Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

Survey on 12 potential superannuation changes in Budget 2016

Changes are expected in some superannuation rules in the Federal Budget 2016. Here we list the 'Deficit Dozen' of potential amendments.

Please take our simple survey on what you would change (not what you think will change). It will only take a minute or so.

We will publish the first results on Sunday 1 May 2016, two days before the Budget.

The survey link is here.

The potential changes in the survey are:

1. Extra 15% tax on concessional contributions ('Division 293 tax') for those earning $300,000 reduced to $180,000.
2. Annual cap on concessional contributions (before tax) reduced to $20,000 (or similar).
3. Annual cap on non-concessional contributions (after tax) reduced to $120,000 (or similar).
4. Abolish 'bring forward' rule which allows up to three years of non-concessional contributions in one go.
5. Introduce a tax on earnings for super in pension phase for people over 60.
6. Introduce a tax on pension payments for people over 60.
7. Introduce lifetime caps on concessional (before tax) contributions.
8. Introduce lifetime caps on non-concessional (after tax) contributions.
9. Abolish future Transition-to-Retirement arrangements (but not retrospectively).
10. Remove current concession on capital gains tax for assets held in superannuation longer than 12 months.
11. Retain the low-income super contribution (LISC) scheme which is due to be scrapped on 1 July 2017.
12. Declare a freeze on any more changes to superannuation rules for at least the next three years.

Are there any other superannuation changes you think may be or should be introduced?

What to look for in unlisted real estate funds, Part 1

Adrian Harrington

In the current low interest rate environment, the hunt for yield is a powerful force. Non-residential real estate via listed real estate investment trusts (A-REITs) and unlisted real estate funds (syndicates) have both benefitted from strong investment inflows. To date, investors have not been disappointed. According to the Property Council/IPD Unlisted Core Retail Property Fund Index* published by MSCI, unlisted syndicates generated a total return of 37.8% in the year to 31 March 2016, with an income return of 8.8%. For the same period, A-REITs generated a total return of 11.4%, with an income yield of 5.8%.

In this Part 1, we show the characteristics of unlisted real estate funds, while in Part 2 to be published next week, we will demonstrate how returns are affected by gearing, and the various exit strategies.

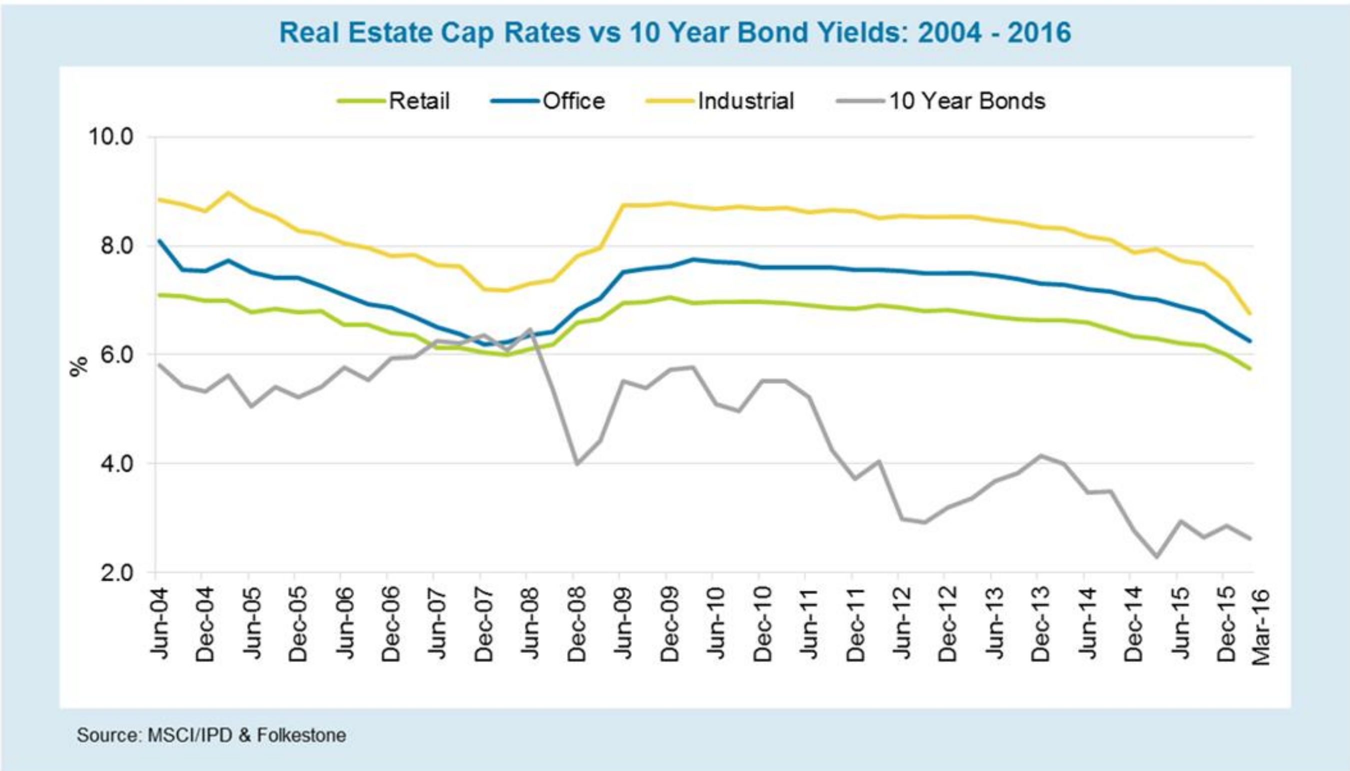
Most of the syndicates in the Index were established between 2010 and 2014 when real estate yields were higher, and hence the relative higher yield they are now generating. As prices of non-residential real estate assets have increased, yields have firmed (see Figure 1). Recent syndicate offers typically have starting yields of between 6.6% and 7.5%. When compared to the cash rate at 2.0% and 10 year bonds at 2.5%, the yields look attractive.

