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This Week's Top Articles

A journey through the life of a fixed rate bond

Warren Bird

"You never really know a man until you stand in his shoes and walk around in them." Atticus Finch, *To Kill a Mockingbird.*

Fixed income securities – or bonds – have the most predictable returns of any asset class in the world, yet they are often maligned and mistreated by market commentators who want to call them risky.

Rather than launching into a conceptual response to these scurrilous accusations, this article takes a leaf from Atticus Finch's book. It walks in the shoes of an actual fixed income security, one whose days on earth are just about over, but which has led a long and fulfilling life. It looks back on the course this bond has taken since early 2002, reflects on the fluctuations in its price and reviews how it performed for investors who owned it. Hopefully readers will feel that they then know the asset class much better.

The security in question is the Commonwealth Government Bond that will mature on 15 April this year at the ripe old age of 13 years.

Issued in May 2002, it promised to make two interest payments every year until April 2015, when it will return its face value to its owners. Its annual coupon rate was 6.25%, so the payments would be 3.125% of face value each in April and October. The rate of 6.25% was in line with market yields at the time, so investors who bought into the issue outlaid $100 for $100 face value (it was priced at par) and sat back to enjoy the steady income over the next 13 years.

The first year

The bond's price didn't stay at par for long. A fixed income security with over a decade until maturity is a frisky sort of animal and moves quickly if you prod it. Nowhere near as jumpy as shares, but still twitchy.

As it happened, over the remainder of 2002 bond yields fell, so our April 2015 security sharply appreciated in value. By its first anniversary in May 2003, it was priced to yield just under 5%, with a market value of nearly $111.90 (see the 'technical footnote' at the end of *Term deposit investors did not understand the risk* for a refresher on the link between bond prices and market yields). Two interest payments had been made, totalling 6.25% of the initial outlay, which when added to the mark-to-market gain of 12% made for quite a handsome return of 18% over 12 months.

Some investors bailed out at that point, locking in their gain. Those who bought the bond from them would now expect to earn 5% per annum over the next 12 years, with the 6.25% coupon payments being offset by the amortisation of the bond from $111.90 to $100 over that period.

That first year pretty much set the trading range for the first half of our bond's life. In yield terms, the market traded the April 2015 bond between 5 and 6% for several years.

Towards middle age

As the years went by, our bond became less frisky. To use the jargon of fixed income, it had a shorter duration. The next time the yield on the April 2015 bond got down to 5% was August 2005, when it had just less than ten years until maturity. Its price this time rose only to $109.

It's as if during its life a bond looks more longingly at its destiny – par value at maturity – and starts to resist the pressure on its price that is exerted by fluctuations in market yields.

By the later months of 2007 and into 2008, investors wanted higher yields to compensate for higher inflation. The April 2015 was traded in the market at a yield above its coupon rate and its price fell below par. Around its sixth birthday in May 2008 the yield peaked at 6.5%, meaning that it hit the low price point in its life. The market at that time valued it at $98.30.

Popularity explodes

Things changed quickly in the second half of 2008. As the global financial crisis unfolded the demand for government bonds exploded. Our April 2015, along with his longer term cousins, had never been more popular. As the world financial system risked collapse, and the global economy faced deflation risk, the yields investors were willing to accept from bonds plummeted.

During October 2008, we were once again back at 5%. This time, as our bond was older and thus getting shorter in duration, its price reached only $106.

However, it didn't stop there. As support for financial corporation debt fell in the opinion polls to all-time lows, the 'yes' vote for government bonds kept climbing. The April 2015 yield fell further - to 4.5%, then to 4.0% and eventually to a new low of just 3.5% by January 2009. Even though our bond now had only six years and a bit to maturity, it still had enough vigour to respond to this fall in yields with a price appreciation to $115. Heady days!

Popularity fades

However, after a while the smart money decided to move back into risk assets. Shares or corporate bonds – anything but government bonds yielding less than 4%. Just as quickly as our bond's popularity had risen, it dropped. By the middle of 2009 it was again yielding above 5% and its price had fallen below $105. It would trade there for a couple more years, until the financial crisis mark II arrived.

