Cuffelinks
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Super reforms not nearly enough

Maree Pallisco

The Federal Government's 5 April 2013 reforms are another indication we're just tinkering around the edges of Australia's retirement savings system challenges. The system will need far more radical policy changes if our nation is to survive its demographic time bomb.

As things currently stand in our system, the cost of supporting Australia's aging population is likely to capsize the national balance sheet within 20 years. Three years ago, the *Intergenerational Report 2010* said the age pension and health care bill from our swelling population of retirees will have the government running a structural fiscal deficit by 2030. By 2050, health care, aged care and pension costs will account for almost 13% of GDP, up from 8% in 2010.

And these figures are probably conservative. In its *Global Financial Stability* 2012, a report warning that governments are underestimating the rapid growth of longevity, the IMF concluded: "If individuals live three years longer than expected … the already large costs of ageing could increase by another 50% [by 2050]."

The current superannuation reforms are a step in the right direction, but have failed to consider the overall retirement system. Will we be in a position where the Commonwealth can no longer afford to pay the aged pension we are currently promising future retirees? Will we bankrupt the country to care for aging baby boomers who could have saved more and worked longer – but weren't encouraged to do so? And are we really prepared to let future generations of workers (our children) pay that enormous price?

This is not a pleasant conversation, but it's one we need to have – now.

To some extent, the purpose of the superannuation system is to take pressure off the Commonwealth budget by reducing outlays on the age pension via the means test. The questions we should be asking are: first, are our super reforms enough to enable more of retirement to be self-funded by those who will otherwise depend on the pension and the cost of doing so? Second, if not, what are we going to do instead?

The simple answer to the first question is: no, they are not nearly enough.

A CPA study (*Household savings and retirement. Where has all my super gone?* CPA Australia, October 2012) shows that compulsory superannuation has had a minimal impact on Australians' capacity to save for a self-funded retirement. Instead, it reveals those approaching retirement age are incurring greater debt levels (not less, as we would expect), and view their superannuation lump sum payments as windfalls to pay off that debt or to fund greater short-term consumption.

The study also shows that the Super Guarantee (SG) system has not predicted changing work and demographic patterns, leaving certain groups, especially those with interrupted work patterns (such as women and casual workers), at a distinct disadvantage.

There is no simple answer to the second question. But there are some obvious places to start.

Encourage longer employment

Australia needs to lift the pension and superannuation access age to match modern lifespans, encouraging longer accumulation phases and effectively putting a cap on the time people spend in retirement.

When the retirement age was set at 65 in 1909, we were expected to live another 10 years. Today, we expect to live about another 20 years and it's increasing rapidly. By 2050, the average length of retirement could be 25 years. Europe has shown us what happens when countries allow early retirement they can't afford.

We should be encouraging people to stay in the workforce, contributing to their super for as long as possible (health permitting) beyond the current average retirement age of 62. Faced with two decades of retirement, many people would actually choose to work past the current retirement age. Although the employer contribution age limit of 70 has been lifted, there is still more that can be done.

Make sure super is used for retirement income

We need to make sure super is actually used for retirement income – especially if we're going to support it with tax concessions.

Most other countries require at least part of the benefit to be paid as income. But, in Australia, the means test of the age pension actively encourages retirees to spend their super lump sum, so they qualify for more of the pension. This is why, according to APRA, in fiscal 2012 retirees took out $35 billion in lump sums payments.

We also need to question the idea that people can access their super from age 55 to 60. It may not be tax-free until you're 60, but this is yet another factor encouraging people to use their super for purposes other than retirement income.

Address those excluded from the super guarantee

Currently, a substantial portion of the working age population does not make contributions to superannuation. In particular, carers for children with disabilities, adult family members or older frail parents have limited opportunities to accumulate superannuation. If we're not going to include them in the SG, should we provide incentives for these people to make voluntary contributions to savings or receive government payments?

Encourage smarter saving through financial education

If we're going to shift policy levers to encourage behavioural change, we need to make sure people understand their new incentives. There are differing views as to whether this is or is not the job of government. Therefore, super funds need to educate their members about what changes mean to them as individuals.

Make the system equitable

It's time to clean up the inequitable CGT concessions and borrowing advantages currently given to self-managed superannuation funds. We don't need to create greater opportunities for maximising financial returns in a segment dominated by higher-income earners already capable of supporting themselves in retirement. Either give APRA-regulated funds the same advantages or level the playing field in the other direction.

