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Connecting investors with ideas

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We need to talk about risk

Chris Cuffe

After nearly 30 years in the investment management industry I can say without hesitation that the thing that irks me most is the use of the word 'risk' and what it actually is. In my view it is the most misused and 'glossed over' of all the plethora of investment jargon that exists.

The word 'risk' is a bit like the word 'love'. It has multiple meanings depending on who is using the word and in what context. You can *love* your dog; you can *love* your sister; you can *love* your child; you can *love* football; you can *love* your wife or husband. These uses of the word *love* all evoke different feelings and they each have a completely different connotation and context. And so it is with the word 'risk'.

One of the better definitions of risk I have seen comes from Elroy Dimson, Emeritus Professor of Finance at the London Business School:

"Risk means more things can happen than will happen."

In the superannuation investment industry people seem to talk about risk as though it means the same thing to all people. But it clearly does not. Risk is very different in the eyes of the client (the person with the superannuation account) versus the investment manager versus the regulator.

Let's look at each.

The person with the superannuation account

My 24-year-old son has a superannuation account with a major industry fund. When I talk to him about risk and what matters concerning his account his answer is straight forward:

- when he contributed to the fund he wanted to know the money arrived safely (aka no one ran off with it)
- whenever he receives a statement he wants to be confident the information shown is correct (aka there is integrity in the underlying data systems)
- when he wants to access his money in future years he knows it will be there (aka the institution is credible and reliable and not a 'fly by night')
- the money is being competently invested
- the fees are fair (aka he is not being ripped off)
- if provided, the insurance will kick in if a relevant event occurs to him.

I'd also add on his behalf, since he's unlikely to be focussing on this yet, will he have accumulated enough money at the end of his working life to live on?

In any case, there's not much here on the standard industry definition of risk, the volatility of returns.

The investment manager

When managing a fund that many others are invested in (that is, a managed investments scheme) the investment manager is trying to invest in one way to suit the needs of many. However, he or she does not know the attributes, attitudes, timeframes and needs of the 'many' and so by necessity must manage the investments with one eye shut.

The investment manager thinks of risk in terms of the following:

- volatility of the value of an individual asset
- volatility of the valuation of an asset sector (usually based on history)
- concentration risk (having too few securities in a portfolio)
- differentiation from competitors
- differentiation from the benchmark being used to measure the performance of the fund.

And most investment managers measure the above things over quite short time periods, often less than a year, and indeed are usually remunerated based on 'success' over one year periods.

The regulator

And then of course we have the regulator. Whilst I am sure the regulator thinks of risk very widely, it seems to me they want trustees to adhere to some of life's basic rules:

- be honest and fair
- take your role seriously, both in the way you act and your knowledge and skill
- try your hardest
- if you make a mistake say sorry and rectify it
- don't receive a personal benefit at the expense of your clients.

I have a short and simple book called *Life's Little Instruction Book,* by H. Jackson Brown, which records personal observations from a father to his son to help him in his life. I sometimes wish our law-makers would use it and save paper!

So where are we going wrong on risk?

With these multiple facets to the word 'risk', where does this leave us?

I believe there is a high misallocation of resources, energy and intellect across the superannuation industry (and investment industry more broadly) to address risk. The media use the word risk in quite a sensationalist manner, often without proper definition and logical timeframe for measurement. And I believe regulators have a thirst to micro manage risk and even attempt to

eliminate risk, as though this unquestionably gives a better outcome, and without proper regard to the cost and benefit of what they are seeking to achieve.

And most talk about risk in investment circles in a one dimensional manner, being the volatility of the value of an asset, when this is often meaningless without appropriate context.

Analysts report as though risk can be measured or adjusted with pin point accuracy, using phrases such as 'too much risk' and 'risk-on, risk-off plays', when this is simply not the case.

The wisdom of Howard Marks on risk

The best overall summary I have read on risk is contained in Chapter 5 of Howard Marks' *The Most Important Thing, Uncommon Sense for the Thoughtful Investor*. Although many investors in Australia may not know of Marks, he is well known in the US investment industry and in my opinion he is up there in wisdom with Warren Buffet. Buffet himself said of this book, "This is that rarity, a useful book."

