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The returns to expect from gearing into shares

Graham Hand

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

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

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

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

Sorry, the returns don't work like that.

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

Margin Lending, Reserve Bank of Australia, Table D10

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

At the market's peak, a quarter of a million Australians borrowed \$41 billion secured against \$93 billion of shares, and this is only one part of the equity gearing market. There is also an unknown amount of drawings against the equity in home loans, internally geared share funds, and other products such as instalment warrants. And when investors do not fully understand the risks, a scandal such as Storm Financial is created, where the Townsville-based adviser had 13,000 clients with \$4 billion invested, much of it borrowed by people without the means to repay.

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

Borrowing to invest will increase if market remains strong

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

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

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

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

The calculation which many geared investors overlook

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A geared investor needs high risk tolerance

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

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

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

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

Sequencing risk and ways to manage it

Kevin O'Sullivan

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

An example of 'sequencing risk'

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

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

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

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

When are individuals most exposed to sequencing risk?

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

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

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

How to mitigate the risk

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

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

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

- **Reduce the level of investment risk as retirement approaches.** The aim is to lower the chances of significant losses on a retirement nest egg, but when should an individual start to de-risk? What are optimal levels of risk to accept? As most individuals' superannuation savings will remain invested for many years after their retirement, should they de-risk as much as occurs in some target date funds? If they take too little risk they may end up with insufficient retirement income. With too much risk, poor returns can erode their savings and jeopardise the sustainability of their retirement income.
- **Increase the level of diversification in the savings portfolio.** But even with greater diversification, poor performance still can occur. Also, at times of stress in the markets, assets previously considered to be uncorrelated may follow each other down.
- **Buy annuities and/or deferred annuities.** This can address post-retirement sequencing risk but doesn't address pre-retirement sequencing risk. Also the market for annuities in

Australia is still relatively small and individuals could be exposed to high annuity prices at time of retirement.

- **Spread contributions more evenly over a working life.** Risk could be more evenly spread if contributions were high initially and decreased as one approaches retirement, but individuals would likely be reluctant to put more money into super when they are younger.
- **Adjust asset allocation over a working life.** Higher exposure to growth assets in the early years than occurs with typical exposure levels by investing mostly in equities (or achieve even higher than 100% exposure using call options or gearing) when younger but switch to less volatile assets when approaching retirement.
- **Keep sufficient assets (about two years of expenditures) in a liquid fund.** This would allow an individual to avoid the need to cash out investments after a significant fall in the markets, before markets have had time to recover. But this does not provide protection from risk on the balance of the portfolio.

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

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

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

Kevin O'Sullivan is Director, Actuarial & Benefits Consulting at Russell Investments.

Don't spend your career further exposing yourself

David Bell

Media Super, an industry fund for those in the media, creative and digital sectors, recently announced that it was investing in a financing facility for local film production. It is interesting to think this through, and lifecycle theory (see article in *Cuffelinks 1* for an introduction to this subject) is a useful framework to apply.

In short, lifecycle theory is about maximising a lifetime of consumption and leisure. Our work, saving and consuming, and investment choices are the levers at our disposal. Of course there is much randomness as we don't know how our lives and the world will pan out. However we can manage the risks we see. The alternative is the typical portfolio construction approach (commonly using mean-variance style techniques) where we focus on the portfolio outcome ignorant of other features of our lives.

One risk to consider is how our investment portfolio interacts with other risks in our lives. A key aspect is our income. It may be exposed to shocks, in particular unemployment, and part of the growth in our income will be linked to the performance of the employer, the sector and the economy as a whole. And income is important as it affects how much can be contributed to superannuation and other forms of savings.

Given that it is impossible to perfectly hedge risks to our income it makes sense to diversify such risks. Rather than focussing on the *optimal* way to diversify, let us first consider the three most *obvious* ways.

