Cuffelinks
Connecting investors with ideas

Edition 54, 21 March 2014

This Week's Top Articles

- **In defence of asset-linked fees** *Jonathan Hoyle*
- **Bank hybrid market undergoing significant change** *Campbell Dawson*
- **Pension indexation is a $300 billion question** *David Bell*
- **The 4% Rule for retirement withdrawals may be too high** *Harry Chemay*
- **Picking winners: the origins of the specious** *Kelly and Umbrazunas*

In defence of asset-linked fees

Jonathan Hoyle

Some people in the financial advice industry think linking fees to assets under management is akin to smoking behind the bike sheds; others think it's no different to charging commissions; and there are even those who think you cannot call yourself independent if you link your fees to assets. A few even believe it's just downright unprofessional.

What is it about asset-linked fees that generates such heated emotion?

Detractors of asset-linked fees argue they are too harsh on the rich (!); work too well for advisers; result in fees that are too high; and incentivise investment of money in the stock market (albeit an asset class that has compounded at 11.6% since 1979).

Following the introduction of FoFA and the proposed amendments, the two most pernicious features of financial planning in Australia will have been materially addressed – the payment of commissions by product providers (other than for 'general advice') and the ability for advisers to collect a 'trail' fee from a client without actually telling them about it. The previous Labor administration was right to tackle both issues. Investment product commissions payable by fund managers have gone. Good riddance. The new Fee Disclosure Statements require advisers to send a regular letter to all new clients detailing the dollar amount of fees charged to their account. This will rapidly reduce the too high occurrence of Australian consumers paying for financial advice without receiving any – a blight on our industry.

Financial advisers tend to use one or more of three different methods to charge their clients; hourly fees, fee-for-service (FFS) and asset-linked fees. It is critical to point out that there is no perfect method to charge for financial advice – all have their pros and cons.

Hourly fees can incentivise inefficiencies, encourage over-servicing, discourage client contact and are widely loathed by clients. They are a retrograde step for the industry.

The FFS method has, for some reason, attracted a deeply illiberal and puritanical crowd. It is seen as morally superior to all other methods and little tolerance exists from its advocates for alternatives. However, the vast majority of those who proudly claim to have transitioned to a FFS arrangement merely use the client Funds Under Management (FUM) as a starting point and work back.

We see three crucial weaknesses in FFS. Firstly, it is just so opaque. From our experience (and Stanford Brown has reviewed the books of many FFS advisory companies), advisors using a FFS methodology base their final figure partly on complexity, partly on hours worked but mainly on sticking a finger in the air and hoping the client can pay. Second, it is nearly always linked to client FUM anyway. And finally, they are a tax on those who can least afford it. FFS is a regressive pricing methodology that makes advocates of flat taxes resemble 1950s Cold War socialists. Our Ultra High Net Worth clients (the 0.1%) are cheering the FFS crowd from the rafters. If the advice industry really starts to charge those with $10 million the same as those with $100,000, one could scarcely dream up a more regressive fee structure.

Asset-linked fees are also problematic. Yes, they do incentivise the collection of assets for advisers to manage. Despite the 11.6% stock market return, there are occasions when this generates a conflict of interest. For example, the best advice for most home-owning clients in their 30s and 40s is the repayment of their mortgage (simple but valuable nonetheless). However there are undoubtedly some less than scrupulous advisors that would recommend establishing share trading funds instead, on which they can charge a 1% fee. Fair criticism.

There are multiple reasons why the cost of servicing a client with $5 million is greater than one with, say, $50,000. These include the cost of correcting mistakes, the greater asset diversification that is invariably required, and the far higher stakes involved. And those who point out that the cost of servicing a client with $10 million is not ten times that of one with $1 million are absolutely right. This is why Stanford Brown, along with many other investment advisers, applies a rapidly dwindling percentage fee as the assets build.

But asset-linked fees provide two key benefits. First, they permit much closer alignment to the client due to fees declining in a falling market. In contrast, a FFS adviser is insulated against poor investment performance. And second, they are transparent and logical for the client to understand.

Progressive firms charge clients through a combination of four factors; the complexity of the client's situation (which should diminish over time if the job is being handled properly), the amount of communication required by the client (e.g. how often and where they wish to meet), the amount of planning strategy required (estate planning, lending, insurance, budgeting etc) and the investment responsibility placed with the adviser (FUM). Younger or working clients with much planning and strategy work to be done are predominantly charged via a fee-for-service arrangement. Older clients who engage their adviser principally to manage their investments are more suited to an asset linked fee. And clients with one-off project work are charged an hourly rate. In essence, different types of advice lend themselves to different fee structures.