Marks makes the point that according to the academicians (his word, not mine!) who developed capital markets theory, risk equals volatility, because volatility indicates the unreliability of an investment. Marks takes great issue with this definition of risk, as he doesn't think volatility is the risk most investors care about. I agree. Like Marks, I think the possibility of permanent capital loss from owning an asset is at the heart of what investment risk is truly about, followed by the possibility of an unacceptably low return from holding a particular asset.

Marks believes much of risk is subjective, hidden and unquantifiable and is largely a matter of opinion. He makes the point that investment risk is largely invisible before the fact – except perhaps to people with unusual insight – and even after an investment has been exited. And in the following words he points out a profound paradox:

"Return alone – and especially return over short periods of time – says very little about the quality of investment decisions. Return has to be evaluated relative to the amount of risk taken to achieve it. And yet, risk cannot be measured. Certainly it cannot be gauged on the basis of what 'everybody' says at a moment in time. Risk can be judged only by sophisticated, experienced, second-level thinkers."

Marks makes the obvious observation that in dealing with risk there are three steps: understanding it, recognising when it is high, and controlling it. I believe we have a long way to go in understanding risk, particularly which risks matter the most, which surely must be those that impact the end investor the most (like my 24-year-old son). And I believe we must all have a far better framework of thinking to decide which risks we should allocate time, cost and resources to minimise or eliminate, versus those risks we should simply accept.

What does a better risk framework need?

What do we need in this risk framework? Risk is primarily about losing money and not meeting a realistic financial goal that you set out to achieve. Volatility or standard deviation of returns is at best a side issue. It's convenient because statistical calculations allow a number to be put on risk, but it's not really what matters.

Short termism has created an obsession with volatility. It would be preferable to prohibit the publication on performance numbers with less than 12 months of data.

I believe the really important things for investors are as follows, and if these matter for the clients, then they should also be the focus for trustees and regulators:

- prevention of fraud, such as the use of an independent custodian
- credibility and reliability of the institution investing the money
- experience, competence and integrity of the people doing the investing
- understanding by clients of investment markets and alternative choices (ie education)
- diversification of investments and avoidance of asset concentration

The regulator should focus on making the system honest and fair, and ensure both its own staff and those in the industry have appropriate skills to meet their obligations.

We can employ the best market experts, compliance officers by the dozen, regulators from every government department imaginable, and have committee signoffs, board approvals and obey every regulation in the land. And then something like the GFC can hit a portfolio, or there can be an environmental disaster, or an act of terrorism, and the best risk management in the world will not prevent a loss of capital. Spread sheets and management reports create an over confidence that we can recognise and understand risks in advance.

As Howard Marks says, and I wholeheartedly agree, the possibility of a permanent capital loss from owning an asset is at the heart of what investment risk is truly about. And ultimately, I don't think there's much that can be done to wholly prevent these risks.

The financial life cycle paradox

Michael McAlary

Changing lifestyles combined with increasing life expectancy have outgrown traditional retirement planning models. But living longer does not translate into financial freedom. The natural conclusion is that you can work longer and therefore have more savings for your retirement. But the paradox is that people have less income-earning years and more education years and a better education does not necessarily lead to an improved financial position.

Increased life expectancy

Over the last 50 years, life expectancy has increased by around 12 years. A child born today will live until they are in their early 90s, and possibly much longer. The reasons Australians are living longer include better diet, improved medicines and living conditions.

In addition to everyone living longer, people are delaying significant life events. Australians are getting married and starting families later and having fewer children. Higher property costs means that children are staying at home longer and this is reflected in the increasing age of first home buyers. Many of these decisions regarding lifestyle are made because of someone's financial position.

Economic structural changes

There have also been structural changes to the Australian economy that are impacting on an individual's ability to save and invest for their future. Notably, Australia has increasingly become a high cost of production economy and to compete internationally we must improve our skills and qualifications. Australians are therefore spending more time at school and in tertiary and vocational training at a financial cost to themselves. Even with Government assistance to fund tertiary education many young adults are starting their working years indebted.

