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This Week's Top Articles

No easy way to make money

David Bell

There is no easy way to make money. There are no shortcuts to building your retirement savings. Do not convince yourself otherwise.

This week, the ABC reported on yet another trading programme which appears to have lost lots of money for the people who signed up. The alleged culprit is 21st Century Eminis, which provides financial education and training services on how to become a successful trader. There is little in life that frustrates me more than to see people lose their hard earned savings on get rich quick schemes.

I have long been outspoken on this topic, including making submissions to ASIC and posting public notices on my advisory business website warning against such schemes. Unfortunately you have to be careful about how you word such public notices for various legal reasons. Simply put, whenever you are introduced to a scheme or an investment opportunity which sounds exciting, please repeat: *"There is no easy way to make money"*. If you know a family member or a friend who is considering such an opportunity, say to them with passion: *"There is no easy way to make money"*. It may be one of the most valuable things you ever do for them.

Retail investors are sometimes shown four possible shortcuts to financial success, each having a different path to potential failure.

1. Investment products which turn out to be fraudulent

A great (though 'great' is far from an apt description) example is Astarra (Trio was the trustee) which funnelled investors' money offshore never to be seen again. Worse still, Astarra products were recommended by financial planners. Another example is US-based hedge fund Madoff, the largest investment fraud ever seen.

Fraudulent schemes are highly likely to lose you money. They typically have an elaborate design and structure and the payoffs for a successful fraud can be huge. The Madoff hedge fund fraud is estimated to have cost US$65 billion. If a fraud is cleverly designed it is extremely hard to identify.

Before making any investment, you should undertake a thorough due diligence. If you are considering an investment then seek professional advice. Question the skills of your advisor and make sure the advice is truly independent. Astarra, for example, sponsored financial planning conferences and Madoff supposedly provided access to a network of high profile people.

Commonly, frauds promise outsized returns but some of the recent frauds (including Astarra and Madoff) only targeted good solid returns, thereby avoiding people's fraud radars. Finally, diversify – it sounds simple but unless you are so confident you have identified something truly amazing and unique (which is unlikely), then diversification makes sense. Question your own skills. Are you really someone who can identify the needle in the complex investment haystack?

2. Investment products which involve leverage

The underlying assets of these investments vary but the constant theme is leverage. Infamous examples here include Storm Financial (leveraging up equities, and in some cases leveraging up leveraged equity funds), or investors providing leverage to property businesses (Westpoint, MFS Premium Income Fund, City Pacific and EquitiTrust). Once again many of these investments were recommended by financial planners, possibly swayed by large commissions.

Leverage has its place in the hands of professionals. In theory leverage has a proportionate effect on risk (an investment in a risky asset with a volatility of 10% combined with a 200% exposure to this asset becomes a leveraged investment with 20% volatility). However in practice the risk created by leverage is much more complex because there are many other risks that come with managing a leveraged product such as maintaining the leverage ratio or margin requirement, particularly in periods of market stress when the underlying assets may be volatile and illiquid. For any investment it is important to determine if leverage is used, how much is applied and explore any risks that may result. If this is too complex for you then stay away. Leverage does not always guarantee disaster but it does create greater risk of disaster.

3. Trading programmes and software which fail to deliver

This takes the form of software or training courses that teach you how to become a successful trader, often promising large financial returns and even the potential to give up your day job and become a home-based trader.

With trading programmes (software and education) I maintain a high degree of scepticism. After 17 years in the investment management industry and having visited thousands of investment managers and hedge funds I know it is difficult to develop a set of trading rules guaranteed to perform. If someone did find something special do you really think they are likely to share this with the world? Surely they would either trade their own money or create a hedge fund to earn the associated performance fees. Either of these approaches would also protect their trading secrets.

While there is much debate among academics about whether markets are efficient or not, I work on the basis that markets are broadly efficient. I believe that simple models will fail to generate outsized returns for the risk taken, a point I have proven to myself (and my uni students) many times! Many trading programmes use underlying instruments with embedded leverage such as futures, margin FX and CFD's (contracts-for-difference). These instruments are dangerous in the hands of the uninformed. If you do not understand them then do not touch them.

4. Tax-driven investments

This is where tax benefits are a major driver of the investment outcome. Agriculture schemes, most notably Great Southern and Timbercorp, are the most prominent (read painful) recent experiences.

Tax-driven investing can be complex. The risk is that chasing a tax objective may lead to money being placed with people ill-equipped to handle the day-to-day business of managing the assets and finances of the investment vehicle. If the business activities are mismanaged, then the investment vehicle may not survive to provide any tax benefits at all.

