Cuffelinks
Connecting investors with ideas

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Retirement income products – what's ideal?

David Knox

For years, the superannuation industry has grappled with how to offer members simple, attractive and affordable solutions together with longevity protection. Certain tax and legislative barriers have made it difficult for some products to be introduced.

The Financial System Inquiry recommended that superannuation trustees should pre-select a Comprehensive Income Product for members' Retirement (CIPR). It suggested that these CIPRs should have certain features including a regular and stable income stream, longevity risk management and flexibility. Before designing a product (or products) for Australian retirees, are there lessons we can learn from overseas practice?

The following table summarises the requirements for retirement income products in eight of the top ten countries from the 2014 Melbourne Mercer Global Pension Index. The two countries excluded are Australia and the United Kingdom, which from April 2015 removed the previous requirement to use at least 75% of retirement funds to purchase a lifetime annuity. Their system is now similar to Australia with no requirements (i.e. total freedom).

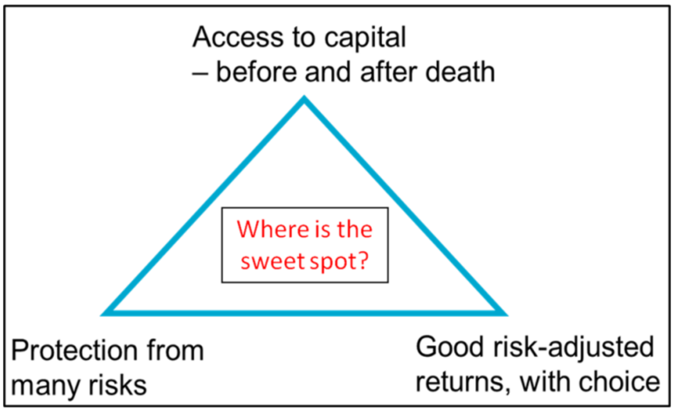
Country	Summary of requirements
Canada	For registered DC plans, an annuity or a locked-in Life Income Fund, with minimum and maximum withdrawals. There is no requirement for Registered Retirement Savings Plans.
Chile	All benefits must be converted into a life annuity or a programmed withdrawal product, except for any portion of the benefit that is above the specified maximum.
Denmark	The tax rules provide no limit on the contributions paid if the benefit is taken as an annuity. However there is a limit if the benefit is paid for a period of between 10 and 25 years.
Finland	Lifetime or fixed term annuities with a minimum term of 10 years
Netherlands	All retirement benefits must be converted into an annuity. Annuity payments are fixed but may be adjusted (up or down) if profit sharing results allow for it.
Singapore	The retirement benefit above the prescribed minimum is converted into a life annuity. However amounts above the prescribed maximum do not need to be converted.
Sweden	All retirement benefits plan must be converted into an annuity which could be a life annuity or a fixed term annuity. However the individual bears some risks as payments can be varied.
Switzerland	Favourable conversion rate favours pensions

It is clear that most of these systems have a lifetime income focus with a concentration on lifetime or long-term annuities. Generally, there is a collective approach which means those who live longer receive greater benefits than those who die earlier. This is in contrast to the Australian norm where superannuation assets are often considered to be 'owned' by the individual for their sole benefit.

The income requirements only apply for benefits above a certain level in Singapore and do not apply when the benefits exceed the prescribed maximum in Chile or Singapore. Both approaches make sense as there is little value to be gained in requiring annuities for small benefits and once a reasonable income level has been attained, the Government may have little interest in how the balance of the benefit is used.

The retirement trilemma of what retirees want

The development of the best retirement product is not straightforward; indeed, the post-retirement years are much more complex than the pre-retirement years, when many individuals continue to receive a steady income.



In short, most retirees seek:

- Access to some capital, both during retirement for those unexpected and significant capital expenditures, and after retirement as a bequest
- Protection from risks, which can include inflation risks (after all, they remember the 1970s), market risk (as they have seen many market downturns) and longevity risk as they become increasingly aware of increasing life expectancies
- Good returns from their investments, often in an account-based pension, which also provides flexibility.