However, choosing to invest in any investment whether it be an A-REIT, a bank stock, or an unlisted real estate syndicate based on just the first year yield may lead to problems down the track when the market turns. Investing is about total returns – income and capital – over the life of the investment and a syndicate typically has a term of between five and seven years.

Folkestone does not believe the non-residential real estate sector will fall off a cliff in the next year or so with the exception of those assets in cities or towns reliant on the mining sector (e.g. Perth CBD office). As we recently pointed out in our [2016 Outlook paper](),

"We are now seven years into the up-cycle, and we see less upside to many markets than we have in recent years … Easing capital market tailwinds and close to full valuations in some markets will mean that earnings growth rather than yield compression will be the key driver of value creation going forward."

Figure 1 – Real Estate Cap Rates (Yields) in Various Sectors



We still see opportunities to invest in unlisted real estate syndicates but it is becoming increasingly difficult to find quality assets at reasonable value. Now is not the time to stretch on price or overcommit to short-term strategies; maintaining investment discipline will be key.

Understand the asset and fund characteristics

Every real estate asset and fund are different, and investors should examine:

Asset level

- Characteristics of the asset – what is the age, quality and location of the asset?
- Tenant covenants - how good are the tenant covenants and what's the risk of default?
- Lease expiry profile – what is the vacancy, when are the leases due to expire, are they staggered through the term of the fund or do they extend beyond the term of the fund?
- Rent structure - is the asset under- or over-rented compared to the rent level in the market, what incentives have been paid to tenants, when and how are rents reviewed during the lease term?
- Capital expenditure - will the asset require capital expenditure during the term of the syndicate and if so, how will the fund pay for it?
- Market dynamics - what is the prognosis for supply and demand in the surrounding market?

Fund level

- Longer-term yields - don't just focus only on the first year yield published on the cover of the fund offer, remember it's a five to seven-year investment at least.
- Distribution policy - is the fund paying distributions from its cash from operations (excluding borrowings) or capital, borrowings or other support facilities which may not always be commercially sustainable?
- Gearing - what's the fund's gearing level and how does that compare to the bank covenants, and how much buffer is there between the gearing level and the bank's maximum loan to value ratio? How much, if any, of the debt is fixed versus variable? (We will show how changing the gearing can appear to enhance returns in Part 2 next week).
- Fees - what is the fee structure, are they transparent and aligned with investors?
- Manager track record - what is the performance track record of the manager?
- Poison pills - does the fund have a 'poison pill' which requires the manager to be paid by the fund if removed by investors for poor performance?
- Regulatory compliance – does the fund meet the six benchmarks and eight disclosure principles for unlisted property schemes described in ASIC's Regulatory Guide 46 on Unlisted Property Schemes, and if not, why not?
- Treatment of acquisition costs – does the manager write off or capitalise costs?
- Exit strategy - what's the manager's likely exit strategy? More on this in Part 2.

Three points worth emphasising

1. Good real estate managers are asset enhancers

They create value by their ability to manage the asset through the cycle. They don't rely on tricky capital management and financial engineering to deliver returns to investors. They also offer true to label simple and transparent funds with fee structures that are reasonable and aligned with investors. We advocate on-going management fees based on a percentage of net assets (not gross assets) of the fund as the manager is not incentivised to take on higher gearing. A management fee of 1.3% of net assets assuming 50% gearing is equivalent to 0.65% of gross assets. A performance fee is also appropriate so long as the benchmark rewards the manager for real outperformance not just turning up for work.

2. Understand how the manager calculates the NTA of the fund

Some managers capitalise part of the acquisition costs rather than write them off on day one, which means the initial Net Tangible Assets (NTA) is higher. Table 1 shows the initial NTA when acquisition costs are not capitalised and Table 2 shows the impact when costs are capitalised. Instinctively when presented with the two options, an investor may think they are better off investing in the fund adopting option 2, where the NTA looks significantly higher.

Table 1 - Unlisted Fund - Acquisition Costs Not Capitalised		
Gearing	**50%**	**A**
Property Price / Debt & Equity		
Acqusition Yield	7%	**B**
Annual Net Property Income	3,000,000	**C**
Purchase Price	42,857,143	**C/B = D**
Debt	21,428,571	**D * A = E**
Equity - Asset	21,428,571	**D - E = F**
Acquisition & Establishment Costs		
Acqusition Costs (stamp duty/asset due diligence - 6% of purchase price)	2,571,429	**D * 6% = G**
Debt Establishment - 0.25% of debt	53,571	**E * 0.25% = H**
Acquistion fee - 1.5% of purchase price	642,857	**D * 1.5% = I**
Fund Establishment Costs (legals, tax, accounting)	100,000	**J**
Total Acquisition & Establishment Costs	3,367,857	**G + H + I + J = K**
Fund Equity Required	24,796,429	**F + K = L**
Profit & Loss		
Total Annual Net Property Income	**3,000,000**	**C**
Recurring Fund Costs (registry, accounting, tax, audit etc)	120,000	**M**
Interest - 4.5%	964,286	**E * 4.5% = N**
Management Fee - 1.3% of Net Assets (Equity)	278,571	**F * 1.3% = O**
Total Annual Costs	1,362,857	**M + N + O = P**
Total Net Fund Cashflow	1,637,143	**C - P = Q**
No of Units on Issue - Assume Issued Price $1	24,796,429	**L * $1 = R**
Distribution Yield	**6.60%**	**Q / R = S**
NTA ($)	**0.86**	**F / R = T**
Assumes the asset and debt upfront acquisition costs are not		

Table 2 - Unlisted Fund - Acquisition Costs are Capitalised		
Gearing	**50%**	
Purchase Price	42,857,143	**D**
Acquistion Costs (stamp duty/asset due diligence - 6% of purchase price)	2,571,429	**G**
Debt Establishment - 0.25% of debt	53,571	**H**
Capitalised Asset Value	**45,482,143**	**D + G + H = U**
Debt	21,428,571	**E**
Equity - Asset	24,053,571	**U - E = V**
NTA ($)	**0.97**	**V / L**

We (and most of the leading managers) advocate taking the conservative path and writing these costs off on day one which unfortunately results in a lower initial NTA. Managers capitalising costs run the risk that if the value of the asset has not risen by at least the amount of the capitalised costs at the next financial review date, then they will have to be written off at that time, impacting the NTA.

