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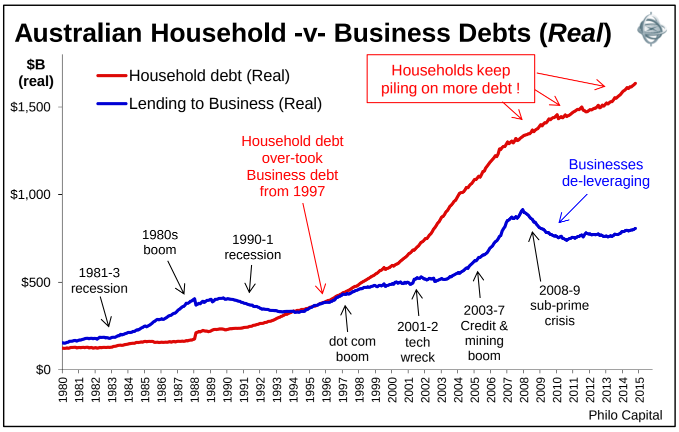
This Week's Top Articles

The pace and structure of lending stifles Australia

Ashley Owen

Lending patterns can often provide valuable insights into likely future trends. Two key indicators are the pace and type of lending. The first chart shows lending to businesses (blue) and to households (red) in Australia since 1980, in real terms after CPI inflation.



Pace of lending

Rapid growth in business lending almost always indicates profligate wasteful acquisitions at the tops of booms. These booms tend to be followed by economic contractions and 'de-leveraging' when companies collapse and banks write off bad debts.

Business lending has been in recession for the past seven years since the sub-prime crisis. Despite Australia's population growing by 10% over the period, lending to business has *contracted* by 10% in real terms after inflation. Long periods of lending recession mean businesses have not been investing for future growth. Likely consequences of this include lower jobs growth, lower productivity growth, lower living standards and lower earnings per share growth in future if the trend continues.

Business lending has only recently shown early signs of life but there are usually long time delays between lending, business investment and resultant growth in productivity and earnings.

Structure of lending

In 1997 lending to households overtook lending to business for the first time in Australia's history, aided and abetted by bank deregulation, bank capital rules that artificially favoured housing lending (because house prices never fall, do they?!) and by the rapid growth of mortgage securitisation. The level of household debt has expanded rapidly ever since and is now more than twice the level of business lending.

Why is this important? Lending to business is usually productive as most (apart from wasteful acquisitions at the height of booms) is spent on new staff, plant & equipment, technology and R&D. On the other hand lending to households is mostly unproductive. Mortgage lending mostly just pushes up the prices of existing housing, and personal lending is mainly spent on consumption, mostly supporting foreign jobs, not local.

Since the financial crisis, households have piled up debt fuelled by unsustainable record low interest rates. Weak growth in jobs and productivity are incompatible with high household debt levels and high house prices propped up by unsustainably low interest rates. Something has to give - either a housing bust or a long decline in living standards.

Broadly-based housing busts are usually caused by high interest rates and high unemployment levels but these are unlikely in the near future, so a sudden housing crash is not likely. Interest rates are very low and unlikely to rise soon and foreign demand for housing remains strong. There will however be severe declines in concentrated apartment markets that are being over-built, notably in Melbourne and Brisbane.

Long term trends

The chart below shows the levels of business lending and household lending in Australia since 1850 relative to gross national income.

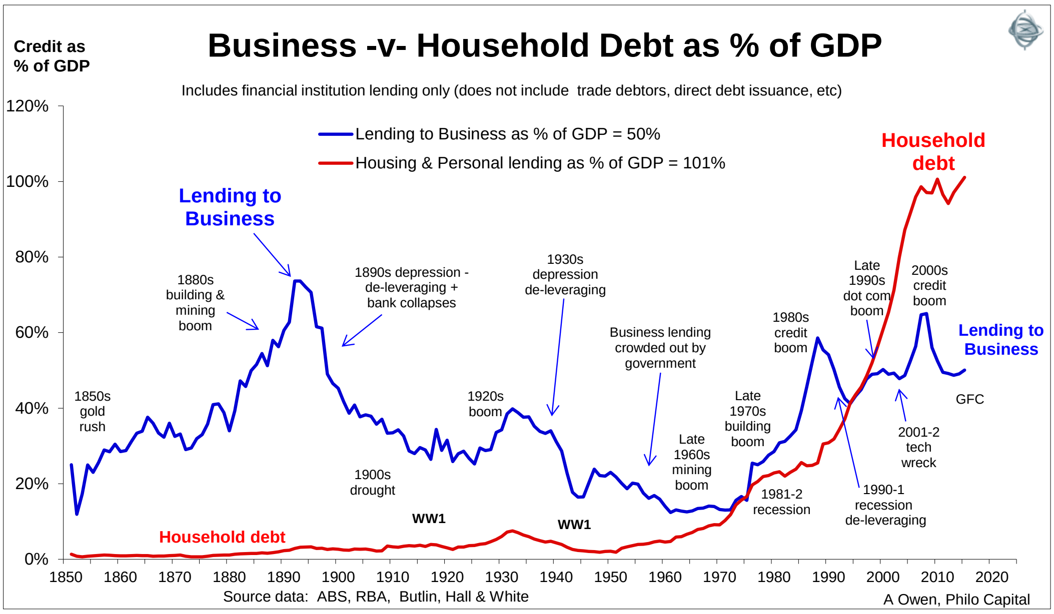
Business debt levels over time

Here we see the great corporate debt build-ups in the 1880s property and mining boom, in the 1980s 'entrepreneurial' boom and in the 2003 to 2008 credit and mining boom. Each of these lending binges collapsed quickly and were followed by painful de-leveraging, economic contractions, and debt write-offs by the banks.