The first way would be to not invest in shares of the company you are employed by. If the company performs poorly your funds for retirement will be adversely affected at the same time that you may be exposed to the risk of being laid off or not experiencing pay increases. An unfortunate example of this comes from the US. In the US corporate 401(k) pension plans (their retirement savings vehicles), companies commonly had their own stock as an investment option. Many employees of Enron (the energy and commodities firm which turned out to be a major fraud) lost their jobs, entitlements and much of their retirement savings as they invested their 401(k) plans in company stock. This practice is still allowed in the US and in some cases employees continue to make large allocations to their own stock.

Why? A possible reason is behavioural: many people take comfort in the fact that they at least know their own company, although the majority of employees know little about valuing and buying their own company's shares. In superannuation, people with their own SMSFs have the opportunity to directly manage this risk. It may be an area where financial advisers can add value to their clients, and it is an issue that trustees of corporate superannuation funds should think about.

Of course an alternative view is that executives should have 'skin in the game' and owners of small businesses will probably put most of their capital into their own business. These are special cases where either there are additional benefits (participation in high wages, bonuses, options etc), or small business owners have substantial inside information. For the average worker, their insight into the company they work for will not be significant.

A second approach would be to avoid investing in shares in the sector in which you work. For instance consider someone who works on the resources sector, where there is a high correlation amongst stocks within the sector. There is a risk that a collection of your investments may perform poorly at the same time as you experience income risk. Media Super is but one example. CBUS (an industry fund for construction and building services) and HOSTPLUS (hospitality, tourism, recreation and sport) both have investment exposures to the industries their members work in. I do not know of a single industry superannuation fund which has a policy to not invest in the industries from which their members draw their income. And yet this seems to be the best thing to do in terms of diversifying a key risk to lifecycle outcomes (and indeed a wonderful opportunity for industry funds to differentiate themselves from their retail counterparts who draw members from various industries).

Why doesn't this occur? Well, industry funds may want to be seen to be supporting the sectors in which their members work. I remain unconvinced on the merits of this. Any individual industry fund represents a small amount of the total capital in the world and is unlikely to make a significant difference to the economic outcome of a sector. And if it is being done to be seen to be supporting the industry, then this is unjustified relative to the extra lifecycle risk being imposed upon members.

However the sector investments may be justified if they come with a higher return potential based on insights gained through the fund being associated with sector specialists. For instance, Media Super Chief Executive Ross Martin, with respect to the film industry investment, was quoted as saying,

"Members have earned a competitive return from this unique portfolio and the assistance from our industry partners has been invaluable for the scoping and due diligence required for this kind of alternative investment."

This benefit may well compensate for any increased concentration in risk to lifetime financial outcomes.

A third technique is to re-allocate from domestic equities to global equities. Academic research has shown that such an approach may be justified because the returns from global equities are less related to Australian economic conditions and thus a better diversifier to income risk. However Australian equities remain the largest asset class exposure across most superannuation default funds. Australian superannuation funds exhibit a home country bias, as do many retirement systems around the world. Once again there are reasons to explain this, some acceptable, some less so. One acceptable reason is the benefits of franking credits (as discussed by Chris Cuffe in *Cuffelinks 1*). Another reason may be taking comfort in the familiarity of Australian companies, but having some familiarity with an investment doesn't offset its risk, and greater financial education may assist here. The final reason commonly cited is peer group risk, that it is risky to act differently than the peer comparison group. This is not acceptable as there is little evidence that managing peer group risk enhances member's retirement outcomes.

This is an interesting example of how lifecycle theory, where we think about all the factors which may affect our outcomes, should lead to different portfolios for people working for different companies and industry sectors. And while I relate it back to theory (that's the academic in me), it is all just common sense. Don't put all your eggs in the one basket, or to stretch the idioms, don't get your butter from where you earn your bread. In superannuation, SMSF's have the greatest ability to specifically manage this risk, as they have complete investment flexibility. Financial planners should incorporate it into their risk assessment. This is an important issue for corporate superannuation funds to consider. And there is an exciting opportunity for industry funds to be more member-focused than retail funds.

