Edition 180, 4 November 2016

This Week's Top Articles

- **Market serves up some savage volatility** *Roger Montgomery*
- **Pension winners and losers from 1 January 2017** *Rachel Lane*
- **Lack of policy direction hurting renewables sector** *Alan Hartstein*
- **Banks team up with their FinTech competitors** *Danny John*
- **Achieving real returns in a low-growth world (part 2)** *Simon Doyle*
- **Meeting the retirement outcome challenge** *Graham Hand*

Market serves up some savage volatility

Roger Montgomery

I recently surveyed our portfolio and was stunned by the magnitude of the daily price moves. It was only 1.50pm yet APN Outdoor was up 4.32% on no announcement, TradeMe was down 2.77%, Healthscope was down 2.64% and Challenger down 1.92%.

Now, it is true that we don't give two hoots about short-term movements. In the short run, price movements are largely random and will always be far more volatile than valuations. Prices can move on the back of sentiment and other factors that have little or nothing to do with the underlying business. A company's valuation will change much more slowly, roughly in line with the growth in equity, from the retention of profits and redeployment of those profits at rates of return exceeding its cost of capital.

Unprecedented movements

Nevertheless, it seems that an unprecedented number of stocks have been hit with issues which have wiped significant amounts off their value, almost overnight. I cannot recall many other periods when a conga line was so populated with companies whose share prices have taken a 10-20% hit in a single day.

Recently, the announcements of the arrest of Crown Resorts executives in China caused its share price to fall almost 20% from $12.95 on October 14 to $10.40 12 days later.

Healthscope, the operator of 45 private hospitals, announced on October 24 that first quarter admissions for some procedures had slowed and that if the experience of the first quarter were repeated for the next three quarters, earnings would be flat for FY17. This caught the market, that was expecting 10% earnings growth, by surprise and the shares initially opened down 27%. As I write this, the shares are trading 24% lower than the closing price before the announcement.

Ardent Leisure's shares have fallen by 25% following the Dreamworld tragedy, Blackmore's shares are down 33% and Bega Cheese's share price is 22% weaker. Unlike Woolworths, whose long-term competitive issues have resulted in a gradual weakening of its share price, the above examples have been rapid.

The questions that should be on investors' minds are:

1) Given examples where shares were 'priced to perfection', and the propensity for businesses to inevitably stumble or naturally endure weaker periods as part of the normal cycle, do these moves indicate a much deeper issue about market valuations overall?, and

2) Are investors, who have been virtually frog marched into equities by rapidly diminishing returns from term deposits, overestimating returns and underestimating the risks of share market trading?, and finally

3) Should the volatility be seen as 'risk' or as 'opportunity'?