Not all booms were financed by massive surges in debt. Notably, the late 1960s speculative mining boom and the late 1990s 'dot-com' boom were both financed largely by equity. Most of the money came from 'investors' who threw money at hundreds of speculative floats of new companies. In each case almost all of these speculative floats had nothing but hype and hope and they disappeared very quickly, taking their investors' equity capital with them.

We can see from the chart that the recent seven year period of business de-leveraging has not been inconsistent with other long periods of de-leveraging after the collapses of debt-fuelled booms. The current level of business lending is not low by historical standards.

Today banks are still writing off bad debts from financing over-priced acquisitions and unproductive projects undertaken in the recent mining boom. There is likely to be more bad debts to come, notably where LNG prices are collapsing due to global over-supply and weak demand growth, and costs are blowing out severely.



Household debt levels over time

Whereas business debt levels have remained well within the range of prior boom/bust cycles, household debt levels have exploded in recent years. After the speculative 'entrepreneurial' stock market boom collapsed in the 1987 crash, 'investors' switched their zeal to residential property, financed by cheap debt following interest rate cuts. This debt-fuelled boom soon collapsed in the deep 1990-1991 recession and Westpac and ANZ banks posted billion dollar losses and cut dividends.

The same pattern took place again over the past decade. After the 2003-2007 boom collapsed in the 2008-2009 sub-prime crisis, global credit crunch and sovereign debt crisis, the interest rate cuts starting in late 2011 have fuelled another debt-fuelled boom in residential property. This will end the same way as previous debt-fuelled booms. (There is also a serious boom underway in commercial property, but that is being financed largely by foreign equity capital, mainly from Asian funds, rather than by local bank debt).

How we compare

What level of household debt is productive or healthy for an economy? Probably it should be lower than the level of business lending, currently around 50% of GDP, which is where it is in Germany and the rest of Western Europe today.

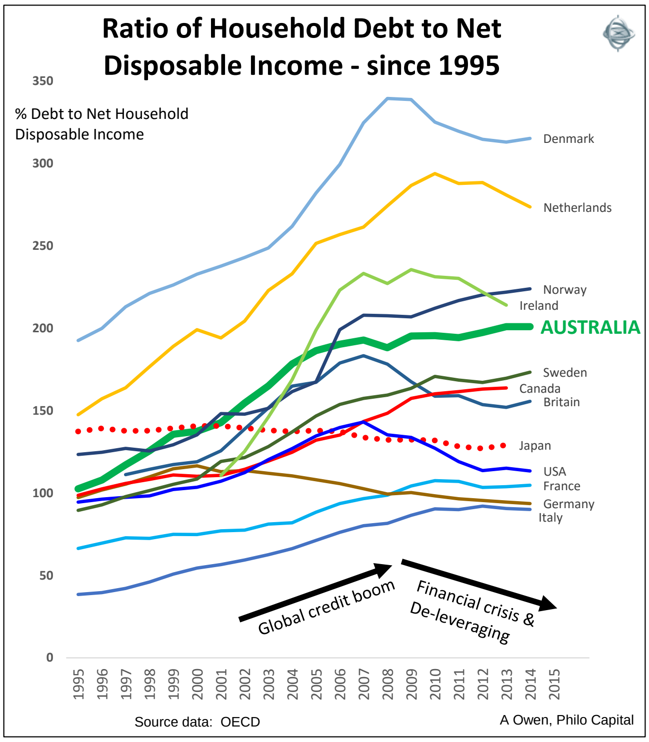
Australia's household debt at 101% of GDP is lower than the UK (182%) but it is significantly higher than the US (80%) and Western Europe.

A more common measure of household debt is the ratio of household debt to the level of household net disposable income, because income is required to service the debt. The next chart shows this ratio in major countries over the past 20 years.

While households in most countries have de-leveraged since the financial crisis, households in some countries like Norway, Sweden and Australia are still gorging on cheap debt, encouraged by the ultra-loose monetary policies adopted by the world's central banks, including zero or negative interest rates and 'quantitative easing' (central banks buying bonds and other assets with newly printed money) to force interest rates down further.

Scandinavian countries appear on the chart above Australia, but Australia's household debt burden is actually *higher* than theirs. How? Because our interest rates are much higher.

For example, Denmark has negative official interest rates and Danish mortgage interest rates are near zero. One bank (Nordea Credit) even offers mortgages with *negative* interest rates – yes they pay borrowers to take out a loan!



Household debts, current account and market volatility

Because Australia has higher inflation and higher population growth, and because our banks are a cosy oligopoly that protects their margins and fees, we are unlikely to see mortgage interest rates drop to Scandinavian levels.

When adjusted for the interest rates paid on household debt, Australia's household debt levels are the highest in the world. This, when combined with sluggish business lending and business investment, is likely to be a drag on growth in productivity and living standards in the coming years.

High household debt levels are also likely to prolong our reliance on foreign debt, to finance the mountain of mortgage debt (channelled into Australia via the banks and mortgage securitisers) and also to finance future growth. This is reflected in our persistent current account deficits. Heavy reliance on foreign debt makes us vulnerable to shocks in fickle foreign debt markets. It was this heavy reliance on foreign debt that caused the US sub-prime crisis (which had nothing to do with Australia) to rapidly and seriously infect our banking system and stock market in 2008-2009.

