Cuffelinks
Connecting investors with ideas

Edition 76, 22 August 2014

This Week's Top Articles

- **Long-term investors fail to reap natural advantage** *Bev Durston*
- **There's more than one way to fund a retirement** *Noel Whittaker*
- **Why we're talking about 'secular stagnation'** *Don Stammer*
- **Rethinking the superannuation fund mission** *Callil and Chee*
- **Home equity release is the fourth pillar** *Christine Brownfield*

Long-term investors fail to reap their natural advantage

Bev Durston

Last month, I discussed the over reliance on liquidity of defined contribution (DC) asset allocation compared with other long-term investors. Despite similar objectives, the proportion in alternative and less liquid assets is much lower, possibly because DC funds confuse liquidity with safety. Here I outline some other justifications for liquidity, then address why it is still not preferable.

Possible causes of the DC liquidity focus

1. Member choice

   There is a belief that the introduction of super fund choice prompted the industry to remain liquid because members can move money on a daily basis requiring daily liquidity for underlying investments. In reality the number of members engaged with their super journey is very low – approximately only 10% actively switch each year. A fund with regular contribution flows has the advantage of developing a liquidity policy that allows it to invest in less liquid assets. It behoves the industry to educate members on how other long-term investors manage their money and why a patient, long-term approach is appropriate.

2. Regulation

   The Corporations Law which governs retail fund products states a certain proportion of their investments must be saleable within a specific number of days for regulatory compliance. This should be contestable as the regulator should not want to make DC investors 'second class citizens' and it is open to reasoned argument.

3. Agency risk

   Agency risk is a constant affliction in financial services. For advisers to demonstrate that they earn fees they may generate activity and frequent switching rather than buying and holding, which requires a liquid approach. In his latest Berkshire Hathaway Annual Report, Warren Buffet states investors should create the best results by *"not falling into the trap of trying to time markets"* and that forming macro opinions and listening to market predictions is a waste of time. He believes investors should focus on what they own, buy and hold, and diversify for long-term investing: *"those people who can sit quietly for decades when they own property too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators. These deliver an implied message of 'Don't just sit there, do something' which can turn liquidity from a benefit into a curse."*

4. Conflicted business models

   The super industry is predominantly home-grown with a local investing bias. Many funds management businesses predominantly sell products that they create in-house, generally local equity and fixed income funds. Our industry is surely creative enough to produce longer-term products with suitable lock-ups across different areas. I am puzzled as to why these alternative structures are not offered in DC plans, especially as member 'self-select' options with suitable lock-up periods.

5. Size

   The lack of size, scale and resources for smaller super funds may also play a role. Is there a certain scale above which funds feel able to broaden their horizons? There may be some truth in this for SMSFs and smaller retail funds but this is countered by the Wharton Global Family Alliance 2011 Survey of Single Family Offices, which shows funds as small as US$50 million still maintain around 51% of their allocation in less liquid assets.

6. Inflexible asset allocation framework

   Maybe fund advisers (and/or regulation) strangle opportunism by forcing funds into too rigid definitions for asset allocations. The desire to maintain assets in pre-defined 'buckets' which are easily explained in Product Disclosure Statements may reduce the flexibility to take on new assets in an opportunistic manner. As DC fund advisers are largely the same ones who provide advice on strategic asset allocations to endowments, DB funds and sovereign wealth funds, it is bizarre that the investing outcomes are so different.

7. Lack of trust and desire for control

   Many investors simply don't trust the industry or are spooked by high profile disasters or involuntary locks. Graham Hand vividly recounts this lack of trust in his article, '[Does the public hate us?](#)'

8. No illiquidity premium belief

   Maybe some super funds lack belief in the illiquidity premium and so keep everything liquid. This is undoubtedly true in some areas at certain times (currently seen in infrastructure) but taking an opportunistic approach provides dozens of strategies with potential for broader investment spheres.

9. Peer group risk

   The industry has a preoccupation with peer group risk. If other funds are all liquid then 'daring to be different' involves career risk. Industry funds should be applauded for their (almost unique) focus amongst super funds on less liquid assets, but many have concentrated dual portfolios of direct property and infrastructure (bringing different peer risks). The retail industry's introduction of lifecycle funds is a refreshing departure with some forecasts predicting these will represent 40% of the market in a decade. This too will hopefully substantially reduce the impact of peer group risk.