Popularity returns

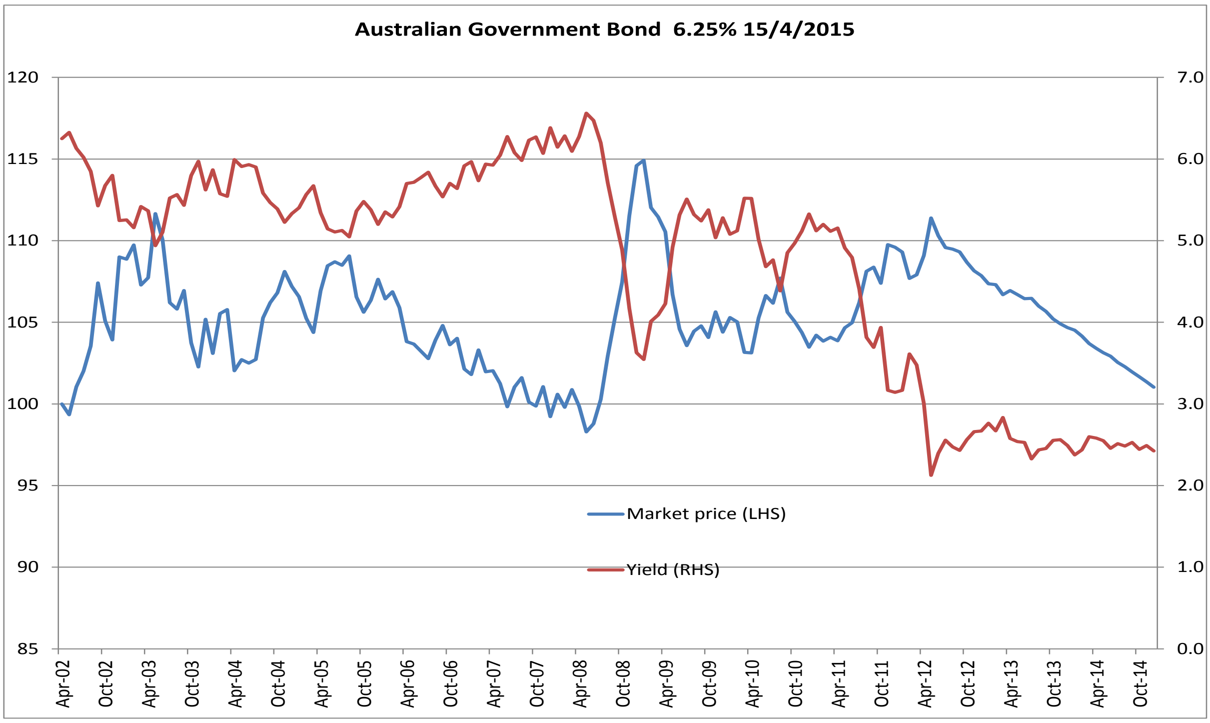
Our bond carried a AAA rating throughout its life which became highly valued by global investors from late 2011 when sovereign wealth funds and central banks were attracted like moths to a flame to the Australian government bond market.

Most of this demand was for securities longer than the April 2015, but our bond was carried in their slipstream back to lower yields. They reached 3.5% again around September 2011, though its vigour was beginning to fade and our bond could only rally to a price of about $109 this time. It managed to appreciate a bit further over the next few months, hitting $111 for its tenth birthday in May 2012. But it took an incredibly low yield of 2.1% to get it there.

Amortising to maturity

Since then, our bond has been enjoying a relatively lazy life. Its yield has traded around 2.5% for most of this time and its price action has been dominated by a steady trend towards par, where it will be valued when it retires in a couple of months. Its owners for these past three years have been receiving $3.125 each half year in coupon payments per $100 face value, but for that to yield them 2.5% pa there has also been a gradual decline in capital value of just under $2 each half year.

The following chart shows the price and yield history of the April 2015 bond in full.



A life well-lived

What have we learned from walking in the shoes of the April 2015 government bond?

First, that the life of a bond can sometimes be a wild ride. Its price fluctuated, sometimes rapidly, reflecting changes in market yields. Therefore its short term return also fluctuated. Rarely, if ever, was the annual return equal to the original yield of 6.25%.

Second, every time the yield got back to 6.25% it was valued at par, but as it happens this bond spent most of its life trading at a yield below that level and thus at a price above par.

Third, the fluctuations became smaller as maturity approached and the inexorable pull of par value became stronger. A yield that early in its life resulted in the price being well away from par produced smaller and smaller premia over time.