Australia's ongoing obsession with housing financed by a mountain of foreign debt continues this vulnerability to the impact of external shocks to our financial markets and it exaggerates our boom and bust cycles. This creates threats but also great opportunities for vigilant investors.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general education only, not personal financial advice.

SMSFs: 8 reasons they are over-spruiked and over-rated

Jonathan Hoyle

(Editor's note: This article may be construed as anti-SMSF, but far from it. In fact, the author has one, as does the Editor. We both believe that in the right circumstances, SMSFs offer tangible benefits over institutional super funds. But they're not for everyone …)

SMSFs have become the must-have financial fashion accessory for high-income earners and those seeking control over their superannuation investments. According to the ATO, there are 556,000 SMSFs in existence, comprising almost a third of the superannuation pie. For some, SMSFs offer a perfect mix of better control, inheritance planning and tax savings. For many, however, SMSFs are expensive, onerous and unnecessary. Too frequently, SMSFs are established by accountants and financial planners with an eye on revenue generation rather than with the best interests of the clients at heart. Despite their overwhelming popularity, here are eight reasons why you might pause before jumping on the SMSF bandwagon.

1. 'Til death do us part

An SMSF is like a marriage – it takes a significant commitment and a lot of hard work to make it run smoothly. If you are the type who doesn't like to commit for the long term, then an SMSF may not be for you. Even if you engage an army of advisers, accountants and auditors, you (as the trustee) are legally responsible for all the decisions made by the SMSF, for running the fund, completing the end of year tax return and audit, and for complying with superannuation laws. If this commitment is too much, then choose a retail or industry super fund as all the administrative, compliance and management responsibility is done for you.

2. Keeping up with the Joneses

Investment seminars, websites and ebooks on SMSFs are everywhere, and your golfing buddy has probably set one up. 'Best thing ever,' he says. Before calling your accountant demanding one, first determine what you want to do with an SMSF. If you see your current superannuation savings as readily accessible money to start trading today and making millions tomorrow, then you are most certainly going to end up disappointed.

3. Honey, trust me, I know what I'm doing

The ATO is quite clear about your responsibilities and the potential penalties. '*As a trustee of an SMSF, you need to act according to your fund's Trust Deed, the Superannuation Industry (Supervision) Act 1993 (SISA) – Superannuation Industry (Supervision) Regulations 1994 (SISR), the Income Tax Assessment Act 1997 (ITAA 1997), the Tax Administration Act 1953 (TAA 1953) and the Corporations Act 2001*'. Got that?

The ATO continues rather more menacingly, '*If you do not follow the rules, you risk one or more of the following: your fund being deemed non-compliant and losing its tax concessions, being disqualified as a trustee, prosecution and penalties*.' So what does non-complying mean? '*A complying fund that has been made non-complying will suffer serious tax consequences. Your fund's total assets … are subject to tax at the highest marginal rate. Any income received in a financial year in which a fund is non-complying is taxed at the highest marginal rate.*

And the, err, penalties? *'If a trustee is prosecuted and is found guilty of either a civil and/or criminal offence under a civil penalty provision, the maximum penalties that may apply under Part 21 of the SISA are $340,000 (civil proceedings) and five years imprisonment (criminal proceedings)'*

Engaging a financial adviser or an accountant to ensure you stick to the (highly complex) rules makes sense. But you are then up for another layer of fees. And what will you do if something should happen to you and you are no longer capable of running your SMSF? Will your partner know what to do in your place? Will they want to?

4. An SMSF! My kingdom for an SMSF!

In a report published in 2013, ASIC commissioned consultants Rice Warner to examine whether there was a minimum cost-effective fund balance for an SMSF. Rice Warner found that SMSFs with balances in excess of $250,000 were more competitive than the alternatives, provided the trustee was willing to undertake some of the fund administration. Those requiring a full administration service needed a balance of $500,000 to be more competitive.

As there are a range of fixed costs that an SMSF must incur (e.g. financial advice, administration, accounting, audit and actuarial costs) it is generally not cost effective for members with small balances to hold their superannuation through an SMSF. The cost of administering an SMSF and filing the tax return has fallen rapidly in recent years with the advent of better technology and you should not really be paying much more than $2,000 for this job (more if your SMSF has real complexity). Unless you are seeking advice about purchasing a property in your SMSF, planning to transfer in some business property or wish to gear up, there may be other more cost-effective options. Whilst there is no need to ransom your kingdom, for most, $250,000 should be the minimum.

5. Nothing is certain except death and taxes

You spend your whole life paying taxes. Wouldn't it be great if you can recoup at least some when the curtain closes? An anti-detriment payment (ADP) is a refund of contributions tax you have paid during your working life. This is an additional payment that can be made to your spouse or children if they receive your death benefit as a lump sum. It can be substantial. For example, a retail super fund with a $1 million balance and 50% taxable component, will spit out an ADP of some $37,000. You are unlikely to receive this if you are still running your SMSF, as funding ADPs in an SMSF can be problematic. Having your super in a larger retail fund can be more advantageous (albeit for your spouse or children) as these funds will have sufficient reserves to pay the ADP in addition to your death benefits. Beware single member funds with large hidden ADPs. If you are unsure, ask your accountant or adviser, and note that the government is considering abolishing ADPs.

