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Beyond the hype, a beginner's guide to QE

Warren Bird

Many writers of opinion pieces have discussed what tapering of the Federal Reserve's (Fed) Quantitative Easing (QE) might mean for investment markets. This article looks at the more basic questions: what is 'QE' and what does 'tapering' mean?

QE is not 'printing money'. They are close cousins, so don't hang, draw and quarter anyone for confusing them, but they are different in some important ways. Printing money happens when governments run deficits and central banks simply create the cash that governments spend in excess of revenues without the need to issue government bonds. This is also called 'monetising the deficit'. Central banks are not currently doing this. QE is in fact independent of the budget deficit and in theory could be undertaken even if the budget was in surplus.

However, the context in which QE has been implemented is a budget deficit. This is how it works.

The budget deficit is funded by the sale of bonds to the market. Money is thus taken out of the economy as the private sector pays for these bonds. However, central banks put money back in, by purchasing long dated assets from the market. These assets include, but aren't limited to, government bonds. For example, the Fed in the US has also bought residential mortgage-backed securities, while the Bank of England bought some corporate bonds.

This is where the Q part of QE comes in. The instrument of the policy is to buy a pre-announced quantity of assets. Currently the Fed is targeting US$85 billion per month. The target quantity of assets is bought at the market price. By standing as a large source of demand, the intention is to increase the price (reduce the yield) of these assets compared to what it would otherwise have been, but with QE a specific yield is not set by the central bank.

Signs of success

The evidence suggests that central banks have been successful in this goal. Dr Min Zhu, the Deputy Managing Director of the International Monetary Fund, said in a speech at the Australian Business Economists conference held on 21 November that the impact in the US has been a 1% reduction in long bond yields. He put the impact in the UK at 0.5%.

Therefore, QE changes the composition of private sector assets. Banks hold less in bonds and more cash. Unless the private sector actually boosts its borrowing or spending by putting the cash to work, the funds invested by the central bank will just sit in bank reserves. The increased money supply doesn't automatically mean that there is more lending in the economy. This is one of the reasons the Fed included mortgage-backed securities in its QE program, as that provided a more direct policy support to the beleaguered housing sector in the US. However, overall it is up to the private sector to decide how QE transmits to the broader economy.

Although QE is called 'unconventional' monetary policy, buying bonds from the market is not unusual at all. The main difference from what central banks do when they are easing policy in normal times is simply that they have a quantity target rather than a yield target.

In normal times, central banks go to the markets to buy short term securities in order to drive the cash rate lower. This is the conduct of open market operations. When the cash rate approaches zero, as it has in most Western economies, this cannot reduce money market rates any further. However, by QE, central banks try to reduce yields across the maturity spectrum. Lower long term yields are an incentive to the private sector to borrow more or to invest in riskier assets.

The intention of easy monetary policy, whether conventional or not, is to create stronger economic growth without generating excessive inflation. There is always a debate about whether policy is being run 'too easy', but the underlying growth rate of many economies – the US, UK, Japan and others – has been so weak, and the risk of inflation so low, that their central banks have chosen to provide additional support beyond zero cash rates.

The other difference from open market operations is that QE results in an increase in the central bank's balance sheet. The assets of the Fed have increased dramatically since the commencement of QE. The first surge was in late 2008 when they purchased mortgage-backed securities. For a brief time in mid-2010 QE was stopped, but when the economic data continued to be weak the Fed announced in August 2010 that it would buy US$600 billion of Treasury bonds by June 2011. This second round became known as QE2.

Continued economic underperformance led to a step-up in the programme, this time leaving its size open-ended. QE3 was initially US$40 billion of securities per month, and then was increased to the current US$85 billion in December 2012.

Unwinding QE

At some point, when economic recovery is more self-sustaining, QE will need to be wound back. What will that involve?

Step 1 is tapering. This is simply a reduction in the quantity of assets that are purchased. The Fed believes, rightly in my view, that tapering is not the adoption of tight policy. It is reducing the amount of stimulus, but even a reduced program of QE is still providing liquidity to the private sector. The Fed has indicated that its judgment about how rapidly to taper the programme will depend on the performance of the economy.

