Cuffelinks
Connecting investors with ideas

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Asset class review of 2015 and outlook for 2016

Ashley Owen

This review is about asset classes, not individual funds or stocks. Getting asset class views right (or wrong) can gain (or cost) portfolios 20-30% or more in any given year. In contrast, managed funds tend to outperform or underperform their asset class benchmarks by only a few percent each year (most underperform in most years). The vast bulk of managed fund returns each year is due to the return from the asset class in which they operate (often called 'beta') and not from the skill of the manager in beating its asset class benchmark ('alpha'). Good asset allocation is usually much more critical for overall portfolio performance than picking funds or stocks.

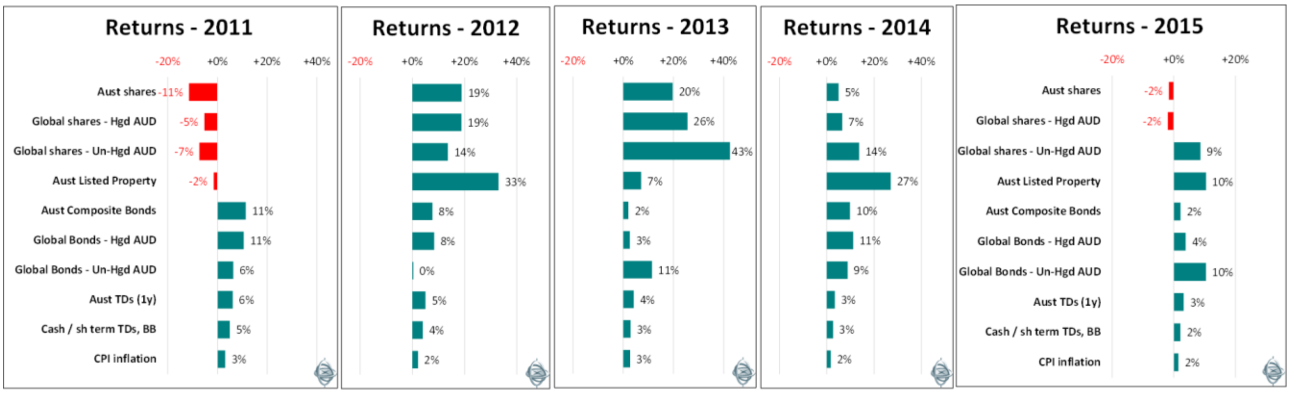
(Data used here is current as at 11 December 2015)

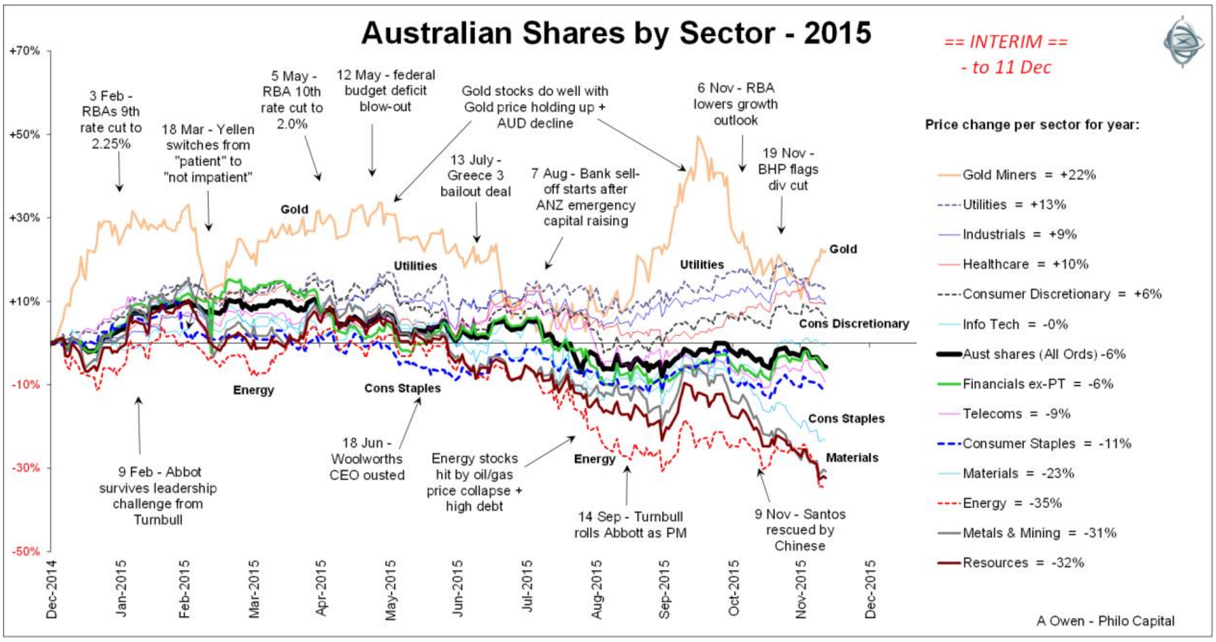
Winners and losers

2015 was a year when all asset classes did relatively poorly relative to their long term expected averages.

We went into 2015 favouring Australian shares, Australian listed property and unhedged global shares (favouring developed over emerging markets) in portfolios. We were underweight Australian fixed income (but favouring short duration), global bonds, TDs and cash.

Our favoured asset classes performed well overall - Australian shares were down a little (-2% including dividends) but unhedged global shares (+9%) and property trusts (+10%) did quite well. Conversely the asset classes we were underweight returned less than their expected averages - Australian bonds (+2%), global bonds (hedged) (+4%), TDs (+3%) and cash (+2%).





Australian shares

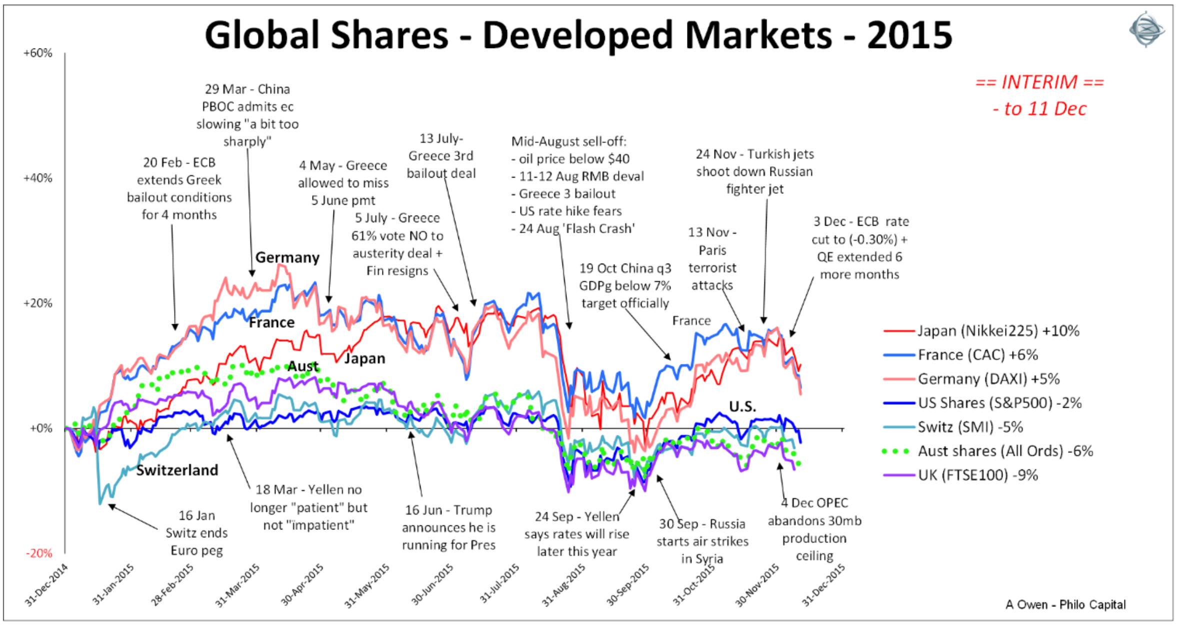
Returns diverged greatly across different sectors of the local market.