There is a world of difference between, on the one hand, preferring one method of charging clients, and on the other, demanding that everyone conform to your personal opinion and calling for legislation. The freedom to engage in robust debate is what makes Australia such a wonderfully successful country. However demanding a private business charge its clients according to your own preference is the road to euro-socialist hell.

If financial advice related asset-linked fees are banned, who will be next to feel the sharp end of new legislation? Fund managers? Stockbrokers? Super funds? And what about real estate agents? After all, does it really cost twice as much to market a house for $2 million than one for $1 million?

In summary, all three charging methods have their drawbacks. There is no panacea. We believe that asset-linked fees, though far from perfect, are the most transparent, easy to understand and honest of all the available choices. Let those who wish to charge by the hour or as a negotiable fee-for-service set up shop opposite our offices in North Sydney, let the invisible hand of competition work its magic and let the customer decide.

Jonathan Hoyle is Chief Investment Officer at Stanford Brown.

Bank hybrid market undergoing significant change

Campbell Dawson

An important change has hit the ASX listed bank hybrid market recently that we think may lead to a contraction of margins on listed hybrids for the remainder of the year.

Since the drafting of Basel III regulations in 2010, bank hybrid structures had been shunned by institutional investors who refused en masse to accept the so-called 'non-viability' clauses embedded in Basel III complying hybrid structures. The non-viability clause allows the regulator to convert the hybrid to equity to improve a bank's solvency under crisis conditions. Such a clause has obvious risks, which retail investors either overlooked or ignored, while institutions thought it gave the issues too much 'equity' characteristic without sufficient return.

(For more discussion on the risks of hybrids and reasons why institutions were not buying, see previous Caveat Emptor article in Cuffelinks, 12 December 2013.)

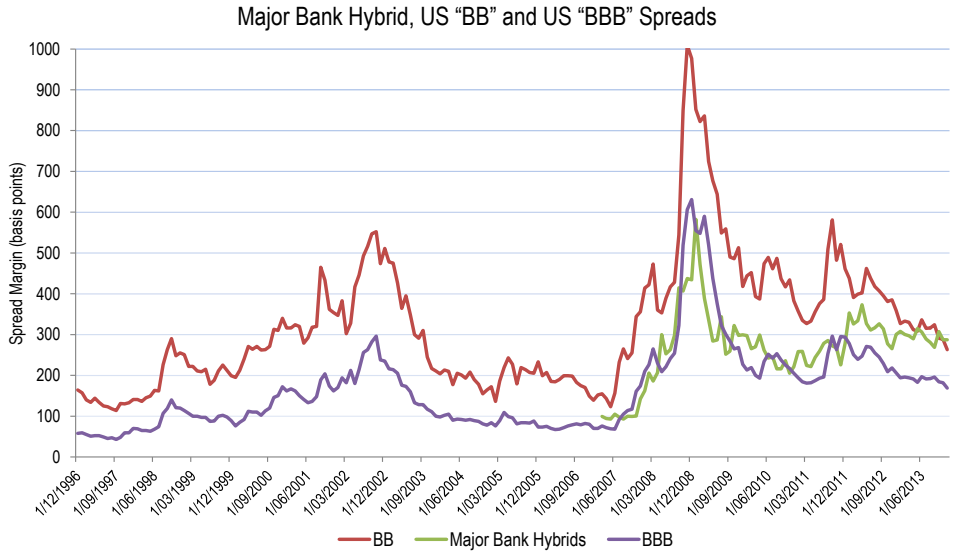
But a flagship Tier 2 capital issue by Bendigo & Adelaide Bank in January 2014 saw institutional investors participate for the first time under the new bank capital regime. Westpac, ANZ and IAG have all issued into the wholesale over the counter (OTC) market to institutional investors since.

We believe that the change in institutional investor sentiment has the potential to squeeze supply for the retail ASX listed market for the rest of 2014.

