by night’)
- the money is being competently invested
- the fees are fair (aka he is not being ripped off)
- if provided, the insurance will kick in if a relevant event occurs to him.

I’d also add on his behalf, since he’s unlikely to be focussing on this yet, will he have accumulated enough money at the end of his working life to live on?

In any case, there’s not much here on the standard industry definition of risk, the volatility of returns.

The investment manager

When managing a fund that many others are invested in (that is, a managed investment scheme) the investment manager is trying to invest in one way to suit the needs of many. However, he or she does not know the attributes, attitudes, timeframes and needs of the ‘many’ and so by necessity must manage the investments with one eye shut.

The investment manager thinks of risk in terms of the following:

- volatility of the value of an individual asset
- volatility of the valuation of an asset sector (usually based on history)
- concentration risk (having too few securities in a portfolio)
- differentiation from competitors
- differentiation from the benchmark being used to measure the performance of the fund.

And most investment managers measure the above things over quite short time periods, often less than a year, and indeed are usually remunerated based on ‘success’ over one-year periods.

The regulator

And then of course we have the regulator. Whilst I am sure the regulator thinks of risk very widely, it seems to me they want trustees to adhere to some of life’s basic rules:

- be honest and fair
- take your role seriously, both in the way you act and your knowledge and skill
- try your hardest
- if you make a mistake say sorry and rectify it
- don’t receive a personal benefit at the expense of your clients.

I have a short and simple book called *Life's Little Instruction Book,* by H. Jackson Brown, which records personal observations from a father to his son to help him in his life. I sometimes wish our law-makers would use it and save paper!

So where are we going wrong on risk?

With these multiple facets to the word 'risk', where does this leave us?

I believe there is a high misallocation of resources, energy and intellect across the superannuation industry (and investment industry more broadly) to address risk. The media use the word risk in quite a sensationalist manner, often without proper definition and logical timeframe for measurement. And I believe regulators have a thirst to micro manage risk and even attempt to eliminate risk, as though this unquestionably gives a better outcome, and without proper regard to the cost and benefit of what they are seeking to achieve.

And most talk about risk in investment circles in a one-dimensional manner, being the volatility of the value of an asset, when this is often meaningless without appropriate context.

Analysts report as though risk can be measured or adjusted with pin point accuracy, using phrases such as 'too much risk' and 'risk-on, risk-off plays', when this is simply not the case.

The wisdom of Howard Marks on risk

The best overall summary I have read on risk is contained in Chapter 5 of Howard Marks' *The Most Important Thing, Uncommon Sense for the Thoughtful Investor*. Although many investors in Australia may not know of Marks, he is well known in the US investment industry and in my opinion, he is up there in wisdom with Warren Buffet. Buffet himself said of this book, "This is that rarity, a useful book."

Marks makes the point that according to the academicians (his word, not mine!) who developed capital markets theory, risk equals volatility, because volatility indicates the unreliability of an investment. Marks takes great issue with this definition of risk, as he doesn't think volatility is the risk most investors care about. I agree. Like Marks, I think the possibility of permanent capital loss from owning an asset is at the heart of what investment risk is truly about, followed by the possibility of an unacceptably low return from holding a particular asset.

Marks believes much of risk is subjective, hidden and unquantifiable and is largely a matter of opinion. He makes the point that investment risk is largely invisible before the fact – except perhaps to people with unusual insight – and even after an investment has been exited. And in the following words he points out a profound paradox:

"Return alone – and especially return over short periods of time – says very little about the quality of investment decisions. Return has to be evaluated relative to the amount of risk taken to achieve it. And yet, risk cannot be measured. Certainly, it cannot be gauged on the basis of what 'everybody' says at a moment in time. Risk can be judged only by sophisticated, experienced, second-level thinkers."

