Cuffelinks
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This Week's Top Articles

Post-retirement income: the drums are beating

John Burnett and Nick Wilkinson

With the future of the age pension thrust into the spotlight by pre-Budget speculation, the debate on retirement adequacy is running hot. After years of focus on the accumulation stage, the drums are at last beating about post-retirement, and specifically, what sort of lifestyle can be funded through retirement savings where superannuation is just one part of the equation.

Towers Watson and the University of Melbourne have created research that factors in other forms of savings as well as the age pension to get a better picture of retirement adequacy – and the result is sobering.

The first tranche of this research focused on a representative sample of Australians aged 40 to 64 and was based on the Household, Income and Labour Dynamics in Australia (HILDA) Survey data collected in 2010. A significant chunk of this age group is likely to fall well short of a 'comfortable' level of retirement income, as defined by the ASFA Retirement Standard, even when super, the age pension and other savings are all taken into account.

The importance of retirement savings outside super

On this basis, our initial findings show that 53% of couples and 22% of singles in this age group are on track for a comfortable level of retirement income. We will release further research covering younger age bands later this year.

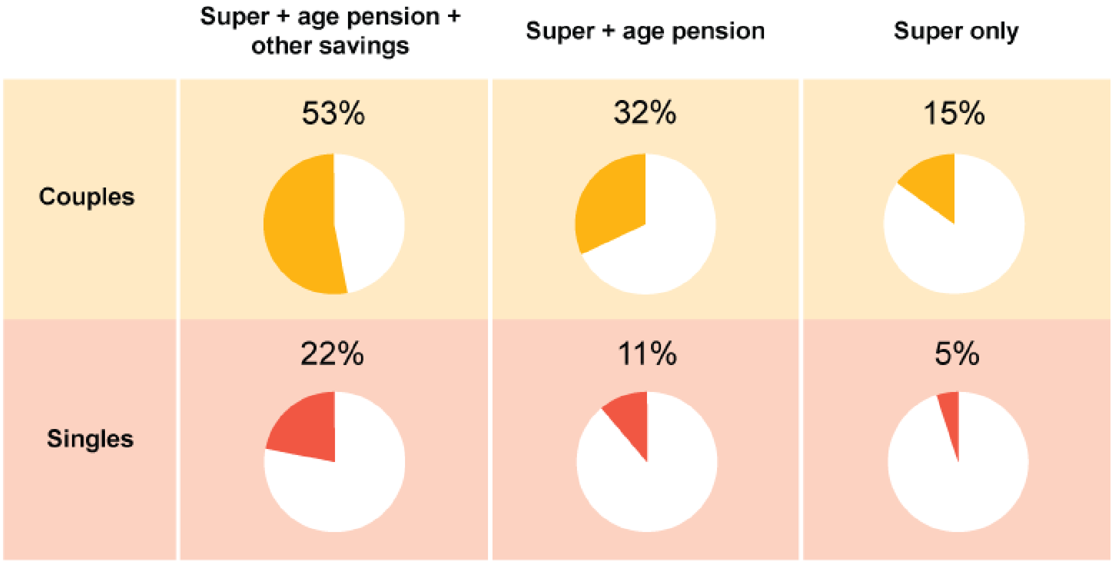
The debate on retirement adequacy and post-retirement income has come into sharp relief not only because of the federal government's signals that the current welfare system is unsustainable but also the superannuation industry's desire to engage members, innovate in post-retirement products and educate people on the need to create an income stream in retirement.

So let's look at the research findings. It demonstrates the relative importance of other retirement savings and the age pension for Australians in this age group to achieve a comfortable level of retirement income.

If we were only to rely on super, and ignore the age pension and other savings, only 15% of couples and 5% of singles would meet the standard. The importance of adding the age pension is clearly illustrated because the percentages more than double – 32% of couples and 11% of singles then meet the standard. When we also include other sources of saving, 53% of couples, but only 22% of singles, achieve the retirement standard.

Chart 1 – Who is on track for a comfortable retirement?

Percentage of those surveyed projected to reach or exceed target



Source: Towers Watson/The University of Melbourne

To further understand the breakdown of the projected retirement income, we look firstly at the people covered in the survey who are expected to receive the median projected retirement income, before considering those with higher or lower projections.

