Cuffelinks
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This Week's Top Articles

It's time to industrialise every SMSF

Graham Hand

The time is long gone when it was acceptable for any SMSF to be administered by a suburban accountant with a spread sheet and a collection of letters and notices in a shoe box. One million trustees of half a million SMSFs holding half a trillion dollars of assets – the sector is now a major political and financial force. But with power and profile comes responsibility, and administration and management of SMSFs must be as robust and accurate as possible. If trustees have the right to control their own super fund, they must ensure it is managed honestly, efficiently and in conformity with a vast array of rules and regulations. Every fund must be 'industrial strength'.

The rise and rise of SMSFs

When Paul Keating wrote for the second edition of *Cuffelinks*, he made an extraordinary admission:

"When we laid the foundations for the current superannuation system in the 1991 Budget, I never expected Self Managed Super Funds to become the largest segment of super. They were almost an afterthought added to the legislation as a replacement for defined benefit schemes."

That 'afterthought' is now an irresistible force. SMSFs are a remarkable feature of the Australian superannuation landscape. Although the ATO data is effectively two years old*, the March 2013 statistical report shows the following (and don't make too much of March's lower growth):

Table 1. ATO Self-managed super fund statistical report, March 2013

	Jun-12	Sep-12	Dec-12	Mar-13
Establishments	11,610	11,466	9,748	5,840
Wind ups	3,251	974	159	62
Net establishments	8,359	10,492	9,589	5,778
Total number of SMSFs	477,461	487,953	497,542	503,320
Total members of SMSFs	907,036	930,614	947,760	958,095

*The latest ATO data is only an estimate. The ATO states: *The number of members of SMSFs is estimated based on SMSF return form data, with the estimates for June 2012 extrapolated from 2010-11 data.*

How is a half a trillion dollars administered?

The largest banks and wealth management companies have allowed SMSFs to become a $500 billion industry administered by others, notably thousands of suburban accountants, supported by software provided by a few relatively small players. There is little or no SMSF administration done by the massive 'industrialised' systems of the largest financial institutions in the country.

There are several explanations for this. Until recently, technology had not advanced to such a degree where the largest banks and wealth managers thought they could administer the funds efficiently. SMSF administration was little more than a 'cottage industry', dominated by accountants as part of an overall tax management relationship. It is claimed that the largest SMSF administrator in the country is Cavendish, with 5,000 funds and 110 employees. This is only 1% of the market. Some large accounting firms which specialise in SMSF service have only a few hundred funds, and many accountants as few as a dozen. AMP has embarked on a major tilt at SMSFs, but at the moment, across all their businesses, administer about 10,000 funds (including Cavendish).

The second excuse relies on the reasons SMSFs are established: the desire for control, the ability to select specific stocks, to save money on fees, the perceived poor performance of large super funds, and the advice of accountants. A quick tick of these reasons explains much of the lack of impact by large institutions. Investing in a traditional retail or industry super fund does not give control over investments or stock selection, with the perception of high fees without decent performance. Little wonder when the friendly family accountant comes along and offers to do all the administration for $2,000 a year, removing $5,000 in management fees, that many investors make the jump.

Most large institutions seem to think that offering a bank account and link to their in-house broker is an SMSF solution. Take a look at the branches or websites of National, CBA and Westpac and their related wealth businesses. Each will claim they have an 'SMSF Service', but they crucially miss the establishment and administration services. For example, go into a National Bank branch and pick up their prettily-boxed package called 'Retire in Comfort'. There is nothing in there on SMSFs. Type 'SMSF' into NAB's search engine and it takes you to deposit accounts, borrowing and remarkable insights such as "an SMSF can own a farming property but it cannot operate a farming business." But where is the entire SMSF package? Amazingly, they actually send customers away:

"You could use a lawyer who specialises in this area or purchase a deed from an SMSF service provider that has been 'pre-prepared' by legal experts."

The other major banks are the same, with the possible exception of ANZ which offers an administration solution through Super Concepts. AMP has established the AMP SMSF unit, comprising Cavendish, SuperIQ, Ascend and Multiport. And the main response from the industry funds is to offer super wraps, such as Australian Super and its Member Direct offer. But they are not SMSFs.

Developments in SMSF software

In the last couple of years, there have been significant advances in the quality and availability of SMSF administration software. Barely a month passes without a new entrant announcing its product. The more established players such as Class Super, BGL, SuperIQ and Supermate continuously refine their products. This software is used by administrators and supports the better back offices of thousands of accountants, advisers and dedicated administration services.

The best software stores all supporting material electronically, including lengthy legal documents such as the trust deed. It ensures documents like the investment policy are regularly updated. Direct feeds into the software from stock brokers and the ASX record share transactions as they occur, bank account records are updated immediately and all dividends and interest payments are automated. There should be none of the scrambling around a year after 30 June, trying to identify transactions. Records are updated real time, and trustees can see their fund balances, transactions and investments on a screen at any time.

Technology has now reached the point where large players can offer full service solutions, and they are becoming more serious about moving into SMSF administration.