2015

- Miners were hit by falling commodities prices plus high debt loads. The only exception was gold mining stocks, with the gold price holding up relatively well due to lingering QE hyper-inflation fears.
- Banks were hit by high capital requirements plus fears of bad debt blow-outs from miners and property lending, and doubts over the sustainability of dividends.
- Revenue and earnings were weak overall but dividends were increased on higher payout ratios.

2016

- Miners are likely to cut dividends, with bank dividends under pressure too. But dividend yields are still attractive, assuming they are not cut significantly in aggregate.
- The overall market is around fair value on long term fundamental valuation measures, but we are relatively bullish in the short term as well.



Global Shares – 'developed' markets

Many developed country stock markets delivered better performances than Australia in 2015.

2015

- Markets were flat overall, but being unhedged on the currency for Australian investors added 9% to returns for the year.
- US markets were flat. The rising US dollar plus the oil/gas collapse hurt not only oil/gas stocks but related manufacturing as well. Most tech stocks were up strongly except Apple which was flat. US revenues and earnings were weak but dividends and buybacks were strong.
- European and Japanese markets held up reasonably well despite stagnation & deflation in their local markets, but were assisted by weakening Euro and Yen.

2016

- US recovery and sentiment has a good chance of remaining strong enough to withstand slow rate hikes. The Fed has made it clear that rate hikes will be gradual and well-signalled.
- European markets are likely to be benign. Greek failure to stick to its repayment plan will be absorbed.
- The US market (which is half the overall global market) is overvalued on several long term fundamental measures.

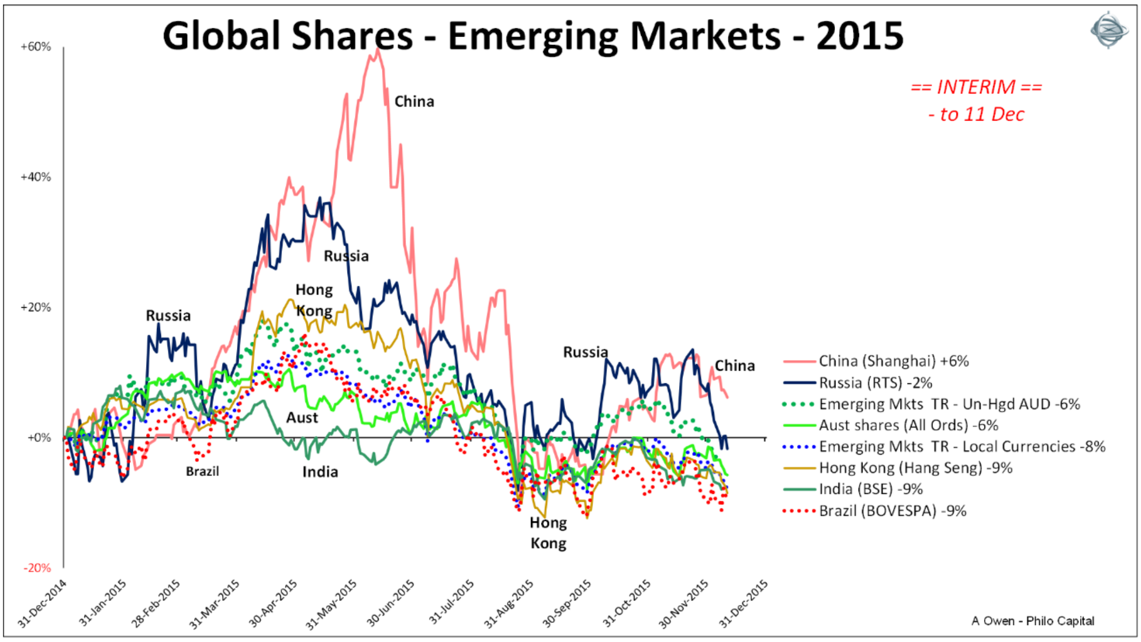
In contrast to the sombre performance of developed markets, emerging markets went on a wild ride during the year but still finished relatively flat overall.

2015

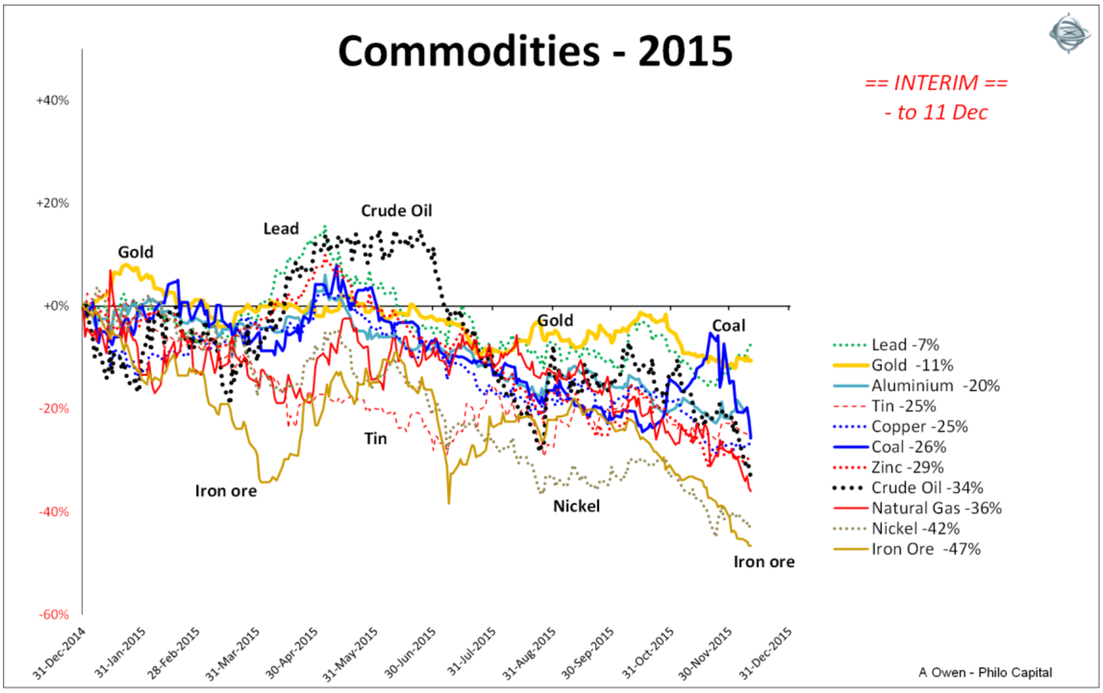
- Commodities price collapses affected many emerging markets.
- The Chinese stock bubble raged on until mid-June but then burst despite stop-start policy action to prop it up.
- Russia was up and down with oil price gyrations, India was the best BRIC economy but had poor returns and Brazil was in deep recession and plagued by widening corruption crises.

