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A brighter view of dependency ratios

Bruce Gregor

Gloom and doom stories are easy to write concerning future ratios of retired population to workers (and I have written such articles). I am not backing off from using these ratios to criticise governments about better balancing the promises of pensions and health care with future revenue capacity. However there is a more positive view we can put to individuals and their advisers who **do** face up to their own balancing of life expectations and future income.

Let's reflect on this Dependency Ratio measure. It's generally been calculated as population aged 65 and over divided by population aged between 15 and 64. Alternatively it can be inverted and shown as 'workers' (population aged 15 to 64) divided by 'retirees' (population aged 65 and over) and that's the way I will express it here.

When the Australian age pension was introduced in 1909 the ratio was 15.0 (i.e. 15 workers per 1 retiree). If we use the same age brackets and current population data (2011 census data) we get 4.9 workers per 1 retiree. Projecting this population and future expected longevity trends the ratio declines further to 3.5 in 2025 and 2.6 in 2050.

But what if we defined the age brackets for this ratio more dynamically? In 1909 age 65 was probably a fair average for when bodies broke down and mental and physical function made sustainable employment impractical. There are a number of ways of dynamically standardising what this age should be and allow for improvement over time in lifetimes and management of disabilities.

One approach is to calculate Disability Adjusted Life Expectancy (DALE). Many readers would already be familiar with 'life expectancy' – average expected future years of life calculated from life tables. DALE is a more complex version of this calculation which measures the equivalent number of years of life expected to be lived in full health i.e. healthy life expectancy. DALE requires quite a lot of data on burden of disease by age and is an evolving methodology. For this reason it's difficult to go back in time and work out what DALE would have been in 1909.

An alternative to DALE is to standardise the worker retiree ratio for different points in time based on assuming a constant percentage of total lifetime which is spent in retirement. Based on my research of mortality tables, I think this is a good proxy for DALE methodology.

For example, in 1909 when 65 was first used as the retirement age, life expectancy from that age was to live to age 77 (average for men and women). This means the average period expected to be spent in retirement (12 years) was 16 % of total lifetime (77 years).

Moving more than 60 years forward to 1975 life tables, there was not a great deal of change in this position. Using 16% of lifetime expected to be lived in retirement as the standard, we get age 68 as the standardised retirement age in 1975 – just 3 years more than in 1909.

However from 1975 onwards to 2011, the longevity improves at a much greater rate. The standardised dynamic retirement age increases a further 6 years to age 73. This is now a long way from the age 65 we normally use in our statistics.

Now if we use this more dynamic way of calculating retirement age, dependency ratios have a much more stable pattern. From 1909 to 2011 instead of reducing from 15.0 to 4.9 workers per retiree, the ratio stabilises around 9.0 from 1950 until the present time. Allowing for longevity to keep improving in future at the rate it has been recently, we do see some further decline in the ratio to 2025 (7.2) and by 2050 (5.3) but well above the catastrophic 2.5 using unadjusted age 65 as the retirement age basis for the ratio.

So what are the conclusions from all this? The following are a few thoughts:

- retirement planning advisers need to consider both total longevity and healthy life expectations

- whilst people (and their employers!) may tire of a 'major' career between say age 55 and 65, it doesn't mean retirement starts and income generation stops when this inflection point is reached. Different, more flexible occupations sustaining basic living costs will need to be planned for by individuals and their advisers until the point when genuine physical incapacity for work arrives

- real value of capital accumulated needs to be protected past the traditional retirement age using endowment fund type strategies, as there may be many years of a healthy lifestyle to come

- longevity insurance products will offer the best value to clients if the income payout is targeted from the 'dynamic' retirement ages (using the above methodology, closer to age 73 than 65) rather than starting payments from when clients cease their 'major' full time careers. This is the 'sweet spot' of deferred annuities (even sweeter now if the government legislates recent announcements)

- if a genuine market now develops for deferred annuity products, published league tables of deferred annuity rates will help educate clients and their advisers much more simply about dynamic retirement age concepts than studying complex mortality tables and talking to actuaries.

It might even help to stop thinking of someone who is 72 as a 'dependent'.

Bruce Gregor is an actuary and demographic researcher at Financial Demographics and established the website www.findem.com.au.

[Are lifecycle funds appropriate for MySuper products?]