Marks makes the obvious observation that in dealing with risk there are three steps: understanding it, recognising when it is high, and controlling it. I believe we have a long way to go in understanding risk, particularly which risks matter the most, which surely must be those that impact the end investor the most (like my 24-year-old son). And I believe we must all have a far better framework of thinking to decide which risks we should allocate time, cost and resources to minimise or eliminate, versus those risks we should simply accept.

What does a better risk framework need?

What do we need in this risk framework? Risk is primarily about losing money and not meeting a realistic financial goal that you set out to achieve. Volatility or standard deviation of returns is at best a side issue. It's convenient because statistical calculations allow a number to be put on risk, but it's not really what matters.

Short termism has created an obsession with volatility. It would be preferable to prohibit the publication on performance numbers with less than 12 months of data.

I believe the really important things for investors are as follows, and if these matter for the clients, then they should also be the focus for trustees and regulators:

- prevention of fraud, such as the use of an independent custodian
- credibility and reliability of the institution investing the money
- experience, competence and integrity of the people doing the investing
- understanding by clients of investment markets and alternative choices (ie education)
- diversification of investments and avoidance of asset concentration

The regulator should focus on making the system honest and fair, and ensure both its own staff and those in the industry have appropriate skills to meet their obligations.

We can employ the best market experts, compliance officers by the dozen, regulators from every government department imaginable, and have committee signoffs, board approvals and obey every regulation in the land. And then something like the GFC can hit a portfolio, or there can be an environmental disaster, or an act of terrorism, and the best risk management in the world will not prevent a loss of capital. Spread sheets and management reports create an over confidence that we can recognise and understand risks in advance.

As Howard Marks says, and I wholeheartedly agree, the possibility of a permanent capital loss from owning an asset is at the heart of what investment risk is truly about. And ultimately, I don't think there's much that can be done to wholly prevent these risks.

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A journey through the life of a fixed rate bond

by Warren Bird, March 5, 2015

"You never really know a man until you stand in his shoes and walk around in them." Atticus Finch, *To Kill a Mockingbird.*

Fixed income securities – or bonds – have the most predictable returns of any asset class, yet they are often maligned and misunderstood by market commentators who want to call them risky.

Rather than launching into a conceptual response to these scurrilous accusations, this article takes a leaf from Atticus Finch's book. It walks in the shoes of an actual fixed income security, one whose days on earth are just about over, but which has led a long and fulfilling life. It looks back on this bond since 2002, reflects on the fluctuations in its price and reviews how it performed for investors who owned it. Hopefully readers will feel that they then know the asset class much better.

The security in question is the Commonwealth Government Bond that will mature on 15 April 2015 at the ripe old age of 13 years.

Issued in May 2002, it promised to make two interest payments every year until April 2015, when it will return its face value to its owners. Its annual coupon rate was 6.25%, so the payments would be 3.125% of face value each in April and October. The rate of 6.25% was in line with market yields at the time, so investors who bought into the issue outlaid $100 for $100 face value (it was priced at par) and sat back to enjoy the steady income over the next 13 years.

The first year

The bond's price didn't stay at par for long. A fixed income security with over a decade until maturity is a frisky sort of animal and moves quickly if you prod it. Nowhere near as jumpy as shares, but still twitchy.

As it happened, over the remainder of 2002 bond yields fell, so our April 2015 security sharply appreciated in value. By its first anniversary in May 2003, it was priced to yield just under 5%, with a market value of nearly $111.90 (see Term deposit investors did not understand the risk for a refresher on the link between bond prices and market yields). Two interest payments had been made, totalling 6.25% of the initial outlay, which when added to the mark-to-market gain of 12% made for quite a handsome return of 18% over 12 months.

Some investors bailed out at that point, locking in their gain. Those who bought the bond from them would now expect to earn 5% per annum over the next 12 years, with the 6.25% coupon payments being offset by the amortisation of the bond from $111.90 to $100 over that period.

That first year pretty much set the trading range for the first half of our bond's life. In yield terms, the market traded the April 2015 bond between 5 and 6% for several years.