If Australia is to have a chance of ageing gracefully, we need to evaluate policy changes using a different litmus test. Let us simply ask: will this change reduce future outlays on the age pension? And, if not, then why are we doing it?

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Social Benefit Bonds: an emerging asset class

Ian Learmonth

Impact investing is an emerging new asset class that provides opportunities for investors to generate both a financial and a social return. There are numerous examples of this across the globe including the funding of social enterprises in Europe and the US as well as microfinance programs throughout Asia. Social Ventures Australia (SVA) has been active in this area since 2009, when it formed a non-profit syndicate (along with Mission Australia, the Benevolent Society and the Brotherhood of St Laurence) to facilitate the GoodStart transaction, a $165 million acquisition of over 650 childcare centres (formerly owned by ABC Learning which went into administration).

The non-profit, 'for purpose' GoodStart syndicate competed with traditional private equity bidders to acquire the early learning centres and was ultimately successful through using an innovative non-profit structure and accessing competitive social finance. The $165 million was raised via a combination of secured senior debt (provided by the NAB and Commonwealth Government) and unsecured debt ($22.5 million paying 12% pa over an 8 year term) provided by private social

investors. This transaction is one of the largest social finance deals globally, offering the investors both a social return, through the provision of high quality early childhood care and education, and a strong financial return.

In reality, if priced on a fully commercial basis taking into account the credit worthiness of the business at that time, the $22.5 million unsecured debt provided by private social investors would probably have needed to yield closer to 20% pa for the risks involved. So in essence, the investors were willing to accept 12% pa instead of 20% pa knowing that the difference would be a 'social dividend' they were contributing.

Following the success of the GoodStart transaction, SVA established a dedicated Impact Investing team in May 2011. In only its first year of operation, the team placed itself at the forefront of the sector with two key achievements: the establishment of the SVA Social Impact Fund, which is investing $8.6 million in social enterprises nationwide; and its appointment as advisor to both Mission Australia and UnitingCare (two of Australia's highly respected non-profit agencies) on two of NSW's first Social Benefit Bonds (SBB). They're also known as Social Impact Bonds.

Social Impact Bonds

Social Impact Bonds are another form of impact-investing or social finance. The bonds are designed to raise private capital for preventative programmes which address areas of pressing social need. If the outcome targets are achieved, the government will repay the private funds plus an agreed rate of return. The payment from the government is in recognition of the fact that addressing areas of social need reduces the financial burden on the government, and only paying when targets are met ensures efficient allocation of scarce public resources.

The first Social Impact Bond was issued in the UK in September 2010 to fund a preventative programme that targets recidivism (definition: *a tendency to relapse into a previous condition or mode of behaviour,* especially *a relapse into criminal behaviour*) of former inmates at Peterborough Prison. If the programme successfully decreases the rate of recidivism, the government will realise savings through reduced expenditure on corrective services, and will pay a return to investors. The expected return to investors is in the range of 7.5% to 13%, dependent on the decrease in recidivism. However, if the programme is unsuccessful, the investors are potentially exposed to losses.

Although only in its second year the initial indications of the programme are positive and the UK has now launched a further 13 bonds, addressing a number of issues, including homelessness and teenagers in out-of-home care. The development of the market in the UK has been helped by committed funding from the government which will support the creation of up to 20 Social Impact Bonds.

The US has also embraced Social Impact Bonds, with President Obama dedicating $100 million to support bonds in the US. A bond has been designed and launched to reduce recidivism at Rikers Island prison in New York with investment bank Goldman Sachs as the founding investor. Michael Bloomberg's Foundation provides a guarantee to ensure the investors can lose no more than 25% of their initial outlay.

In 2012 NSW announced a SBB pilot to address the reduction of recidivism and children in out-of-home care and selected three service providers to work with to issue the bonds, as follows:

- UnitingCare Burnside (targeting out-of-home-care) – see Newpin below
- Mission Australia (targeting recidivism)
- The Benevolent Society (targeting out-of-home-care).

SVA is working with both UnitingCare Burnside and Mission Australia on the structuring, financial modelling and fundraising of the SBBs.