6. All your eggs in one sliced basket

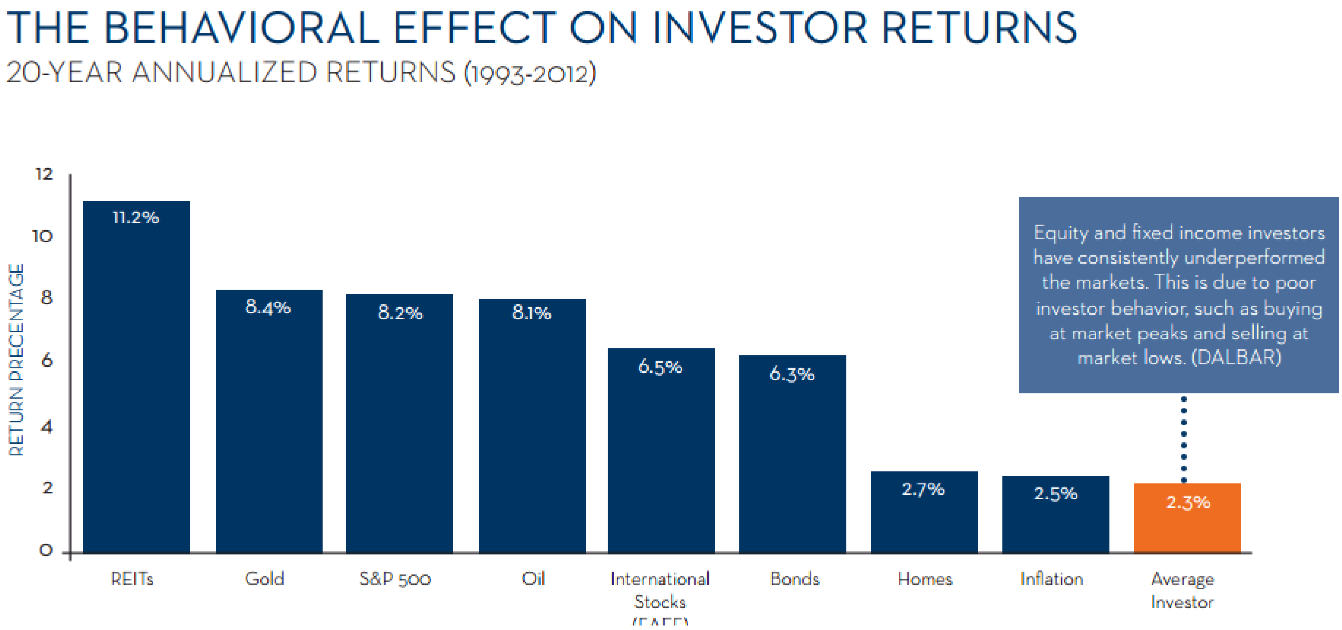
According to the ATO, cash accounts for 31% of SMSF assets, even those with $500,000 - $1 million balances, and 53% of the assets of those funds with less than $100,000. Australian shares appear to comprise another third of the asset base, though the figures are not too reliable. Multiport studies suggest that cash is more like 20%, but Aussie shares may be higher at 40%. Either way, most SMSFs comprise bank term deposits, bank hybrids and a whack of bank shares – akin to owning the senior, junior and mezzanine tranches of a single name Collateralised Debt Obligation (CDO).

7. You've got to call Australia 'home'

An SMSF must have the 'central management and control' (CMC) in Australia and the member must meet the Active Member Test so that the SMSF remains compliant. Therefore, if you are offered a long term position overseas, Houston we may have a problem. If you plan to leave Australia indefinitely, the SMSF will often need to be wound up as the CMC test will not be met and you cannot make contributions into the fund or any investment decisions.

8. I can beat the market!

And we save the best for last. SMSF providers regularly promote the benefits of running your own investment portfolio. Wonderful if you have a thorough understanding of financial markets, diversification, correlation, behavioural economics, volatility and the patience of Job. Otherwise, you are suffering from the over-confidence bias, the most well documented of all the financial behavioral heuristics. The chart below from JP Morgan Asset Management is revealing, quoting research from Dalbar which shows investors underperform the market due to poor timing of entry and exit points.



Recep Peker, a senior analyst with research firm Investment Trends, says that trustees of many new SMSFs are convinced they can outperform the big funds. Indeed, 28% of SMSFs surveyed told Investment Trends that one of the reasons they set up an SMSF is a belief that, '*I can make better investments than the big fund managers*'. And in Lake Wobegon, all the children are above average intelligence.

Make sure it's suitable for you

In the right circumstances and for a well-informed trustee, SMSFs can offer significant benefits over traditional retail super funds. Remember, Stanford Brown's Golden Rule of Investing No. 8 – *Don't Copy Your Mates at the Golf Club.* Just because it is right for them, doesn't automatically make it right for you.

Jonathan Hoyle is CEO of Stanford Brown Group Pty Ltd. This article is for general purposes only and does not consider the specific needs of any individual.

Lessons from the Volkswagen emissions scandal

Tony Adams

The revelation that Volkswagen (VW) has been systematically defrauding environmental regulators (and thus customers) across the world has two main lessons for credit investors. While neither of these lessons is new, this is a timely reminder of both.

1. Companies are not run for the benefit of bondholders

In most jurisdictions, company directors are not required to act in the best interest of creditors unless the firm is insolvent. In VW's case, whether this fraud was known at board level or not, it is clear that a culture existed that focused on profit first and foremost i.e. making the shareholders, and likely management of the firm, rich. While the agency issues of management versus shareholders are well documented, the impact on bondholders of this type of activity is less understood.

Presumably the motivation for their activity stemmed from the cost savings, and hence increased profits, of rigging the emissions testing compared to building the cars, with the same power and fuel economy, that actually complied with the standards. Assuming that this was a deliberate corporate strategy to defraud regulators, there could be one of two possible outcomes for the firm. Below we consider the return profiles for both equity and bondholders in these outcomes, acknowledging that there is always an unknown, but non-zero, probability of being discovered.

