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Do clients understand what advisers are saying?

David Bell

Financial literacy levels in Australia and around the world are low, but it may be eye-opening to learn just how low they are. It's an important issue for financial advice. There's little merit in providing a 70 page Statement of Advice if the client does not understand the basics in there.

How is financial literacy measured? Annamaria Lusardi and Olivia Mitchell (from Dartmouth College and Wharton School, University of Pennsylvania) have led the development of financial literacy survey designs. There are two assessments most commonly used – a basic and an advanced literacy test. Here are the 'Australianised' versions of these tests (created by Bateman and research partners*). Answers can be found at the end of this article.

Test 1 – basic financial numeracy

1. Numeracy/interest rate: Suppose you had \$100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?
(Answers: a. More than \$102; b. Exactly \$102; c. Less than \$102; d. Do not know; e. Refuse to answer.)

2. Compound interest: Suppose you had \$100 in a savings account and the interest rate is 20% per year and you never withdraw money or interest payments. After 5 years, how much would you have on this account in total?
(Answers: a. More than \$200; b. Exactly \$200; c. Less than \$200; d. Do not know; e. Refuse to answer.)
3. Inflation: Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?
(Answers: a. More than today; b. Exactly the same; c. Less than today; d. Do not know; e. Refuse to answer.)
4. Time value of money: Assume a friend inherits \$10,000 today and his sibling inherits \$10,000 three years from now. In three years, who is richer because of the inheritance? (Answers: a. My friend; b. His sibling; c. They are equally rich; d. Do not know; e. Refuse to answer.)
5. Money illusion: Suppose that in the year 2020, your income has doubled and prices of all goods have doubled too. In 2020, how much will you be able to buy with your income?
(Answers: a. More than today; b. Exactly the same; c. Less than today; d. Do not know; e. Refuse to answer.)

Test 2 – advanced financial numeracy

1. Individual shares: Buying shares in a single company usually provides a safer return than buying units in a managed share fund
(Answers: a. True, b. False, c. Do not know, d. Refuse to answer)
2. Shares versus bonds: Shares are normally riskier than bonds (Answers: a. True, b. False, c. Do not know, d. Refuse to answer)
3. Diversification: When an investor spreads his money across different assets the risk of losing money (Answers: a. Increases, b. Decreases, c. Stays the same, d. Do not know, e. Refuse to answer)

Lusardi and Mitchell subsequently identified the three underlined questions as most significant for a shorter test which is known as the 'financial literacy instrument'. It is used in a number of government body and academic surveys in the US.

Table 1 shows the survey results for basic financial literacy for Australia and the US.

	1. Numeracy / interest rate	2. Compound interest	3. Inflation	4. Time value of money	5. Money illusion	All Five Correct
Australia	88.4%	71.8%	78.4%	54.9%	86.7%	36.5%
US	91.8%	69.0%	87.1%	73.8%	78.4%	43.8%

Basic financial literacy results: Australia, Bateman et al (2011)*. US, Lusardi & Mitchell (2009)

In addition, Julie Agnew and research partners (2013)** performed the shorter financial literacy instrument test across a survey group of over 1,000 Australians. They found that only 43% achieved three correct answers.

Most industry participants should find the basic financial literacy questions quite simple, so the numbers in the final column of Table 1 should be alarming. Only 36.5% of Australian participants answered all five questions correctly, especially since the academic literature indicates that people with higher levels of financial literacy are more likely to plan for retirement.

There are many areas where the industry could make use of financial literacy tests, such as:

- At a financial planning level: When assessing risk tolerance do financial planners also assess financial literacy? Financial literacy levels may distort risk tolerance assessments used across industry. Should risk tolerance be independent of financial literacy (ie a true measure of our tolerance for risk)? Does the way that advice is delivered take into account financial people's level of financial literacy?
- For SMSF's: Are people capable of being effective trustees of their own SMSF if they do not have basic levels of financial literacy? Is there a way that basic financial literacy assessment can be included in a checklist on whether it is appropriate for someone to establish an SMSF?
- For institutional super funds: Should there be a basic financial literacy requirement for trustees of super funds? While the diversity of skill arguments across trustees are well made, surely a minimum level of financial knowledge should be a pre-requisite.

The results of this research are worrying. As an industry we have to be careful to understand that financial literacy levels of non-industry participants may fail to even reach basic levels. The way that we communicate complex information is very important and an ongoing challenge for regulators, product manufacturers and financial planners.