Towards middle age

As the years went by, our bond became less frisky. To use the jargon of fixed income, it had a shorter duration. The next time the yield on the April 2015 bond got down to 5% was August 2005, when it had just less than ten years until maturity. Its price this time rose only to $109.

It's as if during its life a bond looks more longingly at its destiny – par value at maturity – and starts to resist the pressure on its price that is exerted by fluctuations in market yields.

By the later months of 2007 and into 2008, investors wanted higher yields to compensate for higher inflation. The April 2015 was traded in the market at a yield above its coupon rate and its price fell below par. Around its sixth birthday in May 2008 the yield peaked at 6.5%, meaning that it hit the low price point in its life. The market at that time valued it at $98.30.

Popularity explodes

Things changed quickly in the second half of 2008. As the global financial crisis unfolded the demand for government bonds exploded. Our April 2015, along with his longer-term cousins, had never been more popular. As the world financial system risked collapse, and the global economy faced deflation risk, the yields investors were willing to accept from bonds plummeted.

During October 2008, we were once again back at 5%. This time, as our bond was older and thus getting shorter in duration, its price reached only $106.

However, it didn't stop there. As support for financial corporation debt fell in the opinion polls to all-time lows, the 'yes' vote for government bonds kept climbing. The April 2015 yield fell further – to 4.5%, then to 4.0% and eventually to a new low of just 3.5% by January 2009. Even though our bond now had only six years and a bit to maturity, it still had enough vigour to respond to this fall in yields with a price appreciation to $115. Heady days!

Popularity fades

However, after a while the smart money decided to move back into risk assets. Shares or corporate bonds – anything but government bonds yielding less than 4%. Just as quickly as our bond's popularity had risen, it dropped. By the middle of 2009 it was again yielding above 5% and its price had fallen below $105. It would trade there for a couple more years, until the financial crisis mark-II arrived.

Popularity returns

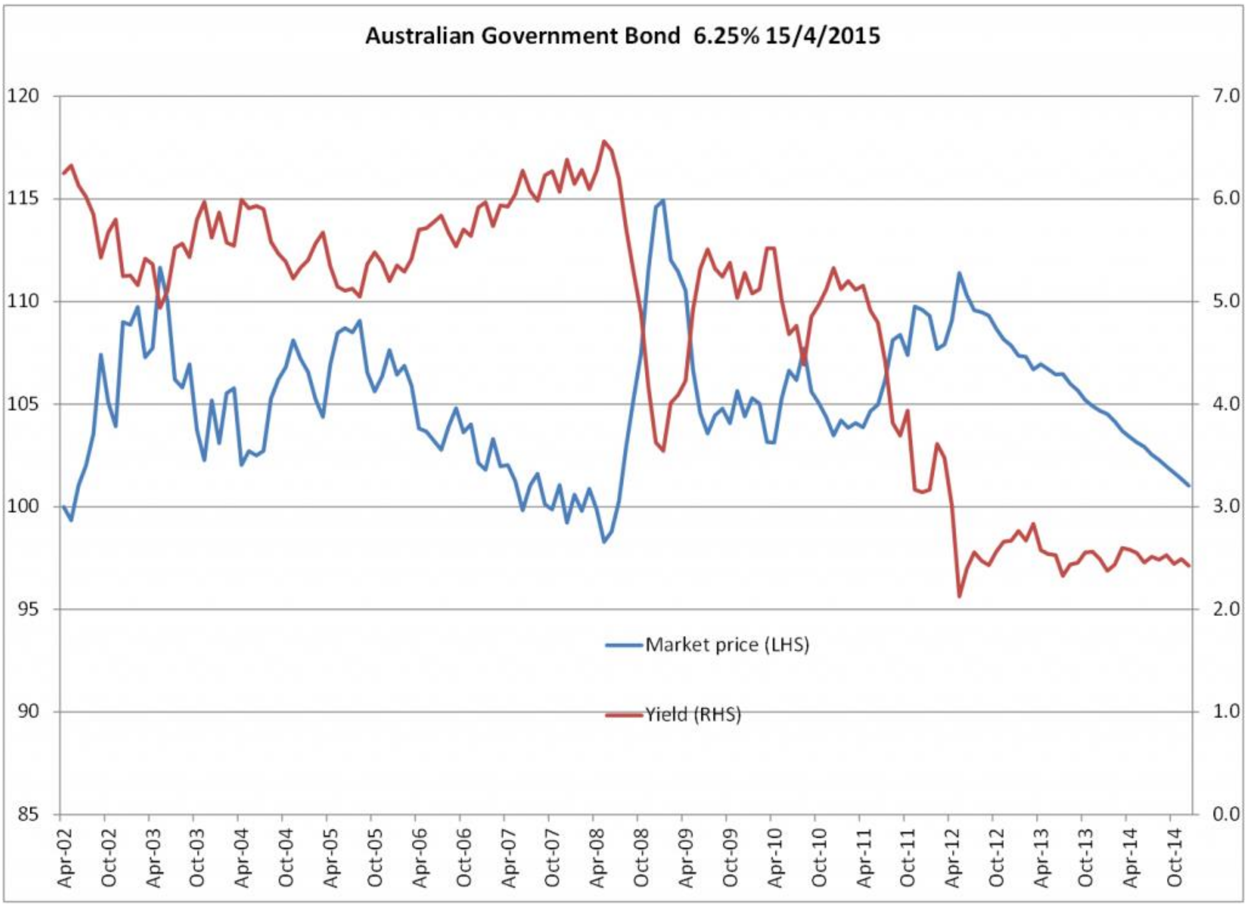
Our bond carried a AAA rating throughout its life which became highly valued by global investors from late 2011 when sovereign wealth funds and central banks were attracted like moths to a flame to the Australian government bond market.