What are the shortcomings at the moment?

There are still thousands of SMSF administrators who have cobbled together their service using various automated and manual sources. Every SMSF is unique, and the administrators strain under the back office workload of identifying every transaction and keeping abreast of rapidly changing, complex regulations. There are an estimated 12,000 SMSF auditors but 50% of them perform less than 10 audits a year – hardly a workload that fosters the required expertise. It is usually the SMSF administrator or accountant who chooses the auditor, which can lead to a cosy relationship, with the client paying an annual audit fee of around $500. Until the recent tightening of regulations, there was often a piecemeal approach to valuing assets, including property.

With predominantly inexperienced trustees unaware of their responsibilities, the potential for SMSFs to breach rules is obvious. The more common violations are loans to related parties, using trust assets for personal purposes, failing to lodge on time and exceeding contribution caps. As part of an annual audit, approved auditors must submit Auditor Contravention Reports (ACRs) for prescribed SMSF contraventions to the ATO. In the year to 30 June 2012, there were 8,125 SMSFs that had ACRs lodged containing 19,823 contraventions. It is not acceptable for a tax-advantaged structure to have such potential for non-compliance.

It is clear that ASIC is worried about some SMSF activities. ASIC commissioner Peter Kell recently warned that the regulator did not want SMSFs to become the 'vehicle of choice' of property spruikers. The former superannuation minister, Nick Sherry, has warned that low balance SMSFs need to watch the significant fixed costs, and that many trustees have no idea of their obligations.

Deloitte Access Economics recently wrote a report for ASFA called '*Maximising Superannuation Capital'*, and highlighted:

- SMSFs are usually managed at a family level, with one person as the primary manager. If that person dies, leaves the family or becomes incapacitated, the other trustees may not have the skills to continue SMSF management.

- The asset allocation of an SMSF moving from accumulation to pension as the members age takes a lot of skill to manage. There may also be problems of high fixed costs as the fund reduces in value.
- One million members represent a massive voter block, and they are more difficult to influence than large funds, which can be directed by regulators to follow a certain course. The regulation of SMSFs by the ATO is also different. Public industry and retail funds are regulated by the Australian Prudential Regulatory Authority, while the ATO relies on auditors to control compliance issues.

Penalties for non-compliance or breaches

From 1 July 2013, the ATO will fine trustees directly, and potentially their advisers and accountants, for breaches in the management of their SMSF. Depending on the type of non-compliance, fines start at $850 for relatively minor offenses, and could be as high as $10,200 for a breach such as lending to a member. Fines cannot be paid for by, or claimed as an expense of, the fund but must be paid by the trustee, and it appears that the ATO has no discretion whether to charge the fine or not. Fines will apply for minor breaches, such as not maintaining records correctly or failing to advise of fund changes. Many will think these are innocent oversights which might previously have been corrected without penalty. In addition, new rules have been introduced on valuing off-market assets. The incentive to maintain a complying SMSF is enormous.

The large institutions are not even attracting the investments

The large banks and wealth managers should be servicing the SMSF space better because they are not only missing the administration role, but they are not managing the investments. Most large retail and industry super funds monitor their inflows by source and outflows by destination, and they are all losing money to SMSFs. Industry consultant, Tria Partners, estimates that 50,000 Australians leave public funds for SMSFs each year.

The ATO's estimated SMSF asset allocation is:

- 37% listed shares and trusts
- 28% cash and term deposits
- 15% real estate, mainly non-residential
- 9% unlisted trusts and 5% 'other managed investments'.

So the massive managed fund industry, comprising perhaps 200 product providers and once the dominant players in wealth management, takes less than 15% of SMSF assets in the 'managed fund' space. They must address their entire SMSF strategy.

In summary, we have an SMSF administrative system holding one-third of all superannuation and the retirement dreams of a million Australians being managed predominantly by small players in Australian finance. For those who choose to use it, SMSF software is improving rapidly, but most trustees are unlikely to fully understand their legal obligations and requirements of their trust deed. Many are in for a shock when they learn of the severity of the new fines for breaches of the even the most minor of the SMSF regulations.

It would be a far more secure and robust sector if the administrative solutions had minimum 'industrial strength' standards, such as real-time updates, online tracking of every investment, and a complete history of trustee decisions. It would also inspire more confidence if it were backed by the capital and resources of Australia's largest financial institutions.

Economic growth does not drive stock market returns

Ashley Owen

In every city in every major country across the world, floors full of well-meaning (and expensive) economists, fund managers and analysts spend their lives assessing the outlooks for economic growth rates in the hope that it somehow translates into stock market returns. Whenever the World Bank, the IMF, OECD, central banks, or a major investment bank comes out with its latest economic forecasts, investors everywhere naturally try to understand what it may mean for share prices.

Good economic growth should be good for share prices, and low economic growth (or even worse, recessions) should be bad for share prices, right? Well, wrong actually. Most of the time, it's the opposite in real life.

