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This Week's Top Articles

- **Who wins? Australia versus US in local shares** *Ashley Owen*
- **The Yin and Yang of retirement income philosophies** *Pfau & Cooper*
- **Longevity risk solutions for retirees** *David Knox*
- **The case for active management in A-REITs** *Adrian Harrington*
- **What is a 'long-term investor'?** *Geoff Warren*
- **Fund Performance Snapshot** *Investors Mutual Australian Share Fund*

Who wins? Australia versus US in local shares

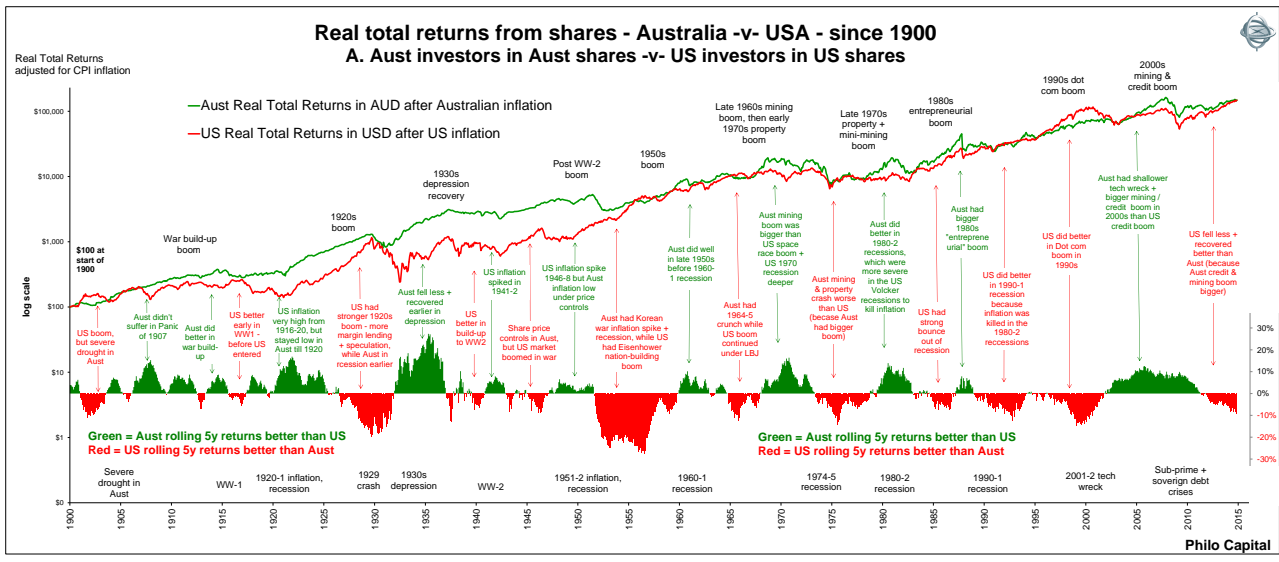
Ashley Owen

I am often asked how returns from shares have compared between the stock markets in Australia and the US. This topic came up again in a Cuffelinks story from last week so I have updated one of my favourite charts. It shows total returns (including reinvested dividends) after inflation from Australian and US stock markets since 1900.

Specifically, the first chart shows real total returns from the broad Australian stock market in Australian dollars after Australian CPI inflation (the green line) versus real total returns from the broad US stock market in US dollars after US CPI inflation (red line). Thus it compares how Australian investors have fared from their local Australian market in their local currency after local inflation, versus how American investors have fared from their local market in their local currency after local American inflation.

Therefore this compares the returns from the point of view of two *different* investors: an Australian in Australian equities versus an American investor in US equities. (In Part 2 we look at whether Australian investors would have done better investing in Australian shares rather than in American shares).

(This graph can be enlarged when read online).



Returns the same from both markets since 1900

The above chart shows total returns to Australian investors has been virtually the same as American investors have received (in local markets, currencies and inflation). A\$100 invested by an Australian investor at the start of 1900 would have turned into A\$148,000 today (end of October 2014) and US\$100 invested by an American investor in US stocks would be worth about US\$148,000 today.

For American shares we use the S&P500 index with dividends re-invested, and for Australian shares we use the All Ordinaries index (and its predecessors) with dividends re-invested. These returns are before tax and brokerage costs. Tax rates and tax rebate regimes have changed many times in each country, and tax benefits from franking in the Australian market since 1987 would probably be more than outweighed by the impact of buy-backs in the US market. We also assume investors have been 'long-only' in each market. That is, they have not used margin lending or any other type of gearing or derivatives that wiped out many investors in the more extreme booms and busts along the way. It also assumes investors don't panic buy in booms, nor do they panic sell in busts. They just hold on, re-investing dividends and adjusting holdings to stick with the index weights of each company.

Alternating booms and busts

Although the total returns have been same, there have been large differences for long periods at a time. Australia and America have taken turns at having bigger booms and bigger subsequent busts.

The lower section of the first chart shows the difference between rolling five year returns. This neatly illustrates how the pendulum has swung between Australian shares beating US shares (green vertical bars above the line in lower section), and US beating Australian shares (red vertical bars below the line).

The green and red text boxes across the middle of the chart highlight the booms and busts:

- In every second cycle the Australian market did better than the US market (green boxes).
- But between each of these periods the US market did better than Australia (red boxes).

Working backwards over time we see this pattern repeated throughout the past century:

- In the most recent big boom during 2003-2007, the Australian stock market generated higher returns than the US market because Australia had both a credit boom and a mining boom at the same time.
- The US didn't have such a big 2003-2007 boom so the US didn't have as far to fall, and has done better than Australia since the 2008-2009 bust.
- However the US market did much better than Australia in the late 1990s 'dot-com' boom, but it subsequently fell further than Australia in the 2001-2002 'tech wreck'.