Most of this demand was for securities longer than the April 2015, but our bond was carried in their slipstream back to lower yields. They reached 3.5% again around September 2011, though its vigour was beginning to fade and our bond could only rally to a price of about $109 this time. It managed to appreciate a bit further over the next few months, hitting $111 for its tenth birthday in May 2012. But it took an incredibly low yield of 2.1% to get it there.

Amortising to maturity

Since then, our bond has been enjoying a relatively lazy life. Its yield has traded around 2.5% for most of this time and its price action has been dominated by a steady trend towards par, where it will be valued when it retires in a couple of months. Its owners for these past three years have been receiving $3.125 each half year in coupon payments per $100 face value, but for that to yield them 2.5% pa there has also been a gradual decline in capital value of just under $2 each half year.

The following chart shows the price and yield history of the April 2015 bond in full.



A life well-lived

What have we learned from walking in the shoes of the April 2015 government bond?

First, that the life of a bond can sometimes be a wild ride. Its price fluctuated, sometimes rapidly, reflecting changes in market yields. Therefore, its short-term return also fluctuated. Rarely, if ever, was the annual return equal to the original yield of 6.25%.

Second, every time the yield got back to 6.25% it was valued at par, but as it happens this bond spent most of its life trading at a yield below that level and thus at a price above par.

Third, the fluctuations became smaller as maturity approached and the inexorable pull of par value became stronger. A yield that early in its life resulted in the price being well away from par produced smaller and smaller premia over time.

Fourth, the bond never missed a beat in paying the regular interest promised when it was first issued. Over the whole of its life, the April 2015 bond delivered. And from any point in its life, its new owners continued to receive the promised coupons plus a predictable rate of capital price amortisation. They could, therefore, easily predict the long term return they would make on their investment.

As its name implied, it provided its owners a regular fixed income. It's been a bond's life well-lived.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing, including 16 years as Head of Fixed Interest at Colonial First State. He also serves as an Independent Member of the GESB Investment Committee. This article is general education and does not consider any investor's personal circumstances.

