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Harry Markowitz on investing until 100

Graham Hand

This discussion with Harry Markowitz took place at the Research Affiliates Advisory Panel Conference, Laguna Beach, California, 30 May 2014.

Markowitz's pioneering work on portfolio management was first conceived in 1950 and appeared as Portfolio Selection *in 1952. It proposed investors should act according to the expected return and risk along an efficient frontier, and became known as* Modern Portfolio Theory*. Markowitz won the Nobel Prize for Economic Sciences in 1990. He now divides his time between teaching and consulting, and he is co-founder of GuidedChoice, a managed account provider and investment adviser.*

The traffic between San Diego and Laguna Beach has been heavy all day, and Harry Markowitz is running a few minutes late for his meeting with me. I am about to meet one of the legends of the wealth management industry, and he starts by apologising for his long journey. He's nearly 87 years-of-age and no longer nimble on his feet, and yet it's soon apparent that the mind is as sharp as the young economist who studied with Milton Friedman. Every second sentence is still a wise crack. He's in the middle of writing four volumes on '*Risk-Return Analysis: the Theory and Practice of Rational Investing*', and is contracted to deliver the final volume in 2019, "So I have to live until at least then", he says.

Markowitz identifies the development of databases and ability to model expected outcomes as the major recent improvements in his portfolio construction work. Given a set of investments with forward-looking returns and defined risks, portfolio theory will show an efficient frontier for the investor. This principle has guided asset allocation and diversification for the 64 years since his original ideas. Says Markowitz, "I lit a small match to the kindling, then came the forest fire."

Markowitz tells me he has a wall in his office dominated by a cork board, and on it, a large graph shows returns over time from various asset classes. It shows $1 placed in small cap stocks in 1900 growing to $12,000, while the bond line has reached $150. I asked whether this shows that for anyone with a long-term investment horizon, their portfolio should be heavily dominated by equities, maybe even 100%. He said he is asked this asset allocation question all the time. His advice is different to a waitress in a coffee

shop versus a well-informed investor with good professional advice. He tells the waitress to go 50/50, a mix of growth from a broad stock fund and security from bank deposits, because she cannot tolerate the volatility of a 100% equity portfolio. But an educated investor with good advice should take their current portfolio mix, find the most efficient frontier, then simulate possible future outcomes focusing on income expectations. The investor can then better judge whether the portfolio is the right mix to achieve the end goals.

Markowitz believes active stock selection is for a few highly skilled people who usually find returns not from stock-picking on the market, but by participation in private placements. He cites Warren Buffett and David Swensen (of Yale University) as consistently delivering excess returns but mainly because of the private deals they are offered and their ability to value them. Otherwise, outperformance is not worth chasing.

His own portfolio is currently equally weighted municipal bonds and equities, the latter with an emphasis on small caps and emerging markets, but with a stable core of blue chips. This is because he feels so many stocks are overvalued at the moment, and his portfolio is also influenced by his age. "I want enough bonds that if I die, and the equity market goes to zero, my wife will have enough capital and income to live well." His current objective is to reach 100 without appearing on the right-hand column of *The Wall Street Journal*, with the heading "Harry Markowitz f*cked up".

He is a great believer in rebalancing, and this is one reason why a cash reserve is always required. As equity markets rise, shares should be sold to retain the same proportional asset allocation mix. This provides a natural protection from overvalued stocks. He recalled working with a major Fortune 500 client in November 2008, after the rapid stock market fall, allocating more to equities in a rebalancing exercise. This has subsequently paid off handsomely. But it was scary at the time, and as the market continued to fall, he thought if he keeps allocating more to equities at this rate, the whole place will be owned by him and Buffett. He likes the expression 'volatility capture' for this process, which is why there is a role for bonds as part of the reallocation mix.

I was still curious why a person with good savings at age of say 40, and strong income flows, would not invest 100% in equities, given their long term outperformance versus cash or banks. He said, "They may think their income is assured, but then may hit a rough patch and need to sell equities at the worst moment." He highlighted that many people have jobs which are also heavily exposed to the strength of the economy, and that they should also "diversify their own job and other income sources". He suggests investors should not become too smart, using leverage and unusual investments, and not try to become rich overnight.

