Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

The story of your life viewed through your SMSF

Jo Heighway

One of the most underestimated attractions of having your own SMSF is the power of a good story.

I love stories – whether it be reading a good book, sharing ideas with friends, or listening to a great story told by a successful entrepreneur, adventurer, close friend, or even a stranger. Stories are the best way to capture someone's attention, make them think, influence their mood, and maybe even make decisions that change their life.

One of the things I love about SMSFs is how passionate people are when telling their SMSF story. How they got one, why they did it, what they've invested in, what they love about it, what they hate about it, and what they wish they did differently.

Even when I think about the most memorable presentations I've seen from SMSF experts, what audiences love most is the stories about real people - the good, the bad, and the ugly of running your own fund.

Understanding that SMSFs deliver the power of a good story better than any other super fund structure can really change your perspective, whether you are:

- a trustee of your own SMSF, or thinking of establishing one
- in the business of competing with SMSFs in the superannuation industry
- an SMSF advisor looking to grow your SMSF business, or
- an auditor of SMSFs.

SMSFs made it cool to be interested in super

The popularity of SMSFs has grown so widespread some are calling this the 'golden age of the SMSF'. But how did that happen?

The answer is really simple – word of mouth!

Like many disruptive innovations, SMSFs delivered their members new stories worth sharing with friends at a BBQ. Just like many of the 'cool' start-ups today, their popularity didn't grow through large companies with massive advertising budgets urging viewers to 'compare the pair'. More often than not, the first time most people hear about SMSFs is from their friends. For Facebook users, it's the equivalent of 'like' and 'share'.

My life viewed through my SMSF

The journey of my SMSF has almost become like a biography of my life so far. Many of the major events in my life are mirrored in my SMSF in some way, and create stories in themselves.

I started my own SMSF when I was in my 20s. One of my first investments was to buy units in my employer's property trust when they were expanding, which I later realised was just their way of trying to tie me in without offering me s partnership (it didn't work!).

I learnt another valuable lesson when I got divorced. It turned out trying to save a few bucks by choosing individual trustees was a mistake, and I had to bite the bullet and buy a trustee company. It cost a fortune to change all my investments, but it was worth it so I never had to go through that again!

I'll never forget the first time I decided that I would contribute right up to my maximum contribution cap. I was young, self-employed and had a mortgage, yet I did it anyway SOLELY because I felt better knowing I held the fund's cheque book. Now it's one of my annual financial goals.

When I sold my share portfolio before the GFC, I gloated about the losses I'd avoided. And I was super proud to buy my first office premises and lease it back to my business, which I never could have done without my SMSF. I also invested in a software company I was passionate about.

Then there's the times I've helped my parents (members of my SMSF) use transition to retirement strategies to save tax and get cash when they need it, for a once-in-a-lifetime European holiday, or to fix their roof that blew away in a cyclone.

I tell how an industry fund stuffed my husband around for over six months when he joined our SMSF, giving every excuse not to pay his rollover. And I talk up how easy running my SMSF is now I have a great broker. I don't have time to research and trade with four children and a busy career, so I found someone I trust.

My SMSF reflects the story of my life, and that's not unusual. Marriage, divorce, business success and failure, ageing, death, good fortune, luck and loss – who said super is boring?!

Thinking differently to compete with SMSFs

If I were looking for a way to compete against the SMSF industry, I wouldn't bother with the traditional arguments. Focusing on fee comparisons, administration burden, historical investment performance, or how much you need to start your own fund comes across as defensive and, to be honest, makes for a pretty ho-hum story.

What if, instead, the focus was on creating unique experiences for super fund members that made them excited to become a member, stay and tell their friends? I'm talking about the type of innovation in customer service that could actually turn super fund members into raving fans.

If the only experience members of a super fund have is receiving an envelope in the mail every six months with a super fund logo printed on the front, which they throw in the bin without opening, then it's fair to say they won't be sharing stories of your fund any time soon with their friends at a BBQ!

Using stories to grow an SMSF business

I'm not suggesting that an SMSF is for everyone, and there are most definitely many important factors that need to be considered. But if someone is looking to grow an SMSF business, it pays to think about giving clients the experience they crave.

Does your service, your technology, your support and ongoing engagement with your client provide them with the opportunity to 'like and share' their story with their friends?

Most importantly, are you focusing your expertise on ensuring their SMSF story is a good one, and that your clients can access the right support at the times in their life when they really need it?

Auditors need to be able to 'see the story' behind the numbers

The key to being a good auditor is to always understand the big picture. When I plan an SMSF audit I recognise that SMSFs are run by real people, with real lives, making real decisions. Rather than seeing my audit as a 'tick and flick' exercise, I read the financial reports like they're telling me a story.

What story do the numbers tell me, and what do I know about the fund that will point me towards the risks most likely to need my attention this year? It makes my work much more interesting but also means I don't waste anyone's time trying a one-size-fits-all approach. I zero in on the real risks and eliminate what doesn't apply.

I would love you to share your SMSF story with me, so feel free to comment and share.

Jo Heighway is a Partner, SMSF Assurance & Advisory, at Deloitte Touche Tohmatsu. Cuffelinks does not favour one superannuation type over another and welcomes other opinions on the merits of alternative fund structures.