10. Fees

    The perennial issue of fees in isolation versus net of fee outcomes may be a causal factor but it does not do our industry justice if we cannot better educate members. It is important to focus on the risk adjusted net of fee outcome over a meaningful period of time (ideally seven years given risk levels of most default funds). Presenting league tables of super funds ranked on fees or returns alone similarly detracts, instead leading to cheap funds full of market beta. These require excellent market timing to perform well but unfortunately not many investors are expert at this.

Regardless to whether some or all of these reasons are involved in the liquidity focus of DC funds, they all involve education to convince investors otherwise.

The advantages of closed ended investment vehicles

Generally less liquid assets are offered via closed ended or 'locked-up' investment vehicles delivering four advantages. Firstly, they eliminate the investor reliance on market timing. A closed-ended vehicle where funds are called down periodically means the skilled manager does not have to select the perfect time to invest all monies. Drawdowns occur over time and assets can be sold at an appropriate juncture, often delivering better risk-adjusted returns. Secondly, with no timing mismatch between assets and liabilities, managers can make judicious use of tools like shorting or leverage with no risk of re-financing in difficult times. Plus there is no danger of forced exits from strategies caused by others 'panic selling'. Thirdly, performance fees are only payable once fund assets have actually been sold and a particular hurdle rate of return paid back to investors; and finally there is usually better alignment of interest. Typically managers invest in locked-up products alongside investors (often the largest single investor) feeling real ownership as opposed to just managing 'other people's money'.

Why might an investor require a liquid portfolio?

This brings us full circle. It is sensible to maintain a liquid portfolio if the investor has a short-term time horizon or good market timing abilities. Unless approaching a retirement crystallation point, superannuation is certainly not short-term. So do DC investors have good market timing abilities? This is an empirical question but evidence from mutual fund investors is not good.

Lamenting how 'yesterday's winners become tomorrow's losers' in his book '*The Little Book of Common Sense Investing*', Vanguard founder, John Bogle warns against reliance on market timing. To demonstrate the pitfalls, he explains what happened to late investors into previously top equity performers. During the telco, technology and media equity bubble (1997–1999), the top ten US mutual fund equity market performers (out of 850) each generated an average upside of 55% per annum. But when the bubble burst, each plummeted into the bottom 60, losing around 34% per annum in the three years following. They were outperformed by 95% of the market and substantially underperformed the broad market over the entire six year period.

The future is diversity

There are many structural and anecdotal reasons why there is too much focus on liquidity in DC schemes. Nevertheless investors must instead focus on their investment horizon and take advantage of being long-term, patient investors. Otherwise they risk becoming 'second class citizens' compared to other long-term investors such as family offices or global pension schemes.

As an industry we have the ability to counter this liquidity obsession. Super funds can focus on unique member characteristics and educate their constituency on the importance of net fee outcomes, why risk adjusted returns matter, and why having diversified portfolios with less liquid investments is suitable for long-term superannuation investing.

Bev Durston has over 25 years' experience in implementing investment solutions for pension funds, sovereign wealth funds and fund managers. She now runs her own advisory business for institutional clients, Edgehaven Pty Ltd.

There’s more than one way to fund a retirement

Noel Whittaker

If you’re aged 40 or under, there are serious choices to make. You won’t be able to access the age pension until you are 70, and it’s likely the superannuation access age may also be raised to 70. Unless you’re prepared to work until then, you need to invest enough money outside super to live on until you can access your superannuation, or the age pension, or a combination of both.

I have stressed repeatedly that every investment decision has disadvantages as well as advantages, and any decision to invest should take into account the negative as well as the positive.

Superannuation is the only investment you can make with pre tax dollars, but contributions are capped and the money is inaccessible until you reach your preservation age. It also enables you to hold money in a low tax environment which allows it to grow faster.

If you invest outside the system there are no caps, and no loss of access. The price is a lower after tax return.

Let’s think about two people who we’ll call Robin and Kim. They are both aged 40, have substantial equity in their houses, and wish to build wealth with the aim of retiring earlier rather than later. They both decide they can afford $25,000 a year out of their pay package to boost their retirement savings.

Robin is nervous about borrowing, and makes an arrangement with her employer to structure her package so that $25,000 is contributed each year into super via salary sacrifice. After deduction of the entry tax of $3750, she will have $21,250 working for her in a 15% tax environment. If her funds can produce 8% per annum long term after tax, she should have $1.7 million at age 65. The problem is, she may not be able to access it then unless transition to retirement pensions are still available.