Fourth, the bond never missed a beat in paying the regular interest promised when it was first issued. Over the whole of its life, the April 2015 bond delivered. And from any point in its life, its new owners continued to receive the promised coupons plus a predictable rate of capital price amortisation. They could, therefore, easily predict the long term return they would make on their investment.

As its name implied, it provided its owners a regular fixed income. It's been a bond's life well lived.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years experience in fixed income investing, including 16 years as Head of Fixed Interest at Colonial First State. He also serves as an Independent Member of the GESB Investment Committee.

SMSFs drop the ball on risk in asset allocation

Paul Resnik and Peter Worcester

SMSFs are taking on more risks than they probably realise by investing most of their assets in Australia. They should reassess the way they allocate assets after taking into account their risk tolerance to reduce the consequence of losses when local markets correct.

In recent years, there has been a steady increase in the number of SMSFs, with growth of about 6% per annum, as the table below shows.

	Total number of SMSFs	Percentage increase on previous year	Total members of SMSFs	Average number of members per fund
Jun-10	414,208		787,544	1.9
Jun-11	440,292	6.3%	836,971	1.9
Jun-12	473,853	7.6%	900,130	1.9
Jun-13	503,135	6.2%	951,997	1.9
Jun-14	529,396	5.2%	1,002,485	1.9

Source: ATO SMSF data statistical report, December 2014.

SMSF assets jumped almost $10 billion to $553.7 billion over the December 2014 quarter, up 23% from two years earlier, according to data from the Australian Taxation Office (ATO).

Holdings of Australian shares struck a record $176.2 billion, accounting for 32% of all SMSF assets. Cash and term deposit investments stood at $156.7 billion, 28% of SMSF assets. A record $69.9 billion was allocated to non-residential Australian property and another $21.1 billion to residential real estate, a combined 16% of investments.

In contrast, SMSFs invested a reported 0.4% of assets or only $2.4 billion in international shares. You can see a full breakdown of SMSF assets here.

The table below shows the investment mix by percentage, which has been mostly steady since 2010.

	Listed trusts	Unlisted trusts	Cash and term deposits	Listed shares	Non-residential property	Other assets	Total assets
Jun-10	4.9%	9.8%	27.5%	31.8%	11.8%	14.2%	100.0%
Dec-10	5.0%	9.9%	26.5%	33.6%	11.2%	13.9%	100.0%
Jun-11	4.2%	9.4%	28.9%	31.7%	12.0%	13.8%	100.0%
Dec-11	4.1%	9.2%	30.7%	29.6%	12.4%	14.0%	100.0%
Jun-12	3.5%	9.1%	32.7%	28.5%	12.9%	13.2%	100.0%
Dec-12	3.6%	9.3%	31.0%	30.7%	12.5%	13.0%	100.0%
Jun-13	3.6%	9.0%	30.8%	30.5%	12.1%	13.9%	100.0%
Dec-13	3.7%	9.3%	29.0%	32.0%	12.1%	13.9%	100.0%
Jun-14	3.8%	9.4%	28.5%	31.8%	12.4%	14.0%	100.0%
Dec-14	3.8%	9.5%	28.3%	31.8%	12.6%	14.0%	100.0%

Source: ATO SMSF data statistical report, December 2014.

Of course, this is not the asset mix of the average fund, and it's likely that a large percentage of SMSFs have their assets concentrated in just one asset class.

We believe that the reasons for SMSFs concentrating their assets in Australian equities, cash and property are as follows.

Australian equities

Investors have been chasing high dividend yields, especially when combined with franking credits. Many investors have probably never experienced a major market downturn. We know from history that equity markets fall by about 50% once every 10 years. Unfortunately, we can never predict the year of the next major fall, how long it will last and how long it will take to recover. Furthermore, many of these investors have probably piled into the market after the first few years of the bull market since 2008-2009.

Cash

These investors were probably burnt during the last major crash in 2008, and have been trying to avoid risk. The problem for them is that the RBA's target cash rate is now 2.25% and may fall further.

Unlisted property

These investors understand that equity investments should comprise a large part of their portfolio, but are worried that share investments are far too risky, and that property investments are safer. They also believe:

a) Property asset values are less volatile than share asset values. Because share values change every day, they appear to be more volatile than property values. Most properties are only valued once a year, and valuers, being paid by property managers, have a vested interest in 'smoothing out' fluctuations in property values. This point is illustrated by the fact that values of listed property trusts are far more volatile than the valuations of the underlying unlisted properties.

b) Property is less liquid than shares. Investors should demand a premium for this lack of liquidity over shares, which is currently not available.