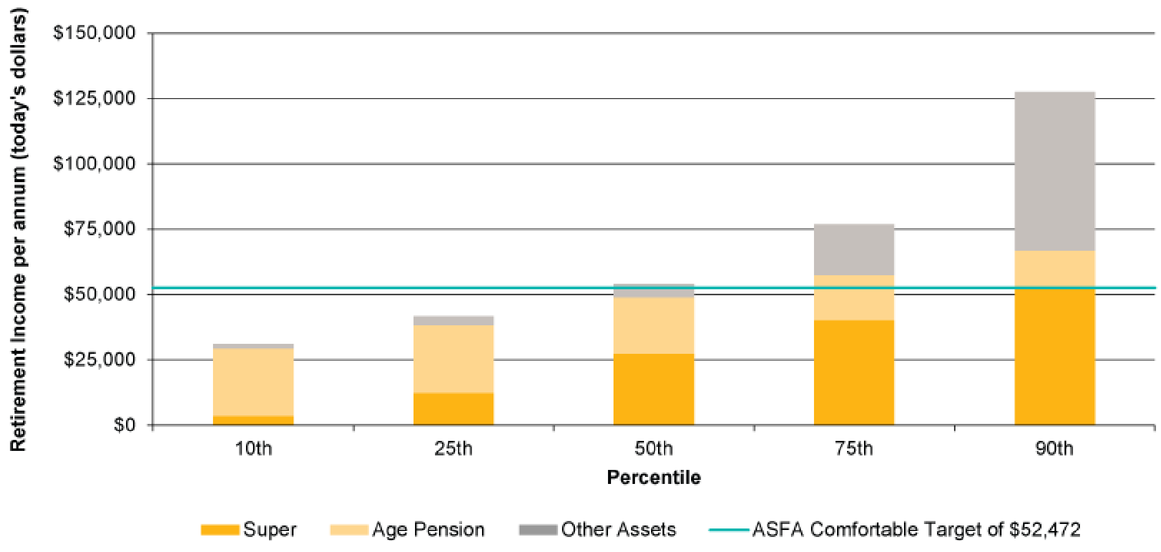
Need to add all components

We found that couples near to the median projected retirement income are expected to reach 100% of the target, but only if superannuation, the age pension and other retirement savings are all considered. In this instance, superannuation delivers 51%, the age pension delivers 40% and other retirement savings deliver 9% of the retirement income. While 100% of target is an impressive figure and a good outcome, we must remember that this is the median result, and 50% of those surveyed are below this level.

The position for singles is not as strong. The median projected retirement income here is expected to reach 68% of the target. There are many contributing factors, including relatively lower balances for singles in superannuation and other savings, as well as the relatively higher target income level required for singles – 73% of the target for couples, but with only one saver.

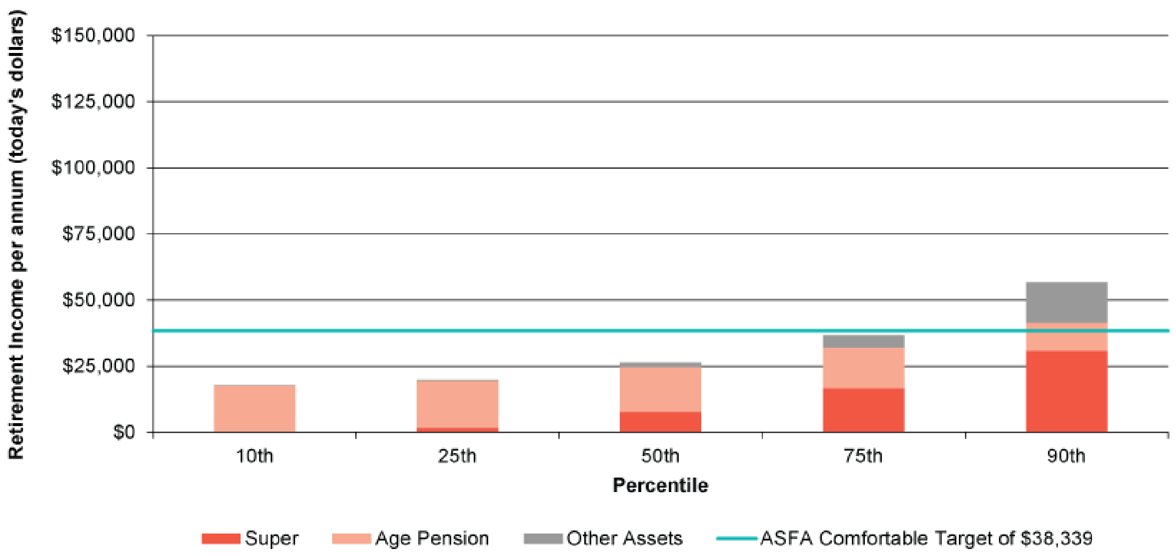
Looking more broadly, to those on higher or lower projected retirement income levels, we see the results in these charts.

Chart 2 - Distribution of Projected Retirement Incomes by percentile - Couples



Source: Towers Watson/The University of Melbourne

Chart 2 - Distribution of Projected Retirement Incomes by percentile - Singles



Source: Towers Watson/The University of Melbourne

Once again this highlights that couples are in a relatively stronger retirement adequacy position when compared with singles. Singles are also more heavily reliant on the age pension than couples. This is shown at the 25th percentile, where the age pension comprises 90% of the projected retirement income for singles, while for couples it is 63%. This is also observed at the 75th percentile where the age pension comprises 42% of the projected retirement income for singles, while for couples it is 22%.

Provide a retirement income projection

What are the opportunities for superannuation funds and financial service providers? The research highlights how important it is for superannuation fund members to be aware of their projected retirement income from all sources, not just super. Some funds are providing retirement projections to their members but this is still in its early stages and by no means widespread.

If the projections don't mesh with their retirement lifestyle ambitions, then fund members need to take steps while they are still working and able to improve their position. It's an important conversation for funds to have with each of their members.

