

Edition 111, 29 May 2015

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**The long and short of hedge funds, Part 1**

**Craig Stanford**

Cuffelinks received the following reader question from Ron Myers about 'alternatives', an investing category which means different things to different people. In this response, we focus initially on hedge funds, in Part 1 showing the advantages and in Part 2 addressing the criticisms. A later paper will consider other definitions of 'alternatives'.

*"I am an avid reader of Cuffelinks and would like to hear more about 'Alternative Investments'. They seem to be becoming more and more popular as a de-risking strategy in balancing equity risk, however like most investments there appears to be just as many comments against as there are for, so would appreciate hearing from a source which I find presents such issues in an easily understood manner with good appraisal summaries."*

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Investing in hedge funds is one of the more polarising topics in the investment world. There are strongly-held views at each end of the spectrum, with little in-between. The advocates of hedge fund investing paint a rosy picture without acknowledging the negative aspects, while the critics paint the opposing view without acknowledging the potential benefits.

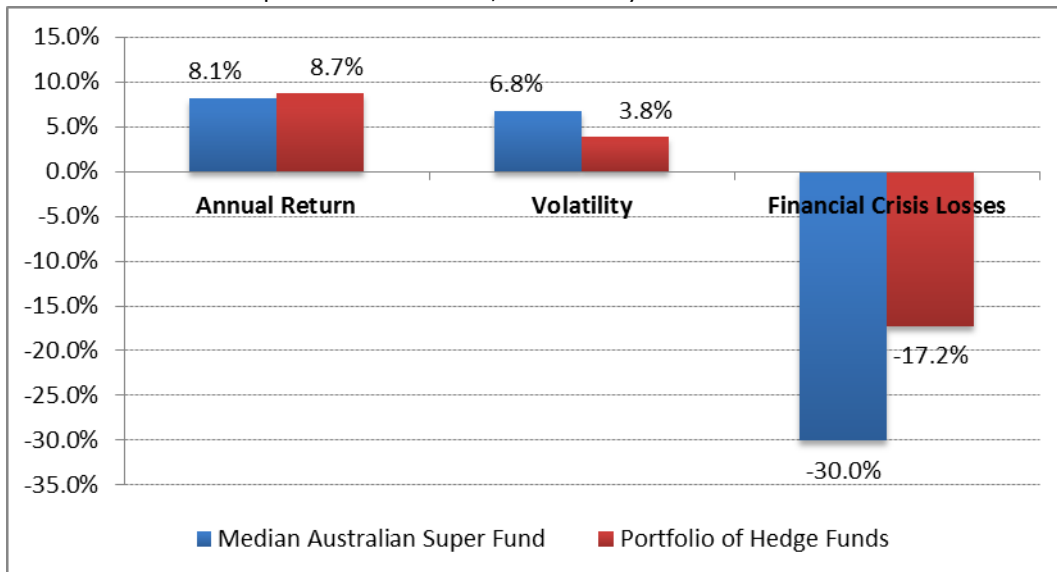
**Benefits and challenges**

The potential benefits of investing in hedge funds include improved portfolio risk/return characteristics, a reduction in the severity and frequency of losses as well as access to new and otherwise unavailable return streams. However, in order to achieve these benefits we have to address issues such as alignment of interests, higher fees, less liquidity, lower transparency and how to efficiently implement our exposure.

As active investors in hedge funds, we know that if we can manage these issues successfully, we're able to provide investors with the advantages mentioned above. The accompanying graphs show a range of these benefits, by comparing various performance metrics for a typical portfolio of hedge funds to the median Australian growth superannuation fund since 1990. The portfolio of hedge funds is represented by the HFRI Fund of Fund Composite Index, hedged into Australian dollars. This should be a fair representation of most investors' experience, because it includes multiple levels of fees and reduces survivorship bias.

The median Australian growth superannuation fund is taken from the Morningstar Australian Superannuation Survey – Multisector Growth universe, and draws on all funds in the survey which have a history dating back to 1 January 1990, a universe of eight underlying funds.

**Figure 1.** Returns, Volatility and Maximum Losses During GFC for Portfolio of Hedge Funds and Median Australian Growth Superannuation Fund, 31 January 1990 – 31 March 2015.



**Figure 2.** Value of A\$100 invested in Portfolio of Hedge Funds and Median Australian Growth Superannuation Fund, 31 January 1990 – 31 March 2015.