Leading superannuation members to the Promised Land

Jeremy Duffield

The next big challenge for super industry leaders is making the shift from a focus on the accumulation phase to a whole-of-life approach. What is it going to take for leaders to succeed in transforming their funds to best help members prepare for and get the most out of their retirement phase?

Many of us in this industry have a Moses Complex. We want to be leaders. We want to help our members. We want to lead our followers to the Promised Land of retirement income adequacy and security. But to date, we've largely acted like it was enough to lead them to the gates of the Promised Land, the day they retire, and stop there. Some large funds lose around 90% of members when they retire.

In a series of articles, I will examine the leadership needed for institutional funds to become the preferred custodians of their members' assets through retirement.

What's it going to take?

Industry executives recognise the need for change. In fact, 48% of fund CEOs in the 2014 ASFA/PWC survey identified post-retirement products as their top strategic priority over the next three years. And, the Murray Inquiry recognised the problem in a chapter devoted to Retirement Incomes:

"The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees."

Moses was leading his people away from oppression by the Pharaohs. Sometimes our industry acts as if the design imperfections of our super system are an oppression. Often our own efforts at leadership seem overwhelmed by the government's attempts to pull the control levers. The industry's innovation budget was consumed almost entirely by regulatory reform during Stronger Super implementation.

So, it's not surprising we spend a lot of our executive energies lobbying for super reform. On the policy front, it's good to see the start of the Committee for Sustainable Retirement Incomes. This group wants to provide leadership by influencing government policy settings.

Time to take the lead

Super fund industry leaders must act. The baby boomers' metamorphosis into retirees is gathering momentum. For boomers still in accumulation, it's 'last call' for retirement readiness. And those hitting retirement – some 250,000 per year – need to make the best use of their super savings.

As over 50s own 60+% of superannuation assets, what members choose to do at retirement is a critical survival issue for funds. With vast numbers of pre-retirees and retirees leaving their super fund at this stage of their lives, we must ask the question "are we failing these members?" Surely the purpose of the super industry is to help members secure a sustaining level of retirement income. If we haven't earned the loyalty to help them in their retirement phase, what have we achieved?

As I observed in over 30 years with The Vanguard Group, there are many dimensions to leadership and the opportunities vary over time. Sometimes it's product leadership, other times new markets, operational breakthroughs, team development, IT transformation, ratcheting up service delivery, expanding the service offer or communications. Making the right choice about where to spend leadership energies is the central decision for executives.

Different ways to lead

Judging by the ASFA/PWC survey and encouraged by the Murray Inquiry recommendations for a Comprehensive Income Product for Retirement (CIPR), many funds will start with a product leadership focus and some funds have already moved in this direction.

Beyond product, there's a host of other initiatives funds can undertake. Some leaders will excel in communications. (One suspects Moses was big on communications; those tablets with the Ten Commandments were an inspiration!) Strong communications are needed to ensure members know, and believe, the fund is there to help them with the retirement phase. A key part of the communication programme is likely to be a shift from the reporting of balances to more meaningful forecasts of retirement income.

Others will try to lead members through advice. It's a challenging transition from a working life earning a salary to a life dependent on an income stream from a super fund and the age pension. Few people can make this transition without substantial help. And few make it well if they leave it to the last minute and a one-off discussion with an adviser.

Making quality advice available is perhaps the most important step a fund can take to prepare members for retirement and encourage them to take-up a sustainable retirement income option with their super fund. As traditional means of providing advice are expensive and reach only a small portion of the membership, the opportunity to expand access through digital advice capabilities is a current leadership opportunity.

And then there's the service leadership angle, aiming to make it as easy as possible to move into retirement with the fund. Or providing novel services such as easy access to your accounts, ATM access to income, and ongoing personalised investment management to ensure income sustainability. Service leadership can also extend into product packaging, for example catering for the differing needs of the various life stages of retirees.

I'm fascinated to see how industry leaders take up the challenges in retirement incomes. In future articles, I'll tackle many of the dimensions of leadership in our industry through profiling successful and prominent industry leaders. In my next article, I'll focus on one of the greats, an inventive and inspiring leader I know well, Jack Bogle, Founder of The Vanguard Group.

Jeremy Duffield is CoFounder of SuperEd. See www.supered.com.au. He was Managing Director and Founder of Vanguard Investments Australia, and he retired as Chairman in 2010.

Death and taxes on your own terms

Gemma Dale

Benjamin Franklin's statement that nothing in life is certain but death and taxes remains relevant after 200 years. As a result of an ageing population and increasing household wealth for older generations, Australia faces the largest intergenerational wealth transfer in history in the coming decades. This has significant policy implications, but at a personal level, raises many challenges also. How do we prepare for the inevitable, and do the best for our loved ones?

Facing one's mortality is rarely an enjoyable or engaging experience. Many would prefer to believe they will live forever, or at least long enough to justify putting off consideration of the implications of their death. Others feel uncomfortable discussing or even thinking about wealth and its implications for their estate. The consequences of a head-in-the-sand approach, however, are often dramatically less benign than the deceased may have presumed. Instead of leaving a secure or empowering legacy, they may bequeath angst, conflict and considerable expense. Feuding families and disappointed potential beneficiaries are a lawyer's best friend; even those who can amicably settle an estate may still struggle with the cost and administrative burden of a non-existent or ineffective will.