3. Chasing short-term yield may not deliver the best outcome

Thirdly, unlisted real estate funds or syndicates offer a legitimate investment option for investors where liquidity is not a high priority. But like any investment, investors need to understand the risk and return. The first-year headline yield should not be a priority. Real estate is a long-term investment and chasing short-term yield may not deliver the best long-term investment outcomes.

*Note: The Index tracks the performance of 28 funds with a gross asset value of $3.3bn. These funds own either office, retail, or industrial assets and must have greater than 90 per cent direct property exposure, less than 50% per cent gearing, must not capitalise interest and be an ASIC registered managed investment scheme.

In Part 2 next week, we will examine gearing and how an unlisted real estate syndicate generates returns, and the different types of exit strategies.

Adrian Harrington is Head of Funds Management at Folkestone (ASX:FLK). This article is general information and does not address the specific investment needs of any individual.

Pension drawdown affects asset allocation decision

Gordon Thompson

In the 1998 movie Sliding Doors, Gwyneth Paltrow's character's life splits into two parallel universes depending on whether or not she catches a train. The parallel universes that will be the focus of this article are the different outcomes that a member experiences based on their asset allocation choices.

Let's assume we have a 50-year-old and the year is 2000. Their income is $75,000 per annum, increasing by 2% p.a. The starting balance in their super account is $200,000 and each year they contribute 9.25% of their income. Their investment choices are either an asset allocation to growth/defensive assets of 30/70 or 70/30. Which selection will result in the better outcome for the client?

Competing views on correct strategy

For the first 20 to 25 years of a client's working life, their contributions to super dominate investment returns as the principal drivers of growth in balance. To quote former Treasurer Joe Hockey, the best thing that a client can do to grow their super balance over this period is to "get a good job that pays good money".

However, once a client hits their mid-forties, investment returns dominate contributions as the key driver of growth. Further asset allocation is the dominant factor driving investment returns, having a bigger impact than either manager or security selection. Appropriate asset allocation becomes even more critical for this age group.

There are two competing schools of thought on the right thing to do later in life.

The first is the 'risk off' school which reduces exposure to equities to reduce volatility and the risk to retirement date. Lifecycle funds are an automated approach to implementing this glide-to-retirement approach.

The second is the 'risk on' school which maintains an exposure to equities to deliver reasonable returns to enable investors to build a sufficient balance for a comfortable retirement. This view is that moving clients into a low risk environment locks in low returns.

So let's have a look at the returns of our 30/70 and 70/30 options from 2000 to now as shown in Chart 1 (next page).

Our 70/30 client's experience is more like the Gwyneth Paltrow character's universe where she catches the train, arrives home in time to catch her boyfriend cheating, starts her own PR firm and falls in love with John Hannah. The 70/30 client has experienced both the highs (annual return of 19.5% in 2013) and the lows (annual return of -17.77% in 2008). Alternatively, our 30/70 client has probably slept better at night with only one negative annual return (-5.37% in 2008) and a high of 11.62% in 2004.

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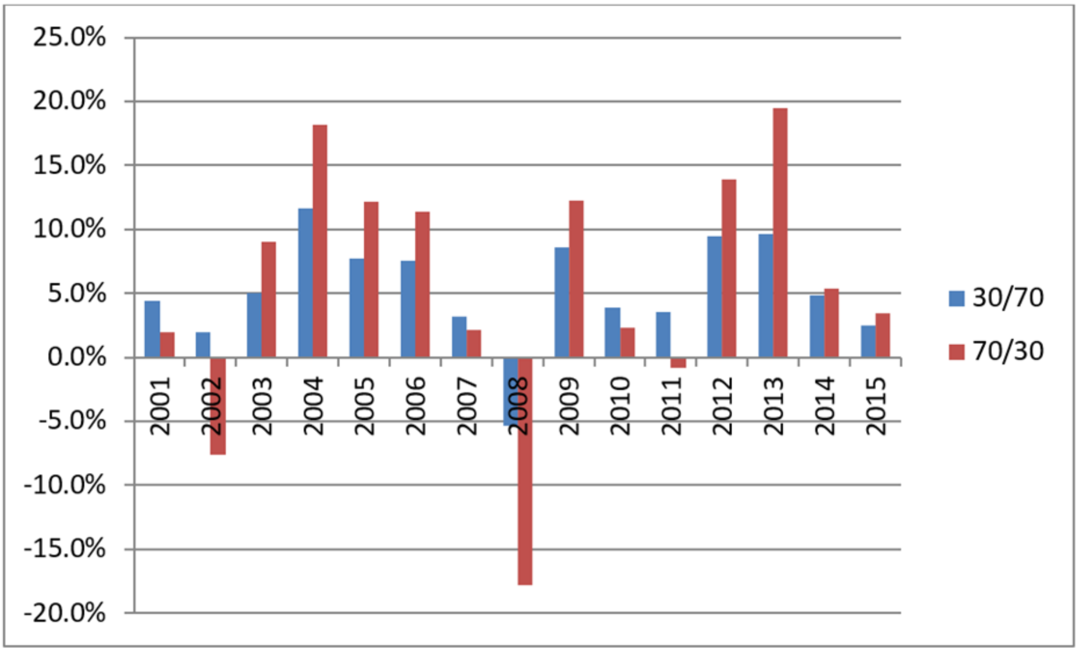
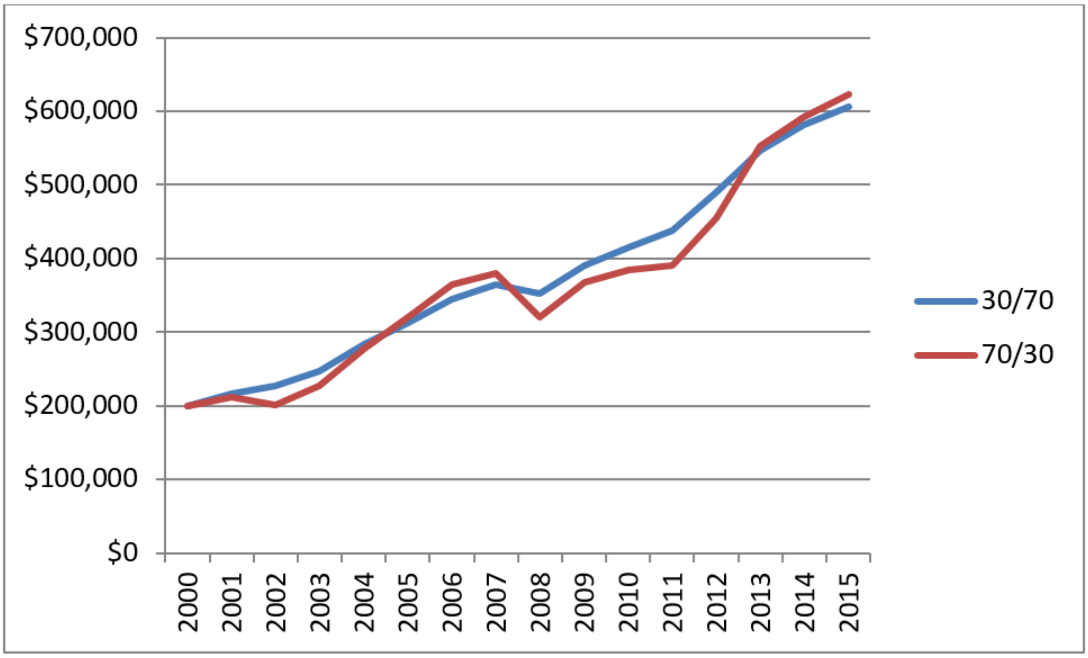
Chart 1: Returns for growth/defensive asset allocations of 30/70 and 70/30 for 12 months ended 31 December each year (after fees and tax of 15% on super earnings)