Always be wary of terrible governance practices. Prime Trust is a distressing example where exorbitant payments were made to the founder. While poor governance can exist anywhere there seems to be a greater risk away from mainstream investment opportunities.

I hardly paint a pretty picture for get rich quick schemes. Really, none of this article should be new information. If it is, then you are vulnerable to these risks. If you are presented with an opportunity that looks really exciting, make sure you remind yourself that *"There is no easy way to make money".*

In July 2014, David will cease his independent consulting and become the Chief Investment Officer at AUSCOAL Super. He teaches the Hedge Funds elective for Macquarie University's Master of Applied Finance.

Interview with Elroy Dimson on investing mistakes, expectations and truth in the numbers

Graham Hand

Elroy Dimson is a Finance Professor at Cambridge University, Professor Emeritus at the London Business School, Chairman of the FTSE Advisory Board and Chairman of the Strategy Council of the Norwegian Government Pension Fund. With his co-authors, he is the world's leading authority on the history of financial markets. His Global Investment Returns Yearbook, produced annually with Paul Marsh and Mike Staunton, gathers data across major asset classes for 25 countries (including Australia) over 114 years, and is often quoted as the definitive source of market information.

I met Elroy Dimson at the 2014 Research Affiliates Advisory Panel at Laguna Beach, California.

When Elroy Dimson presents a paper or consults to clients in New York, he tries to be back home in London the same or the next day, often without needing a hotel room. Some of his meetings with the Norwegian Pension Fund are held at Heathrow or Oslo Airport. He is acutely aware that his highest profile work, the Yearbook, is taking up more of his time each year. Dimson is one of those people who needs 25 hours in every day.

Real return expectations

The obvious question for someone who analyses thousands of data points across 25 countries each year is what should an investor learn from reading the Yearbook. For example, it reports that US equities have never delivered negative real returns in any 20 year period. Does this mean a long term investor with a 30 to 40 year horizon should be invested almost all in equities?

Dimson does not encourage this view. He agrees that if you look at the statistics since 1900, the minimum holding period to be confident of a non-negative real return for US equities is 17 years. But the average for European countries is between 40 and 50 years, and he advises not to extrapolate from the past US experience, as the US may not be superior to most other countries in the future. Looking forward, with real bond rates around zero and an equity risk premium of maybe 3 to 3.5% and a 60/40 asset allocation, the overall return will be 2% real before fees. This is well under the expectations of most people.

He says expectations of returns have come down, and now many 'thinking people' believe a 3 to 4% real return is a more sustainable level for equities. By 'thinking people' he means consultants and asset managers who are honest with their clients, not worried that the client will think the consultant is failing to help achieve return objectives. Or that the next consultant or manager pitching 30 minutes later will be more optimistic and win the business.

Most investors need to accept and manage with these lower returns. Some endowments are supported by gifts, so maybe it matters less for a higher education institution or a charity funded by a flag day, but others who have to exist on what they earn need to manage it very carefully.

Asset allocation and rebalancing

Dimson has strong views on so-called tactical asset allocation. He says there is no evidence that market timing works. But he is in favour of countercyclical investing, in other words, buying when the mass of investors need to sell. When equity markets have declined, for example, insurance companies are faced with solvency margin implications, which means they can't do their ordinary insurance business. If they don't have the right balance sheet, they are forced to sell their risky assets. It makes sense for longer term, long horizon, low liability funds to move in the other direction.

The most difficult part of a rebalancing, such as buying stocks when markets are still falling, is going against what most others are doing. Dimson says it's very important when buying on weakness and selling on strength to have a long term strategy that stops knee-jerking. He quotes a British insurance company which during a heavy market fall announced a strategy of buying cheap. They were loading up on equities as prices fell, but then had to reverse their actions to maintain their solvency margin. Likewise, family offices, institutional investors or sovereign wealth funds must be able to maintain the strategy, because the worst of all is to knee-jerk and end up in a big mess. The Norwegians don't fall into that trap because they have a disciplined approach to strategy.

The truth in the numbers

Dimson is most often referenced for his long term data work, but the Yearbook has become more than simply an accurate source of financial markets numbers:

"Occasionally we do venture into expressing strong opinions, but quite often, we try to let the data speak for itself. We don't make such strong statements as people who make a living from forecasting. Most frequently, we are listening to what we think are current concerns. We have to form a judgement by about September each year on what will be the hottest issue in February the following year, and then we do the research. We try to capture what many people believe, and we can then let the data confirm or reject the story.