Possible outcome 1: they continue to get away with it, thus profits are boosted and shareholders win. Dividends and share prices would continue to rise and hence the owners benefit from the reward of taking the risk (of getting caught).

Possible outcome 2: they get caught and they face large fines, restitution costs, brand damage and possible longer term viability issues for their firm. Clearly here, equity holders have borne the cost of the losing bet.

Now look at this from the perspective of bondholders. Outcome 2 clearly impacts bondholders negatively. The value of the company's bonds falls (as credit spreads widen), their credit ratings are downgraded, and bondholders too, face the heightened probability of future distress for the firm.

But what about outcome 1 – do bondholders win or lose? Clearly the benefits of increased profits go completely to shareholders – so bondholders do not win as a result of not getting caught. But further, to the extent that the firm looks to be more profitable than it really is, this will, all other things being equal, result in credit analysts assessing the firm to have a lower default probability than it really does. The implication is that bondholders actually lend to this company at a lower rate than they otherwise should. Hence bondholders are not being appropriately compensated for the true risk they are exposed to and in turn receive lower returns.

While equity holders face a symmetric outcome, winning under outcome 1 and losing under outcome 2, bondholders lose under both!

This example highlights the need for investors to, as fully as they can, incorporate environmental, social and governance (ESG) risk assessments in their credit process. Directors at VW either created a culture where the imperative to achieve performance targets overrode any requirement to remain within the law, or they were blind to the weaknesses in their own governance framework. Companies who control these risks poorly will often manage other risks poorly, resulting in significant financial impacts on the firm. Whilst such analysis will not always uncover these risks (as is clearly the case with VW), the risks are real and can rapidly convert into financial risks.

2. Diversification is the ultimate protection against shocks

Recent high profile corporate scandals, such as the BP oil spill in 2010, have been accompanied by commentary and analysis around whether it would have been possible for a credit analyst who 'knew the company' to have identified, ex-ante, the issues around this company. While no analyst would ever have predicted the Gulf of Mexico disaster, it is possible to argue that some of the risk factors were more visible in the VW case.

While VW had some visible governance issues around it – a single shareholder block holds 90% of the voting shares, non-independent majority on the board, no fully independent audit committee nor independent remuneration committee – these are not all that unusual in many bond issuers. Despite these issues, it would be highly unlikely that any credit analyst, who really dug deep into and 'knew' VW, would have identified that the firm was undertaking such a widespread fraud on its customers.

Such an unexpected outcome, especially given the asymmetric return profile explained above, clearly argues against credit approaches that rely on 'really knowing a company' and holding large concentrations in them.

In debt, concentration is an unrewarded risk. The best way of managing credit portfolios, where outcomes like the VW case can, and do, happen is to build highly diversified portfolios.

To summarise:

- Shock events like the VW emissions scandal are almost impossible to predict. Even the best analysts are unlikely to 'know' a company well enough to uncover this level of fraud.
- Likewise, the best ESG processes would not have discovered the 'diesel dupe', but rather are more likely to pick up governance issues supporting a culture for unlawful practice.
- Bondholders will lose in these scenarios as companies are run to benefit shareholders, not bondholders.

- The best way to limit the impact from these shocks in a corporate bond portfolio is to diversify. Hold a little of a lot so that losses due to a big event / default are limited, minimising the impact to your overall return.

Tony Adams is the Head of Global Fixed Income and Credit for Colonial First State Global Asset Management. This article is for information purposes only and does not consider the circumstances of any investor.

Retirement: Making income the outcome

Graham Lennon

The consensus is that retirement income should be the primary goal of superannuation and the federal government plans to enshrine an objective in legislation. This will require a change in focus for investment managers around the risks they manage and the options they provide to investors.

In its response to the Financial System Inquiry, the government also agreed to remove impediments to retirement income products and for the publication, where practical and cost-effective, of income projections on members' statements.

As always, the devil is in the detail. While publishing income projections is a good idea, it must be meaningful for investors.

That means participants should be able to see not only what they may be able to afford in retirement, but the uncertainties around those projections. They should be given investment options to help manage those uncertainties so that confidence in the income projections increases as they near retirement.

If their plans are not on track, they need to be made aware of their options, whether it is saving more, working longer, or otherwise adjusting their expectations for retirement.

We also must be mindful of the nature of the risks that may affect retirement income. If the solution is not managing market risk, inflation risk and interest rate risk, are the income estimates actually useful?

Managing the right risks

If income is the goal, we need to think about risk management in different ways. Currently, many of the options offered to savers may be managing non-crucial risks, sacrificing asset growth goals with no clear benefit relative to an income goal.

If the volatility of an account balance is all that is managed, employees will not be in a position to know how much inflation-adjusted income that balance can provide when they retire.

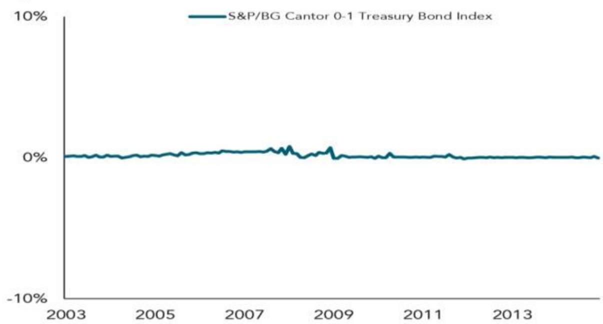
Just about everyone who saves or invests does so to support some future consumption. We know that the key to any asset allocation is to identify the right hedging asset for a given liability.