Maintenance of 3% margins since the implementation of Basel III

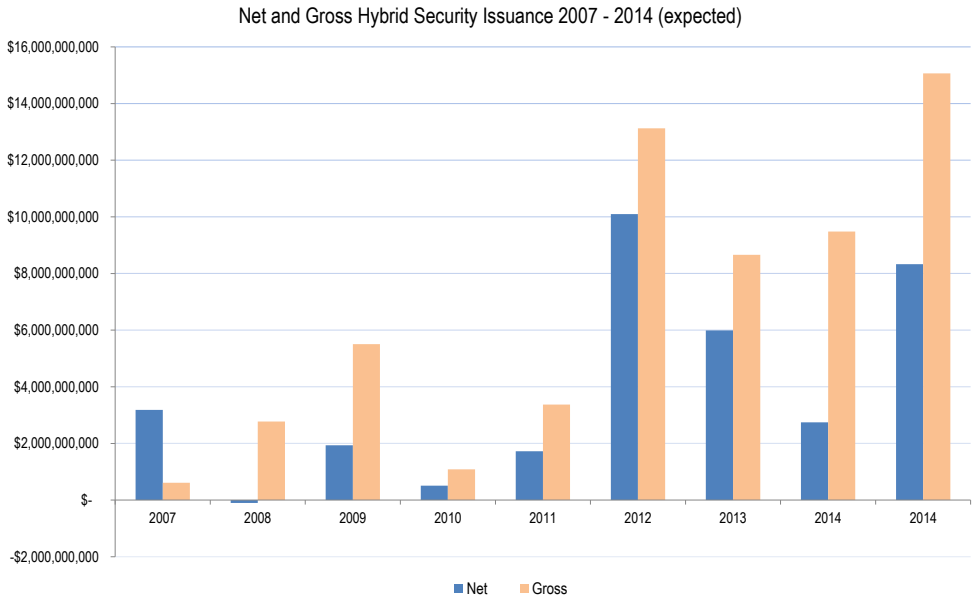
A few months ago, we thought the listed hybrid market would produce a total return this year close to 6% (including franking). However, due to the changed sentiment of institutional investors in the wholesale OTC market, there now appears potential for spread contraction and capital growth in prices in the listed hybrid market. Absent another equity market crisis or major event shock, we think that listed major bank issues are unlikely to attract a margin of greater than 3% again (the margin is paid above the bank bill rates, currently below 3%, and adjusted for franking).

The chart below shows margins on US corporate BBB and BB debt and the composite margin of ASX Listed Major Bank Hybrids. The zero cash rate in the US has driven investors into higher-yielding assets since the GFC and margins on BBB and BB corporate debt are close to 1996-2006 levels, half their late 2009 levels. However, margins on the ASX Listed Major Bank Hybrids are largely unchanged, having fluctuated around 3% for the past four to five years. They were recently higher than US BB corporate debt for the first time ever.



Data: Bloomberg, ASX and Elstree

Major bank hybrid margins have been relatively flat due to a massive amount of supply as banks began to comply with the much more restrictive Basel III capital regime. In absolute terms, the market size has doubled since late 2011. Prior to the GFC, the market used to absorb about $3 billion on an annual basis. The chart below shows gross and net (after allowing for redemptions of issues) since 2007. The net issuance amount is probably the best guide to supply/demand equations.



Data: ASX and Elstree

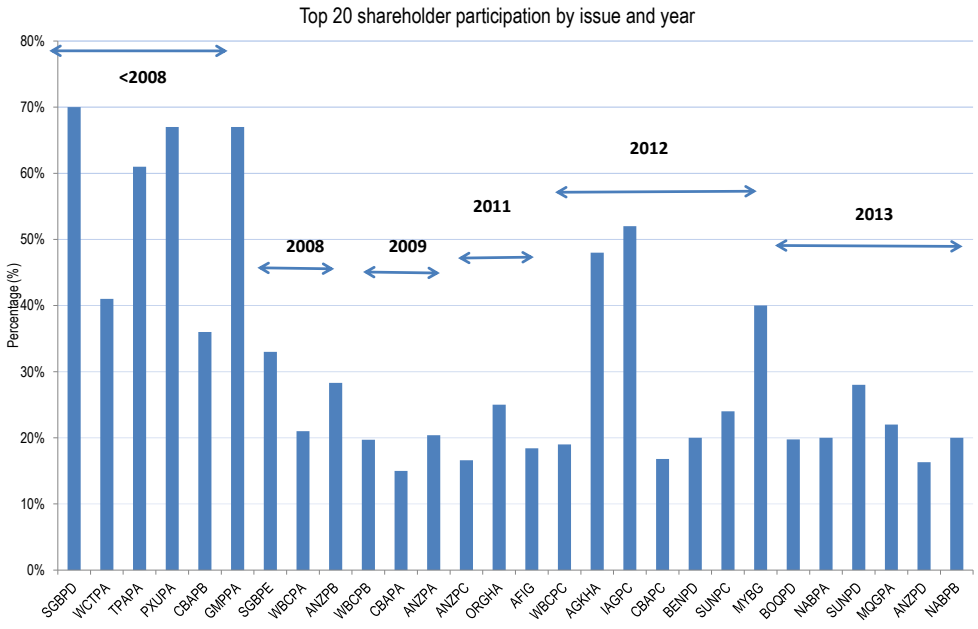
The year 2012 was characterised by about four years of normal issuance while 2013 was about 3 years of normal issuance. Until recently, we expected that 2014 would produce about $8 billion in net issuance or $15 billion in gross issuance. The two bars for 2014 show two outcomes: the first assumes that banks refinance all their Tier 1 hybrids in the ASX market and the second adds another $6 billion of Tier 2 debt that banks need to finance. Financing $15 billion of gross issuance would mean that margins would remain high.