David Bell

The Government's Stronger Super reforms have significantly raised the profile of lifecycle funds by legitimising their use as a single investment strategy for MySuper products. Treasury's Stronger Super summary states:

"Lifecycle investment options enable trustees to automatically move members into a different investment mix based on their age and can be particularly relevant as part of a transition to retirement … the Government has decided that trustees will be allowed to use a lifecycle investment option as the single investment strategy for their MySuper product."

However, Treasury leaves the final decision clearly in the hands of trustees.

"Trustees are best placed to decide whether a lifecycle investment option is best suited to their members."

We have already seen lifecycle funds chosen as MySuper default options, and within high profile products such as BT Super for Life. Some industry consultants actively promote the merits of lifecycle strategies. But it is far from clear whether lifecycle funds or traditional balanced funds deliver better outcomes. The question remains whether Stronger Super should have allowed lifecycle investment strategies such a prominent role in MySuper.

Lifecycle funds are multi-asset class funds which systematically transition from 'higher risk' assets such as equities to 'lower risk' assets such as bonds as retirement approaches. They are often called 'target-date funds' or in the super industry 'age-based defaults'. The alternative is traditional balanced funds which provide constant asset class exposure through time.

Lifecycle funds sound like they are closely related to lifecycle theory. This is not necessarily the case and it is worthwhile understanding the history of lifecycle funds. I have written previously on lifecycle theory (see *Cuffelinks 1 February 2013*). Essentially lifecycle theory takes other components of your life into account when constructing investment portfolios rather than looking at investment portfolios in isolation. This is what good quality financial planning is all about, and there is much academic research on the topic.

So where did lifecycle funds come from? The marketing department of course! Barclays Global Investors is credited with launching the first lifecycle fund in the US in 1993. Lifecycle funds, more commonly called target date funds in the US, are now a large part of the retirement landscape in the US. According to Morningstar, in 2012 around US$400 billion of retirement savings was invested in such strategies. But be clear, especially as MySuper approaches: lifecycle funds are far from unanimously supported amongst researchers.

To many people, myself included, lifecycle funds 'feel' logical. And with big name wealth managers and super funds using such strategies, and overseas money flowing into them, shouldn't we feel comfortable and accept lifecycle strategies as appropriate? Even though it 'feels' right, I just can't personally endorse them until I have fully convinced myself (and I have done a lot of research on the topic) that they improve outcomes.

From the research on lifecycle theory we see a number of reasons why we should reduce exposure to risky assets as retirement approaches. Important examples include:

- many people experience full employment through their lives and this feels like an annuity income stream. This allows us to accommodate risky asset exposure while we are working. As retirement approaches the support of income drops away and we may be unable to bear the variability that comes from a risky portfolio

- many of us have flexibility in retirement age (we can choose to retire early or work an extra year or two if we like). This provides flexibility to take on more risky assets. If we haven't accumulated enough wealth, we can defer retirement. As we approach retirement age, flexibility drops away and we should be more conservative with our exposure to risky assets

- if we annuitise at retirement to hedge longevity risk (see Cuffelinks 22 March 2013 for an introduction to the mortality component of longevity risk) then we are exposed to annuity purchase price risk. If yields happen to be low at retirement then the size of the income stream that can be purchased is small. One way to hedge this risk is to allocate more to bonds as retirement approaches

- there are arguments that equity markets mean revert over time, suggesting we can allocate to risky assets while we have time on our side. However as retirement approaches and we need to start drawing down our income stream we become unable to allocate for long enough to experience these longer term outcomes and hence reduce exposure to risky assets.

However, the same body of research gives reasons <u>not</u> to lifecycle:

- if our jobs are risky and have some correlation with the economy and equity markets then we may view our careers as a large equity-like exposure and diversify this with bonds. As our career risk reduces towards retirement (less time exposure to career risk) we may need to replace this risk with another source of risk and can in fact increase our exposure to equities

- notwithstanding talk of life annuities becoming more popular, the standard post-retirement solution is likely to remain allocated pensions. We are left with longevity risk, and the need to earn enough returns to fund a post-retirement life. This suggests we should continue to work our accumulated savings hard by maintaining a high exposure to risky assets

- the young are often heavily mortgaged with a house and so have significant financial exposure to property prices. They may be already bearing substantial risk and so should run conservative portfolios until later in their lives (as the mortgage reduces)

- the age pension in Australia may provide a backdrop which allows us to continue to take high levels of exposure to risky assets.