Answers

Basic financial literacy: 1 – a, 2 – a, 3 – c, 4 – a, 5 – b

Advanced financial literacy: 1 – b, 2 – a, 3 – b

* Hazel Bateman, Christine Eckert, John Geweke, Jordan Louviere, Susan Thorp and Stephen Satchell

** Julie Agnew, Hazel Bateman and Susan Thorp

Fixed income investing when rates are rising

Jim McKay

Recent financial headlines have focussed on the timing of the US Federal Reserve 'tapering' its purchases of long-dated US bonds. A consequence of any tapering - rising US interest rates - continues to raise it head. The rising interest rate topic first made headlines in the US in 2010, and then again in 2011 and 2012, but only in 2013 have we seen the first sustained increase in long bond yields. For some investors, rising interest rates are a good thing, with potential for increased returns on the billions of dollars holed up in cash and short term deposits, whilst for holders of long-dated bonds, rising interest rates may be cause for concern.

Interest rates and bond prices

Bond prices and interest rates usually move in opposite directions. This means that when interest rates rise, bond prices tend to fall, and vice versa. For example, if you pay \$100 for a bond with a face value of \$100 paying a 5% coupon, and interest rates then rise to 6% for the same maturity, the value of your bond will fall in price to equate to 6% yield to maturity.

For the past 30 years, developed market bonds - represented in bond indices by the United States, Japan and the core Euro region which make up over 90% of traditional bond indices - have had

the tailwind of falling interest rates, delivering capital gains in addition to regular income. However, with long bond rates only a little above their 30 year lows, the future expected return from long term bonds is more cautious.

But opportunities to make money in bonds still exist. Notably, one of the major changes to bond markets over the past 30 years, and especially in the last 10 years, is the significant increase in the supply of bonds from a wide variety of new issuers, including Emerging Market countries, and companies the world over.

This broadening of bond markets provides opportunities to diversify bond portfolios by investing in economies and companies not linked solely to the economic fortunes of developed markets. This is a good thing, given the limited appeal of investing in developed country bonds, where real interest rates (nominal interest rates less inflation) currently provide little, or even a negative, return to bond holders.

These low rates are a deliberate policy, with Quantitative Easing (QE) initiated by the US Federal Reserve to support the US economy, and designed to exert downward influence on bond rates. The theory is that lower long term rates make companies more willing to borrow to invest and expand their businesses, resulting in economic expansion and increasing employment. The QE policy has been implemented by 'printing' US dollars which has also had the added benefit of lowering the US dollar.

So far our discussion has focussed mainly on government bonds, but it's important to note that not all fixed income is created equal. Some securities are more sensitive to interest rate movements than others, and some deliver strong performance in a rising interest rate environment.

Reducing interest rate sensitivity

The following fixed income strategies tend to have lower interest rate sensitivity:

1. Credit-oriented strategies, and in particular, non-investment grade sectors such as high yield corporate bonds and corporate bank loans tend to be more correlated to the overall economic outlook and corporate earnings than interest rates. Improved balance sheets and liquidity, healthier credit ratios and increased credit availability may reduce the impact of rising interest rates.
2. Short-duration strategies such as short term bonds and floating rate bank loans have lower sensitivity to rates than their longer duration counterparts, and they can capitalise on the higher income from rising rates more quickly.
3. Global fixed income strategies offer diversification through exposure to bonds and currencies which seek to capitalise on differing business cycles and economic conditions around the world. In some cases they offer not only higher yields, but also the potential for currency appreciation.

There are many different countries, yield curves, and currencies to invest in. Importantly, in the current environment, seeking strategies that can diversify away from traditional bond benchmarks, such as the Barclays Global Aggregate Benchmark, in which the most indebted nations (and potentially those with less ability to repay) of the US, Japan and core Euro region dominate, will be critical to minimise the risk of losses, and achieve positive returns for investors as global rates continue to rise.

Bonds continue to provide significant diversification benefits for investors, and in most cases offer negative correlation to equities. This reduces portfolio volatility and provides the shock absorber for portfolios in times of economic and equity market stress. These positive characteristics should not be forgotten even though the bond investing environment is more challenging looking forward.

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Global QE causes currency and fiscal impotence

Michael McAlary

The world has never worked through a period where Quantitative Easing (QE) has been undertaken by most of the major global economies, including for the first time the United States.

A goal of QE is to increase liquidity through the central bank by buying illiquid bank assets, freeing up funds which the banks should in turn lend to consumers and businesses. This has not occurred in the US. Instead banks have tightened their credit criteria and are using QE as an opportunity to re-capitalise their balance sheets. QE is a godsend to US banks as it is simpler and substantially cheaper than raising equity capital. It has helped to address a bank solvency issue but has not increased money supply.

Having a strategy to deal with it is critical, yet neither the Reserve Bank of Australia (RBA), nor past or present governments have articulated one. QE is the foremost issue impacting on our economic future.

Put simply, QE is an admission of failure to properly manage an economy in prior years that results in a central bank having to print money to stimulate economic growth. On a global scale, countries that have made a mess of their economy and are engaging in QE generate flow on problems to the rest of the world.