[Inside the hidden world of diversified income funds](#)

Campbell Dawson

Diversified income funds which invest in a range of debt, bonds and hybrids have been extremely popular and have performed well recently. With cash and term deposit rates falling, this popularity will continue, but most investors in diversified income have little knowledge of what their fund buys and where its exposures lie. Many investors incorrectly assume that because of the focus on 'income' and 'fixed interest', the returns should be relatively stable and similar to term deposits and even cash.

Our conclusions are that most of the asset sub classes that make up global diversified income funds are not 'income' at all. Returns are volatile and dependent on changes in the capital value derived from equity markets, changes in high yield margins or movements in long duration bonds. We calculate that a typical diversified income fund is actually around 30% equity and 10% long bond exposed.

Diversified income funds – what's in the recipe?

Although every portfolio is different, most of the diversified income portfolios offer a combination of the following assets or sub sectors:

- global investment grade bonds (fixed rate, investment grade)
- global high yield bonds (fixed rate, sub investment grade)
- convertible bonds (fixed rate, sub investment grade on average)
- high yield bank loans (floating rate, sub investment grade on average)
- hybrids (floating rate, low investment grade on average).

The charts used in this paper are rather busy, but each coloured bar represents a type of security, as listed above, included in a typical diversified income fund.

Returns

We gathered benchmark and fund data to evaluate the drivers of returns and risks of these assets. We used four return periods; 2012, 2011, the post GFC period (September 2009 as the starting point to avoid the immediate post GFC bounce), and the GFC period (defined as March 2007 - March 2009). In addition, because most bonds are fixed rate, we isolated the credit spread on BBB and BB bonds to calculate the 'credit effect'. The non AUD component is generally hedged into AUD.

The return results on the graph below can be summarised as:

2012 returns: all sectors performed well, including investment grade and non-investment grade credits, aided by a contraction in margins and small falls in interest rates.

2011 returns: any sub sector with equity exposure did badly (markets sold off heavily), while anything with duration did well (US bond yields fell) and Australian hybrids did okay.

Post GFC returns: equity-related income produced reasonable returns while duration-related assets performed well, and Australian hybrids did better than high yield bank paper.

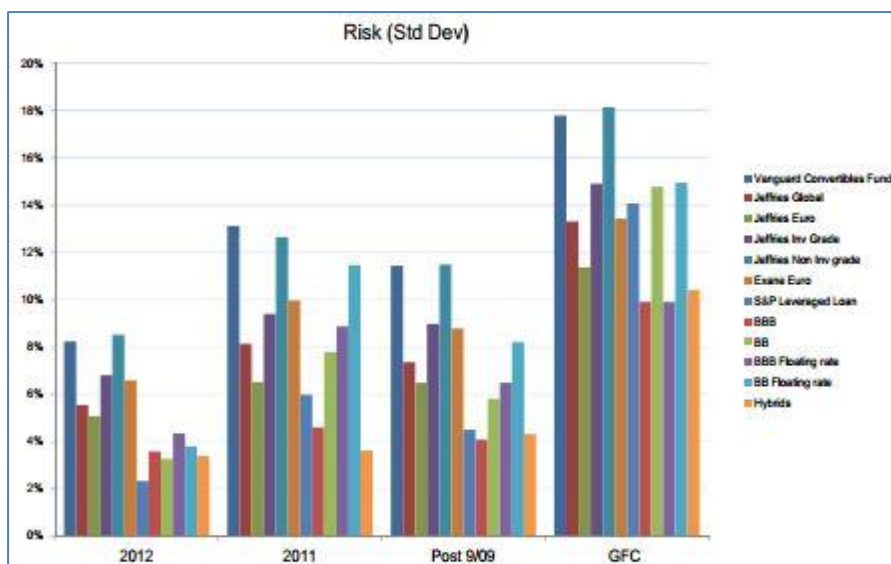
GFC returns: convertibles obviously produced poor returns given the implicit equity exposure, fixed rate BBB bonds performed relatively well given the fall in fixed rates and Australian hybrids did poorly.