- Following the same pattern, the Australian market did much better in the 1980s 'entrepreneurial' boom, but then fell further in the 1987 crash that followed.
- Further back, Australia did much better in the early 1980s recession, because the US was hit with the full 'Volcker' double dip recessions to kill inflation. Australia rejected monetarism and instead relied on the 'Accord' process to partially control inflation, and did not have the big inflation-busting recession until a decade later (Keating's 'recession we had to have') in 1990-1991, when US shares did better.
- This pattern where Australia and the US took turns to have a big boom followed by a big bust goes all the way back for more than a century – even through world wars, recessions, the depression, inflation spikes and political crises – and each is noted on the chart.
- The biggest bust in the Australian market was in 1973-1974 (worse than the 2008-2009 GFC). It came after a double-barrelled boom – a speculative mining boom in the late 1960s followed by a speculative property bubble in the early 1970s. The Australian market rose higher than the American 'space race' boom at the same time, but then had further to fall.
- Further back still, the 1920s boom was much bigger in the US, fuelled largely by US margin lending and speculation. Australia did not have the same penetration of margin lending and was already in recession in the late 1920s well before the 1929 crash. Because the US boom in the 1920s was much higher, it crashed further.
- This pattern of baton-changing extended back even before 1900. Before the 'panic of 1907' in the US, Australia had a larger 1880's boom because it was not just a banking/property boom but a mining boom as well. Consequently our early 1890s property and banking collapse was worse.

Given the remarkable consistency of this pattern, it is tempting to say that, because the last boom/bust was bigger in Australia than the US (the 2003-2007 boom and subsequent 2008-2009 bust), it is America's turn for the next big boom/bust. Only time will tell.

Structural similarities and differences

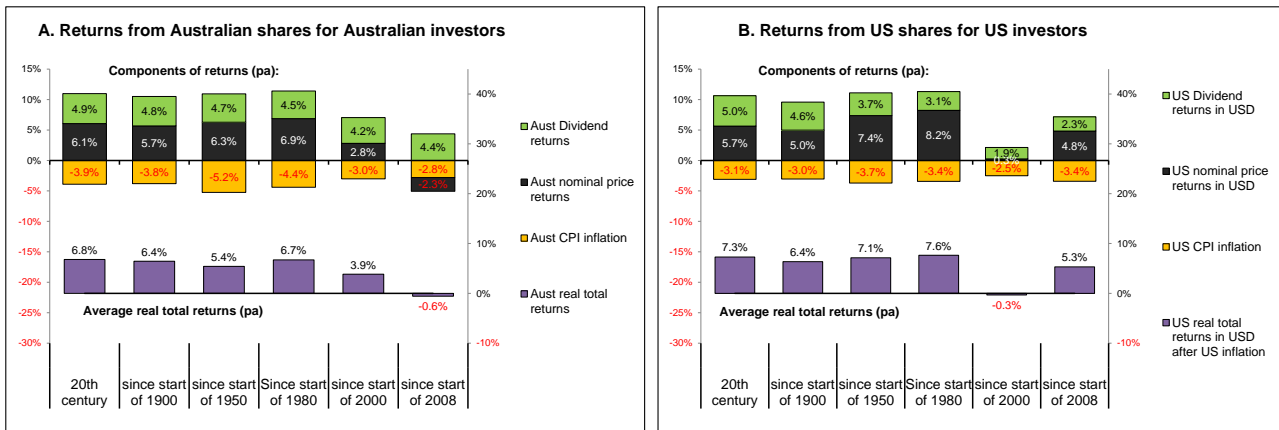
The fact that both markets have generated similar returns from their stock markets over long periods is no great surprise. There are some important similarities but also some key differences.

Both are pluralist democratic former British colonies with relatively strong political, administrative, social and judicial institutions, rule of law and protection of private property rights, civilian control of the military, and both economies have grown by a little above 3% per year over the past century. Importantly, both countries have managed to stay out of destructive all-out wars against foreign powers on their own soil, and both have also avoided revolutionary changes in power and wholesale confiscation of private assets.

One key difference is the source of economic growth. Only one-third of American economic growth has come from population growth (more people producing the same output per person) while two-thirds of the growth has come from productivity growth (more output per person), but it has been the reverse in Australia. Two-thirds of Australian economic growth has come from population growth (more people doing the same old things), while only one-third of the growth has come from productivity growth (doing things better per person).

Difference sources of returns

Another difference is the components of returns. The following two charts show returns from Australian shares (left chart) and US shares (right chart) broken into their component parts: dividends, price growth and inflation.



The purple bars on the lower section of the charts show total real returns over various periods. Both markets have generated total real returns of around 6% to 7% per year averaged over very long periods.

However, Australian companies have generated higher dividends and higher nominal price growth but Australia has suffered higher inflation. Higher dividends are a function of our market being a couple of hundred years younger than the American market. In younger markets investors demand quicker returns and allow boards to retain less for future growth. (In the US market's first century US companies also generated near 100% dividend payout rates, much like Australian companies did in the Australian market's first century). More recently, since 1987, the existence of franking credits on dividends in Australia has also led to higher dividends and less re-investment of earnings. In recent years the market structure in the US has favoured share buy-backs which have contributed an additional 2% to 4% to dividend returns (far exceeding the benefit of franking credits on Australian dividends, which has added around 1% to 1.3% to returns).