Institutional demand will impact directly on ASX listed issuance

The institutional acceptance of the 'non viability' clause in Basel III compliant transactions stems from a broad-based change in sentiment toward banks in general.

A recent issue in Europe by UBS for example was five times oversubscribed, and was issued at a record low margin. Australian banks could now issue Tier 2 capital instruments at margins well under the current trading margins of ASX listed hybrids. If the Australian bank issuers tap the international market and local institutional investors continue to follow their international contemporaries into the market then the level of net issuance in the ASX listed market could potentially fall to the level last experienced in 2006.

Unless there is a sudden reversal, institutional investors are now most likely to absorb the $6 billion of Tier 2 debt that the Australian banks need to issue this year. The chart below shows the proportion of hybrid issue ownership by the top 20 holders for each issue, grouped by years of issue. In recent years, the Top 20 (i.e institutional) investors have held as little as 20% or less of some issues, showing a high percentage of small retail investor participation, with around 40% of some issues owned by investors with less than $50,000 holdings. Investors will buy anything with the margins higher than 3% recently.



Data: Elstree and ASX.

Retail and SMSF support

In 2011, bank term deposits were readily available at rates of 6% or higher. In 2012 they were still around 5%. Driven by the volatility of equity markets, SMSF holdings of cash, including term deposits, doubled from around $70 billion in 2007 to $150 billion in 2013.

As the cash rate is now down to 2.5% and term deposits of less than 12 months are prefixed with a '3' the loss of purchasing power after adjusting for inflation is causing concern among retirees. Unlike their institutional brethren, retail investors have been comfortable since the implementation of Basel III with the major bank name hybrids, and were willing to overlook the complex regulatory clauses and risks in search of total returns in excess of 6%.

Although official statistics on SMSF investments are dated and too aggregated, there are signs in the 2013 statistics of an absolute fall in cash holdings, despite total SMSF funds increasing rapidly. There is a lag between new term deposit rates falling and cash flows, but any term deposits that were written in 2012 at rates of 5% or above will now be rolling at around 3.5%. We estimate that as little as a 2% reallocation by SMSF trustees from term deposits to hybrids will account for all the expected net new issuance in the listed hybrid market this calendar year.

If institutional demand in the OTC market soaks up the bank Tier 2 issuance, there will be a shortage of ASX listed hybrid supply at the time when a decent chunk of the $150 billion in SMSF monies invested in term deposits is looking for a new home.

Campbell Dawson is a Director of Elstree Investment Management Limited. Information and opinions contained in this article should not relied upon as authoritative and may be subject to change without notice.

Pension indexation is a $300 billion question

David Bell

In the past week, some of the heaviest hitters in Australian economics have addressed the impact of various policy changes on the budget deficit. Professor Ross Garnaut, former Governor of the Reserve Bank, Bernie Fraser, and former Secretary of the Treasury, Dr Ken Henry, have all spoken publicly. Ken Henry said the entire welfare system needs to be fixed, and "There will be a day of reckoning", specifically identifying the age pension as needing attention. And Treasurer Joe Hockey is currently worrying about where the money is coming from while he frames his first budget.

I have previously suggested that reform of the age pension is likely (Cuffelinks, 21 February 2014). Age pension reform is a complex, controversial and sensitive issue. What may seem at first glance an obvious (and perhaps an easier) reform opportunity proves difficult once all issues are considered. The indexation of age pension payments is a case in point.

Background on age pension payments

Currently the full age pension fortnightly base payment for a single is $751.70, which can increase to $827.10 once supplement payments are included. Combined couple base payments are $1,133.20 ($1,246.80 with supplements).