Risk

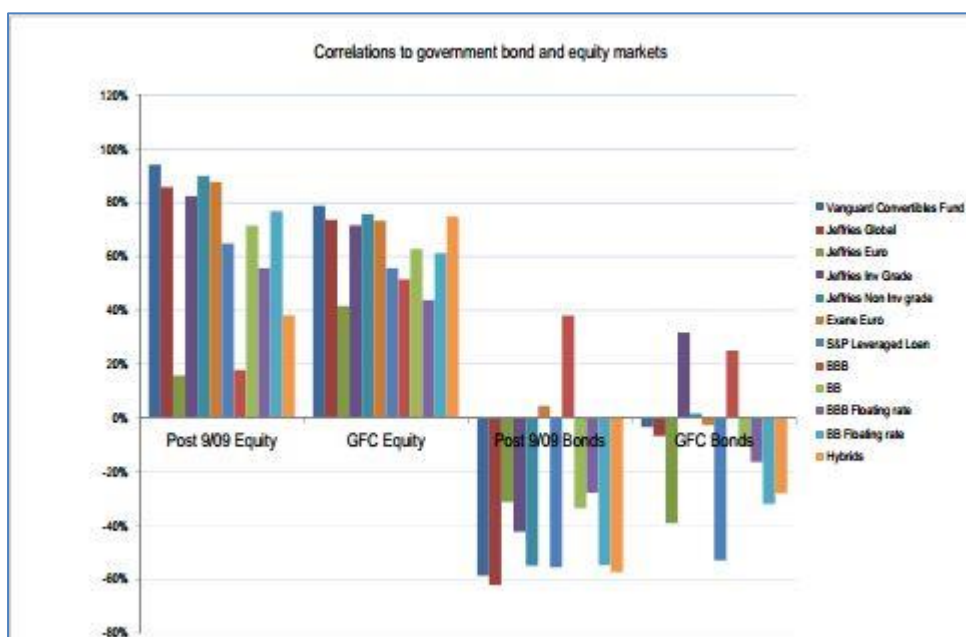
The chart below shows the risk (annualised standard deviation) over the same time periods of the same types of security. The pattern is consistent over all periods:

- convertible bonds display risk that is around half that of the equity market
- all the 'credit'-type subsectors have lower risk by up to half that of equities
- hybrids are the least risky of the subsectors.



Surprising correlations

The following chart displaying the correlations to equity and government bond markets was the one that surprised us the most.



Our conclusions include:

- convertible bonds have a high correlation to equity markets and negative correlation to bond markets. Investors in convertible bonds have about a 40% equity beta on their investment. It's not income at all.
- high yield bank loans display a high correlation to equity markets and given their floating rate nature, a high negative correlation to government bonds.
- BBB fixed rate bonds have a low correlation to equities since the GFC (but not during the GFC) and a high correlation to government bonds. An investment in US BBB bonds will be dominated by changes in fixed rate bond yields. It is not alternative income.

- other credit-type investments show the 'expected' correlations. That is, a relatively high correlation to equities during the GFC and less so afterwards, and low correlations to government bonds (except for BBB fixed rate credit).
- Australian hybrids have displayed a relatively low correlation to equities since the GFC.

Hedging – the interest rate differential bonus

The factor that has made diversified income funds really work for investors since the GFC has been the hedging interest rate differential. When investors buy non AUD assets and hedge them, they receive the interest rate differential. Since the GFC the interest rate differential has been in the order of 2% to 3% p.a. Most of the return of the diversified asset classes has been capital in nature, so the interest rate differential has been an added bonus. Note, however:

- the process of hedging is complex and it is difficult to remove all exposures. For example, if you had hedge a \$100 investment in US high yield pre GFC and its price fell to \$80, you are exposed to the currency effect on the unhedged amount. The AUD fell around 30% after the GFC which would have resulted in a 6% currency loss to add to the asset loss. In addition, legal agreements often allow counterparties to require collateralisation or a cessation of the hedge.
- interest rate differences are narrowing and therefore, the hedging benefit is unlikely to deliver the same level of 'income' in future.