So to answer the question: "Which market has generated higher real total returns for local investors?", the answer is: "It's a dead heat" - although there has been a consistent pattern of the pendulum swinging between Australia and the US for more than a century.

Part 2 of this story will consider whether Australian investors have received better returns from the Australian or US market after accounting for differences in inflation rates and exchange rates.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general educational purposes and is not personal financial advice.

The Yin and Yang of retirement income philosophies

Wade Pfau and Jeremy Cooper

Within the world of retirement income planning, there are two major opposing schools of thought: probability-based and safety-first. Understanding the distinctions and thought processes of both schools is important in achieving the best outcomes.

Separating accumulation from drawdown: the difficulties of retirement income planning

In defined contribution schemes, there are differences between the wealth accumulation phase and the income distribution phase. One important difference is that the investing problem fundamentally changes in retirement.

The traditional goal of wealth accumulation is generally to seek the highest returns possible in order to maximise wealth, subject to the investor's risk tolerance. After retiring, however, the fundamental objective is to sustain a living standard while spending down assets over an unknown, but finite, length of time.

Investing **during** retirement is a rather different matter from investing **for** retirement, as retirees worry less about maximising risk-adjusted returns and worry more about ensuring that their assets can support their spending goals for the remainder of their lives.

The two schools of thought

As an introduction to these schools, consider a simple example. Suppose a retirement plan has a 90% chance of success of providing income for a retiree taking into consideration longevity and market risk. Both sides will have dramatically different interpretations about what this number means.

From a probability-based perspective, 90% success is a more than reasonable starting point. It is likely to work. Safety-first advocates, however, will not be comfortable with this level of risk, focusing instead on the 10% chance of failure. They will seek a solution that removes the impact from any possible failure.

Table 1: Retirement income philosophies

	Probability-based	Safety-first
How are goals prioritised?	Retirees have a particular lifestyle goal in mind and not meeting this overall goal indicates failure. Lifestyle goals are not prioritised between essentials and discretionary.	Goals are prioritised. For instance, the funding hierarchy could be: (1) basic needs, (2) contingency fund, (3) discretionary expenses, (4) legacy goals.
What is the investment approach?	Usually a total returns perspective framed in the same terms as pre-retirement accumulation using techniques such as portfolio diversification. The focus is wealth management for the financial portfolio.	Assets are matched to goals so that risk levels are comparable. Lifetime spending potential over uncertain horizon is the focus, not maximising wealth. There is a wider role for products to hedge interest rate risk and provide longevity insurance.
What is the role of an account-based pension?	The account-based pension is sufficient for an outcome that will probably work. They're flexible enough to make adjustments when required.	The account-based pension can be utilised after the safety requirements have been met. It can then deliver aspirational or discretionary spending.

The probability-based school of thought

The probability-based approach is closely associated with the traditional concepts of wealth accumulation. In this frame, people do not differentiate between essential needs and discretionary expenses. Rather, people operate on a total budget concept.

Probability-based approaches are based closely on the concepts of maximising risk-adjusted returns from the perspective of the total portfolio. Different volatile assets classes, that are not perfectly correlated, are combined to create portfolios with lower volatility, that provide the highest 'expected return'. It is an assets-only analysis, and the investor's spending needs are not relevant to determining the appropriate asset allocation.

For retirement planning, spending and asset allocation recommendations are based on mitigating the risk of wealth depletion that is inherent in drawing down a portfolio of volatile assets (ie due to sequence of returns and market risk). The failure rate is the probability that wealth is depleted before death, or before the end of a fixed time horizon.

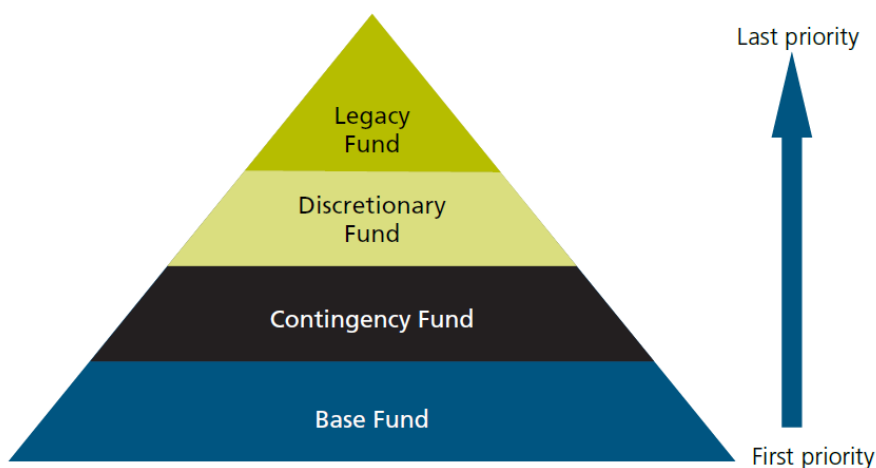
Probability-based advocates tend to focus on the potential of equities to provide positive real returns and to outperform bonds over the long run. Retirees are thus advised to take on as much risk as they can tolerate to minimise the probability of failure. This has led advocates of the probability-based approach to use more and more aggressive asset allocations.

The safety-first school of thought

Advocates of the safety-first school of thought view prioritising retirement goals as an essential component of developing a good retirement income strategy. Prioritisation will be very important because the investment strategy is to match the risk characteristics of assets and goals.

Retirees' spending priorities are prioritised like the pyramid in Figure 1. Essentially, spending is required to satisfy basic needs, with additional spending on discretionary items after basic needs are met. The pyramid model requires each goal to be properly funded before continuing to the next level.