In addition, property promoters constantly spruik investments in off-the-plan property developments, which are even more risky than normal unlisted property. This is because the investor accepts what is known as 'construction risk', the risk associated with building the property, for which the investor does not receive an additional risk premium.

Furthermore, many trustees feel they have been let down by traditional investment management when markets have fallen. As a result, they mistakenly believe that by taking direct control of their own investments, they will receive a better outcome.

In reality, their financial planner, if they have one, has not properly engaged with them in determining their risk tolerance, and they have likely gone missing when markets crashed. By properly engaging with their clients, financial planners will be able to keep their clients during periods of market uncertainty, and receive additional clients as a result of positive referrals.

Diminishing the risks

Such a high level of investment in property and shares is probably much more risk than is consistent with SMSF investors' risk tolerance or financial needs. SMSFs are saving for retirement and such a high exposure to growth assets involves more risk than they need to meet their cash flow. Good investment advice can help to minimise this risk. At the very least, advisers should be testing the risk tolerance of SMSFs to determine suitable investments for their clients.

Geographic diversification is also important. There are unlimited opportunities to diversify SMSF exposures across different asset classes and geographies, thereby reducing investment risks. The benefits potentially include stronger returns. US markets have, for example, outperformed Australian markets over the past 12 months and the fall in the Australian dollar has magnified returns. If the

Australian dollar continues to fall, then we could see even further gains from international shares. Most SMSF investors are currently missing out on these gains.

Paul Resnik is a co-founder of FinaMetrica, a provider of psychometric risk tolerance testing tools and investment suitability methodologies to financial advisers in 23 countries. Paul has 40 years of experience in the financial services. Peter Worcester is an actuary who also has 40 years of experience in financial services, and he was a key witness for the Joint Parliamentary Committee investigation into Storm Financial. This article contains general information only and readers should seek their own professional advice.

Ten great quotes from Buffett's annual letter

Graham Hand

Warren Buffett's annual letter to Berkshire Hathaway shareholders is always eagerly awaited and this week's did not disappoint. It marks 50 years since Buffett and Charlie Munger took charge, and each has summarised expectations for the next 50. Anyone short of time could read the expectations section, starting on page 34. Here are some direct quotes from the letter.

1. The best days lie ahead

Indeed, who has ever benefited during the past 238 years by betting against America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, real per-capita U.S. output has sextupled ... The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead.

2. Volatility is not risk

Stock prices will always be far more volatile than cash-equivalent holdings. Over the long term, however, currency-denominated instruments are riskier investments – far riskier investments – than widely-diversified stock portfolios that are bought over time and that are owned in a manner invoking only token fees and commissions. That lesson has not customarily been taught in business schools, where volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is far from synonymous with risk.

For the great majority of investors, however, who can – and should – invest with a multi-decade horizon, quotational declines are unimportant. Their focus should remain fixed on attaining significant gains in purchasing power over their investing lifetime. For them, a diversified equity portfolio, bought over time, will prove far less risky than dollar-based securities.

3. Forget market timing and forecasting

Investors, of course, can, by their own behavior, make stock ownership highly risky. And many do. Active trading, attempts to "time" market movements, inadequate diversification, the payment of high and unnecessary fees to managers and advisors, and the use of borrowed money can destroy the decent returns that a life-long owner of equities would otherwise enjoy. Indeed, borrowed money has no place in the investor's tool kit: Anything can happen anytime in markets. And no advisor, economist, or TV commentator – and definitely not Charlie nor I – can tell you when chaos will occur. Market forecasters will fill your ear but will never fill your wallet.

4. Difficult to find good investment managers

There are a few investment managers, of course, who are very good – though in the short run, it's difficult to determine whether a great record is due to luck or talent. Most advisors, however, are far better at generating high fees than they are at generating high returns. In truth, their core competence is salesmanship.