Step 2 is a decision about what to do with the enlarged balance sheet once purchases cease. Will they simply let bonds run off and allow the balance sheet to return to a more normal size gradually? Or will they actively sell bonds out of their portfolio to reduce the balance sheet more quickly? Either way, it will take a long time before the Fed's assets returns to 'normal'. Dr Zhu from the IMF suggested a timeframe of at least 10 years.

Many analysts fear that the unwinding process will be disruptive. Some use emotive imagery, likening financial markets to a drug addict dependant on QE, and the unwinding process to the pains that an addict experiences when they start to kick their habit.

While that sort of language is over the top, there is no doubt that past episodes in which easy monetary policy has been turned around have seen higher bond yields and weaker equity markets. It's understandable that many forecasters see markets behaving the same way when QE ends.

However, when forming your own view on the outlook for market, I hope you'll keep in mind that QE is really only a form of easy monetary policy. A lot of the hyped-up commentaries you see around the place seem to suggest it is a dark art that has introduced all sorts of abnormalities into the world economy and that it can only end in tears. I hope that this article has put QE into a more sober perspective.

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Retirement: who's a happy little Vegemite?

Adele Horin

The history professor was sick of people assuming he was bored and depressed now that he was newly retired. Even a young researcher doing a thesis on retirement who'd interviewed him had presumed he was facing a crisis. The professor wanted to tell people, "Hey, retirement's pretty good; don't be scared." When I met him, I was a full-time working journalist, and if I thought of retirement, it was with fear and trepidation. But this engaging man with a big intellect couldn't have been more cheerful. We sat on his balcony that overlooked sparkling Sydney harbour and he said he'd never been happier.

Retirement is getting bad press these days. At a conference I attended recently, one speaker said the 'R' word should be banned. Baby boomers are being exhorted to work as long as they can. The already-retired are being encouraged to take up 'encore careers'. Yes, some people can't wait to retire. But a lot are terrified of the abyss.

From the BBC comedy, *One Foot in the Grave*, here's how the typical retiree is portrayed: "So how are you coping now, Victor? Bit of a big one isn't it, retirement? … Suddenly being thrown on the scrapheap of life, a prisoner in your own home with no prospects, no purpose, nothing to live for … It's not getting you down, I hope?"

Or another stereotype, no more comforting, is of the retiree who insists she's "never been busier"– but busier at what? Borrowing the title of a recent book on retirement, a cynical worker might ask, "Are you just existing and calling it a life?"

Well, my husband retired last week, and though I avoid the R word like the plague in describing myself, I've been out of the paid workforce, too, for almost a year. So it seems a good time to dig deeper into the retirement quandary. Does it bring a loss of self-esteem, isolation, boredom? Is it as bad as I feared back then on the balcony when I wondered if the jolly professor was kidding himself?

Let's look first at the research on retirement. A recent Australian study of 1,344 retirees found the large majority described themselves as feeling happier in retirement than in their previous life. Around 60% felt happier, 33% felt the same, and 7% felt worse, researchers Garry Barrett of the University of Sydney and Milica Kecmanovic, of the University of Technology, Sydney, found.

As I looked further afield, the story repeated itself. Most retirees are satisfied with their lives. Sixty it seems is the new thirty. The latest British study by Britain's Office for National Statistics shows that people in their late 60s feel like they're back in their prime. They rate their physical and mental health higher than at any time since their 30s. Since the 1950s, people have been trying to show retirement is stressful, bad for health, and destructive of people's sense of self. But according to US gerontologist David Ekerdt, of the University of Kansas, "the evidence, when you pile it up, says that's just not the case".

Unhappy campers

That's the big picture, the majority experience. But some studies also show up to one-third of retirees aren't happy little Vegemites. Even with the more usual 7% to 10% being disgruntled, it represents a significant number having trouble adjusting. A key is choice, the Australian study shows. People who choose to retire are happier than people forced out at younger ages through job loss or ill health, and on lower incomes than anticipated. And according to the Australian Bureau of Statistics a sizable number of retired people – over one-third – leave the workforce because of sickness, disability or job loss.

