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This Week's Top Articles

Investment objectives: are you max return or min risk?

Raewyn Williams

If superannuation funds and other large investors decided to hold all their wealth in bank deposits, they wouldn't need investment objectives. In practice, they want to achieve the best outcome to meet their needs. How do these investors choose between the myriad of investment alternatives such as different asset classes (e.g. equities versus fixed income), styles (e.g. value versus growth), structures (e.g. listed versus unlisted) and regions (e.g. Australia versus global)? By anchoring these choices in well-defined and articulated investment objectives.

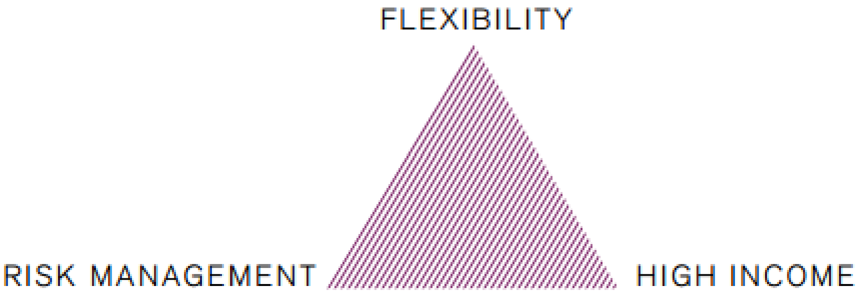
How to set investment objectives

Setting investment objectives is not as simple as it seems. A menu of key considerations might look like this:

Needs, wants and horizon	Constraints
Income	Fees
Capital (growth)	Liquidity
Risk tolerance	Values (avoiding certain positions)
Pre or post tax	Appetite for complexity, leverage, etc.
Time horizon	
Values (positive positioning)	

Values-based investing is a topical investment theme at present. Many large superannuation funds offer specific 'Responsible Investing' (or similarly named) investment options which allow members to express certain preferences regarding values such as exposure to fossil fuels, tobacco, gambling and cluster munitions. For some, values are a core, driving influence over how their capital is invested (a need or want); for others, it is an important second-order issue (a constraint).

One key challenge with setting objectives is the competitive tension between the multiple needs and wants an investor may have. An example of this is the 'Comprehensive Income Product for Retirement' (CIPR) triangle of needs and wants of a retiree investor as recommended to the Federal Government last year in the *Financial Systems Inquiry: Final Report*:



Source: "Number One With A Bullet: Adding Defence to a 'CIPR' Retirement Solution for Super Members", Parametric Research, December 2015.

Conflicting objectives and revealed preferences

Each of these investment objectives is much easier to deliver in isolation than in combination. For example, an options strategy providing downside protection can be bought by a superannuation fund as part of a CIPR portfolio to help protect a pension member from loss of capital, providing a 'tick' on risk management. However, pricing on such strategies is typically quite expensive and could erode much of the income generated, jeopardising the high-income objective. The exercise of investment objective-setting therefore needs to include not just a list of the things important to the investor but also some sense of the weight of importance of each of the objectives. This then becomes an optimisation problem for the fund or investor to solve; that is, to find the optimal combination of *those* aims with *those* weights as specified by the investor. Optimisation is a good way to solve problems like this also because it is relatively easy to add the investor's constraints.

The other key challenge in setting investment objectives is the possibility of revealed preferences. An investor may say they care about one thing when, in fact, their behavior reveals something different. The onset of the GFC showed a clear example of this. Though most superannuation members articulated a long-term investment horizon in which short-term results would matter little, superannuation funds saw high levels of switching from growth options like equities into 'safe' options like cash. There is a challenge here for investors to examine their beliefs in the course of setting investment objectives. *If I ask for a fossil-free portfolio, will I really be happy if my portfolio underperforms a market-cap index with no fossil fuel screens? If I ask my manager to beat the ASX 200 and the ASX 200 returns -4%, will I really be happy if my manager delivers -2%?*

Max return v min risk

If institutional investors do just one thing as they set investment objectives, my recommendation is to use a distinction set out by JANA's former Chair and Head of Investment Outcomes, Ken Marshman, in its January 2013 *Capital Market Insights* brief: determine whether the investor is a return maximiser for a given unit of risk or a risk minimiser for a given unit of return.