It is far from clear. Financial planners are best placed as they can take personal situations into account. For those designing super fund defaults there are many complex issues which need to be considered and modelled. These include inflation, wages, unemployment risk and career breaks, investment risk, mortality risk (idiosyncratic and systematic), the age pension, taxes and superannuation rules, savings rates, home ownership, post-retirement product solutions, philanthropy, risk aversion and bequest motives, and all across different household structures. Not an easy list, and I haven't seen any research that incorporates all of these considerations. You can see the Government's predicament: it is inconclusive whether balanced funds or lifecycle funds are most appropriate. Thus they have left final responsibility with the trustees of the super funds. Effectively they are saying balanced funds and lifecycle funds are worthy of consideration but do your own homework.

Investors should question what they read on lifecycle funds, and if possible request the basis and modelling behind the decision to go down the lifecycle path. The super fund ratings groups are doing this, especially as MySuper approaches. One asset consultant has said that lifecycle funds will "provide better retirement outcomes to members". This could well be a myth as on average this statement is untrue, because we have less dollar-weighted exposure to the risky assets that we expect to outperform over time. They do however reduce the risk of large stressful drawdowns prior to retirement so the worst case outcomes may be less painful. So the true benefit of lifecycle funds would be based on a risk-adjusted basis. Unfortunately assessing risk aversion of individuals has always been a grey area.

Remember that 'lifecycle fund' is a marketing term and not the same as 'lifecycle theory', and you should delve a little deeper before accepting this intuitively obvious investment solution for retirement. Of course much of the same could be said of balanced funds.

Wealth managers need a new car not a faster horse

Rick Cosier

"If I had asked people what they wanted, they would have said faster horses." Henry Ford

"The market research is all in my head. You see, we create markets." Akio Morita, Chairman, Sony

"People don't know what they want until you show it to them." Steve Jobs

Product innovations are rarely asked for or thought about by the general public. Inventors give consumers what they need without them realising that they need it. No-one ever said that they'd like a television, and Sony didn't research potential demand for the stereo Walkman and it went on to revolutionise mobile music.

During the course of a financial year, I attend a great many fund manager presentations. In the most recent seminar I sat there thinking about how little innovation there had been in the managed funds industry in the last 15 years. Am I being harsh? Well, let's think about it.

Most innovations happened years ago

In the early to mid-1980s when I first started investing, managed funds did not exist. Instead, a stockbroker managed your portfolio. It was inefficient and relatively expensive. Managed funds were truly an innovation. They pooled the money of many individuals and provided the benefits of economies of scale, diversification and professional management. Soon after, in the early 1990s, the 'master fund' was invented. Now referred to as 'platforms', they allowed people to invest in a number of different funds from different managers whilst providing consolidated reporting. Later, allocated pensions radically changed the ability of Australians to maximise their retirement money. These three drivers of the wealth industry were invented about 20 years ago.

Since then, just how much innovation has there been? Superficially you would think a massive amount, but how many are simply 'line extensions' such as long short funds, sector specific funds and some tweaking from platform providers. Colonial First State's FirstChoice was undoubtedly innovative because it reduced the administration inefficiency and associated cost by creating pools of money instead of using third party wholesale funds. By doing so, clients are able to transact on the platform knowing they will get that day's price and will receive a confirmation letter in a couple of days. All other platforms are simply a supermarket where you can buy other company's wholesale funds. As such you are a hostage to that company's administration and simple transactions can take more than a week to be actioned.

To date, the inefficiency elsewhere has perpetuated and no other institution has followed Colonial's lead, as their platforms are tied into the old technology.

The really big innovation in recent times has been SMSFs, but for obvious reasons it wasn't the managed fund industry that invented them. SMSFS are not just growing, they are taking off. Fuelled by a desire to take control and save money, they represent almost a third of the superannuation market and the largest segment. The fund manager response has been to promote managed funds to SMSFs, but the funds are seen as part of the problem not part of the solution.

An inflexible tax structure

And managed funds do have shortcomings. They have a trust structure, so at the end of every financial year, they are required to pay out any realised capital gains they make. If one's objective is to invest for the long term, it's not much help if you keep receiving taxable distributions every six months. And unfortunately, the better the performance is, the higher the distributions are. In an effort to ‘beat the index’ most active fund managers create major capital gains tax liabilities due to the incredibly high turnover (70% of the portfolio each year is not uncommon).