2016

- Corporate defaults likely to increase with rising US dollar and rising US interest rates.
- Emerging markets deficit / debt / currency crisis looming in Latin America, Middle East & South-East Asia.
- US rate hikes and credit market shocks likely to suck hot money out of emerging markets stock and bond markets.



Emerging Markets shares



Commodities

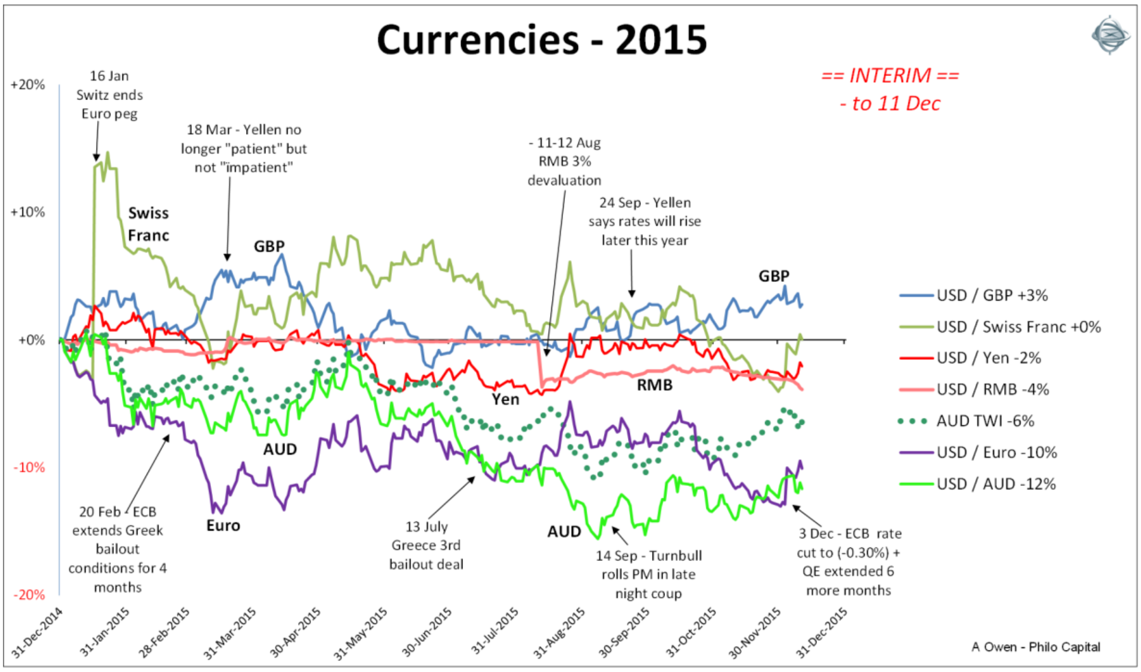
Commodities prices continued their long slide since the cycle peaked in 2011 with major impacts on developed and emerging stock markets.

2015

- All commodities were down heavily again.
- Global demand and growth outlooks were lowered progressively during the year.
- Over-supply worsened, with new production still coming on stream, swamping weak demand.

2016

- Demand remaining weak, with stagnant Japan and Europe, slowing China.
- Prices may stabilise if over-supply curtailed as mine closures accelerate.
- LNG over-supply to hit Australian LNG. Buyers may renege or renegotiate.
- Escalating Middle-East conflicts should support oil prices - good for markets.



Currencies

Currency hedging decisions are critical and make a big different to portfolio returns.

2015

- The US dollar and UK pound rose on expectations of rate hikes by the Fed and Bank of England.
- The Aussie dollar was weakest despite having the best economic growth.
- Chinese RMB mini-devaluation in August.

2016

- Further RMB devaluation is likely, but expect retaliation from US, especially with US election rhetoric.
- Emerging market currency crises (like 1997) may be triggered by commodity revenue collapse.
- Aussie dollar sell-off likely if budget blow-out continues to worsen, without credible plan to return to surplus.
- The AUD is still over-valued on fundamentals, and likely to be sold off in EM debt / currency crisis, so still more potential gains to be had from being un-hedged.

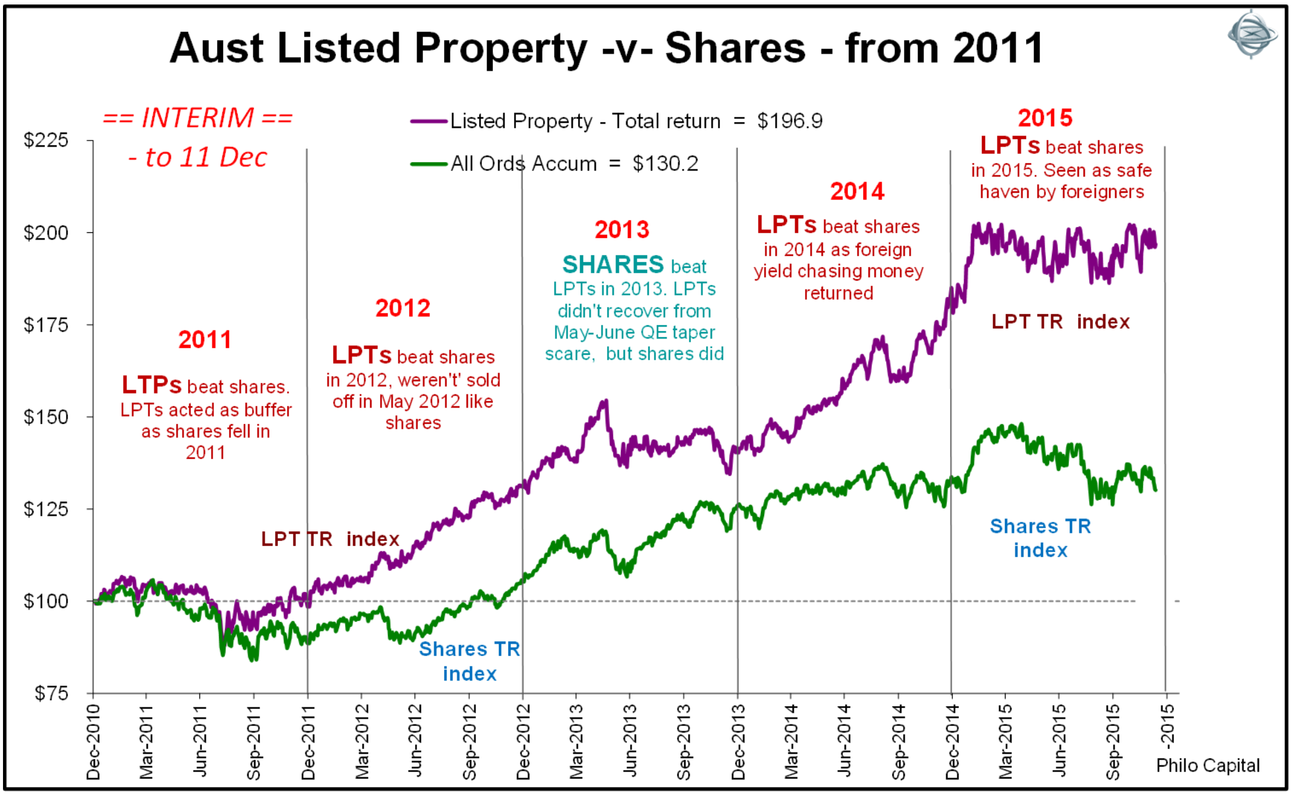
Australian real estate

2015

- Good returns from listed property which beat shares again.
- Listed returns have been better than direct property over the past four years but the gap is now gone, and both are overpriced.
- Returns have come from yield/cap rate compression plus gearing rising at ultra-low interest rates (neither is sustainable) rather than from rent rises.
- Listed trusts returned as 'safe haven' after 2013 QE taper sell-off.
- Mergers and acquisitions activity boosted prices.