'Max return for risk' investors – typically including accumulating superannuation funds and other diversified portfolio investors – will craft investment objectives by defining a risk budget and then exploring what is possible in terms of returns and other outcomes. On the other hand, 'min risk for return' investors – typically including charities, defined benefit funds and many family offices – will more likely start with required capital and yield objectives and *then* look to mitigate the undesirable consequences of targeting these return objectives.

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Managing uncertainty in retirement

Bev Durston

This article is a response to Jeremy Cooper's paper on retirement calculators entitled 'The flaw of averages'. His paper highlighted that superannuation fund calculators simplistically assume constant average annual investment returns. Cooper remarked that these deterministic calculators 'sugar-coat' what really happens and he foreshadowed big improvements if the calculators provided a range of outcomes to expect for investment returns.

Developments already underway

Many parts of the industry strongly agree with his argument and have already adopted this approach. SuperEd and other firms are using 'stochastic' modelling to provide a variety of outcomes for retirement projections for individual fund members and self-directed investors. These toolkits provide a personal journey through a retirement process anchored on this retirement income forecast. It integrates features to engage, educate, and advise as well as providing next steps towards implementing the resultant actions.

('Stochastic' means estimating the distribution of possible outcomes by varying key inputs over time, while 'deterministic' means the final outcome is fixed by the initial inputs).

Instead of a member being presented with a single expected capital balance at retirement, the member is provided with a range of balances including very likely, most likely and unlikely to achieve. These terms correspond with varying confidence intervals such as 95% for very likely, 5% for unlikely and between 75% and 25% for most likely outcomes. These are generated from a distribution of 1,000+ simulations.

The approach also converts those projected balances into annual income values, rather than capital balances, and provides a range of income outcomes for a member's personal circumstances. These income answers are available to members both including and excluding the age pension. Providing individual members with tools like this is critical to helping them understand the range of outcomes so that they can plan around these uncertainties in the retirement phase of life.

Risks to navigate in retirement

Unfortunately, the defined contribution system of superannuation burdens individual members with a number of substantial risks to navigate - risks that the average member is ill equipped to bear. These include the risk of running out of money (longevity risk); the risk of investment loss (sequencing risk); the risk that markets do not produce the income they require (investment risk); the risk that their income does not keep up with their lifestyle costs (inflation risk); and the risk of continued governmental interference in superannuation legislation (legislative risk).

Whilst legislative risk cannot be managed, the rest can be mitigated or planned for by providing members with the tools to allow them to vary their run-out age (death), their level of contributions and the level of investment risk assumed (proxied initially by their current superannuation investment option risk).

Consider the example of Etta, a 51-year-old female earning $70,000 with a current super balance of $300,000 investing in a balanced fund. Etta is projected to achieve a most likely income ranging between $40,700 and $48,600 including the age pension. She is almost certain to achieve an income of $36,600 whilst she is unlikely to achieve a retirement income of $61,100 or above. According to ASFA, this should provide a level of income for a single person either approaching or above their 'comfortable' retirement standard. Note that this is only because the age pension comprises a substantial component of the income in retirement.

Reactions to the range of outcomes

Good communication of this approach is essential to success. Our feedback shows that the use of a stochastic range of income forecasts equips members to plan for this eventual uncertainty. That said, there are different reactions from the average super member to seeing the range of outcomes demonstrated for the first time.

A common concern comes from members who do not appreciate that their retirement income even has a possible range of outcomes. Some members view their super balance as a savings account with minimal risk and do not recognise their balance can go down. The shock experienced during the GFC was typical of the way many people interpret their super account, and showing members a range of outcomes as early as possible reveals the variability of their retirement forecast. The use of deterministic calculators - with their straight line projections – reinforce the incorrect interpretation of a savings account. It also fails to grasp an opportunity to educate members.