However the 'best' product which responds to these divergent needs is not the same solution for every individual. It will depend on the individual's investment risk profile, health condition as well as their family and housing situation. Furthermore the best solution is likely to change during their retirement years as they pass through various phases of retirement.

A single lifetime annuity is unlikely to be the best solution notwithstanding the requirement in many pension systems. Retirees are now seeking more flexibility than provided by a single lifetime annuity. Whilst an annuity provides longevity protection it does not provide access to capital and investment choice. A combination of products or a single flexible product with several features is more likely to respond to the needs of retirees.

Pooling of risk is big difference between Australia and other countries

We need to move away from products that are solely focused on the individual; some risks are better managed when shared. There is an urgent need to find a better balance between the individual orientation of a defined contribution plan and a collective (or pooled) approach where there is some sharing of risks within and between generations.

The most obvious area to pool risks is in respect of longevity risk. Whilst annuities represent one form of such pooling, the Financial System Inquiry showed that other forms of pooling (such as through group-self annuities which require no capital) can deliver significantly higher retirement incomes while also reducing the risk of outliving retirement savings.

If, or indeed when, CIPRs are introduced into Australia's superannuation landscape, the key to success has to be a definition that enables a wide range of solutions to be available, including a general acceptance that the pooling of risks will normally provide a more efficient outcome.

Dr David Knox is Senior Partner at Mercer.

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The momentum of winning and losing share prices

David Bell

In the spirit of recognising that there are many different ways to pick stocks, a year ago I wrote an article, *Stock market winners versus losers*, on using a basic momentum strategy to select stocks. The premise went as follows: academic researchers found that portfolios of recent outperformers outperformed portfolios of recent underperformers. So a long short strategy constructed this way should generate a positive return. We tested this approach in the Australian marketplace and found what appears to be a volatile but high performing strategy. How did this strategy perform in the most recent financial year?

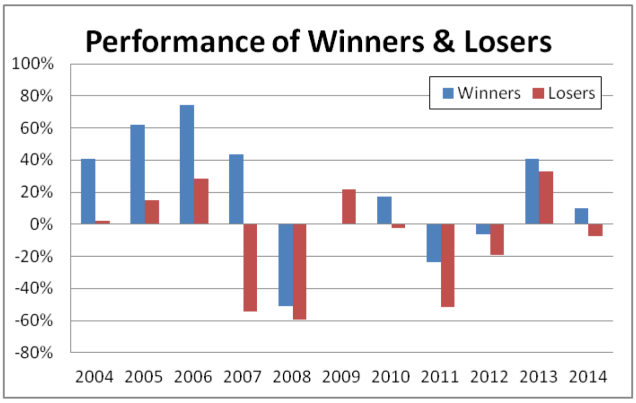
2014-15 financial year performance

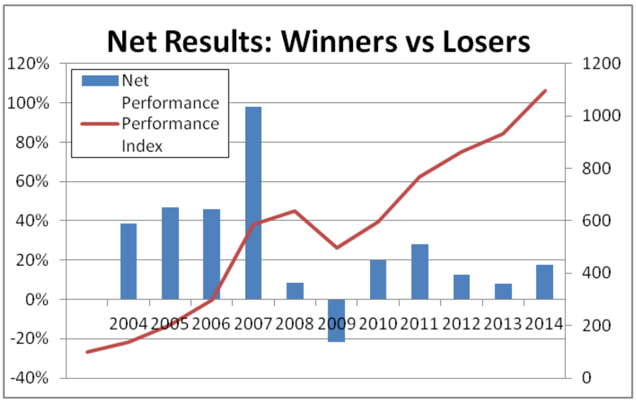
A brief refresher on the strategy:

- At the start of each financial year we hypothetically go long an equally weighted portfolio of the previous financial year's top 10 performing stocks on the ASX 200
- We hypothetically also short an equally weighted portfolio of the previous financial year's worst 10 performing stocks on the ASX 200
- This portfolio is held untouched for the subsequent financial year (i.e. a 12 month holding period)

The table below lists stocks we would have held, long and short, during the previous financial year (2014 / 2015), based on their performance over the previous 12 months, along with their subsequent performance.