Base pensions are indexed twice a year. The pension is increased to reflect growth in the Consumer Price Index and the Pensioner and Beneficiary Living Cost Index, whichever is higher. When wages grow more quickly than prices, the pension is increased to the wages benchmark. The wages benchmark sets the single base pension rate at a minimum of 27.8% of Male Total Average Weekly Earnings (41.8% for the combined couple rate).

Wages have grown at a faster rate than inflation, by about 1.2% pa over the last 30 years. It is likely that real wage growth will be positive and thus it will be changes in wages which drives changes to base pension rates.

Wage indexation is generous, but is it sustainable?

The Department of Social Security website states that the *"Age Pension is designed to provide income support to older Australians who need it, while encouraging pensioners to maximise their overall incomes."* If income support is interpreted to mean poverty alleviation then wage indexation may appear a generous provision by the government. An argument could be made that poverty alleviation refers to a cost of living and this makes inflation a more relevant indexation reference.

Given 40% of the population are predicted to receive the full age pension at some point in their lives and 80% of the population receive the part age pension, then wage indexation will have a significant impact on the retirement outcomes of the majority of Australians. Consider the chart below where we assume that real wage growth is 1.2% pa and inflation is 2.5% pa into the future.

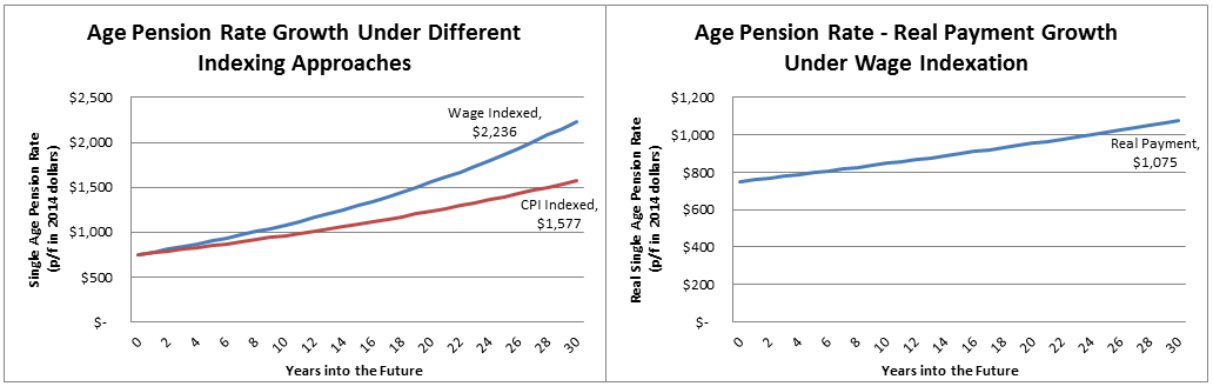


Chart 1: LHS: Single age pension rate growth under two indexing approaches; RHS: Real single age pension rate under wage indexation.

While, as expected, age pension payments grow faster when indexed to wage growth rather than inflation, it has a remarkable impact over time. In today's dollars, in 30 years' time, age pension payments would be 43% higher ($1,075 per fortnight).

What does this mean for retirees? For those on the full aged pension, real aged pension payments will be significantly larger when they are indexed by wage growth. The story for those with higher super accumulation balances is less clear as the threshold income levels also rise with wages making the age pension harder to access.

If age pension recipients are far better off under a wage indexation process then this means the government is paying out more. If we take Treasury's forecasts (from the Intergenerational Report), age pensions will cost 3.9% of GDP in 2050 or about $60 billion in today's terms. If we just look at those on the full age pension (which I will guess makes up 75% of the budget expense) then an estimate of the difference in age pension expenditure in 2050 due to the choice of indexation is $18 billion ($60 billion x 75% x 40%). From now until 2050, an estimate of aggregate government expenditure due to the choice of indexation method is $270 billion. That's a large number in anyone's books!

This is not forecast to create a huge windfall benefit for retirees (as we saw in Cuffelinks on 7 February 2014, the benefits of higher wage growth are modest for low income earners). This is because the increased age pension payments may be offset by income tax due to bracket creep. Over time tax brackets have tended to be indexed by inflation rather than wage growth and this means more people, including future full age pension recipients may actually pay income tax (this in itself is an interesting policy issue). So what the government giveth with one hand, it may taketh with the other.