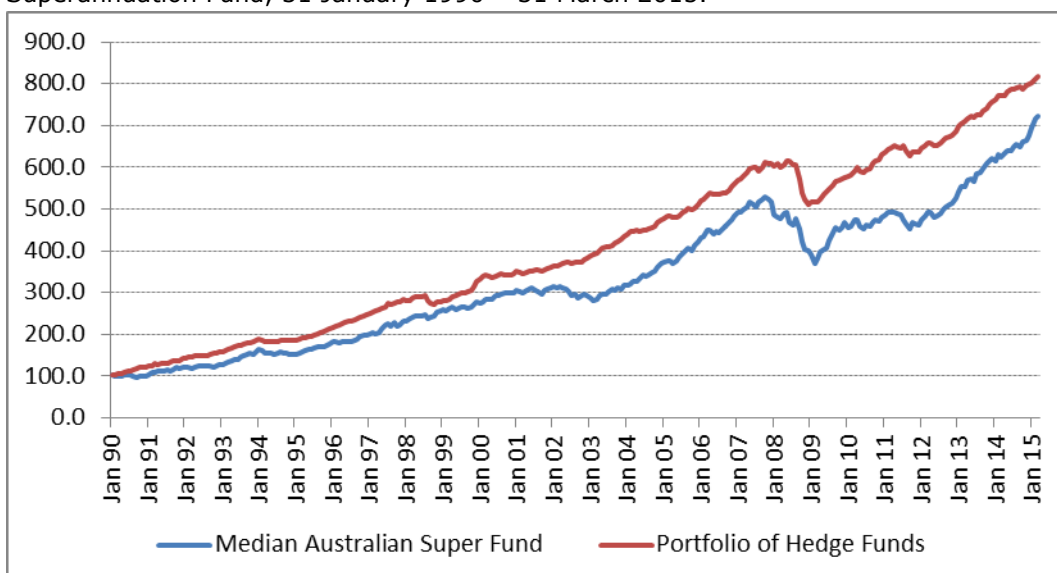


Figure 1 shows that over this period, the return from the portfolio of hedge funds has been higher (8.7% compared to 8.1%), with substantially less volatility. The median superfund also sustained losses that were over 70% greater during the financial crisis. As a result, the portfolio of hedge funds returned to its pre-crisis value well before the median super fund (Figure 2).

An issue to address is the poor general perception of hedge funds. The press frequently portrays hedge funds as speculators that are determined to destabilise markets, and media accounts of hedge funds losing money are common. Our experience of investing in hedge funds is that these characterisations are inaccurate, while not denying that certain investors have experienced losses from investing in hedge funds. This highlights the importance of due diligence, which we regard as a critical part of the investment process in order to avoid investing in hedge funds where there may be catastrophic trading losses or fraud.

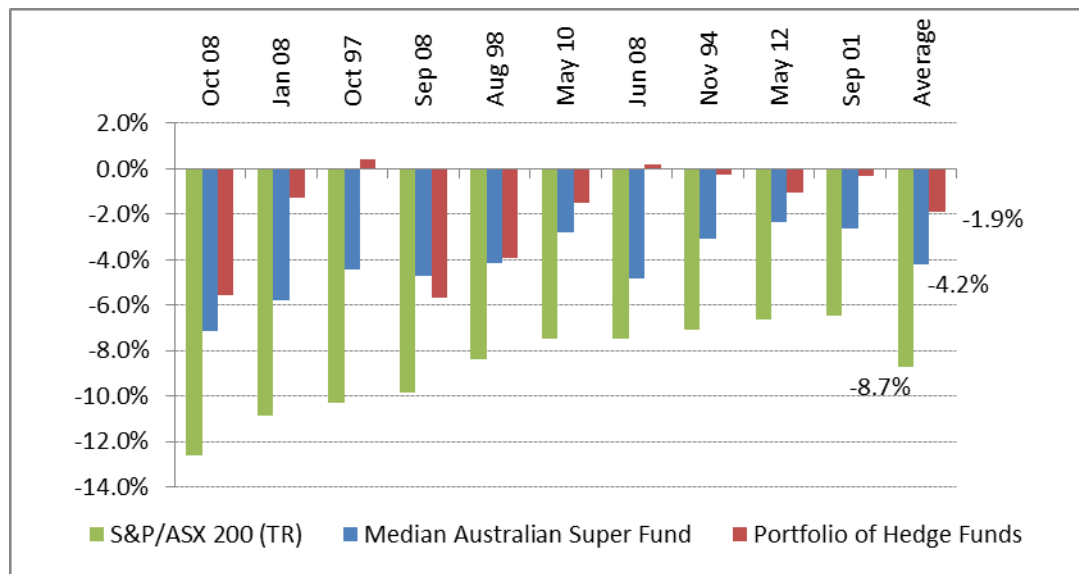
### Potential benefits of hedge funds

In the following paragraphs we detail some of the potential benefits of investing in hedge funds, before addressing some of the common concerns in Part 2.

#### Ability to reduce losses

Some hedge funds have an ability to reduce losses during share market selloffs. This is illustrated in Figure 3, which compares the performance of the median Australian growth superfund to a portfolio of hedge funds during the worst 10 months for the S&P/ASX200 Index since January 1990. During these months, the portfolio of hedge funds lost less than 2%, although the loss for the median superfund was over double that (-4.2%), and the loss from the share market was more than four times higher (-8.7%).

**Figure 3.** Monthly returns of Portfolio of Hedge Funds, Median Australian Growth Superannuation Fund, and S&P/ASX200 Total Return Index during 10 worst months of share market performance over 20 years to 31 March 2015.



#### Capital preservation

Hedge fund managers think about risk in terms of loss of capital, and actively manage risk to try and limit their losses. A traditional fund manager, by contrast, tends to think about risk in terms of performance deviation from a benchmark, and will generally lose as much as the market does in difficult times.

**Figure 4.** Portfolio of Hedge Funds, Median Australian Growth Superannuation Fund and S&P/ASX200 Total Return Index, losses from 31 January 2007 – 31 March 2015.