He is also keen on using simulation to determine possible future outcomes. In his financial advice business, GuidedChoice, and especially in their new work on GuidedSpending, they ask clients to define an upper band of future income requirements, which might be say $50,000. Clients then define a 'scrape through' amount, such as $30,000. Simulations are done based on variables such as living longer and market returns "to capture the essence of the spending problem". Clients can vary scenarios to see the outcomes. The most common consequence of the process is that people save more, often dramatically and commonly 50% or more. While the technology behind the scenes is complex in this modelling, it is presented in ways the client can easily understand. But he dislikes mechanical rules such as taking 4% from the portfolio each year. "Why should someone who is 90 only take 4% if they want to spend more?" he says.

I ask him how a fund with investors aged from 16 to 90 should allocate its assets. "It's like a family," he responds. "There is a trade off in a family structure between paying for the education of the children, versus the future retirement of the parents. All families make these 'social choices', and so must the fund. Their decisions may not be ideal for the 16 year old or the 90 year old but everyone makes these choices in life".

And one of Markowitz's choices is to keep working as hard as ever. "I enjoy this, and what else would I do all day?" He now dedicates every Friday to writing to ensure he meets his deadlines, spends every Thursday afternoon at GuidedChoice where he consults to their institutional clients, and he maintains a heavy teaching and advising schedule. If his health allows it, he'll still be doing it when he's 100, and that right hand column of *The Wall Street Journal* will be singing his praises.

Ten things for SMSF trustees to check before EOFY

Monica Rule

As 30 June approaches there are many things SMSF trustees must consider to maintain a complying superannuation fund as well as take advantage of tax benefits. Here's my Top Ten.

1. Valuation

The assets in your SMSF must be valued each financial year. Your administrator needs to report the market value of the assets in the SMSF's financial statements for income tax purposes and your auditor needs to verify that the SMSF has not contravened any provisions of the income tax and superannuation laws. The valuation must be based on objective and supportive data - refer to ATO publication: *Valuation guidelines for SMSFs*.

2. Contributions

Make sure current year contributions are received by your SMSF on or before 30 June. Remember that electronic funds transfers may not be credited into your SMSF's bank account until the following business day.

If making a non-concessional contribution (NCC), check NCCs made during the last two financial years to see if the bring forward provision has been triggered. It will affect the amount you can contribute in the current financial year.

The contribution caps (CCs) for the current financial year (i.e. **1 July 2013 to 30 June 2014**) are:

Contribution type	Age of the member	Contribution cap
Concessional contribution	Aged under 59 on 30 June 2013	$25,000
Concessional contribution	Aged 59 or over on 30 June 2013	$35,000
Non-concessional contribution	Everyone	$150,000
Non-concessional contribution	Under 65 at any time in the 1st year	***$450,000 for 3 years**

*Only people who are aged under 65 at any time in the first year of contribution can bring forward two years of NCCs and make three years worth of NCCs (i.e. a total of $450,000) in one year or over three years.

3. Employer contributions

Employers are required to make Superannuation Guarantee (SG) contributions by the 28th day of the month following the end of the quarter in which an employee's salary was earned. An employee's SG contribution for the June 2013 quarter (i.e. last financial year) may have been received by your SMSF around 28 July 2013 (i.e. current financial year). If so you will need to include the SG contribution in your CC cap for the 2013-2014 financial year.

4. Salary sacrifice contributions

If you have a salary sacrifice arrangement (SSA) with your employer to sacrifice your pre-tax wages into superannuation, these are treated as CCs. Check your records before contributing more CCs to avoid exceeding your CC cap.

5. Tax deduction on your personal superannuation contributions

A tax deduction is restricted to self-employed people and people who either do not receive any superannuation support (e.g. retirees) or receive very limited superannuation support from their employer. They must also be aged under 75. If you are eligible to claim a tax deduction then you will need to lodge a 'Notice of intention to claim a tax deduction' with your SMSF trustee before you lodge your personal income tax return. Your SMSF trustee must also provide you with an acknowledgement of

your intention to claim the deduction. The amount claimed as a deduction will change the character of your original NCC into a CC.