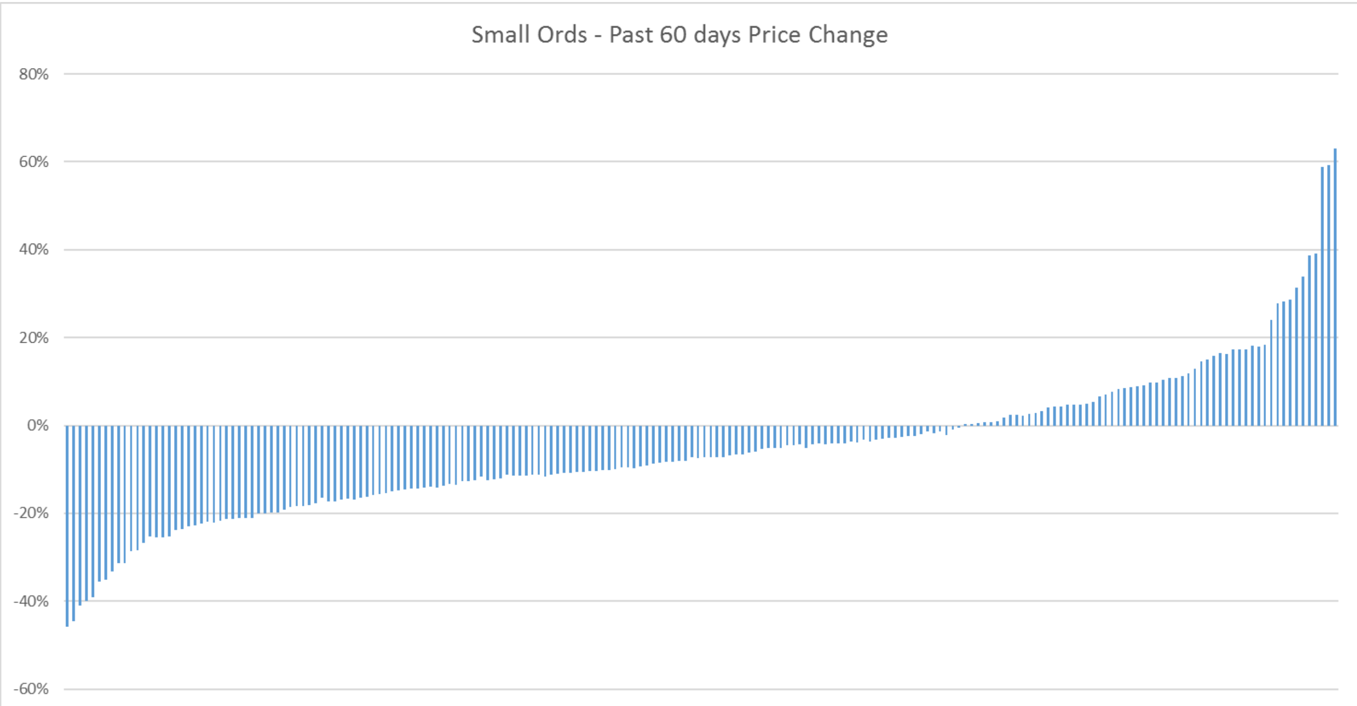
Volatility clusters

Volatility is still taught at school in the form of risk and portfolio construction, and dominates Wall Street thinking. However, our practical understanding of volatility has moved on somewhat from the days of Bachelier applying probability theory to French bonds, and the subsequent and elegant-but-flawed work of Eugene Fama's Efficient Market Theory. Bachelier's assumption that price changes are statistically independent and normally distributed is not borne out in the real world. The tails of the normal distribution curve fail to even remotely predict the frequency with which large price moves occur. Enter Benoit Mandlebrot, who observed that volatility tends to cluster around points in time, and after longer periods of lower volatility.

While roulette wheels spin by chance, over time the share prices of Blackmores, Woolworths or BHP don't move by chance. But because prices can be described as if they move by chance, that has been how they've been described. As the aphorism goes, to a man with a hammer all problems look like a nail. And so odds and risks are being miscalculated.

The investor is best served by the work of Benjamin Graham, who without the benefit of a computer, observed that in the short run the market is a voting machine, but in the long run it is a weighing machine. In the short run, prices will frequently move independently of the underlying business, but in the long run they cannot help but follow the accretion or diminution of the value of the underlying business.

The following chart shows the movement, over the last 60 days, in the share prices of the companies that make up the Small Ords Index. There are some remarkable changes.



Source: ASX, The Montgomery Fund

Markets at high earnings multiples

In general, the frequency and magnitude of negative share price moves suggests a general overvaluation of markets. We know for example that the CAPE Shiller P/E ratio for the US S&P500 is at the 97th percentile at the moment – in other words, the earnings multiple has only been exceeded on 3% of occasions. Similarly, the P/E ratio for the Australian Materials index is at an all-time record as it is for the S&P/ASX200 index ex banks. This is to be expected when interest rates are at multi-century lows, however forecasts of a 'new normal' extended period of low interest rates is simply another version of 'this time is different', the four most dangerous words in investing.

