Cuffelinks
Connecting investors with ideas

Edition 110, 22 May 2015

This Week's Top Articles

- **SMSF trustees have longer lives and more certainty** *Doug McBirnie*
- **Platinum's Kerr Neilson: it's all about the price** *Graham Hand*
- **What exactly is the ATO's role in SMSFs?** *Gordon Mackenzie*
- **Why a good active manager should outperform** *Chris Stott*
- **How to think rationally about shares** *Roger Montgomery*

SMSF trustees have longer lives and more certainty

Doug McBirnie

One of the greatest risks facing retirees today is the uncertainty over how long they might live. How do you plan your retirement when you don't know how long you need your savings to last? Whilst an individual's lifespan can never be known for certain, the more information retirees have on how long they are likely to live, the easier it will be to make sustainable retirement plans.

The most commonly quoted life expectancy figures are from the Australian Life Tables and are based on the whole population. If we allow for recent trends in improving mortality to continue, these tables show that 65 year-old Australian men have a life expectancy of 87 and women, a life expectancy of 89. However, different cohorts of the population will live longer than others.

Wealth and education lead to longer lives

Research from around the world has shown that wealth and higher levels of education are strongly correlated with longer life expectancy. SMSF trustees are, on average, both wealthier and better educated than the average Australian so they are one such cohort that might be expected to live longer than the average.

In the first research of its kind in Australia, Accurium's SMSF Retirement Insights paper, *SMSF Trustees - healthier, wealthier and living longer*, carried out a mortality investigation on the 65,000 SMSFs in its database to test this hypothesis and calculate how much longer SMSF trustees might live. The results showed that SMSF trustees can expect to live around three years longer in retirement than average.

The table below shows the life expectancies of SMSF trustees in retirement compared to the population as a whole:

Life expectancy from age 65	Males	Females	Couples (last survivor)
Australian population	86.6	89.0	92.7
SMSF trustees	89.8	91.5	94.5
Difference	*3.2*	*2.5*	*1.8*

Half will live even longer

While life expectancies are helpful for retirement planning, few people will live to their exact life expectancy. Even amongst SMSF trustees, only one in six will live to within a year either side of the life expectancies shown above. Life expectancy is just an average. In fact over half of SMSF trustees will live beyond this.

Many retirees want greater certainty that their savings will last for life so it can be useful to look at the probabilities of living to older ages. Accurium's research predicts the proportion of trustees who will survive to each age in retirement. These figures can be used as confidence levels for retirees when setting their retirement planning horizons. The table below shows the age trustees retiring at age 65 should plan for with differing levels of confidence:

Planning horizon from age 65 for SMSF trustees	Males	Females	Couples (last survivor)
50% confidence	91	92	95
80% confidence	95	97	99
90% confidence	98	99	100

For example, one in five 65 year-old women with an SMSF is expected to live to age 97, therefore those wanting 80% confidence in their retirement plans should be planning for their savings to last around 32 years. A couple wanting 90% certainty should be planning for living for a further 35 years to age 100.

The price of long lifespans is a high cost of retirement and requires trade-offs between how much an SMSF couple spend each year in retirement and how much risk they are willing to accept around outliving their capital.

'Typical' couples may need $1.3 million to $2.5 million

Accurium estimates that a 65 year-old couple wanting to spend $70,000 each year and willing to accept an 80% probability of a successful outcome would need $1.3 million as an SMSF starting balance; those wanting to spend $100,000 a year would need a starting balance at 65 of $2.1 million. To achieve 95% certainty that they won't outlive their capital, that same couple would need $2.5 million if they wished to spend $100,000 per year.

Exactly how long an individual is expected to live has been found to be affected by a number of different factors as well as age and gender. Factors that are known to influence individual life expectancy include smoking, genetics (e.g. family history of certain diseases), current health problems (such as diabetes), occupation and geographic location. SMSF trustees retiring in good health are likely to fall into the higher percentiles for life expectancy and should be planning accordingly.

An important conclusion is that, while fewer SMSF trustees will pass away in the early years of their retirement compared with the population as a whole, a greater proportion will live to their mid-nineties. SMSF trustees can have greater certainty over how long they will live.