Source: Perpetual. Investment returns are the post fees and tax of Perpetual WealthFocus Super Perpetual Conservative Growth (30/70) and Perpetual Super Balanced Growth (70/30). Past investment returns are not indicative of future returns.

Chart 2: Client's balance in their super account



How do the two strategies compare?

So how have these two alternative paths of returns flowed through to our client's balance at retirement at the age of 65? Somewhat inconclusively the balance of the client at the end of 2015 is much the same regardless of which path the client took, as shown in Chart 2 (previous page).

Over this period, the 'risk off' school could claim victory on the basis that the 30/70 path has delivered much the same level of return at a much lower level of volatility. The 30/70 asset allocation has delivered a superior risk adjusted return.

There is also some support for the 70/30 path. The client experienced the GFC seven years out from retirement, but still ended up slightly in-front at retirement in 2015. Over this period, while risk has not been rewarded, neither has it been punished.

Part of the decision on whether to reduce risk comes down to how equity markets perform over time. If each year's return is essentially a random selection from a range of possible outcomes, then risk reduction is an important step to take.

However, if there is a relationship between year-on-year returns then long-term equity market returns may not be as risky as suggested by the volatility in 12-month return. Periods of bad returns tend to be followed by periods of better than average returns and vice versa. This can be seen over the 2000 to 2015 period with the tech wreck of 2002 being followed by strong returns from 2004 to 2006 and the GFC of 2008 being followed by the strong returns of 2012 and 2013. This view is that markets over react to both good and bad news, swinging between periods of under and over valuation.

Superannuation is the ultimate long-term investment strategy for an individual in that the timeframe is for the whole of the client's life. The timeframe does not end at retirement, but continues (hopefully) for another 20+ years. If periods of poor returns are followed by periods of better than average returns, then clients have the capability (but not necessarily the willingness) to maintain exposure to risky assets as they approach retirement.

Asset allocation in the pension phase

The pension phase is complicated by the pension payments made from the member's account. Let's assume the member will have four alternate paths depending on their two asset allocation choices and two drawdown choices.

The member is 65-years-old and the year is 2000. They have accumulated a superannuation account balance of $500,000. They are commencing an allocated pension and have the choice of an asset allocation to growth/defensive assets of 70/30 or 30/70. Their desired income is 6% of their account balance, which they may choose to specify as a dollar amount (increasing by 2% p.a. for inflation) or as a percentage of their account balance.

The member is invested in the pension equivalent of the funds described in Chart 1 above. The following two charts (next page) compare the impact of the returns on the client's account balance when they are drawing a pension.

A set pension payment with an asset allocation that results in volatile returns is not a good combination for the member. The member is better off with the lower risk 30/70 allocation. However, with the variable pension payments, the member is better off with the higher risk 70/30 allocation.