The evidence suggests that most members currently don't receive any information on their projected retirement incomes. Online calculators and financial planners are unlikely to solve this gap alone, unless more members become aware of the issues they may be facing.

Providing all members with a retirement income projection each year is a significant step in reaching a wider audience. Annual projections will be a vital starting point in raising awareness and should encourage members to obtain more detailed projections either online or assisted by financial planners.

Issuing annual benefit projections in accordance with ASIC's Class Order is one of the ways of proceeding. Whichever approach is adopted, there are options available for funds to raise member awareness about their projected retirement income.

About the research

John Burnett and Nick Wilkinson partnered with Professor Kevin Davis, Associate Professor Roger Wilkins and Dr Carsten Murawski from The University of Melbourne in this research which uses data from the HILDA Survey, to provide retirement projections based on an extended methodology of the retirement planner that Towers Watson built for ASIC's MoneySmart website.

Using this model, we project the retirement savings for 5,124 individuals aged 40 to 64 residing in 3,519 households to the assumed retirement age of 65 and then the age pension eligibility is calculated each year in line with means-testing requirements. During this post-retirement period, superannuation and other retirement savings are then drawn down so that this wealth is exhausted by age 90. We calculate the level of retirement income that is maintained in real terms over the period from age 65 to age 90.

The current status as either a home owner or renter is assumed to continue into retirement. Where home ownership applies, we assume this continues to at least age 90 and do not draw on this asset when projecting retirement income in this research.

While there are many ways to measure retirement adequacy, in this research we have adopted a target of $52,472 for couples and $38,339 for singles. This is based on the ASFA Retirement Standard 'Comfortable' level (December 2012 figures) deflated to 2010 dollars to be consistent with timing of the HILDA data used. These targets have been indexed to allow for wage inflation in future years so the same target applies in real terms.

More detailed information on the initial research is available here.

John Burnett is a senior consultant and Nick Wilkinson a consultant in the Towers Watson Australia Retirement team.

Barry et al, this is what a good gift policy looks like

Graham Hand

In 2010, I was planning a personal trip to the 2010 FIFA World Cup in South Africa. A South African bank found out I was attending, and a formal offer of tickets and match hospitality arrived to a couple of games, including a semi-final. Tickets are always hard to find and I was keen to accept, but knowing how strictly our gift policy was applied, I followed the internal procedure which required senior management approval subject to certain value limits. The tickets were worth at least $600, and no doubt the hospitality a whole lot more.

My application came back saying that I could only accept if I paid for the match tickets myself. Fine by me. I told the South African bank why I needed to buy the tickets, and I was eager to attend. But they replied that under FIFA rules, they were not allowed to resell the tickets. I either had to take them for free or not at all.

What to do? Surely, we could come to an arrangement. After much discussion internally and externally, we agreed that if I donated an equivalent amount to a South African charity, then I could accept the tickets.

Which brings us to the Independent Commission Against Corruption (ICAC). I don't criticise Barry O'Farrell for forgetting the bottle of wine received three years earlier. At the time, he had been recently appointed Premier, his father-in-law had died the week before, and he had hundreds of things to do each day. Many people laugh at the 'I don't recall' answers at ICAC, but who can remember some of life's details from a week ago, never mind years? I once testified before an ASIC enquiry into a rogue trader, and the defendant's QC asked me about transactions we had done a couple of years earlier. We did hundreds of deals a year, and I could not recollect the ones he spoke about. Although it is an overused excuse by some witnesses, the 'I don't recall' is often not as bad as it sounds.

It is harder to accept not declaring the gift at the time it was received. That's not forgetfulness, it's ignoring an obligation. It should be the same in the corporate world, or almost any form of business. While many people will think corporate gifts are the classic 'snout in the trough' experience, all major institutions have strict gift policies, and the penalties for ignoring them include dismissal.

What's included in a good gift policy?

A good gift policy ensures employees are not subject to conflicts of interest, and do not breach regulatory obligations. It is part of maintaining professional standards and business ethics, and protects the reputation and integrity of the business. It includes:

1. Who does it apply to? On the receiving side, it should cover everyone from directors, employees, contractors, volunteers and temporary staff. On the giving side, any external party including clients. The rules should apply to family members and associates.

2. What is a gift? A gift is anything that confers a benefit, including money, event tickets, flights, accommodation, lunches, specific goods, special privileges or subsidies, and any payments or fees made to an individual.

3. What is the limit? As a general rule, a gift may be accepted if it is usual in the business, such as a lunch or match ticket, but never a direct financial benefit like cash. In determining appropriateness of a gift, every company should set a value limit, with varying levels of disclosure and approval, such as:

    - Less than $100. No disclosure or approval required.
    - $100 to $500. Disclosure in gift register but no formal approval required.
    - Over $500. Disclosure in gift register and formal approval required.

    The seniority of the approver may go as high as the CEO for substantial gifts.

4. Who maintains the gift register? There should be a compliance function in every business which has independent reporting lines, and it has monitoring responsibilities for the gift registry. Senior management of the business should review the register regularly to ensure the policy is operational. Clearly, if employees are known to receive extravagant entertainment, or there is consistent attendance at major events, the register should be well used.