So if you want to reduce the volatility of your account balance, you can invest in assets that are stable in wealth terms, like term deposits or short-term fixed interest. But short-term fixed interest is the wrong hedging asset if you are seeking to manage income risk. Instead, you end up accepting a lower expected return with no clear benefit relative to an income goal.

Figure 1, using US data as an illustrative example, shows how risk and return characteristics differ when looked at through an income lens.

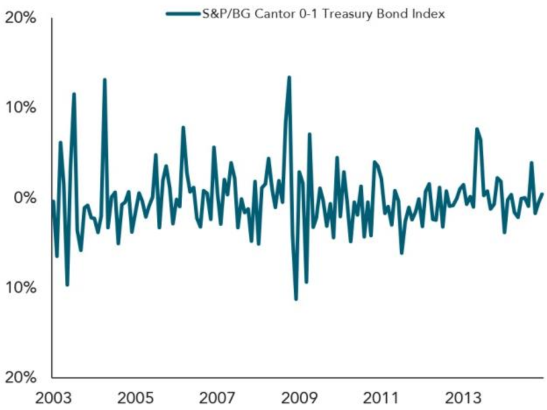
The first chart shows that when managing the volatility of an account balance, short-term government bonds are a fine hedge. But the second shows if you are managing toward income, those same securities become much more volatile.

Figure 1 MONTHLY RETURN: WEALTH UNITS



Monthly returns in wealth units are the returns of the S&P/BG Cantor 0-1 Treasury Bond Index (January 2003–December 2014).

MONTHLY RETURN: INCOME UNITS



Monthly returns in income units are the returns of the S&P/BG Cantor 0-1 Treasury Bond Index adjusted by monthly change in the cost of a $1 cash flow for 25 years starting in January 2015.

To hedge a retirement income liability, we need to devise a solution that manages relevant risks – among them rising inflation and interest rates.

We can conceptualise our retirement liability as a series of equal inflation-adjusted payments from retirement to life expectancy.

This future liability looks a lot like a bond. The series of payments, like any bond, has a duration. By investing in a portfolio of inflation-protected instruments that match the duration of those payments, we construct a strategy that hedges interest rate and inflation risk.

DB, DC and a middle way

The idea of buying assets today that hedge a future liability is called 'liability-driven investing and is an approach that is commonly used among the old defined benefit (DB) pension plans that used to prevail before the introduction of defined contribution (DC) superannuation in 1992.

A DB plan is designed to provide a predetermined retirement benefit to members either in the form of a specific dollar amount or as a percentage of compensation. In a DC plan, individuals contribute to their fund through their working lives, but they do not know how that may translate to supporting income once they stop working.

There are a number of advantages in DC plans, such as member control and better portability. But the individual carries all the investment risk and must make often complex asset allocation decisions with little or no expertise.

A middle way is to use two key principles established by lifecycle research in financial economics.

The first principle says that investors derive utility from being able to afford a steady stream of consumption through retirement. The risk management framework should be designed to deal with uncertainty risk around that goal.

Every asset allocation involves a trade-off between growth assets and risk-hedging assets. If the goal is retirement income, the right measure of risk is uncertainty about income. And the right trade-off is between income risk management and the opportunity of growing income.

The second principle is that investors should make saving and asset allocation decisions based on various sources of capital throughout their lifecycle.

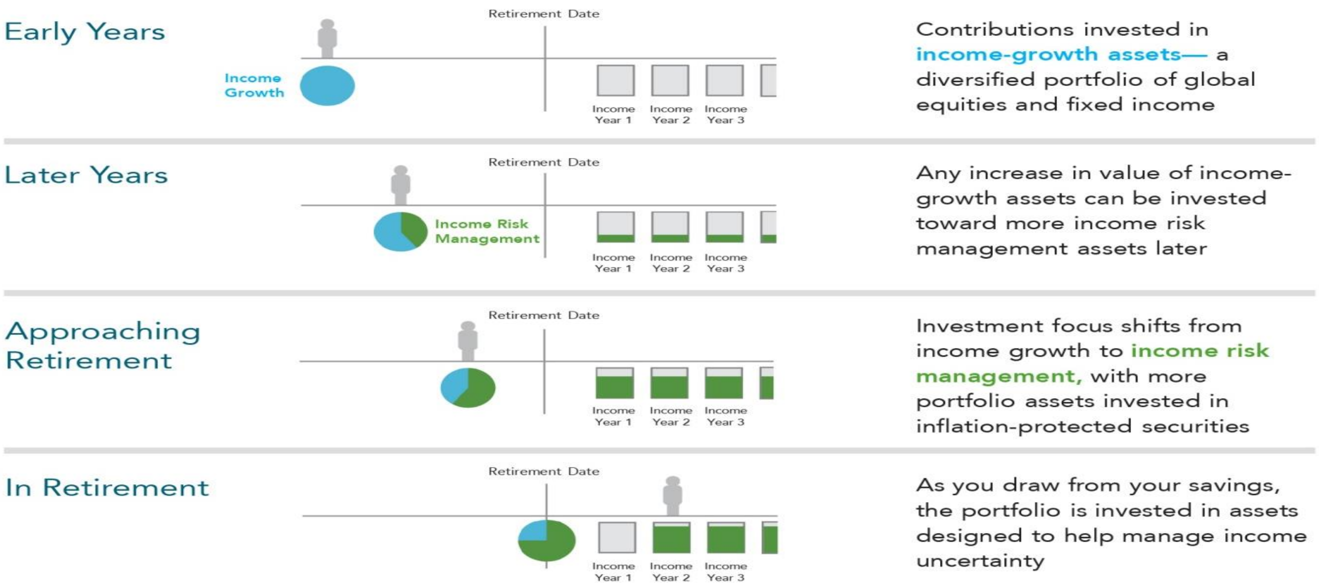
Fund members have two main sources of capital to fund future consumption - today's financial assets and expected future savings from their human capital. For most investors, the human capital component tends to be less risky than equities.