Other members appreciate the volatility of their balance but have difficulty translating a projected capital sum into an income in retirement. This is perfectly understandable given the complexity of the calculations involved and the lack of financial literacy. For people who have not been trained in the intricacies of compound interest and longevity modelling, projecting retirement income must be as difficult as being expected to complete your own dentistry.

Behavioural work highlights this is particularly difficult when the sum involved is large. Faced with a super balance which hopefully grows to multiples of a member's income, many members have no idea how to switch to an income measure from such a large sum. It is common for a member to believe that Etta's estimated income of between $40,700 and $48,600 is achieved entirely from her own super balance of $300,000.

In fact, a simple averaging of this $300,000 sum over the around 23 years to average life expectancy from age 65, with no growth, would yield a yearly income of only $13,100 per annum. The difference in the most likely forecasts comes from two components: real growth in the assets over time and the significant value of the age pension that Etta is assumed to receive.

The single age pension of $874 per fortnight (or $22,700 per annum) which grows at a 2.5% assumed inflation rate is equivalent to a present day lump sum for Etta of $516,000 (discounted at the 3% long bond rate). It is obviously worth more if she lives longer. This value is more than 1.7 times larger than her own superannuation account balance and, indeed, dominates the calculation for many super members with few assets outside of superannuation. It means that, together with the age pension, she effectively has a pension account balance to invest now of around $816,000. The remainder of the income comes from growing the assets over inflation during the period to her chosen run-out age.

Importance of age pension for most people

No wonder Etta can't easily estimate her income range in retirement. Much of this does not yet exist in her own balance and will accumulate over time. Plus, the significant value of the age pension dominates most people's current super balance. Of course, if Etta does not receive the age pension – for example, due to her not passing the income or the asset test, or changes in legislation - then her income in retirement will be significantly revised down.

In our experience members need to be walked through these concepts using educative content and examples to cement their understanding and also integrate retirement planning tools with both telephone and face-to-face advice. The earlier in the journey that these tools are provided, the better off we believe members will be. The 5 P's: "Perfect preparation prevents poor performance" is a great premise on which to base a retirement education campaign.

Members need engagement, context and educational tools to assist them to manage this complex journey to and through retirement. Over time we hope that most superfunds will naturally switch to using stochastic calculators which better explain the variability of outcomes.

Bev Durston is Head of Investments at SuperEd, a retirement income solutions provider and founder of Edgehaven Pty Ltd, a consultancy for long term, institutional investors.

Commodities: has the trend changed?

Karl Siegling

On the 22 March 2016, Mr Richard Elman, Founder and Chairman of the Noble Group Limited was quoted on Bloomberg as saying:

"We all know that commodities are cyclical, but predicting when that turning point comes is only possible with hindsight, especially with such excessive moves as are currently occurring. Those who come hoping for some kernel of wisdom leave disappointed when I tell them that I don't know how all the different factors will play out - nor does anyone else."

It is unusual for a high-profile executive to be so frank and explain how things really are. For someone like Elman who has been involved in building a large commodities business over five decades to admit that predicting turning points in commodity prices is impossible has consequences for all other market participants. If turning points are impossible for him to predict, then it follows that predicting turning points in resource companies is as difficult, if not more difficult. As Ed Seykota famously stated in an interview:

"Commodity trading is the purest form of trading in the world and resources companies are simply a leveraged version of this."

Nobody rings a bell

Of course, resource journalists, researchers, newsletter writers and research analysts cannot admit this 'simple truth' otherwise their very reason for existing would be cast into doubt. Mr Elman has the luxury of having built up a large business and five decades of experience and is a major owner of a business that has experienced significant share price movement over long periods of time.

It follows from this logic that *'no one rings the bell at the top of a resources cycle'* because it is impossible to predict. Similarly, *'no one rings the bell at the bottom of the resources cycle'* because it is impossible to predict. It didn't happen at the top of the last resources boom and it won't happen at the bottom of the current resources downward trend.