Kim is not fussed about super because he’s worried about rule changes, and decides to take out a home equity loan of $350,000 to invest in a portfolio of managed share trusts. He likes the idea of share trusts because of diversification and he’s not worried about short term price volatility, and by securing the mortgage over his home he’s unlikely to be caught with a margin call. The interest will be a tax deductible $25,000 a year.

Notice that in the first year, Robin has just $21,250 working for her while Kim has $350,000. The name of the game is to maximise the amount of assets working for you at an early an age as possible, so at this stage Kim is the winner.

But, our old friend compounding is going to play a part. Let’s assume that both Kim and Robin have an identical share portfolio, but that Kim’s produces 7% per annum after tax (1% less than Robin because the earnings will be taxed at his marginal rate). He will have just over $2 million at age 65 but will still have a mortgage of $350,000. Just that 1% difference in earnings has a big impact after many years of compounding. However, he has the advantage of access to his funds at any stage in the investment programme.

This is not a recommendation of any sort – the sole purpose of this article is to help you think about the range of options available and suggest you seek advice about strategies that may speed you on the way to wealth. Our present welfare system is unsustainable, and those who don’t take action will be the losers. The more options you have, the better informed you will be.

Noel Whittaker is the author of Making Money Made Simple *and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. Email: noelwhit@gmail.com.*

Why we're talking about 'secular stagnation'

Don Stammer

The phrase 'secular stagnation' is again popping up in reports and discussions on the global investment outlook. Secular stagnation – persistently weak economic growth - can result from a sustained deficiency of demand, continuing low growth in productivity, or from a slowly growing or shrinking workforce. One of its consequences, over the medium-term and longer, is that investment returns are very low, even negative.

In my view, secular stagnation is unlikely in countries like the US and Australia. However, with populations ageing and with enthusiasm for productivity-boosting reforms waning, both countries are likely to experience, over the medium-term and longer, modest reductions in potential growth rates and in average investment returns. Japan has experienced a couple of decades of secular stagnation and the euro-zone is now at serious risk of a similar experience.

Concerns about secular stagnation come and go

The concept of secular stagflation was developed by Alvin Hansen, a US professor of economics, during the Great Depression and soon after the publication of *The General Theory of Employment, Interest and Money* by John Maynard Keynes.

Hansen postulated that capitalist economies would suffer both a sustained glut of saving and limited opportunities to invest. As a result, the 'natural' rate of interest (the interest rate level that would balance saving and investment at full employment) would be significantly negative – and well beyond the ability of central banks to deliver.

The outbreak of the Second World War caused attention to switch to other, more immediate matters, and both the allied and axis powers undertook massive increases in military spending that had war-time economies operating at full capacity. Almost as soon as peace returned, concerns developed about economies and investments falling into the grip of secular stagnation – now renamed the 'under-consumption theory'. As things turned out, however, the 1950s and 1960s were the decades of postwar prosperity, and most economies operated close to their potential output levels. Interest in secular stagflation fell away.

The oil price shocks of the 1970s led to a revival of fears about secular stagnation – re-badged simply as 'stagflation'. As the oil producers' cartel weakened and central banks brought inflation under control, those fears subsided.

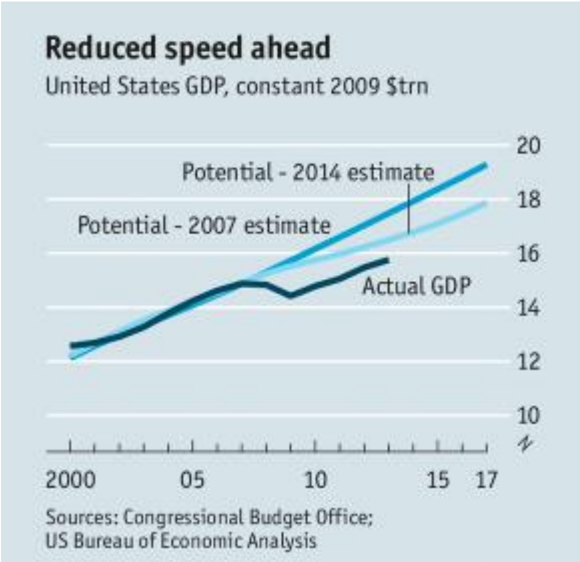
Fears about long-term stagnation (and with it, sustained low investment returns) have come to the fore again during and since the global financial crisis. Initially, these concerns were usually presented as part of predictions for 'a new normal' of very modest growth in GDP and low investment returns.