"When it became clear that expected returns were lower, we wrote extensively about that. We also analysed historical data to see if equities might save you from low interest rates. History reveals that income oriented equity strategies have had a long-term total return that has been superior to growth oriented strategies. There, we were a bit more forceful.

"Some market beliefs are not well-founded. The work we did earlier this year on emerging markets addressed the belief that emerging markets outperform, but there's no compelling evidence one way or the other. Some investors who follow our work closely have ended up having much the same percentage in emerging markets, Europe, North America, and the rest of the world.

"We've also looked at country rotation strategies. People have said if you're invested internationally, you should avoid countries with weak currencies. You don't want gains on a national stock market to be offset by weak currencies. But we find you get a higher long-term reward from the equity markets of countries that have experienced prior currency weakness.

"Some believed if you buy countries with strong economic growth, you'd be rewarded. We thought this was implausible, and our evidence is clear. If you buy the common stocks of countries that have low economic growth, the subsequent performance is on average better. The extra risk is rewarded."

Financial markets commonly feed on urban myths and generalisations, but Dimson finds truth in the numbers. He likes nothing more than testing a market perception that has gained credibility, using long-term data to evaluate it – and quite often, to shoot it down. And then he's off to track down someone who has the data on the 26th country to add to the investment return series, or to tweak the accuracy of last year's numbers. It's a project which will never end.

China's growth slowdown is underway

Sam Churchill

China's extraordinary economic growth of recent decades has been driven by the mass mobilisation of rural labour, huge capital investment, low-cost manufacturing exports and the acquisition of foreign technology. However, in recent years, a number of imbalances have been developing that pose risks to the country's stability. Since the GFC, China has experienced an unprecedented expansion of credit, from around 140% of GDP in 2008 to over 200% of GDP in 2014. Meanwhile, it has experienced a property construction boom that has shifted its housing market from structural undersupply to oversupply, with millions of properties now lying vacant.

Credit growth

The Chinese financial system comprises a traditional banking system of state-controlled banks and a shadow banking system made up of investors, borrowers and unregulated financial intermediaries. The traditional system is highly regulated and credit creation within it is tightly controlled by the government. However, rapid credit creation in the loosely-regulated shadow banking system is of particular concern. Shadow lending has grown to approximately 70% of GDP and now accounts for most of China's new credit, which is expanding at a rate of around 15% of GDP per year.

Credit expansion has been concentrated in 3 main areas:

1. **Corporate borrowing** makes up the majority of new credit creation, particularly by state-owned enterprises. China's corporate sector is among the most heavily indebted in the world, with corporate credit having risen from around 90% of GDP in 2008 to around 125% of GDP in 2013.

2. **Household borrowing** remains low compared to other countries, but the pace of recent growth has been quite strong. Household debt, most of which is mortgage-related, has risen from around 11% of GDP in 2008 to around 20% in 2013. The ratio of household debt to disposable income has doubled between 2008 and 2013.

3. **Provincial government borrowing** makes up a large proportion of new government borrowing which has been undertaken to fund construction of infrastructure, property and local enterprises. Provincial government debt has risen from around 27% of GDP in 2010 to around 33% in 2013, according to a recent audit.

China's shadow banking system is comprised of opaque financial instruments, such as trusts and Wealth Management Products (WMPs), sold as deposit-like products to investors hoping for higher rates of return than are available in a Chinese bank account. These products provide equity and debt capital to Chinese corporates, local government financing vehicles (LGFVs) or other financial instruments on unknown terms. Investors are generally unaware of the underlying exposures. Most WMPs have short-term maturities, which could lead to a systemic liquidity problem in the event of defaults and an investor run.

The extent of moral hazard in China's financial system adds to such concerns, with many investors relying on an implicit guarantee from the central government in the event of counterparty default.

A recent run on a small rural Chinese bank demonstrates the vulnerability of the financial system to changing investor sentiment, as well as the likely response of the government. In this case the PBOC (People's Bank of China) quickly came to the rescue to restore order to the local financial system.

Not all credit booms end in economic crisis. According to a 2012 IMF paper around 23% of credit booms are followed by a financial crisis and economic underperformance. China is no stranger to banking crises but these have been typically well managed. In the late 1990s, non-performing loans (NPLs) at Chinese financial institutions rose to well over 20% before government-backed Asset Management Companies took over the debt to recapitalise the banking system. Reported NPLs of Chinese banks are currently low, but are likely understated.