What is extremely interesting, however, it that commodities and consequently resource companies do experience significant periods of trending. This brings us to how an investor actually makes money in resource companies. *The short answer is by following the trend once it has been established and exiting the trend once it has ended.*

Diagram 1: ASX200 Resources Index over last decade.

Diagram 1 is a ten-year chart of the S&P/ASX 200 Resources Index. We can see a period up to 2008 when the index was trending up strongly, then a severe sell off during the GFC and a strong recovery and trend until 2011. Since 2011 the resource index has been falling for five years. Only recently we have seen an 'uptick' in the resources index and many of the stocks that underlie this index. Clearly the longer-term trend is down but we may be seeing the first early signs of a recovering resources sector. However, as Mr Elman points out, this is impossible to tell, but will be easy in hindsight.

Closing shorts and entering longs

Diagram 2

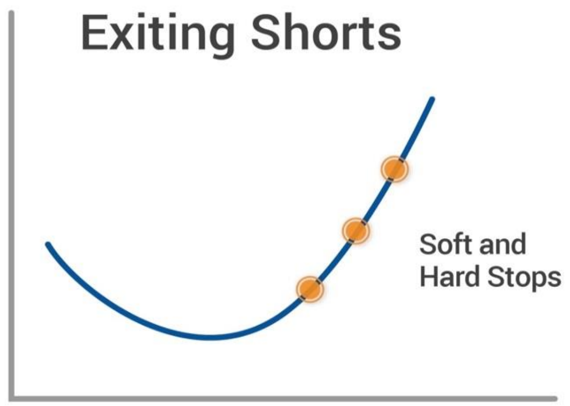
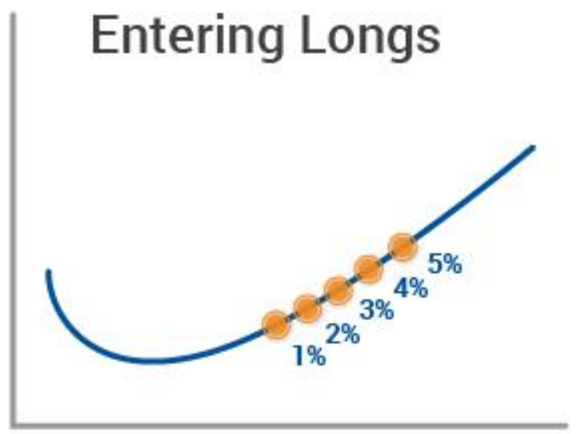


Diagram 3



How do we deal with this set of circumstances at Cadence? Having been short a number of commodities over the past three to five years we find ourselves scaling out of these short positions a bit at a time. Diagram 2 illustrates our process of scaling out of (buying back) short positions.

As we exit these short positions we may find that many resources stocks have become fundamentally cheap and are starting to trend up. This process then allows us to enter small long positions and potentially scale into a longer term recovering trend (Diagram 3).

Should this prove not to be the case then we would simply exit these small positions with small losses. In this way we adopt a risk-adjusted approach to determine whether the resource decline has in fact ended and the market is entering a new trend. We believe this is the only way of establishing a position.

It is very difficult to predict turning points in any stocks but particularly difficult in resources stocks. However, once a trend has been established, trends tend to last for considerable periods of time, particularly in cyclical stocks and industries.

As we write this article we know that recent price movements have at a minimum tested long-term resource and energy price trends and may be indicating a longer term change in trend. Only time will tell, but our process for dealing with these trends is well-defined. We are not professing to '*ring the bell at the bottom*' but the bell may currently be ringing.

Karl Siegling is the Managing Director of Cadence Capital Limited (ASX: CDM). CDM is a Listed Investment Company currently celebrating its 10-year anniversary. This article is for general education and does not consider the individual circumstances of any investor.