Some people may argue ETFs are an innovation, but they have the same legal structure and suffer the same tax fate as managed funds. Consequently, in my view they are not really much different to an index managed fund. For an individual tax payer, or an SMSF, buying shares directly means that capital gains and losses can be carefully controlled.

When you run your own SMSF, you are effectively combining your investments with those of the other members. This means you can efficiently manage the fund so that you minimise your tax. Not only did my family’s fund create sufficient franking credits to eradicate the tax on performance returns last year, it eradicated the contributions tax as well. And gave us a refund.

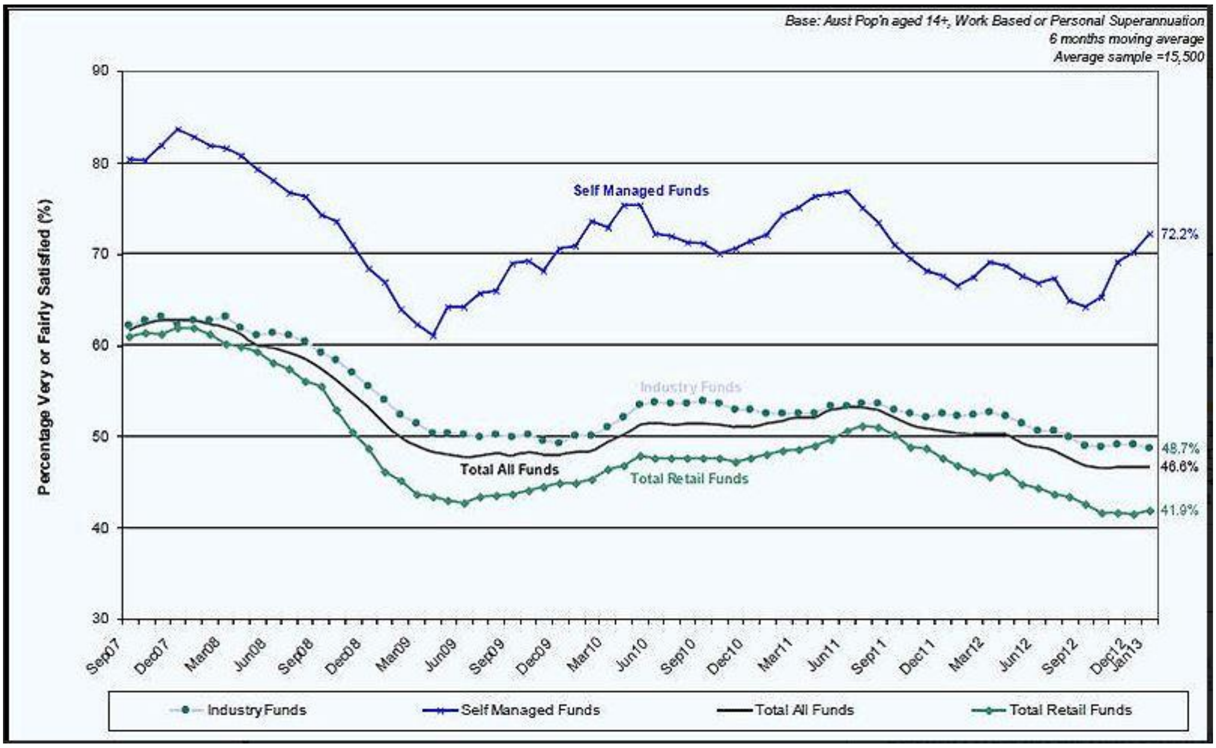
In 15 years of accumulating super in a managed fund that mostly invested in Australian shares, the 15% contributions tax was always deducted, never to be seen again. And I certainly never received a refund. Maybe I got some benefit in the unit price, but I doubt it. Most managed funds have such a large turnover in their portfolios that the capital gains tax on any profitable transactions eats up much of the franking credits.

Fees are too high relative to potential performance

What about the fees? Lately I have noticed an increased backlash from clients when they examine the fee structures. It is not uncommon for a global share fund to charge well over 2% per annum management fees, especially when performance fees are included. I defend many funds manager’s fees on the grounds that they have shown a historic ability to consistently beat the benchmark index. However, I recently saw a document in which one of Australia’s largest share fund managers stated a target return of 2% above the index before fees. This hardly seems a ‘stretch’ target and clients are often outraged that managers can skim off so much money for so little performance. The latest Morningstar survey on managed funds reports that the average manager in the majority of asset classes underperformed their benchmarks.