Using the table, if we subtract the short performance (-7%) from the long performance (+10%) we end up with a total performance of 17%. The last financial year has been another solid year of performance for this strategy; a little less than the long term average. The chart below presents the updated track record (now 11 years).





Data: Acadian Asset Management (Australia) Limited

Long Portfolio			Short Portfolio		
Stock	**Previous FY Performance**	**Subsequent FY Performance**	**Stock**	**Previous FY Performance**	**Subsequent FY Performance**
BBG	276%	15%	SBM	-74%	83%
OGC	166%	5%	BLY	-73%	-41%
NST	124%	80%	ACR	-69%	-12%
DMP	100%	69%	PDN	-66%	-7%
WSA	100%	-29%	LYC	-65%	-74%
IGO	94%	-2%	TRS	-48%	-36%
GEM	94%	-25%	WTF	-43%	36%
CGF	93%	-6%	MMS	-41%	39%
FXJ	90%	-6%	RRL	-41%	-34%
AQA	90%	1%	KAR	-40%	-27%
Total Long Portfolio Average Subsequent Performance		**+ 10%**	**Total Short Portfolio Average Subsequent Performance**		**- 7%**

The performance numbers above only focus on the active return piece and leave out cash returns, stock borrowing fees and transaction costs (in theory if you have long and short positions of the same dollar amount then you have 100% of the portfolio earning cash returns).

Digging deeper into the theory

This strategy is a simple one. In fact it catches two known theories in one strategy. First there is the cross-sectional momentum strategy between individual stocks, first identified in 1993 by academics Narasimhan Jegadeesh and Sheridan Titman (their paper was titled *"Returns to buying winners and selling losers: implications for stock market efficiency"*). However the strategy does not control for sector bets (nor did that of Jegadeesh and Titman) and so we are potentially exposed to a cross-sectional momentum strategy between industries. This has been shown to explain much of the performance of the individual stock effects described above. This was identified by Tobias Moskowitz and Mark Grinblatt in their paper titled *"Do Industries Explain Momentum?".*

In practice…

In practice it is unlikely that we would see a strategy like this offered as an investment fund. It is highly volatile and there are question marks around its applicability and performance in a real world environment, namely:

- The high volatility of the strategy may make it unpalatable
- The ability to borrow underperforming stocks may prove difficult and costly

However in practice we find momentum is a strategy commonly applied by many fund managers, typically those who adopt a quantitative approach. They would apply a more complex form of the strategy. Specifically most fund managers would control the size of the sector bets, hence ruling out the simple strategy presented here. Nonetheless many quant managers use momentum as an indicator of performance for stocks and sectors. It would commonly form part of a suite of signals; indeed I have never seen a fund manager offer a momentum only stock strategy.

Takeouts

As stated last year, I am not recommending you to go out and replicate this 'strategy' – I wouldn't myself. And as per last year I don't tell you the current positions such a portfolio would be holding – you have to do your own homework! The point of this article is to remind you that there are many different ways to pick stocks. Some are based on company analysis, some are technical, and some are behavioural. You need to pick out an approach that you believe you can execute well and understand the strengths and weaknesses of your approach and the environments in which it will work well and in which it may struggle.

David Bell is Chief Investment Officer at Mine Wealth + Wellbeing (formerly Auscoal Super). He is also working towards a PhD at University of NSW.

SMSFs and house and land packages

Monica Rule

Property investment is gradually becoming more popular with SMSF investors, and I am often asked whether SMSFs can purchase house and land packages. Not only would the SMSF hopefully achieve some long term capital gain, it would also be entitled to claim some depreciation on the new asset as it ages. I always clarify first whether my clients want to purchase a house and land package or purchase a vacant block of land and then build a house on it. What is the difference? It can make a huge difference in the SMSF world, especially when there are borrowings involved.

Purchase as a single acquirable asset

An SMSF can borrow money to purchase a house and land package as long as it is purchased together in the one transaction as a single acquirable asset where the asset is identified up front as vacant land with a completed house on it.

But if an SMSF purchased a block of land with borrowings and then later built a house on the land, this would not be allowed under the limited recourse borrowing arrangement (LRBA). The superannuation law does not allow the single acquirable asset, in this case the block of land, to be improved (by building a house on it) while the loan remains outstanding. There is a very good reason for this.