Longevity risk for a retiree isn't the risk that they will live a long time; it is the risk that they will live longer than they have planned for. As long as trustees set their retirement plans using appropriate time horizons, this research shows that SMSF trustees really can have their cake and eat it. Not only will they live longer than the average Australian, but they actually have less longevity risk too.

To download the full research paper on *SMSF Retirement Insights*, click here.

Doug McBirnie is a Consulting Actuary at Accurium. This information is factual and is not intended to be financial product advice or legal advice and should not be relied upon as such. You should seek appropriate professional advice before making any financial decisions.

Platinum's Kerr Neilson: it's all about the price

Graham Hand

Kerr Neilson, Managing Director of Platinum Asset Management, was interviewed by Vincent O'Neill, Director of Private Wealth at Stanford Brown, on 24 April 2015 at the Stanford Brown Quarterly Investor Insight luncheon.

VO: What makes a good investment manager?

KN: You need to have some idea about what you bring to the game. You wouldn't enter the Olympics without some 'edge', and it's the same in the investing business. You have to define your 'edge' to yourself. One 'edge' you could bring is that which others find difficult, such as thinking in a contrarian manner. There's a big problem with investments. Believe it or not, there's no specific price for any asset. Some good companies are now worth 10 times the amount they got down to in the GFC. They haven't become 10 times better companies. When you buy and sell in the stockmarket, you need to have a reference point against what other people think. Value can shift around massively. You need to be a contrarian to start looking for gaps. You need a way to distill out the confusion and noise.

VO: And what have you changed or learned over the years?

KN: Like all investors, you initially start looking for a bargain. But now we have the internet, it's completely transformational. It's as important as the railways and the automobile. On the one hand, you know what you'd pay for traditional companies, but then you've got this ginormous event which opens up the world to everyone. A company can be so much more valuable even though it started in a garage in Sydney. The value proposition is difficult to understand. With these changes, you need to change your own approach, at least at the margin.

VO: And you need a recognition that some are speculative.

KN: You need a high upside to justify the uncertainty and you need peripheral vision. A problem analysts have is that they spend a lot of time on a company, and they feel they need to be rewarded for that time. They still want to buy it, but you can't do that if you're running money.

VO: In what conditions does Platinum underperform?

KN: The times we are least effective are the times like the last six years, where there is little dispersion of valuations, and huge trending. The herd is going in one direction. The one market you had to be in was the US, and we have been progressively moving out of it.

VO: Does that make it difficult for you, as people question your stance?

KN: You need to build a team slowly over a long period of time because you have to think differently. To keep people of that nature is not easy, it's a certain type of mentality.

VO: You're a keen student of history. Can you share some of the key lessons from the past, including any insights for the current conditions of extreme monetary policy.

KN: You don't need to be an historian, just start with the human condition. We are all slaves to our frailties, and we have little ability to suppress those animal instincts: fear, greed, jealousy, all these weaknesses we have. When you read the literature of the 1930's, we had all this discussion about when to tighten monetary policy, and then you had some very volatile markets. So you can find precedents in history, but you must always look for the differences. We have a big change which is globalisation, and it is more powerful now. We have a transfer of capital and technology, and a massive pool of labour in China and India that is priced at $100 a week rather than $100 an hour. You need to be careful because we'll have a lot of labour substitution which implies that growth in the West will be lower. The gap is so huge and the biggest problem we face is this arbitrage of labour costs. Through technology, you can quickly teach people how to do things, you can automate so much of this.

VO: Older people spend less on goods and services, they don't have babies or buy houses, while they have higher health costs. What do you think about the drag on global growth from changing demographics over coming decades?

KN: In my view, technology is more disruptive than the ageing of the population. And India and Indonesia have the opposite problem of millions of young people entering the labour force, what do they do? The challenge is expectations. We've had 24 years of growth in this country. We're not prepared to make these adjustments and it will come through the exchange rate. I don't think the exchange rate will drop right now, but our labour costs are making us uncompetitive, so there must be more reduction in the currency. Our expectations have to be reined in.