At the beginning of members' working lives, they tend to have little financial wealth. The majority of their total wealth consists of future savings from human capital. As time progresses, members convert future savings into financial assets.

So the right asset allocation approach should be to manage the trade-off between assets for *income-growth* (increasing the balance available to draw income from) and assets for *income risk management*.

This relationship drives changes in the allocation to income-growth and income risk management assets. Early in life, the focus is on income-growth assets. Later, as human capital is depleted, the focus shifts to income risk management assets – duration-matched inflation-protected securities. Figure 2 below shows how this might work.

Figure 2 MAKING THE RISK-RETURN TRADEOFF



For illustrative purposes only. Not guaranteed. Based upon the market observations of Dimensional Fund Advisors LP.

Summary

The primary goal of retirement savings should be to provide a steady stream of income for people when they stop working. So a primary *risk* for people is uncertainty about how much income they can afford in retirement.

An ideal solution would allow participants to invest toward retirement income over time, and seek to protect those investments from inflation and market risks.

Providing relevant information to investors alongside solutions that manage the right risks can be a powerful combination in pursuing better retirement outcomes.

Graham Lennon is head of retirement investment strategies and a senior portfolio manager in Sydney with Dimensional Fund Advisors, a wholesale asset manager with more than $500 billion under management globally.

Sin stocks and divestment: the right to choose

David Gallagher

The notion that superannuation funds and other fiduciary investors may choose to divest themselves of certain investments, typically stocks, on philosophical grounds is not a new one. But the debate surrounding divestment has grown louder in the past year or so, especially in Australia.

There are now several prominent examples of Australian funds, from super funds to university endowments, which have announced certain divestments, typically in fossil fuel companies.

Most recently, a lot of attention was given to the health industry fund HESTA divesting itself of Transfield shares on the grounds that the investment looked unsustainable in the light of the company's apparent involvement in morally suspect practices at the detention centres it manages.

Last year, and more commonly around the world, a similar debate focused on divestment of fossil fuel stocks – a debate which continues to rage. Once again, fiduciary investors usually emphasise that a decision to divest is taken on the grounds of lack of sustainability.

Are trustees acting in the best (retirement) interests of members?

But super funds and other fiduciaries manage money on other people's behalf, often people who have little or no say in how the money is to be directly managed. This places considerable pressure on the trustees and management of the funds to make sure they really are acting in the long-term interests of their investors.

In the case of super funds, there is the Sole Purpose Test which makes it clear all decisions of the fund have to be made with a view to providing (maximum) retirement benefits to members. With university endowments, the position is not as uniform as superannuation funds, although trustees are aware the purpose of endowment funds is in contributing to the long-term viability of the institution.

The Australian National University announced in October 2014 it would divest itself of $16 million worth of shares held in seven stocks involved in fossil fuels, creating quite a political storm, although it represented a tiny component of the $1.1 billion fund. Other stocks, such as BHP, Woodside Petroleum and Rio Tinto, were retained. The decision was modelled on that of Stanford University's sustainability review, announced a few months earlier.

Both decisions followed considerable student body lobbying.

In an interesting note on another set of deliberations, which ended in a different course of action, the University of New South Wales, through the then Vice-Chancellor and President, Professor Fred Hilmer, said last October that the University Council met and resolved 'overwhelmingly' to maintain the current approach – to retain its existing investments in fossil fuel stocks.

After outlining the University's concerns about greenhouse gas emissions and global warming, and its considerable research and other efforts relating to clean energy, he quoted the words of Drew Faust, President of Harvard:

"Conceiving of the endowment not as an economic resource, but as a tool to inject the University into the political process or as a lever to exert economic pressure for social purposes, can entail serious risks to the independence of the academic enterprise. The endowment is a resource, not an instrument to impel social or political change."

A key element in the debate is how much, if any, short to medium-term financial damage a divestment program is going to cost the stakeholders. Professional fund managers assume there will be a cost.

New research both supports this view over the shorter term and also suggests divestments may be counterproductive over the longer term. The research paper, 'The Unintended Consequences of Divestment', by Shaun William Davies and Edward Dickersin Van Wesep from the University of Colorado, says there are two major flaws in the pro-divestment argument. First, any reduction in the target companies' share price will benefit other 'amoral' investors who buy the initial dip and in any event the price discount will shrink over time. Second, executive stock options will work in the opposite direction. A higher return, after the granting of stock options, increasing their value, so executives would prefer the high returns that being subject to a divestment campaign would provide, according to the paper.

The belief sets in a co-mingled fund

Any investment programme should match the belief sets of the investor. In the case of big co-mingled funds, such as an industry super fund, the members need to be informed of the implications of investment policies so they can make an informed decision.

One industry fund which uses an aspect of its investment programme for marketing purposes is Cbus, the multi-employer fund for the building and construction industry. Cbus has for many years held overweight positions in direct property. Asset consultants, however, are critical of this because the fund is 'doubling up' the members' risk. If the building industry goes into a slump then members' returns would decline at precisely the time they may need extra money. But the members love the fact that their fund invests back into their industry. The policy attracts and helps retain members in a competitive world. The programme fits the beliefs.