5. The conflict of acquisitions versus spin offs

Investment bankers, being paid as they are for action, constantly urge acquirers to pay 20% to 50% premiums over market price for publicly-held businesses. The bankers tell the buyer that the premium is justified for "control value" and for the wonderful things that are going to happen once the acquirer's CEO takes charge. (What acquisition-hungry manager will challenge that assertion?) A few years later, bankers – bearing straight faces – again appear and just as earnestly urge spinning off the earlier acquisition in order to "unlock shareholder value." Spin-offs, of course, strip the owning company of its purported "control value" without any compensating payment. The bankers explain that the spun-off company will flourish because its management will be more entrepreneurial, having been freed from the smothering bureaucracy of the parent company. (So much for that talented CEO we met earlier.)

6. Investing in Berkshire Hathaway shares

For those investors who plan to sell within a year or two after their purchase, I can offer no assurances, whatever the entry price. Movements of the general stock market during such abbreviated periods will likely be far more important in determining your results than the concomitant change in the intrinsic value of your Berkshire shares. As Ben Graham said many decades ago: "In the short-term the market is a voting machine; in the long-run it acts as a weighing machine." Occasionally, the voting decisions of investors – amateurs and professionals alike – border on lunacy. Since I know of no way to reliably predict market movements, I recommend that you purchase Berkshire shares only if you expect to hold them for at least five years. Those who seek short-term profits should look elsewhere.

7. Long-term survival

Financial staying power requires a company to maintain three strengths under all circumstances: (1) a large and reliable stream of earnings; (2) massive liquid assets and (3) no significant near-term cash requirements. Ignoring that last necessity is what usually leads companies to experience unexpected problems: Too often, CEOs of profitable companies feel they will always be able to refund maturing obligations, however large these are. In 2008-2009, many managements learned how perilous that mindset can be.

8. Investors panicking

The reason for our conservatism, which may impress some people as extreme, is that it is entirely predictable that people will occasionally panic, but not at all predictable when this will happen. Though practically all days are relatively uneventful, tomorrow is always uncertain. (I felt no special apprehension on December 6, 1941 or September 10, 2001.) And if you can't predict what tomorrow will bring, you must be prepared for whatever it does. A CEO who is 64 and plans to retire at 65 may have his own special calculus in evaluating risks that have only a tiny chance of happening in a given year. He may, in fact, be "right" 99% of the time. Those odds, however, hold no appeal for us. We will never play financial Russian roulette with the funds you've entrusted to us, even if the metaphorical gun has 100 chambers and only one bullet. In our view, it is madness to risk losing what you need in pursuing what you simply desire.

9. Charlie's simple blueprint

From my perspective, though, Charlie's most important architectural feat was the design of today's Berkshire. The blueprint he gave me was simple: Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices.

10. Cut out the bureaucracy at headquarters

At headquarters, we have never had a committee nor have we ever required our subsidiaries to submit budgets (though many use them as an important internal tool). We don't have a legal office nor departments that other companies take for granted: human relations, public relations, investor relations, strategy, acquisitions, you name it. We do, of course, have an active audit function; no sense being a damned fool. To an unusual degree, however, we trust our managers to run their operations with a keen sense of stewardship.

Can an SMSF run a business?

Monica Rule

I am often asked whether an SMSF can run a business. The usual reason for this question is not because the SMSF trustees are thinking of starting a conventional business, but because they are attracted to their SMSF running a share trading business. I'll explain why later.

While the superannuation law does not specifically disallow an SMSF from conducting a business, the activities of the SMSF trustee must not contravene super law provisions, including:

- *The sole purpose test*. The purpose of an SMSF is to provide retirement benefits or retirement related benefits for its members and their dependants. So, if an SMSF is conducting a business, it could be perceived that the money in the fund is being used to provide a current-day benefit to its members instead of it being there for their retirement.

- *Investment strategy*. An SMSF trustee must formulate and give effect to an investment strategy. This means the nature of the business activities and the manner in which they are conducted must be in accordance with the investment strategy of the SMSF.

- *Lending*. An SMSF trustee is prohibited from lending money or providing financial assistance to members and relatives. Therefore, the business activities must not involve selling an asset of the SMSF for less than its market value; purchasing an asset for greater than its market value; acquiring services in excess of what is required; or paying an inflated price for services acquired from members or relatives.

- *Borrowing*. An SMSF must not draw upon a bank overdraft or margin lending product to fund its business activities nor can it borrow money for the business by taking out a mortgage over the SMSF's assets.

- *Arm's length investments*. An SMSF must not employ a member or a relative in the business at a salary higher than the going rate.