Motivation to address the issue

This is not just thinking or talking about money. It is your legacy to the world and the potential contribution to other people (or the community or the planet) in the future. A vision of the future you would like to create can help to frame a positive outcome from a potentially depressing process. Alternatively, consider that you are simply reducing the future burden on loved ones. If you have a spouse who is refusing to engage, you may need to go it alone and hope that your persistence will motivate them to act. Set a deadline to have your affairs in order, not too far in the future, and stick to it. Make an appointment with an estate planning professional if necessary.

In addressing your estate planning needs, consider both your objectives (what you want to achieve) and your strategy (how you plan to achieve it). While the most perfectly-designed estate plan has little value if it has not been documented, similarly, a perfectly drafted but ill-considered will may not support those who will ultimately rely on it. This article provides a framework for determining your estate planning objectives. Part 2 will consider strategy alternatives, including the structures, professionals and documentation required to ensure your wishes are met.

Estate planning checklist

The amount of time and thinking needed for this process is not the same for everyone: a 40-year-old with young children and a mortgage will plan differently from a 65-year-old who owns their own home and has several million dollars in investments. Similarly, those with complex personal lives, particularly blended families, will have more challenging decisions to make than those with simple affairs.

Here's a useful framework for your estate planning objectives.

1. **Consider all potential eventualities**. These include your death (sadly this one's a certainty), *and* physical or mental incapacity (such as dementia, long term illness or permanent injury). Many people prepare thoroughly for what will happen on their death, but do not consider a lengthy period of declining mental and physical capacity that may erode capital otherwise intended for their estate, or expose them to unscrupulous individuals. For younger people, injury or illness could have devastating financial consequences. Consider a protection plan for ensuring your needs are met if you no longer have capacity to make your own decisions, and insurance to ensure your dependants are financially secure in the event that you are no longer able to earn an income or due to substantial medical costs. Some of these decisions can be made independently (such as preparing Enduring Powers of Attorney so someone you trust will make decisions if you can't); others should be considered together (life insurance should form part of your overall estate plan).

2. **Ensure your needs are met**. Many older people care greatly about providing for their children and grandchildren, and yet may not have considered their own needs for retirement and aged care. This can result in tragic circumstances where the elderly are financially dependent on the age pension and receive little recognition from the children (or others) who have benefitted from an early inheritance. Once an asset has been given away, it is generally the property of the recipient and the giver has renounced their rights to compensation, even if their circumstances change and they now require support. In addition, Centrelink and the Department of Veterans Affairs have specific rules for assessing gifts and other forms of 'deprivation' which can result in a reduced social security entitlement for the giver. Have a clear view of what you need to live a comfortable lifestyle, and determine what you can give only once these needs have been met. This doesn't mean you can't help others, it simply means taking care to do it prudently, as we will discuss in more detail in Part 2.

3. **Consider the legacy you would like to leave**. This should speak to your personal values most of all. Your beneficiaries will likely to be top of mind, so identify every person you wish to provide for, as well as those causes that are dear to you. Bill and Melinda Gates, for example, have invested their wealth in charitable programmes and innovations in healthcare and education for developing countries, while leaving a (proportionately) small inheritance for their children. Contrast this with the poor outcomes of 'trust fund babies', where children inherit vast fortunes which they are often ill-equipped to manage. For some, a legacy will be as simple as ensuring their grandchildren have a private school education while others may have grander objectives, such as preserving land for environmental causes.

4. **Prioritise your objectives**. Planning for the ideal scenario on your death may require compromises. Can you achieve all of your objectives with the available resources? If you are eroding your capital during your retirement, you may need to adjust your arrangements over time. It can be challenging providing for your dependants equally when they clearly have different needs. Providing for young children or a child with a disability, for example, is very different to providing for financially secure adult children. Blended families can create significant challenges. Adult children from a first marriage may have lesser needs than young children of a second marriage, but desire an equal share of the estate. They can also resent large bequests to very recent new spouses or partners. Similarly, family businesses can create disparities where one or more children or family members have made different contributions to the business without being adequately compensated or with expectations of receiving a disproportionate share of the business on your death. Finally, one or more children may make a disproportionate contribution to your care if you become physically or mentally incapacitated.

   Seek professional advice if you are concerned or your scenario is particularly complex. Succession planners and estate planning experts can give you guidance and assist with counselling and conflict resolution once you choose to engage with potential beneficiaries.

5. **Review.** While your estate plan is ultimately a reflection of your wishes, the most positive outcomes are likely to occur when all beneficiaries are informed and prepared for what's to come. Your spouse will preferably be assisting with the process; ideally you will reach a mutually beneficial agreement as to how you'll look after each other and your children or others. If there are areas of contention, however, it is best to discuss these openly and engage a professional if you're having trouble

reaching agreement (if nothing else, to avoid costly litigation at a later date).

While you are under no obligation to change your plans as a result of other's concerns or wishes, they may raise legitimate concerns and have alternatives or strategies you hadn't considered. An informed conversation will also help to keep relationships intact in the future.

Once you have considered your objectives and your legacy, the process of preparing and documenting your estate plan becomes easier.

Part 2 will help you understand the various strategies for achieving your goals and avoiding the pitfalls that can create emotional and financial stress for those you care about.

Gemma Dale is the Head of SMSF Solutions at National Australia Bank. This information is general only and does not take into account the personal circumstances or financial objectives of any reader. Readers should consider consulting an estate planning professional before making any decision.