The social importance of wage indexation

The Harmer Review advocates wage indexation, or 'benchmarking', of the age pension rate. The finding of the Harmer Pension Review was:

"The Review finds that automatic indexation of pensions and a two-part approach of benchmarking and indexation should continue. Benchmarking pensions relative to community standards should be the primary indexation factor, with indexation for changes in prices acting as a safety net over periods where price change would otherwise reduce the real value of the pension."

The primary argument is that benchmarking maintains the relativity of the age pension to community measures of living standards, and avoids dispersion of quality of life increases between those who are working and those who are retired. Changing living standards and changing social and technological structures in society are important issues for which income is a better proxy than inflation. The example provided in the Harmer Review was computing and the internet. Most would find that computer and internet access is a near essential part of life now.

The Harmer Review is well-balanced and raises additional concerns about wage indexation:

- In an aging society where the ratio of pensioners to workers is increasing, an age pension rate indexed to wage growth will mean that workers, via tax, will forgo an increasing proportion of their income. This would create an inequity in the other direction – pensioners maintain living standards while workers experience declining living standards (due to higher income taxes). There are obvious social and equity issues that follow from this. Any sustainability-driven approach to link pension payments to tax receipts would likely find wage indexation unsustainable.

- Wage indexation provides a mechanism to share the benefits of productivity gains across the community. There are other claims on productivity gains, notably those that come from the workers themselves (working harder and smarter), their employers, and ultimately their shareholders if the employer is a corporate. Governments may argue for their piece of any productivity improvements as well.

Some countries have moved away from earnings to price-based indexation, arguing that the purchasing power of pensions is preserved but that fiscal constraints restrict them from providing wage indexation. Of course they could in the future provide one-off adjustments to the pension rate to improve social

balance if the fiscal position permits. One positive aspect of indexation is that it is automatic and removes uncertainty and politics from pension rate determination.

Indexation of the age pension rate is a complex, controversial and sensitive area. The debate needs to balance both economic and social issues. Ultimately, given the numbers are so large (circa $300 billion over the next 30 years), I'm sure the government at some point will review indexation practices as part of its desire to bring the burgeoning budget under control.

David Bell's independent advisory business is St Davids Rd Advisory. In July 2014, David will cease consulting and become the Chief Investment Officer at AUSCOAL Super. He is also working towards a PhD at University of NSW.

The 4% Rule for retirement withdrawals may be too high

Harry Chemay

An Australian paper on safe withdrawal rates from capital at retirement concludes that over 30 years, a 50/50 portfolio with a withdrawal rate of 4% a year would run out of money about 18% of the time. This is despite the excellent returns from Australian equities over the sample period. The study has important implications for financial planning over long retirement periods.

In contrast to academic work on the accumulation phase of investing, a trifling amount of research has been done on the decumulation phase of investing, where accumulated wealth must be managed to fund retirement needs for potentially 30 years or longer.

Twenty years ago, William Bengen, a practising financial planner with an aeronautical engineering degree, set about calculating the rate at which capital could be drawn for a US retiree with a high probability of the portfolio lasting 30 years. Bengen used US investment return data from 1926 to compute a safe maximum withdrawal rate (which he called SAFEMAX) of 4.15% per annum for a 50/50 portfolio of US shares and bonds. He thus suggested that if a US retiree commenced a systematic withdrawal plan drawing 4% of the initial portfolio value, and thereafter that same dollar amount (adjusted for inflation each year), a 50/50 'balanced' portfolio would last for at least 30 years. Subsequent studies confirmed Bengen's findings, and thus the '4% Rule' was born.

Finsia safe withdrawal rate report

The 4% Rule has come to be the default safe withdrawal rate in retirement planning assumed by planning professionals. It relies on historical data for the US. How safe is it for other countries? A recently released Finsia report seeks to shed light on the matter.

Finsia's report is the latest contribution in its Retirement Risk Zone initiative, focussing on the risks in the last two decades of work and the first fifteen years of retirement. The report was authored by Professor Michael Drew and Dr Adam Walk of Griffith University.