So the retirement experience is more nuanced and diverse than first appears. The Australian study points to other factors that may influence the transition. Being healthy, having a partner who is healthy and owning your own home make a difference. For some retirement is like a sugar hit. Particularly if you've been unhappy beforehand, the extra sleep and reduced stress retirement brings can boost happiness.

But how long does it last? Some new unpublished Australian data shows for most retirees, all is well for the first three years, then many experience a dip in satisfaction with life. Dwindling finances may be part of the story, and health problems. But so may boredom. Almost 230,000 previously retired Australians, the majority women, were back at work or looking for work in 2010-11, according to the ABS. The most common reason was money (41%) but boredom came next (28%).

For me, taking voluntary redundancy with about 80 of my colleagues from a contracting newspaper was a good move at 61. Even so, I was a candidate for the disgruntled retirees' club. I had no hobbies, no grandchildren, I loved to work, and I didn't want to devote my life to leisure and travel. I doubted that volunteer work could fill the void. I think baby boomers want and need to continue to contribute and that an ageist society must get over its hang-ups and allow us to do so.

What's kept me happy is having projects, including writing a blog for a start. I'm re-creating a work life with its structured day, albeit less pressured, with time for friends and exercise. Perhaps

I lack imagination; I'm failing to explore new paths. But I figure retirement is not an event. It's a process. And I've got lots of time.

Adele Horin was the social issues journalist with the Sydney Morning Herald for 18 years prior to her 'retirement'. This article was first published on her Coming of Age blog (adelehorin.com.au).

Too much jam: the consequences of choice overload

David Bell

In academic circles, the phrase 'too much jam' doesn't refer to over-consumption of jam (though a useful reminder at this festive time of year) but rather a well-known behavioural experiment by the psychologists Sheena Iyengar and Mark Lepper. It refers to the problem of choice overload and it provides useful insights for the funds management industry.

The paper is titled *"When Choice is Demotivating: Can One Desire Too Much of a Good Thing?"*, and was published in the *Journal of Personality and Social Psychology* in 2000. It has been cited in over 1500 subsequent pieces of research. The paper contains three choice experiments.

In the first experiment, shoppers at an upmarket supermarket encountered a tasting booth that displayed either a limited range (just six) or an extensive selection (varieties) of different flavours of jam. This type of research is known as a field experiment and research assistants dressed up as shop employees ran the jam-tasting booths so that outcomes could be carefully observed.

In the second experiment students in an introductory social psychology class were given the opportunity to write an extra-credit (ie not compulsory) two-page essay. Students were given either six or 30 potential essay topics on which they could choose to write.

The third experiment involved tasting chocolate (where do I volunteer?!). Participants were presented with either a limited or extensive range of chocolates from which to make an initial choice. After this some people were given the chocolate of their choice to taste while others had a chocolate chosen for them.

So what results came out of these experiments? In the first (jam booth) experiment:

- consumers appeared to be more attracted to a tasting booth that offered significant choice, with 60% of customers stopping at the booth with the extensive selection
- however, significantly more shoppers purchased a jar of jam when presented with only the limited selection compared with an extensive range (30% versus 3%).

In the second (extra-credit essay) experiment:

- students showed greater participation when offered limited choice (74% undertook the essay when offered limited topic choice versus 60% when offered extensive topic choice)
- students offered limited choice attained higher grades than those offered a wider topic choice.

In the final (chocolate) experiment:

- those offered an extensive range of chocolates found the choice decision more enjoyable than those offered a limited range, but they also found the decision-making process relatively more difficult and more frustrating

- for those who tasted the chocolate they chose, subjects who chose from a limited range were more satisfied with their choice than their counterparts who chose from an extensive range.

So what do we take out of all this? Clearly the results highlight the issue of choice overload where too much choice can have adverse effects on outcomes. It also highlights the complexity of choice.

There are many examples of different industries which cleverly account for consumer behavioural choice issues. For instance, Aldi supermarkets only provide one or two choices in each product category, and many car companies have over recent years reduced the number and complexity of choices within their model range.

Choice and investment decisions

Is the funds management and superannuation industry similarly affected by these complex choice behavioural issues? Logic would suggest yes. Why wouldn't investment decisions be affected by the size of the range of investment options? Making investment decisions is complex and too much choice may create similar experiences as in the chocolate experiment.