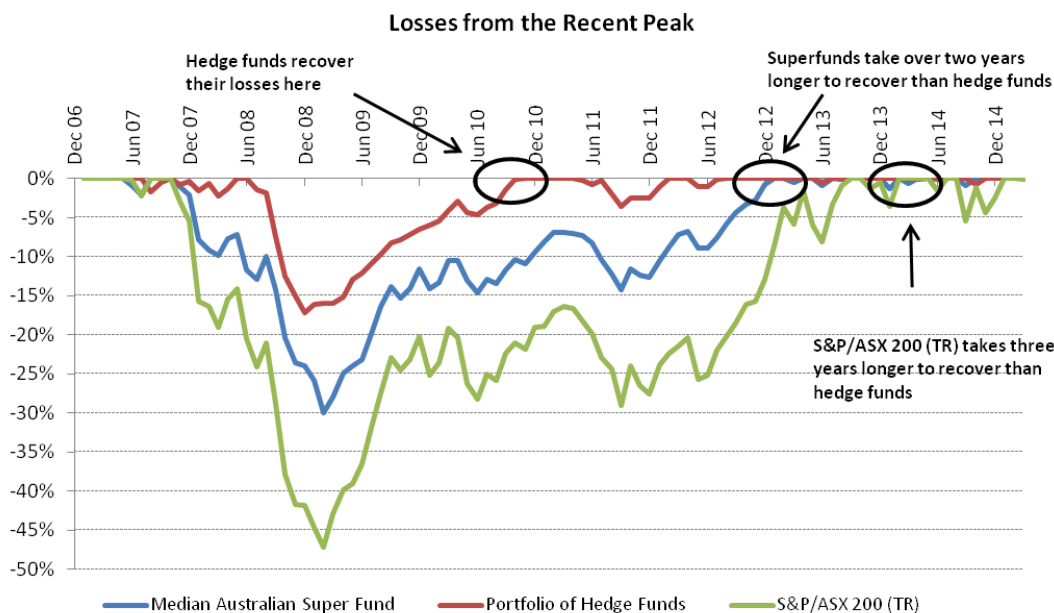


Figure 4 shows why we think investing in hedge funds makes sense from a capital preservation perspective. The graph shows the loss that each index experienced from 31 December 2006. This was the worst example of hedge fund losses that we could find, and shows that the hedge fund portfolio lost around 17% over a period when the median Australian growth superannuation fund lost 30% and the Australian share market fell more than 45%. The graph also shows that the portfolio of hedge funds recovered from its losses by November 2010, although the median super fund took a further two years to do so, and the ASX 200 took a full three years to reach its prior high.

### Diversification

By reducing exposure to general market movements and only targeting specific risks, a hedge fund can produce a return stream that has a low level of correlation with, and a lower level of downside volatility than general risk assets like equities. This has valuable benefits in portfolio construction, and can lead to a more consistent return profile in a diversified portfolio.

Our data shows that the performance of the median superfund is approximately 90% correlated to movements in the Australian share market, whereas the portfolio of hedge funds is only around 30% correlated (more on this is Part 2). Pleasingly, correlations for hedge funds have dropped toward lower levels which should result in higher benefits to portfolio construction.

### Targeted risk-taking

Another key advantage of hedge funds is the ability to target specific risks and hedge unwanted risks (in a similar manner to a person 'hedging their bets'). An example would be a hedge fund which holds a portfolio of favoured stocks but at the same time wants to protect the portfolio from a general fall in the share market. This allows the hedge fund to target risk-taking to the areas where the manager's expertise is strongest.

### New return streams

Hedge funds are also able to provide exposure to return streams that are generally not available from traditional funds. Hedge funds can invest in assets or strategies whose returns are driven by different factors to those that drive bond and equity returns. An example is investing in companies that are being liquidated, where the returns are driven by a fairly well-defined legal process, or having exposure to strategies that may require arbitrage or relative value techniques beyond the reach of traditional funds.

## **Benchmark-unaware**

Hedge funds do not generally use index benchmarks, so the concept of tracking error does not constrain them as it does with a traditional manager. Being benchmark-unaware, hedge funds are free to invest in their best ideas and to avoid assets with a poor outlook. Contrast this with a traditional benchmark-aware fund which is compelled to hold overvalued assets that are part of the benchmark index.

## **How much should be invested?**

The question of how much of a portfolio should be invested in hedge funds depends on the specifics of each situation, in particular the initial structure of the portfolio as well as the investor's goals and competing opportunities. It's worth repeating that we don't recommend an allocation to hedge funds for the sake of it, and similarly, we are not advocates of large allocations to hedge fund replication strategies. For most portfolios, we think it makes sense to start with an allocation of 5% to 20%.

*Craig Stanford is Head of Alternative Investments at Ibbotson Associates and is Chair of the Investor Education Committee for the Alternative Investment Management Association in Australia. Ibbotson Associates is a member of the Morningstar group of companies. Information provided is for general information only, and individuals should seek personal advice before making investment decisions. The objectives of any individual have not been considered in this article.*

## **What is robo-advice?**

### **Jeroen Buwalda**

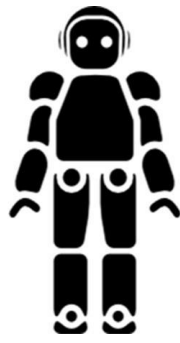
The term robo-advice is now widely used within wealth management circles, but exactly what does it mean? If that question was directed to someone on the street corner their response would be more likely to include R2-D2 or C-3PO rather than a computer telling the user how they should invest their money to achieve their financial goals.