In an important departure from previous US-centric studies the authors used a global database of real (after inflation) investment returns for 19 countries spanning a period of 112 years. They focussed their analysis on Australia and a selection of other countries representing the quartile performers (Japan 25th, Netherlands 50th and New Zealand 75th) as well as the worst performer, Italy. The table below provides details of these nations (with the US and UK added for comparison):

Real returns for Australia and selected countries; 1900 to 2011

Ranking (Shares)	Country	Real Share Performance (Annualised %)	Real Bond Performance (Annualised %)	Ranking (Bonds)
1	Australia	7.22	1.57	9
3	United States	6.19	2.01	6
5	New Zealand	5.76	2.12	5
7	United Kingdom	5.20	1.52	10
10	Netherlands	4.81	1.51	11
14	Japan	3.62	-1.06	17
19	Italy	1.68	-1.74	18

Source: Finsia report (Dimson Marsh Staunton Database)

Drew and Walk used a simulation process to model the probability of portfolio ruin (retirement capital exhausting) for various retirement timeframes, and for various growth/defensive asset allocations. The results for a 30 year retirement for Australia appear below:

Asset allocation (rebalanced annually, 30 years)	Withdrawal rate as a percentage of initial portfolio value			
	SAFEMAX100	SAFEMAX95	SAFEMAX90	SAFEMAX50
100% stocks	2.74	4.20	5.13	7.63
75% stocks/20% bonds/5% bills	2.94	4.01	4.31	6.71
50% stocks/45% bonds/5% bills	**2.96**	**3.54**	**3.62**	**5.37**
25% stocks/70% bonds/5% bills	2.45	2.69	2.85	4.11
95% bonds/5% bills	1.66	1.83	2.04	5.37

The highlighted row indicates that using a 50/50 asset allocation, the Australian safe withdrawal rate is **3.62% p.a.** (real) at a 10% chance of portfolio ruin (SAFEMAX90) over a 30 year retirement.

Whilst Australia has enjoyed the highest equity returns of all 19 nations over the 112 years analysed, its 50/50 SAFEMAX90 real rate of 3.62% p.a. is not the highest. Both NZ (3.97% p.a) and the Netherlands (3.67% p.a.) had higher safe withdrawal rates, owing to superior risk-adjusted returns from their respective bond markets. The two laggards were Italy with a SAFEMAX90 rate of 1.23% p.a. and Japan with a rate of 0.29% p.a.

What conclusions can be drawn from the report?

The report's authors conclude that there is no 'silver bullet' when it comes to retirement planning. They warn against using the 4% Rule in a deterministic way, instead suggesting that the underlying philosophy of the Rule can be a useful tool in framing retirement conversations and in forming expectations. They note that a retiree couple with a $1 million starting pension balance would need to draw in excess of 5.6% to generate the ASFA comfortable retiree budget.

Perhaps more importantly, the report suggests that asset-liability management needs to be considered more thoroughly in retirement planning. The authors note that, "The conversation is a difficult one in that, for many investors, their focus is on the asset side … of the equation, not the liability. We posit that the first challenge in tipping the scales in the retiree's favour is to get the framing right, moving from a 'pot of gold' (asset) mindset to an 'income replacement' focus (liability)."

Scope for future research

Whilst the report is an important step, especially given its Australian context, much more needs to be done to further our understanding of the decumulation phase. The report does not consider, for example, the interaction between personal retirement assets (superannuation), other assets and the age pension.

It ignores important personal planning issues such as mortality risk, taxes, franking credits or the bequest motive. Current government statistics indicate that less than 20% of retirees are fully self-funded, and that most Australians will be dependent on some level of government assistance in retirement. With those aged 65 plus estimated to grow in number from the current 3 million to some 4.2 million by 2020, and with pension assets expected to exceed $1.4 trillion (2011 dollars) by 2026, there is a lot at stake. This report shows that even if the future repeats the excellent past returns, the old 4% Rule is little more than a conversation starter.

Harry Chemay is a Certified Investment Management Analyst, a consultant across both retail and institutional superannuation and Fellow member of FINSIA. He has previously practised as a specialist SMSF advisor, and as an investment consultant to APRA-regulated superannuation funds.

The full study is, "How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective", FINSIA Research Report, Professor Michael Drew and Dr Adam Walk. Available on the FINSIA website.

Picking winners: the origins of the specious

Leah Kelly and Paul Umbrazunas

"Investing should be more like watching paint dry or grass grow. If you want excitement, take $800 and go to Las Vegas." Paul Samuelson, Nobel Prize for Economic Sciences, 1970

If we believe the financial press, superannuation has been wrongly turned on its head. Every week in our highest profile financial newspapers and magazines, we have headings like: *"Exclusive fund superstars - investment tips from top managers."* It's as if long-term investors need to respond to daily announcements and behave like traders.