VO: Can you talk us through your views on China.

KN: China will grow slower and in our view, India will outpace it by a factor of two. China might go down to 4½% to 5%. It was spending $4 out of $10 on building for the future, capital works like bridges and roads. In China, the locals are switching from property to shares, at the same time superannuation and insurance is growing, so there is more of a market economy going into financial assets. We can still buy companies at reasonable prices but they've moved very quickly.

Here's a point I can never repeat often enough. This business is not about creativity and great dreaming. It's all about price. When the price of something has collapsed by two-thirds, as the Chinese stockmarket did until a year ago, that's not when you get worried. It's when it's gone up three-fold you should be worried. When it goes down you should be delighting in the prospect. Let me labour this point. If I offered you the car of your dreams, you'd be hounding me to tell you the price. I used to be in stockbroking, and as prices went up, our clients really lusted after shares as they became more expensive. But that's not what they'd do with their Mercedes Benz S- Class.

VO: You've had a lot of exposure to Japan, can we expect Japanese companies to be managed to deliver shareholder value better?

KN: This is a remarkably introverted country, but we are seeing clear evidence of the leading companies changing in the way they select directors and the focus on profit. They don't have bad returns on sales but they always over invest. They have such social cohesion that they'll all fall into line. The market's around 20,000 and it's likely to get to 25,000 and then get into trouble at 30,000 – I think it's got 50% to go over the next couple of years. When you have a currency that falls from 75 to 120, your cost competitiveness is spectacular.

VO: What are your views on the economic outlook for Europe.

KN: The central problem is the productivity gap between the north and the south. The south can't close the gap. There's no central exchequer, there's no backing of a central bank. I suspect somewhere down the line we will get into trouble again.

VO: Are you still happy to be overweight in shares and not too much in cash at the moment?

KN: It depends on your time frame. In 1939 if you owned shares in Deutschland and your cities were flattened and industrial base destroyed, it took until 1954 to get your money back. The same is true in Japan. The only places that you did not retrieve your wealth was in China and Russia because there was a regime change. So you're talking to a junkie here, we always see the benefit of shares because of the rewards over the long history. The trouble is, most of us go to water because we do not fully comprehend that it's the very essence of our living, our whole structure, to own these companies. To lose faith in equities, you have to believe there's a change in the entire structure. A fundamental change in the economic management of the system. So that's why we say it is volatile but it is the underpinnings of our living standards. Even in the worst of times, capital will migrate to the best business opportunities. It's a constant in our system, and to lose that, you must think we're going back to some form of central control and ownership.

Please take away from this one critical message. Price is critical. What does the price say? It's not about the headlines, it's what is in the price.

This information is commentary only (ie general thoughts). It is not intended to be, nor should it be construed as, investment advice. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information. Before making any investment decision you need to consider (with your financial adviser) your particular investment needs, objectives and circumstances.

Graham Hand was a guest of Stanford Brown Financial Advisers.

What exactly is the ATO's role in SMSFs?

Gordon Mackenzie

In 1999 the regulation of SMSFs was moved from the Superannuation and Insurance Commission (subsequently APRA) to the Australian Taxation Office (ATO). At that time, it was suggested that the ATO acquired the role because SMSFs were seen to be just tax play vehicles, not serious retirement funding vehicles. So, in 2015 when SMSFs hold one-third of the $2 trillion or so in super, is it still correct to say that the ATO's role in SMSFs is just revenue protection? Or does the ATO have a role in ensuring that SMSF members have a comfortable retirement?

Comparing ATO and APRA regulation

Our starting point has been to compare the way that the ATO regulates SMSFs with the way that APRA regulates the institutional super funds it is responsible for (retail, industry and corporate super funds for example) against five criteria.

First, we looked at the main rule which links the way that a super fund is managed with the tax concessions received on contributions, fund income and benefit taxes: that is, how to be a 'complying superannuation fund'. The compliance test for SMSFs is different to that for the other type of super funds and, generally, it relates to ensuring that the assets of the SMSF are not misused, such as being a liquidity vehicle for a fund member who has an otherwise illiquid asset. What we also saw was that the chances of non-SMSFs falling foul of this rule are virtually zip.