Is there an Uber or Amazon of wealth management?

By Graham Hand, March 5, 2015

"Even well-meaning gatekeepers slow innovation. When a platform is self-service, even the improbable ideas can get tried, because there's no expert gatekeeper ready to say 'that will never work!' And guess what – many of those improbable ideas do work, and society is the beneficiary of that diversity. I see the elimination of gatekeepers everywhere."

Jeff Bezos, quoted in *The Everything Store: Jeff Bezos and the Age of Amazon*, page 315.

"Spend the vast majority of your time thinking about product and platform. Many large, successful companies started with the following:

1. *They solved a problem in a novel way.*
2. *They used that solution to grow and spread quickly.*
3. *That success was based largely on their product.*

In the Internet Century, all companies have the opportunity to apply technology to solve big problems in new ways … if you focus on your competition, you will never deliver anything truly innovative."

Eric Schmidt, CEO of Google from 2001 to 2011, quoted in *How Google Works*, pages 91-93.

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I recently read *'The Everything Store'* about Amazon, *'How Google Works*', and Walter Isaacson's biography of Steve Jobs and Apple. The creation of these three extraordinary companies in a short time from the vision of a few individuals left a nagging question in my mind at almost every page: can any company do to the Australian wealth management industry what Amazon did to Borders, what Apple did to Nokia, what Google did to all other search businesses? They are all remarkable stories of redefining how business is done, breaking the traditional rules and in the process, destroying much of their competition.

Markets where anything seems possible

It's the same with Uber, the ride-sharing service with operations in 53 countries and a market value of about US$40 billion. There are 5,500 taxi licences in Sydney worth about $400,000 each or $2.2 billion. In Melbourne, metro licences have fallen in value from $515,000 a few years ago to $290,000 on a combination of new licences and Uber drivers given access to the market. Uber has fought legal battles all over the world, as it is in NSW, but there's no denying the public demand.

It's a good example of a change in the way the global economy operates. It's a platform business that matches customers with drivers, turning employees into 'entrepreneurs', in a similar way to the thousands of businesses run from home using eBay as a distribution platform. And there are 'ubers' for all types of services such as cleaning and massage, and of course human resources with sites like Freelancer and Elance.

Amazon is portrayed in the book as a brutal competitor. When diapers.com (owned by a company called Quidsi) was gaining market share among mothers but refusing a takeover offer, Amazon reduced the price of diapers by 30%, and then launched a new service called Amazon Mom, with additional discounts. Quidsi executives estimated that Amazon lost $100 million in three months on diapers. Then Wal-Mart made a bid for Quidsi, and Amazon threatened to drive prices to zero if Wal-Mart won the bidding. The diapers.com founders sold to Amazon out of fear.

"The money-losing Amazon Mom program was obviously introduced to dead-end Diapers.com and force a sale, and if anyone had any doubts about that, those doubts were quickly dispelled with by Amazon's subsequent actions. A month after it announced the acquisition of Quidsi, Amazon closed the program to new members." The Everything Store, page 299.

Of course, the Federal Trade Commission investigated the deal but gave its approval. If Amazon and Uber can take such actions in the face of legal hostility, anything seems possible in the age of the internet.