The 'top down' approach

There are many approaches to forming views about the outlook for share prices and whole stock markets. One of the main traditional and widely used approaches is the 'top down' method. This starts with the global economic outlook and then the outlooks for regions, countries, sectors, industries, and then individual companies.

It is all based on the quite logical assumption that economic growth drives (or is caused by, or at least coincides with) company earnings growth, and that earnings drive stock prices. Or at least expectations of economic growth and expectations of earnings drive stock prices. Or perhaps even that expectations of likely changes in economic growth rates drive stock prices directly.

Of course there are many links between economies and company earnings. After all, what makes up the 'economy' is individuals, firms and governments receiving and spending money; buying, selling, exporting and importing goods and services; saving, investing, borrowing, employing people, etc, - and listed companies are involved in almost all stages of these activities that make up the economy. So it would make sense that increases or decreases in economic activity should affect listed company earnings and share prices.

The problem is that none of these assumptions hold true very often. In fact in most years and in most countries the *opposite* is the case.

There is no exploitable statistical relationship between economic growth rates and stock market returns, either at a global level or in individual countries, or indeed individual companies. We will look at the global picture first, since economies are highly interconnected and stock markets are also highly correlated.

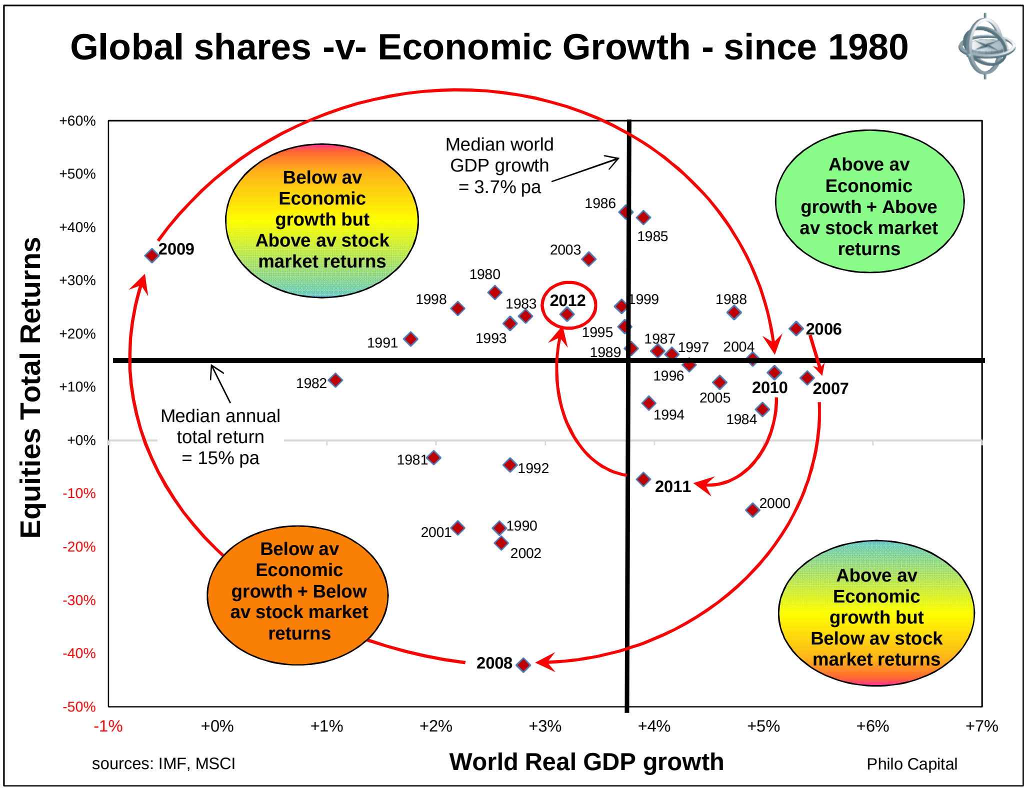
Global economic growth versus global equities returns

Only rarely do *above* average world economic growth rates coincide with, cause or result from, *above* average stock market returns. In only 2 years in the past 32 years since 1980 has this been the case – 1988 and 2006.

Likewise, in only 6 years have *below* average world economic growth rates coincided with, caused or resulted from, *below* average stock market returns – 1981, 1990, 1992, 2001, 2002 and 2008.

In fact at least half of the time when economic growth was *above* average, stock market returns were *below* average, and at least half of the time when economic growth was *below* average (including in global recessions), stock market returns were *above* average.

This can be seen in the following chart of world real GDP growth and world stock market total returns (ie price changes plus dividends) for each year since 1980:



If economic growth rates coincided with, caused or resulted from, or somehow translated into stock market returns then most years would be in either the top right segment (above average economic growth + above average stock market returns) or in the lower left segment (below average economic growth + below average stock market returns). But in real life this has not been the case.