Of course, many of these contraventions now come with steep penalties imposed by the regulator.

A share trading business in an SMSF

If a person is an ordinary share holder then the cost of purchasing shares is not an allowable deduction, and the losses from sales of shares cannot be offset against the income of the SMSF but is instead offset against capital gains received from the sale of those shares. On the other hand if a person is a share trader, they can treat the shares as trading stock and claim deductions for costs incurred in buying and selling shares.

The Australian Taxation Office will determine which category a person belongs to on a case-by-case basis. The general rule is that a share trader is classed as someone who is undertaking business activities for the purpose of earning an income from buying and selling shares. It is the volume and frequency of transactions that is important and not necessarily the amount of capital invested. Other important factors would include things such as evidence of a business plan and keeping records in a business-like manner.

Nevertheless, what people need to be aware of is that a law was introduced in June 2012 that abolished trading stock exceptions for SMSFs. This law limits the ability of SMSFs to pass gains and losses from certain assets (e.g. shares, units, land) through the revenue account. Gains and losses are treated in accordance with the capital gains tax provisions. However, if an SMSF did hold assets as trading stock prior to 10 May 2011 then it can continue to be taxed on revenue account.

So whether an SMSF is conducting a share trading business or not, all share trading activities of the SMSF will now be treated as an investment and the capital gains tax provisions will apply. If you were thinking of a share trading business solely as a way of avoiding capital gains tax then you will need to rethink your plans.

Monica Rule worked for the ATO for 28 years and is the author of the book titled "The Self Managed Super Handbook – Superannuation Law for Self Managed Super Funds in plain English"
www.monicarule.com.au

What are wealth industry regulators thinking about?

Graham Hand

At the SMSF Association Conference on 19 February 2015, representatives from Australian Securities and Investments Commission (ASIC), Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (ATO) spoke at a session called, 'The evolution – Superannuation as the leader in the wealth industry'.

None of these presentations (which have been edited and paraphrased rather than quoted directly) have been posted on the respective websites.

Chris Jordan, Commissioner, ATO

We have a major transformation programme called 'Reinventing the ATO'. It's aimed at improving the overall experience of those who deal with us in tax or superannuation. It is designed for the majority who do the right thing, and not for the minority who do not. I want to cut red tape and make complying easier. Transforming the ATO is not just about communication and online products, it's about how we change our approach, including to SMSFs.

Generally, within eight weeks we will risk assess SMSFs that have a contravention and we'll notify them of any action. It used to be up to 12 months. Our three categories are:

1. Low risk funds, where we have done a review and we will take no further action.
2. Medium risk funds, where we will contact the trustees by phone about the contravention to resolve the issues. With some ongoing discussions, we can usually reach a 'no further action' point.
3. High risk funds, where we progress to a comprehensive audit within three months of notification.

All trustees who have had contraventions noted will know where they stand quicker.

It's extremely important how advisers, accountants, auditors and trustees work together to ensure all people understand their obligations and the need for adequacy of retirement savings. We work with ASIC to ensure the integrity of auditors in the sector. One example is we recently approached 280 auditors about their claimed level of activity who said they did not have a requirement to sit an exam. People don't realise we can count the number of returns they have done. It's not that hard.

We look at the 150 highest risk auditors each year out of the 6,650 auditors listed on 2013 returns. We will also contact about 300 auditors where we have concern about their independence. We work well with APRA and ASIC, and we're on many forums and industry advisory groups.

We want to make sure people have modern technology, using the right software, and trustees and advisers know the difficulty of going from accumulation to pension phase, and we look at Limited Recourse Borrowing Arrangements. We are concerned about some of the heavy marketing and promotion of particular property developments using their funds as a vehicle. People might lose sight of the investment and be sold heavily on the tax benefits.

Less than 1,500 SMSFs have over $10 million, there are five SMSFs with over $100 million. They tend to be very old people in those funds who put a lot in over many decades, and I can tell you, they're legitimate because we've looked at them. Often they've been lucky. They have not made contraventions. You don't design a system for a handful of large SMSFs.

Peter Kell, Deputy Chairman, ASIC

ASIC's primary role is not about regulating SMSFs as such but regulating the gatekeepers who provide products and services. Financial planners, accountants, SMSF auditors, mortgage brokers and product providers are pretty much all regulated by ASIC. Our aim is to ensure these professionals carry out their work in such a way that the SMSF sector continues to succeed. Obviously, if we see some of these gatekeepers fail, that's when there will be a regulatory response.