Figure 1: Modern Retirement Theory hierarchical pyramid



Source: Branning and Grubbs www.modernretirementtheory.com

The general view of safety-first advocates is that retirees only have one shot at getting sustainable cash flows from their savings. This means they must develop a strategy that will at least meet their needs, no matter the length of life or the sequence of post-retirement returns.

Retirees often have little leeway for error, because returning to the labour force is not a realistic option for many retirees. Volatile investments like stocks are not appropriate when seeking to meet basic retirement living expenses. Volatile (and hopefully, but not necessarily, higher returning) assets are suitable for discretionary expenses and legacy, where the spending is more flexible.

The goal is to have cash flows available to meet spending needs as required. Investment assets are matched to goals so that the risk and cash flow characteristics are comparable. This can include defined-benefit pensions, bond ladders, and fixed rate annuities.

The retirement income challenge

The essential difference between the schools of thought relates to the degree of comfort people have that equities will always perform well enough for a broadly diversified portfolio to meet a retiree's basic needs, without relying on more secure assets. With essentials-versus-discretionary, lifetime flooring protection is created for essential needs. This is really 'goal segmentation.' Systematic withdrawals generally leave the entire lifestyle spending goal at risk, since spending needs must be supported from a portfolio of volatile assets.

Concluding remarks

Super funds and financial advisers alike can help retirees overcome the complexities of generating retirement income by first understanding the different philosophical approaches to retirement. While neither a probability-based nor a safety-first approach is definitively right or wrong, different people will align more easily with one or the other. Nor is it an all or nothing approach. A fund or adviser shouldn't advocate for only safe assets and no risky assets. The safety first approach is about securing essential spending needs in retirement, with room for more probability-based approaches for discretionary spending.

The full paper by Pfau and Cooper is available [here](#). An extended version of this summary is [here](#). Wade Pfau is professor of retirement income at The American College and hosts the Retirement Researcher blog at wpfau.blogspot.com. Jeremy Cooper is Chairman, Retirement Income at Challenger Limited.

Longevity risk solutions for retirees

David Knox

The Interim Report of the Financial System Inquiry observed that the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.

Indeed the financial risks faced by retirees are more complex than individuals in the accumulation phase, and include:

- investment risk – the possibility of lower than expected returns affecting future income
- sequencing risk – the possibility of negative returns at or near retirement affecting the market value of the investments which cannot be fully recovered in the future as pension payments are made reducing the level of investment
- inflation risk – the possibility of high inflation which causes retirees to spend a greater proportion of their capital than expected
- expenditure risk – the possibility of unexpected one-off payments in retirement which have longer term implications for future income levels
- longevity risk – the possibility of running out of money as the retiree lives longer than expected

Whilst some of these risks can be mitigated through certain investment strategies or lifestyle decisions, longevity risk remains, as the time of one's death is unknown. It is one risk where it is definitely better to pool the risk with others. As the Interim Report noted, "Managing longevity risk on an individual basis can lead to a dynamically inefficient allocation of resources." The Report concludes the total cost of this inefficiency is likely to be substantial.

Before considering the longevity products available in the market, it is worth considering different groups of retirees who may benefit from longevity protection.

Segmenting the retiree market

We think it's useful to divide the market into three broad categories:

1. Retirees with relatively small retirement benefits, say below \$150,000. Most of these retirees will rely heavily on the age pension for much of their income in retirement. As such, longevity protection is already available for these individuals as the age pension is available for life, means testing permitting.
2. Retirees with significant retirement benefits, say above \$1 million, who can live largely off their investment earnings. Although some of these retirees may wish to have some longevity protection, many will have sufficient assets so that they may not need to purchase any protection.
3. Retirees with retirement benefits between say \$150,000 and \$1 million. This group represents most retirees. They are likely to want a retirement income above the age pension, noting that the ASFA Comfortable Standard is about twice the age pension. Currently many in this group are 'self-insuring' their longevity by drawing down the minimum pension from their account-based pension and thereby not enjoying the actual retirement lifestyle that could be afforded. As the Interim Report noted, this is not an ideal outcome.

Potential post-retirement solutions

Three potential solutions were discussed in the Interim Report:

1. A lifetime annuity
2. A deferred lifetime annuity
3. Group self-annuitisation

Lifetime annuities are an insurance product that provides a guaranteed level of income for life (guaranteed by the issuing entity, not the government). However, as with all guarantees, there is a cost to the investor as capital is needed to back these long term promises. Nevertheless, lifetime annuities have become more popular recently.

Deferred lifetime annuities (DLAs) are a form of lifetime annuity where income payments are delayed for an agreed period. For example, a 65-year-old retiree may purchase a DLA that will provide a steady income stream after the retiree turns 85 and thereby guarantee an income above the age pension for the remainder of the retiree's life. The advantage for the retiree is that they can run down the balance of their retirement benefit to age 85, knowing that the annuity payments will commence from that age.

The current tax rules relating to pensions provide a disincentive for the introduction of DLAs and therefore this product does not currently exist in the market. However their introduction would represent an important broadening of product availability.

Nevertheless, DLAs would still require significant capital as there remains considerable uncertainty about future liabilities for the insurer. The relative attractiveness of DLAs to retirees is also untested as the cheaper (and more efficient) DLAs would offer limited or no death benefit during the deferral period which may be unacceptable to some investors.