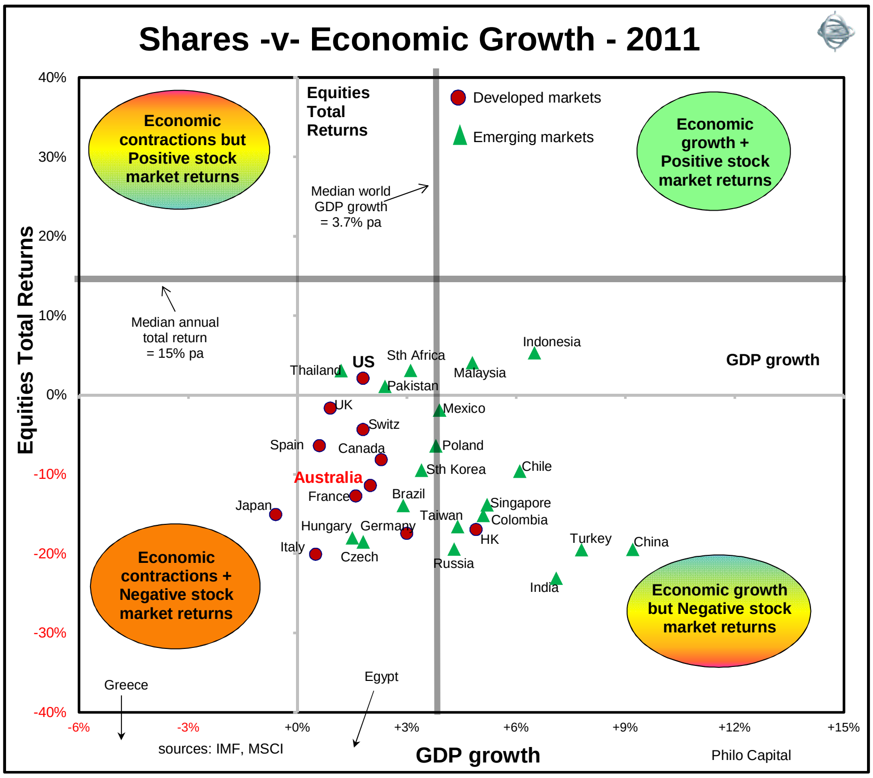
For example 2012 was similar to several other years in the recent past – when economic growth was *below* average but stock market returns were *above* average. This followed 2011 when economic growth was *above* average (3.9% compared to a 30 year average of 3.7%) but stock market returns were very poor and well *below* average.

Going back further, in 2009 world economic growth contracted in the deepest global recession since the 1930s depression, but shares had a great year in 2009 and the world stock market index was up by 29%!

Individual countries

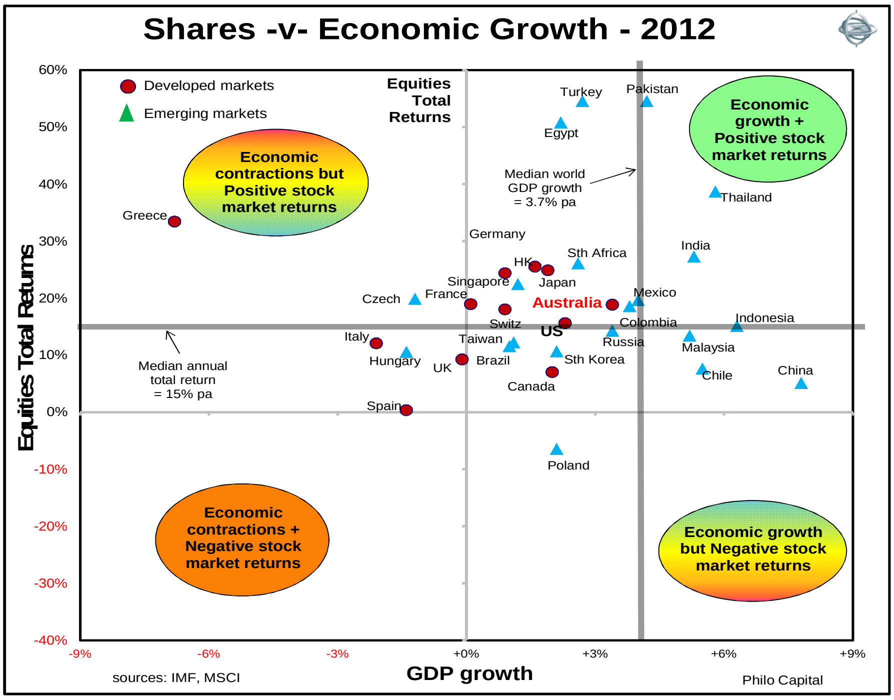
There is a similar story when looking at cross sectional returns in individual countries in any particular year.

For example, in 2011 economies almost everywhere grew (except Japan with its tsunami/nuclear crisis), overall global growth was above its long term average, and earnings and dividends grew strongly in most of the major countries. But almost all stock markets were *down* heavily that year, despite the good growth in economies, earnings and dividends.



In 2011 the highest growth economies (China, India, Turkey) had the worst stock market returns. Of those very few major stock markets that had positive total returns in 2011, only Indonesia posted price gains. In the others (US, Thailand, Pakistan and South Africa) the broad market price index fell, but the addition of dividends helped them just scrape into positive total return territory, while Malaysia was flat.