Value of an allocation to hybrids

Hybrids are valuable in a diversified income portfolio for the following reasons:

- the listed hybrid market is now predominantly an investment grade, floating rate market, and while there is more event and maturity risk, there is no interest rate duration risk
- there is less equity risk than alternative sectors, and therefore correlation benefits
- they have been, and are more likely to be, less volatile than other alternative sectors
- yields on hybrids are currently higher than other alternative income sectors, although there are varying views about risk-adjusted returns
- for an Australian investor, there are benefits in not having to hedge currency risk.

Portfolio structure and future returns

Our analysis indicates that 'income' is often not really income at all. Returns are volatile and dependent on movements in the capital value of equities and fixed rate bonds and changes in credit margins, and investors must decide if they want these exposures in an 'income' fund.

Diversified income products should work by combining subsectors with various risks that have a correlation benefit. However, many of the securities used are highly correlated to equities and long duration bonds, and can suffer significant capital losses at times of market stress.

For the past few years, there has been a favourable combination of excellent overseas equity markets, contracting credit margins and falling bond yields which have bolstered returns. In addition, Australian investors have earned the currency hedging benefit. If there is a reversal in some or all of these factors, returns are at risk in these types of income funds.

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Dynamics, disruptions and opportunities in 2013

Andrew Gale

How tough can life be? To the casual observer it might appear that industry participants in Australia's \$1.5 trillion superannuation and wealth management sector are assured of future prosperity and revenues served to them on a plate.

Think again.

Behind the big numbers and mandated growth is an industry jostling to get on top of fundamental shifts, each with potentially highly disruptive consequences and opportunities for those who are fleet of foot.

Here are six market-shaping forces that I foresee.

1. Middle Australia and the rapid growth in 'scaled'/'scoped' advice

Australia's 20,000 or so licensed financial advisers are already migrating to higher value segments (mass affluent, affluent and High Net Worth). The transition to 'fee for service' and 'opt-in' arrangements will hasten this trend.

There is a real risk that Middle Australia will be disenfranchised from advice in the process. MySuper may increase the degree of member disengagement with super. Industry funds and bank channels will dominate advice delivery to Middle Australia, predominantly through 'intra fund' advice and what is variously known as 'scaled', 'scoped' or 'limited' advice. A series of scoped or scaled advice provisions covering different issues may largely displace comprehensive advice in this sector. How well this is delivered will determine the extent to which Middle Australia is engaged with advice.

Scaled advice delivery will need to be very efficient to close the gap between the cost of delivering advice and what members and investors are prepared to pay. Therefore, expect a significant increase in the use of technological solutions, including call centres, online, mobile apps and co-navigation approaches.

2. Continued inexorable growth of SMSFs

This inexorable growth is no longer news. It is more interesting to examine the granularity of the next stages of growth, such as:

- Post-retirement. The growth in the post-retirement population over the next 20 years is mind-boggling, with different quinquennial (five year) age groups (e.g. 65-70, 70-75, etc) growing between 60% and 100% between 2010 and 2030. There will be major boost in the 65-70 years segment over the next five years as the first of the 'boomers' reaches the mid-60s retirement milestone. Based on the Deloitte Superannuation Model, SMSFs will account for close to half the prospective fund flows in post-retirement. There is a need for much greater sophistication in post-retirement advice and investment solutions, including the use of investment scenarios or stochastic modelling in building optimised portfolios. This poses particular challenges for product and advice providers.
- Gen X. Strong growth in SMSF establishment is coming from this age group, with something like 25% of new SMSF trustees being people aged less than 45.
- 'Coach seekers'. Based on the SPAA/Russell Investments research conducted by CoreData in February 2011, the first major wave of SMSF trustees and investors was dominated by DIY people or 'controllers'. The next wave will be the 'coach seekers', who seek a more co-navigation experience with service and advice providers. This second wave will be more pre-

disposed to use of Managed Discretionary Accounts (MDAs) and similar structures as part of advice execution.