Investors who own companies trading on high multiples need to be on their guard, especially those in large caps offering little or no growth thanks to high payout ratios (Telstra and the banks), challenged business models (Woolworths, Wesfarmers) or cyclical industries (it will take much less time for BHP and RIO to ramp up production if the price of iron ore rises again thanks to the mine development work having already been completed during the last boom).

Investors also need to be wary of the elevated prices of infrastructure stocks such as Transurban, Sydney Airports and Auckland International Airports. They are only justified by the application of the weighted average cost of capital calculation in valuing those businesses. Due in part to low interest rates and high levels of debt, the result is a high estimated valuation. But should interest rates rise, the justification for these valuations disappears, and the two listed airports are situated on a vacant block at the end of a global cul-de-sac, which hardly justifies them being the world's two most expensive listed airports on an EV/EBITDA basis.

When market valuations are extreme, investors need to be wary of any stumble or miss in market expectations. Inevitably, it will be through this mechanism that extreme valuations are de-rated. In time, we will look back with surprise at the low rates of returns managers were committing their investors to for extended periods.

Ultimately, however, lower prices are a good thing. All investors should see themselves as net buyers over time. It is only through this lens that they will make wise decisions with respect to quality and value.

Net buyers want lower prices in the future. With that in mind, investors should always see heightened volatility as an opportunity, as long as the long-term economics and prospects for the business are bright. In the case of an operator of 45 hospitals with the ability to manufacture more hospital beds at one-third of the cost of the government, and in a market where the number of people over the ages of 65 and 85 are growing as a multiple of the population, we believe this is the case.

Roger Montgomery is the Founder and Chief Investment Officer of The Montgomery Fund, and author of the bestseller 'Value.able'. This article is general information and does not consider the circumstances of any investor.

Pension winners and losers from 1 January 2017

Rachel Lane

The biggest changes to the pension asset test in 10 years will occur in two months, on 1 January 2017.

Whenever the government makes such drastic changes it creates 'winners' and 'losers' (and some that stay the same, but worry about the changes nonetheless). If you're a pensioner the important thing is to know which bucket you fall into and make a plan for how best to deal with it. If you're a financial adviser, communicating with your clients about the changes, the impact on them and putting strategies in place to minimise the impact before it happens are imperative.

What is changing?

Currently the asset thresholds (ignoring the value of an owner-occupied home) are:

- Single Homeowner $209,000
- Single Non-Homeowner $360,500
- Couple Homeowner $296,500
- Couple Non-Homeowner $448,000

The fortnightly pension payment reduces by $1.50 for every $1,000 over the assets test threshold. To put it into context, if a pensioner exceeds the asset test by $100,000, their pension reduces by $150 per fortnight, or $3,900 p.a. If they can earn more than 3.9% p.a. on that asset then they may be better off investing the money rather than taking the pension.

Post 1 January 2017, the asset thresholds will increase to:

- Single Homeowner $250,000
- Single Non-Homeowner $450,000
- Couple Homeowner $375,000
- Couple Non-Homeowner $575,000

When assets exceed the new threshold the pension will be reduced by $3 for every thousand dollars of assets per fortnight. So if assets exceed the new threshold by $100,000 the pension would reduce by $300 per fortnight which is $7,800 p.a. meaning those assets would need to earn more than 7.8% for them to be better off.

Don't forget the income test

Of course, the pension is calculated under two tests: an asset test and an income test (with the one that produces the lowest pension entitlement being applied). In all the hype about the asset test changes it is important not to forget the income test. The government has not reported any changes to the threshold or taper rate for this.

The income test does not assume a portfolio of purely cash and fixed interest. The current deeming rate on the amount above $49,200 (single) or $81,600 (couple) is 3.25%, a rate of return that is hard to get in cash or term deposits. The income test reduces pension entitlement by 50 cents per dollar above the threshold, regardless of whether it is actual income or deemed.

Let's look at some examples, starting with a winner …

Betty is a single homeowner with $248,000 of assessable assets outside her home.