Then in 2012 the situation reversed. Economic growth rates were lower and earnings growth stopped or fell in most countries (including in most of the big markets), but stock markets in almost every country boomed.



Nearly all stock markets were up for the year while economic growth was patchy. US growth was sub-trend, and Europe drifted in and out of recession, with significant contractions in the PIIGS, and yet share prices rocketed up almost everywhere.

Conversely, the highest economic growth rate was in China, which once again had one of the worst stock market returns. The worst economy was Greece, which had one of the best performing stock markets that year (up 33% plus dividends!).

(2012 was one of those very rare years when *every* asset class did well - shares, commercial property, every type of bond market - government, corporate, high yield, emerging market and inflation-linked, and even gold was up 6%. These great returns across every asset class were achieved despite rolling recessions and high unemployment in the developed markets, slowing growth in the BRIC markets, escalating currency wars, rising political and social unrest across the world, troubling military tensions in north Asia, plus the odd nuclear scare thrown in for good measure from Iran and North Korea).

The relationship between economic growth and stock market returns is so perverse that the regular economic outlook statements from the World Bank and the IMF have almost become contrary indicators. Whenever they lower their global growth outlooks it is usually followed by good returns, and vice versa.

There are examples of this everywhere. Every time US Fed Chairman Ben Bernanke declared that the US economy was so weak it had to be put on life support (in the form of QE-1, QE-2, Operation Twist, QE-3, QE-4, etc) investors rejoiced and stock and bond markets in the US and around the world boomed. But in late May 2013, when suggested that the US economy is strengthening to the point where it can now be taken off life support, stock and bond markets fell heavily in the US and everywhere else as investors panicked and ran for the exits. The last thing investors want is a strong economy.

In conclusion, links between economic growth, company earnings and share prices are not as simple and as straightforward as assuming that higher (or lower) economic growth leads to higher (or lower) share prices. Like most things in life, timing is everything, but that’s another story for another day.

Ashley Owen is Joint Chief Executive Officer at Philo Capital Advisers.

An SMSF inequity that cries out for attention

Ramani Venkatramani

With Australia’s ageing population, more and more SMSFs are moving from the pure accumulation phase into a hybrid phase with the use of transition-to-retirement (TTR) pensions and eventually into the pure pension phase. This transformation introduces many significant challenges for the trustee members and their professional advisers: continued relevance of investment strategies, segregation versus non-segregation of assets, actuarial certification of the proportion of exempt pensions income, compliance with minimum and maximum pensions, tax deductions on TTR pensions and the practical implications of advancing age in managing the SMSF.

A particular concern is the need to manage fund cash flows to meet emerging pension obligations to comply with ATO minimum and maximum limits, without resorting to fire sale of assets. The global financial crisis demonstrated these difficulties, with the Government reducing the payment obligations in the past. From 2013/14, the normal limits are restored. While lump sum benefits are able to be paid *in specie*, circumventing the need for a fire sale, pension benefits must be paid in cash. This makes careful cash flow management even more critical in the pensions phase.

In addressing the issue, SMSFs need all the help they can get. Whilst pro-active investment planning, retaining a portion in readily-liquefiable assets and taking account of potential pension drawdowns are useful, the scope for enlisting the assistance of the ATO, the SMSF regulator, has received scant attention from trustees and their advisers. This article explains the issue.

Many SMSFs invest in assets that pay franked income. With pensions income being tax-exempt (based on segregated assets or the actuarial certification of exempt income proportion in the case of unsegregated assets), the only tax payable would relate to the concessional contributions and taxable income attributable to accumulation assets (ignoring non arms-length income). As a result, such SMSFs do claim large amounts as refunds in their annual tax returns. The refunds that accrue over the financial year are not able to be used in the SMSFs for many months. This delay could be almost a year for a fund that lodges its return by the due date of 15 May, following the fund year.

This delay affects SMSFs in two ways: reduced liquidity and forgone investment earnings, not to mention the work and pressure on trustees to navigate stressed conditions.

Where any taxpayer (including a super fund) is expected to have a net tax obligation in a financial year, the ATO requires periodical payments of the estimated tax for the year. Based on the last return lodged, the ATO estimates the advance tax the fund must pay. The frequency of payments is determined having regard to the total tax liability: the larger the liability, the more frequent the payment. Here, the ATO acts to protect the cash flows of the government, as indeed it should. Taxpayers have an ability to request a variation of the ATO estimate, based on changed circumstances.

While a fund can seek to reduce its advance tax payment to nil, if it can justify it, it is worth noting that the payment cannot be negative: the fund cannot require the ATO to pay its expected refund in advance, even where it can make out a case for it. Exempt pension income, substantial franking credits (due to say, share buybacks where a part of the buyback price is often deemed to be franked income) or reduced concessional contributions (as happened during the global financial crisis) could all result in refunds (or increase their quantum) rather than a liability.