Wikipedia defines robo-advisors as: "a class of financial adviser that provides portfolio management online with minimal human intervention. While their recommendations may vary, they all employ algorithms."

The key words are *portfolio management* and *algorithms*. Portfolio management indicates it has something to do with investing while the algorithm component refers to "a finite set of instructions that can be performed in a prescribed sequence to achieve a certain goal and has a recognisable set of end conditions." (Source: thefreedictionary.com)

### **Split robo-advice into three groups**

The term robo-advice has quickly evolved to cover a broad range of automated advice and investment solutions. But the underlying principle is the use of a formula or set of rules to assist a customer in finding the optimal approach to their investments, savings, retirement, or protection of assets. In practical terms, robo-advice can be split into three distinct groups and each has tremendous application for wealth managers and their customers.



**A. Fully automated non-discretionary investment advice**



**B. Self-service investment and financial advice**



**C. Guided investment and financial advice**

## **A. Fully automated non-discretionary investment advice**

This refers to an individual subscribing to wealth guidance and advice that is implemented without the customer's explicit consent. Managed accounts fit this definition and dealer group model portfolios could probably be put here as well, particularly if the portfolio is rebalanced periodically without customer consent at each rebalance. The main distinction between these investment approaches and the new crop of robo-advice offerings is that the new kids on the block advise the customer which fund or portfolio to invest in. Traditional managed accounts, on the other hand, rely on an adviser to select the initial portfolio based on their clients' personal circumstances and appetite for risk.

The new breed of automated investment solutions still apply the principles of diversification, passive investing and regular rebalancing. Many also offer extended tools, including tax lot harvesting, to optimise capital gains tax outcomes. What really sets them apart though is an intuitive, clearly-defined and consistent investment approach which resonates with experienced and novice investors alike. As these solutions continue to innovate, they will increasingly appeal to a wider audience.

## **B. Self-service investment and financial advice**

This group provides digital tools to support customers in identifying, scoping and creating wealth advice and guidance, typically in relation to a specific goal or range of goals such as an income stream in retirement or saving for education. They may use behavioural finance techniques to encourage customers to regularly monitor and contribute to their wealth journey. Some of these tools build on this even further by streamlining the goal setting process and providing default goals and timings.

The main difference between these robo-advisors and the automated investment options is that they optimise and allocate cash flow across goals. In Australia, optimising across goals is particularly difficult given the complexity of our income tax and superannuation systems. As an example, one question that sounds simple but is quite difficult for robo-advisors to answer could be whether a client should make voluntary contributions into superannuation or pay down the mortgage. If a robo-advisor can't answer this fundamental question, then chances are it optimises on investment and not on strategy.

What makes these types of robo-advisors more compelling is the aggregation of client data. This enhances the user experience and removes unnecessary friction from the goal setting process. Where the wealth manager already has personal and investment data for the user, it can be integrated into the tool. Alternatively, the front end tool could request the user's various account details. This gives the robo-advisor a powerful advantage as it can link all the accounts together, monitor movements in the investments and track ongoing progress towards goals. At the very least, the robo-advisor could apply basic user information, such as their age and suburb, and provide an estimate of their income, expenses and assets.

### C. Guided investment and financial advice

This option is typically focused on holistic strategies. It includes traditional face-to-face advice as well as remote advice delivered over the phone or by video. It also includes omni-channel advice, where a person is involved or ultimately responsible for the advice strategy.

There are a number of services available which provide online tools and access to a financial adviser for a one-off initiation fee and low monthly charge. The providers have embraced a user friendly and simplified approach to the financial advice process, with some even offering automated investment advice supported by a real financial adviser.

#### Robo-advisors versus real financial advisers

Will robo-advisors replace real financial advisers? The answer is, probably not. The more likely scenario is that robo-advisors will complement the work done by real financial advisers.

There is a huge gap between what regular households are willing to pay for advice and what advisers are willing to charge for advice. Robo-advisors will help to bridge that gap.

Where the two worlds are more likely to collide is in an adviser-led robo-advice tool becoming part of a dealer groups' sales process. This has real merit and could revolutionise financial advice in Australia based on the principles of customer centricity, connectivity, contemporariness and compliance.

Adviser led robo-advice tools could help to close the gap around perceived quality of advice. The ASIC report 279 - *Shadow Shopping Study of Retirement Advice* found that 39% of advice examples were poor and failed to meet the requirements of S945A. Yet, in the same study, 86% of mystery shopper participants felt they had received good quality advice. From ASIC's standpoint, adviser-led robo-advice tools could significantly improve the quality of advice. If customers continue to rate quality highly and ASIC starts seeing measurable improvements, the wealth management industry and financial advice profession will benefit in the long run.