6. Spouse contributions

If you are intending to make NCCs for your spouse, you will need to make sure the contributions are received by your SMSF on or before 30 June in order for you to claim a tax offset on your contributions. The maximum tax offset that you can claim is 18% of NCCs of up to $3,000 (i.e. $3,000 x 18% = $540 maximum claimable). To claim the maximum tax offset your spouse's income must be $10,800 or less in a financial year. The tax offset progressively decreases for income over $10,800 and cuts out when income reaches $13,800 or more. Your spouse must be under 70 years of age. If your spouse is aged 65 to 69, they must be gainfully employed for at least 40 hours over 30 consecutive days. You will also both need to be Australian residents for tax purposes and not be living separately and apart on a permanent basis at the time the contribution is made.

7. Contribution splitting

CCs made into your SMSF can be split between you and your spouse. The requirement is that your spouse must not have reached their preservation age or if they have reached their preservation age, they need to be aged under 65 and not retired from the workforce. The maximum amount that can be split for a financial year is 85% of the CCs made into your SMSF in that financial year up to your CC cap. You cannot split NCCs.

If you are intending to split contributions, you must do so in the financial year immediately after the one in which your contributions were made. This means you can split CCs you have made into your SMSF during the 2012-2013 financial year in the 2013-2014 financial year. You can only split contributions you have made in the current financial year (i.e. 2013-2014) if your entire benefit is being withdrawn from your SMSF before 30 June 2014 as a rollover, transfer, lump sum benefit or a combination of these. If you split your CC with your spouse, the full amount of the original CC counts towards your CC cap. In addition, you cannot claim the superannuation spouse contribution tax offset for a contribution split to your spouse's superannuation account.

8. Superannuation co-contribution

Under certain circumstances, the Commonwealth Government will match your NCCs with a co-contribution of up to $500 per year. To be eligible you must earn at least 10% of your income from business and/or employment, be a permanent resident of Australia, and be under 71 years of age at the end of the financial year. The government contributes 50 cents for each $1 of your NCC to a maximum of $1,000 made to your SMSF by 30 June 2014. To receive the maximum co-contribution of $500, your total income must be less than $33,516. The co-contribution progressively reduces for income over $33,516 and cuts out altogether once your income is $48,516 or more.

9. Low income superannuation contribution

If your income is less than $37,000 and either you or your employer have made CCs into your SMSF, you could be entitled to a refund of the 15% contribution tax (up to $500) paid by your SMSF on these contributions. To be eligible, at least 10% of your income must be from business and/or employment and you must not hold a temporary residence visa. To receive the refund, you need to make sure that the CCs are received by your SMSF by 30 June 2014.

10. Minimum pension payments

If you are accessing an account-based pension from your SMSF, make sure that the minimum amount required to be paid under the superannuation law is paid from your SMSF by 30 June 2014 in order for your SMSF to receive tax exemptions. The minimum amount is determined by your age and the percentage value of your pension account balance at either the commencement date of the pension or 1 July each year. See the table below for your percentage value.

Age	Percentage factor
Under 65	4%
65 to 74	5%
75 to 79	6%
80 to 84	7%
85 to 89	9%
90 to 94	11%
95 or more	14%

There is no maximum pension payment amount required unless you are accessing your pension under the 'Transition To Retirement' (TTR). The maximum amount that you can receive from your SMSF under TTR is 10% of your pension account balance. If you exceed the maximum limit under TTR, then your SMSF will not be entitled to tax exemptions.

Monica Rule is the author of the book The Self Managed Super Handbook. Monica is running an SMSF Seminar on 3 July 2014. See www.monicarule.com.au

Brazil on the eve of the World Cup

Vivienne Taberer

I have spent the past 23 years involved in emerging markets, particularly on the fixed income side. I have always loved travelling and experiencing new things, especially if there is a bit of adventure involved. Being responsible for Latin America means I have the perfect region and the perfect job. My trip to Brazil on the eve of the Football World Cup took in much of the country. The thing that struck me most was the excessive gloominess of the locals. I am more optimistic. Debate around the issues that face Brazil is vigorous and the government realises what the challenges are.

Focus will turn to Brazil

As a sovereign, fixed income investor, it is definitely a very interesting time to travel in Brazil. We are in the run up to the 2014 Football World Cup and the world will turn its focus in June not just to the competition, but also to all the broader issues that are part and parcel of Brazil in 2014: a presidential election later this year, an uncomfortable economic backdrop that sees inflation higher and growth lower than is ideal, and the compounding effect of some of the driest weather on record.