By law, trustees are obliged to act in members' best interests. This includes following up all receivables periodically, receiving them in cash and reinvesting them promptly in accordance with the investment strategy. Where, as in the case of tax refunds accruing during the year, the receivables are from the regulator itself, this duty is in no way diminished.

My enquiries show that while there are express provisions that enable the ATO to collect taxes in advance, there is no corresponding provision enabling the ATO to release refunds progressively over their accrual period, based on an estimate. While this explains **how** the current asymmetry (of collecting taxes in advance, but not paying refunds like-wise) arises, it does not explain **why** it should be so. It fails the reasonableness test.

The ATO's apparently conflicted role (of holding trustees to account in their conduct, while maximising government revenue) adds another dimension.

I have focused largely on SMSFs in explaining this issue, because in practice, others are able to estimate their franking credits, exempt income and taxable contributions and earnings for the forthcoming year and request a reduction by way of an amendment to their tax payments (limited to zero, as noted above). Most non-SMSFs would expect to receive large taxable contributions and earnings in accumulation phase and would be net payers to the ATO. To be viable, they have to be so. With no loss of liquidity for the fund, equitable treatment of pension and accumulation members in large funds needs consideration.

Many SMSFs in pension or hybrid phases, on the other hand, would be net receivers of refunds. They cannot adjust their cash-flow like their bigger cousins to seek progressive refunds.

As our population and SMSF membership age, this issue will loom larger. The hidden subsidy from the pensioner population to the government, in cash flow and lost income terms, will only increase.

It is about time that those concerned with equity, looking after our retirees and assisting them in cash-flow management, achieve an amendment to the current symmetry. The vocal SMSF lobby has its work cut out. SMSFs should be able to estimate their likely refunds for the future year, and receive a reasonable proportion (say 80%) in advance through quarterly or monthly ATO payments. This should be adjusted in the final return as lodged. As always, measures to prevent abuse can and should be implemented.

What is sauce for the goose is sauce for the gander.

Ramani Venkatramani is an actuary and Principal of Ramani Consulting Pty Ltd. Between 1996 and 2011, he was a senior executive at ISC/APRA, supervising pension funds.

Look at super with different eyes

Andrew Bloore

Too often I hear from people that the only important thing about super is 'the return on my investment'. When you have a better understanding of superannuation regulations, you quickly find out it is far from the most important thing.

The purpose of this article is to encourage people to think differently about super, not to provide the only answer to a problem. The only golden rule of super is that there are no golden rules. Everyone's situation is different. It is important to make your fund work for you, not you for it.

Thinking differently starts with the terms we use. Most people think of super as that thing we do for when we are old. Pensions are things we only use when ultimately we stop work, again about being old. Not so. Super is simply a trust structure, and pensions are just distributions from a trust. They are actually called income streams not pensions. In the same way, a distribution from a company is called a dividend and a distribution from a family trust is a trust distribution. The real driver is the tax benefits that the super environment provides everyone. Anyone who is paying tax on their investments should be asking the question, how can I do this better?

Let's take it away from super for a moment. Here is a simple example of how to think differently:

- person aged 55 with small business
- expects to work for another 15 years then retire with children taking over the business
- trustee of an SMSF with $200,000, all concessional amounts in accumulation
- wants to acquire the business premises valued at $1 million
- has $400,000 cash outside super.

What would normally happen?

- continue to work and pay the base super guarantee amount to the fund, but no additional amount because borrowing money so will want to pay loan off quickly
- head off to the accountant who will set up a Family Trust to buy the property
- contribute or lend the $400,000 cash to the Family Trust and then go to the bank and borrow the remaining $600,000, giving bank security over the property in the Family Trust. This will ensure the asset is there for the family and a few tax benefits of distributing the earnings and capital gains around the family via the Trust.

Sound familiar? There is nothing wrong with this strategy, but there may be a better way to do it that ensures the whole family ends up better off with debt paid off faster. I suggest a rethink.

Starting with the existing SMSF, the first step is to commence a pension. This is where most people fall down – they don't want a pension because they are not old.

By commencing the pension, there will be no income tax or capital gains tax in the fund on the income generated from the assets in the fund. I do note, however, being 55 and with the SMSF money coming from a concessional source, there will be some tax on the pension paid as outlined later. If the pension money is not needed, put it back into the SMSF. This is also a start of estate planning. It changes assets that would be taxed against the children into assets that won't be taxed against the children. If the asset were in a Family Trust, the income every year would be distributed and tax would be paid.

Next, contribute the $400,000 cash to the SMSF and start a second pension with it. There are tax and estate planning benefits here as this is all a Non Concessional Contribution(NCC) therefore not taxed as it goes in and not taxed as it comes out, regardless of who it is paid to.

The client then buys the property through a holding trust entity within the SMSF, following the superannuation rules for borrowing money and buying property. Follow the rules when considering borrowing within your fund as getting it wrong can have adverse consequences. Don't rush out and do this without getting proper advice. The bank is given the security. Strangely, this sounds exactly like the first scenario. The key benefit is that the asset in the fund is not subject to income tax or capital gains tax. If it were in a Family Trust, they would be. Which one do you want?