3. Political, regulatory and self-regulatory developments

There is obviously a risk that superannuation will be a political football in an election year. Various bodies including the SMSF Professionals' Association of Australia (SPAA), the Financial Services Council and Association of Super Funds of Australia are advocating bipartisan support for sound, long-term policy and commitment to superannuation rather than short-term tinkering, which could erode confidence in superannuation. The political parties are aware of the voting power of the baby boom bulge which is approaching retirement.

Other key regulatory issues are:

- The FoFA proscribed Best Interests Duty. FoFA is likely to have profound implications, and Best Interests Duty is largely principles-based and therefore more powerful than any prescription-based regulation. It is likely to affect portfolio construction with significant implications for fund managers and will shape the major growth area of scaled or scoped advice.
- Licensing. The removal of the accountant SMSF exemption and the introduction of an SMSF-specific licensing framework with a three year phase in from 1 July 2013 will also have a significant impact. Enlightened accountants will move ahead of the required timetable, and that, due to residual ambiguities in limited licensing, many accountants will opt for full licensing, or have strong partnering arrangements with financial advice firms. Accountants will be at the vanguard of a renaissance in the independent advice sector.
- APES 230. This draft accountant professional standard is still being debated and a final form is imminent. The current form is much more onerous than FoFA, including retrospectivity provisions, and has the potential to be very disruptive. It poses a challenge for the professional accounting bodies in terms of how they respond – the Institute of Public Accountants has already indicated its position. And, lest financial advisers think this is only an issue for accountant-based advisers, there is real contagion risk with APES 230. Some of its provisions extend more broadly, including to licensees and product providers (especially life companies and lenders), and there is a risk that ASIC will decide that APES 230 sets a new higher standard than FoFA.

4. Professionalism and advisers

Professionalism and sound practice management will witness the following:

- advisers developing clear market segmentation, with crystal clarity on ideal clients, clear value propositions and service/pricing models (if they have not done so already). They then need the discipline to consciously shift their client base to the ideal target profile.
- professionals in the accounting sector will want to be specialists in the SMSF sector, and this will drive strong interest in SPAA's specialist accreditation (advisers and auditors).
- a natural market shift from asset based fees to retainers. This should be naturally occurring and left to market forces. It shouldn't be mandated by the proposed standards in the APES 230 model or ASIC Regulatory Guidance.

5. Social media in the wealth management and advice sector

In terms of the classic 'S curve' in product and service adoption, the use of social media for business purposes is still in the early stages of the S curve. Expect 2013 to be the year that this really takes off, with fund managers, platform providers, licensees and advisers all rapidly adopting social media for both sourcing new clients and engaging and servicing existing clients. When the penny drops that a sound, well-executed social media plan has the potential to be enormously more powerful than traditional 'above the line' marketing such as television, radio and print advertising, then this medium will really come of age.

6. Corporate activity

Although some large wealth management transactions have already been done, there will be continued strong activity in the following areas:

- change in ownership of practices (both financial planning and accounting), driven partly by demographics (age of practice principals), but also the merger of planning and accounting practices and competencies.
- continued licensee consolidation, driven by industry dynamics, FoFA regulation changes and the need to modify business models.
- fund managers, largely driven by industry dynamics such as shifts to core/satellite, and a shift to cheap beta strategies (e.g. passive funds and ETFs), insourcing of investment management by large super funds, and arguably an excess of boutique fund managers.
- SMSF strategies, such as AMP's acquisition of Cavendish and a 49% interest in Super IQ, as mid-large wealth management organisations more clearly define where and how they will participate in the burgeoning SMSF sector.

With all this in the pipeline, 2013 will be a year of disruption, but as always when so much changes, it will also be a year of opportunity.

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