The borrowing rule is referred to as a limited recourse borrowing arrangement. It means the lender's rights, on any default on the borrowing by the SMSF, are limited to the single asset acquired under the arrangement. This means, the lender does not have any claim over any of the SMSF's other assets. The borrowing is quarantined to the single acquirable asset. The law is designed to protect the remaining assets within the SMSF in the event of its default.

So, if an SMSF borrows to purchase a block of land and later builds a house on the land, and then due to some unfortunate financial circumstances cannot repay the loan, the lender will take possession of the asset – which is now a property consisting of a house and land. The money that the SMSF spent building the house on the vacant land is lost as it cannot be recovered from the lender. To make matters worse, the SMSF has also contravened the LRBA and would be in trouble with the Tax Office.

Make sure the SMSF complies

The trustees of the SMSF must ensure that:

- they identify up front that the single acquirable asset is the land with a completed house on it
- the lender's security on the borrowing is at all times over the land and the completed house
- the LRBA with the lender allows for multiple draw-downs for the deposit, progress payments and the final payment at settlement.

House and land packages can offer investment opportunities for SMSFs, but if they don't comply with the law, the investment could end up being a costly mistake.

Monica Rule is an SMSF Specialist Adviser and the author of 'SMSFs and Properties' – www.monicarule.com.au

Online wealth advice is a reality

Maggie Callinan

Financial advice in Australia has not been static. Fuelled by the superannuation guarantee system, the industry provides a wide range of services to investors; strategic advice, insurance, investment management, portfolio reporting, social security guidance, assistance navigating the superannuation and retirement systems, etc. The list goes on.

Unfortunately the infrastructure required to support financial planning services and regulation has grown unwieldy and costly. Most planners rely on cumbersome administration systems. A typical large practice financial planner is locked into a single or at best two or three investment platforms. This has reduced flexibility, and increased the cost of stand-alone investment advice.

A key part of the financial planning offer – investment advice – has become less tailored over the last 10 years. The need for better compliance, scalability and fee harvesting has meant that investors are often recommended benchmark-hugging model portfolios such as fund-of-fund offers, typically manufactured internally. The investment advice part of financial advice has become commoditised, making it less important as part of the overall financial advice value proposition.

What is the focus of 'direct wealth' or 'robo' advice?

Direct wealth is effectively a 'cut out' of the financial planning offer. It is not a 'full-service' offer, but concentrates on tailored strategic asset allocation and investment advice, without the complexity or cost of the complete financial planning administration and infrastructure.

In North America and the UK, direct investment advice is thriving. In these markets there is no problem with segregating *investment* advice from the broader financial advice offer.

There are three other important drivers of the growth of direct advice.

First, fees are coming down both in Australia and globally. But the cost of the complex investment platforms that Australian advisers are using means that these fees are not coming down quickly enough.

<u>Second</u>, smart phones have now been around for many years and we love them. They are always with us. For most Australians, young and old, this has become their primary conduit to information, purchasing of goods and services and interaction with friends and associates. Paper communication, talking face to face with people and even emails, are being replaced. This is a challenge for the traditional financial planning models that still seem to require endless paper and face-to-face meetings. In contrast, direct investment advice is easily completed using just a smartphone.

<u>Third</u>, we now have a better understanding of how investors think. Behavioural finance has alerted us to mental accounting where investors tend to think in 'buckets', however illogical that is. Unfortunately 'bucket' investing doesn't quite fit with holistic financial advice – where there is usually one investment solution across a client's entire portfolio.

This is an ideal environment for online direct wealth solutions.

More people need advice but are not willing to pay for it

As an example, take an investor with an SMSF. They have already paid for the superannuation framework and typically choose their own investments without the help of an adviser. This has worked well until recently; relatively accessible investments like term deposits and Australian shares have delivered good returns. Now, these self-directed investors are noticing that global markets and property have outperformed, while deposit returns have reduced dramatically and Australian shares have borne the brunt of the commodity market downturn.