Her pension entitlement now is $819 per fortnight, and post 1 January 2017 her pension will be $877 per fortnight if the majority of Betty's assets don't produce income: for example cars, caravans, boats, vacant blocks of land and trusts don't produce taxable income.

But what if Betty's assets were primarily income producing? If she has $240,000 in investments and $8,000 in personal assets, then she is still a pension winner but her pension will increase by only $4 per fortnight not $58.

Now let's look at those who will stay the same, which is basically anyone who is currently receiving the full pension. Why? Because the changes will increase the asset test thresholds but anyone on a full pension is already under the required level.

Kevin is a single homeowner with $130,000 in investments and $20,000 in personal assets. He is entitled to $877 per fortnight under the asset test and the same under the income test. From 1 January 2017, his pension will remain the same.

As an example of how people will lose out under these changes, Fred and Shirley are homeowners with $600,000 in investments and $50,000 in personal assets.

They currently receive $792 per fortnight of pension entitlement (combined) and they earn $15,000 p.a. from their investments, meaning that their combined annual income is a little over $35,000.

Post 1 January, their pension will drop to around $497 per fortnight (combined), which means that their combined annual income (assuming they continue to earn $15,000 p.a. from their investments) will be around $28,000.

The major consequences

There are a couple of key messages the government is sending to retirees in these changes. The first is that the means-testing arrangements are likely to get tougher not easier and the second is that cash and fixed interest investments are not risk free.

If investment returns are not sufficient to meet the cash flow needs of retirees, they will be forced to dip into their capital. Sure, if the investments are in cash or term deposits, they are not at risk of the same volatility as they are in shares. However, the irony is that avoiding the potential drop in the value of the investments due to market volatility doesn't mean they are preserving the value of their capital. It's just that the retiree is eating it, not the market.

The bottom line is that retirees need to take more responsibility (and maybe a little more risk) in meeting their retirement income needs. While these changes are the biggest we have seen in nearly 10 years, don't expect they will be the last for another decade.

Rachel Lane is the Principal of Aged Care Gurus and oversees a national network of financial advisers specialising in aged care. This article is for general educational purposes and does not address anyone's specific needs.

Lack of policy direction hurting renewables sector

Alan Hartstein

Government dithering at the state and federal levels is hurting the renewable energy sector, with the net result being greater investment uncertainty, according to a panel at the Asia Pacific Impact Investment Summit held in Sydney last week.

The panel, which was chaired by Ian Learmonth from Social Ventures Australia, consisted of Carnegie Wave Energy (CWE) Managing Director Mike Ottaviano, NAB Director of Capital Financing Solutions David Jenkins and ClimateWorks Head of Implementation Services, Scott Ferraro.

Australia's commitment under the Paris Accord agreed to at the end of 2015 is to keep emissions at 1.5 degrees above pre-industrial levels and to reduce current carbon emissions by 20% by 2020, with five-year reviews thereafter.

Australia's Climate Change Authority, meanwhile, is calling for a reduction in carbon emissions in the range of 40-45% by 2030. Interestingly Samoa, one of those Pacific islands at the mercy of sea-level rises, has launched an initiative titled '1.5 to Stay Alive'.

Low renewable uptake

Ferraro said the emissions targets agreed to in Paris represented a "compelling need to mobilise global capital" and that ClimateWorks was engaged with state and federal governments to achieve the most tangible emissions benefits possible.

Australia's renewable penetration rate is still extremely low, however, with wind and solar combined providing less than 15% of total electricity output. "Grand ambitions are not being matched by action. States have completely different targets to the federal government, which doesn't even have a target beyond 2020. We need to have uniform policies, settings and guidelines before we can achieve anything meaningful."

Some state governments aren't waiting for Canberra to act. South Australia and Victoria have already set extremely ambitious zero net emissions targets by 2050, something which came under the microscope following the recent blackout in South Australia.