Philanthropy can blend tax deductions, engagement and impact

Antonia Ruffell

Towards the end of the financial year, many people start focussing on potential tax deductions to reduce their taxable income. The most common techniques include bringing forward expenses or realising capital losses, but don't overlook the role philanthropy can play in end-of-year tax planning.

Tax deductible donations to charities always increase at this time of year. However, there are other ways to support the community in a tax-effective way over the long-term, such as by establishing a private ancillary fund or a sub-fund in a public ancillary fund.

What is a private ancillary fund?

A private ancillary fund (PAF) is a type of charitable trust, your own foundation that you control with the purpose of providing funding to charities. Put simply, when you establish a PAF, you donate capital into it (usually an initial donation of $500,000-$1 million) and get an immediate tax deduction for the donation. The capital is then invested long-term, and a minimum of 5% of the value of the PAF assets must be distributed as grants to charities each year.

What is a sub-fund in a public ancillary fund?

A public ancillary fund (PuAF) has the same tax advantages as a PAF but is a communal structure. Unlike a PAF, there is no requirement to establish a new trust or trustee company, so a sub-fund can be established immediately (you could even do so just a few days before 30 June), and there's no set-up cost to do this. Amounts donated are usually smaller with a minimum of $50,000.

Why set up a philanthropic structure?

Tax deductions are a great incentive to set up a philanthropic structure of your own, but that's by no means the full story. People choose to establish a foundation for a range of reasons, including a wish to involve the family in giving, concerns around succession planning, and a desire to be actively involved in the charities they support over the long-term.

Family is perhaps one of the most powerful incentives as giving through a PAF is a good way to engage other family members. It can increase children's social awareness and help to inspire future generations. People use PAFs and sub-funds to bring the family together in innovative and different ways.

One PAF founder set up his foundation as a way to actively inspire all family members to get involved in the community. Extending his generosity to nephew and nieces, as well as his siblings and his own children, he uses the PAF to recognise any contribution a family member makes to charity. If someone sits on the board of a not-for-profit or has a role as a volunteer, the PAF makes a $5,000 donation to that charity. Similarly, if someone is involved in fundraising activities, such as through the CEO Sleep Out, the Cancer Council's Morning Tea or a fun run, the PAF matches any money they fundraise themselves. This has proven to be a great incentive for family members, and their involvement has deepened and grown. His children are now making donations to the PAF themselves, and the family makes strategic grants in areas they are collectively passionate about, as well as supporting the varied interests of individual family members.

Another popular use is to allocate an amount to each family member. The children research charities, find a cause or project that resonates with them personally, and present back at the PAF meeting where other family members sign off on a grant.

Of course, families are complex, and working out how to give money away can be even harder than the decision to set up a structure in the first place. At Australian Philanthropic Services, we work with over 200 families, and there is no doubting that every family has a unique way of making decisions. We help clients to articulate what they are passionate about, the ways in which they would like to make a difference, and how they should focus their giving.

We also find clients who receive a taxable gain (such as a share sale or large redundancy payout) often want to share their good fortune with others, but do not want to make a quick decision and donate the entire amount in one go. A PAF or PuAF allows an immediate tax deduction while the choice of charity can be made at a later stage when there's more time for research.

Philanthropy isn't just for the super wealthy

There is a perception that philanthropy is only for the super-wealthy. Certainly, you do need a reasonable level of wealth to set up your own structure, but it is by no means the realm of high profile business people and the ultra-rich alone. A sub-fund in the Australian Philanthropic Services Foundation can be kicked off with a donation of $50,000, and our clients include doctors, dentists, vets, small business owners, lawyers, farmers and corporate executives.

When people first start and are still growing the assets of their foundation, the grants being distributed are likely to be relatively modest in size. This does not mean that they are ineffective. Part of the beauty of having your own structure is that you are not bound by the bureaucracy of some of the larger, more established foundations. Donors can be nimble and responsive, using their intuition and stepping in quickly where other funders may not be able to respond promptly. Small grants given in a considered way can be very impactful. Many people like to fund those areas that are overlooked by government, or to support slightly riskier, pilot projects that seek to find new ways to respond to some of society's most entrenched and difficult issues. Many people will also make a contribution that is much more powerful than dollars alone, using their expertise, skills and networks to support the charities in which they are involved.