Spinning the wheel in retirement

Jeremy Cooper

A common perception in finance is that the risk in growth assets, like equities, declines over a longer investment horizon. Recent research by consulting economists, Drew, Walk & Co into the equity risk premium (ERP) shows that even over the long run, equity investing is like a chocolate wheel: there are plenty of winners, but also losers. Retirees should not assume that the volatility of equity returns will be smoothed out over time, not even over 20 years. Retirees need to factor this into their goals for retirement income.

What is the ERP?

The ERP is the additional return that investors require, on average, for taking the extra risk of investing in equities, over and above any risk-free return (the government bond return). If investors do not expect to receive this additional return, they won't invest in the risky asset.

The ERP has been labelled the most important variable in finance and is used in a number of applications. Just about every decision in finance has a link to the ERP.

Unlike a long-term bond, where an investor can hold to maturity and receive a known term premium, the equity premium is unknown in advance and is far from certain. The challenge for investors and superannuation fund members is the range of actual equity return outcomes, compared to the originally expected ERP.

The (un)predictable equity risk premium

In their paper, Drew, Walk & Co explore whether investing in equities in previous 20-year periods was adequately rewarded for the risk taken. They calculated the historical equity return (out)performance over various periods in a range of jurisdictions. The report concludes, among other things, that the equity return (out)performance:

- is uncertain, and its timing and magnitude are unpredictable
- has shrunk in recent history to below its long term average in Australia
- was only 1% per annum for the last 20 years.

The flaw of averages

Traditionally, the ERP is calculated by averaging the entire period of available historical data, and this average is then used to make an assessment of future returns. In using such an average, people miss the fact that an Australian retiree household is planning for roughly 30 years, which is obviously well short of the 115 years since 1900.

Long-run historical average returns can be flawed because:

- They are not an indicator of future outcomes.
- There are potential survivorship biases, where losses incurred in failed companies are not properly included.
- The early history reflects the benefit of Australia emerging as a financial economy. Since WWII, Australian equities have actually performed lower than prior decades and in line with other major global markets.
- Most people do not get the average outcome. Around 50% will do better and a similar proportion will do worse.

In addition, retirement is different, because most retirees:

- Need to spend their capital and so are impacted by sequencing risk.

- Segment their retirement capital over a range of time horizons within their retirement timeframe, to meet their investing and spending goals.
- Won't have an unbroken exposure to equities for decades.

Time doesn't diversify equity risk

Most people assume that 20 years is long enough to get the 'long-run average', however the research indicates that there are a wide range of potential outcomes, even when they can stay invested for 20 years.

Only with hindsight, at the end of the 20 years, will a retiree find out their premium (if any) for taking equity risk over that period.

Figure 1 shows the frequency of the 20-year historical equity return (out)performance. The graph shows that Australia performed better in the first half of the 20th century, when it would still have been an emerging economy rather than the fully developed market economy it is today. There have been 14 periods of 20 years in Australia where the equity return outperformance exceeded 10% per annum, but they were mostly before WWII (shown in light green).

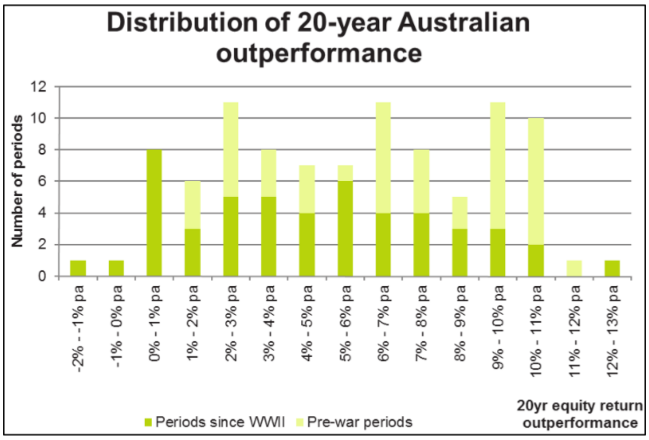


Figure 1: Distribution of 20-year Australian outperformance

The typical retiree needs some equity exposure

Even though equity investing is volatile over the long range, most retirees typically have the time horizon and risk tolerance to invest in at least some equities and they are likely to benefit from the premium. This is why the great majority of account-based pensions already have a generous exposure to equities.

A retirement risk management strategy

But what do retirees do about the equity risk? What happens when something goes wrong? Instead of adopting a conventional 'set and forget' approach, well-advised retirees work with a risk management strategy for their equity exposure in retirement. The idea of having a safety strategy is common in everyday life, and when it comes to investing in risky assets, retirees should be no different.

Using a long-term bucket for equities in retirement is one strategy that is sometimes used. However, as equity outperformance is uncertain over 20 years, a retiree will not have certainty about how much will be in the bucket after even as long as 20 years.

Portfolio allocation in retirement

Starting with Chhabra (one of the early papers that advocated goals-based investing rather than efficient frontier targeting), there has been a distinctly different approach for making asset allocation decisions in retirement. This approach is to consider the full range of the retiree's objectives and goals. Instead of trying to meet all targets with one investment decision, a goals-based approach will segment the main objectives. The approach is similar to the asset-liability matching practised by many insurance companies and defined benefit funds around the world.