Newpin Social Benefit Bond (Newpin SBB)

The $7 million Newpin SBB is Australia's first Social Benefit Bond and is now being offered to investors by SVA. An investor in these bonds will be funding the maintenance and expansion of an important children's care program run by UnitingCare Burnside. Over the past four years, the Newpin programme has worked with over 270 families and successfully restored over 120 children previously in out-of-home care to their families.

The expansion of the programme will see more children live safely with their parents. Over the expected seven year term of the Newpin SBB, it is estimated that based on historical performance more than 400 children will be safely returned to their parents. Newpin centres will expand from the current four to a planned 10 locations across New South Wales.

The savings to the NSW Government generated by successfully restoring children to their families will be shared with UnitingCare to fund the delivery of the Newpin programme. The investment returns offered by the Newpin SBB reflect a sharing of these savings. This investment opportunity is a significant milestone in the rapidly developing Australian impact investing market.

Ian Learmonth is Executive Director at Social Ventures Australia responsible for heading up its Impact Investing team.

Putting off that retirement speech

David Bell

It is a question most working Australians face eventually – when is the right time to retire? When do we punch that time card for the last time and make our farewell speech, thrilled to be stepping into the world of retirement leisure? As with many decisions, it is complex and personal (and hopefully voluntary). Finances are an important component but non-financial elements such as health and work enjoyment are also important. How these elements are weighed up depends on personal preferences.

Benefits depend on income level

From a financial aspect the benefits of deferring retirement differ across the population, largely depending on income levels. To explore this further we need a measure of retirement outcome. This in itself is a somewhat controversial area. It is common to use a replacement rate measurement. This measures the retirement income (age pension, drawdowns from an allocated pension, and payments from income stream products) as a percentage of pre-retirement income. Treasury advance this gross measure further by using an expenditure replacement rate which takes into account taxes paid and savings made; essentially it compares what we have available in retirement as a percentage of our pre-retirement expenditure levels. I concur with Treasury's approach.

If we defer income there are two somewhat obvious but important financial implications. The first is that we do not draw down on our superannuation savings. The second is that we actually make further contributions to our super accounts. The net effect of this is that instead of beginning the process of drawing down on our retirement savings account for the rest of our lives we actually add to our savings and then when we do retire, we are drawing down on those retirement savings for fewer years. The financial impact of this deferral process will differ across households, largely based on income levels. For lower income households the age pension will make up a large part of retirement income, whereas higher income households will be relying more on their own savings to

fund their retirement. It is higher income households who experience a more substantial improvement in retirement outcomes by deferring retirement.

The exact effect on financial outcomes is unknown. Why? Well simply put we do not know our financial outcome. There are many sources of uncertainty the most significant being variability in real investment returns and age of death. However we can estimate the impact through using simulation. I undertake such calculations in an academic paper I wrote in 2011 titled *"Variability in the Projected Financial Outcomes of Australians"*. The results are summarised in the table below.

As we move across the table we move from low income to high income levels (based on a multiple of average weekly earnings (AWOTE). So 1.0x means a household on average earnings).

	Earnings Multiple of AWOTE*			
	0.75x	**1.0x**	**1.5x**	**2.5x**
Expected Replacement Rate (RR) Outcome (%)	81.1	68.4	56.0	61.0
Expected RR Outcome – Retirement Deferred by 1 Year (%)	81.9	69.5	57.7	64.5
Percentage Improvement in Retirement Outcomes (%)	1.0	1.6	3.0	5.7

* Average Weekly Ordinary Time Earnings are approximately $70,000 pa.

The last line in the above table represents the annualised expected improvement in replacement rate outcomes. It is clear that retiring is a more financially important decision for higher income households relative to lower income households. For example, someone earning $175,000 a year can improve their retirement outcome by a healthy 6% by delaying retirement only one year.

Treasury undertook similar analysis as supporting information for the Henry Tax Review. The numbers are not exactly the same (we do not know all the assumptions and details of Treasury's modelling) but the theme is consistent that deferring retirement increases expected replacement rate outcomes and that the increase is larger for higher wealth households. This forms part of the reason Henry recommended changing both the age pension eligibility age and the superannuation preservation age to 67.

Permanency of retirement

An important related issue is the permanency of the retirement decision. Is it possible to return to work once one has retired? This represents flexibility which could prove valuable if financial hurdles are experienced early in retirement. While Dame Nellie Melba and John Farnham have been able to make countless comebacks and farewell tours, it is generally not as easy for most people to re-enter the workforce. This will differ by occupation and characteristics of employers and the retired potential employee.