Then – and just when some people were thinking it safe to go back into the ocean - Larry Summers (former head of treasury under Bill Clinton, and also President Obama's preferred pick as chairman of the US central bank before the position went to Janet Yellen) launched a hard-hitting campaign on the long-term risks to the US and global economies from sustained negligible growth. No old wine in new bottles for him: he uses the phrase, secular stagnation, minted almost 80 years ago.

As Summers sees it, the US economy was kept afloat, even in the decade before the global financial crisis hit, only by debt and asset bubbles. He foresees a lasting glut of saving in the US, Asia and the Middle East – at a time when opportunities to invest and to raise productivity in western countries are limited and when an ageing population will be constraining growth in the US workforce. This combination of events will "reduce normal levels of interest rates…(and) we're getting financial bubbles before we get full employment".

Fears of secular stagnation and economic policy in the US

This graph, from *The Economist*, illustrates the thinking of the US Congressional Budget Office on the secular stagnation debate in the US: that the trend rate of potential growth has been lowered by the reluctance to invest and the abundance of saving, but only modestly; and the current under-performance of the US economy is mainly cyclical in nature and will correct.



Senior officials at the Fed share this view: expectations are that the trend rate of potential growth in the US is reducing but without secular stagnation being a likely outcome. They expect the labour force participation rate, which has fallen sharply in recent years, to experience a powerful cyclical increase.

How big a risk is secular stagnation?

In my view, the risk of secular stagnation is being exaggerated, particularly for countries such as the US and Australia, though both economies seem likely to experience some slowing in trend rates of economic growth, and somewhat lower average returns from investments, as populations age and productivity gains prove hard to come by.

Japan's two wasted decades show, among other things, that a failure to reform and re-capitalise banks is a major contributor to secular stagnation – a lesson that the euro-zone countries need to learn from and to act on.

Fidelity's Michael Collins offers a sensible conclusion in his review of Summers' arguments:

"There are solutions to the prospect of secular stagnation such as sustained increases in infrastructure spending. And then there's the possibility that Summers is overstating the case for endless stagnation."

"The world could simply be undergoing the sluggish growth that is expected after a financial crisis. Carmen Reinhart and Kenneth Rogoff in their book This Time is Different *found that damage from a financial binge takes years to repair …"*

"Summers' likely mistake [is] he appears to be underplaying the fact that economic booms sow their own demise and recessions create their own revivals, largely through pent-up demand after time has allowed the worst excesses to be tackled … Economies have built-in mechanisms to drive economic cycles, even if those recoveries can sometimes come too slowly for many including the most articulated and respected economists."

Don Stammer chairs QVE, is a director of IPE and an adviser to the Third Link Growth Fund, Altius Asset Management, Philo Capital and Centric Wealth. The views expressed are his alone. An earlier version of these comments was published in The Australian*.*

Rethinking the superannuation fund mission

Nick Callil and Jeff Chee

Many Australian superannuation funds have developed a broad mission or goal. Often, this statement will include an objective of delivering strong returns to members, together with engaging and providing valuable additional services to them.

While no one would dispute these are worthwhile objectives, we contend that funds can go further. As the superannuation system in Australia matures, the fund mission can evolve to articulate a goal for the retirement standards of its members.

Specifically, we argue that:

- trustees can and should take on greater responsibility for ensuring that members are aware of their potential outcomes at retirement, and – within limits – take steps to control the range of those outcomes
- the fund mission should be defined as the delivery of reasonable retirement expectations in a reliable fashion, in such a way that member retirement plans will not need to change materially as retirement approaches, and
- retirement expectations should be expressed in terms of the level of income in retirement, rather than the accumulated lump sum value. The planned retirement date is also a key aspect of retirement expectations.

It is pleasing to see a growing number of superannuation funds presenting projected incomes in retirement to members with their annual statements. While this suggests an increased focus on delivering income in retirement, we believe the thinking behind the fund mission we outline here has not yet become entrenched among funds. Account balance remains the primary benefit indicator for most funds, and fund objectives remain expressed in terms of a target real return and likelihood of a negative return, rather than retirement outcomes.

We have produced a comprehensive article on our proposed approach, which can be found on our website. Here is a summary of the main issues.