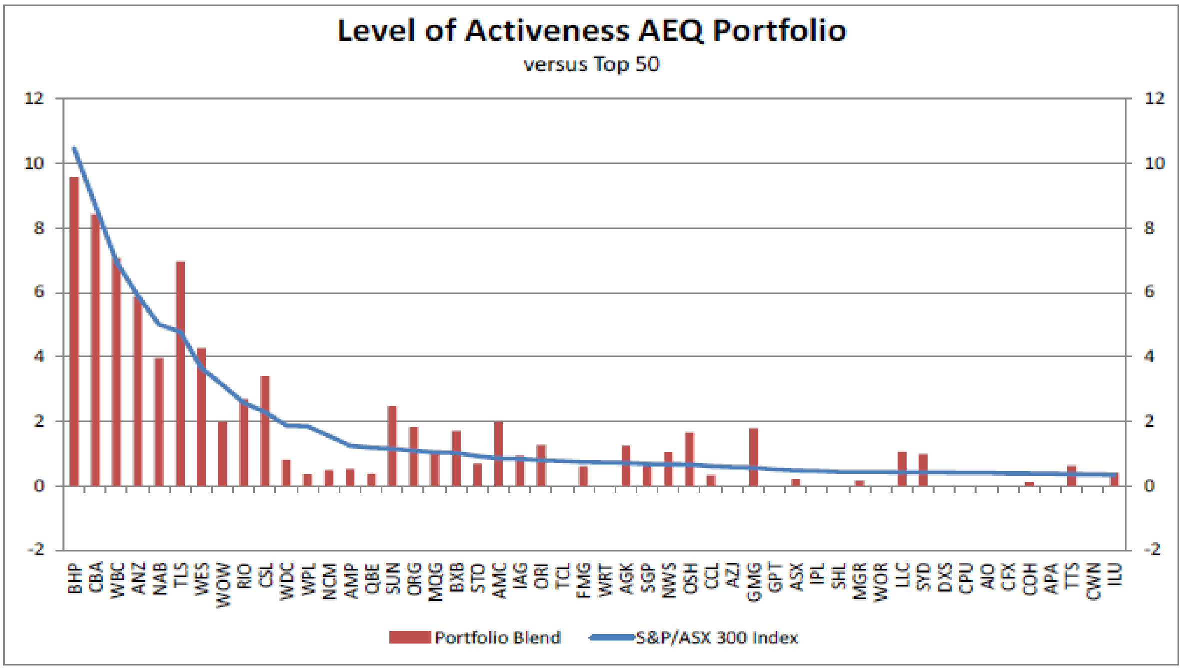
One notable recent development is ING's Living Super. The balanced option has no fees and a 50/50 cash and shares allocation, and it appeals to investors for whom perception is reality and they don't want to pay fees. The product actually pays for itself in the profit margin on the cash, which is a different approach to charging a management fee.

A growing percentage of Australians believe they can manage their own fund, outperform the professionals and save a bundle of fees. The chart below from Roy Morgan Research illustrates how poorly retail funds are perceived compared with SMSFs.



It's debatable whether SMSFs actually do beat the professionals but the mere fact that fund managers can't demonstrate their superiority is a worry. Surely with all that research capability and 40 hours a week at their disposal, the professionals must be able to find 'hidden gems' that the average part-time investor can't?

Unfortunately, the chart below shows that the professionals are mostly investing in the household names that the average SMSF portfolio already has in its portfolio (AEQ is Australian Equities in the van Eyk universe).



Source: van Eyk

When asked why they don't invest more of the fund's money in small companies, they suggest using their small cap fund.

But I don't want to invest client's money in a large cap fund and a small cap fund. I want to invest client money in a diversified portfolio of shares that delivers better returns than clients can themselves. The market is littered with Asian share funds that don't invest in Japan, and global share funds that have no exposure to emerging markets.

In truth, some of these Australian share funds are so large that it is impossible to buy enough stock in a small to medium sized company to make a difference to their performance. Can they use derivatives to gain exposure? Some can, but most have strait-jacketed themselves by an overzealous trust deed. I don't mind if a manager judiciously uses derivatives to increase their exposure without moving the market. Or sells short stocks they think will go down. After all, Platinum has been doing it for years with pretty good results. The irony is that in the eyes of many wealth managers Platinum is somehow cheating. Platinum's really a hedge fund, they say, whereas we're a diversified global share manager. This sort of thinking is the hallmark of production-led companies instead of marketing-led companies. And herein lies the problem.