Debt capacity in the local market

Jenkins said NAB had witnessed a marked rise in demand for renewable energy investments and was encouraging more corporate and individual investors into solar and wind technology, adding that bank was now the leading debt financier of renewable energy in the country. He said the investment needed to achieve the 2020 carbon reduction target is about $8 billion and $2 billion a year thereafter, for which he said there is ample debt capacity in the Australian market.

The total cost bandied about for Australia's total reductions commitment to 2050 is something around $50 billion, though the vagaries surrounding this number are considerable. Globally, the cost has been estimated at over $50 trillion.

Whether these figures are fact or fiction, it's safe to assume that the final amounts will by necessity be gigantic, and that this money will flow to renewables through a combination of government and private spending on technology, building and modifying power networks and grid infrastructure, and modifications to commercial and residential properties through the use of technology such as solar panels.

Much of this investment will take the form of Green Bonds, of which governments, corporates and organisations such as insurance companies facing increased exposure to extreme weather events are likely to be the biggest supporters.

A long, slow wave to success

Carnegie Wave Energy is a good example of the difficulties faced by start-ups in the renewables sector. As a world leader in wave energy technology, and after 10 years in operation, CWE is still regarded as a minnow, with a share price hovering around the 4 cent mark and a market capitalisation of $80 million. Ottaviano said there is still a huge gap in the financing structure of the sector and the company's travelled a long, hard road towards commercialisation. CWE would not have been viable at all without the $30 million in government funding it received through the ARENA programme and the enthusiasm of smaller investors.

"We were inadvertently one of the first to engage in equity crowd funding in 2006, not because we wanted to, but because we had no other options. Institutional investors and venture capitalists basically said to us, 'come back in 10 years when you have a commercially viable product.' We attracted a lot of small investors who weren't going to bet the farm but had a genuine interest in us succeeding, and not just for financial gain. Ten years on, we're finally beginning to attract interest from institutional investors."

Ottaviano said the company had done much over the past decade to understand grid infrastructure and had recently branched out with the acquisition of local battery and solar engineering company Energy Made Clean, making CWE the only ASX-listed company with a dedicated renewable energy microgrid project delivery capability. The immediate beneficiaries of this technology will be remote communities that may not have ready access to an existing power network or grid.

He also said it was a tad ironic that those in the fossil fuel sector were criticising the subsidies offered to renewable start-ups at every opportunity. "We get admonished for supposedly sucking on the government teat, but that's a bit rich coming from oil and gas companies, given that they were the beneficiaries of massive government subsidies for decades."

Bad press and bad regulation

Regarding the fallout from SA's grid disaster that left the entire state without power for several hours, much of which was blamed on the smallish wind component of the state's power supply, Ottaviano said, "renewable energy technology is an extremely complex subject, especially when it relates to grid infrastructure. It's easy to use renewables as a scapegoat when people have no idea what they're talking about, but it's virtually never the fault of the technology. South Australia's renewable penetration is way below that of several states and countries internationally. In reality, the government failed to plan for the freakish storms that caused the blackout."

There have also been some high-profile failures over the past decade that haven't done much to enhance perceptions of the renewables sector. "Anyone who put their money into geothermal or hot rocks-related start-ups would have been extremely disappointed," Ottaviano added.

Ferraro said certificates still prop up the sector to some extent, as do feed-in tariffs, though their effect is overstated. "We need a national price on carbon, pure and simple. This will remove any future uncertainty around what governments and businesses need to do now to fix this problem."

Jenkins agreed that the uncertainty around emissions targets and the price of carbon is having a profoundly detrimental impact on the sector. "It's frustrating, that's for sure."

Lack of will to invest

Ottaviano added that the industry is hampered by the lethal combination of a shallow venture capital market and capital-intensive technology. "Everyone's looking for that next big market disruptor, but there's a lack of will among decision-makers to invest. Sure there's Uber and AirBnB that have had a big disruptive impact here but they're not Australian companies."