Samuelson reminds us that when saving for retirement, investors should expect some level of boredom in their investment returns. Warren Buffett has said that he buys investments "*on the assumption that they could close the market the next day and not reopen it for five years*."

The superannuation goal is to have an adequate balance after your working life to live according to your expectations, but not worry about the markets every day.

How best to achieve this goal has led to debates around fundamental principles such as: the robustness of current asset allocation techniques; use of optimisation models; appropriate risk levels; the definition of risk; passive versus active management - to name a few. The fact such debates continue with rigour also shows that a lot of the 'principles' we take for granted should be challenged. Different perspectives should be encouraged and examined.

Focus on avoiding losers, not picking winners

One traditional focus is on picking winners as opposed to avoiding losers. The former makes for great news articles (when someone does get it right) whilst the latter is more akin to Samuelson's quote.

Have you ever noticed the language of English Premier League football managers when interviewed post match? Those challenging for the title will refer to 'points lost' or 'given away' as critical, acknowledging that, as soon as too many points are lost throughout the season, the title chase is effectively over. For those at the bottom of the table, there is also the expression of the need to achieve, say, 41 points to stay in the League, i.e. an aspirational target.

This illustrates something that most of us know instinctively when investing and is routinely mentioned as a behavioural preference. If asked: "would you give up some upside to protect downside?", most answer "yes". Numerous behavioural finance studies show that we dislike incurring losses far more (by around a

factor of 2) than we 'enjoy' making profits. Yet it is questionable if this philosophy is accurately reflected in current asset allocation and risk management practices.

The one thing we can say definitively on our superannuation journey is that during the intervening years from commencement until retirement, there will be 'up' years and 'down' years for anyone investing in other than cash.

Superannuation needs to preserve capital

It is our belief that the primary focus of the wealth management industry has changed from conservation of capital, with the ability to take advantage of compounding and long term horizons as core principles, to that of picking winners in the guise of various 'risk adjusted' frameworks.

But there should be more focus on minimising the 'points' lost rather than maximising the gains required. The reason is clear. Upon incurring a market loss a larger return is required simply to get back to where you started. As a simple example, consider the following two investors, both investing $10,000 at the end of May 2000.

- Investor 1 invests $10,000 in the ASX 200. Here the volatility is approximately 12% per annum.
- Investor 2 is more conservative and invests $10,000, 40% in the ASX 200 and 60% in cash. Here the volatility is approximately 5% per annum.

What were their experiences like?

Both investors had a good time up until September 2007. At this point, they were fine, with about $30,000 and $20,000 in capital for Investors 1 and 2 respectively. Then disaster struck. Investor 1 was hit with a drawdown period that lasted from September 2007 until January 2009, culminating in a total loss of 49%. Meanwhile, Investor 2 did not escape unscathed. A total loss of 17% was accumulated from September 2007 until January 2009. In order to return to the equivalent capital balance prior to September 2007, the total required return for Investor 1 was 92% while Investor 2 was 22%.

We assume for this illustration that both investors kept the faith and did not change their asset allocation.

How long did it take these investors to return to break-even? For Investor 1, it took six years to recover. For Investor 2, it took two and a half years. As an aside, by the end of January 2014, the annual realised return since May 2000 for Investors 1 and 2 was 5.5% and 4.7%, respectively. The realised annual volatility over the (nearly) 14-year investment was 13% and 5%, respectively.

This example illustrates something we all know. As the loss increases, the return required to retrieve your capital increases exponentially.

More importantly, neither of these relationships is linear and neither bears any relationship to the 'risk' that, as measured by volatility, these investors suspected they were taking.

Furthermore, the assumption that both investors stayed with their initial allocation is an optimistic one. There is a high likelihood they would have changed their allocations, especially away from equities after such a scare, causing the recovery time to be even longer.

Whilst 'value add' in the form of picking winners is admirable and part of every participant's core belief, it appears that, in the pursuit of validating this quest for *long term, consistent* alpha - even if it is risk-adjusted - the other principles of downside risk mitigation and the preserving of capital become diluted, or lost.

We suggest that a focus on minimising disasters and downside, whilst clearly not as exciting as picking winners, is a better goal and results in an improved, long-term outcome for the individual, as well as a less hair-raising experience for all.

Dr Leah Kelly and Paul Umbrazunas are Principals of AccumNovo Financial Group.

Disclaimer

This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.

For complete details of this Disclaimer, see http://cuffelinks.com.au/terms-and-conditions. All readers of this Newsletter are subject to these Terms and Conditions.