So what are the benefits of all this?

- pension from the $200,000 @ 4% is $8,000 and is taxable at marginal tax rates less 15% (from age 55 to age 60)
- commence a separate pension for $400,000 with all NCC tax free money (need to ensure the property is segregated to this account and the rent will cover the loan interest payments)
- pensions are paid on net pension amount ie $400,000 not $1 million as the debt is taken off the calculation and 100% tax free even at age 55 ie 4% of $400,000 is $16,000 tax-free.
- capital gains tax on the property if sold is nil under current legislation
- net rent received is taxed at nil, yet fully deductible to the small company
- in retirement 100% of income to client is not taxable
- on death asset passes from NCC account to children tax free (no capital gains tax or ETP tax)
- more effective loan payment (rent received is tax free so more money to pay off loan more quickly).

I do stress, this is not the only answer. This example was put together to illustrate my point. We don't think enough about how to get the best out of superannuation. Take some time to talk through the options and design it for yourself. Get some advice, super is designed for your benefit, use it if it helps but if nothing else start the thinking process. And go and see a professional.

Andrew Bloore is Chief Executive Officer of SMSF administrator, SuperIQ.

[Simple investment risk management – this is the risk issue we need to talk about]

David Bell

I feel Chris Cuffe's article 'We need to talk about risk' (*Cuffelinks* 21, 27 June 2013) may understate the benefits of aspiring to best practices in investment risk management. While it is hard to quantify the benefits of risk management (a claim also easily made of other important areas such as governance) this does not mean it should be discounted. Chris laments the use of volatility as a measure of risk, and I agree on this. But risk management is far more than the calculation of volatility; it is an unfair perception of risk management professionals to think they only calculate volatility. Those associated with the retirement savings of Australians need to strive for best practices in risk management. Many super funds already do much more than just calculate volatility. Perhaps it is the difficulty in communicating risk to non-financially literate people which is the issue – and it is this which has led to the use, and subsequent criticism, of the relatively simple measure of volatility.

Explaining complex topics to non-experts is a difficult challenge. Many industries face these communication challenges. How do you communicate the complexity in products such as cars, or medical procedures such as heart surgery? I'm sure we don't want to see advancements in these areas slow down so that the communication process is easier, and I feel likewise about risk management. There are two issues at play here. One is the need to constantly improve risk management practices. And the other is the communication challenge of explaining to people that their risk is well managed.

It is unfortunate that there is no single measure of risk – life would be so much easier. Alas, risk is a complex beast and there are many different sources of risk, some of which we may not even have considered. The industry often paints risk managers as 'quants' or 'pointy heads' but the best risk management teams I have seen have been able to marry the science and the art of risk management. The best examples generally combine a mix of quantitative techniques (and continual development in this area) with the qualitative overlay of experienced people. The discretionary piece cannot be understated. Understanding the environment where models or inputs are unlikely to be reliable is crucially important. Unfortunately good risk management does not guarantee the avoidance of bad outcomes – but we still have to do our best.

If all risk represents is the calculation of volatility and this was the only risk management tool we had, then we would have even more bank failures, insurance company bankruptcies and super funds delivering disastrous results. In fact we wouldn't need risk management teams – a simple model could do this job. Risk management would be nothing more than risk reporting. There is much more to managing risk and there are some great examples across the industry. If you ever have the privilege to meet firms with top risk management, the confidence it gives you that they understand the risks that may adversely affect their performance is very comforting. While nothing is guaranteed they are doing their best to manage the risks in their portfolios. Surely everyone deserves this, whether it is well-communicated or not.

The concept 'best practice risk management' cannot be defined. We do not know every possible source of risk that may affect portfolio outcomes. And models are only tools which attempt to estimate the possible outcomes. The inputs used in these models are simply estimates, hence the importance of qualitative judgement and experience. Indeed some of the best case studies in risk management have involved the judgement of an individual person.

When I am asked to analyse the risk management practices of a fund and its managers, I look for:

- how they define risk
- risk awareness and their understanding of possible sources of risk that may affect them so that their portfolio represents risks they appreciate and are prepared to take on
- active risk management and not just risk reporters
- the systems (and the quality of those systems) they use to estimate risk along with their understanding of the limitations of those systems
- the resourcing of the risk management team
- the experience of the risk management team and their preparedness (and authority) to overwrite what their models are saying.

I do agree with Chris that volatility is a simple risk management tool with many flaws (an article for another day). Simple volatility calculations are frustrating for all involved - frustrating for those communicating with investors because of its flaws in explaining risk and frustrating for risk managers as well because there is so much more to good risk management than simply calculating volatility.

We shouldn't hold back the aspiration of best practices in risk management by tainting it with the perception that risk management is simply calculating volatility. Risk management is not risk reporting. It is much more and good risk management is critical to protecting financial outcomes. How to communicate risk and how risk is managed are different issues.

Dear friends, colleagues and fellow rockers ...