We've had a particular focus on financial advisers in recent times. Last year we set up a wealth management team to look at the advice provided by the largest financial planning firms. We've also focussed on life insurance. In the SMSF space, we set up a task force in 2012 to examine some of the higher risk areas in this sector, and I'd like to mention two.

One is the risk of over-aggressive property spruiking, and I hardly need to explain why some of the activity at the moment lends itself to that sort of activity. This is not affecting the majority of SMSFs but we want to make sure it does not grow. We want to address the risky activity at the margin before it becomes widespread. Providing financial product advice which requires a licence includes making a recommendation or a statement to a person to set up an SMSF or to use an SMSF to purchase real property. It's not the case if you're operating outside an SMSF. The real estate industry has not necessarily understood that. We are seeking to take action against the unlicensed activity we see out there. Our aim is to make sure the spruikers do not build up a head of steam in a sector which is working well.

The second area of risk is our focus on false and misleading advertising. We have especially looked online at free set up or free benefits of one sort or another for establishing an SMSF. If only life was that simple. Normally what we have found when you look behind it is that there are significant costs. We don't want people being encouraged to set up an SMSF when it's purported to be free, in effect being misled. We are targeting new media and something like YouTube as in many cases, more people will see something like that than an ad in the newspaper.

On SMSF auditors, we are ensuring people who want to be in this space have the right qualifications. In December 2014, we cancelled the registration of 440 SMSF auditors who did not undertake or pass their competency exam.

Helen Rowell, Executive Board Member, APRA

I want to touch on three areas mentioned in the FSI: governance, retirement income options and how we access the performance of the industry.

On governance, implementation of the Stronger Super reforms has been a priority for APRA, aimed at enhancing the risk management practices of the industry. Our experience on how the super industry is going is only average. Whilst there's been effort and goodwill, it's hard to do good risk management if you have not got good governance and culture. It's the role of the Board to ensure there's a good culture in the entity, and the trustees on the Board must have a wide range of skills and capabilities. The industry must think about the process of appointment and selection of Board members. The evidence that we need independent directors is our experience in other APRA-regulated industries. Adding independent directors does lift the standard of governance. It adds a lot of value into the way the Board operates.

On retirement income options, there is a limited product set available, partly because of regulations but also due to individuals and their thinking. There's a focus on the pot of money at retirement rather than what they need after that. Murray will shift the emphasis, including some of the policy initiatives. It concerns us how some APRA-regulated institutions are managing the risk of providing incomes through retirement, so we're looking at product design and the level of guarantees, which a super fund without any capital cannot provide. There are investment issues to consider because the investment, liquidity and cash requirements around drawdown of income are difficult versus accumulation of a lump sum. Some of the systems, processes and advice models are also different. We are challenging the industry to think about these issues as we head towards pension provision.

On industry performance, the FSI focussed on why costs haven't come down. My response is that we should not only look at costs, it's no good delivering the cheapest system in the world if it's not delivering the best retirement outcomes. We want trustees, when thinking about the scale of their business, to consider a broad range of factors and it's not just about being the biggest or the cheapest. They need to look at their entire offering.

One last point on complexity. I was staggered recently when we looked at some of the reporting to find that there are over 40,000 investment options offered across the APRA-regulated space. There is no need for this across the super industry, we need to get rid of that complexity.

Graham Hand attended the Conference as a guest of the SMSF Association.

Illiquid assets and long term investing

Geoff Warren

Many people would place 'capturing the illiquidity premium' at the top of their list of benefits from long-term investing. However, extracting additional returns from illiquidity is not as simple as just buying and holding any illiquid asset. Returns to illiquidity vary across investors, markets and time. In this article, I sketch out the traits of illiquid assets. Investors should ask two questions before seeking the illiquidity premium. First: *Am I suited to investing in illiquid assets?* Second: *Am I being adequately rewarded?*

Trait 1: Illiquid assets involve additional costs and risks

Exposure to illiquidity brings with it additional costs and risks:

- *Illiquid assets cost more to transact.* The additional transaction costs often appear as greater 'market impact', i.e. the need to pay a price premium to get set, or accept a price discount to exit. Costs of locating, analysing and accessing illiquid assets can also be higher, especially in unlisted markets, including advisory fees and agent commissions.