Group self-annuitisation (GSA) products are where participants invest funds into a pool of financial assets with regular payments made to surviving members. As the Interim Report noted, "Pooling mortality risk delivers higher income in retirement than an account-based pension that is drawn down at the minimum rate, while also providing significantly more protection against longevity risk." This pooling enables members to share, but not completely eliminate, longevity risk without the need for any capital to back guarantees. Another way of expressing the outcome is that GSAs protect investors from idiosyncratic (or individual) longevity risk but not totally from significant systemic longevity risk.

GSAs will be offered by superannuation funds for account-based pensioners from the first quarter of 2015. The option pools an investment from each retiree's account-based pension, which represents part (say 20-30%) of their total retirement benefit. The option pays investment earnings each quarter to support the pension payments whilst retaining the capital in the investment trust. Up to 95% of each investor's capital would be returned on their death or exit from this investment option with the balance retained by the trust to be distributed to survivors on a six-monthly basis.

As the Interim Report noted, "GSA income is not guaranteed like annuity income, but it is expected to be higher due to the absence of capital requirements to back guarantees." As a GSA represents a mutual pool of retirees supporting each other, this approach to longevity protection is also consistent with the ethos of many Australian superannuation funds.

No single solution for everyone

There is no single longevity product that is right for all retirees. For those with minimal assets, the age pension provides the only realistic protection. However, as superannuation benefits increase, a broader range of products need to be developed to provide longevity protection for retirees into their late 80s and 90s. After all, about half of all retirees will live beyond their life expectancy.

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The case for active management in A-REITs

Adrian Harrington

Amid the growing popularity of ASX-listed real estate investment trusts (A-REITs) as a way for investors to obtain exposure to real estate, there is a debate over whether investors should use an actively managed A-REIT fund, a passively managed index managed fund or exchange traded fund (ETF).

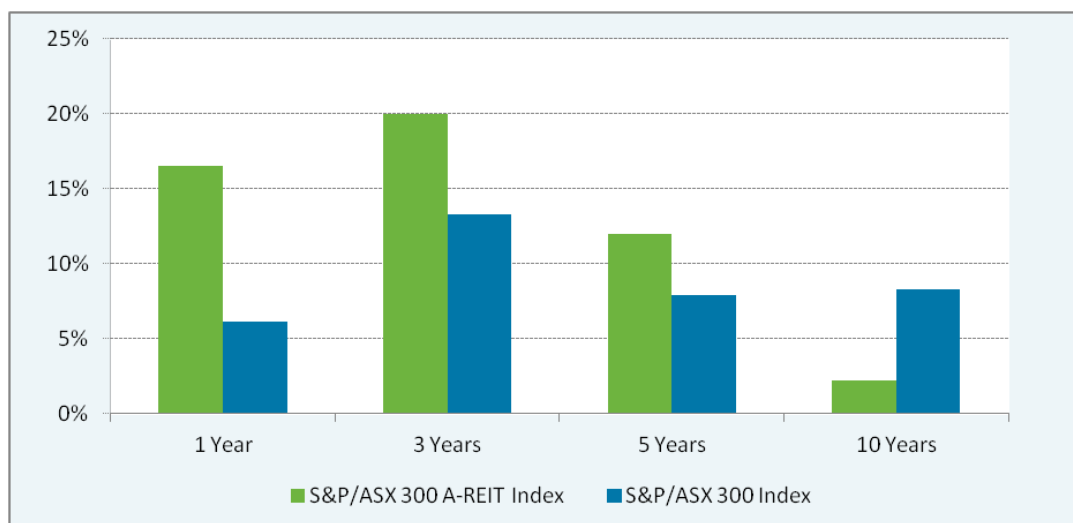
What is active versus passive management?

Active management focuses on identifying securities that the market may have mispriced through analytical research and judgement to minimise exposure to riskier or overvalued securities. A passive index manager owns all the securities in the S&P/ASX 300 A-REIT Index even those A-REITs which may have poor management, lower quality assets or high gearing, or are overvalued on a relative basis.

The A-REIT sector

In the last five year, the A-REIT sector has recorded strong performance relative to the broader equities market (Figure 1), due largely to the low interest rate environment which has diverted capital from cash and bonds to higher yielding assets such as real estate. Not surprisingly, with the S&P/ASX 300 A-REIT Index generating such a strong return, the spotlight has turned back to active managers of A-REIT securities funds to justify their relevance.

Figure 1: Performance of A-REITs vs Australian Equities: 31 October 2014



How can active managers add value?

An active A-REIT securities manager has a number of opportunities to add value to a portfolio, including:

1. tactical allocation to real estate subsectors
2. analysis and research on individual A-REITs
3. building a more diversified portfolio based on value, and
4. participating in securitisation opportunities.

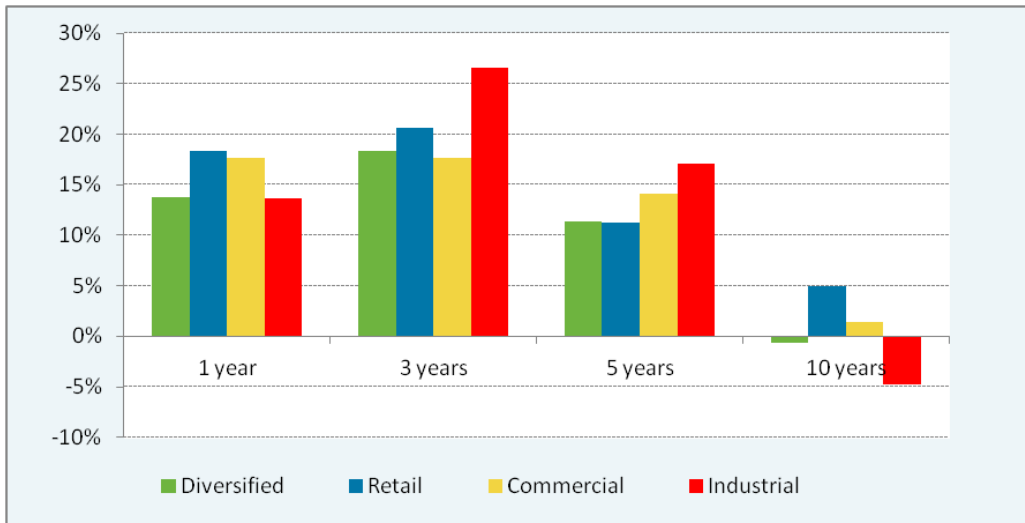
1. Tactical allocation to real estate subsectors