Rob Prugue

Dear friends, colleagues, and fellow rockers

The quest for stable and inflation protected investment ideas grows as the era of market uncertainty ingrains itself for what looks to be a long and bumpy roller coaster ride. Such tumultuous and volatile market conditions, coupled with capital inadequacy, threatens to impact when baby boomers can retire, if and when they do, and how comfortably they can do so. Increasingly, the luxury and ability to retire at the age of 65 is looking more and more like a distant dream.

Pete Townshend may have once said never to trust anyone over 35, but today at 68 years himself, no doubt he's changed his tune. Actually, it's the rock and roll stars we baby boomers grew up on who are the best examples of working WELL beyond 65. The Rolling Stones, for one, are touring North America this northern hemisphere summer. Not bad given that Mick Jagger himself turns 70 in just one month's time. But for rock lovin' baby boomers wanting to retire in comfort, however, perhaps we're immunizing against the wrong CPI target.

No, am not referring to health care inflation, which is near twice the rate of CPI. Nor am I referring to food inflation, which here too dwarfs the official CPI levels. Rock and roll may never die, but the cost of seeing it is killing us.

Courtesy of a high school friend, who I've happened to share many a rock concert WAY back when with, I received a photo which speaks in volumes to the aforementioned. My friend sent me two ticket stubs: one of last night's Rolling Stones concert in Washington DC; and another of a Rolling Stones concert we both attended back in 1981. Same rock band, same city, same venue, and very near same seats. Way back in 1981, to see the Rolling Stones would set you back a whole

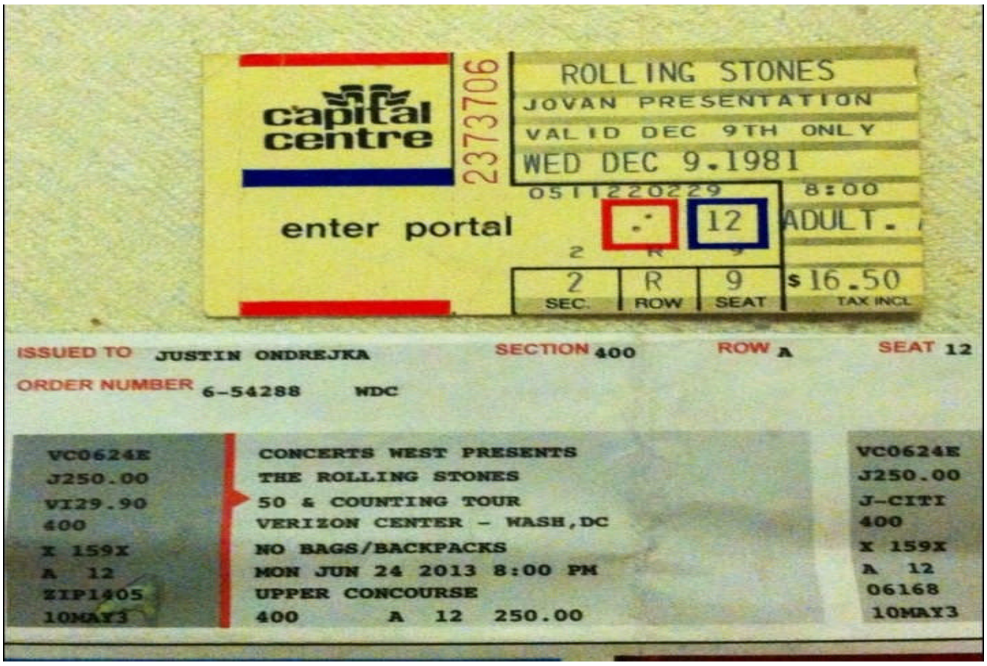
US$16.50. Today, to see these now septuagenarians rock on stage would set you back US$250! In 32 years, the price of a Rolling Stones ticket has risen by 15X! I tell you, baby boomers have no chance immunizing their retirement portfolios towards such luxuries.

Consider the following stats. Back in 1981 the average US household weekly gross salary was US$340, compared to today's gross weekly salary of US$930. From 1981 through to 2013, the average weekly gross household salary rose by a nominal 1.74% annually. During this same time period, the price of a movie ticket rose nominally by 1.9%, whilst the price of a gallon of petrol rose by 1.5%. The cost of a Rolling Stones ticket, however, rose nominally by 8.6% pa. I wonder what impact this would have if the statisticians would dare to include the price of Rolling Stones in their CPI calculations?

Perhaps this increase has more to do with demographics than just CPI calculations? Well consider this. The affordability of seeing a movie, or cost of driving to the movie theatre, has not changed much over this 32 year period. But the same cannot be said for Rolling Stones. Back in 1981, seeing the Rolling Stones would only deplete 5% from one's weekly gross salary. Today? Seeing these aging, diamond-stoned rockers deplete a whopping 27% of the average US household income.

Either way you look at it, and to paraphrase the Stones, what a drag it is getting old.

Rob Prugue is Senior Managing Director, Lazard Asset Management, Asia Pacific.



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