Second, we looked at the 'covenants' in super fund trust deeds. Covenants are, in effect, standards of conduct by which the trustee must run the fund. Again, these differ between SMSFs and non-SMSFs and, importantly, the covenants applying to institutional funds are all directed at protecting the members of the fund from mismanagement by the trustee around various risks that members may be exposed to. On the other hand, the covenants by which a SMSF trustee must comply with relate again to protecting against misuse of the fund assets.

One important covenant for SMSFs is that at they have an 'investment strategy', which is referenced to things about investing such as having regard to asset/liability, liquidity and diversification. Interestingly, while the ATO will want to see the SMSF's investment strategy that is about as far as they go. They do not comment on whether it is good or bad. They just want to see that one exists.

Third, we looked at any differences in the application of the 'sole purpose test' between the two types of super funds. It's the principal regulatory tool for SMSFs and it comes from a 1967 High Court decision about whether a Western Sydney solicitor's super fund, which was running a property development business, was in fact, a super fund (it wasn't.) In any case, with two exceptions, all the cases on the sole purpose test have involved SMSFs. It's not a relevant issue for non-SMSFs.

Fourth, we looked at the rules restricting how a super fund invests. Again, with two exceptions, these rules apply equally to both types of super fund, but what we see is that most of these restrictions are about related-party transactions, which is also not an issue for non-SMSFs.

Finally, we looked at the difference in the style of regulation between the ATO and APRA. This is very telling as the way the ATO regulates SMSFs is against breaches of black letter laws, which, necessarily, can only be done after the breach has occurred. On the other hand, APRA is a prudential principle-based regulator, which assesses the risks to members in the way that the super fund is being run and then

offers guidance to the trustees about how to manage those risks. Of course, that is regulation in advance of a breach, besides being directed at protecting members' interests.

SMSF regulation is simply to ensure qualification for tax concessions

Overall then, our preliminary view is that the ATO simply regulates SMSFs to ensure that they are used for the purposes for which they receive tax concessions. For example, all that is required of an 'investment strategy' is that it exists, with no opinion on whether 0% or 100% of anything is suitable.

The next stage for us is to compare SMSF regulation with equivalent type pension funds in the US, Canada and the UK, to see how they do it and why. Also, we will have a look at how some other tax preferred funding vehicles are regulated, such as venture capital funds.

So what? Why do we need to know how SMSFs are regulated? Well, they do hold around $600 billion in assets so it would seem sensible to understand how they are regulated and whether this is appropriate, just in case we can make some suggestions for improvement. For example, is it reasonable that there is no guidance given to the trustee of a super fund on how money should be invested?

Gordon Mackenzie is a Senior Lecturer in taxation and business law at the Australian School of Business, University of New South Wales.

Why a good active manager should outperform

Chris Stott

The advent of cheaper and more novel financial products in the last decade has placed downward fee pressure on fund managers and focused attention on the merits of active versus passive fund management.

As an active manager at Wilson Asset Management, my position is clear, but in finance, scepticism is healthy and robust debate is good for both investors and the industry. Investors should be clear about the benefits and faults of both management styles.

To me the biggest issue is that passive managers fail to provide a reasonable answer to the obvious question: with many good active managers in the Australian market, why should investors settle for benchmark returns? These active managers consistently beat the benchmark, after fees, over the longer term. Despite this fact, much of the criticism of active managers is centred on their level of management and performance fees or the cost of an active versus passive managed portfolio.

Trends in the evolving market

Downward pressure on management fees during the past 10 years has been inescapable – most managers charged fees of around 1-2% in Australia whereas at one extreme, some overseas hedge funds charged as much 5%. This has fallen to an average of around 1% in Australia for plain vanilla long only equity funds. There is a growing trend towards no management fees, with performance fees only, where a fund manager backs their ability to beat the market providing a significant incentive system for investors.

However, we believe that in assessing the merits of an active manager it is important to look over the long term to see how they perform in all market cycles.