All big super funds provide considerable investment choice for members within their fund and most – but not all – members can readily change funds if they so wish. This adds to the responsibility on trustees to provide adequate information about what is happening in their fund.

Default option is where debate is most relevant

It is the default component of the fund which is the most important for the purposes of this debate because it is usually the largest component and because it usually represents the least-engaged members.

To my mind, the smoking analogy is appropriate. People are entitled to exercise a right to smoke, without harming others, as long as they understand the risks. It may well be, in a similar vein, that divestments of fossil fuel stocks and other 'sin' stocks can damage your financial health. The choice should be the members'.

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Super is struggling to please anyone

David M Brown

Most of us working in the superannuation industry can be rightly proud that in spite of all the tensions and internal debate, the system is largely successful. The Australian super system is 'doomed to success' because of generous tax concessions, a strong adequacy lobby pushing for increased contributions and a sophisticated array of industry bodies and service providers to galvanise our collective efforts.

But an existential crisis looms in legislating a 'purpose for super'. To what seems like a simple question, the community responds with a variety of competing answers, some of which challenge what we currently do.

Divergent views on assumed purpose

A survey released last week by the retail industry super fund REST claims "*… almost three quarters of more than 1100 over-50s … place one of their main aims for their super proceeds as not being retirement income for themselves, but 'for helping the kids'*". 72% of them intend to help with school fees and house deposits or provide an inheritance.

The Treasurer, Scott Morrison, joined the chorus in the AFR saying "*Some people see it as an inheritance pool, others see it as wealth creation,…*"

Sadly, while my own mum and dad don't have that attitude, the survey also highlights the contrast between high ambitions and short achievement. 55% of members do not believe they will have enough to comfortably retire.

We can write this off as just another example of the sense of entitlement of the baby-boomer generation, or we can actually see that on some level the system has shortcomings that need to be addressed.

After 25 years of compulsory super, could it be that super satisfies no one? The government is unlikely to relieve intergenerational social security costs, nor will superannuation returns be enough to provide the generous retirement members expected.

If member (and government) expectations are so skewed towards higher final balances, the logical conclusion is that the whole industry has been labouring under the false assumption that a slow and steady low-cost balanced risk strategy is what members want. In the world described by the REST survey, a high-growth, wealth creation strategy rather than a meagre low-return income strategy, is likely to meet more objectives.

Cost concern is outweighing generating quality returns

MySuper has produced a low-cost, vanilla approach that, from an investment strategy perspective, almost guarantees to reduce long-term absolute returns. Superannuation researcher Warren Chant was quoted saying:

"What MySuper did was to offer the only way for retail funds to compete by introducing more indexing. Having more passive management is a step backwards."

Gone are the high cost, high alpha assets with uncorrelated returns, replaced by passive indexed approaches delivering an unmitigated ride on the market beta.

While this article is too short to delve the depths of the debate on active versus passive management, a variety of investment approaches have been scaled back or abandoned, not because they don't deliver alpha, but because the cost is too great to bear. While downward pressure on fees in general must be a good thing for consumers, and entirely appropriate for a compulsory system, the extent to which quality returns can be achieved has undoubtedly been compromised.

Australians missing private equity opportunities

My own involvement as a co-author of the annual *Private Equity Media "Australian Institutional Investor Survey of Private Equity & Venture Capital Investing*" has demonstrated to me the seismic changes underway. We have charted the decline in money allocated and an erosion of internal teams in seniority and expertise devoted to private equity.

Flying in the face of conventional wisdom in each and every developed pension industry across the globe, Australia stands alone in its abandonment of private equity.

"*Recent academic research has provided accumulating evidence that private equity investors have performed well relative to reasonable benchmarks … private equity funds have outperformed public equity markets net of fees over the last three decades. The outperformance versus the S&P 500 in Harris et al. is in the order of 20% over the life of the fund and roughly 4% per year. Consistent with that net of fee performance, Axelson, Sorenson and Strömberg (2013) find outperformance of over 8% per year gross of fees.*" – Harvard, April 2015, Working Paper by Paul Gompers, Steven Kaplan and Vladimir Mujharlyamov, titled "What do Private Equity Firms Say They Do?"

Cambridge Associates publishes an Australian survey of private equity results which, time after time, resiliently shows not only a more stable pattern of returns than the listed market, but higher levels of outperformance against public markets than those quoted in US studies.

Ironically, the private equity industry in Australia is thriving by sourcing its capital from pension funds in other countries, who remain astounded that the local industry has little interest in a rich vein of returns and diversification sitting on its doorstep.

One feature of super funds in other countries is the preponderance (although reducing) of defined benefit funds. Their attitude to returns is razor sharp because of the clarity of the trustees' *hangman's noose*: that is, actuarial hurdle rates to ensure solvency. It is typically these funds that are greedy for efficiently squeezing return from their risk budget. Assets like private equity have for much of the global industry become a near universal inclusion to meet their goals.

The return goals for defined contribution funds are no less onerous but they are also less immediately visible and the REST survey casts some dim light upon these goals. However, this is just one example of how the rush to satisfy the MySuper fee agenda may have lurched our industry away from achieving the ultimate objective of its own members, and the government.

There are many competing objectives to which the super industry must show deference, but it seems that healthy returns should be the last place to make a compromise. An industry that draws upon the largess of the government for generous tax concessions might be better insulated from change if its members are enthusiastic about results. However, from what we see from the recent REST survey, member gratitude has faded.

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