Real estate is not a homogenous asset class in which real estate subsectors (office, retail, industrial, residential, social infrastructure) or individual securities generally move together. Each real estate subsector has its own supply and demand drivers, which can alter the duration and direction of its cycle, often resulting in significantly different returns (see Figure 2).

A specialist A-REIT manager who understands the relationships between economic drivers and the real estate cycle may acquire A-REITs in subsectors they believe are more attractively priced in the current

market and conversely avoid or underweight subsectors that they believe are expensive or are likely to underperform. A passive manager must own A-REITs in every subsectors within the index.

Figure 2: A-REIT Subsector Performance to 31 October 2014



Source: UBS

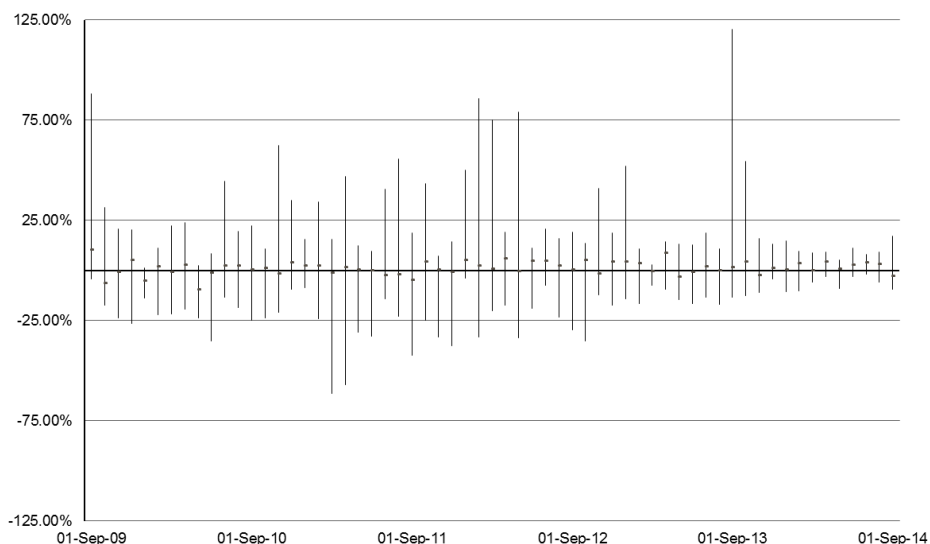
2. In-depth analysis and research of individual A-REITs

A specialist active management team has the ability to uncover relative value between A-REIT securities. Smaller cap A-REIT securities have the greatest potential to be mispriced by the market due to lower liquidity and less broker research coverage than the large cap A-REITs.

Within the A-REIT sector, there has also been a wide variation in the performance of individual securities, up to 196% in one month (Figure 3). The variation can be driven by the quality of management, specific issues relating to the underlying assets, the ability of management to grow earnings through accretive acquisitions or development and capital management strategies such as gearing levels, debt profiles and security buy-backs.

The growing presence of general equity and hedge funds in the A-REIT sector also creates short-term mispricing opportunities at the individual security level. For many of these investors, their rationale for investing in a security maybe very different to that of a A-REIT securities manager, often driven by their short-term investment horizon or an arbitrage trade around corporate activity. The recent Australand takeover by Frasers Centrepoint saw large inflows from hedge funds seeking to capture the spread between the price at the time of the announcement and the eventual price paid by the acquirer.

Figure 3: Highest and Lowest Monthly Total Returns from A-REITs – 2009 to 2014



Source: UBS

3. Building a more diversified portfolio based on value

Most indices, including the S&P/ASX 300 A-REIT Index, are weighted based on market capitalisation resulting in a high concentration of larger companies within the Index. The top eight A-REIT securities account for approximately 82% of the index and the retail sector focused A-REITs account for nearly 50% of the Index.

Passive investment strategies face significant concentration risk and therefore are taking on more security specific risk. Diversification is one of the basic strategies for reducing risk. An active manager can mitigate the concentration risk by taking more meaningful positions away from the top eight securities by investing in smaller caps or A-REITs not included in the Index.

4. Participation in new issue opportunities

Advocates for passive management often argue that the corporate activity in the A-REIT sector results in a smaller number of securities for active managers to choose from. The number of A-REITs in the index has declined from 62 in June 2006 to 47 now. However, the recent increase in initial public offerings (IPOs) has added breadth to the A-REIT sector (Table 1). This in turn creates more opportunities for active managers.

Whilst the number of new A-REITs has been welcomed by active managers, it is the widening of the subsector offerings (other than the traditional retail, office and industrial) that provides the greatest opportunities through portfolio tilts to the various subsectors. Self-storage, health and agriculture are just three of the new sectors, albeit they are still small.