2016

- Continued strong foreign demand for direct and listed property, M&A activity to continue.
- Likely to suffer along with shares in EM debt scare (like in QE taper scare).
- Although we have favoured listed over unlisted property, unlisted is less prone to flight of hot foreign money in panic sell-offs which may hit markets in the coming year.



Australian fixed income

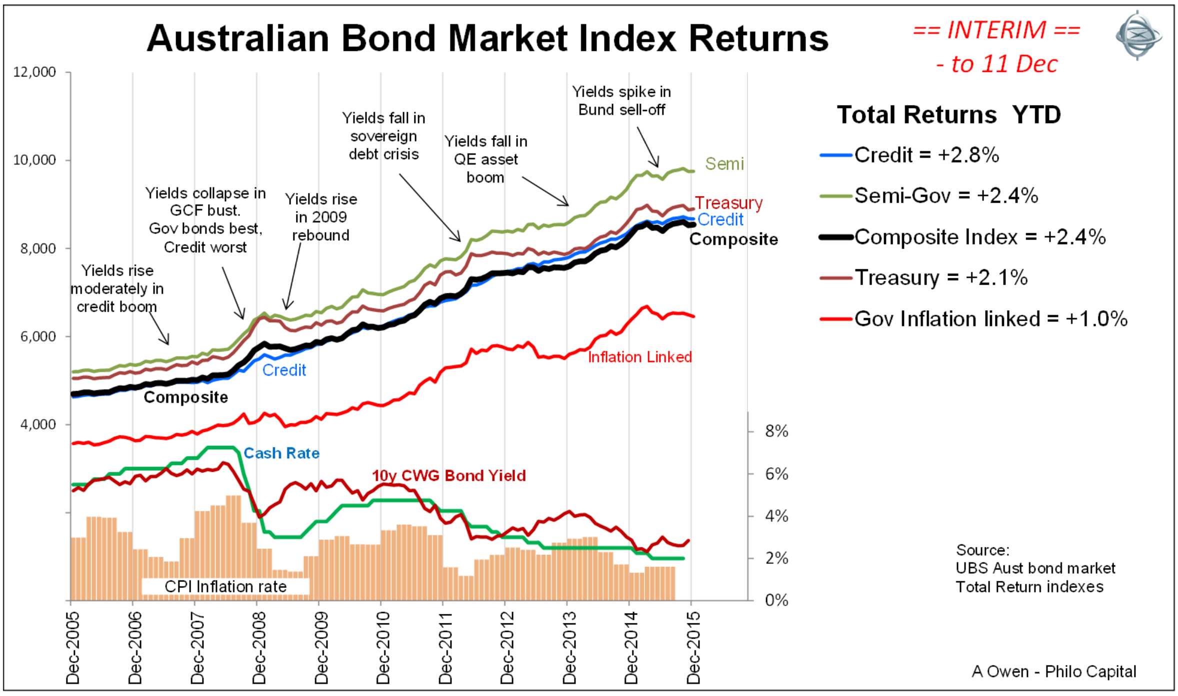
The next chart shows returns from the main sectors of the domestic bond market over the past 10 years.

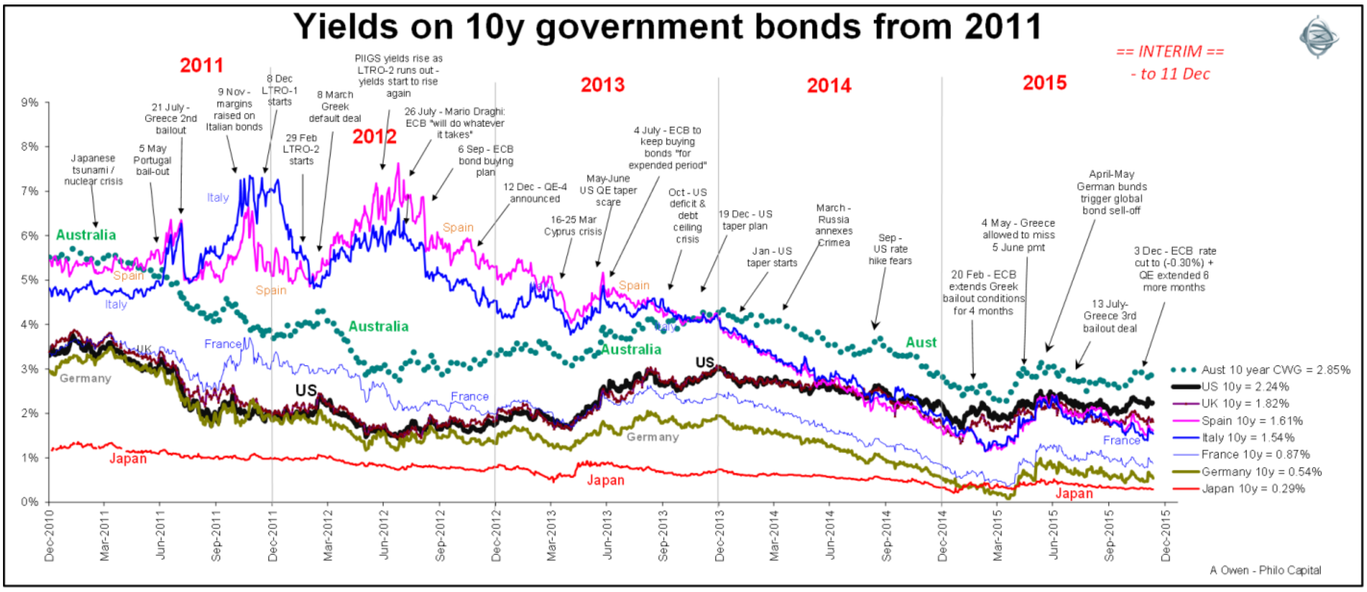
2015

- Below average returns from all sectors this year.
- Yields spiked in the April-May German Bund crisis.
- Short yields finished lower with declining cash rates but long yields ended flat or a little up.
- Credit did best, but spreads are still vulnerable to sharp sell-offs in credit market scares.
- Strong foreign demand supported prices.

2016

- Long term returns likely to be below average.
- Short term returns likely to be benign, with yields staying relatively low.
- Australian bonds likely to be sold off by foreigners in emerging markets debt scare. There is also an increasing risk of Australia losing its AAA credit rating with the budget blowout continuing. This would scare some foreign investors and cause yields to spike.
- Short duration likely to perform better than long.





Global bonds

After the yield declines across the board in 2014, bond yields in most markets edged a little higher in 2015, leading to below average returns.

2015

- Negative yields across much of Europe. Almost all of Europe is below US yields.
- Broad global bond sell-off in April-May triggered by snap back in German Bunds which had been pushed down to ultra-ultra-low levels by mid-April.
- Japanese yields remained virtually flat all year supported by QE, with deflation and stagnation persisting.
- US and UK yields rose with their economic recoveries and expectations of very slow rate hikes.
- The global government bond benchmark returned 4% in hedged AUD, but 10% unhedged due to the falling Aussie dollar (but few investors use unhedged global bonds, preferring the 'safety' and much lower volatility of hedged bonds).

2016

- We expect benign returns for global government bonds with yields staying low, especially in the big markets of Japan and Europe. No sign of serious inflation for years.
- US rate hike programme should keep US yields relatively low. The quicker the rate hikes, the lower the yields will remain.