The latest Morningstar Australian Institutional Sector Survey 2015 found the average active large cap manager in Australia beat the market by 1.4% per annum over the past 10 years, whereas the average active small cap manager outperformed by 7.3% per annum over the same period. There is obviously a stronger argument for small cap management, where managers generally focus on undervalued growth companies where the overall market is far more inefficient.

Not all managers beat the market and thus investors should look for those that consistently outperform and 'stick out' in such surveys. It's important for fund managers to have as flexible a mandate as possible and thus be as active as possible. Beware the index huggers who charge active fees.

Key drivers of outperformance

While performance fees are somewhat taboo for many investors, they play a key role in driving the right behaviour. Many active fund managers work incredibly long hours to stay ahead of the game due to performance incentives. This chase for alpha and constant attention on the market translates to benefits such as meeting with investee company management and participating in capital raisings.

Many of our active peers regularly meet with management to stay closely attuned to what the companies are doing and what management is thinking. It is no exaggeration that most active small cap managers spend the majority of their week meeting with company executives. Unsurprisingly, this research drives a lot of alpha and represents a serious value-add for investors who don't have the time or access to do it themselves.

Institutional investors benefit from immediate access to trading opportunities, which can include initial public offerings, placements, block trades, rights issues, corporate transactions and arbitrage opportunities. These trades present active managers with the ability to access value quickly and regularly. As retail investors are (unfairly) excluded from directly participating in many of these deals, they can take part indirectly through active managers.

On an after-tax basis, an active manager can offer better results depending on the structure of the investment vehicle. We are advocates of the listed investment company (LIC) structure, which can pay investors fully franked dividends derived from its investee companies and additional franking credits from any tax paid from its own company profit. This means that over time, as a LIC investor, your after-tax return can be enhanced by the use of franking credits, depending on where those shares are held and your applicable tax rate.

Avoiding bad investments

Active managers earn their keep in volatile markets, especially in downturns, where the flexibility to reallocate assets and preserve capital is of a higher importance. In contrast, passive funds are forced to ride the storm and absorb the market's losses. Similarly, active managers with a flexible mandate are able to avoid unattractive sectors and companies.

In Australia attempts to diversify by 'buying the market' through a passive index fund can backfire given the overrepresentation of particular sectors. Most investors would know enough from anecdotal evidence alone that resources have been a bad bet over the past few years. Worse still is an index's exposure to banks, which make up 30% of the All Ordinaries Index. The recent large-scale sell off in the major banks following negative industry news single-handedly drove the index down.

Final words

Investors without the time or access required to successfully manage a portfolio are well placed outsourcing the task to a good fund manager with a consistent track record. An active manager will work hard to find good investments, avoid bad companies and sectors, and manage risk. The better ones will outperform the index return, which is all an investor will achieve with a passive manager. Both will charge for the pleasure, however we believe good active managers offer greater value than passive managers.

Chris Stott is Chief Investment Officer at Wilson Asset Management.

How to think rationally about shares

Roger Montgomery

At times of buoyant markets and relatively easy gains, ask yourself whether your approach to investing in shares and building a portfolio condemns you to a lifetime of returns and emotions that rise and fall with the market. If a rising tide lifts all boats and if it's easy to mistake a rising market for genius, then it pays to examine the approach you have adopted to investing and ask whether it is repeatable and replicable.

Shares are pieces of businesses

It is cause for increasing dismay that despite the rise in popularity of shares and dividend yields, there has been no trend towards a rational approach. And perhaps surprisingly, this is true of both seasoned professionals and part time 'investors'. For example in the professional space, fund managers, in an effort to reduce portfolio risk, build portfolios of low covariance stocks – buying even very risky companies simply because their shares move in a different direction to the others. Perhaps even more worryingly, part time investors buy shares in companies without proper due diligence and in the hope they'll simply go up.

Indeed, John Kenneth Galbraith in his book *The Great Crash*, wrote that one of the key ingredients of a bubble was the replacement of considerations of an asset's long run worth, future income and its enjoyment, with base hopes of rising prices next week and next month.