5. What if refusal would offend or endanger a relationship or it is impractical to return a gift? Approval should be sought immediately, and the likely solutions are to raffle the gift among staff with proceeds to charity, give it directly to charity or distribute widely among the staff to dilute the per member benefit (such as a case of wine).

6. What extra restrictions apply to giving gifts? Giving of gifts has similar sensitivities to receiving, but special care must be taken dealing with any government or public officials, or political parties. The company involved in donations must be aware of the consequences of their actions, such as

legal limits, or even worse, bribing officials to achieve results. Such donations should only come from the highest level, not at the discretion of individual business units.

Apparently, less buys more

Networking with customers, suppliers, competitors, regulators, journalists and all manner of hangers-on is a vital part of business. It is the lubricant that drives activity. The main problem to watch for is the potential creation of a conflict of interest.

An example of a highly-detailed study on gift-giving is 'You Owe Me' (warning, this is a 52-page study). Apparently, gift-giving does change behaviour, but less buys more. The authors from the US National Bureau of Economic Research found that a small gift encouraged the recipient to award contracts to the donor's company, but a more valuable gift (say three times as much) cut the response back to little better than giving no gift at all. If this is correct, then putting limits on gifts will not achieve much.

So what does your policy look like, and how do you police it?

When the cheap seats to see Bruce Springsteen cost $200, or the Wallabies charge $300 for a seat plus function (and scarf, football and souvenirs), every major event or game should be generating hundreds of entries in gift registers. It's not enough just to have a policy. It needs to be adopted by all.

I must admit when I attended those football games in South Africa, knowing how much FIFA World Cup tickets cost, I wondered how many of the hundreds of guests in the fine dining rooms had been able to devise a solution like mine? Was it a good time for charitable fund-raising?

Or was it just a game, worth not much more than a good bottle of wine?

(For a more detailed look at the Audit Office of NSW's views on managing gifts and benefits, more information is available here).

Avoid too much yeast when making dough

Roger Montgomery

Confidence in the markets plays an important role in the level of deal activity. It's like the use of yeast when it comes to bread-making. Too little yeast, and no reaction will occur. Too much, and the end result will be quite different from the original intention. Like baking, there must be a balance of the right ingredients in order to generate value.

There was a shortage of mergers and acquisitions in the aftermath of the Global Financial Crisis. In 2013, confidence started to return, and so too did management's appetite for deals. This has intensified in 2014, and investors should be watching closely to ensure that the balance between deal activity and value creation is being maintained.

In Australia, the total value of all M&A deals for the first three months of 2014 was $4.5 billion, according to Mergermarket. This is three times the total deal value in the same period last year.

In America, the value of takeovers announced in 2014 hit $1 trillion, according to Bloomberg. This was the fastest pace in seven years. If it continues at this rate, then 2014 would be the second-most active year for M&As ever. The most active year? 2007.

Risk of too much confidence

Investors and management alike can be drawn into the hype of deal activity and lose sight of the underlying value that is being created or destroyed. Indeed, the evidence suggests that companies typically pay a sizeable premium for control of a company, but seldom realise the expected benefits from the deal.

How does this happen? Well, too much confidence certainly has an effect. Amid the excitement that is generated from a buoyant market, management may become more aggressive in order to secure a company, or overestimate their ability to do more with the assets than the existing owners. The more confidence there is in the markets, the less focus there tends to be on the underlying value of the combined entity.

To illustrate the first point, let's return to 2007 with the acquisition of Coles by Wesfarmers. In that year, Coles reported a profit of about $747 million. In its balance sheet from the same year, Coles reported about $3.6 billion of equity in 2006, and $3.9 billion of equity at the end of 2007. Using only these numbers we can estimate that the return on average equity of Coles was around 19.9%.

Wesfarmers paid $22 billion for Coles, which on this basis would imply a return on equity of about 3.4%. Even if the management team was comprised of brilliant retailers, it is difficult to justify this return as reasonable for many investors.

The other reason combined companies may underperform is the failure to realise expected synergies. Value is created when the acquiring firm can earn a higher return on the existing assets of the acquired firm. This can be done by way of cost reduction or revenue growth.

Eliminating costs is typically easier than growing revenues, as many expenses may be duplicated upon integration, such as call centres and IT systems. Management can demonstrate cost control by picking the easiest fruit first. But when the pipeline of acquisitions slows, it can be difficult to grow the business organically. It's worth noting that Wesfarmers has gone some way in justifying the synergies implied by the takeover price, as the performance of Coles has improved markedly under new stewardship.

Watch a company's acquisitions

What should you do when companies that you hold positions in begin to announce acquisitions? For starters, you should understand what the acquired company is worth if it were to continue operating separately from the bidding company. You can then get a sense of the price that is implied for the synergies and the likelihood that they can be realised. Keep in mind that it is easier to integrate a business when it is smaller, has similar operations to the acquired firm, and has a complimentary culture.