Many SMSF self-directed investors have been hurt by their lack of diversification. They need advice about non-Australian markets and strategic asset allocation but are loathe to pay a financial adviser for the administration and strategic advice they don't need.

The good news for SMSFs is that direct wealth or 'robo' advice can offer online tailored strategic asset allocation and security selection advice quickly, efficiently and at low cost. The trustee can receive a robust diversified portfolio in less than 10 minutes, using their phone or home computer. There is no need to pay for the extras that traditional financial advice provides (accepting that many other investors need these and are willing to pay for them) such as retirement strategy, budgeting, face-to-face meetings, costly administration and all that paper work.

Then there is the forgotten investor – perhaps an individual who has accumulated savings, received an inheritance or downsized their house. The money is not in superannuation, which is well catered for by financial advisers. This investor's easily accessible choices are limited. They can put it into the bank, buy an investment property, buy some Australian shares or find a financial planner. The difficulty is that the financial planner will want to look at all of the investor's portfolio in a holistic solution. Clearly, there is a role for such a broad offer, but many investors only want the money invested efficiently, not complete the work necessary for a 70-page Statement of Advice.

Direct wealth advice is the solution. Tailored strategic asset allocation and investment advice using online risk profiling includes quickly opening both a bank account and brokerage account, a process which can take many weeks with a financial adviser.

Direct investment advice is also more flexible for 'bucket' investing. Let's assume that the investor splits their investment money into two buckets. The first bucket is a short term investment (say, 18 months), and the second bucket is more of a long term investment, say five years. The investor can open two accounts in the direct wealth channel, and simply alter the time frame for each account. This will produce tailored strategic asset allocation and investments to suit both buckets.

The other benefit of direct wealth advice is that investors have a transparent portfolio rather than the opaqueness of a multi sector balanced fund with many underlying managers. Using *any device,* investors can call up reports, see daily updates in portfolio value, redeem and invest additional funds. Direct wealth 'robo' advice is investment advice brought into the reality of our digital world.

Maggie Callinan is Chief Investment Officer of Indeksio, due to release in Australia in Q3/2015.

Market psychology, emotions and … more emotions

Karl Siegling

We spend a significant amount of time explaining to investors our process for entering and exiting investments, which we call technical research. This process occurs after a stock has met our fundamental criteria and it gives us a framework on how best to enter and exit a position. Technical research is based largely on the 'psychology of the market' or the 'psychology of a particular stock'. The process is designed to eliminate as much emotion as possible from the investment process.

Scaling into a position

Our previous article for Cuffelinks *Cheap stocks: how to find them and how to buy them* explained how we purchase a stock that we think is fundamentally cheap. We commence by adding a 1% position (1% of our portfolio value) only once a stock has finished falling and is rising in price.

There is a lot of emotion and psychology contained even in this initial 1% purchase. If this stock is fundamentally cheap, how did it become cheap? Market participants must have been selling it, but why would they be selling a fundamentally cheap stock? Why did some stocks during the GFC halve in value despite earnings actually going up? Was it based on fundamentals or psychology or, the most important of the emotions, **fear**? Notably, any initial position is only a 1% position: we are not 'betting the farm' and if we are wrong we simply sell the position and take a small loss. This means that each investment decision is not a 'life and death' decision but merely part of an established process.

We do not add to an initial 1% position unless the stock price is going up. We add to our positions in 1% increments and **never** add to the position if it falls in price.

More often than not potential investors who pride themselves on being deeply fundamental investors challenge this approach. A common question is: if you liked it at $1, don't you like it more at $0.90? Actually no, we have already lost over 10% on the first position and do not want to 'throw good money after bad'. What if the fundamentals we have evaluated are wrong, then we would simply be adding to the size of a position that is already 'going against us'. Another common emotional state is that 'you never go broke taking a profit', so instead of adding another 1% to a position that has gone up in value why not just sell the first 1% for a profit? The answer is that whilst you cannot go broke making a 5% or 10% profit on a 1% position, you will never make much either and you will not be around to benefit if the stock doubles, triples, quadruples or goes up ten-fold (what Peter Lynch calls 'ten-baggers' in his book 'One Up on Wall Street').