Matching objectives enables a retiree (or their adviser) to consider the risk/reward trade-off that is represented by the ERP and select a suitable allocation of risk for each objective. For example:

- Generating income for life to meet essential spending needs will generally have a limited exposure to risky assets, as the objective is to maintain a minimum standard of living for life.
- Investing for spending on holidays and luxuries later in retirement can have a higher allocation to growth assets.

Under this approach, retirees with differing objectives, but the same wealth, age and risk tolerance will actually have different asset allocations.

Spinning the chocolate wheel in retirement

Retirees should think about investing as being like spinning the chocolate wheel shown. This has been assembled using the global historical numbers, the average of which roughly matches the forward projections for the ERP made by Drew, Walk & Co. in their paper.

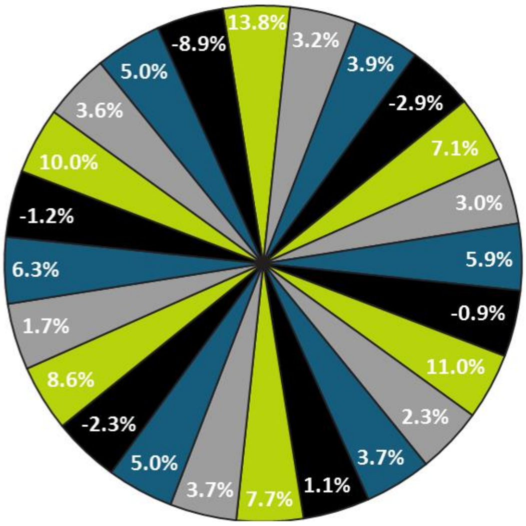


Figure 2: Chocolate wheel of global historical average annual equity return outperformance over-20 year periods

This 'chocolate wheel' reminds retirees that the average annual outperformance that might be expected over a 20-year investment period is not certain. It will not be a guaranteed rate. Most outcomes are attractive returns, but the risks are broader than what Australian history alone suggests.

Conclusion

For investors and retirees today, care needs to be taken in drawing conclusions from long-term averages when planning for the future. In addition, a set and forget approach will not ensure that a retiree's exposure to equities risk will be appropriately mitigated.

Jeremy Cooper is Chairman of Retirement Incomes at Challenger, and chaired the Super System Review (the 'Cooper Review'). Drew, Walk and Co.'s full report, is available at www.challenger.com.au/equityriskinretirement

Is the current market really more volatile?

Ashley Owen

Over the last few months, the media have been full of scary-sounding headlines claiming 'extreme volatility' in markets. However if we look at the facts we see that the current level of 'volatility' is simply a return from 'dead calm' back to more usual levels.

If you think the current market is 'volatile' – then "you ain't seen nothing yet!"

Well actually you have – much worse than the current so-called 'volatility' - and many times before. People have such short memories!

Most people didn't realise we had higher volatility several times in the past because they were probably too busy doing other things – like working in their careers. Many more people are now 'retired' or taking an interest in their investments, which doesn't mean they suddenly have to act on the daily chatter.

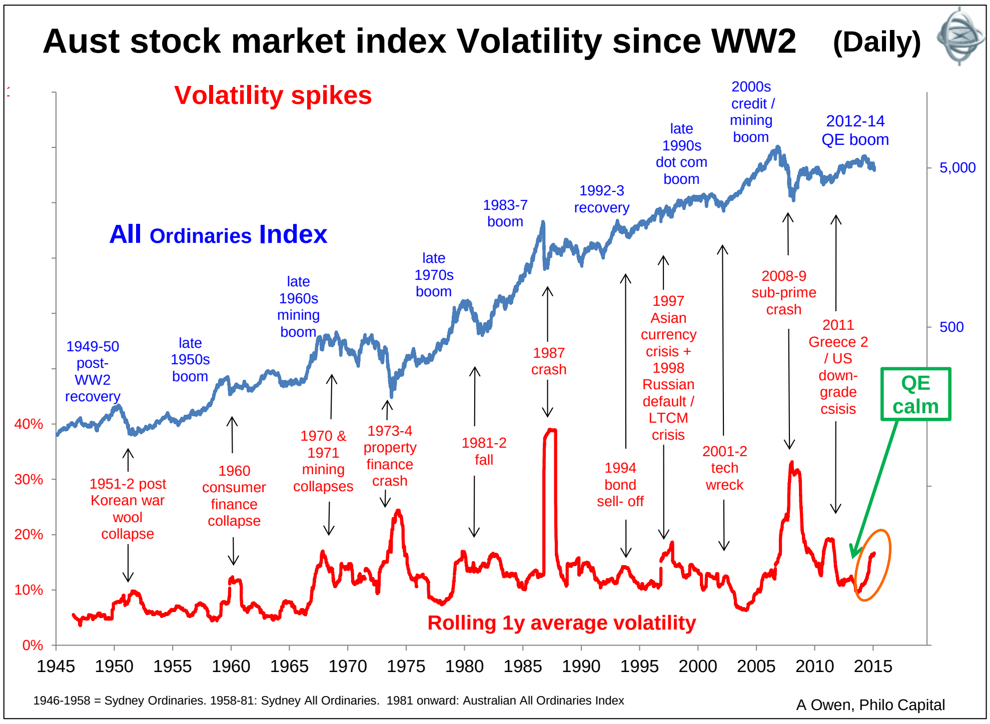
The facts on volatility

The recent headlines about extreme volatility are just media scare-mongering. Australian and global markets (shares, bonds, commodities, exchange rates) have been so calm for so long that investors and media commentators were simply asleep - lulled (or lullabied) into a false sense of security by unusually <u>*low*</u> volatility for so long.