Shares need to be treated as pieces of businesses rather than bits of paper that wiggle up and down on a computer screen. But few investors do this. Witness the professional investor who buys a company loaded with debt and a manufacturer of some generic junk because its inclusion in the portfolio reduces its overall volatility. Witness the same professional who cannot buy the shares of a great business when they are truly cheap, instead having to wait until the shares have risen sufficiently to cause them to be included in the S&P/ASX200. Buying shares this way or simply buying in the hope they will rise, is not the same as buying a piece of a business.

Over time, the value of a business changes only slowly, and much less than their daily prices on the stock market. The purchase of shares without reference to the quality or value of the business is no different to betting on black or red. Similarly, the focus on daily quoted prices of shares encourages the treatment of the stock market as a casino. Gamblers and those who frequent casinos tend to lose. In contrast, treating shares as pieces of a business helps investors outperform those who don't.

Focus on relatively few excellent businesses

Whether it is because it is seen as too difficult or produces too much volatility, few investors simply purchase at attractive prices, a portfolio of 15 to 20 excellent businesses. This is despite the fact that such an approach can produce substantial outperformance.

There are two steps investors need to adopt: first, identify superior businesses, and second, estimate their true value.

Identifying a superior business is easy. Simply look at its economic performance and earnings power.

In our previous article, *Airlines and indices*, I described the economics of an airline and explained how the behaviour of equity, debt, profits and return on equity, over years, provides an indisputable picture of the economics of a business as if it were owned in its entirety and how this can be used to select extraordinary businesses.

As Warren Buffett once quipped, "If you aren't prepared to own the whole business for 10 years, don't buy a little piece of it for 10 minutes."

Once you embark on an examination of a business from a business owner's perspective, using equity and return on equity, you not only create a list of candidates worthy of inclusion in a portfolio but you simultaneously simplify your investment process, by creating a benchmark.

A benchmark is a line in the sand or a corral against which you compare outsiders to those things already inside. Your investment process is simplified because nothing needs to be considered unless it is better than the things already on the inside.

Many investment professionals, and the academics who taught them, agree that you reduce your risk by diversifying broadly. I agree that if you buy shares in a lot of different companies whose share prices move in different directions, you will reduce the overall price volatility of your portfolio. But does it make sense to buy shares in an inferior company simply because its share price moves in a different direction to the others that you already have? Why on earth would you buy shares in your twentieth best thing, when you can buy more shares in your best holding? Why cut down your roses to let the weeds through? I believe you reduce real risk – the risk of permanent capital loss - by only owning superior businesses.

Great businesses have high rates of return on equity, little or no debt, bright prospects and sustainable competitive advantages. A sustainable competitive advantage is the intangible thing about a company that the competition cannot replicate or imitate. It's the reason people will cross the street to get the product even if the guy on this side has an alternative with a lower price. It's a barrier to entry or a barrier to imitation. Ultimately, it generates the high rates of return on equity. Over time such business should retain profits at a high rate and increase in intrinsic value at a similar rate to the rate of growth in their equity value. And if I told you that company XYZ's intrinsic value would rise substantially over the next 5 or 10 years, would it matter if the shares fell today?

Choose quality at the right price

Take the case of a company with a low rate of return on equity and little prospect of improving dramatically in the near future. Exclude it. What about a company with bright prospects for its product or service, no debt and 10 years of stable returns on equity of 30%? Include it. Eventually you fill a corral with companies showing a demonstrated track record of superior economic performance. No longer will you be tempted to dabble in the unknown, punting on whether the market or interest rates, employment or inflation will rise or fall in the next few days. Instead, you will keep a protective eye over a short list of great businesses, any of which are candidates for your portfolio if they become available at a discount to intrinsic value.

In our next column for Cuffelinks, we'll write about that intrinsic value, a DIY on estimating intrinsic value for popular mechanics.

Roger Montgomery is the Chief Investment Officer of The Montgomery Fund. This article is for general education purposes and does not address the specific circumstances of any individual.

Disclaimer

This Newsletter is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for your circumstances. To the extent permitted by law, no liability is accepted for any loss or damage as a result of any reliance on this information.

For complete details of this Disclaimer, see http://cuffelinks.com.au/terms-and-conditions. All readers of this Newsletter are subject to these Terms and Conditions.