There was a gloominess permeating my meetings with many locals working in the private sector. The extent of this was evidenced in the market's reaction to the recent Standard & Poors' ratings downgrade. Rather than sell off, the markets actually rallied, as they responded to the 'relatively good news' that the outlook going forward was stable. In fact, in our meeting with S&P, it appears they are comfortable with Brazil at a low investment grade going forward, even with growth in the 2-2.5% range, and inflation sitting up towards the top of the inflation band at around 6% over the next few years. It's not a particularly bright outlook and one that seems to be the base case, with risks to the downside factored in by the locals, who are generally downbeat on Brazilian asset prices, from bonds to currency to equity.

Need to spend on infrastructure

While President Dilma Rouseff remains the favourite to win the presidential election later this year, the players on the ground like the idea of a closer election and a political outcome that would push the agenda towards one that they perceive as more market friendly. Across the entire political spectrum though there is plainly a focus on what needs to be done to raise investment in the country, and increase potential growth levels. The message is clear: spending on infrastructure needs to be a priority. The population is pressing hard for better roads, better hospitals and better education.

The continuing protests into the World Cup emphasises this point. While no doubt football fever will overtake the Brazilian people when the competition actually begins, roads and airports are creaking under the strain of systems that desperately need upgrading.

Our discussions with the Ministry of Finance and the state-owned Brazilian Development Bank (BNDES) highlighted both the progress that has been made to date and how much has yet to be achieved. Although limited in terms of the actual projects completed, the improvement in the infrastructure concession auctions implies that a marked acceleration in spending is expected from here. While there is a clear push for more private sector involvement in a lot of these projects, it is painfully obvious that certain projects will have to remain the domain of the government, even though the current model of financing through the state-owned banks is not optimal.

Government officials are keen to point out where progress has been made, in contrast to the market where the emphasis is on the shortcomings of the current administration. The need for reform is acknowledged from all quarters, but the reality of the Brazilian system is that significant reform is difficult to achieve. The current approach of piecemeal measures that can be done by decree, rather than face the difficulties of pushing something more substantial through Congress, will remain in place at least until the election. Opinion is divided about the strength of the post-election reform agenda. The question, as one economic consultant put it, is 'which President Dilma will we get: the one who embraced Castro, or the one that went to Davos?' The appointment of the next Minister of Finance is going to be key in answering this question.

Not surprisingly, with economic forecasts for this year consistently seeing revisions down to growth and inflation expectations edging up, there is huge concern regarding the ongoing drought and the historically low levels of reservoirs in a country where power generation is largely hydroelectric. Private sector analysts have been highlighting the increasing risks of power rationing and drawing parallels to the situation in 2001/2002. The government, on the other hand, is quick to say that the issue is not one of capacity, but rather one of price, where more reliance must be placed on accessing the thermal electricity.

The reality is somewhere in between. Although seen as politically unpalatable in the run-up to the election, if it does not rain heavily soon the prospect of power rationing will become increasingly probable. In fact, some districts are already on water rationing. Widespread rationing would have a knock-on negative impact on an economy already struggling with insipid growth. The increased cost of placing higher reliance on more expensive thermal generation has further negative implications for both headline inflation and the fiscal position. While our meetings with the government made it clear that they will try and limit the impact on all fronts, they do not have much room for manoeuvre.

More optimistic than the locals

My key take away from my time spent in Brazil is probably a bit more optimistic than these paragraphs might suggest. Debate around the issues that face Brazil is vigorous. The government realises what the challenges are. The social fabric is one that is likely to drive change. The Brazilian population has seen its middle class explode in the last two decades and is increasingly demanding its government to deliver. To date progress has been slow, but there has been progress and President Dilma Rouseff, or whoever else may next be at the helm, will need to focus on these challenges and help Brazil achieve at least some of its huge potential.

How does this view translate into investment opportunities over the shorter term? The Brazilian authorities have helped to strengthen the exchange rate in a bid to contain inflation, and raised interest rates sharply. In our view this means that despite the high carry rates, the currency looks expensive. On the local bonds, however, the exceptionally high real rates, against a backdrop of a relatively steep curve where the market is pricing in even higher short-term rates, looks like good value. For this reason we remain constructive on the outlook for hedged returns over the remainder of the year.