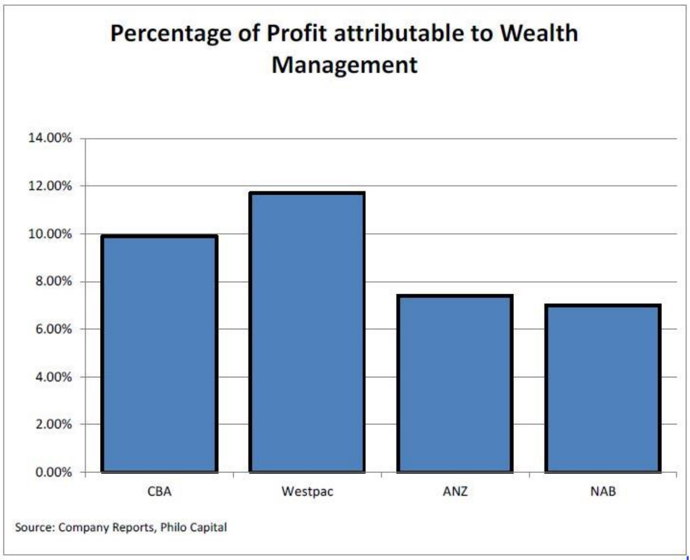
Australia has its home-grown examples of severe market disruption, the most public being the turmoil created for newspapers from the success of realestate.com.au, seek.com.au and carsales.com.au, almost bringing the once mighty Fairfax to its knees.

Unlike Facebook and Twitter which have invented new 'social media' activities, companies like Uber and Amazon are killing off competitors. When Jeff Bezos convinced publishers to allow him to put their books on the Kindle, they thought he would charge a margin over the usual wholesale price of books of around $16. But by retailing books online for $9.99, Amazon reinvented the price point. It did not take long for booksellers like Borders and Angus & Robertson to go out of business. Despite the fact that Amazon made a loss in 2014, the market has spoken: its market cap is about USD170 billion.

The defining characteristic of these great American companies moving into retailing, mobile communications, social media, search, taxis, employing contractors and booking B&Bs is that they break the mould for the way business is done. New methods are often not appreciated by the incumbents until it is too late, and it is fanciful to predict what future disruptions will occur. When Mark Zuckerberg developed Facebook, he did not have a notion that it would become the way a billion people shared their most intimate secrets, and he certainly had no idea how to make money from it.

What is major disruption in Australian wealth management?

By disruption, I don't mean somebody developing an online 'robo-advice' model (such as GuidedChoice, eMoney, Betterment and Wealthfront in the US or Stockspot and BigFuture in Australia) and collecting $1 billion in funds in a few years, although that would be considered a great success and will happen. With $2 trillion in superannuation, real disruption is at least $100 billion within a few years, which is only 5% of the market. Such numbers would worry the four major Australian banks, which are not only almost 30% of the market capitalisation of the ASX200, but wealth management is significant to them all. They also control the majority of financial advisers in Australia.



Where can disruption happen in the value chain?

Wealth management is usually broken into at least three parts:

* financial advice
* administration platforms
* asset management

Let’s consider what happens if an investor uses a platform such as Colonial First State’s (CFS) FirstChoice Wholesale, the most popular among financial advisers. It requires a minimum of only $5,000 so it is a retail product. On a typical and popular fund such as the Schroder Australian Equity Fund, CFS charges a fee of 1.02%, and splits it with Schroder. Call it 0.5% for CFS administration and 0.5% for Schroder asset management. CFS also has an Australian share index option for only 0.40%, where the asset management costs only a couple of basis points (0.02%). So we can generalise that major platform administration costs about 0.4%-0.5% with asset management on top of that. Financial advice costs are additional: it may be fee for service, say $350 an hour, or a percentage of funds, say 0.5%.

In simple terms, there’s the Australian wealth management value chain. If a market disruptor comes in, they can easily remove the asset management cost by using index funds; they can automate advice based on an internet-based, self-service model; and investments can sit on a simple and inexpensive administration platform. Would it be the equivalent of Amazon charging $9.99 for a book that previously retailed for $30, and destroying other booksellers?

I’m not looking here for the disruption of SMSFs holding $600 billion or one-third of all super. They are serviced by thousands of advisers, accountants and administrators as well as being users of the products of major banks, fund managers and the ASX. My focus here is on a single company coming in with a game-changing, disruptive product offering.

What will the disruptor do or look like?