*Jeroen Buwalda is EY's Asia-Pacific wealth and asset management advisory leader. The views expressed in this article are the views of the author, not Ernst & Young. The article provides general information, does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Liability limited by a scheme approved under Professional Standards Legislation.*

## [There's nothing sleepy about Rip Van Winkle indexing](#)

### Graham Hand

*Graham Hand recently attended the Research Affiliates Advisory Panel conference in California, featuring presentations by many of the world's leading investment professionals. The innovative paper reviewed here uses 'stale' prices to compile a 'cap-weighted' portfolio, with surprising results. The full academic paper will be published in the Summer 2015 edition of the Journal of Portfolio Management (JPM). Research Affiliates and JPM gave permission for this summary to be released in advance of the full paper.*

There's no doubting the spectacular success of 'passive' investing based on the market capitalisation weights of companies. It is estimated that almost 20% of all managed fund assets are based on cap-weighted indexes, up from less than 9% in 1998. It is based on the theory that in an efficient market where equity prices reflect all known information about a company, there is no capacity for a talented analyst to outperform, and a portfolio that uses the most up-to-date prices should deliver the best results. On the other hand, even if the market is not efficient, then surely the active manager with the timeliest information has the best chance to outperform (ie, deliver 'alpha').



Researchers at the California-based index and asset allocation specialists, Research Affiliates, have tested another theory, which they call the 'Rip Van Winkle' approach. The story goes that the idle Rip Van Winkle fell asleep for 20 years after a drinking session, and he woke to a vastly different world. What if we did this with a cap-weighted investment portfolio by discarding 20 years of market data?

The table shows the market cap of the Top 10 companies in the United States over the last 20 years at five-year intervals, and the changes have been dramatic. There are companies in every Top 10, such as General Electric (from 4.1% of the index down to 1.5%), Exxon (from 3.6% to 2.3%) and Wal Mart (from 2.6% to 1.3%). Most have dropped out of the Top 10 over the years, while Apple and Google were nowhere even five years ago.

**List of Top 10 stocks in the US at current time plus 5, 10 and 20 years ago (Jan 2014)**

Current Cap-Weighted Portfolio			5 Year Stale Cap-Weighted Portfolio		
Rank	Name	Weight (%)	Rank	Name	Weight (%)
1	Apple	2.62	1	Exxon Mobil	4.72
2	Exxon Mobil	2.31	2	Wal Mart	2.56
3	Microsoft	1.62	3	Procter & Gamble	2.15
4	Google	1.62	4	Microsoft	2.01
5	General Electric	1.48	5	General Electric	1.98
6	Johnson & Johnson	1.35	6	AT&T	1.95
7	Wal Mart	1.33	7	Johnson & Johnson	1.93
8	Chevron	1.25	8	Chevron	1.75
9	Wells Fargo	1.25	9	Pfizer	1.39
10	Procter & Gamble	1.16	10	JPMorgan Chase	1.37

10 Year Stale Cap-Weighted Portfolio			20 Year Stale Cap-Weighted Portfolio		
Rank	Name	Weight (%)	Rank	Name	Weight (%)
1	General Electric	3.34	1	General Electric	4.12
2	Microsoft	3.17	2	Exxon Mobil	3.61
3	Exxon Mobil	2.91	3	Coca Cola	2.67
4	Pfizer	2.89	4	Wal Mart	2.64
5	Citigroup	2.69	5	Altria	2.24
6	Wal Mart	2.46	6	Merck	2.03
7	Intel	2.23	7	Procter & Gamble	1.79
8	AIG	1.85	8	IBM	1.50
9	Cisco	1.79	9	Du Pont	1.50
10	IBM	1.71	10	Pepsico	1.50

Source: Research Affiliates using data from CRSP, Compustat, Worldscope, and Datastream.

**How are the performance numbers calculated?**

Research Affiliates assumes Rip Van Winkle wakes up and constructs a portfolio reusing the cap weights of the 1,000 largest stocks from when he fell asleep 20 years earlier. He ignores stocks that no longer exist and invests their weight in remaining companies in proportion to their old capitalisations. In subsequent years, he then rebalances back to the stale weights 20 years earlier. For example, since the reliable data starts in 1926, the analysis waits until 1946 to use the 20-year-old cap-weighting data. This gives results over the past 67 years (1946-2013) for a portfolio always weighted back to 20 years ago.

The method produced a risk-adjusted outperformance of 1.8% per annum over the normal cap-weighted index, which would have placed Rip near the top of active managers.

What's happening? Research Affiliates argues alpha is added by severing the link between the weight of a company in the portfolio and its price. It's the same argument they make for fundamental indexing, where stocks are weighted according to their economic footprint. Using cap-weights, the more expensive a stock becomes, the heavier its weight in a portfolio, and similarly, the cheaper the stock, the less its weight. Almost anything that breaks this link will outperform, based on the known empirical factors of value and mean reversion.

As with any strategy that deviates from the usual cap-weighted index, there are long periods of disappointment in the results before the market 'corrects' itself. Indeed, the results were almost flat for the first 20 years, and then kicked in over the last 47 years, when the incremental returns were almost



3% per annum. This is a lesson in not jumping out of a strategy in the short-term, or leaping on to the latest fad.

The final results are spectacular, with 1.8% per annum compounded from 1947 to 2013 producing nearly three times the value of a cap-weighted portfolio over this time period. Rip's strategy ignored the tech bubble and wreck of the late 1990s and allocated to financials just like any other year during the GFC. This obliviousness to fears and fads turns into an advantage in following years, especially since the stock values of yesteryear did not carry such valuation excesses.

### **Investment characteristics of the Rip Van Winkle portfolio**

The longer the numbers were lagged in the analysis, the better the results. Research Affiliates argues it is because the weight is no longer linked to the price of a stock (at least, not anymore). The longer-lagged indexes were less biased towards today's most expensive stocks. By severing the link between the price of a stock and its weight in the portfolio, value is added ... even when using cap-weights!