China’s domestic debt levels significantly exceed those of its emerging markets peers, but generally remain below the levels of advanced economies. However, the pace of recent credit growth is of greater concern as it may reflect the misallocation of capital towards unproductive investments, low credit standards, and generally unsustainable spending growth. A material portion of recent credit growth may be related to the rollover of existing debts rather than real economic activity.

Property market

Following the privatisation of the housing market in the late 1990s, China has rapidly become a nation of property owners, with approximately 80-90% of households owning at least one property. At the same time property development has become a major industry. In 2007, the country was constructing around 1.5 billion square metres of gross residential floor space per year (or 15 million housing units) to support urbanisation, replace demolished old housing stock and to meet the upgrading and investment needs of Chinese households. During the GFC property market restrictions were loosened considerably, driving up prices and increasing speculative investment. Growth in land sales by local governments and construction by developers followed suit, and the annual residential construction rate reached 2 billion square metres in 2013. This rate of construction equates to at least several million more units of housing than new households being formed, a story analogous to recent construction booms in the United States, Spain and Ireland.

Most of China’s excess housing supply is thought to be vacant stock held by private investors, with the remainder sitting on the books of real estate developers, many of whom are highly indebted. There is also a serious geographic mismatch between housing supply and demand. Tier 1 cities such as Beijing and Shanghai generally suffer from housing shortages, while Tier 3 and 4 cities hold most of the excess supply. Another problem is the lack of affordable housing available for migrant workers who account for most of new urban household formation.

The risk is that the build-up of unoccupied properties held by developers will result in a major contraction of construction activity. Developers that have borrowed from shadow banks may default if their properties remain unoccupied or unsold. A fire sale could lead to large falls in prices and result in huge capital losses, rendering developers insolvent. Furthermore, investors may choose to dump some or all of their property holdings to mitigate losses, exacerbating any downturn. Interest rate liberalisation, the opening up of capital markets and availability of alternative investments (e.g. WMPs) could also undermine faith in the property market. Real estate accounts for around half of household wealth in China so there could be meaningful wealth effects on consumption; however the threat of negative equity for households appears low given limited mortgage debt.

What does this mean for markets?

Although there are a number of reasons to be optimistic about China’s long-term economic future, the short-to-medium term challenges are considerable.

To run down current excess residential property supply it is possible that China’s residential property construction activity could fall by as much as 50%. With housing construction representing around 9% of GDP this would cause a major slowdown in the economy and perhaps even a recession. There are signs that the rate of urbanisation may be slowing, and the Chinese leadership will be hoping that the housing adjustment can be managed gradually, alongside offsetting economic stimulus measures and orderly defaults. A ramp up in social housing initiatives is likely to form part of the solution, while helping to maintain positive sentiment.

China’s ongoing push to reign in excessive credit growth and liberalise financial markets risks creating a credit event somewhere in the shadow banking system. This could be linked to the property market or LGFVs. Although a major growth slowdown was avoided during China’s financial crisis of the late 1990s, the shadow banking system may prove a lot more difficult to control, especially since products such as WMPs are complex and involve millions of retail investors. Recent defaults by trust products and corporate bonds, as well as changes to lending regulations, are prime examples of such moves.

The Chinese government has a number of tools it can use to deal with any crisis, with combined central and provincial government debt relatively low at 56% of GDP. It can stimulate the economy or nationalise a large share of the debt if systemic problems arise, as the debt is domestically held, RMB denominated and issuance is fully controlled by the government itself. Notwithstanding recent moves to internationalise the RMB and open the country's capital account, China's economy remains relatively closed and the financial system remains fully funded by domestic deposit holders. A large domestic debt problem is more manageable than a large external debt problem, as the economy is less vulnerable to capital flight. Furthermore, the country's huge foreign exchange reserves and current account surplus make it highly resilient to external financial shocks.

It is possible that we could see a larger-than-expected slowdown in China's economy in the years ahead. This would have major effects on countries to which it has trade and financial links. Commodity exporters such as Australia and Brazil would be particularly vulnerable, as would emerging economies in Asia, Japan and Germany. Financial links between Chinese and Hong Kong or Singaporean banks could be channels for the international transmission of a Chinese financial shock. Furthermore, capital repatriation by Chinese investors could hit property markets in Canada, Australia, the UK and Hong Kong, while any move by China to sell its foreign currency reserve holdings could also lead to global asset price volatility, including a spike in US Treasury yields.