Most wealth management corporations entrust their new product development to non marketing people. Sure, marketers are involved, but the major thrust seems to come from the 'factory' which designs a product they know they can easily make, and given to the marketing and distribution departments to sell. Contrast this with consumer goods companies where marketing departments use a blend of research and gut feel to design products that can increase their company's market share, or better still, create an entirely new category. A classic example is the dearth of products suitable for the post-retirement phase of superannuation. How are retail funds helping those moving from accumulation to pension who need income but with lower volatility than equities?

The wealth management industry needs to make more serious attempts to find some new cars – otherwise they will be riding their horses into the sunset.

SMSF property spruikers on borrowed time

Graham Hand

Most of the one million SMSF members have not read their 70 page trust deed, but every deed says something like: *The Trustees must ensure that each investment strategy is appropriate at all times for Members of the Fund.* The thousands of people attending property seminars aimed directly at SMSFs have additional risks to consider that are rarely, if ever, mentioned during the presentations. ASIC is watching how the industry's gatekeepers behave.

For example, is it appropriate to use high leverage to invest in a single, illiquid asset worth many times more than the SMSF itself? Or in pension phase, how will minimum pension payments be met if the property is untenanted? And where will the money come from for major repairs if all the funds are in the property?

It was welcome that Peter Kell, ASIC Commissioner in charge of the SMSF taskforce, recently spoke at the CPA Conference, and attempted to clarify the requirements for property purchased through an SMSF. To quote him:

"In the past you may have seen ASIC comment that we do not regulate direct property investment. This is the case except where the investment is made through an SMSF. Let me be very clear – a person requires an AFS licence if they recommend that an existing or proposed member of an SMSF purchase a property through their SMSF. This is because the vehicle through which the underlying investment is made is an SMSF and an interest in an SMSF is a financial product."

Then he issued this request (my underlining): *"Where you see examples of unlicensed SMSF advice, please let us know."*

So we should give Peter and ASIC our stories.

There are many property companies and real estate agents running seminars targeting SMSFs. The property agents issue emails to people who have visited one of their displays or responded to an advertisement. To quote from an email from one of the largest real estate companies in Australia:

"Worried you won't have enough when you retire? Find out how you can utilise your existing superannuation to buy your next investment property. The presentation will provide insight into SMSFs and how they can help you create a brighter future for you and your family. According to the ATO's most recent SMSF bulletin, 3,000 SMSFs are being established every month, that's 100 daily and around 4 every hour!"

The seminar is held in the offices of the real estate company, and each session is packed. On the night I attend, extra lounge chairs are brought into the room, and it is standing room only at the back (near the bar). The clients are of all ages, including some surprisingly young couples. The real estate agent welcomes the crowd, says he will talk about some specific properties later, and then introduces the main speaker. We are told it's an amazing presentation that will blow us all away.

The main speaker is from an SMSF administrator. He's got quite a patter. First he tells us, "Those in the front row may need an umbrella. I tend to spit a lot". I look at the real estate man to see if he is cringing in embarrassment, but he thinks it's very funny. Then we're told some surprising statistics. We don't need much super to buy a $1 million property. 72% of SMSFs plan to buy property at some stage, and 92% of them plan to borrow. 86% of people prefer property to equities. In the near future, $500 billion will move into property from SMSFs, and one-third of all property will be bought by an SMSF. He tells us he has a telescope that can see into 2020, when we will be printing human organs to put into the body. And this telescope tells him there will be $3 trillion in super and the market capitalisation of the ASX will be only $2 trillion. The balance must find a home. In fact, the government introduced borrowing in super to encourage purchases of property. So this is going to be an LRBA night. That's Limited Resource Borrowing Arrangement, because that's how SMSFs buy property.

We are told there is a financial planner at the back of the room who any of us can talk to later.

The presentation makes the following points:

1. Using property, you can take control, diversify and stop managed funds and market fluctuations affecting your families (sic) financial future.

   In fact, it couldn't be less diversified. Residential property is one single, illiquid investment. How is it diversified? Because the rent covers the interest expense on the loan, leaving money for other assets. Oh, that's fine then.

2. There's an ability to use leverage in super that cannot be accessed through 'normal' superannuation.

   What is this, 'abnormal superannuation'? It is possible to leverage into other assets in super, although maybe not to the extent possible in property.