Getting started

Setting up a PAF is straightforward but, as a new entity has to be established, you'll need to move quickly if you want to get something up and running before 30 June. A sub-fund, on the other hand, can be established right up until the end of the financial year, creating an immediate tax deduction for the entire amount, while leaving the decisions on which charities to support spread out over time.

Antonia Ruffell is CEO of Australian Philanthropic Services (APS), a not-for-profit organisation that sets up and administers private ancillary funds, offers a public ancillary fund, and provides grant-making advice. Chris Cuffe is the pro bono Founder and Chairman of APS.

Term deposits: safe or risky for SMSF investors?

Shane Oliver and Paul Clitheroe

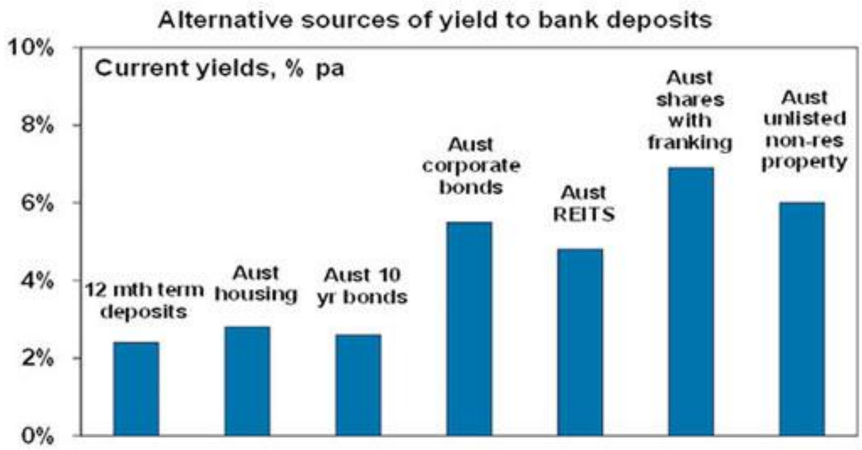
If you're a long-term investor, ironically term deposits are one of your riskier assets. Investors have the potential to receive a higher cash flow from growth assets such as Australian property and shares. In times like the present, a focus on the income an investment provides is important. With interest rates set to remain low or fall further, bank deposit rates – already at their lowest in Australia since the 1950s – are likely to remain low or go lower.

(Shane and Paul provide more views in the video linked at the end of the article).

Beyond day to day cash requirements, the key for investors currently in cash or term deposits is to work out what is most important to them: absolute certainty regarding the capital value of their investment or obtaining access to a higher more stable income flow at the cost of volatility in the value of their investment. In this, there are several alternative investments to cash.

Alternatives to term deposits for income return (yield)

The chart below shows the yield on a range of Australian investments. Yields on global investments tend to be lower.



Source: Bloomberg, AMP Capital

All of these yields have fallen over the last few years, but most of the alternatives offer more attractive yields than term deposits.

- Australian 10-year bond yields are now around 2.5%. This will be the return an investor will get if they hold these bonds to maturity. They can generate a higher return if yields continue to fall, but they are already very low. Global bond yields are lower, averaging around 1%.
- After the house price boom of the past twenty years the rental yield on capital city houses is just 2.8% and that on apartments is around 4.2% and even lower after costs.