Another major structural change occurring is the increasing trend to casual or part time work. Until the early 1990s it was common to have a job with one organisation for life. Today, this is rare and it is expected that people will change not only jobs four or five times in their career, but also the industry. This trend to part time or casual work, particularly amongst older workers, means their pre-retirement incomes are lower, limiting their ability to save.

Wealthmaker Financial Services has analysed these trends and structural changes, producing some telling ratios that have implications not only for financial institutions, but every Australian.

Life Expectancy Analysis	1960 Years	Today Years
Life expectancy	71	82
Comprised of:		
Childhood & education	19	25
Income earning	44	35
Retirement	8	22
Ratio Analysis		
Income Earning/Life Expectancy	61.7%	42.7%
Retirement/Life Expectancy	11.3%	26.8%
Income Earning/Retirement	5.5/1.0	1.6/1.0

Sources: CIA World Fact Book, World Bank, ABS School Statistics Census, Australian Bureau of Statistics. Averaging has been applied to cover the differences, e.g. males versus females.

The table shows that a person born in 1960 was expected to live to 71, today that person's life expectancy has been revised to 82. The table then shows how those years will be spent. The table contains three important points for all of us:

1. Income earning/life expectancy

In 1960 the average Australian spent 61.7% of their life working, whereas today it's only 42.7%. This means that Australians have less time in the workforce, and therefore a reduced timeframe to save and invest for their retirement.

2. Retirement/life expectancy

In 1960 the average Australian was expected to live for 8 years after they retired. Today it's around 22 years. For many in their pre-retirement years, they are unable to accumulate anymore wealth because they are working part-time, even though they may wish to work full time. This means that their income is being used for living expenses.

3. Income Earning/Retirement

In 1960, an Australian had 5.5 income-earning years to save or invest for each retirement year. Today the ratio is 1.6 earning years. An individual must save enough during their income-earning years to pay for 22 years of expected retirement.

Another factor frequently overlooked is the increasing tertiary education costs. Even with HECS and VET fee assistance, most children today when they start their working lives are indebted and often have to pay off this debt before they take out a mortgage. This is unlike the baby boomers, many of whom received free tertiary education, so they started their working lives debt free.

As our income-earning years are decreasing and our retirement years are increasing the current level of superannuation savings is insufficient. The Federal Government is taking some action to address this by increasing the superannuation levy, however, this only goes part of the way. Australians will have to work longer and may have to accept a lower standard of living both before and in retirement.

Michael McAlary is Founder and Managing Director of WealthMaker Financial Services.

Managing for real returns

David Bell

I have previously made the case that real return outcomes are crucial for those saving for retirement and living off their retirement savings. Yet institutional super funds do not explicitly manage the risk of real return outcomes. The typical mix of assets in a default super fund results in the risk to real outcomes (that is, the returns adjusted for inflation and the more important outcome) being greater than the risk to nominal outcomes (that is, returns before adjusting for inflation, a less important outcome). This article explores the concept of managing for real returns.

In a nominal return portfolio construction framework, investors think of the major asset classes as follows: cash is our risk-free asset, bonds are a defensive asset class which should perform well in a difficult economic environment, and equities are a growth asset which participates (less consistently than you may think) in the strength of the broader economy.

As a result we see higher levels of risk, as displayed in the rolling nominal return volatility table below. Table 1 below looks at the volatility of annualised returns for both nominal and real outcomes over a period from 1900 to 2012.

Asset Class	Volatility (Nominal)	Volatility (Real)
Cash	3.9%	5.4%
Domestic Bonds	10.7%	12.1%
Australian Equities	17.7%	17.7%
Global Equities (unhedged)	18.7%	17.6%

Table 1: Volatility of annualised returns for different asset classes (1 January 1900 to 31 January 2012). Source: Schroders; "Why SAA is Flawed?" March 2012, Schroder Investment Management.

The nominal results are in accordance with the expectations described above. However, the returns from bonds and cash have, over the very long term, been more volatile than one may expect, since the last 20 years has been a period of low volatility for these asset classes. Once we switch our mindsets to focusing on the risk to real return outcomes, the risk profile changes:

- The historical real return from cash is more volatile than the nominal return, which may surprise, given the current setting we have become accustomed to whereby the Reserve Bank adjusts the cash rate to control medium term inflation.