Indeed, in a subsequent Pension Research Council Working Paper by Iyengar, this time with Wei Jiang and Gur Huberman (entitled *How Much Choice is Too Much? Contributions to 401(k) Retirement Plan*s), the authors explore whether extensive choice is a deterrent to participation in a pension plan. They find that participation in 401(k) retirement plans falls as the range of investment choices increases. Note that plan participation in the US is not compulsory, and so this result isn't directly applicable in Australia, where we have the Superannuation Guarantee. However, it lends weight to the argument that choice overload can be a deterrent to making an active choice, and can lead to a difficult and frustrating investment decision-making experience.

Yet the concept of choice overload is challenged by the rapid growth of SMSFs, with no restriction on investment choice, and the increasing range of investment options offered by super funds. Why offer more choice if this reduces the experience?

While SMSFs offer huge flexibility, they do not compel members to make an active choice from a defined menu list. Some investors may run very simple investment strategies (high allocations to term deposits and domestic equities) while some SMSFs may be established with an investment strategy already pre-conceived. So an argument can be made that SMSFs actually provide the benefits of choice without the restriction of a limited choice menu or the stress of an extensive choice menu.

When it comes to menu choice, the retail super funds have historically offered much greater choice than industry, public sector and corporate super funds, generally more than 200 choices for a retail fund versus around only 10 or less for a non-retail fund. So does this mean that retail funds encounter substantially higher level of choice overload problems than non-retail funds? Not necessarily – it most likely depends on the financial service model. Many retail super fund members have been placed in these funds by a financial planner who is trained to make investment decisions (of course, planners may have their own technical, agency and behavioural issues). However they would most likely be better placed to handle larger investment choice menus than the fund member.

What will be interesting to watch are moves by industry funds to provide a greater range of choice to their members in an attempt to stop the flow of high balance members shifting their accumulation balance to an SMSF. It may be that many members choose to switch to this broader offering (a la the more extensive jam booth) but perhaps, if this extended range of investments is not complemented by advice, we may see choice overload issues come to the fore.

Choice overload is one of many complex issues associated with the study of how choices are made. It is a major (and realistically incorrect) assumption that rational financial decisions will always be made. We are soon to enter a major review of the Australian financial system and choice should be considered in far greater detail rather than simply taking an ideological view that more choice and more freedom is always better.

David Bell's independent advisory business is St Davids Rd Advisory. David is working towards a PhD at University of NSW.

Lending policies can spoil good SMSF strategies

Alex Denham

I have been a financial adviser for only three years. Before that, I had an 18 year career as technical manager researching superannuation legislation, interpreting it and providing technical advice and strategies to advisers on superannuation. I made for a very interesting dinner companion, I'm sure.

As a technical adviser, I wrote endless articles for advisers on clever superannuation and retirement strategies, on how and why they work under the legislative framework and the benefits and pitfalls involved.

So it was with great pleasure that as an adviser, I came up with a strategy that would be life-changing for a married couple. This strategy would get my clients their new house built without increasing their debt (in fact reducing it) and save them thousands in future capital gains tax – all with the core purpose of building up their superannuation for their retirement.

But it's one thing to write about life-changing strategies, and quite another thing to actually implement them.

Farm sale plan

My clients own a 40 hectare cattle farm. It's a small farm, and they have to work in other jobs to make a living, but it is a primary production business in the eyes of the Tax Office. On the farm is a small cottage that they are currently living in, and they have council approval to build a new home on the property, leaving the cottage intact to be used as a farm stay.

To buy the farm four years ago, they mortgaged themselves to 80%. They have been paying interest-only on their mortgage, as they were saving up for the home building project. Impressively, they have now saved up about half the anticipated cost of the build, but they need to raise the other half.

Together the couple have $275,000 accumulated in super which could be rolled into an SMSF. The idea was for the SMSF to buy the farm from the couple (the SMSF members), and to do so, it must borrow the rest of the purchase price from a bank under a limited recourse borrowing arrangement.

Under the proposed strategy, the farming business – a partnership between the husband and wife – would lease the farm including the cottage from the SMSF at market rates, and on an arms-length, commercial basis in line with superannuation laws.