With any investment, the price that is being offered must present a sufficient margin of safety. If at the end of this process you believe that the acquisition is unlikely to add value, then it may be prudent to reassess your position.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'

Private Ancillary Funds suffer same 'retail' treatment as SMSFs

Steve Hawkins

The uncertainty of when an SMSF meets ASIC's 'wholesale' or 'sophisticated investor' test was covered in a previous Cuffelinks article: '*When does an SMSF qualify as a 'wholesale' investor?*'. My experience is that the lack of clarity is also hampering much-needed philanthropic efforts, even as Australia strives to improve its performance in this socially-critical sector.

Private Ancillary Funds (PAFs) combine gift-giving with tax efficiency and are becoming increasingly popular in Australia. A more detailed description of PAFs can be found here on the Cuffelinks' website. Their benefits include:

- a mechanism for inter-generational giving (the whole family becomes involved in philanthropy from an early age) and creating a family legacy
- an amount removed from a donor's other assets with the sole purpose of supporting philanthropic causes, within a tax-exempt structure
- a more sophisticated and controlled approach to philanthropy with tax advantages.

Since setting up our family PAF, over the last seven or eight years, my original expectations have been exceeded. Our children, while still young, have become involved in donation decisions, we have been able to provide multi-year support to philanthropic causes and we believe our decision-making around how and when we give has improved significantly.

Indeed our involvement in the PAF community was a key determinant in my decision to join The Benevolent Society where one of my roles was in developing the Social Benefit Bond issue in late 2013 with our partners, Commonwealth Bank and Westpac.

Social Benefit Bonds are one form of impact investing and a powerful way of harnessing money for worthwhile causes. At the moment our investment policy is for up to 20% of our PAF's investments to be impact investments.

However, in my involvement both as a PAF founder and with the Social Benefit Bond, a real impediment to the level of impact investing has been the application of the 'wholesale' investor tests under the Australian regulatory regime.

Regulation of financial investment products requires that an offer of investment products to 'retail' investors must be made under a 'retail disclosure document'. These have stringent content requirements, particularly for a new product, and also involves the directors (among others) assuming an increased level of potential statutory liability. A 'retail' offer will generally involve:

- significant increases in legal and auditor costs
- establishment of formal due diligence and board sub-committees
- a more precise and longer timetable
- the issuer having an Australian Financial Services License (AFSL) that permits relevant interactions with 'retail' investors (for which more onerous regulatory requirements apply) or the availability of an exemption
- the participation of a larger number of small investors with the resultant additional costs.

To date, the two NSW Social Benefit Bonds projects chose to undertake 'excluded offers', also known as 'wholesale only' offers, for which the above matters are not (or are lesser) considerations. I expect most future issues will do the same.

In general, to participate in a 'wholesale' offer, an investor will need to meet the defined requirements for being a 'sophisticated investor' or a 'professional investor' under the Corporations Act.

PAFs and the wholesale investor tests

Cuffelinks has previously highlighted issues for Social Benefit Bonds conducted as 'wholesale only' offerings, made under an information memorandum.

One of The Benevolent Society's closest supporters wanted to invest via an SMSF and, despite this person being a senior manager in financial services, the book-runners found it difficult to accept due to the regulatory uncertainty that the SMSF would satisfy the 'wholesale investor' tests. This uncertainty is due to a statement by ASIC that, for the purposes of sections 761G(6)(b) and (7) of the Corporations Act, the phrase 'relate to' should be given a broad meaning. Any financial service provided to an SMSF may 'relate to' a superannuation product and would therefore be a 'retail' offering unless the SMSF itself held more than $10 million in net assets. The provision of these services to such a 'retail' investor would have required significant additional costs described above.

Unfortunately, the issue is similar for the PAF community. Our PAF has been involved in transactions where all of the following have been adopted:

- providing a certificate from a qualified accountant that in my personal capacity I am a sophisticated investor
- acceptance that our PAF can be a sophisticated investor as long as all trustees are sophisticated investors
- a complete prohibition on any PAF being considered to be a sophisticated investor unless it meets either of the $2.5 million in net assets or $250,000 of gross annual income tests.

These differing approaches are resting on different interpretations of sections 708(8) or 761G(7) of the Corporations Act. In particular, under section 708(8)(d), a 'sophisticated investor' is designated to include "a company or trust that is controlled by a person who [themselves] meets the requirements [of being a sophisticated investor]".

ASIC has not been able to provide clear guidelines on what 'control' means for these purposes and accordingly, the different approaches are driven by the degree of conservatism in each organisation.

ASIC needs to take a 'substance over form' approach. If our trustees supplied a minute from a meeting of our PAF that identified me as the Investment Officer (who is ultimately responsible for the investments our PAF makes) and I was able to prove via a qualified accountant's certificate that I am personally a sophisticated investor, this should meet the intent of the legislation.

It is disappointing that in recent impact investing transactions, some PAF and SMSF investors have been turned away from participating simply because of a lack of clarity. From a government policy perspective, state and federal, impact investing should be supported for the development of private sector funding strategies to reduce the burden on taxpayers of funding social and environmental projects.

Steve Hawkins is an investment banker at Fort Street Advisors, Chairman of The Benevolent Society Business Advisory Council and founder of a family PAF.