However retirement is not just a financial decision, though the finances are very important. A very important aspect is health. Health and mobility may restrict one's ability to travel in retirement, be an active grandparent, and enjoy an active retirement lifestyle in general. Say at 65 someone believes they only have 10 active years left before they anticipate switching to a less active lifestyle. Then the decision to defer retirement by a year represents giving up 10% of their expected active retirement years. That is a big issue to weigh up. Imagine the frustration of having the retirement income stream to support an active retirement lifestyle only to find the body is not willing. Think of this as a form of regret risk.

Of course this article frames work and leisure in a black and white format: work as dutiful and retirement as leisure. Much of the academic literature reflects this same notion. However it is possible to enjoy and derive leisure from work. If so this may make the decision to defer

retirement an easier one – why give up something enjoyable which provides an income? As Nobel Laureate Robert Merton said on the decision to defer retirement:

"*Look at how much cash it would take to generate what you generate yourself with your own human capital. And if you generate that cash by doing what you like to do, rather than hitting balls around a golf course, you have a good deal*".

This highlights the merit of actively positioning to have the ability to extend a working career as a conscious choice. This obviously requires foresight, which may entail the explicit decision to seek further education or change career paths. And of course some good luck in the form of a few career breaks would not go astray.

The message is clear. If you are close to retirement, consider your finances, health and retirement lifestyle objectives. If you are younger, focus on a career which you enjoy and create some flexibility around your retirement decision.

Capital allocation and management ability – Part 2

Roger Montgomery

In last week's *Cuffelinks*, I showed this table, where a company with a profit of $50,000 was trading on a price to earnings ratio of 10, to give a market capitalisation of $500,000. It did not pay a dividend, and in the second year, it made a return on equity of 5% again, giving it $52,500 in net profit. I left you with the question, with profits and market capitalisation rising, what's the problem?

Table 1: How to lose money despite profits and capitalisation rising

	Year 1	Year 2
Equity at Beginning	$1,000,000	$1,050,000
Return on Equity	5%	5%
Net Profit	$50,000	$52,500
Dividend	$0	
Equity at End	$1,050,000	
Price Earnings Ratio	10	10
Market Capitalisation	$500,000	$525,000

On the surface things look rosy. The company is growing, equity and profits have increased and management is no doubt drafting an annual report that reflects satisfaction with this turn of events. But not all is as it first appears. Indeed management has, perhaps unwittingly, dudded shareholders.

As a shareholder your return is made up of two components – dividends and capital gains. If two dollars is earned and you don't receive one of those dollars as a dividend, then you should receive it as a capital gain. If, over time you don't, it has been lost and management may be to blame. Every dollar that a company retains by not paying a dividend should be turned into at least a dollar of long-term market value through capital gains.

The company has not achieved this and unfortunately lost its investors' money. Even though the company appears to have grown – remember equity and profits are indeed growing – the reality is that as a shareholder you have lost money. How? The company 'retained' all of the $50,000 of the profits it earned in Year 1. You received no dividends. All you got was capital gain but the capital

gains were only $25,000. In other words the company failed to turn each dollar of retained profits into a dollar of market value. And so investors have lost $25,000. If the situation were to continue, you should insist that the company stop growing and return all profits as dividends and if that is not possible, the company should be wound up or sold.

What happened to the other $25,000? You didn't get the money as a dividend and you didn't get it as a capital gain. It was lost. The only way of receiving it is if the price earnings ratio went up. That would require people to pay more for the shares and hoping for that to happen would be like betting on number 5 in race 7 or betting on black. And that is speculating not investing. It might happen but there is no way of predicting it. The worst business to own is one that consistently employs growing amounts of capital at very low rates of return. This is because for a low-return business demanding incremental funds, growth harms the investor financially.

By retaining money, the company is hurting investors as it expands. The reason for retention of profits is largely irrelevant because, either the money needs to be retained which makes it a poor business or management chooses to retain which makes them poor decision makers.