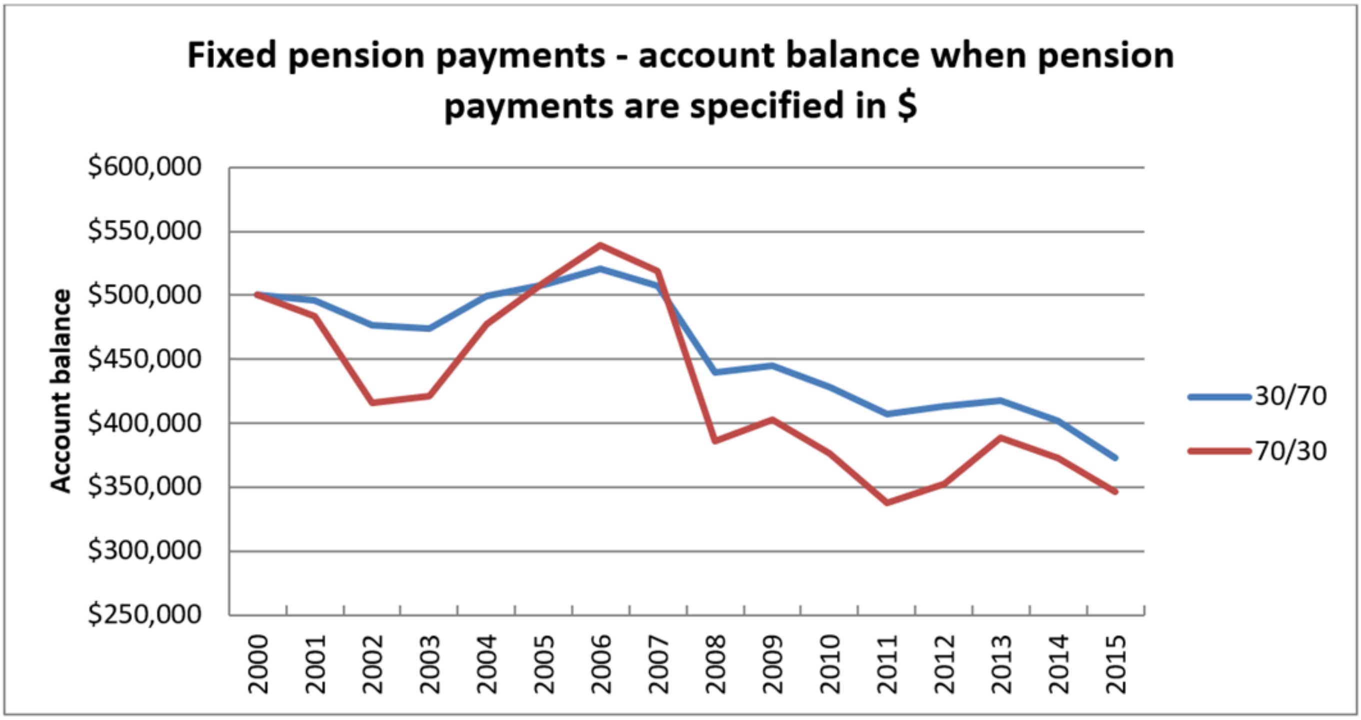
The reason is that specifying the pension payment as a set dollar amount results in a 'reverse dollar cost averaging' effect where more units are sold when markets are down and less when markets are up. The impact of this is greater the more volatile the returns.

Alternatively, specifying the pension payment as a percentage of account balance works as an automatic stabiliser. Pension payments are lower when markets are down and higher when markets are up. This works in favour for members holding more volatile investments in terms of preserving their remaining balance.

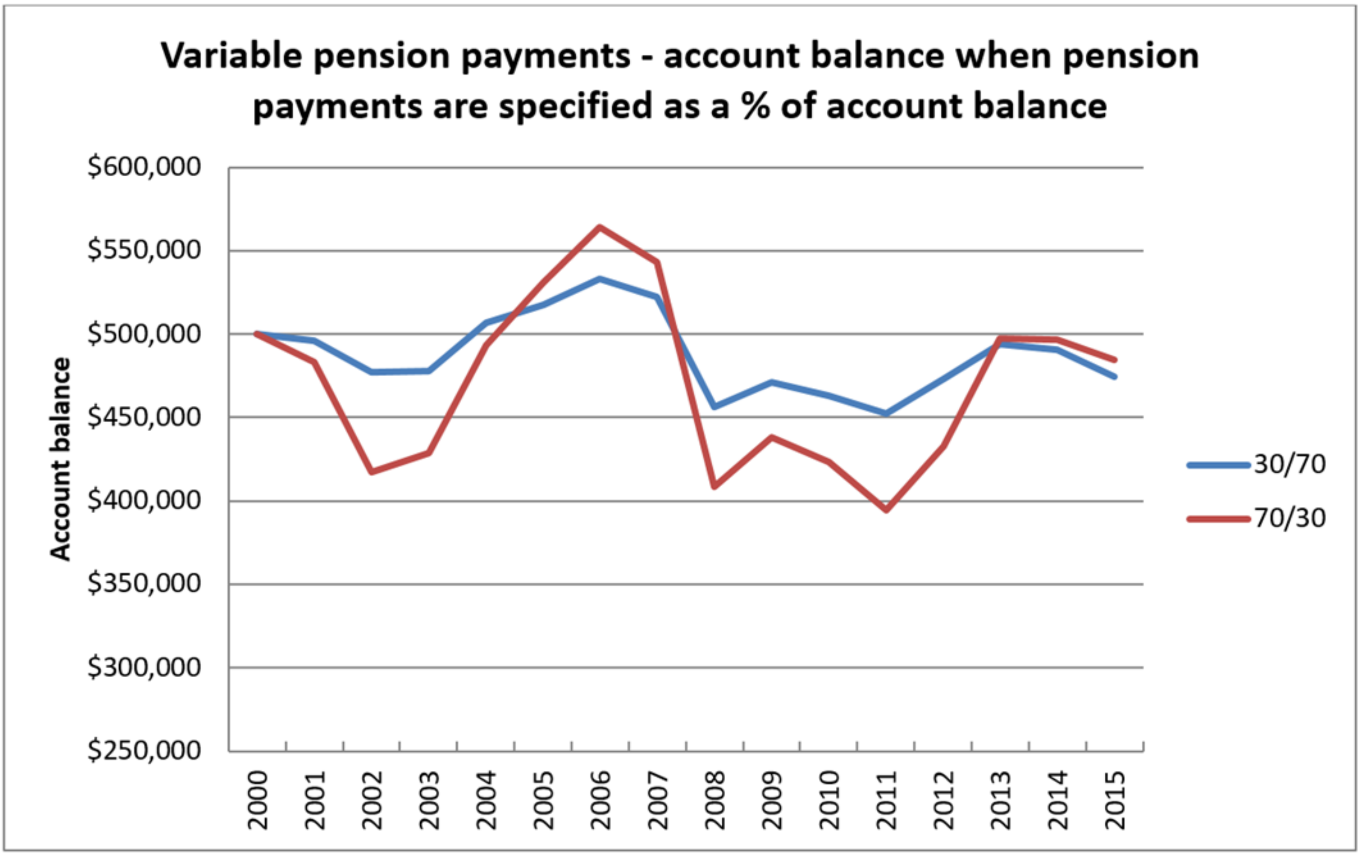
Pension drawdown method affects asset allocation decision

Therefore, the method of pension drawdowns has an impact on the asset allocation decision. For clients requiring the certainty of income of a specified dollar amount, the exposure to growth asset should be reduced. For clients with the capacity and willingness to accept some volatility in income by specifying their pension as a percentage of account balance, a greater exposure to growth assets may be appropriate.