By way of example, Michael Glennon, the managing director of small-cap LIC Glennon Capital, said his fund had looked at adding renewables to its portfolio but he couldn't find anything that met his investment criteria. "We need to see a clear path to stand-alone profitability before we take a position in a stock. Apart from that, I don't know enough technically about the sector to make an informed judgement."

The panel agreed it is particularly frustrating that in many parts of the world, solar and wind technology is now at least as cost-effective as fossil fuel-derived energy. In Chile, for example, renewable energy costs in the range of 3-4 cents per kilowatt hour, and they don't even have a price on carbon.

Another major hurdle is Australia's regulatory environment, which is often multi-layered and suffers from a total lack of co-ordination between state and federal governments, resulting in multiple networks across states with different energy mixes and the rules governing them.

Optimism abounds

When asked what excited them most about the future, Ottaviano said CWE's looming trial at the Garden Island naval base off the coast of WA and the possibilities surrounding Energy Made Clean gave him much cause for hope.

Jenkins said the continuing decline in energy-generation costs in conjunction with the wave of capital expected to hit the sector was extremely encouraging, while Ferrero said he couldn't wait for the federal policy review, slated for 2017, and the ratification of the Paris Accord in Morocco in a couple of months.

On a final note, despite the wealth of information on offer and the undoubted passion of the protagonists, I found it somewhat disconcerting that at a regional impact investment summit, where ideas are exchanged that supposedly lead to investment and outcomes that benefit the planet and its citizens, there were only about 30 attendees at this discussion, several of whom were from the speakers' respective organisations, with many seats left vacant.

Alan Hartstein is Deputy Editor of Cuffelinks and attended as a guest of the Impact Investment Summit.

Banks team up with their FinTech competitors

Danny John

These are challenging times for the incumbent heavyweights of the financial services sector. Beset by regulatory, governance, technological, capital, and investment issues, they are increasingly facing competition for business from a whole host of new players, primarily from 'FinTechs'.

Growth of marketplace lending

In the case of online lenders, this trend began in the UK in the mid-2000s when Zopa, the world's first digital and now Europe's largest peer-to-peer (now called marketplace) provider, launched, quickly followed by the likes of Prosper, Lending Club, and OnDeck in the US.

Eleven years on, Zopa has lent around 1.8 billion pounds to more than 150,000 borrowers funded by 63,000 investors of whom 53,000 are said to be active participants into its lending marketplace.

The US players have had a similar impact on the US home market by exploiting a sector of the financial system not previously well-served by the banks. Prosper, for example, has originated $US7 billion of funded loans while Lending Club, now the world's largest marketplace lender, has provided in excess of $US20 billion in finance for personal and business loans.

This growth hasn't been without problems. Lending Club has been hit by internal governance and management troubles over the past few months, while Prosper and OnDeck have had to curtail their operations amid concerns about the state of the US consumer credit market.

But what all of these new-style lenders have shown over time is that there is a demand from consumers, previously wedded to their banks as their primary financial provider, for the new generation products they offer.

These companies have enjoyed relative success by targeting particular segments of the consumer finance market where the speed of their digital service, offers of better customer experiences and, in the majority of cases, lower interest rates have left traditional lenders unable to keep pace. And just last week, Lending Club announced it was moving into re-financing car loans to exploit that sector.

Developments such as these have prompted different responses from established players and led to questions from boards, analysts, and investors as to whether banks should compete head-on or collaborate with these upstarts to protect their existing markets.

Fighting digital entrants on their own turf

A competitive response requires legacy companies to fight on the terms that gave rise to the FinTechs in the first place. Take, for example, the launch last month of Marcus, an online small consumer loans platform from Goldman Sachs in the US designed to take advantage of a market grown by Lending Club and Prosper.

Collaboration between the old institutions and the FinTechs varies, from taking part as shareholders or providers of seed capital to becoming loan funders and referrers of customers who the banks, for instance, can't or won't serve.

But until the new players get scale in terms of total business and customers, it's not surprising that the banks, particularly the major ones with their dominant market shares, have tended to be slow to react.