With the proceeds, the couple would then pay off their mortgage, leaving them with the additional cash needed to complete the build. The SMSF would pay for the build via non-concessional contributions. This is an important point; the loan is NOT funding the build. In effect, we were transferring the loan from one entity (the couple) to another (the fund). After completion of the build, the property would have significantly increased in value and it would be generating income for the fund, making it a valid investment for a SMSF.

Technical issues

There were myriad technical issues to tick off before proceeding, such as:

- Could the fund buy the farm from the members, especially given it has a dwelling on it? Yes, it is 'business real property' and there is a special rule in the law for primary production businesses allowing a dwelling to be on the property if it is on less than two hectares.

- Would building the new house fundamentally change the property? This was up for debate, but we decided that no, it wouldn't. It starts out as a primary production business with a residential house, and finishes as a primary production business with a residential house.

- Would this strategy fit in with the sole purpose test? Yes, the property would increase significantly in value, and it would be generating income for the fund. The two hectare dwelling exception mentioned above applies for the sole purpose test as well.

After carefully ticking each box, the strategy appeared ready to implement. The SMSF was established, and it was time to approach the bank. Their own bank has a SMSF loan product, so it was the obvious first choice.

This is where reality and theory parted company. The bank, with which they'd both banked for 20 years, declined the loan application. This bank had an issue with the servicing of the loan. Its policies required that employer contributions – as evidenced by the previous three years superannuation statements – would service the loan.

Although the couple have combined income of over $300,000 and they could easily afford to make enough contributions to service the loan, their employer contribution history was too short to meet the bank's stringent policy requirements. The couple's loan application was complicated by the fact that the husband recently started working on a contract basis. Unfortunately, his voluntary concessional contributions were not good enough from the bank's point of view. Nor were the lease payments on the land, which covered more than half of the loan repayments.

Banking brick wall

We have tried several other banks and came up against brick walls in every case. Some banks would not lend on rural properties, and others required minimum loan balances of $1,000,000 before they would even look at lending.

At the time of writing, we haven't given up on the strategy. It is currently being looked at by another major bank, and we haven't been turned down at this point. My clients are getting their heads around using their savings and their substantial monthly income to build the house to lock up stage, and then save up enough to gradually complete it, room by room.

After nearly 20 years of writing up strategies, I realise that theory and law is one thing, but implementation is a whole different ball game. The legislation allows for such a strategy, but that's useless if the banks don't go for it.

Why, I hear you ask, don't the clients just get the bank to value their property on the completed value and borrow the extra money that they need to complete the build? They could do that, but they would prefer to do it as owner builders, and the bank won't touch that. They would need a building contract. Meanwhile, I'm off to call a few more lenders. After all, surely someone wants the business …

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Super funds need a member engagement makeover

Maree Pallisco

For superannuation funds, members are their reason for being. Attracting new members and retaining existing ones is critical to their survival, especially in this world of continual change. The top priority on all superannuation funds' lists is improving member engagement. But what does this mean and where do funds start?

Let's begin by looking at the ways funds have traditionally engaged with their members and the challenges associated with these methods.

Correspondence filed away, web sites ignored

Legally, superannuation funds are required to inform their members of their balances and changes to the fund at certain times in writing. So members receive annual statements and other occasional correspondence from their funds.

However, disengaged members are likely to not even read their annual statements. Instead, they simply file them away until they are about to retire and want access to this money.

Over recent years, we have seen funds begin using their websites to correspond with members in a faster manner than by mail. But if a member is not engaged, why would they be looking at this website? Conversely, if a member actually does visit the fund's website, how often is it refreshed with the type of information the member is looking for?

Lost call centre opportunity

For years, many superannuation funds have been outsourcing their call centre functions. Although funds have monitoring processes in place to listen to what their members are being told, this is usually done merely from a compliance perspective rather than from an engagement point of view.

When a member calls the fund to rollover their money to another fund for example, the call centre operator is obliged to follow member instructions in order to satisfy the member and all compliance obligations. While this results in a 'pleasant transaction' – the member gets what they wanted and the call centre meets its service level standards – the fund loses a member. In most cases, even if funds train call centre staff to use prescribed wording to encourage members to stay, by the time a member gets to this stage it is usually too late to change their mind.