Challenges in defining a fund's mission

Given a fixed level of contribution, a static investment strategy, and the wide range of individual circumstances, retirement outcomes are highly uncertain and can vary significantly across members. Factors such as division of member benefits between multiple arrangements and a shift away from the traditional 'work, then retire' model make measuring an 'adequate' income difficult. Finally, there is a range of risks – in particular, large drawdowns in markets occurring near retirement – which make planning member outcomes a challenge.

However, if the ultimate aim of superannuation savings is to deliver retirement income to members, clarity of mission is an important first step in managing the risks in the fund.

Developing a fund's mission is complex. There is no single form of mission which will satisfy all funds, or even satisfy all stakeholders within a fund in terms of the level or certainty of outcome. However, we believe fund-specific factors may be incorporated into each fund's mission, and that the challenges posed by the changing external environment can also be addressed.

Fund versus individual targets

If a 'good outcome' target is set using only a single measure of adequate income in retirement (e.g. a replacement ratio), we risk setting funds an impractical and undesirable target. When members choose to retire, they will have accepted that the retirement income generated from many sources is at least sufficient for them to stop or reduce their working week.

Every member will accept a different trade-off and have varied emotions depending on their expectations of retirement timing and anticipation of their standard of living. Here, 'adequate' might be defined as a neutral emotional state, neither disappointed nor surprised with the outcome.

Setting a target retirement income – and financing it – is also highly complex, requiring current and future income requirements to be compared and valued based on potential future returns. This is a self-referencing problem: lower ability to contribute or lower future expected returns imply a worse retirement outcome. As such, we believe members may redefine 'adequate' a number of times during their working life.

This suggests a need to recognise risk in defining the superannuation fund mission. We must discuss risk in terms of the range of outcomes to plan for, rather than the degree of certainty with which a single outcome may be achieved. We argue that material adjustments to member expectations of retirement income or date are risk events that the fund should be managing. A 'good outcome' would then be that a fund enables members to form reasonable expectations of retirement income and a retirement date and then deliver an outcome not materially worse.

Articulating member expectations

Investment choices are disengaging to most individuals and beyond their understanding and experience. Members don't generally form expectations of their ultimate retirement benefit based on their investment strategy. A member's expectations are more likely to link the amount paid in contributions (the input) with the amount they receive in benefit (the output). Together, these can be seen to form a plan which allocates to future consumption from current consumption.

Within such a plan, a level of risk and uncertainty in both the inputs and outputs is inherent. Investment strategy can then be seen in two ways: it attempts to translate the member's plan into reality and also implies a likely range of adjustments to the plan that should be expected. These adjustments may be in terms of the inputs or outputs – to achieve a given level of benefit, members have the choice between making higher contributions with low potential volatility in their contribution level or making lower contributions with a high potential volatility. We believe communicating risk in this way provides a more engaging approach to retirement planning for members.

Journey planning

Under the mission framework proposed here, we have accepted the inevitability that a member's plans will alter over time, but it is important to distinguish between the scale, and potentially the direction, of alteration. We define this as material alteration to the plan and treat it as a risk event for the fund.

A material alteration could be the result of one of the following:

- the member was too optimistic (or pessimistic) in setting their retirement income expectations previously
- events were within the expected ranges of likelihood, but the trustee took a higher (or lower) level of risk than that communicated to the members
- events were outside the expected ranges of likelihood.

In this framework, trustees have a wider role to ensure that members understand not only the expected level of retirement income but also the reasonable revised range of possible outcomes from the fund based on the chosen investment strategy (or the default strategy if no choice is made). Through this process, a member will, over time, see how their journey is developing relative to this range, and the impact on the expected outcome. For members who are sufficiently engaged, access to the necessary tools will allow them to understand the impact of utilising the 'levers' available to shape their potential retirement incomes.

Engagement with the member in this way builds an understanding of the changes they can expect, making it more likely they will react appropriately to events as they occur.

Actions for trustees

Trustees seeking to develop a member-focused mission can begin with the following steps:

- Understand your membership in more detail – this could in the first instance involve analysis of the projected retirement incomes your members are on course for.
- Decide where along the spectrum your fund should sit in terms of designing a default investment strategy – this could range from a generic default strategy at one end, to a highly customised, member-focused strategy at the other.
- Improve the information provided to members about their expected outcomes and the range of potential retirement incomes, with the width of this range being driven by decisions regarding the default strategy design.
- Provide members who choose to be engaged with the tools to help them understand the impact of using the different levers at their disposal and thereby design a better journey plan.