China is entering a period of heightened risk and uncertainty as it attempts to address some key systemic risks. As a major driver of global growth, China's stability and growth performance will bear very close watching in the years ahead.

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Active versus passive – what about risk?

Jim McKay

The core focus of the active versus passive management debate is an analysis of the value added after fees by active managers compared to a benchmark. Noting that you can't invest in a benchmark, passive investment options are used, for example an index fund or ETF, that aim to replicate benchmark returns for a fee.

Considering this, an analysis of active versus passive approaches should focus on the relative returns of the two alternatives, not of the benchmark per se. This analysis should also include issues such as risk and tax.

The purpose of this discussion is to consider the issue of risk.

Risk can be defined many ways, and few people seem to share a common understanding of it. From an active management perspective, risk is often considered on a relative basis. For example, the risk that an investment may perform poorly compared to an index fund or ETF.

A simple framework for retail investors to understand risk

Risk management is a dimension of active management not often discussed, especially with retail investors, due to its perceived complexity. However, the following is an outline of a simple, integrated approach to determine whether investment risks are:

- recognised and understood
- rational and taken on intentionally, and
- rewarded (every risk should have a commensurate long-term reward potential).

To illustrate this framework, let's look at the Global Fixed Income sector and why it may not make sense from a risk perspective alone to invest in an investment approach that aims to replicate the benchmark.

The Global Aggregate Bond Index is the most widely followed bond index in the world and is the major benchmark against which global bond managers are measured. Unlike equity benchmarks where the more successful and profitable a company is, the more it grows in size and the larger its weighting in the benchmark becomes, global bond indices could be said to work in reverse.

The largest constituents of the Global Aggregate Bond Index are those countries or regions that issue the most debt: the United States, Japan and the Euro. It could also be argued that they are among the least sound long term financial credits, partly based on the amount of outstanding debt they have on issue. In this case does it make sense to follow the benchmark via an index strategy just because it can be accessed cheaply?

What are the risks of investing in this benchmark approach? Using the framework above, we can identify the risks:

1. Is the risk recognised by investors? At a retail investor level, the answer is likely to be no. Many investors are unlikely to be aware of the composition of the benchmark, and in particular its significant concentration risk. In the Global Aggregate Benchmark, the top three issuers represent over 90% of the benchmark.

2. Is the risk rational? Diversification is one of the basic strategies for reducing risk. A compelling case could be made that the majority of investors would not intend to invest 90% of a portfolio in just three issuers. The significant growth of absolute return fixed income strategies and the shift away from benchmark-aware global fixed income strategies supports this.

3. Is the risk rewarded? In the current environment, yields on ten-year US treasuries are 2.6% and on Japanese bonds 0.6%. That is, an investor lends the US and Japanese governments money for ten years and receives just 2.6% or 0.6% return. It would not appear that the risk is being rewarded. Add to this the widely held view that after a 30-year bull market in bonds, the only way is up for bond yields, and the potential loss of capital value for those currently holding bonds becomes significant, so there's even less appeal to invest in either absolute or relative fixed income options.

Investor expectations of performance

In looking at risk from an active management perspective, ineffective risk management becomes evident in the gap between investor expectations of performance relative to a benchmark and actual performance. An active manager might be happy to outperform an index by a margin, even if delivering negative returns to the investor. We don't need to look too far back (2008) to see that ineffective risk management can lead to disappointment. There are a number of examples from that period where underestimating the risks of Collateralized Debt Obligations (CDO's) or municipal bonds left many investors in active strategies suffering significant losses in both absolute and relative terms. In these instances the risks were not recognised, rational or rewarded.

The purpose here is not to dismiss the case for active or passive approaches as there are roles for both, but rather to broaden the discussion to include risk as a necessary and integral part of any active versus passive debate, especially for retail investors.

Jim McKay is Director of Advisory Services at Franklin Templeton Investments.

Making judgments based on age

David Williams

Complexity is one of the challenges of our information society, and we typically respond by making simplifying assumptions. This helps us manage the complexity but increases the risk of focusing on the wrong things. Worse, our prejudices easily lead us to simple answers which are consistent with our views but are often biased and misleading.

Increasing longevity is one of the most challenging and complex issues we face – as a community and as individuals. It's easy to fall into the trap of making sweeping statements before really understanding the complexity. Prejudice (often fuelled by personal fear of our own mortality or that of our parents) can lead to big errors of judgment.