The factors leading to the outperformance include a small-cap tilt, due to overweighting companies which are smaller relative to their cap-weights at the end of the measurement period. And there is a value tilt, an anti-momentum bias and of course long-term mean-reversion, all at the economically significant level. But this factor attribution explains only about half the residual alpha, so there is some priced factor missing from the explanation. The analysts invite the finance community to join the hunt.

Some of the great benefits of cap-weighting are the high capacity, strong liquidity and low turnover of a portfolio. Of course, these also apply for Rip's portfolio. Large companies tend to stay large for many years, and the portfolios both have hundreds of familiar names, with weights that have broad representation in the economy even 67 years later.

Cap-weight portfolios have low turnover because they rebalance automatically. In this analysis, Rip rebalances every year, but turnover is surprisingly not much larger, and significantly less than most active managers.

### **Sleep on it**

The 'active versus passive' investing debate has raged for decades. One side argues the cap-weighted index cannot be consistently outperformed and is an optimal portfolio. The other side believes talented active managers with superior analysis and better information can deliver alpha. Both sides accept to differing degrees that opportunities are arbitrated away by competition in the market.

Then along comes Rip Van Winkle, who could not be bothered changing his portfolio weightings for 1,000 companies after he fell asleep for 20 years. He uses the same approach in global equities, including emerging markets, and then repeats the exercise over 67 years of data. It's not 'value versus growth' or 'active versus passive'. It's market cap indexing versus market cap indexing with a lag.

Research Affiliates is not arguing that Rip has hit on a great new investing strategy, as there are better choices available. Rather, they explore a crazy idea to support their long-established argument on the benefits of breaking the link between the stocks in a portfolio and their current market price.

And any active manager who could deliver outperformance of almost 2% per annum for a long time would sleep easy on the result and dream of the dollars rolling in.

*The authors of the research are Robert Arnott, Noah Beck and Vitali Kalesnik of Research Affiliates.*

*Graham Hand is Editor of Cuffelinks and was a guest at the Research Affiliates Advisory Panel. This article is for information purposes only and does not constitute investment advice, nor an opinion on the appropriateness of any investment. Research Affiliates, LLC does not warrant the accuracy of the information provided herein, either expressed or implied, for any particular purpose.*

## Top 10 hints for SMSF trustees before 30 June 2015

### Monica Rule

As 30th of June approaches there are many things SMSF trustees should consider to make the most of their SMSF. Better not to leave the following until the last minute:

- 1. Valuation.** The assets in your SMSF must be valued each financial year based on objective and supportive data. Refer to ATO publication, 'Valuation guidelines for SMSFs'.
- 2. Contributions.** Ensure contributions are received on or before 30 June, especially if made by electronic funds transfer. A day too late could cause problems.
- 3. Employer contributions.** Check whether Superannuation Guarantee contributions for the June 2014 quarter have been received by your SMSF in July 2014. If so, include the contribution in your concessional contribution cap for the 2014/2015 financial year.
- 4. Salary sacrifice contributions.** Salary sacrifice contributions are concessional contributions. Check your records before contributing more to avoid exceeding your concessional contributions cap.
- 5. Tax deduction on your contributions.** If you are eligible to claim a tax deduction then you will need to lodge a 'Notice of intention to claim a tax deduction' with your SMSF trustee before you lodge your personal income tax return. Your SMSF trustee must also provide you with an acknowledgement of your intention to claim the deduction.
- 6. Spouse contributions.** Spouse contributions must be received on or before 30 June in order for you to claim a tax offset on your contributions. The maximum tax offset claimable is 18% of non-concessional contributions of up to \$3,000. Your spouse's income must be \$10,800 or less in a financial year. The tax offset decreases as your spouse's income exceeds \$10,800 and cuts off when their income is \$13,800 or more.
- 7. Contribution splitting.** The maximum amount that can be split for a financial year is 85% of concessional contributions up to the concessional contributions cap. You must make the split in the financial year immediately after the one in which your contributions were made. This means you can split concessional contributions made during the 2013/2014 financial year in the 2014/2015 financial year. You can only split contributions you have made in the current financial year if your entire benefit is being withdrawn from your SMSF before 30 June 2015 as a rollover, transfer, lump sum benefit or a combination of these.
- 8. Superannuation co-contribution.** To be eligible for the co-contribution, you must earn at least 10% of your income from business and/or employment, be a permanent resident of Australia, and under 71 years of age at the end of the financial year. The government will contribute 50 cents for each \$1 of your non-concessional contribution to a maximum of \$1,000 made by 30 June 2015. To receive the maximum co-contribution of \$500, your total income must be less than \$34,488. The co-contribution progressively reduces for income over \$34,488 and cuts out altogether once your income is \$49,488 or more.
- 9. Low income superannuation contribution.** If your income is under \$37,000 and you and/or your employer have made concessional contributions by 30 June 2015, then you will be entitled to a refund of the 15% contribution tax up to \$500 paid by your SMSF on your concessional contributions. To be eligible, at least 10% of your income must be from business and/or employment and you must not hold a temporary residence visa.
- 10. Minimum pension payment.** Ensure that the minimum pension amount is paid by your SMSF by 30 June 2015 in order to receive the tax exemption. If you are accessing a pension under the 'Transition to Retirement', then ensure you do not exceed the maximum limit also.