Nick Callil and Jeff Chee are senior consultants at Towers Watson.

Home equity release is the fourth pillar of retirement funding

Christine Brownfield

There has been a lot of focus recently on retirement funding, across topics such as growing age pension payments, longevity, retirement age and costs of living. It is surprising not to hear more on the role that home equity could play in funding the retirement of senior Australians who own their homes.

The family home is not just a place to live but also a store of wealth. The wealth could be released by simply selling the home, but this creates the problem of where to live. Downsizing is an option that might work for some people. Alternatively there are products which facilitate the separation of the 'place to live' and 'store of wealth' attributes. The most well-known home equity release product today is a debt product, known in Australia as a reverse mortgage. There are also equity products which involve selling a fixed share of the future sale proceeds of the home.

Our retirement income system is generally viewed as comprising three pillars: the age pension, compulsory superannuation and voluntary savings (including non-compulsory superannuation). Home equity represents a substantial additional pool of savings, and could be viewed as a fourth pillar of retirement funding.

Australian residential property assets have been estimated recently at $5 trillion, around triple the market capitalisation of the ASX. Housing wealth dominates retiree household wealth due to more than 85% of Australians aged 75 and over owning their homes. Substantial levels of housing wealth are bequeathed with annual intergenerational transfer of housing wealth projected at $20 billion in 2014, rising to $35 billion in 2025.

Borrowing to buy a home is effectively buying a large asset 'brick by brick' with the principal component of each mortgage repayment. Ideally, a home could be sold in the same way, to provide financial support in retirement. Home equity release products effectively facilitate this.

Retirees might release home equity for reasons such as unplanned medical expenses, home modification, a new car, in-home care services or simply to supplement income to fund a more comfortable retirement. Imagine the difference for some retirees if they could access their home equity to provide them with, say, $10,000 - $20,000 each year for the rest of their lives, rather than living on just the age pension then bequeathing their home when they die.

Tapping into home equity to fund retirement also provides a societal benefit, improving intergenerational equity, or fairness between older and younger generations of society.

The current system, where each generation funds the age pension costs of the previous generation, is breaking down because people are living longer in retirement, ratios of workers to retirees are falling, and the age pension is not well targeted.

The family home is fully exempt from the age pension assets test. This provides a disincentive to unlock housing wealth to fund retirement and worsens intergenerational equity. Many of those bequeathing wealth will have received a part or full age pension, and the benefits that come with that, during retirement. Intergenerational wealth transfer is generally not taxed (other than a tax on some components of inherited superannuation).

Better targeting of the age pension would increase the likelihood that government can afford to pay pensions at adequate levels to those retirees with no other sources of financial support. Targeting should consider a retiree's full wealth and means of financial support, including housing wealth. Removing all or part of the family home exemption from the age pension assets test would be politically sensitive - many voters view the age pension as an entitlement, not a safety net, and today around 80% of retirees access either a full or part age pension.

Critical in any change to the assets test is good public policy to avoid unintended adverse consequences. Senior Australians should not be forced to sell their homes. There would be a risk of this if the exemption were simply removed and the private sector did not step in to provide universally available home equity release solutions. Public policy must consider the availability and design of products on offer.

The home equity release market today is small. There are challenges on the demand side (that is, the demand for money from retirees) for a range of reasons including emotive issues relating to the family home, a lack of product providers and no promotion of the concept by government. The main challenges on the supply side (that is, the provision of funding) are around market capacity.

The November 2013 report by the Grattan Institute entitled "Balancing Budgets: tough choices we need" put forward one approach to utilising home equity to help fund retirement. It involves including the family home in the assets test but mitigating the impact on low-income retirees with high-value houses by allowing them to claim the pension and then repay the value of the pension drawn when the house is eventually sold. It is estimated that this would improve the budget by $7 billion per annum, without undesirable social consequences.

The issue was also touched on earlier this year when the Commission of Audit proposed capping the extent to which the family home is exempt from the age pension assets test, but interest in the topic waned when government rejected this proposal.

Retirement funding should be considered more holistically than it is today. There will be challenges in utilising home equity release and creating a framework that is fair. But as our population ages and our fiscal challenges continue, we must create mechanisms such as home equity release which become a meaningful fourth pillar of retirement funding.

Christine Brownfield is an actuary with 20 years' experience in life insurance and wealth management, and is currently working at Homesafe Solutions, a provider of home equity release products.