- *Illiquid assets cost more to hold.* Many illiquid assets involve higher ongoing expenses, related to management, monitoring, and capital commitment. For instance, investment managers charge considerably more in unlisted markets.

- *Illiquidity = loss of flexibility.* Illiquid assets take longer to transact, and in some circumstances, trading may be prohibitively costly or even impossible. The inability to trade quickly, or at an acceptable price, can result in being stuck with a portfolio.

- *Risk of being a forced seller at the wrong time.* Liquidity is like finding a taxi: plentiful when not required, hard to find when really needed. When markets come under pressure, not only does illiquidity tend to worsen, but the chance of some investors losing funding and becoming forced sellers rises. Market crises can go hand-in-hand with redemptions, margin calls, withdrawal of trading capital, and so on. Becoming a forced seller at the wrong time can be very, very costly.

Trait 2: Impact of illiquidity varies across investors

The impact of illiquidity will be typically lowest for those with high discretion over trading, which was nominated in my first article as characteristic of long-term investors. Being able to choose when to trade facilitates waiting patiently for a high return premium before buying. Once invested, it provides the scope to continue holding. Longer holding periods dilute the influence of transaction costs on returns. In rough terms, transaction costs of 10% reduce returns by ~10% over a 1-year holding period; by ~2% over 5 years; by ~1% over 10 years, and so on. Further, an investor with discretion over trading is never a forced seller, while short-term investors are more exposed because they may not always have a choice.

Trait 3: Pricing depends on how illiquidity impacts the marginal investor

The identity of this 'marginal investor' is pivotal to who sets the price, as it dictates the magnitude of the opportunity. An important question to ask is: "*who is setting prices in this market?*" Before expecting an excess return, an investor should be facing off against a marginal investor who is more affected by illiquidity, and places a high value on liquidity.

Trait 4: The marginal investor varies

The identity of the marginal investor varies with market context and the extent to which illiquidity is reflected in prices. At times, a high illiquidity premium can be on offer. At other times, it may be non-existent. It is during liquidity crises that investing in illiquid assets can be most lucrative, as the marginal investor is more likely to be a desperate seller who pays handsome rewards for providing liquidity. For example, a large illiquidity premium seemed evident in bond markets during the GFC, when US Baa corporate bond spreads over treasuries exceeded 7% amidst a near-complete drying-up of liquidity. These spreads subsequently fell back to well below 2%. In contrast, no illiquidity premium currently appears on offer in unlisted infrastructure, notwithstanding being a clearly illiquid asset. Infrastructure prices are being set by funds with long horizons and a flood of capital to invest. Thus the marginal investor is not only highly tolerant of illiquidity, but is willing to pay a price premium (accept a return discount) to get set.

Trait 5: Yields are a key indicator

A good indicator of the compensation for illiquidity is the level of prices relative to income, e.g. the yield. The logic is as follows. The costs associated with illiquidity might be thought of as additional cash outflows; while the additional risks might be viewed as requiring a higher discount rate. Recognition of these features means a lower price per unit of income. If a large illiquidity premium is on offer, illiquid assets should trade on noticeably high yields either relative to their more liquid counterparts, and/or relative to that seen during more liquid times.

Summing up

The answer to the first question of '*Am I suited to investing in illiquid assets?'* depends on the degree of discretion over trading held by an investor, as well as how costly it is for them to access illiquid assets relative to the marginal investor. Investors who may be poorly suited to investing in illiquid assets might include institutions with limited control over their funding; or smaller investors who lack the capacity to access illiquid assets at a reasonable cost. The answer to the second question of '*Am I being adequately rewarded?'* hinges on the nature of the marginal investor in a particular market and is evidenced by a sizeable yield premium. The answers are likely to lead to a more dynamic approach, whereby illiquid assets are purchased in times of markets stress when large premiums are on offer, and exited when liquidity is plentiful and the illiquidity premium is skinny.

Geoff Warren is Research Director at the Centre for International Finance and Regulation (CIFR). This article is for general information purposes and readers should seek independent advice about their personal circumstances.

This series of Cuffelinks articles brings out the key messages from a research project examining long-term investing, conducted by CIFR in collaboration with the Future Fund. The full report, which comprises three papers, can be found at: http://www.cifr.edu.au/project/T003.aspx

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