We add an additional 1% to positions as a stock increases in price up to a maximum of 5% exposure (at cost). In this way we accumulate a 5% position which is a 'winning' position i.e. we could only have accumulated a 5% position if the initial position was purchased at lower prices. In this way we add to our winning positions and become more relaxed as our profit in the position grows.

Some investors I talk to take an initial 1% position at say $1.00 but will then add to the position if it falls to say, 90 cents and then add to it again at say, 80 cents. What an emotional roller coaster it must be. You have made an investment, you add to a losing position, now you are losing twice as much money on the same position and the best solution you can come up with is to add further to a losing position. Now you have a 3% position losing even more money, and where does this logic end? How often can you add to a losing position and how much pain can you bear? Once you have added to a losing position several times, how well equipped are you emotionally to admit you have made a mistake, and at what cost?

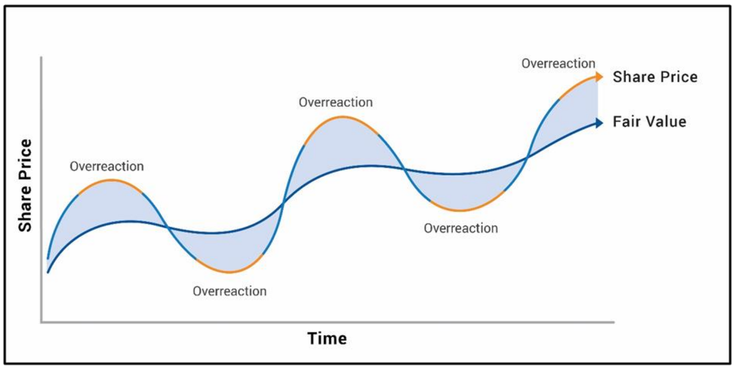
Why do share prices overreact?

We see time and time again the huge role psychology plays in investment and to suggest that psychology does not play an important role is to 'invest in a bubble'. We believe that an investor's fundamental investment process has to be adapted to take account of psychology, including a disciplined approach to entering and exiting fundamental positions.

Diagram 1 shows share price overreactions where stocks move well beyond their 'fundamental value'.

Why does this happen? In 'Reminiscences of a Stock Operator', Jesse Livermore gives three main reasons: **hope, fear and greed!** These three

Diagram 1: Share price overreactions



emotions affect the psychology of the market or a particular stock. We experience these emotions despite what the fundamentals are saying.

Remember the very point at which you need to rely on your fundamentals is the very same point when you start to doubt them. (It is important to note at this stage that the phrase 'fundamental analysis' is generally incorrectly used. These so called 'fundamentals' are in fact future earnings estimates for a particular company, which are at best informed guesses and at worst pure 'pie in the sky' fabrications.) We start to doubt our future earnings estimates (i.e. act emotionally) at the very moment we need to rely on them.

Generally speaking stock prices tend to move up on good news and earnings growth and down on poor news and poor earnings growth. As outlined above these moves tend to 'overshoot' in each direction.

The diagrams below illustrate two basic rules that prevent an investor making common emotional mistakes in an over-reacting market.

Rule Number 1: Do not buy a falling stock

Why are investors attracted to buying falling stocks? **Emotions**. If it was cheap at higher prices it must be cheaper now. Pick the bottom and look like a hero. Fear of missing out on getting the lowest price and paying more if the price goes back up.

Rule Number 2: Do not sell a rising stock

Again why would someone sell a rising stock? **Emotions**. The stock has doubled so it must be expensive, and fear that the stock will fall again. Locking in a profit after a doubling of a price feels safe. The desire to 'lock in a profit' and 'be safe' is potentially one of the biggest investment mistakes we can make.

You would think these two simple rules would be easy to follow, but all the emotions tied up when trying to follow these rules prevent most people from doing so.

Don't ignore market emotions

Ignoring the psychology of the market is like investing in a bubble. Each investor should realise that with every buy and sell decision, they are bringing to the table a number of powerful and potentially destructive emotions. Good investors should recognise these emotions when they are experiencing them and have processes to deal with them.

Karl Siegling is the Managing Director of Cadence Capital, see www.cadencecapital.com.au.