- The return profile of nominal bonds becomes more volatile when viewed from a real return perspective rather than a nominal return perspective. The reason why is that in high inflation environments it is common to see nominal bond yields rise (based on inflation expectations). Rising bond yields results in falling bond prices so investors in bonds may take two hits in an inflationary environment: the purchasing power of their capital falls (due to rising inflation), and the value of their nominal portfolio falls.

- The return profile of equities remains volatile when outcomes are viewed in real terms. There is no clear pattern whether companies are able to pass on input cost increases (including labour). Indeed there are many other factors at play such as government policy and macroeconomic effects such as changes to exchange rates and interest rates. So we see the volatility of real outcomes remain high.

Overall, when we are focused on managing the risk to real return outcomes we are considering outcomes relative to inflation. In this sense inflation becomes what we call the numèraire (the basis for comparison). Observing and hence managing nominal return risk assessment is easier because risk is measured as variability in the nominal outcomes. When considering real return risk

assessment, we need to consider the nominal return against the inflation outcome. That is why nominal bonds appear more risky in a real return context: they often experience negative returns at the same time that inflation is high (so a double whammy), as illustrated previously.

In terms of other assets and investment strategies:

- Inflation-linked bonds are often viewed as a low risk investment when we are focusing on real return outcomes. However this is only true over a long term holding period. Over shorter periods of time indexed bonds often have very long maturities and carry significant duration risk, so the short term variability in the bond price may be quite large even though the risk to inflation outcomes is offset by the indexation of the coupons payments. This is an important consideration if you have a range of investors in a fund all retiring at different times (we call this sequencing risk, as discussed in *Cuffelinks* on 6 March 2013).

- Real assets are often regarded as good inflation hedges. Examples include property and infrastructure where the income stream may be linked to inflation. However the real outcomes could still be volatile due to other factors. For example, if interest rates rise significantly in response to inflation, the asset price may fall if based on a discounted cash flow technique.

- Investments in commodities are also viewed as inflation hedges. There is logic to this argument but there will still be large variability as there are many supply and demand factors (besides inflation) which affect commodity prices.

Overall the challenge of managing real outcome risk is significant. Managing real outcome risk is more complex than managing for nominal outcomes (because the numèraire, inflation, is itself a variable quantity). It creates the challenge to think more strategically about inflation itself and the role of each potential investment in different inflationary environments. The starting point of a real return focussed asset allocation framework would be:

1. Create expectations of real returns for each asset class. For each asset consider the underlying ability for its return stream to change with inflation.

2. Consider the risk to real return outcomes for each asset class. How could each asset class perform in different inflationary environments?

3. Consider the likelihood for the inflationary setting to change.

I'm yet to see any super funds that explicitly manage for real outcomes. There is also an opportunity for asset consultants to frame their asset allocation advice in this manner as well. There are some managed funds in the real return or target return space that are heading down this path. There is a significant leadership opportunity for super funds to manage real return risk and ultimately improve the outcomes of those in Australia's retirement income system, where the inflation risk represents a potential erosion of their retirement outcomes.

This is the third of three articles which makes the case that we need to have a greater focus on real return outcomes. Simply stated, real return outcomes are more volatile than nominal outcomes, and of course have been lower. However there is a dangerous tail risk element evident as well, due to periods of higher inflation. By explicitly targeting real return risk we are better positioned to manage the risk that most directly relates to retirement outcomes.

Supersize and individual reporting for members

Bruce Gregor

Financial institutions have for centuries put great store on 'bigger means better'. In the early days of banking, this was manifest in the size of stone façades, vaults and ceiling height. In the explosion of life insurance companies in the 1960's, it was to be the tallest building in town.

Now that superannuation holds the greatest sway with savings, it's a bit more difficult for these new standalone institutions to make a great show of size. Most services are outsourced and direct employee numbers and operating revenues are small. It's hard to justify that skyscraper.

So what should these supersize funds be doing to demonstrate the greater capacity they have to do more for members – **individually?**

It should be so simple. They should provide a calculation of a member's actual average return over their period of membership based on their own cash flow of contributions and fees experienced. Technically, this is an internal rate of return. Not fund averages, not generalisations about all the members, but individual reporting, preferably in real terms.