Table 1 - IPO activity 2013/2014

Name	Date	Sector	Market Cap (\$m)	Post IPO Included in S&P/ASX 300 A-REIT Index
Arena REIT	13/06/2013	Childcare/Social Infrastructure	300	Yes
Australian Industrial REIT	21/10/2013	Industrial	199	Yes
Industria REIT	3/12/2013	Industrial	251	Yes
Hotel Property Group	10/12/2013	Hotel	332	Yes
GDI Property Group	17/12/2013	Office/funds management	500	Yes
National Storage	19/12/2013	Self Storage	404	Yes
Rural Funds Group	14/02/2014	Agriculture	119	No
360 Capital Office Fund	24/04/2014	Office	153	No
GPT Metro Office Fund	24/10/2014	Office	251	No

Active managers also have the opportunity to participate in the recapitalisation of an A-REIT through placement and rights issues. Whilst an index manager is forced to participate to maintain their relative exposure to A-REIT, an active manager has the opportunity to assess the merits of the transaction and act accordingly.

Conclusion

Active management of A-REITs securities has a role to play in either listed or unlisted funds, notwithstanding the higher fees than charged by passive funds. In choosing a manager, the skill and track record of an active A-REIT securities manager is paramount, and also their level of funds under management. Ultimately, their long-term success depends on how well the manager understands the dynamics of the listed real estate securities market, the interaction with the broader capital markets and real estate sector and whether the manager has a disciplined, risk-adjusted investment approach.

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What is a 'long-term investor'?

Geoff Warren

There is a tendency to equate 'long-term investing' with buying an asset and holding it for many years. While a long-term investor might indeed do so, being a long-term investor has more to do with the combination of an investor's circumstances and the perspective they adopt. If anything, it is better described as a state of mind than by observed behaviour.

There is no widely-accepted definition of long-term investing. Neither is there any theory on what determines an investment horizon. Nevertheless, it can be argued that investors with long horizons are marked by two key attributes. First, they have high discretion over when they trade, and at what price. Second, their approach to investing is focused on the long-term.

Wait for opportunities

Discretion over trading provides the latitude to invest for the long-run including the option to hold an asset indefinitely. There is no pressure to invest immediately, and investors can wait for opportunities. This first attribute is almost a necessary condition for long-term investing.

The importance of unfettered discretion over trading is best understood by contemplating what happens when it is absent. If an investor lacks confidence that they can maintain a position as long as needed to secure the payoff, their horizon will recede. This issue goes beyond just the possibility of having to liquidate to meet some short-term cash flow need, or to service a liability that is falling due. It entails aversion to short-term underperformance due to concern over adverse reactions from your end-investors, your trustee board, or your boss. It can relate to the impact of short-term losses on capital or solvency requirements. It also extends to pressures to invest along with the crowd into recently outperforming assets, no matter how over-cooked.

Flows incurred by investment funds are an important influence. Flows may not only force a fund manager to trade; but wariness over flows (and the related focus on short-term relative performance that it entices) can induce managers to adopt shorter horizons. Indeed, much of the investment industry is configured to provide investors with liquidity, rather than deliver security of funding to investment managers. This aspect manifests in the form of open-ended funds offering immediate redemption, and member investment choice in the case of superannuation funds. Liquidity is valuable but there is a trade-off. Redemption-at-call impacts on manager perceptions of their control over trading, and is one of the factors that encourages short-termism. By contrast, private investors who are their own masters often possess high discretion over trading. This gives them greater latitude to pursue a long-term approach, if they want.

'Trading' versus 'investing'

The second attribute of long-term investors relates to *how investment decisions are made*. Merely having discretion over trading is not enough. An investor must also behave like a long-term investor. This boils down to investment approach, including the information used in evaluating investments.

The main concern of a long-term investor should be long-term outcomes. In many cases, this will entail considering the cash flows that an asset can generate over the long run, relative to the price that is paid for that cash flow stream. Another concern should be what happens to the free cash flows generated by the asset: if the cash is not returned to investors, will it be reinvested wisely? That is, long-term investors focus on the drivers of long-term value and long-term returns. In an equity market context, relevant information is that which sheds light on aspects such as earnings potential, sustainable competitive advantage, future investment opportunities, management alignment and competency, and so on. A long-term investor will pay attention to this type of information, and filter out the short-term noise.

By contrast, short-term investors are primarily concerned with the drivers of price. The very simple reason is that short-term returns are dictated by price fluctuations. Such investors would hence focus on aspects such as news flow, how the market may respond to earnings announcements, the actions of other investors, current market themes – anything that could result in a price reaction. The difference between short-term and long-term investors is closely related to the concept of 'trading' versus 'investing'.

Thus long-term investors are best characterised as those who set their sights on the long-term, backed by considerable discretion over trading. *Why not holding period?* In essence, the aim of long-term investing is to achieve the best long-term outcome, not just to buy and hold for extended periods. The option to trade is valuable, and may be used to enhance long-term outcomes. This is foreseen in the academic literature, where researchers such as Robert Merton as well as John Campbell and Luis Viceira point out that portfolios should be adjusted if expected returns vary over time. The fact that an investor trades does not make them a short-term investor. What matters is how they make investment decisions.

To drive home this point, consider the following situation (with thanks to Jack Gray). Assume you buy an asset with cash flows that are expected to grow strongly over the next 20 years from a low base. The asset offers you a 20-year expected return of 15% pa. Over the next year, the asset price triples. The long-term expected return consequently falls to 6% pa; and there are other opportunities offering a much better return. As a long-term investor, what do you do? It is argued that it is totally consistent with long-term investing to sell and invest elsewhere. What makes for a long-term investor is the fact that the decision is made with a view to the long-term expected return; not because of some slavish adherence to a long holding period.