The first casualty of QE is exchange rates. Rather than a rate reflecting underlying economic fundamentals, there is a distortion of both spot and forward markets as those countries engaging in QE attempt to devalue their currency, to improve their competitiveness and increase exports.

For Australia, these so-called currency wars are a major factor causing the strength of the Australian dollar, as global investors seek out safe haven currencies. This combined with continuing strong commodity prices and Asian investors looking to protect their wealth through Australian property investment are maintaining the upward pressure on the Australian dollar.

Another impact that needs to be considered is whether the nexus between the Australian dollar and commodity prices has been broken in the long term. Only time will tell, however if it has not and the Australian dollar's correlation with commodity prices returns, then Australia will once again be relegated to being a price taker, not maker. For the nexus to remain permanently removed we must continue transforming the Australian economy through significant productivity improvements to reduce unit costs of production. We must also commercialise our innovations and embrace the structural changes to our economy that the internet and offshoring are driving. These major challenges can bring huge rewards.

Low interest rates associated with QE encourage investors to switch from cash to higher risk assets. On this score QE has been successful as investors have returned to equity and property markets. However, it only takes a slight hint of tapering to cause equity markets to fall.

Interest rates around the world will increase when tapering commences as competition between governments for budget deficit funding intensifies. For Australia, the Federal budget deficit will blow out further as interest costs on current borrowings jump before including the funding costs for the proposed infrastructure projects. Based on recent company earnings forecasts, tax receipts will remain stagnant, so the pressure is on the Federal Government to make necessary structural changes to the budget if it wants to return to surplus over the forward estimates.

The RBA has acknowledged that its response to global QE through lower interest rates has proven impotent. The Australian dollar will continue to ride high regardless of RBA policy settings as the QE programs of major economies wreak havoc on economies that have been managed well. Australia must fight back with well thought-out strategies. In addition to addressing structural problems within the budget, tax and industrial relations reform, we should be looking at re-negotiating free trade agreements with QE protagonists while avoiding protectionism. We need to broaden our intellectual property laws and advocate solutions that place less reliance on the world's reserve currency.

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Protect your personal digital assets

David Addinall

Most people are moving away from the world of paper and towards a more digital life, which in turn has created a new form of asset – the 'digital asset'. A digital asset refers to anything you own or have rights to that is accessed via the internet or any other form of digital technology.

A digital asset does not only refer to an asset with financial value, they can also hold personal or sentimental value to friends or loved ones.

Some examples of digital assets include:

- online banking accounts
- email accounts
- social media accounts (e.g. Facebook, Twitter, LinkedIn)
- online multimedia accounts (e.g. iTunes, YouTube)
- shopping and business accounts (e.g. EBay, PayPal)
- online photos and document storage accounts
- domain names and websites.

It is important to note that the current legislation in NSW does not classify some of these digital assets as a form of 'personal property' and therefore they may not be included in the assets that form part of the residual estate in a will.

The important question that arises with these new digital assets (as with any other asset) is, what will happen to the assets when a person becomes incapacitated or dies?

Some websites have policies providing their procedures when accounts are left dormant for a specific amount of time. For example, Yahoo will deactivate accounts that have not been accessed for 12 months. Other websites, such as Facebook allow the option to create a 'memorial page' from a deceased users account.

However, there are a lot of websites that do not offer these options and therefore, to ensure these assets are not lost, digital assets should now be specifically referred to and incorporated into current wills and estate plans.

Failure to do so may prevent loved ones from being aware that these digital assets exist, and may also prevent the Executor from accessing and distributing the contents of the digital assets at a time of your incapacity or death.

Further, if digital assets are not dealt with correctly at the time of death, the information stored in these accounts could be lost forever, or be susceptible to identify theft.

It appears that to be abundantly cautious it will be necessary for your will to include a clause that will give the Executor of your estate the necessary power and authority to handle and manage your digital assets, so that they are able to deal with and distribute them accordingly.

In preparing your will, you should provide a full inventory of all your assets including your digital assets, including where appropriate, all usernames, passwords and secret questions. This will ensure that the Executor is fully aware of all your digital assets and will be able to successfully access and manage them. Due to the important nature of the information in such an inventory, it should be stored in a sealed envelope separate from your will and in a secure place.

Some online accounts require passwords or secret questions to be frequently updated, and in turn, the inventory must also be kept up to date, although this may not be practical for most people with busy lives and little spare time.

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Caveat Emptor? Q&A on long term annuities

Do you have a criticism or question about a financial product, and want an explanation?

This week, we start a new regular feature called 'Caveat Emptor?'

Caveat Emptor is defined as: 'the principle that the buyer alone is responsible for checking the quality and suitability of goods before a purchase is made.' So we want to help the buyers, and you can contribute by sharing your issues. We'll ask the product manufacturer or another expert to respond. Write to us at mail@cuffelinks.com.au.