Gordon Thompson is Senior Product Manager Platforms at [Perpetual Investments](). This article is general information and does not consider the circumstances of any individual.



Pension payments specified as a set dollar amount, set initially as 6% of the member's account balance in 2000. The dollar amount is increased by 2% p.a. for inflation.



Pension payments reset each year to 6% of the account's balance.

Bankers must realise they are already fiduciaries

Ashley Owen

As a 'banker' for half of the past 30 years (Citibank, HSBC/Midland, ANZ) including at senior executive levels reporting directly to the Group Chief Executive, I conclude that 'culture' comes mainly from personal principles and ethics. And these mainly come from within, driven by childhood and family values. In the old days of 'careers for life', some culture might have come from the formative years in a career job. Now, in the era of frequent job and company hopping, it is more about beating the numbers to look good for the next bonus or employer, which inevitably means short-term gains. These often involve papering over problems, deferring expenses, accelerating revenues, etc. Just like short termism with our two- to three-year election cycles, it is extremely difficult to change.

Remuneration is key

Add the 20:1 to 30:1 gearing in banks plus the leverage in executive option packages, there is the potential to make big dollars fast, as rewards guide behaviour. That will only change when fractional reserve banking is radically wound back to say 5:1 gearing (such as former Bank of England Mervyn King's plan) and either banks or bank salaries are nationalised, which tends to be the European way. I believe both of these radical outcomes (nationalisation and lower gearing) will eventually happen, but only after a very major crisis, much more serious than the GFC.

An early sign what is coming is the statement by the Australian Bankers Association, in response to the call for a Royal Commission, which includes:

"We intend to strengthen the alignment of remuneration and incentives and customer outcomes. We will work with regulators to implement changes and, where necessary, seek regulatory approval and legislative reform. Each bank commits to ensure it has overarching principles on remuneration and incentives to support good customer outcomes and sound banking practices."

The model of choice today is denial and doing the minimum to delay the problem as much as possible (Japan, Europe approach) or water down reforms so they are minimalist (US approach). The same old banks are even bigger and badder than they were before the GFC and the regulators have not helped.

We will see what is achieved by the new funding and determination by ASIC and its boss Greg Medcraft.

Economy relies on public confidence in banks

I think banks already have a super-fiduciary duty. Not legislated but implied by their central role in the whole economy. Banks (not governments) create most of the money in the economy, and bank deposits (ie unsecured bank debt) are assumed blindly by the public to be 'cash' and unquestionably reliable, liquid and safe. Maintaining public confidence in bank debt (deposits) as cash is the central core of all public confidence in money, and underpins all spending, which in turn underpins employment. Bankers should not forget their fiduciary role, or the economy will fail.

What does that mean? Recall that the evaporation of confidence in money thanks to the money-printing inflation in the later years of the Roman Empire plunged Europe into a thousand years of barter and feudalism (5th century to the 15th century, aided and abetted by the Catholic Church's outlawing of lending at interest). Trade and commerce ground almost to a halt for a thousand years in Europe. Most people returned to living from hand to mouth and there were no economic surpluses to fund arts and sciences, so innovation and productivity gains stopped (hence the 'Dark Ages'). China and India flourished far better than Europe until Marco Polo brought back tales of wealth and wonder and triggered a resurgence and renaissance in Europe in the 15th century.

The fragile myth that allows society and the economy to function

Today, everybody is paid their wages in bank deposits, and people believe that bank debt is cash. Public confidence in bank debt is absolutely critical to the functioning of the entire economy. If today's bankers' greed and self-interest results in a breakdown of public confidence in banks (ie money), people will once again resort to barter. It will encourage alternatives to banks, such as peer-to-peer lenders, bitcoin, etc.

Thus far, the banks have managed to keep public confidence but assisted materially by the government guarantee. This must be removed. It creates a moral hazard and take bankers' minds off the central importance of their super-fiduciary duty.
Thus far all the bank scandals in Australia have been at the periphery – financial planning, FX trading, bank bill swap rate rigging, over-charging of fees, credit card interest rates, isolated cases of staff skimming

from accounts, isolated rogue traders, occasional insider traders, etc. People don't regard these as important enough to erode their basic view of bank debt as 'money', which is the core of banker's super-fiduciary duty. The core asset and liability management of Australian banks is still pretty sound.

Bankers' memories fade over the decades

The core of banking is asset and liability management (ALM), ensuring bank assets (mainly loans) are there to meet liabilities (mainly deposits) when they are needed. In my experience on ALM committees, most of the attention is on the liability side. The process is usually run by the bank treasury departments (liability side of the equation). The problem is that the rogue element is credit growth, which is on the asset side of the balance sheet.

Australian banks learned the lessons from the disastrous experience of the 1893-94 bank collapses, and this served them well in the 1930s depression when they were the bastions of conservatism, unlike US banks at the time. But after 50 years, memories fade. Westpac and ANZ came near to insolvency in the early 1990s recession following the late 1980s lending binge. It was pure luck that it wasn't worse. RBA Governors Bob Johnston and Bernie Fraser (whom Paul Keating boasted was 'in his pocket') defied Keating and fortunately jacked up interest rates fast enough in 1988 and 1989 to stop the mad bank lending binge just in time, otherwise AGC (Westpac) and Esanda (ANZ) would have blown up their parent banks.