Many investors don't understand this very real way of losing money even when the company is reporting profits. But investors aren't the only ones for whom this lesson is lost. A large number of company directors don't understand this 'loss' either or, if they do, they apply their knowledge with a dose of schizophrenia. Inside their businesses, they employ managers in a variety of divisions, who in turn conduct analysis to determine whether to expand their domain. If the returns aren't high enough they don't invest in expansion, instead sending the profits back to head office to be invested elsewhere for higher returns. But when the whole business isn't earning a high return on equity, those same directors often don't send the money back to the owners to be invested elsewhere. They keep the money! They find something to buy or they pay themselves more. And some, even if they do pay the profits out as a dividend, replace what they paid out by raising money through a dividend reinvestment plan or some other form of capital-raising. This is not a problem for a high return business, but it is reprehensible for a low return business with few prospects of improving its earning power (return on equity).

Back to our company above, many chief executives will present its results in the annual report as reflective of a great year. What they won't say is that they have lost half of your money!

Thanks to return on equity, we are able to assess management's treatment of shareholders and discern whether they are favoured or flouted.

It is important to look for businesses where management act like owners and treat shareholders like owners. Keeping funds for growth when the returns are low is not acting like an owner. A manager who behaves this way is not treating you like one either. As Adam Smith observed in 1774, it is almost impossible to align the interests of a manager with those of the owner when the manager is merely employed to manage the company on the owner's behalf.

The decision by management to pay dividends or retain profits falls under the heading of 'capital allocation' and when managers are making capital allocation decisions, it's essential that they increase the intrinsic value of the company on a per-share basis and avoid doing things that destroy it. In **Part 3** of this guide, I will show how allocation decisions can have a material impact on the per share intrinsic value of a company. For executive directors, while it is important they understand how to run the business to its full potential, this knowledge and the positive results are wasted if the board knows little about capital allocation.

The above example demonstrates that a company with a low rate of return on equity will lose money for its shareholders if profits are unwisely retained. As Warren Buffett further observed, if profits are unwisely retained it is likely that management have been unwisely retained too.

Roger Montgomery is the founder and Chief Investment Officer at The Montgomery Fund.

An historical (not hysterical) look at gold

Ashley Owen

Around the world in the last two weeks, people have rushed retail stores to buy physical gold. Perth Mint has reported sales are at their highest level in five years, and they traded over the weekend to cope with demand. People are queuing across Asian cities in panic-like conditions, while the US mint has been forced to cancel sales of its gold coins. Buyers are responding to the rapid price fall to USD1,322 per ounce in mid-April, the lowest level for two years.

What is most extraordinary is that retail investors usually react to rapid market falls in the opposite way. When equity prices drop, investors usually panic from fear it will fall further. Inflows to managed funds are always at their strongest when the market is at its peak, and outflows at their highest when markets bottom. But something else is happening with gold.