The main metric currently focused on in advertisements by these funds seems to be around expense ratios. This is meaningful to individual members and worth being highlighted as a competitive advantage. A typical promotion of this advantage might be something along the lines of "*if you pay an extra 1% each year in fees, you could lose up to 20% from your retirement benefit over 30 years*". Will these funds actually calculate individually for a 30 year member what their actual compound average fee percentage has been? They certainly have the data and technology to do this but I'm unaware of anyone doing this.

More importantly, will these funds be progressively calculating the actual investment return the member has earned over their 30 years of membership (as an internal rate of return) on their contributions? They could easily do this with the 'big data' and 'big technology' achieved by size. Just as easy to do would be the equivalent average inflation rate so that 'real return' would be readily available as well.

The individual calculation of average return and real return over total membership period is the missing ingredient in educating members individually from their own experience. By becoming more familiar with the stability of average returns over the long-term membership period, members can learn to avoid knee-jerk reactions to stock market gyrations which generally see them move out of long term strategies at the worst time and never return.

This information would also help financial advisers in delving deeper into finessing long term strategies for the member in the context of their own experience, knowing that the member can be expected to have a more rational future behaviour within assumed risk profile.

So how might the 'supersize' fund promote the benefit of their new individually targeted real return reporting. Something like:

"*If you join our fund we will provide you with actual lifetime reporting of your long term returns, after inflation and fees. With this personally targeted information you can be learning about long term investing from your own actual experience. This on demand calculation service will also assist your financial adviser in evaluating long term investment strategies for you based on your own experience. For example, if you do not develop sufficient knowledge to keep to long investment strategies, a 2% pa lower average return could lose up to 30% from your retirement benefit over 30 years.*"

Whilst superannuation funds put great store on generic glossy reports and newsletters to educate members, there's nothing like the impact of an individual learning from the university of life. Best to start doing this education when balances are small.

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

Australia's economic future, with Dr Ken Henry

The Conversation

Dr Ken Henry is the part-time Executive Chair of the Institute of Public Policy at the Crawford School of Public Policy, ANU. He is the former Treasury Secretary and the Prime Minister's Special Adviser, responsible for the 'Australia in the Asian Century' White Paper.

Just where is the Australian economy heading? The investment mining boom has peaked, and the structural changes sweeping manufacturing continue. Dr Henry tells SBS business reporter Ricardo Gonsalves that Australia can reposition itself as a quality supplier of high grade goods and services the growing Chinese middle class will increasingly desire – but only if critical microeconomic productivity reform is taken seriously.

Q: There seems to be a lot of talk about a slowdown in China but even today, the Reserve Bank of Australia (RBA) said in its **monthly board meeting minutes** that 'China's economic activity appears to be expanding at a steady pace and Japan is pointing to continued growth in April'. So with that in mind, do you think Australia's key stakeholders like the government and businesses really understand the importance of Asia?

A: Well it's mixed frankly. When I go around Australia and indeed internationally, and talk to people about what's happening in Asia – notwithstanding the publication of the **White Paper**, notwithstanding the intense focus that there has been in certain quarters about the developments in Asia – I find that some people understand what is going on very well, they get it. But there are still a lot of people who don't get it, including in business in Australia. You know, this is true all over the world. I was in the United States last week talking to people who would see themselves as Asia experts and you know what? In my view they don't get it.

Q: Well what aren't they getting?

A: Well, the question that gets asked all the time about Asia is whether the spectacular growth we have seen to date can be sustained or whether it can't be sustained and whether in particular, and this is a question which matters more to an American audiences than it does Australian audiences, whether in particular and when China is going to surpass the United States as the global superpower.

And people seem to get preoccupied with this question, when is China going to replace the United States as a global superpower? In my view, that question has limited relevance. What's of much more interest really is how is the lives of people in Australia and the lives of people in the United States and indeed all over the world, how are they going to be affected by what is happening in China and other parts of Asia.

It is not just a China story, but of course it is largely a China story. And the truth is this, their lives have already been affected by the spectacular growth and spectacular economic growth of China and China's growth will continue to impact on their lives for decades to come. Quite possibly right

through this century. In fact, the emergence of China as a major economic power has to be recognised as the most spectacular economic shock ever, to hit the world.