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Don't set and forget

Roger Montgomery

As value investors, we buy high quality companies with good long term prospects. A company that is able to produce a product that is in high demand, whilst maintaining its competitive advantage, may be able to enjoy above average returns for a considerable period.

Yet the lure of excess profits can be too much for competitors to resist. A strong competitive advantage supports earnings growth, but there may come a time when a company's defences are breached, and the share price comes tumbling down. This reversion can be quite dramatic, so while we advocate investing for the long-term, it doesn't mean you should discount short-term developments.

To illustrate this concept, there have been three market darlings that have experienced material share price declines in recent months. These companies are Coca-Cola Amatil (ASX: CCL), Super Retail Group (ASX: SUL) and Cochlear (ASX: COH). Investors that maintained an active interest in their investments would have been better placed to identify the negative structural shifts experienced by each company than those that kept their holdings in the 'bottom drawer'.

You would all be familiar with Coca-Cola Amatil, one of the largest bottlers of beverages in the Asia-Pacific region. The company controls iconic brands, which has translated to strong financial performance. Between 2006 and 2011, the company's earnings per share grew by 12% each year.

Yet since 2012, Coca-Cola's volumes in the Australian soft drink market have declined from 50% to 42%. The oligopoly that makes up Australia's grocery retail landscape has put Coca-Cola Amatil on a strict diet of shrinking volumes, values and loss of market share, particularly to 'private label' soft drinks.

As such, it has become unclear if Woolworths, Coles and Aldi are significant distributors of Coca-Cola Amatil's products, significant competitors, or both? To find the answer, the company has launched a strategic review, which typically marks the beginning of a prolonged, and costly, turnaround programme. The CCL share price has declined from over $15 to around $9.50 in the past 14 months, such is the uncertainty of the company's long-term prospects.

Super Retail Group is another company that has generated consistent earnings growth with quality brands such as SuperCheap Auto, BCF, Rebel and Amart Sports. Between 2006 and 2013, the company increased its average annual earnings per share by 20%.

Super Retail Group has experienced a number of hurdles this financial year; the leisure category has been impacted by customers in regional and mining areas spending less on fishing and recreational equipment; the implementation of a company-wide IT system has not gone to expectations; and existing store sales have been cannibalised by an overlapping store network.

One of Super Retail Group's core competitive advantages has been its ability to integrate large acquisitions into its network – Rebel Sports being a case in point. But the more time management is focused on remedying the above issues, the less time is spent looking at large scale acquisition opportunities to assist growth.

While management has a clear strategy to remedy these issues, they cannot confidently state if these benefits will be realised in 2016, 2017 or 2018. The market has certainly reacted unfavourably, with the share price falling by around 35% in the past six months.

The final example is Cochlear, the company that brought hearing to the deaf with the cochlear implant. This incredible leap in technology allowed the company to enjoy many years of favourable growth. From 2004 to 2011, the company grew earnings per share by an average 24.7% per annum.

But problems began to emerge in 2011 when the company was forced to announce a product recall. Recalls can be very costly events, in terms of the financial burden to replace the damaged goods, and the potential reputational damage. Cochlear was able to maintain its strong brand power after this event, and by the end of 2012 the share price was above the pre-recall price.

Yet since the beginning of 2013, the company's share price has again declined materially. It is becoming increasingly apparent that Cochlear is ceding market share to its competitors. Even for a company like Cochlear that is dedicated to a strong innovation, research and development program, it seems that competitors have been able to replicate their technology and are stealing market share with lower prices.

The aforementioned companies have built their quality reputations by withstanding and overcoming adversity. But during these periods of material uncertainty, even the companies with the longest records of success may not emerge with their competitive position intact. While investors should always invest with the long-term in mind, at times it can be quite painful to simply 'set and forget'.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'

Raising the pension age is no reason to panic

Alex Denham

The raising of the pension age to 70 has caused quite a stir, indeed outrage, amongst working Australians. Is it really as bad as everyone is saying or are some important points being missed in this debate?

Just to be clear, I am not defending the Government or the Budget, nor making a political statement, nor providing an opinion on policy. I am merely discussing how to work within a proposed framework.