Geoff Warren is Research Director of the Centre for International Finance and Regulation (CIFR).

CIFR has recently collaborated with the Future Fund on a research project examining long-term investing from an institutional investor perspective. This is the first in a series of Cuffelinks articles aiming to bring out some of the key messages for a broader audience. The (lengthy) full report, which comprises three papers, can be found at: <http://www.cifr.edu.au/project/T003.aspx>

Fund Performance Snapshot

Investors Mutual Wholesale Australian Share Fund

How to understand the report on the following page

The Sector Exposure shows the weighting of the portfolio to particular industry sectors at different point over the last five years.

The Performance Breakdown (Sector Based) separates the Total Annualised Return over five years of 10.47% pa into Style (9.01% pa) and Stock Selection (1.46% pa). The Stock Selection component is the excess return of the Fund over the Style.

The Excess Performance Breakdown (Sector Based) of 3.90% pa over this period is the amount the Fund outperformed the ASX300 index, divided into Timing of 2.04% pa and Excess Selection of 1.86% pa. The Excess Selection is the Selection component of the difference between the Fund and the benchmark.

The Style Analysis section does the same calculations based on Style (eg growth or value) rather than Sector.

The analytics does not necessarily capture what the fund manager actually invested in, as the report is not coming from the fund manager. Rather, it uses MPI's technology to show what sector exposures are equivalent to the performance. For example, if some stocks in the portfolio deliver 'cash-like' returns over a period, then the analytics puts them in the 'cash' bucket, even though it was not actually a cash investment.

For a more comprehensive explanation with worked examples provided by TTA and MPI, see the Fund Performance Snapshot section of our Education Centre (on the Cuffelinks main menu). All quoted returns are per annum.

Fund reports and data for the Performance Snapshot provided exclusively to Cuffelinks by:



Investors Mutual WS Australian Share

Performance Snapshot

As of September 30th, 2014

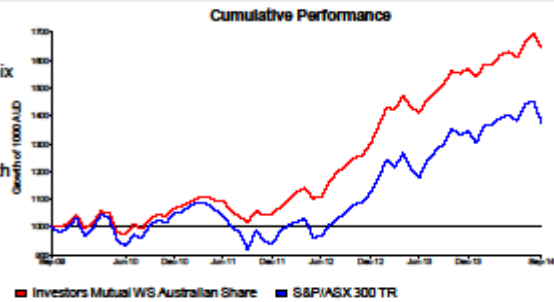
Performance Summary

- Fund has outperformed the Australian stock market as a whole over the last five years.

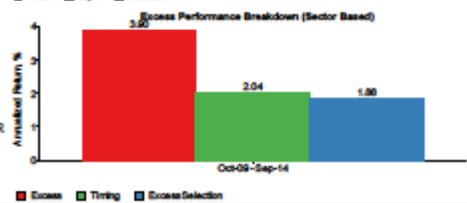
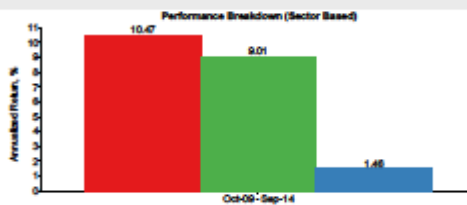
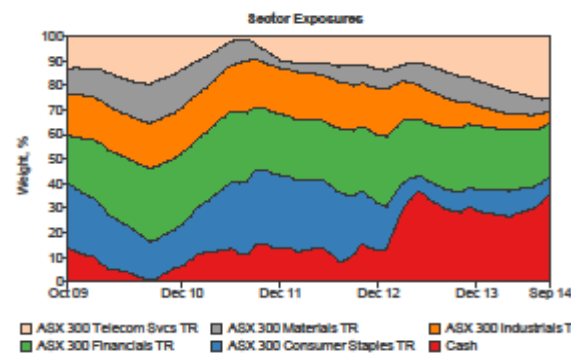
- Sector attribution shows that the fund behaves as if it is a mix of five sectors; Industrials, Financials, Materials, Consumer Staples, and Telecom Services.

- Analyzing the fund's excess performance based on sector exposures, we see that the fund has outperformed due to both selection and allocation.

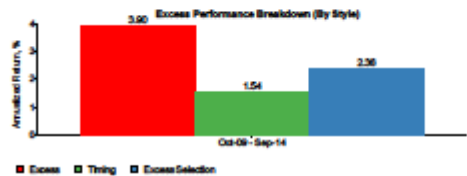
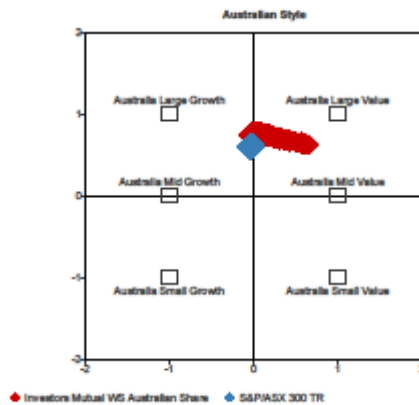
- Style Analysis shows that the fund has shifted style bias, moving over time from value to blend.



Sector Analysis



Style Analysis



Past performance does not guarantee or indicate future results. Analytics are presented for informational purposes only and do not constitute an offer or recommendation to buy or sell securities or to engage an investment manager. Mutual fund results do not reflect the deduction of sales loads. Market indices included are a general source of information and may not be the designated benchmark to evaluate an investment's performance.

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