Markets have been calm for four years following the Greece 2/US downgrade crisis in late 2011 up until the middle of 2015. During this 'QE' calm, markets were calmer for longer than they had ever been since the mid-1960s. Although markets are now more volatile than in QE years, volatility is still much lower now than it has been in many in more volatile episodes in recent decades.

Australian shares and a focus on 'big' days

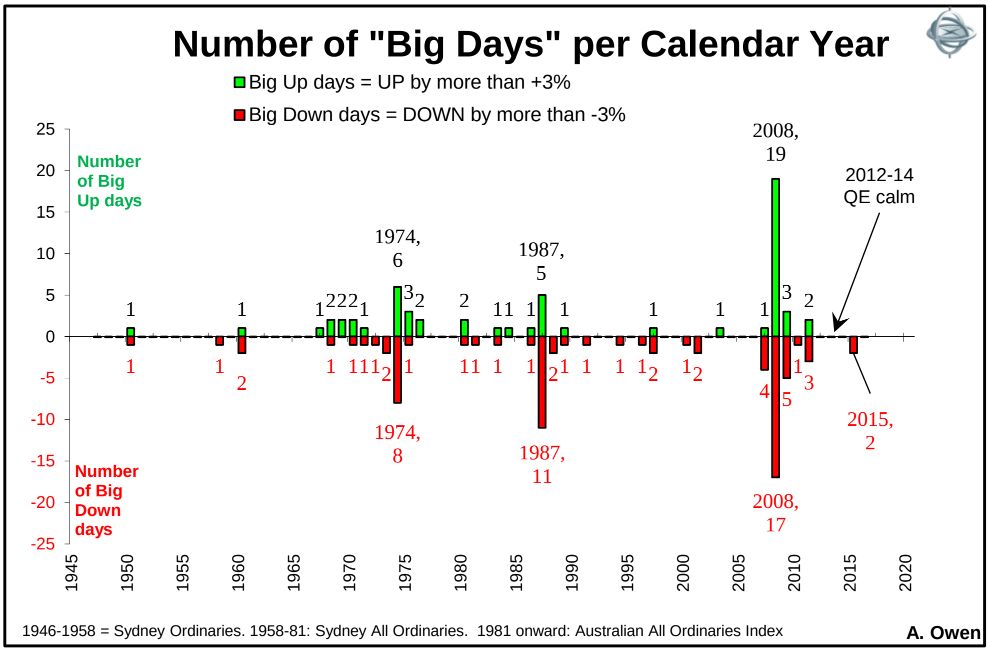
Australian shares seem to affect local investor sentiment more than any other market. The first chart shows volatility of daily changes in the market index since WW2. The red line shows the rolling 1-year annualised volatility of daily price index changes (standard deviation measure – more about this below). Here we see the recent rise in volatility from the period of QE calm.



Because the statistical 'standard deviation' measure is so riddled with flaws and false assumptions, I use a variety of different measures of volatility. The next chart shows the number of 'big days' in the Australian stock market per calendar year over the same period. I define a 'big day' as a move of at least 3% up or down (we could use any threshold – the patterns are the same).

'Big days' are what grab media attention and tend to make investors nervous. In 2008, we had by far the most big days. It was a seemingly relentless stream of gut-wrenching days. But 2008 had more big UP days than big DOWN days, but most people only remember the bad news.

In contrast, late 2011 to mid-2015 had with no 'big days' at all, which is unusual. The market had not been that calm for so long since the mid-1960s. Even 2015 only had two big down days, and there have been none so far in 2016. Hardly justifies the 'volatile' headlines!



Other global markets repeat the pattern

We also find that other global markets have been just as calm. The chart below shows daily price volatility in seven markets since 1970: Australian shares, US shares, Australian 10 year government bond prices, US 10 year government bond prices, USD/AUD exchange rate, gold (in US dollars) and oil (West Texas Crude in US dollars).

Here we see similar patterns in all markets because markets are inter-connected. The recent rise in volatility is mainly in oil prices, the rest are still relatively low.

If we take a simple sum of all the seven volatilities above we get a broad volatility index, shown as the red line on the chart.

Here we see the two 'big ones' – the 1973-1974 crash and the 2008-2009 sub-prime crash – and numerous other minor crises in between.

(Many people also ask about the "VIX" index. The VIX is not a measure of actual volatility – it is a mathematically flawed measure of *perceived future* volatility *implied* by an *options* contract over a *futures* contract over a market index. It can be useful for some short term traders, not investors.)

Reasons for the low volatility and recent rise

The 2012-2014 QE boom put markets, media commentators and many investors to sleep. They got used to the unusually *low* volatility and started to think that was 'normal'.