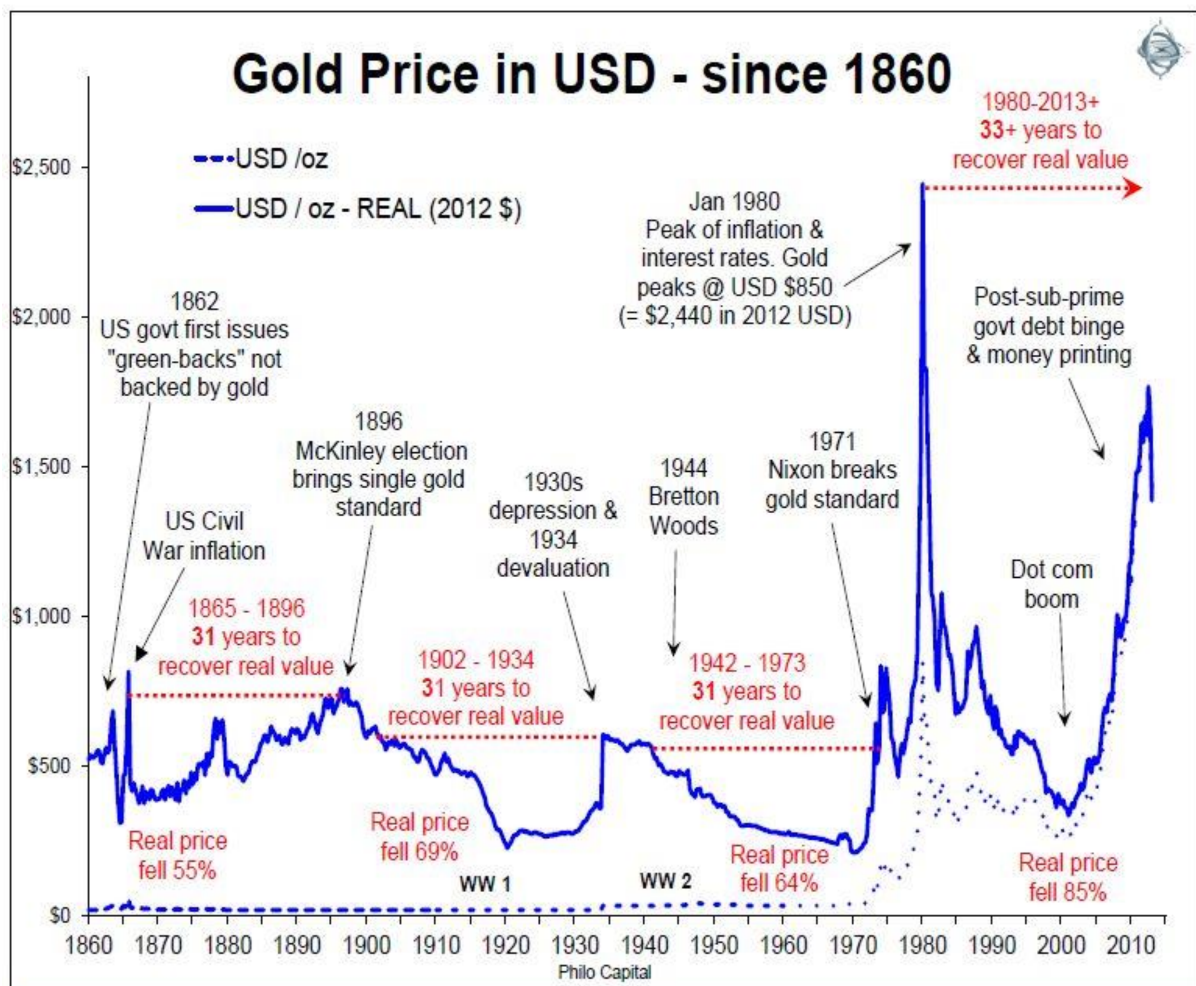
Source: Compiled by Grant Williams of Mauldin Economics from various public sources.

A brief look at gold price history

Most of the time over history, one ounce of gold has been able to buy items worth the equivalent of around USD500 in today's dollars adjusted for inflation. It has done so for much of the past 2,500 years through many societies. Occasionally the gold price (when measured in paper currencies) surges when paper currencies devalue, but it then falls back again in real terms. If bought below its long run level, gold can provide a hedge against the devaluation of paper, but if bought above the level it is speculation, not 'investing'. It is not a matter of whether gold represents a store of value or some other safe haven characteristic. For an investor, it is only worth buying when it is cheap.

The gold price reached USD1,900 per ounce on 5 September 2011 in the midst of the US debt ceiling and credit downgrade crises. Since then it has fallen by more than 20%, including a 10% fall on 15 April 2013, triggered by fears that Cyprus and the PIIGS may have to sell their gold reserves to repay debts.

Gold may shoot up to USD4,000 or USD5,000 in one of two scenarios: (a) an extreme left wing outcome resulting in run-away US inflation leading to a breakdown of society; or (b) an extreme right wing scenario with a Tea Party-led Republican government bringing back the gold standard. These scenarios look remote. People who bought gold in the last bubble in 1979-80 are still waiting to get their money back in real terms after inflation 33 years later.



Investors cannot consider gold without also thinking about currencies and inflation, as the three are inextricably linked. Long term holding of gold makes sense as an inflation hedge or as a store of value if bought at or below the long term price around which it has oscillated for thousands of years. However, if paper currencies collapse, the nominal value of gold expressed in paper money terms can rise dramatically. So gold has most appeal if the investor's home currency is about to experience massive hyper-inflation which destroys the value of paper money, which is unlikely in Australia in the near future. Or since the price of gold is expressed in USD terms, any expected rapid destruction in the value of a home currency may merit purchases of gold.

Of course, profits from short term trading are always possible as a more speculative bet, but long term portfolios are designed to look after long term needs, such as producing income and protecting wealth.

A copy of our comprehensive 2012 study of gold can be found here.

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