Likely shocks

Every year there are usually one or more general sell-offs in global markets, but most are not serious and markets recover quickly.

The most likely source of a general market shock in the coming year would appear to be from the combined effects of collapsing commodities prices, high debt levels (particularly US dollar debt), unsustainably low credit spreads, and rising US dollar and US interest rates. The most likely candidates would be high indebted emerging market corporates and governments, especially those with budget deficits and weak reserves.

Chinese corporate defaults will probably continue to escalate but should be manageable due to China's huge reserves and government ownership of the banking system.

The problem is likely to be more serious in smaller emerging markets with wide deficits and dwindling reserves. There are likely to be sharp currency collapses as capital is withdrawn rapidly from some markets. Another Russian default (like 1998) is not out of the question. The Australian dollar, shares and bonds are usually sold off quickly in such circumstances.

In the developed markets there will probably be some losses and collapses in credit funds and commodities hedge funds, including perhaps even some commodities or credit ETFs.

Wishing all readers a safe and prosperous 2016.

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund. This article is for general education only and is not personal financial advice. It does not consider the financial circumstances of any individual.

Underperformance from investing at the wrong time

Jason Hsu

(Editor's note: The following data and conclusions relate to the US market).

Substantial research evidence supports the long-term predictability of returns based on factors such as dividend yields, Price/Earnings ratios, value and low volatility. However, investors are not reaping the benefits of such knowledge due to their timing of fund manager selection. By chasing winners from previous years, individual investors miss the mean-reverting factor and create underperformance, sometimes called a 'return gap'.

Trend-following allocations push valuations

The procyclical or trend-chasing allocation accentuates the underlying economic shocks to various investment styles as flows push valuations. In the short run, this results in self-fulfilling prophecy and momentum. In the long run, it becomes self-defeating and gives rise to mean reversion. This investor pattern contributes to a predictive relationship between the valuation multiple and future return. As shown below, Frazzini and Lamont (2008) and Hsu, Myers, and Whitby (2015) find evidence that mutual fund flows predict negative future fund performance. **Figure 1** shows that mutual funds with high inflows have low next-period relative performance. **Figure 2** shows that the investor return gap, which is driven by the negative correlation between flows and subsequent returns, is large across all fund categories.

Figure 1. Returns of Stocks in Low- vs. High-Inflow Funds

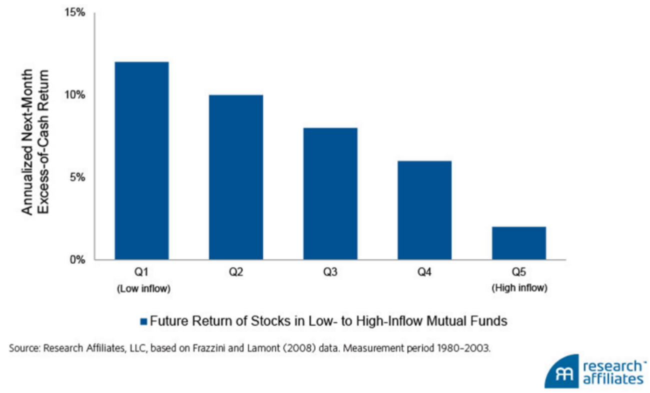
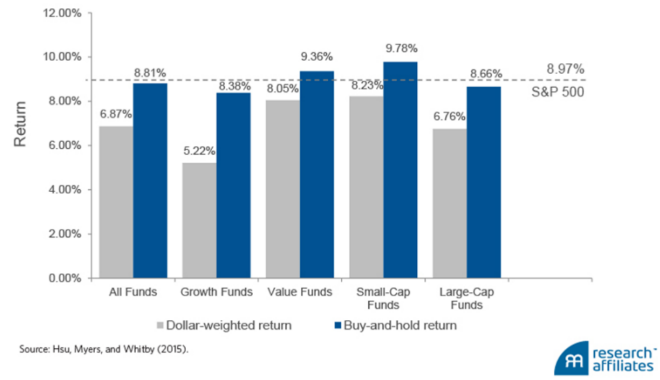


Figure 2. Investor Return Gap Is Large for All Fund Categories (January 1991–June 2003)

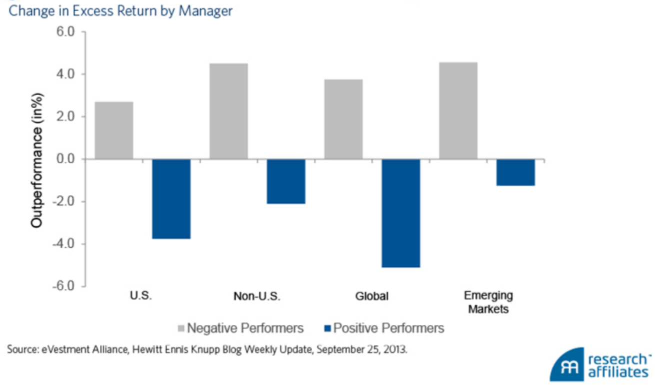


Alpha is a zero-sum game and so are flows

It is important to remember that flows are zero-sum, meaning that for every seller of a cheap value stock a buyer must exist on the other side of the trade. It is thus important to be clear about the investor cohorts being examined in the research. Most studies are based on mutual fund investor flows, with a few studies examining pensions and their allocations to institutional asset managers. The emerging evidence is that this particular investor cohort has earned negative dollar-weighted alphas on a gross-of-fee basis, as indicated by their large negative return gaps versus a buy-and-hold strategy. These negative return gaps are driven primarily by trend-chasing allocation decisions, which have largely been institutionalised by the investment industry through its hiring and firing decisions, the majority of which are based on recent performance. Given the poor performance of the adopters of modern investment selection practice, it is not unreasonable to label mutual fund investors and pensions as naïve flows, which are supplying dollar alphas to others.

Ironically, the pursuit of positive alpha, which leads to the regular switching of investment strategies and managers, is the very reason why mutual fund investors and pensions have earned negative alpha. Investors should realise that the widely-followed selection practice is technically an attempt to time manager alpha. **Figure 3**, using institutional manager data from eVestment, shows that managers who underperformed in the previous five years tend to outperform in the next five years, while the outperformer tends to then underperform. As manager styles come in and out of favor, the hiring and firing of managers is akin to timing the returns of style factors. That procyclical timers, such as mutual fund investors and pensions, do poorly is the very reason why countercyclical factor returns persist.

Figure 3. Past Five-Year Performance vs. Trailing Five-Year Performance
Change in Excess Return by Manager



Individual investors delegate investment decision making to mutual fund managers. Pensions delegate investment decisions to institutional asset managers. Delegation is supposed to prevent less sophisticated investors from being the proverbial pig, slaughtered by better-informed bulls and bears. Putting aside the facts that the average investment manager charges just enough fees to extract all of the alpha they create, the delegation of investment decisions has failed miserably along a dimension that has received scant attention.

The modern investment delegation practice is one in which manager skill has minimal impact on the wealth outcome of investors. To fully understand this, we need only examine the buying and selling activities of professional managers. In 1999, when value stocks were as cheap as they have ever been, value managers were the biggest sellers of value stocks. This was also true in 2008. It isn't at all surprising when we realise that the selling is driven by redemptions! The manager could be doing *exactly* the right thing by tilting the investor's portfolio toward value stocks. But by redeeming the allocation to value managers, the investor is able to more than offset the manager's insight and effort.