The unusually low volatility was driven mainly by central banks buying up everything, regardless of quality or consequences. When US QE ended, and the Japanese and European central banks kept ramping up QE with no visible results, investors came to realise that QE doesn't work:

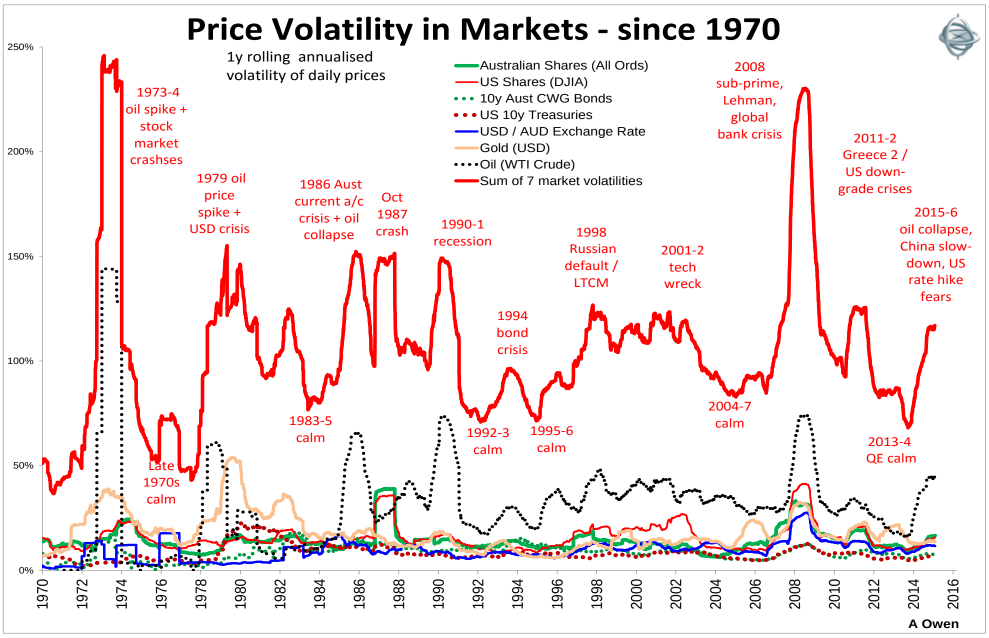
- QE artificially inflates prices and creates bubbles – in bonds, shares, property
- Debt levels have kept rising – in governments and households (although the corporate sector has reduced gearing)
- Not even negative interest rates encourage spending or borrowing
- The US economy is still weak and Japan is stagnant, and it economy is dying off – literally. Europe has zombie banks and an economy dying off under crippling government debt, unaffordable welfare promises, and political gridlock.

Some general comments for investors

Investors can never afford to be complacent. Don't assume that rising markets will rise forever, and don't assume that falling markets will fall forever. Specifically, the QE calm gave people a false sense of security.

Don't panic buy in booms, and don't panic sell in busts. Specifically, investors should not interpret the recent rise in volatility as a reason to panic and make sudden decisions.

Instead, investors should stay awake, calm and vigilant at all times. Avoid market noise and stick to facts. For every loser there is a winner with risk there is opportunity. If one asset class is losing,



what is winning and why? Above all, don't be swayed by uninformed media chatter. Think for yourself and take your time.

Volatility and subsequent prices

Volatility does not 'cause' prices to fall. Investors should not look at a rise in volatility and think 'prices will fall in the future'. It is the other way around: it is price falls that 'cause' volatility measures to rise (because price falls are generally more sudden than price rises, sharp price falls result in higher volatility measures).

Investors should not wait for prices to fall (volatility to rise) before thinking about markets, valuations and asset allocations. It is generally when prices are rising and volatility is low (the 2012-2015 QE calm) that assets become overpriced. Many investors should have reduced weight or taken profits while prices were high and volatility was low.

The recent rise in volatility (from dead calm to more moderate levels) is because prices have *already* fallen. There is no statistical relationship between volatility and *subsequent* price moves, so there is no statistical or historical basis for assuming that the recent rise in volatility means more price falls to come.

Shares have already sold off here and around the world but prices will not fall forever. Investors should not panic and abandon their strategy unless either the strategy is no longer appropriate for their needs or if their future needs have changed. Investors would only sell now if they are happy to take a loss and can re-invest in other assets with potential for better returns from current levels.

Investors should not look at volatility as any sign of future moves. My main purpose for raising it here is to add a few facts into the heated media hype about 'volatility' and to remind investors not to take comments about the current volatility as a reason to panic and make sudden decisions in the portfolios for the wrong reasons.

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Giant steps towards managing investment adversity

Peter Bull and Nimalan Govender

"[Benjamin Graham's] … vantage point was from the perspective of eternity and calamity – timelessness and a worst-case scenario to arrive at a margin of safety." Christopher M. Begg, Founder and CIO of East Coast Asset Management

A multidisciplinary perspective to investing

Many approaches to equity investing either overlap or disjoin according to underlying principles, be they quality, value, growth, capital cycle, thematic, behavioural, or some combination. A multidisciplinary perspective enables a broad scrutiny of investment decisions and also serves as a wellspring for inspiration and creativity, akin to Charlie Munger's 'latticework of mental models'. Otherwise, the daily pursuit of shareholder value is littered with distraction, vignette, portfolio construction gimmicks, and models that stand for nothing.

Like many others, we seek insight through equity factor construction and statistical analyses, primarily as it pertains to risk control. We don't, however, seek the 'investment truth' in these things. It's vital to discern causality from coincidence and narration from science, particularly when a story coalesces around hard-looking numbers. Historical back testing and even great live track records are dangerous primarily when a mistaken belief of completeness or inevitability is attached to them. While a good econometrician will always relish new and interesting data points to improve a model, it is small consolation to investors who may have inadvertently signed up to a 'crash-and-burn' teachable moment.