The RBA would have been stretched to bail out depositors. In the late 1980s lending binge, not only did Westpac and ANZ do their best to blow themselves up with bad lending, the state banks of every state of Australia (except Queensland, which didn't have a state bank) also went mad and were closed and sold off by governments. Most of their assets were picked up by CBA (then owned by the Commonwealth Government) without loss to depositors but at great cost to state governments and their tax payers. The early 1990s experience following the late 1980s bank lending binge taught us that we cannot rely only on central bankers to watch over and regulate the banks. Monetary policy saved the day but the supervisory function was asleep.

Rather than rely on well-meaning but under-resourced regulators and legislators, the most powerful force is the bankers' existing super-fiduciary duty, which is implied by their role as creators of money and custodians of the illusion of the safety and unquestioned liquidity of bank deposits.

Credit and ALM are all that really matters

Credit quality and growth are the key to the asset side of the balance sheet, but it is overall ALM that sets gearing and exposure levels. It is essential that the top levels of all banks understand the power of strong ALM.

The problem is three-fold. First, the current batch of bank CEOs have no deep experience in either credit or liability management. Second is the highly geared nature and short-term structure of their remuneration packages and this cannot help but skew their decision-making. Third is the existence of the government guarantee and the implied guarantee of their jobs and bonuses, which takes their mind off balance sheet management. The guarantee was probably warranted for a very short period in late 2008 but it entrenches complacency.

The current level of gearing is scary. Take no notice of those fictitious 'risk-weighted' capital ratios. They are artificial numbers based on banks setting their own rules and ratings, and on ridiculous myths like 'you can't lose money on housing loans'. What about the US sub-prime crisis, or in Portugal, or in Ireland, or in Greece, or in Spain, or in Iceland?

Unfortunately, the free market does not work, especially in Australia where we have a cosy cartel of four big banks controlling the market. The bank 'culture' issue would be solved if all bankers understood their existing super-fiduciary duties to the whole community. They are simply not equipped to handle the current 20:1 to 30:1 gearing ratios without tax-payer funded safety nets. Until they are, we need tighter regulations to restrict the damage they can do to the economy.

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As with all articles in Cuffelinks, we welcome any contrary views.

Large funds need to earn retirement loyalty

Jeremy Duffield

This is the third in a series of articles highlighting the leadership attributes that can help superannuation industry executives move from the industry's historical focus on accumulation to a whole of life focus and particularly on retirement income provision.

For executives in the super industry, driving change from an accumulation focus to a whole of life focus is a major change management exercise. How do you drive change management? Leadership expert Harvard's John Kotter identifies creating a sense of urgency as step 1 of the 8-step programme he prescribes in *Leading Change*.

Where is the sense of urgency?

It's often said that you need a 'burning platform' to create the sense of urgency to drive change. While APRA statistics suggest we have that in terms of member retention, rarely do we hear the word 'fire' from our executives.

According to the 2015 report, over 50% of funds are losing more accounts than are coming in and, likewise, over 50% have higher outflows than inflows when benefits payments are included. And most funds are doing a poor job in retaining members into pension phase, with the number of lump sum payments dominating pension account openings by a factor of four to one.

The retention problems can be devastating for fund economics and, like demographic changes, can manifest themselves slowly at first and be overlooked. But continued gradual losses of members or outflows erode a fund's economic competitiveness. The industry would appear to have an impending loyalty problem.

Fred Reichheld has been perhaps the most articulate advocate of 'loyalty management' as an imperative of business success. The author of *The Ultimate Question* and creator of the Net Promoter Score championed the idea that loyalty leadership was the key driver of success in many businesses.

Loyalty drives firm economics. Firms with better client loyalty enjoy both higher revenues and lower costs. Higher revenues come from more sales to existing clients, the additional revenues from not losing clients or holding onto them longer, and from referrals from satisfied clients. Lower costs come from satisfied clients having a lower cost to serve for many reasons (eg acquisition costs are defrayed over a longer tenured relationship). And lower marketing costs accrue from referral.

Driving client loyalty

Even before I joined Vanguard in 1980, the redemption ratio (the inverse of retention) was a key driving variable. We drove redemption rates to less than half the industry average. That meant Vanguard each year had to sell billions less, later tens of billions less, and today hundreds of billions less than competitors to exceed them on cash flows. That fact, certainly more than large or clever marketing spend, was the driver in making Vanguard the top US mutual funds manager by cashflow for nearly every one of the last 20 years.

Client loyalty is something you have to earn and can't buy or take for granted. It's multi-dimensional as clients appraise your features and services against competing offers. It's built on trust over time, is hard won and easily lost. It's often built on a relationship - personal or brand-related - and a sense of engagement. The heart of a firm's strategy and execution should be beating to earning client loyalty.

But it's also obvious that there are certain critical points in customers' lives when client loss is more likely. The two most important for our industry are job change and approaching retirement. We'll focus on retention at retirement here. People over 50 control more than 60% of assets in the super system and balances are, on average, much larger for pre-retirees and retirees than for younger members.

Member retention in retirement

It should be an urgent and galvanising problem that many superannuation funds are losing more than 90% of their members going into retirement phase. Ironic indeed that a fund should nurture its members throughout their working careers and then lose them when the fund should be helping them with the ultimate mission of the super industry: assistance through retirement years.

Talking to fund executives, few have really taken the retirement phase loyalty challenge to be a matter of urgency, and there are even some executives who think the fund is only about accumulation. Some funds don't even offer a pension choice.

It's a loyalty leadership challenge. A multi-year and multi-dimensional approach to increasing the organisational focus on retirement is needed. The fund needs to demonstrate its credentials and interest in helping members with their journey to and through retirement. Raising awareness that the fund is there for the member in retirement is a key element.

Providing retirement income forecasts is an obvious and effective way to start members thinking about retirement with the fund, supplemented by coaching and advice solutions. Advice is probably the best way to help members with retirement. And as traditional advice won't reach the vast majority of members, digital advice has to come to the forefront, with the option of triaging to traditional telephone based or face to face advice when needed.

Simplifying the transition to retirement is also critical. A complex transition is the enemy of member loyalty. Behavioural finance research shows how making something easy is a winning strategy for serving members. A default solution, like the government's mooted Comprehensive Income Product for Retirement, may well be part of the answer.