3. Use your limited super as a deposit.

   The transaction example uses $140,000 of superannuation ("maybe take it out of an industry fund") to buy a property for $500,000. Then when you sell it for $1 million ten years later when you are 'only' 55, you will be in pension phase where there is no capital gains tax. No mention that it might not suit you to enter a 'transition to retirement' pension for other reasons, or that for many in the room, the pension age is 60 and not 55.

It gets even better. If you don't have enough money in super but you have equity in your house, you can borrow against your house and lend the money to your SMSF under an LRBA.

4. You can reduce the purchase price of the investment property by 40% using concessionally-taxed superannuation compared to after-tax salary for loan repayment.

   The 'reduced purchase price' comes from the tax-effectiveness of superannuation, not property. Every investment is 40% lower on this basis, plus the fact that there is a $25,000 a year limit on concession contributions. That's not much for a property deposit.

5. If you don't have enough money for a deposit, four people can pool their money to fast track to wealth, allowing increased exposure to property assets.

   So now someone with a really small amount in super, plus three of their friends, can leverage into property.

And on it goes. The numbers are wonderful. The money that buys the property does not incur any income tax, and there's no capital gain on sale. Only an SMSF allows you to avoid tax like this, it is 'below the tax line'. You would be ridiculous to buy property outside an SMSF, because for your $140,000 deposit, you need to earn $261,682. It's so much cheaper in the SMSF. You save $514,429 over the life of the property investment.

The structure can be put together for a fee of $7,995 for the complete package of legal work setting up the SMSF, establishing the trust deed plus independent legal financial (sic) advice. When you check their website, where they promote their services to real estate agents, you see the 'wholesale price' is $5,000. The rest is the agent's commission. In fact, allowing for referral fees and insurance premiums, an agent can earn $5,700 on an average SMSF package attached to a property.

It's been quite a spiel, and the property agent is welcomed back to the microphone to offer a "grab bag of gold nuggets". These are various property developments around Sydney. And at the end, the financial adviser offers his services to anyone who wants to talk about SMSF strategies.

Is that what the licencing process intends, that as long as there is a licenced adviser in the room, everything is fine? To quote again from Peter Kell: *"a person requires an AFS licence if they recommend that an existing or proposed member of an SMSF purchase a property through their SMSF."* At what stage is the licence required and when does the financial advice begin?

It's an irresistible combination for a marketing person based on four massive numbers: $4 trillion in residential housing, $1.5 trillion in superannuation, $500 billion in SMSFs and one million trustees, many of whom are far more comfortable with bricks and mortar than they are with shares and bonds. Throw in an ability to borrow in the SMSF and an industry that has never taken a backward step in seizing an opportunity, and residential property in self-managed super has become part of every real estate agent's kit bag.

This regulatory environment is confusing many participants. The Mortgage and Finance Association of Australia (MFAA) recently launched a training programme to improve the skills of their brokers when dealing with SMSFs. The Property Investment Professionals of Australia (PIPA) recently said accountants, financial planners and mortgage brokers were tentative about who could legally lead SMSF trustees through the property investment process.

High-profile financial adviser and author, Noel Whittaker, is currently collecting stories about victims of property spruikers. He reports in his latest newsletter that just one firm of property marketers was making 22,000 cold calls a week. He has many stories of people losing money from property investments, and although not specifically targeted at SMSFs, no doubt this product is part of the spruiking.

When borrowing was allowed in SMSFs in 2007, did the regulators expect an industry to develop that encouraged leverage of four times the value of a superannuation balance? Superannuation has tax advantages to encourage people to save for the years when they cannot work. We'd better hope Australia does not have a property price fall worth anywhere near countries like the United States and Ireland, or a lot of retail superannuation money will be lost.

At least the SMSF trust deed also has provisions to cover member insanity.

Investment strategies need healthy dose of realism

John Stroud

Formulating an investment strategy and more specifically an appropriate 'strategic asset allocation' should balance what you are hoping to achieve ultimately against the risk of adverse outcomes along the way. A realistic and humble appreciation is needed of the magnitude and unpredictability of potential short term underperformance of markets, especially the sharemarket, informed by the historical volatility of actual returns. This must then be combined with an honest self-assessment of the investor's tolerance for such risk.