Big Four understand benefits of digital collaborations

This appears to describe the current trend in Australia, where the entry of marketplace lenders like SocietyOne from 2012 onwards added new competitive pressure to the Big Four banks and other traditional lenders in areas such as personal loans, car finance and SME lending.

That pressure, while low level at the moment, is real, according to Ernst & Young's 2016 Global Consumer Banking Survey released a couple of weeks ago.

Ernst & Young surveyed 55,000 people globally of whom 40% indicated they were becoming less dependent on a bank as their primary financial services provider and were increasingly excited about what alternative finance companies could provide.

While initially slow to respond, banks certainly understand the threat posed by the digital era. In the latest annual results announced by NAB on 27 October 2016, management devoted several slides in their investor presentation pack to improvements to their digital banking services to help compete with those offered by new players.

What has been interesting, though, is the increasingly two-pronged approach taken by the big banks in Australia to collaborate with start-ups and their investors as part of an 'if you can't beat them, join them' strategy.

Westpac kicked that off in a significant way when it created the first retail bank-owned venture capital fund, Reinventure, in 2014 with the aim of backing and learning from digital disruptors, primarily in the financial services sector. It made available an initial $50 million and has since topped that up by the same amount.

From its first investment, in SocietyOne, Reinventure now owns stakes in 13 start-ups including payments platform PromisePay, secure bitcoin platform CoinBase, and SME lending marketplace provider Valiant.

Westpac has since taken a direct stake in new online mortgage lender Uno and also refers customers to the digital SME lender Prospa (not to be confused with US Prosper). The Commonwealth Bank has the same arrangement with small business loan provider OnDeck in Australia.

As for NAB, it recently set up its own venture capital fund NAB Ventures with $50 million to invest in start-ups while the bank teamed up with Telstra in June this year to launch a new SME-dedicated platform called Proquo.

Small business has been the target too for ANZ, which at the start of 2016 partnered with technology-led Honcho which helps new SMEs to set themselves up through the registration process. ANZ also has a tie-up with a Melbourne start-up incubator called York Butter Factory.

Mutually beneficial arrangements

But it's not just the major banks who see benefits in co-operating with FinTechs. Mutual banks and credit unions, who have seen the proportion of their total lending book made up by personal loans slide over the past 20 years from 52% to just 8% now, are teaming up with new companies to tap back into this market as a new growing asset class.

Customer-owned groups like G&C Mutual Bank, Beyond Bank Australia, Regional Australia Bank and the Maritime, Mining & Power Credit Union are doing that in two ways: as equity shareholders and as direct investor funders (with other credit unions) of borrower loans where the returns are currently averaging 10%.

This sort of collaboration shows how digital disruption can benefit incumbents and create value, despite understandable investor concerns that the opposite is likely to occur.

Danny John is Director of Communications at SocietyOne and a former Business Editor of The Sydney Morning Herald. SocietyOne is a sponsor of Cuffelinks.

Achieving real returns in a low-growth world (part 2)

Simon Doyle

If you believe we are in a low-growth world, as we do, the attainability of real-return objectives will be difficult in an environment where bonds (and their proxies) are likely to be more challenged than equities. The response largely comes down to asset allocation.

In this article, we look at the part that cyclical volatility plays in achieving real returns, providing clues on how well-timed asset allocation can capture the upside of this cyclical volatility while attempting to avoid losses.

Cyclical considerations for decent returns

Cyclical volatility is normal in markets and can be significant in magnitude and can endure for relatively extended periods (three to five years in some cases). Returns are not linear. Even within structural 'bear' markets, significant rallies are likely. Investors who participate in the cyclical rallies but who can avoid the inevitable downswings can achieve decent returns. In contrast, in structural bull markets, cyclical volatility is less relevant as set and forget (i.e. beta alone) will deliver.

The critical question is can this cyclical volatility be managed and captured? It's easier said than done.