Q: Okay, so which sectors will find it easy and in addition to that, you said in a recent interview that "some areas it may be already too late to get its act together in Asia". Which areas are you talking about?

A: It's too difficult, it's quite difficult to be terribly specific. But look, there are some businesses and some sectors in Australia that really do get the implications of this structural change that is taking place in Australian economy. Those are the ones that understand the developments in Asia. Okay. Thus far, as I have said we've seen very strong growth in Chinese demand for Australian raw materials, particularly for iron ore and coking coal. India too, strong demand for Australian resources. Japan continues to have strong demand for Australian resources. In South Korea also, strong demand for Australian resources. But that's not the only development that is underway in Asia.

Today, there are something like 60 million people in China that could be regarded as middle-class people. We think of ourselves as middle class here in Australia by and large. There's probably three times as many middle-class people in China as there are in Australia today.

In 15 years' time, Asia will have 3.2 billion middle class consumers. The Australian market, even if we define ourselves to middle class consumers, the Australian market will be less than 1% of the Asian middle class consumer market. Those business that are likely, those Australian business that are likely to be successful in the Asian century are those that have already figured this out and are already repositioning their businesses in order to market product, whether it's goods or services, to that 3.2 billion middle class consumers in the Asian region.

And those that I talked to that I feel most confident about are those that understand the very important truth – that if you want to do well in the Asian Century, you don't have to be a mass marketer of low-grade commodity in order to do well, you only have to get a tiny percentage of that 3.2 billion consumer market in order to be able to do well. How do you get a tiny percentage of that market? What's the best ingredient for success? It's quality. Quite simply, it's quality.

You go to China – I was in China a couple of weeks ago – it's evident wherever you go in China what the Chinese middle class want to buy is brand. That's what they want to buy. Because brand means quality. They're not buying trash. They're not buying low-grade stuff. They're into the very high-grade stuff. And they actually see Australia as a supplier of high-grade stuff and it's not just wine by the way but also in design and architectural services, they see Australia as being a supplier of high-grade stuff. Then the big one, the really big one, is tourism. Australia is a major exporter of tourism services, we don't always articulate it this way, but we are a major exporter of tourism services.

Q: For businesses to grow effectively, from Australia into Asia they need appropriate policies and regulations. So given that, is the government failing in its Asian relationship-building duties?

A: Well look, in the white paper, in the government's own white paper – five platforms were articulated in order for Australia to secure its place in the Asian Century. And the first of those platforms was a productive and resilient economy – that's what it says and that's what the government commits to. The first point to make about that is that there's much that Australia has already done in terms of building institutions and institutional frameworks and in terms of economic reform particularly microeconomic reforms through the 1980s and the 1990s in particular.

There's already a lot that's been done to construct a fairly dynamic industrialised economy. If you compare the Australian economy with the recent performance of the United States, or I would say with any economy in Europe including the United Kingdom, that's not in the Eurozone but

nevertheless in Europe, you'd have to say that the Australian economy exhibits extraordinary dynamism and much of that can be put down to that long period of economic reform.

But that's not to say that everything's been done. A lot of people recently have made the point and I have publicly myself that you would feel more comfortable about Australia's ability to remain resilient in the future, in the Asian century, were we now doing on the economic reform front, more to lift national productivity.

One of the things in this respect that really disappoints me is that in 2007, in 2008, there was agreement among state/territory governments and the Commonwealth Government – agreement to embark on a sustained program of productivity-enhancing microeconomic reforms. And it's fallen apart. And if we can't secure national agreement to productivity-enhancing national reforms and then deliver them, then I'm going to have to continue to question Australia's ability to make the most of the Asian Century.

Q: So which side of politics do you believe is better to lead Australia into the Asian Century?

A: I would make no comment on that.

Q: So given that we are headed into a federal election, which leader – Julia Gillard or Kevin Rudd – is more appropriate to lead Australia into an Asian Century?

A: I don't want to comment on that either. But I would say this and I hope you don't think this is ducking the question. I actually think this point is more important. What's going to matter for Australia is policies, much more than leaders.

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THE CONVERSATION

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