A mere matter of a few days ago, the US stock market was on a roll, with the major indices finally regaining pre-GFC levels, and then setting new record highs. This helped the Australian market indices to smash through what had previously seemed a ceiling at the 5,000 level (S&P/ASX200) and quickly run up another 3% or so to around 5,150. And this, little more than a year and a half after it had plunged below the 4,000 level and seemed in near freefall, at the height of the 'Euro-debt crisis'. At the time, some feared that this was the start of 'GFC Mark II', until ECB head Mario Draghi stepped in with his celebrated 'whatever it takes' commitment to dealing with the problems, prompting sharemarkets to reverse course abruptly and set sail into the aforementioned rally.

But more recently the mood suddenly threatened to turn sour again, with the major US indices dropping back nearly 3% in just a couple of days, while the local index dived back under 5,000. And reportedly, all mostly due to a few softer economic indicators out of the US and especially China, including the report that March quarter GDP growth came in a mere matter of tenths of a percent below expectations and the previous period's actual.

Losses are more frequent than many expect

Of course, this is only a mild taste of the volatility that sharemarkets are capable of. For example, a recent analysis of S&P/ASX200 index movements since its inception by Morningstar highlights how frequent negative returns are, and how extreme they can be:

- over 20% of 1-year rolling returns were negative
- the largest peak-trough decline in a defined 'bear market' was 55% (and perhaps disturbingly, if you assumed that was the 2008-09 GFC, you'd be wrong! Rather, it was the 1973-74, OPEC oil shock/recession episode).

This serves as a reminder of two things (as if we should *need* reminding of them):

- investment markets are fickle in nature, and shorter term movements are highly unpredictable, often triggered by what might, in isolation and objectively, be seen to be relatively minor pieces of new information, and often come completely 'out of left field'
- human emotions and behavioural biases play important roles in shorter term fluctuations, as well as conditioning investors' responses to these same fluctuations.

Of course, one of the keys to successful investing over the longer term is being able to 'rise above' these shorter term market fluctuations and the emotional roller-coaster.

Easier said than done! Many years of observing investors, including 'professionals', suggests that despite constant reminders of the inherent unpredictability and volatility of financial markets, and routine acknowledgements thereof, investors often seem to be merely paying lip service to the risk. It seems that that the longer the good times roll, the more overconfident many investors become in their ability to predict markets' future course and in their ability to 'get out in time'(if their investment approach allows such tactical flexibility). The more they seek to capture the upside, the more they forget how extreme the downside volatility can be. Or maybe, they just don't want to know.

Investors need to accept reality

Indeed, over many years as a consultant to institutional investors, one of the most common laments heard when they are caught by severe downturns is that they didn't realise that it could get quite so bad, nor that their particular investment strategy could produce such poor returns in a shorter period. Yet the strategy had often been set in light of analysis of the possible distribution of outcomes over time, including downside risk measures such as the frequency of negative annual returns, or some confidence interval of the range of possible returns.

Which bring us back to the need for realism in formulating an appropriate investment strategy, including:

- Make an *honest and* sufficiently *humble* assessment of whether you or your advisor have the forecasting skills, temperament and practical capacity to 'time' markets.

In other words, do you really believe you can vary exposure to the various asset classes to take advantage of shorter term deviations in expected performance (aka 'tactical asset allocation')? To cut a long story short, since the vast majority of investors aren't blessed with the supposed insight or information sources of market "gurus", the honest answer should be NO. That being the case, you are better off choosing a relatively fixed, strategic asset allocation, being the one that is likely to achieve your investment objectives ultimately, and the consequences of which you can live with though all the intervening market ups and downs, and essentially sticking to it.

- Be *realistic* about the volatility of markets, especially sharemarkets

This means properly allowing for how sharp the downturns can be, and how frequently they can in fact occur. (And without wishing to get sidetracked into technical aspects, these are probably greater than predicted by the normal distributions used in the standard quantitative approaches to optimising investment strategy).

- Be *honest* with yourself about just how much risk you really can tolerate

How much pain you can truly bear, in the form of poor shorter term investment performance? If you invest in equities, for example, would you lose sleep or would it compromise your retirement plans if the market lost 30% in a month?

This isn't the place to dive into the debate about whether Australian super funds are more heavily weighted to shares than they should be. Nevertheless, many investors pursue a strategy that exposes them more to sharemarket volatility than they actually need to, and often find themselves lamenting that they did not fully appreciate the risk. These investors might be better off reducing their exposure to the 'equity risk premium', and take better advantage of alternative means of enhancing overall returns.

John Stroud is currently Principal of Newport Investment Consulting, after many years in senior roles with major investment consulting firms and fund managers.