The wisdom or madness of crowds

The classic study on the wisdom of crowds suggests that a large collection of investors with different information, experience, and expertise tend to get prices right. Experiment after experiment shows that the crowd is better at figuring things out than the experts. Yet the wisdom of crowds can give way to the madness of crowds when the crowd herds on the same piece of information and/or adopts similar thinking. Experiments show that if the crowd is made aware of the presence of experts, its members synchronize to the expert opinion, and the wisdom that once was, is no more.

When the majority of investors adopt an investment selection process based on recent performance, they are forced to pile into similar stocks belonging to similar styles—that is, they allocate to an increasingly crowded trade. There is little wisdom in the prices that result, though the madness can certainly persist for a long while, creating the illusion of investment "guru"-ness on the part of many.

The institutionalisation of individual behavioural biases

The prognosis for improvement is unfortunately pessimistic. What started as behavioral biases—that we confuse short-term performance as vital information on manager skill, and that we enjoy blaming others and holding them accountable for random bad outcomes—have been institutionalised. No longer can behavioral biases be overcome by the greater mastery of one's emotional state or by attaining greater investment enlightenment. These biases are now organisational problems that cannot be easily fixed by any single individual in the process. Would a consultant or financial advisor recommend a shortlist of managers with poor recent performance? Would the pension CIO and his staff choose a manager with a negative trailing three-year alpha to present to their layman board? Given a keen understanding of investors' buying behavior, would salespeople and marketers educate client prospects on products that have recently underperformed? The investment ecosystem has conspired against the end investor. Oddly, the end investor is leading the conspiracy against himself. The path of least resistance is the path most often taken: buy recent performance.

The individual investor's edge

Given the institutional challenges of traditional investment advice that plague pension sponsors and the wealth management industry, in general, a savvy individual investor could actually have an edge by being a contrarian in the modern investment-selection process. Buy the style that is out of favor and whose stocks are trading meaningfully below historical norm. Sell the popular style and its expensive stocks. The individual investor may be early in buying or selling, but has a far greater ability to deal with that potential discomfort than does an institutional investor. An individual is unencumbered by the constraints and oversights—a board, quarterly reviews, asset-raising goals, angry clients, or other pressures—that dominate institutional investment decision making.

Investors who have the courage to be a contrarian will earn a handsome "fear" premium for taking the other side of the industry's trades, counter to those who seek to avoid uncomfortable client conversations. For those unable to fully embrace a contrarian stance, they should at least consider adopting a buy-and-hold strategy. Indeed, most investors might benefit from simply forgetting the ID and password to their trading account.

Jason Hsu is Co-Founder and Vice Chairman of Research Affiliates LLC. This article is for general information purposes only and does not consider the personal circumstances of any investor. Readers should see their own professional advice. The full paper with greater detail, footnotes and references is [linked here](#).

My purpose of super is probably not yours

Graham Hand

Have you ever been in a meeting where everyone in the room, except you, seems to agree on something? You wonder whether you should keep quiet or start asking a few probing questions. I sat through half a day of speeches before launching into my own special version of the truth, much to the dismay of other delegates.

It was in June 2015 at the inaugural conference of the newly-formed Committee for Sustainable Retirement Incomes (CSRI) where everyone else seemed in furious agreement that we not only need to define a 'purpose' or 'objective' for superannuation, but it was obvious what it was. As the Committee's Chairman, Michael Keating, wrote later:

*"The FSI [Financial Systems Inquiry] recommended that the objective of superannuation should be to provide 'income in retirement to supplement or substitute the age pension', and there is an **emerging consensus** that superannuation should be directed to providing a retirement income and not other benefits, including bequests." (my emphasis).*

Whatever the future, that was not the past

Is that right? It that the consensus? Not for me. I have been putting money into superannuation for 20 years without an expectation that I will need the majority of it 'to provide a retirement income'. It's a tax-effective place to save, entirely within the rules, and I have foregone current consumption to secure my future and avoid any likelihood of being a drag on the public purse.

For many people, superannuation is both about funding a retirement and leaving a bequest. It's a piggy bank, a store of wealth, with a strong expectation there will be plenty left over beyond retirement income to give to their children. Why is it different to the favourable taxation rules around owner-occupied housing, or to a lesser extent, negative gearing, or family trusts? I could have bought a harbourside home and enjoyed tax-free capital gains, but instead I chose superannuation. If we are defining 'purposes', we should look at the entire package of different taxes and benefits, not only superannuation.

My view may even be part of the majority in the real world. At the recent 2015 CSIRO and Monash University Superannuation Research Cluster, a study reported that 90% of the amount an average retiree enters retirement with (including family home and non-super) remains unspent upon their death. On 23 May 2015, *The Australian Financial Review* quoted Treasury work which found that most people still have around half of their superannuation balances at the time of average life expectancy. This CEPAR research paper explains why retirees under-consume and over-accumulate.

So the 'purpose of superannuation' is far from settled based on actual experience, and while it may fund part of a retirement, it is at least as likely to become a bequest.

What did David Murray say?

David Murray and the FSI identified a major deficiency of superannuation being the lack of a clearly articulated objective to guide policy. Recommendation 9 states:

"Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objective over the long term."

That's a high bar for the 'objective' to jump over, and a major challenge for the government. It goes on to say, "Superannuation is a vehicle for individuals to fund consumption in retirement largely from working life income." Not much sympathy for bequesting there.

What does the Superannuation Complaints Tribunal say?

The government agency charged with adjudicating on superannuation disputes is the Superannuation Complaints Tribunal (SCT). In its Annual Report 2014-2015, it writes:

*"There are some common misconceptions about superannuation death benefits that can result in unexpected outcomes for the beneficiaries of a death benefit, and may result in a complaint being made to the Tribunal. The most common misconception, arguably, relates to the purpose of superannuation. Broadly speaking, **the purpose of superannuation is to provide income in retirement to members and their dependants**; it does not form part of a person's estate. Accordingly, a superannuation death benefit should be paid to dependants and those who had a legal or moral right to look to the deceased member for financial support had they not died." (My emphasis. Thanks to Robin Bowerman of Vanguard for this point).*

There it is … "**and their dependants**". Sounds like a bequest to me. The SCT is an independent government body that deals with complaints relating to the decisions trustees make in relation to superannuation, and of the 2,700 complaints processed in 2014/2015, 29% were about death payments. A large amount of its work, therefore, is sorting out who should benefit from a bequest.

Superannuation specifically acknowledges bequests

Superannuation legislation has specific features designed for appropriate bequeathing. For example, Binding Death Nominations (BDNs) ensure superannuation is distributed according to the wishes of the deceased member, not at the whim of the trustee of the fund or executor of the estate. Superannuation is not an asset of the estate and a trustee is not obliged to follow directions in a will, even if super is specifically mentioned in the will. The instructions in the BDN define the money flow.

Superannuation death benefits are paid directly to a dependant rather than the estate to ensure others (creditors, claimants for bankruptcy, etc) cannot access the benefits provided to a dependant.

In fact, the superannuation rules themselves even facilitate bequests to non-dependants. There is no restriction on withdrawing money from superannuation for anyone who has reached preservation age and satisfied a condition of release (including retiring). However, on death, if it is given to anyone other than a spouse or a dependent child, there is a tax of 16%. The obvious approach is to gift it before death, if possible. Continuing from the Treasury work quoted in the AFR as above:

"People typically don't die all of a sudden. They might know it is coming so they draw down at least some of their super in advance and gift it to others to avoid the 16% tax that is payable if you leave your super to independent children or people other than your wife or dependent children," one source said."