- Corporate debt is an option for those who want higher yields than term deposits but don't want the volatility of shares. For Australian corporates, investment grade yields are around 6.5% or less and lower quality corporate yields are higher. Sub investment grade corporate bond yields in the US are actually now yielding around 9% as worries partly about loans to energy companies have pushed them higher.
- Following the turmoil of the GFC Australian real estate investment trusts (A-REITs) have refocused on their core business of managing buildings, collecting rents and passing it on to their investors, with lower gearing. While their distribution yields have declined as rental growth has not kept up with total returns of 15% over the last five years, they are still reasonable at 4.8%.
- Unlisted commercial property also offers attractive yields, around 6% for a high quality well diversified mix of buildings, but higher for smaller lower quality property. And it doesn't suffer from the overvaluation of residential property.
- Unlisted infrastructure offers yields of around 5%, underpinned by investments such as toll roads and utilities where demand is relatively stable.
- Australian shares also fare well in the yield stakes. The grossed up dividend yield on Australian shares at around 6.9% is well above term deposit rates meaning shares actually provide a higher income than bank deposits. In fact, the gap is now back to levels seen during the GFC.

Key issues for investors to consider

All of the alternatives come with a risk of volatility in the value of the underlying investment. In the case of shares the key for an investor is to work out whether they want a stable value for their investment in which case bank deposits win hands down or a higher/more stable income flow in which case Australian shares win hands down.

More broadly, in searching for a higher yield investors need to keep their eyes open. It's critical to focus on opportunities that have a track record of delivering reliable earnings and distribution growth and are not based on significant leverage. In other words, make sure the yields are sustainable. On this front it might be reasonable to avoid relying on some Australian resources stocks where current dividends look unsustainable unless there is a rapid recovery in commodity prices.

Click here to view a video of the authors discussing the ramifications of holding bank term deposits in a low-yield world.

Shane Oliver is Chief Economist and Head of Investment Strategy at AMP Capital and Paul Clitheroe is Executive Director at ipac. This article contains general information only and does not consider the individual circumstances of any investor.

Results of retrospectivity and Budget survey

Graham Hand

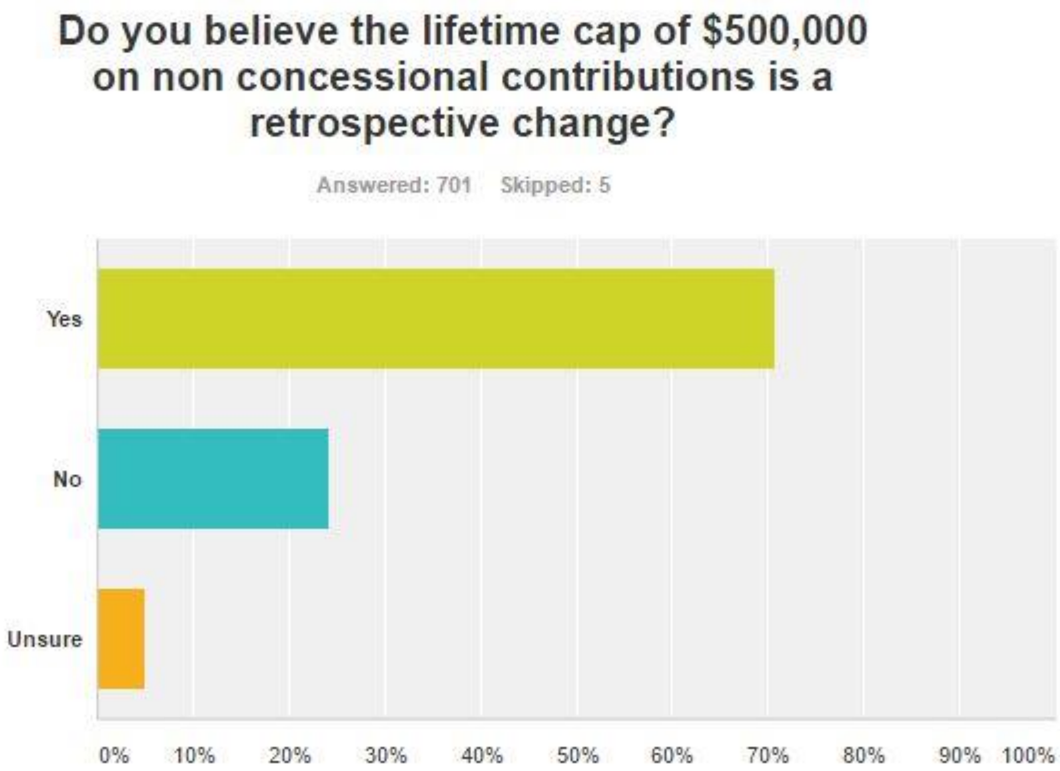
The proposed superannuation changes generated the full range of emotions, from outrage to praise. The comments among the 700 responses reveal as much as the overall scores.