What is the outlook for bank hybrid yields?

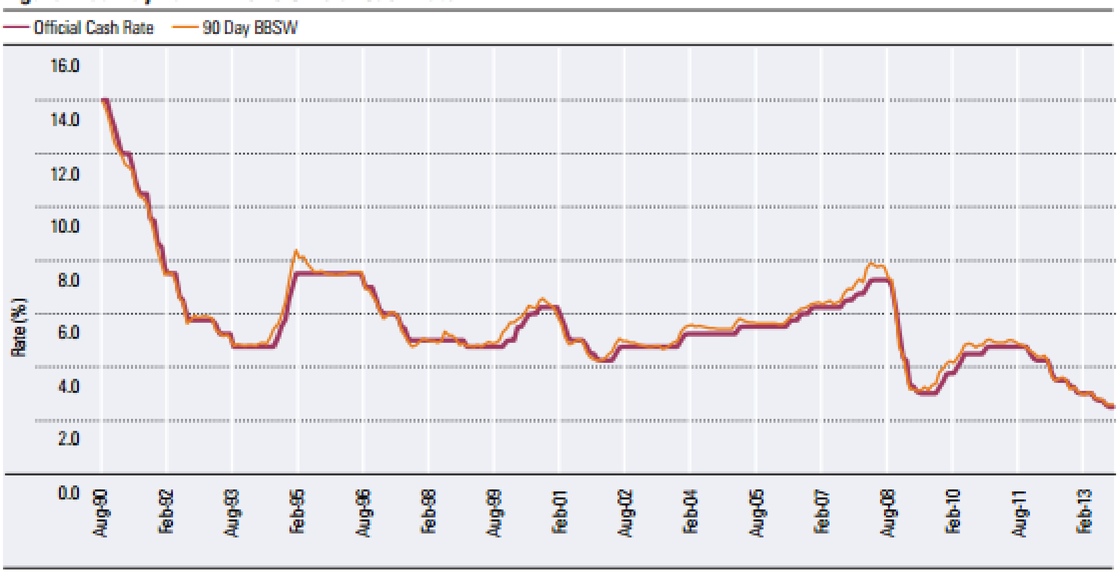
Graham Hand

The bank hybrid party rolls on, although not with the heady issuing volumes of 2012. Regardless of the added risk of investing down the capital structure, many investors facing term deposits at 3% cannot resist hybrids paying 5.7% issued by Australian banks. This week, it was Westpac's turn to announce a new deal. Despite the equity-like characteristics of no fixed maturity date, no security, subordination, convertible to shares and non-cumulative payments (missed distributions are not recovered), the book build at 3.05% to 3.2% over the Bank Bill Rate (adjusted for franking) will drag in as much as Westpac wants. It is, after all, Westpac, and investors love the major banks.

It is a beautiful meeting of demand from retail investors for yield and the desire to raise cheap capital by banks, encouraged by a regulator who wants risk reduced in the banking system, and distribution agents who collect millions of dollars in fees. The only losers will be the investors if we have GFC-like conditions again, and even then, nobody who has held Australian bank paper to maturity has lost money. So the party music keeps playing and everyone is joining the dance.

Although issuing volumes are down from levels of recent years, the margin is holding at a little above the 3% level. Morningstar's April 2014 Monthly Review of Australian Debt and Hybrids shows the fall in the Bank Bill Rate against which the margin is set. The current 90 day Bank Bill Rate is about 2.7%.

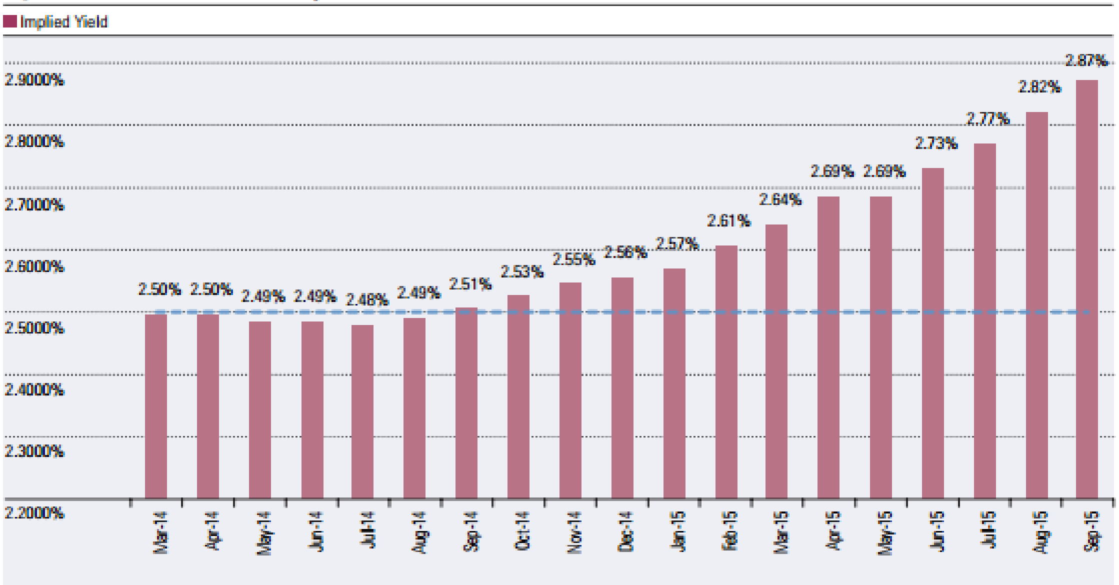
Figure 1: 90-Day Bank Bills vs Official Cash Rate



Source: Morningstar, Reserve Bank of Australia

The Morningstar Review also looks at the futures market and implied rates until the end of 2015. No material increase in returns from hybrids can be expected soon (ignoring movements in capital price).