To kick off, Jeremy Cooper of Challenger responds to a question on annuities.

We ask anyone else with a constructive view to then write a comment on our website. The Q&A will be collected under a new menu tab called 'Caveat Emptor?' for future reference. We hope this becomes a good reference point for product enquiries.

Question from Ross Johnstone

Could we please have informed comment on the (in)security of purchased annuities? It seems to me there is unjustified believe they are a safe investment for those who seek them, however, nobody can be assured that the many assumptions made by actuaries, auditors and managers of vendor companies will turn out to be correct. They are very risky especially as the payouts will cover many years with many unknowns.

Response from Jeremy Cooper, Chairman, Retirement Income, Challenger

In Australia, annuities can only be issued by life insurance companies that are prudentially supervised by APRA, the Australian Prudential Regulatory Authority.

While no investment is ever completely risk-free, life insurance products, including guaranteed annuities, are highly secure investments because of a robust framework of legislation and prudential standards, an effective and targeted supervisory process and a strengthened and well-resourced regulator with appropriate interventionist powers.

Most recently, these investor safeguards have been supplemented with the introduction of a regulatory capital regime tougher than that imposed in North America and Europe, post GFC.

Capital is the cornerstone of a life company's strength and the adequacy and sustainability of this capital is the focus of APRA's regulatory framework. Currently, APRA requires life companies to hold enough capital to withstand a 1 in 200-year shock event, which represents a 99.5% margin of safety over a 12-month period. That is, life companies must keep aside enough capital to withstand the events of the next year with only a 0.5% chance of default.

It is generally accepted that the GFC was around a 1 in 70 year event, and no annuity provider in Australia was required to raise equity capital to achieve regulatory minimums.

So the safety of an annuitant's claim on the issuing life company does not depend on any assumption by actuaries, auditors or anyone else. The safety for policy holders actually comes from being compulsorily prepared for events to be very wrong (the 1 in 200-year event). When the bad event doesn't occur, the life company's shareholders will get a return, and they provide the capital buffer in case it does.

An under-appreciated safety valve for lifetime annuitants is the buffer of shareholder capital that sits between them and the underlying investments of the life company.

The *Life Insurance Act 1995* expressly deals with the possibility of failure of the life company by requiring that the premiums paid for annuities and additional capital are 'ring-fenced' in a separate account called a 'statutory fund' held by the life company. The statutory fund is specifically intended to outlive the life company in the event of it encountering financial difficulties.

When annuities are issued, extra capital must be put in as a buffer to protect policyholders. This capital is provided by the life company (i.e. its own shareholders' equity) and any claim the life company has on this capital ranks behind the policyholders.

This is a unique feature of annuities: shareholder capital is there to protect policyholders in the event of a fall in the value of the assets backing the annuity.

APRA can even direct a life company to raise more of its own capital to contribute to the statutory fund under expanded powers given to it by legislation in 2010.

If a life company wishes to hold riskier assets than the usual government and investment grade corporate bonds, APRA requires more capital to be held against those assets under its risk-weighted approach. This approach takes into account a range of risk factors that might adversely impact a life company's ability to meet its obligations and includes: insurance risk (e.g. increasing longevity); asset risk (e.g. adverse market movements); asset concentration risk (e.g. too much exposure to a particular asset or counterparty); and operational risk (e.g. exposure to loss from internal processes or external events). In addition, APRA can impose a 'supervisory adjustment' requiring even more capital to be held if it is of the view that there are prudential reasons for doing so.

While necessary to give the complete picture, this discussion of riskier assets is probably misleading. The assets backing annuities are typically conservative: investment grade bonds, high quality property assets with long-term leases to creditworthy tenants and a small amount of infrastructure creating inflation-adjusted cash flows. In fact, the fixed income portfolio of Australia's leading annuity provider includes more investment grade debt than do the balance sheets of the nation's big four banks.

Lifetime annuities are by nature long-dated liabilities, allowing a life company to invest in financial assets with long-term cash flows and longer tenor, making them one of the few institutional investors capable of earning duration, or illiquidity premia. These assets are typically held to maturity, so while market movements can impact their market value in the short-term, short-term fluctuations do not impact the underlying cash flows available to policyholders.

In fact, the short-term fluctuations in the value of assets and liabilities which are sometimes visible through the statutory income statement of life companies are another safeguard for policyholders and demonstrate life companies' unique position to make and honour very long-term financial promises.

Life companies' mark to market accounting requirements gives an annuitant better transparency than available to bank term depositors. While a life office must regularly value its financial investments at their fair value, a bank can hold an identical financial asset at par, its purchase price.

In the event that an Australian annuity provider did run into problems due to a market downturn, you could only imagine what a typical 70/30 managed fund or super investment option would look like: burnt toast.

Want to join the debate? Please add your comment on the Cuffelinks website.

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