Why, for example, is there a disproportionate number of professional ice hockey players in Canada born in the first months of the calendar year? Readers of Malcolm Gladwell's 'Outliers' know that the selection of young players for higher-level ice hockey coaching starts in year seven or eight. Children born early in a calendar year are more mature than their age peers born late in the same year. So they tend to be chosen for further coaching. Same 'age' but different capabilities.

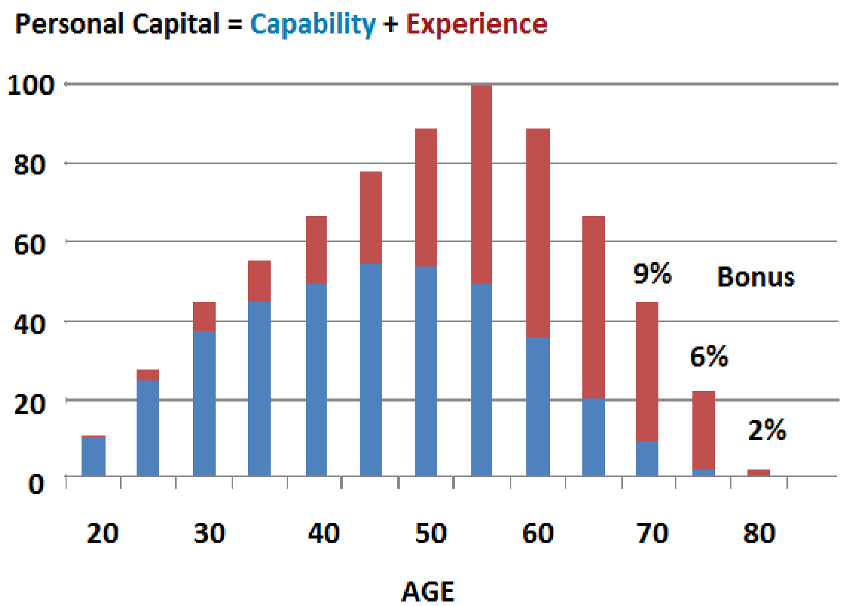
We become increasingly individual and different as we mature. Our community largely avoids using age as a basis for judgment until around age 60 when quite suddenly 'age' again becomes an issue. It's used as a decision point if we want to 'retire' or access our super or get a free transport pass. In its report '*Access All Ages – Older Workers and Commonwealth Laws*' (March 2013) the Australian Law Reform Commission identified a plethora of areas in which age has become more obviously a basis for discrimination than it might have been at the time the original legislation appeared.

'The end of the Age of Entitlement' has now entered our vocabulary as a justification for a series of age-based changes to government support (along with many other changes).

Has the notion of a numerical age outlived its usefulness? We are already evolving more sophisticated ways of evaluating ourselves. Could we be heading for a new 'Age of Enlightenment' where we create more contemporary models to help us know and manage ourselves better with increasing longevity? If so, this should lead to more effective allocation of expensive resources. Benefits would accrue to both individuals and governments.

Personal capital or value

At My Longevity, we developed a simple model which a person can use to help with their 'retirement' decisions. It shows how our personal value (capital) can be seen as a simple combination of our capability and experience. These accrue and eventually decline at different rates over our working life. The model invites people to consider the impact of retiring on their personal value. Each of us is different so the individual model varies accordingly. It can help shift the retirement focus to one of personal value rather than just financial value, and introduces the notion of a personal time frame to underpin decisions. It also fosters the important notion of mastery over personal circumstances which in turn supports the quest for independence.



Source: My Longevity Pty Ltd

This illustration shows how personal capital can accrue over time and the potential bonus from deferral of retirement. Personal circumstances can vary a lot from this model but the concept encourages people to make more considered decisions.

There are many other ways of showing people the diversity of options that can open up with greater longevity awareness.

Older people are increasingly seeking information and services which help them manage their lives better. Many of them want to continue to contribute to society and do so.

When governments discriminate in delivering services using outdated metrics like age, they risk giving the message that they are behind the times and out of touch with reality. They attract criticism and waste opportunities to encourage informed independence.

Success in managing longevity requires an effective partnership between individuals and governments. Maximising personal capability requires an environment that is supportive and nurturing.

As Malcolm Gladwell suggests: "It's true in sports and it's true in the rest of our lives as well. We need to wake up to the fact that as a society we haven't been doing our part."

David Williams began longevity research in 1986 and was a Director with RetireInvest and CEO of Bridges. He chaired the Standards Australia Committee on Personal Financial Planning. David founded My Longevity Pty Limited in 2008.