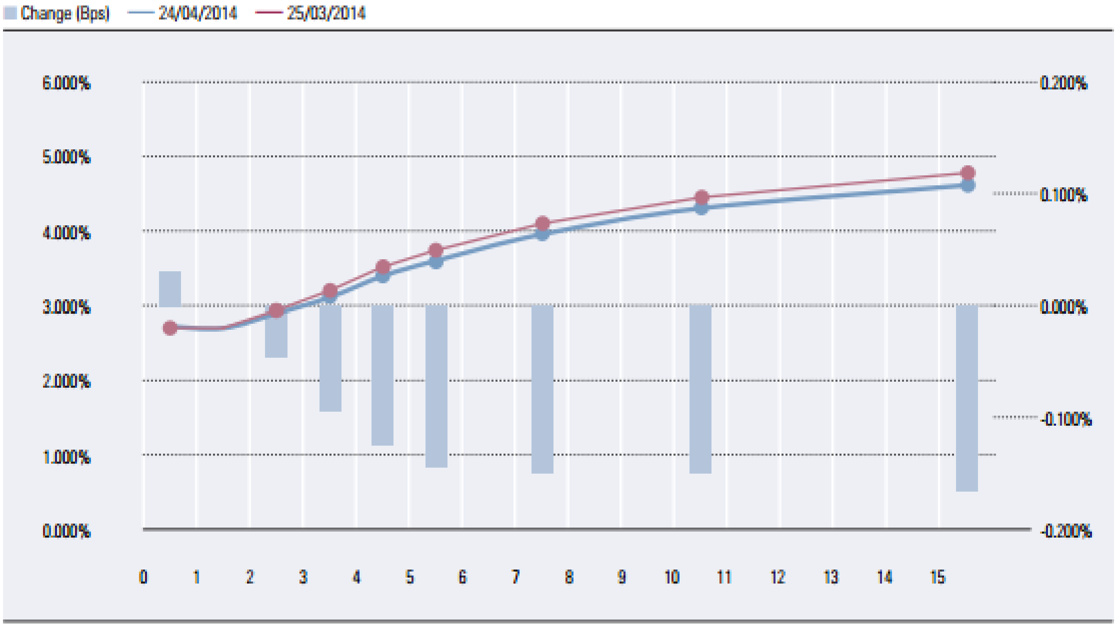
Figure 2: Interest Rate Futures Implied Cash Rate



Source: ASX

Looking further along the yield curve using long term interest rate swaps to 15 years, there's little cause for celebration for investors relying on debt securities to live on. The current long rates are fluctuating around 4% for seven years and only 4.5% at the peak.

Figure 3: Money Market Curve (Interest Rate Swaps)



Source: AFMA

In the absence of a 'black swan' event, the search for yield will continue, bringing strong support for bank hybrids and the buying of solid dividend-paying shares including the banks.

Choosing the right ingredients for inflation-linked investing

Jan Baars, Petr Kocourek and Epco van de Lende

For investors whose liabilities or spending objectives are linked to inflation, the decision to link investment objectives to inflation is a natural one. Not only does it crystallise the link between the inflation-linked components of an investor's liabilities and its investment strategy, it can also provide a simple, transparent method of measuring performance. Additionally it allows an investment policy to be set and reviewed without having to continually revisit the liabilities.

An investor who would benefit from an inflation plus objective is a retiree who uses their defined contribution savings in order to provide for old-age income. This spending objective is specified as a percentage of the nominal sum at retirement, but indexed with inflation over time so that real spending is maintained. Another example would be an endowment that has a spending goal expressed as a percentage of the available funds with preservation of real capital being crucial to ensure perpetuity in its operations.

Inflation as an objective vs. inflation hedging

An important aspect to note is that in building a portfolio that has an 'Inflation Plus' target, you are not seeking to hedge inflation, rather to add returns over and above inflation (whilst keeping the latter in mind). This is an important distinction, because if hedging were the sole purpose, the portfolio selection and risk criteria would be different.