Conclusion

A potential benefit of this debate about the 'purpose of super' is to force each person to consider their own objectives, but we will be sorely disappointed if we think this will create consensus. I know what my purpose is, I know what David Murray's purpose is, and I know what Michael Keating's purpose is. But most importantly … what's yours?

Graham Hand is Editor of Cuffelinks and has worked in the finance industry for almost 40 years.

Take care when assisting parents financially

Melanie Palmer

This article continues from Alex Denham's, '[Providing financial assistance to parents](#)', and is in response to a reader's request to delve further into this little-explored theme. It focusses on what happens when circumstances change or where financial arrangements are challenged by other family members.

Parents are often giving a 'leg up' to their children, whether a gift to put a deposit on a house, guarantee a bank loan for a new business or the like. What happens if the 'leg up' is from the child to the parent, particularly in the event of marital or family breakdown? The following scenarios illustrate the main considerations:

Marital breakdown

Suppose a son has supported his parents by purchasing an investment property with them, and he has paid their bills and other essentials on an ad hoc basis. The son's marriage has broken down. Will his now ex-wife be able to make a 'claim' on the assets or money given to the son's parents?

The answer is mixed. The issue in a marital breakdown is a division of assets based on a number of factors and largely depends on the facts of the marriage, such as length, earning capacity of each spouse, whether there are children of the marriage dependant on one spouse and so on.

The paying of bills ad hoc in this scenario is unlikely to be included in calculating the 'pool of assets'.

It is arguable that the investment property, as it is held as joint tenants, might not form part of the 'pool of assets'. However, I am of the opinion it would be difficult if not impossible for the son's share of the property not to be included in a calculation of the 'pool of assets'.

This doesn't give the wife a claim on the property however, when all the assets are being divided. I would be of the view that the value of the son's share in the property would be included in calculating the pool and may affect how other assets, such as money held in bank accounts, are divided.

Changes among siblings' own financial circumstances

Suppose three siblings purchase a property for their parents to live in. What happens if, due to loss of employment, one of the siblings stops making the mortgage payments, or one wishes to exit and be bought out?

To answer these questions, it is essential to examine the agreement when the siblings entered into this purchase.

Unfortunately, few people think about this at the time of purchase but they really should. There should be an agreement in writing and with each party obtaining proper and independent legal advice. This may sound unnecessary in family situations, but it is not uncommon for people's circumstances to change through no fault of their own, leading to family discord.

As I often say to my clients, if everyone knows the rules beforehand, then disputes later are minimised or avoided all together.

So the answer to these questions will depend on the agreement in place. If nothing is in writing, then what was discussed before the property was purchased cannot be verified. If no discussions were had, then it's an even bigger mess.

Essentially, if there is a mortgage over the property then all owners will have agreed to be liable for the mortgage, usually jointly and severally, and one or all are liable. So if some siblings aren't paying the mortgage then the other siblings will need to make up the difference. If the mortgage goes into default, it will affect all of the sibling's credit rating.

If one sibling wishes to exit the situation, then usually the other siblings will buy their share. It is usually based on a market value of the property at the time of the sale and requires the agreement of all owners.

Can they sell to someone else? Yes, but only with the consent of the other owners. If there is a mortgage, then the mortgagee's consent will be required as well.

If agreement cannot be reached, then I see little choice but for the property to be sold and the proceeds divided amongst the siblings. The obvious problem is that mum and dad will be homeless.

Planning at the beginning is the key to avoiding headaches and arguments at a later date.

Unequal contributions within the family and inheritance

Another common issue is where one child helps the parents out more financially than the other children. On death, one child may feel entitled to more of the estate. This feeling of entitlement however, is not entirely accurate when it comes to administering the estate.

The parents' will should largely address these issues. If the child gave money to the parent, then that is a nice gesture, but it was a gift. It is not intended to be repaid by that child inheriting a larger portion of the estate.

If it's a loan, then the loan should be in writing before death and be reflected in the parents' will, recording that the estate will repay the loan.

A parent may leave a larger portion to one child over another to reflect the contributions made before death, but this situation usually causes more trouble than it is worth. It is likely that unless there was careful discussion and agreement before death, a claim on the estate by the child with the smaller portion will eventuate, which will lead to unnecessary stress and legal fees.

I again would say planning is the key with prior agreement as to what the money means and whether it will be 'repaid' by the estate of the parents.

If property is involved, then the child's investment or loan to the parents should be reflected in the ownership. For instance, where the child owns a share of the property or there is a mortgage granted over the property in favour of the child, the death of the parents will not affect that child's investment.

In the absence of documentation to outline the situation, in my view, the money will be treated as a 'gift' and recovery from the estate would be difficult if not impossible.

Summary

Not all situations are straightforward and each matter will be determined on the facts. Documents outlining the intention and agreement of all parties may seem unnecessary when family is involved, however, courts are full of family members fighting about money.

If everyone knows their obligations and rights from the beginning, in my experience, most disputes are quickly resolved, or avoided all together.

Melanie Palmer is a Partner of Palmers Legal. This article contains general information only and does not consider the personal circumstances of any individual. Professional advice should be obtained before taking any action.

Six challenges for robo-advisers

Paul Resnik

We believe robo-advisers will be paradigm-changing, but that doesn't mean they have a free pass to success. They must overcome six significant challenges if they are to evolve into profitable financial services businesses:

1. Changing perceptions of financial advice

For a large group of consumers, investment advisers are self-interested and greedy, financial markets are rigged and corrupt and their money is better off being self-invested into real estate, gold and other real assets. This widely-held perception of the finance industry is deserved.

There have been far too many financial services scandals that prove these theories, from an outright fraud like Bernie Madoff through to a local adviser churning an unsophisticated client through a procession of high brokerage-fee products. Meanwhile, the global markets collapse of 2008 left many investors wary and untrusting of the entire financial market framework. They would rather buy real estate that they can see and touch.

The financial advice industry has failed to make a convincing argument to justify its value to consumers. The industry has struggled with the intangibility of advice, the potential uncertainties of outcomes should markets crash and perceptions of greed among the people running the 'system'. The impact is that most people don't want to pay for financial advice.

2. Establishing trust

In financial planning, human interaction has traditionally been vitally important. As many a salesperson knows, selling something that is intangible requires the establishment of trust. This is problematic, because trust in the planning industry is low.

Trust is defined as "a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behaviours of another" (Rousseau, Sitkin, Burt, & Camerer, 1998).

Repeated surveys around the world show financial advisers sit towards the bottom of the trust ladder. How do robo-advisers show they are trustworthy? To show you are trustworthy, you must display the behaviours that will lead people to trust you.

Three important requirements are:

- Competence in the matters in which competence is claimed and required
- Reliability, by doing the things as expected and promised, and
- Honesty and transparency in dealings with customers.

To convince the broad public that it can be trusted, a robo-adviser will be required to invest in processes and marketing to tell the story of how and why they are trustworthy.

Established brands and the large end of town already have customer bases into which to market to achieve scale while also having the marketing budgets and communication channels needed to attract new business to a robo-adviser.

3. Advice and guidance gaps

'Advice gaps' arise when people who could benefit from financial advice do not receive it because:

- Their level of assets is too low to viably warrant the attention of a financial adviser, or
- They are not prepared to pay a fee to receive advice.

In the US, the desire to maximise planner profits makes accessing a financial planner high compared with the rest of the world. US advisers focus almost exclusively on what would be regarded as high wealth clients in the rest of the world.