*Monica Rule is the author of The Self Managed Super Handbook. See [www.monicarule.com.au](http://www.monicarule.com.au)*

## The need for retirement income reform

### Patricia Pascuzzo

The decision by the Hawke-Keating Government to introduce the superannuation system, which allowed the majority of workers to receive income to supplement the age pension, was visionary. It was not however led unilaterally by the Government but rather emerged from an extended process of engagement and consensus building.

Many critical elements of the system were far from ideal. The decision to apply tax at the contributions phase rather than only at the benefit phase was driven by the desire to bring forward revenue collections rather than effective tax design principles.

#### **No overall grand design**

Since that time the superannuation system has been subjected to frequent and significant changes such as annual changes to super contribution caps. These changes have not been part of a grand design (more often than not they have been in conflict), but rather were based on short-term budgetary or political circumstances. The frequency of the changes has created uncertainty and undermined confidence in the system.

It is hard to make and sustain good policy if there is confusion about the objectives of that policy. And in the case of the retirement income system, there is an unfortunate lack of clearly articulated goals and objectives that has contributed to a number of fundamental problems:

**Poor targeting** – whichever way you measure it, the value of super tax concessions favours high-income earners. Equally concerning is the availability of part pension payments, and associated health card in-kind entitlements, to retirees with substantial assets.

**High complexity** – The superannuation tax and pension systems have evolved largely independently without sufficient consideration given to their interactions. This was less of an issue in the past when the vast majority of retirees were either subject to the pension system or the tax system but not both. With the majority of retirees now being part-rate pensioners, the interactions between the systems takes on an added significance.

**Waning community support** – Most superannuation members are not highly engaged. This has been linked to low financial literacy and the difficulties of decision making within a highly complex system. Support for the system relies on engagement, certainty and stability all of which are lacking.

**Limited sustainability** – The cost of assistance to the aged has risen by more than 50% in the past decade outstripping real GDP growth. The cost of superannuation tax expenditures is also large and rising.

**Poor longevity risk management** – the system provides no incentive for lifetime annuities so that longevity risk is left to individuals to manage with the age pension acting as a minimum guarantee. As people live longer, there is a growing risk that they will exhaust their assets before they die or live overly frugally and (intentionally or unintentionally) leave unused superannuation savings to their estates.

#### **The need for sustainable retirement income**

The system has therefore evolved into what can be better characterised as a government-subsidised wealth generation vehicle. What we need is to refocus the system on the provision of sustainable income throughout the years of retirement.

Articulation of goals for the retirement income system which are broadly accepted, including for superannuation as recommended by the Murray Inquiry, would guide future policy development and ensure the coherence of the whole system. It would also help to counteract calls for using superannuation

for other purposes – infrastructure, housing, and education - that undermine the system’s ability and stability to fulfill its fundamental purpose.

Australia’s public policy record shows that real reform can only be brought about through broader acceptance of the need for change and agreement on essential features of a reform programme. If we are to leave behind piecemeal changes and move towards a coherent retirement income system, greater agreement is needed among the Australian community on the reform agenda.

Instead, a comprehensive reform would encompass a balanced package, after considering all the following aspects of the retirement incomes system:

- Age of access to the age pension, and how income from part-time work might be assessed in future.
- Means testing, especially the deeming arrangements and whether and how pensioners' homes should be brought to account.
- The adequacy of the age pension and superannuation pensions when the present scheme matures, and the interaction with other elements of the welfare system including health, aged care and rental housing.
- The generosity, efficiency and fairness of the tax concessions for superannuation saving, much of which is compulsory.
- The extent to which it should be a requirement to use superannuation payments to generate a retirement income, and how the longevity risk of living longer than expected can be best handled.

With most people now spending 30 to 40 years in retirement, good policy is too important to leave to the vagaries of political cycles and short-termism.

*Patricia Pascuzzo is the Executive Director and Founder of the Committee for Sustainable Retirement Incomes (CSRI). The CSRI is an independent platform bringing together government, industry, media and community leaders to debate retirement income issues and allow the alternative perspectives to be heard. The [Committee for Sustainable Retirement Incomes Leadership Forum in Canberra on 2-3 June](#) provides the first step in an informed and purposeful retirement income reform agenda for Australia. See [www.csri.org.au](http://www.csri.org.au).*