Bad returns at bad times are just bad for investors

More return with less risk is the best achievable outcome for investors, and those who forfeit that objective should feel a twinge of guilt. Beside the false inevitability of joining more risk with more return, from a total portfolio perspective, riding junky, leveraged, cheap 'value' companies on the way down is its own kind of punishment, not compensated by any commensurate rise on the way back up. Bad returns at bad times are just bad for investors.

Begg's invocation of eternity and calamity is tantalisingly close to our abstract views on quality and value. We first briefly take a step back to frame the more general trade-offs in equity investing.

"Intelligent people make decisions based on opportunity costs." Charlie Munger

Risk and time are the price of admission

Successful equity investing usually requires investors to forego their capital for an extended period of time. The question is: how do investors trade this opportunity cost most wisely? As **risk** and **time** are the price of admission, what are the appropriate rewards to seek for bearing these costs, or else avoiding them altogether?

The relevant risks are two-fold: instability/volatility and the potential for the permanent loss of capital. While equity investors **can afford** a certain amount of return volatility, they **can't afford** the permanent loss of their capital. We therefore orient our process to rest on sure fundamental footings. The exit strategy from investments is the cash flows generated by the businesses, not the hope or expectation that the market will bail us out in one form or another.

The concept of time is more nuanced and encompassing, more given to abstraction and imagination. While we experience time sequentially, we routinely abstract from it to consider events that are distinct to the current set. This is a very useful thing to do, not least because it helps guard against real dangers that have no immediate precursor.

"All a musician can do is to get closer to the sources of nature, and so feel that he is in communion with the natural laws." John Coltrane, legendary saxophonist and composer

Eternity and calamity

Calamity, while usually absent, is the event that needs be accounted for in the fullness of time, to avoid courting disaster. 'Quality' should be the invariance of a profitable business franchise, unconditional on any particular events occurring or not occurring. But don't conflate quality with growth as some do. Unprofitable growth is the definition of value destruction, while a profitable but static or even shrinking business only requires non-reinvestment to achieve nearly perfect investment results, potentially more reliably. And don't conflate quality with capital cycles, as there's no such thing as conditional quality. The steady characteristic of quality is paradoxically only visible through time, and so one point in time tells us nothing very meaningful about quality.

What we commonly refer to as value is the recognition that a business may be trading close to its worst-case scenario. It may be experiencing its own version of calamity in its fundamental performance, market perception, capital cycle, or some combination. Collapsing the dimension of time enables us to reconcile our investments against the certainty of eventual calamity and to act upon it when it does occur, enhancing the prospect of improving conditions having representation in our portfolio.

The relationship between quality and value is only that they should be mutually consistent, and the timeless perspective helps make that more clear. One company's version of calamity may look very different to another's. In fact, its calamity may look nearly the same as its own best-case scenario, if it has an inherent robustness to varying conditions. Consider the industries of beer, chewing gum, or canned soup, and all the possible future events that will **not** materially impact their fundamental demand-side outlook. Given that's the case, it's no surprise that some companies look cheap or expensive based on current superficial considerations, only to switch places upon a fuller examination of what may happen.

Viewing quality as a 'flavour-of-the-month'

Some market observers like to point out that quality, when viewed as a factor, is like all other factors in that it can become the flavour-of-the-month, overvalued, and potentially painful to investors when inflated valuations subside. We agree with this basic observation but feel it overlooks an important point.

While all segments of the market can experience over-valuation, high quality companies should not experience the same severity in the reduction of their underlying cash flows when adversity eventually does arrive. Recall that large portions of the market or economy may essentially disappear under relatively modest macro-economic pressure, following any number of plausible events. Or they may be particularly prone to capital over-investment relative to the (un)steadiness of future demand, severely impacting their profitability. Our view of quality focusses on the eventual delivery of reliable cash flows. The multi-decade recovery of the Nifty Fifty (1960's and 1970's 'must own' businesses that investors were told they could buy and hold forever) offers a kind of testament to that fact.

This consideration has bearing on the appropriateness of core equity portfolios that occupy a steady-state allocation within diversified portfolios.

While value-oriented or opportunistic strategies may have their place, the deliberate move from cash into riskier assets should include a proper inventory of both the trade-offs and opportunities available along the way. We see quality as the first logical stop for consideration, especially where it is positioned to deliver relatively low risk and a strong risk/return trade-off.

Investors should not be lulled into a false sense of comfortable helplessness

Adhering to a few time-tested investing precepts turns the advantage away from the market and back to the investor, without cause to bother with the disconnected portfolio construction gimmicks that have more recently caught favour. We do not believe that investors should be lulled into a false sense of comfortable helplessness, placing their fortunes on overly passive or formulaic solutions that have only a tenuous connection to the discipline of investing, if only because of the potential dangers involved.

Adapted for Cuffelinks from 'Ibbotson Insight Letter' of January 2016.

Peter Bull and Nimalan Govender are Portfolio Managers in Sydney with Ibbotson Associates, a Morningstar company with more than $180 billion under management globally. This material has been prepared for educational purposes only, without reference to your objectives, financial situation or needs. You should seek your own advice and consider whether the advice is appropriate in light or your objectives, financial situation and needs.