In the UK, financial advice is generally more readily available to the middle classes – what might be termed the 'mass affluent'. The dollar figure required to access a basic service is driven significantly by the regulatory framework. Ironically, rules that were introduced to protect consumers now deny many of those people any service at all as the costs of regulatory compliance are too high to make them financially viable clients.

It is, perhaps, a logical conclusion to see robo-advisers as the solution to the advice gap as they have scalability and can service customers at low cost. Some people see robo-advisers 'democratising' financial advice, making it available to all.

By definition, those in advice gaps have lower investable asset balances, which means, per customer, lower income for the robo operator. Robo-advisers need profitable clients, but to acquire them as clients they need to invest serious marketing money, which is why existing big players have advantages over new entrant start-ups no matter how well funded. The exception is perhaps those providing a B2B robo white-label platform for existing distributors.

4. Economic influences

Around the world, wealth is being squeezed into upper economic groups, with corresponding falls in income and wealth for the middle and lower economic groups.

The loss of the middle range investor means that an increasing number of service providers are marketing to a shrinking pool of affluent investors, albeit that each of those customers comes bearing a larger pool of assets.

At the same time, there might be increased demand for robo-advisers that focus on providing budgeting tools and cash-flow forecasting, as these issues are of more significance to lower economic groups than questions of investment.

5. Cost of acquiring clients (CAC)

Robo-advisers need clients to operate and the cost of acquiring clients in financial services is high.

To us, this is the elephant in the robo-adviser room that is seldom discussed – which we believe is a strategic failure of the highest order.

Acquisition costs include the costs of initially finding a prospect and then converting those prospects into clients, with the inevitable attrition rate that those conversions incur. When total costs are compared to clients gained the results can be surprisingly high. Lucian Camp calculates the cost of acquiring a client in the UK to be around £200 (US$312).

This cost is beyond the means of many advisory firms, which is why they grow slowly – largely through word-of-mouth referral. In the past, they might have relied on product manufacturers and distributors to provide them with marketing support. Under new regulations in the UK, such supports are now largely no longer possible. But they continue to thrive in the US marketplace. In a world where former specialties have become commoditised, being able to make a financial product or service no longer makes you special as it once did.

Where, in the past, you may have been able to extract an economic rent because you occupied a position of advantage, market forces have now equalised you. Today, the ability (knowledge) and capacity (cash-flow) to quickly market financial products to scale is what separates successful financial services businesses from the 'also-rans'.

It does not matter if you arrive at the marketplace with a better mousetrap if that trap is hidden where the mice cannot find it. Cheese – in the form of marketing, advertising and promotion – will help to attract them. But cheese isn't cheap. Robo-advisers are very good at servicing customers, but do nothing to attract customers.

6. Behavioural biases

It is human nature to want it now. But it is also human nature to make plans for the future, including saving money. Of course, the two natures quickly come into conflict. You want a holiday now – but spending the money will reduce your pension in 30 years' time.

More often than not your 'present' self will defeat your 'future' self. The future loss is so far away that it is diminished, but the present benefit is NOW! "Pack your swimsuit, honey, we are going to the beach."

There is good reason to believe that robo-advice systems might do a much better job than human systems at helping people confront and manage this 'present-day' bias, by allowing them to visualise the impact of financial decisions made now projected into the future.

As ever when there are challenges, those who are successful will find new solutions and build the scale critical for success, while many others will fall by the side.

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The importance of updating your SMSF Trust Deed

Nicholas Ali

The Trust Deed for an SMSF is the Fund's most important document. It forms the core component of the Fund's governing rules. Whilst legislation typically stipulates what trustees must not do, the governing rules of a Fund specify what trustees are allowed to do.

For example, the appointment of an Enduring Power of Attorney to stand in the shoes of an incapacitated trustee must be expressly permitted in the Fund's governing rules. Merely having an Enduring Power of Attorney does not of itself mean that an Enduring Power of Attorney is appointed upon a trustee losing mental capacity. The Fund's governing rules must provide the mechanism for the removal of a trustee that has lost mental capacity.

Therefore, if the Fund's governing rules *do not expressly allow for this to occur,* the appointment of the incapacitated trustee can have serious ramifications for the Fund's qualification as a complying superannuation fund. Superannuation regulations do not state a Legal Personal Representative (LPR) is automatically appointed if a trustee loses mental capacity. If not correctly documented in the Trust Deed, the Fund may not be able to be restructured to remove the incapacitated trustee and replace them with the LPR. This may render the Fund inoperative, as all trustees must actively make decisions regarding the Fund (including the removal of a trustee).

The requirement for updating an SMSF's Trust Deed can come from many sources:

Changes in legislation

Some of the more prominent recent changes in superannuation legislation are:

- Refund of excess concessional contributions
- Limited Recourse Borrowing Arrangements
- Remuneration of trustees
- Covenants to be included in the Fund's governing rules
- Requirement to report assets at market value
- Requirement for the trustees to consider insurance for members.

Court cases and decisions

Recent court cases such as ***Ioppolo & Hesford (as executors of the estate of the late Francesca Conti) v Conti & Anor*** **[2013] WASC 389** and ***Wooster v Morris [2013] VSC 594*** outline the importance of sound estate planning practices, such as Binding Death Benefit Nominations (BDBN). An SMSF member is not automatically granted a BDBN; the Fund's governing rules must allow for such direction to the trustee (this may include a non-lapsing BDBN). With regard to death benefit payments, the Fund's governing rules are crucial in determining who will run the Fund once a member has passed away.

Again, by way of example, there is nothing in the superannuation regulations that appoints an LPR as trustee of a Fund in place of a deceased person. The Fund's governing rules need to expressly allow for the appointment of the deceased's LPR for this to occur.

Change of member circumstances

Changes in personal circumstances may also warrant a review of the Trust Deed to see if it is up-to-date. For example, a member may look to go from accumulation phase to Transition to Retirement (TTR) pension phase. If the Fund's Trust Deed is an older deed, it may only allow for a pension to commence once the member has retired. Again, there is nothing in the legislation that states a particular Fund can commence a TTR for a member.

Relying on deeming clauses in the Trust Deed will not provide the ability for the Fund to pay such a pension because the legislation only defines a TTR and outlines the payment rules for such an income stream, but there is no mention of a Fund's ability to pay such a pension. Unless the Fund's governing rules expressly allow for a TTR, then it is likely the Fund may breach its governing rules if it pays a TTR income stream.

Requirements by third parties

It may be prudent (or a requirement) to update the Trust Deed if the trustees are looking to undertake a specific investment. For example, a bank may require a Deed to expressly allow for Limited Recourse Borrowing Arrangements before it provides finance to the SMSF, or it may be necessary to upgrade the Fund's governing rules to undertake a derivatives transaction.

Don't rely on an old Trust Deed

Without an up-to-date Trust Deed, the trustee may not be able to operate in a way that it wishes without being in breach of trust. Beneficiaries may also take action against trustees for losses or damage (for example, if a particular strategy needs to be unwound). Beneficiaries are not limited to seeking recompense from trustees under this section, but also third parties such as accountants and financial planners.

How often should an SMSF's Deed be upgraded? It is prudent to upgrade the Deed regularly by using an online updating service. This type of proactive service ensures a Fund's governing rules are current, as well as providing accountants and advisers with comfort that all their clients' Deeds are the same, making it much easier to administer the funds and advise trustees. SMSF auditors are also required by the Audit Standards to determine whether the trustees are acting in accordance with the Fund's governing rules.

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