It's critical to the member that they make the right choice and get the help they need to do so. The right decisions at retirement are challenging and highly personal. Default MySuper may get many members through their accumulation phase but in retirement members will need a personalised solution.

To focus on maintaining loyalty, the right metrics are critical. As Peter Drucker argued, "what gets measured gets improved." Funds should establish their loyalty metrics around retirement and then work relentlessly to improve them.

Fund executives have a burning platform to move fast on client retention around the retirement phase. They must develop the sense of mission that can motivate their teams around highly measureable goals. Funds that lead and win in maintaining client loyalty through retirement will grow and prosper.

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Lenders asleep at the wheel on Arrium

Jonathan Rochford

When people ask me what I do for work, I often tell them I spend my time lending money and getting it back. Those who understand lending often laugh. Anyone can lend money, it is getting it back that makes a lender profitable. This has two key components: the initial analysis and the ongoing monitoring.

The initial analysis

The importance of initial analysis is understood by pretty much all lenders, in that they have some process for making a risk assessment. In my experience working in banks, the initial assessment for institutional loans is typically very long (10-100 pages) and often requires the approval of several risk committees. Much of the report is copied and pasted from previous reports, with true original risk analysis often lacking.

The reason for the length is that many lenders haven't yet figured out how loans go bad and thus spend a lot of time covering potential risks that aren't really risks at all. The Narrow Road Capital process zeros in on volatility, ratios and structure as the key risks and initial assessments can be kept to a reasonable length. The old banker's saying that "there are no new ways to lose money" is a reminder that a healthy knowledge of previous defaults and their causes is the best guide to the future.

The ongoing monitoring lacking for Arrium

Getting the money back requires ongoing monitoring. My experience here is that many lenders, including the major Australian banks, do a poor job of this. Monitoring covenants and quarterly reports is typically given to a junior staff member who simply confirms that the ratios don't breach the covenants. There's little or no meaningful analysis done by the experienced staff. It wouldn't take much time, perhaps 15 minutes per company per quarter would be sufficient to pick companies that are deteriorating and where action should be taken.

In the case of Arrium the banks claimed that they were shocked when presented by management with a proposal that would have seen them take a 45% loss on their exposures. They shouldn't have been surprised. Arrium had been struggling for years and anyone who was conducting regular monitoring would have seen the problems coming.

Arrium summarised financials (A$m)	FY 2013	FY 2014 pre-raising	FY 2014 post-raising	FY 2015
Revenue	6,954.9	7,132.1	7,132.1	6,179.4
EBITDA	531.7	781.1	781.1	(90.0)
EBIT	(715.1)	400.5	400.5	(1,880.7)
Interest	(119.7)	(117.5)	(117.5)	(93.2)
Discretionary cashflow	253.3	483.0	483.0	(331.6)
Net Debt	2,128.6	1,735.0	1,003.0	1,739.8
Market capitalisation	833.4	888.0	1,174.9	411.2

The problems are obvious in the 2013 financial year, with substantial write-downs leading to negative earnings before interest and tax (EBIT). The market capitalisation was very small when compared to net debt. **This was clearly a sub-investment grade credit.** Despite this, in June 2014, US$725 million of unsecured debt was renewed at an interest rate of roughly 4%. The failure to increase the interest rate to reflect the sub-investment grade risk and the failure to take security is mind-boggling. That was compounded by the lack of proper covenants, which would have given the banks a clear warning of later problems.

In September 2014 Arrium undertook its infamous capital raising. $754 million of new equity was raised, but the share price was trashed in the process falling from 65 cents to 40 cents. The net proceeds of $732 million reduced debt levels materially, but only increased the market capitalisation by $287 million. Just after the capital raising was an ideal period for an alert lender to sell their loans. The business had recorded losses, was poorly managed and had two high cost business units (steel and iron ore mining) that had deteriorating fundamentals. Despite this, the banks didn't act.

Ongoing deterioration

By December 2014 the share price reached $0.16 with the market capitalisation below $500 million. At this point the banks should have known that they were on their own, equity wouldn't be able to stump up any reasonable amount to de-lever their position. When the half year results were announced in February 2015 there was another round of write-downs and the business was unprofitable even on management's 'underlying' results. Net debt rose by $427 million in the three months from the capital raising to the end of the period. It was now clear that the company could not de-lever from either an equity raising or positive cashflows, without an enormous increase in the iron ore price. The writing was on the wall a year before the debt haircut proposal was announced.

The 2015 full year results in August 2015 contained another $310 million increase in net debt. The half year results in February 2016 added another $336 million of net debt. By this stage, net debt of $2.077 billion towered over the market capitalisation of $146 million and the 'underlying' EBIT of $7 million. Days after the February 2016 half year results announcement, management put forward their restructuring plan which involved the lenders taking a 45% haircut. The banks claimed they were blindsided by the plan, but what alternative did they have? The potential sale of Moly-Cop was never going to yield enough to see the debt repaid in full. If Moly-Cop was sold Arrium would have been left with a rump of unprofitable business units and debt they had no hope of servicing.

The mistakes made by the banks illustrate a failure to monitor their borrower and to structure their lending appropriately. A proper credit process would have:

- not rolled over the debt in 2014 and forced the company to take seriously sale options
- if debt was extended it would have been with security and with much higher margins
- kept the facilities much smaller, restricting Arrium's ability to incur more debt
- implemented proper covenants so that the underperformance would have triggered a default event
- sold the debt in late 2014 or early 2015, even if a small discount to par was required.

The big four banks are now looking at a loss of 30-60% of their exposures ($75-150 million each) and an extended workout period. In my time in workouts I've seen many examples like Arrium, situations where it was obvious 12-24 months in advance of a crisis point that a loss was highly likely. At a time when everyone is focusing on return on equity, arguably the best investment return would be found by properly monitoring existing loans.

Jonathan Rochford is Portfolio Manager at Narrow Road Capital and this article expresses the views of the author at a point in time. It is for educational purposes and is not a substitute for professional and tailored financial advice. Narrow Road Capital advises on and invests in a wide range of securities.