Inadequate member surveys

Member surveys have been used by the superannuation industry for years. If the majority of survey respondents are satisfied and the fund's targets have been met that is an excellent result,

right? Wrong! Have the funds looked more closely at the members that are not satisfied or the members that have not responded at all, to understand the causes of dissatisfaction and non-response and try to address the underlying issues?

Enquiries and complaints

Legally an enquiries and complaints mechanism is required for all Australian superannuation funds. As long as funds respond to any issues raised within the required timeframe, this is viewed as an excellent result. But what do funds do with the knowledge they have gained from these enquiries and complaints? How can they use the information to help them understand what members do or don't want from the fund?

It's clear the existing communication channels and frameworks need to be revisited if superannuation funds want to increase member engagement and retention levels. So now let's examine some of the key areas that funds should consider as part of their overall member engagement strategies.

End outsourcing

In many cases, call centres remain a member's main touch point with their superannuation fund. Having control of this channel is vital. Funds need to take back ownership of their members, not leave this important role in the hands of an outsourced service provider.

Digital innovation

Funds have digital ambitions. There is no doubt that innovation in digital technology has transformed the world and is dramatically altering customer experiences across all sectors of the economy. Australians are enthusiastic adopters of digital and mobile technologies, so funds need to get on board this trend, and fast. However, this is easier said than done and, for funds to ride this wave of change, there are a number of factors they need to consider.

Firstly, there is the issue of technology investment. Funds need to look at whether their current infrastructure supports their digital ambitions. How easy will it be to design or develop the required infrastructure? For some it may be easier than others. Important areas to consider during the planning stage include the use of outsourced service providers, the cost to design and implement, and allowing flexibility for future changes. In the digital space, what is relevant today may not be tomorrow.

The second area that needs focus is organisational structure. Will the fund's current organisational structure support its digital ambitions? Does the fund have people with the right skills to design, deliver and promote their digital strategy?

Make better use of social media and web sites

Social media is a relatively inexpensive marketing and customer communication tool. It's an influential medium, particularly for digital savvy younger consumers. While some funds have started to incorporate social media elements into their member engagement toolkit, success to date has been minimal. The question that funds need to ask themselves is whether they have developed a robust social media strategy based on specific, measurable goals.

Having an engaging online presence is not about putting hard copy documents on your website. It's about giving members meaningful information and allowing them to interact with it.

Funds need to make their websites more engaging. If members are leaving their superannuation management in the fund's hands, it's because they don't want to think about it. They want funds to make the hard decisions and deliver the information they need to know – in simple terms. So funds need to consider not just whether their website has the content members want, but also how easy it is to access and use. Can customers complete forms and get questions to their answers directly from the website?

How can funds make their websites interactive and fun, so members want to go back for more? Photos and videos attract a more engaged online user. And what about gaming? The rise of smartphones means online games and apps are becoming increasingly popular and mainstream, not just the domain of Gen Y and the digital generation.

Building trust is the key

While improving channels and methods of customer engagement is important, doing so is meaningless unless one very important thing is achieved: trust.

The global financial crisis meant many members lost faith in the superannuation system. The talk of negative double digit returns was something members were not used to and, as a result, the rise of an 'I can do better than you' mentality has seen an increasing number of members switching to SMSFs.

People are increasingly looking to alternative channels, such as advice from friends and their family accountant, for financial decision-making, because these are channels they trust.

In this environment, implementing new means for members to keep in touch with their funds will not make a difference unless funds are prepared to analyse the results and learn from these, in order to build a trusted relationship.

Funds are already engaging with their members via emails, enquiries, complaints, and website visits. Developing a strategy to better analyse the information available through these interactions – and being willing to act on the findings – may be the starting point funds need when it comes to increasing member engagement.

Maree Pallisco is the national superannuation leader for Ernst & Young Australia. *The views expressed in this article are the views of the author, not Ernst & Young. The article provides general information, does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Liability limited by a scheme approved under Professional Standards Legislation.*

Caveat Emptor

Two Caveat Emptor sections on dividend income funds and bank hybrids are on the website.

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