1. It will not attack one part of the value chain, it will be end-to-end with a complete investment solution. For example, it will not be sufficient to only offer ‘great asset management’, as plenty of companies claim that. A disruptor could hardly ‘out-Vanguard’ Vanguard (or State Street or BetaShares) and provide cheaper and better asset management through ETFs. Broad-based domestic or global equity portfolios can already have negligible costs, less than 0.1%. These ETF providers are successful, well-capitalised companies with overseas parents or partners who already have the capacity to take large shares of the Australian market. Although their growth has been impressive, they only have $15 billion, less than 10% of the money managed by CFS.

2. It will be price-led. I cannot see how anyone can convince enough people that a superior product is worth paying up for because that will depend on a promise (guarantee) of outperformance over time. Amazon can set up systems to deliver a book next day and Telstra can have the best phone coverage in Australia but nobody can promise to outperform the market consistently, whatever their resources. This ‘game-changer’ will be index-based or with some type of ‘beta’ engine, not a bunch of superb stock pickers making company visits all day. They are too expensive.

Similarly, the portfolio will not include alternatives or unlisted investments, as they have higher fees and are more expensive to manage, even if done internally. The portfolio is likely to be dominated by cash and term deposits where the ‘fees’ can be hidden in the product margin.

(Of course, Apple’s success is far from price-led, its phones are the most expensive on the market. They have achieved this through beauty of design and creating massive desirability and arguably the best product. But in my wildest dreams I cannot see people queuing up around the corner to invest in a managed fund based on its beauty and desirability).

3. It will need to be well-capitalised and carry a great deal of market trust. This is not like buying a book with a secure credit card charging system. People will be handing over their future, their life savings, and the company must be beyond reproach. Whatever they do, they will need to buy time and spend a lot of money on marketing and disrupting and delivering results, plus ongoing R&D specifically for the Australian market.

4. It will be technology-based and self-service. Investors will input their own characteristics into an engine and it will recommend a portfolio of investments, selected according to the risk appetite and demographics of the client. This 'robo-advice' (a large part of 'fintech') is already being embraced by major players in the US, such as Charles Schwab and Fidelity's acquisition of eMoney.

5. It must break established distribution networks. An estimated 70% of financial advisers are already 'tied' to the four major banks, AMP and IOOF. At the moment, eight out of every ten people default to the super fund selected by their employer and $10 billion a year automatically flows into default super funds. Whereas everyone selects their own phone, most people do not engage with their superannuation.

A new winner would need to capture the hearts and minds of investors in the way no financial product has done before. The only alternative to making the product 'sexy' is 'fear', but how would that gain traction? As David Blanchett, Morningstar Head of Retirement Research, said:

"We all know most people aren't on track for retirement. I think surveys that talk about poor savings in the US, or the fact that people haven't saved enough for retirement, are relatively worthless. Kind of like saying, 'The sky is blue'". (Yahoo! Finance, 8 February 2015)

Severe disruption is unlikely

The growth of superannuation assets in Australia is assured by the Superannuation Guarantee regime, making it a highly desirable industry to be in. It must attract new competitors. There's no denying wealth management will change significantly over the next ten years, just like every industry driven by technology. There will be surprises, developments nobody has yet thought of, perhaps from a couple of young computer geeks in the proverbial garage. Some will do well and drag in a few billion. But that's not disruption like the executives of Kodak, Blockbuster, Nokia and Borders experienced.

Based on the short and glorious histories of Amazon, Google and Apple and their impact on established businesses, how can anyone conclude that wealth management will not face a similar massive overhaul from a new competitor? Yet that's my conclusion: I don't see how any company can make wealth management sufficiently exciting for enough people to grow a market share of 5 to 10% in the next few years. To use Google's test, what problem will the disruptor solve in such a novel way that hundreds of billions will divert from incumbents? I hope I'm wrong because it would be fun to watch.

Graham Hand has worked in banking and wealth management for 35 years and is Managing Editor of Cuffelinks.

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