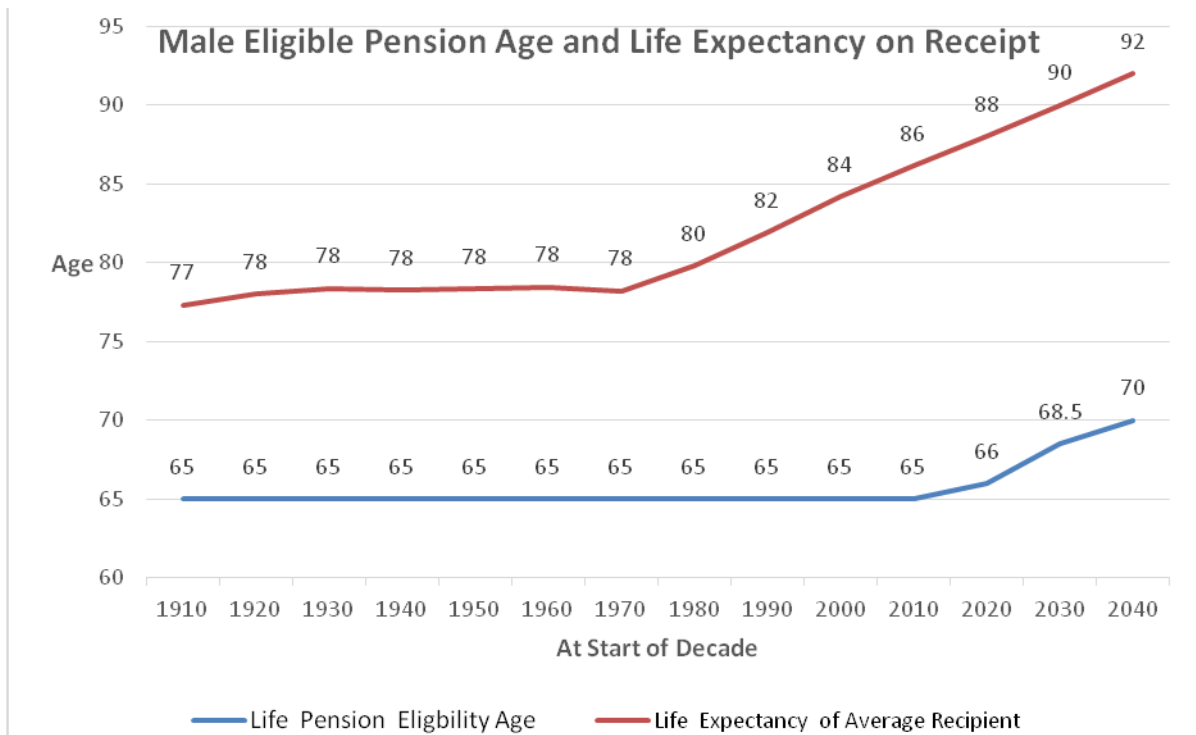
## **Longevity awareness and the shaky three pillars**

### **David Williams**

The latest Intergenerational Report (IGR) postulates the three pillars of the Australian retirement income system as the age pension, compulsory superannuation and voluntary saving. All three are looking increasingly shaky for the task ahead, as policy struggles to cope with changes. The failure to increase the eligible age for the age pension has been one of many flaws in retirement income policy, caused by changes that accelerated in the 1970s.

#### **Life expectancy at time of pension eligibility**

The IGR graphs life expectancy against pension age eligibility (page 70). Unfortunately it uses the life expectancy of a baby. A better insight comes from using the life expectancy at the age of eligibility for the age pension, which for males has stood at 65 for more than 100 years. It is belatedly being increased from 2017 so that by 2035 it will have reached 70 for both genders.



The increase in eligibility is too little too late. From the inception of the age pension, male life expectancy at age 65 rose only slowly until the 1970s (ABS numbers rounded to the nearest year). From then it increased by roughly two years per decade until today and this is expected to continue, as shown.

The last two federal governments have initiated increases in the eligible pension age which top out at 70 in 2035. The chart shows that the gap between eligibility age and average life expectancy for males is likely to have increased from 12 years in the 1970s to 22 years by the decade starting 2040. For female life expectancy, add about four years at age 65, resulting in an even greater gap.

On the face of it, the chart shows just how badly successive governments have failed to respond to the ongoing increase in longevity. The shift towards an older population has further compounded the problem of funding the age pension.

**Lower returns and compromised expectations**

In earlier Cuffelinks articles (such as [this](#)), David Bell neatly defined the many issues in attempting to reform an age pension system that has for so long failed to adapt to the reality of ongoing longevity increases.

Failure to adapt the superannuation system to increasing longevity is likewise building in a gap between expectation and reality. Lower economic growth and low interest rates (in real terms, *negative* returns in many countries) feed through to entrenched lower returns, leading to a widening gap between perceived need and funds availability. Policy should determine whether the age of access needs to be increased as well as contribution levels.

Financial adequacy is only part of the problem. Financial literacy programs are improving as well as financial awareness at the individual level. People should increasingly be able to conduct an effective financial conversation and contribute to decisions about their savings.

**Longevity awareness crucial for retirement planning**

The foundations of retirement planning need to be deeper. Few people are aware of their personal time frame that the three pillars need to support. Failure to increase the age of access to the age pension and

superannuation has fostered an expectation that it is reasonable to expect access at much younger age than is realistic, other than for those in genuine need. This also has an impact on willingness to add to voluntary savings, the important third pillar.

There is an urgent need to improve longevity awareness across the community, especially at times of tight budget funding.

Since people become more different as they age, using averages such as from the Life Tables is unhelpful. Averages are misleading for individuals and actions that people can undertake need to be personally framed, not generic.

Once people start to recognise what influences their personal longevity, they can take personal ownership of the financial consequences. As a first step, they can begin to address any unrealistic expectations of maintaining living standards with increasing age in the absence of better personal planning such as increasing savings and working longer.

Longevity awareness can underpin weaknesses in the increasingly shaky three pillars. Collective action to boost longevity awareness by governments needs to be complemented by individuals who are well enough informed to commit to making the best of their opportunities to secure their future.

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

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