Pension age set to go to 67

The age pension age is already legislated to increase to 67 over the next 10 years for those born after 1 January 1957, so if you are currently 57 or under, your pension age is 67 – that's a fact.

Under the new proposal , those aged between 49 and 56 will see their pension age lifted to somewhere between 67.5 and 69.5 years of age, and it is anyone currently 48 or under who will cop the full three year increase in their pension age to 70.

Let me focus on this group. The oldest of this age range, the 48-year-olds, have 22 years until they turn 70. That's 22 years to plan for this extra three years they will have to wait for their age pension.

A 48-year-old who has been working since, say, age 18 joined the workforce in 1984. Two years later in 1986, new industrial awards were established by the National Wage Case resulting in superannuation coverage for public sector employees of around 79%, and 68% for private sector employees by 1991. Then, in July 1992, in came the Superannuation Guarantee (SG) forcing employers to make super contributions on behalf of their employees, or pay a penalty.

Granted, it took 10 years for the contribution rate to move from an inadequate 3% to a better 9%, but suffice to say that most 'employees' currently in their 40s have been beneficiaries of the SG system for a large chunk of their working lives. Employees currently in their 30s have almost certainly been in receipt of some superannuation support *all their working lives.* And the 20-somethings – they've been getting the full 9% since the day they started work.

Point being, many 48-year-olds in the workforce today will, at the age of 67, have superannuation savings that has been accumulating for over 40 years. They are not like the 70-year-olds of today who haven't had many years to benefit from the compulsory super system.

It’s your money, take charge

For those who do fall under the SG system, this Budget was a wakeup call; it’s time to stop ignoring your super and get interested in it. You have 22 or more years to turbo-charge your superannuation so that it can fund that extra three years before the age pension kicks in.

What do you need to do? Here’s a start:

1. Research or get advice to find the super fund that is best for you, taking into account investment options, fees and charges, insurance options and costs. You have the right to choose which fund your superannuation goes into.

2. Find any lost accounts, there are websites that assist with this. Once they have been found, claim it back and roll it into your fund of choice.

3. Amalgamate all your small accounts into one fund of choice.

4. Seek advice on appropriate asset allocation for your age and goals. Are you happy to outsource all investment decisions to fund managers, or do you prefer more control or to know exactly where your money is invested thus focussing on direct share investment? It is your money and you do have the choice.

5. Educate yourself.

6. Explore the possibility of salary sacrifice strategies with your adviser or accountant.

Superannuation, for many Australians under the age of 50, is likely to be their biggest pool of wealth other than their home by the time they retire and yet it still receives little attention.

Of course, there are many who are not covered by the SG system – self-employed people (sole traders, some contactors, partners in partnerships), those unable to work due to disability, illness or family commitments and the unemployed to name a few.

The superannuation system includes incentives for the self-employed to contribute by way of tax concessions. Some do, some don’t. Some put all profits and excess cash back into the business, effectively building an asset that becomes their retirement fund. For those self-employed who do not do anything to plan for their retirement, this Budget might be a reason to start thinking about it.

However, for those who are just unable to work or contribute to super for whatever reason, it is true this feels like a tough Budget. They will either be forced to work an additional three years - which at the age of 67 I imagine would feel like an eternity – or go on unemployment benefits. The system *must* look after these people.

But for the many employed people who ignore the additional 9-10% salary they receive in the form of superannuation contributions, and allow it to be either not paid at all, or lost, or all the decisions on it made by complete strangers, this Budget is a clear message to start taking an active interest in it.

Access age for superannuation

There have been a lot of reports and rumours swirling in the media that the Abbott Government is planning to raise the access age of superannuation. Joe Hockey has stated that there won’t be changes to superannuation in ‘this term’ of Government, but they are not promising no changes ever.

I think it is likely that taking lump sums from super will eventually be either disallowed or discouraged through tax penalties, or the age for access uplifted to 70. However, I would be very surprised if there wasn’t some sort of access in the form of an income stream for those in their 60s. This is merely my prediction, and if there were proposals to raise income stream access to age 70, I’d be writing to my local member in protest.

It’s important to remember that the age pension system is not there as a reward for a lifetime’s hard work, it is a safety net for those who - for whatever reason – are in need of it. We have a world class superannuation system; use it, don’t squander it.

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