Click here for full survey results and comments.

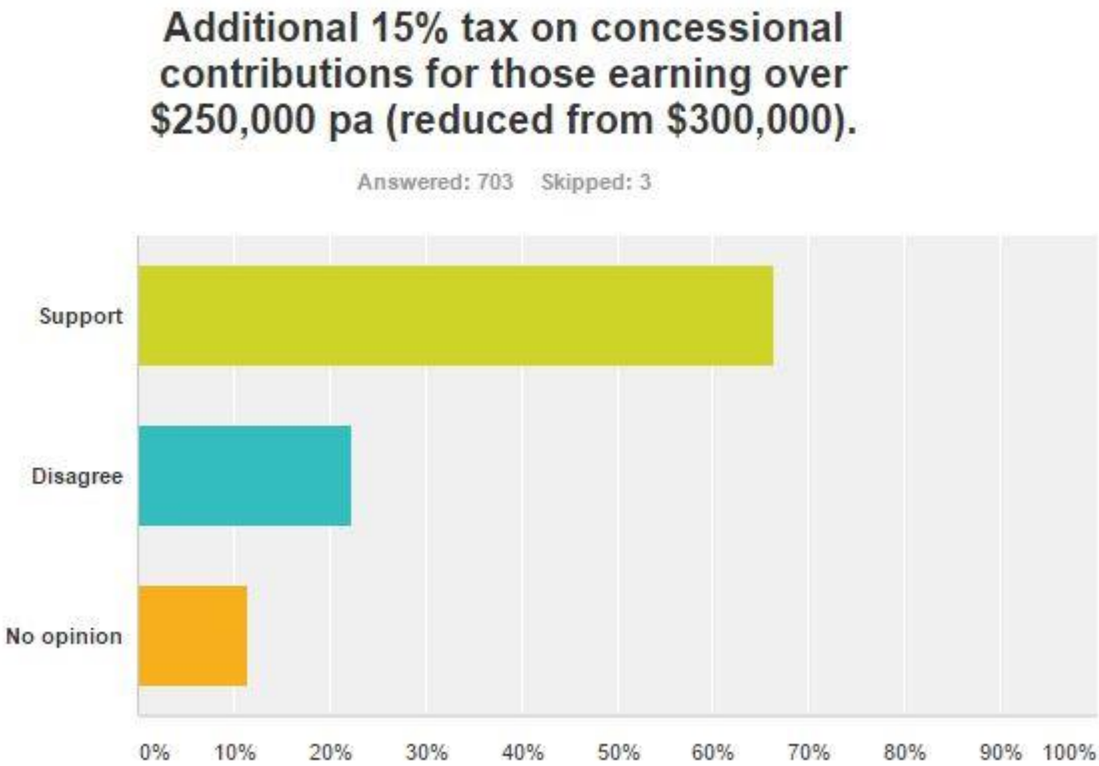
For a complete range of additional comments, see also the article on retrospectivity and the article on how future large balances will be limited.

At one extreme supporting the proposed changes, responses in the survey and the articles argue the current tax concessions are too generous and unsustainable, and the proposals still mean superannuation retains its benefits. At the other extreme, readers are upset about broken promises (from both sides of politics), even suggesting this is a vote changer for them. And everything in between.

On the question of retrospectivity of changes, over 70% of respondents believe the proposed non concessional cap is a retrospective change.



But illustrating that the survey results were not simply about preserving benefits for the wealthy, a solid 66% supported the reduction in the threshold where the additional 15% tax on concessional contributions applies.



Answers to all 12 questions are available by clicking the link above.