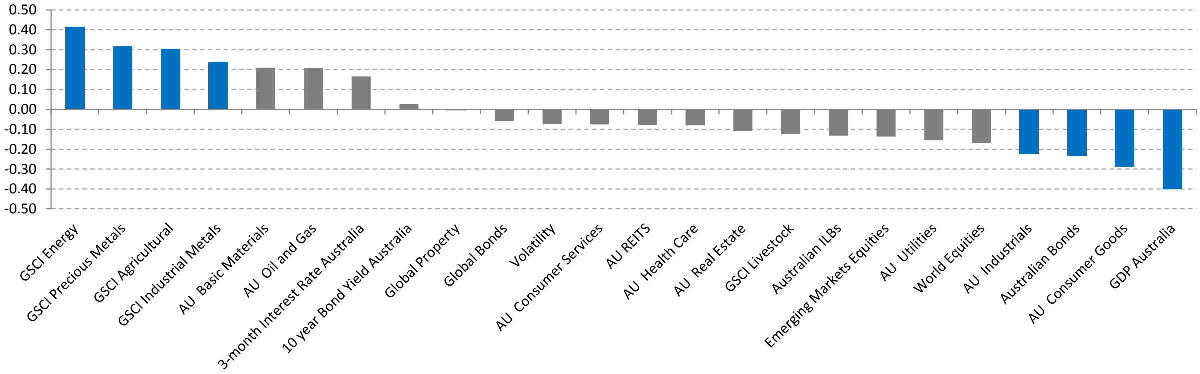
Inflation obviously fluctuates over time, but typically varies slowly within a consistent epoch. Discontinuities arise due to shocks, such as rapid currency movements, sales tax changes, spikes or troughs in commodity prices and demand and supply shortfalls. At the time of writing, central banks globally are embarking upon a gradual exit from quantitative easing, against a backdrop of low inflation rates. The countries where quantitative easing had not taken hold, such as Australia and New Zealand, find themselves in a different position but nonetheless in a climate of contained inflation. Building a strategy with an objective of outperforming inflation has to include the climate as a key ingredient whilst also trying to be responsive to any shocks that might occur.

Identifying the appropriate asset classes for inclusion

In identifying which asset classes are most suited to a real return portfolio, a large range of potential liquid candidates was analysed, including Australian dollar cash, nominal bonds, inflation-linked bonds, domestic and international equities, commodities, listed real estate and even volatility itself as an asset class. The focus was on identifying liquid assets which could provide potential inflation-hedging possibilities as well as return-enhancing ones.

Our findings for Australian inflation show significantly negative correlations of inflation with the overall Australian stock market, and on a sector level only two positively significant correlations in the Basic Materials and Oil and Gas sectors.

Figure 1 shows the correlation with inflation, sorted by highest to lowest correlation, by asset category; with statistically significant correlations shown in blue.



All data used in this analysis is based on quarterly observations, spanning the period from the quarter ending 30 June 1991 to 31 March 2012 for a total of 84 observations, with all data in AUD.

Nominal bonds showed a significant negative correlation with inflation, as might be expected. After all, interest rates and bond yields are expected to increase with rising inflation, hence depressing total returns. More surprising however might be the fact the Australian inflation-linked bonds showed a statistically insignificant negative correlation with inflation. The reason for this is the mark-to-market noise introduced into the total returns by movements in both real and nominal yields. If bonds were held to maturity, the real yield over inflation would be realised, but other factors impinging on the inflation-linked bond market make it a poor inflation hedge if one has to mark one's portfolios to market. As we are considering liquid mark-to-market portfolios here, we do not explore the hold-to-maturity strategy in detail, but instead focus on inflation-linked bonds as a liquid investment.

Commodities do seem to possess inflation-hedging characteristics, with significant correlations for the Energy, Precious Metals, Agricultural and Industrials sub-indices of the S&P GSCI commodities index series. The highest correlation at 0.41 is recorded by the Energy sub-index, which is mildly remarkable as the Australian CPI basket does not contain an explicit energy component. Nonetheless the indirect impact of energy prices seems to be sufficiently large to result in a relatively high correlation. The inflation-hedging properties of commodities have also been well documented in previous studies.

Listed property securities do not have any great inflation-hedging characteristics, which is consistent with the literature. We also included volatility as an asset class as a possible hedge against tail risk.

While these inflation correlations results are consistent with previous studies, it is surprising that it is not more explicitly considered in the construction of multi-asset portfolios. A reason may be that until recent times the majority of diversified offerings in Australia have been designed in fund of fund structures, thus limiting the ability to implement a more bespoke allocation that can accommodate these findings. Nevertheless, we believe it is worth taking the time to challenge the relevance of the ingredients we choose to achieve your objective, before attempting to blend them together.

Blending the right mix of asset classes

After establishing a range of potential asset classes to invest in, the next step is finding the combination of assets that best meets the objectives within reasonable risk limits. This can be done in a number of ways, from naïve application of modern portfolio theory to using risk-weighted baskets, minimum variance portfolios, principal components-weighted portfolios, copula-based approaches and others. Furthermore, the optimisation and portfolio selection process can take place in a real asset space, rather than in the more traditional space of return and volatility. If the long-term objectives are stated in terms of real assets and spending, this evaluation space makes more sense.

We do not lose sight of the fact that we are not seeking to hedge inflation but to create a return stream that outperforms inflation with a certain amount. So while the inflation-relative characteristics are important, the real expected returns of the assets need to be taken into account.

Further information on this research, details of the literature referenced and a worked example of how to blend these allocations are linked here.

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