This cyclical volatility is, in broad terms, driven by two interrelated factors: changes in valuations and the rotation of the business cycle. Our approach is to condition the long-run structural trend return in assets with shorter-run valuation dynamics to produce return forecasts over our investment horizon (three years), and to overlay this with an assessment of where we are in the cycle, and what this means for asset-price behaviour and policy. While by no means perfect, this provides a disciplined framework to buy when risk is low and sell when risk is high.

The key here clearly is the ability to capture the upswing but not ride the reverse. A summary of our cyclical (three-year) return forecasts is shown in the following chart and these are compared to our longer-run numbers.

It highlights that equity markets can be expected to deliver reasonable returns to investors over the next few years (albeit not necessarily in a linear fashion), whereas bond markets, and asset values that have been driven primarily from the decline in bond yields, could be expected to struggle or deliver negative returns. The numbers in the table exclude the impact of currency and active security selection, which over time we would expect to contribute to returns.

Expected three-year and longer-run returns

Asset class	Expected 7- to 10-year return %	Expected 3-year return %	Difference %
US equities	4	4	0
European equities	5	7	2
UK equities	5.5	8	2.5
Japanese equities	7	10.5	3.5
Australian equities	8	10	2
Global equities ex-Aust (hedged)	6	6.5	0.5
Emerging-market equities (hedged)	10	11.5	1.5
Asia ex-Japan equities (hedged)	11.5	12.5	1
Global REITs (hedged)	2	-2	-4
Australian REITs	1.5	-3.5	-5
Global high-yield bonds (hedged)	6	6.5	0.5
Emerging-market debt	5.5	5	-0.5
Australian hybrids	5.5	4.5	-1
Global investment-grade bonds (hedged)	3.5	1	-2.5
Global composite bonds (hedged)	2	-3	-5
US government bonds (hedged)	1.5	-2	-3.5
Australian government bonds	2	0	-2

Sources: Schroders as at 30 June 2016. Returns are in local currency unless stated otherwise. Hedged is to $A.

There are significant implications from an investment perspective:

1. **Which market and when will be crucial:** Market performance (beta) will be crucial in order to deliver real returns in coming years. Appropriate and potentially aggressive shifts in asset allocation will be essential to capturing upside, and more significantly, avoiding giving away gains as markets decline.

2. **Sovereign bond outlook looks poor:** Until appropriate risk premia in bond markets are restored and monetary policies move towards more normal settings (albeit probably a 'new normal'), the sovereign bond outlook looks poor (at best). Equity markets are more likely to be significant contributors to returns (albeit will likely struggle if/when bond markets re-rate).

3. **Assets structurally linked to declining bond yields are at risk:** The most problematic assets are likely to be strategies where performance is structurally linked to the decline in bond yields. At an asset-class level, these include sovereign bonds, infrastructure and REITs.

4. **Be cautious around structured/alternative betas and complex financial engineering:** We remain cynical about alternatives, particularly when market pricing has been heavily distorted by central bank policies. Alternatives such as hedge funds have historically over-promised and under-delivered, particularly after fees. While it is logical in a world where returns from equities and bonds (the predominant market betas) are likely to be constrained, this path is unlikely to solve the low-return problem in the medium to longer term.

5. **Leverage brings additional risk and may not solve the fundamental problem of low returns:** Non-directional alpha strategies are for the most part relative value trades, requiring leverage, potentially bringing additional risk. The current environment is not one conducive to leverage. There's also often more beta in these strategies than what appears on the surface.

6. **Transparency, liquidity and the ability to hold cash will be important elements of a successful strategy:** The implications of low bond yields on portfolio diversification may mean less aggregate equity positions, higher cash weightings than would be traditionally the case or more aggressive use of lower-risk equity substitutes.

7. **Active asset allocation (in fact, active management generally) will be incredibly important**. Capturing the upside of this cyclical volatility will be crucial, but more crucial will be avoiding the losses on the other side.

There is no doubt that achieving CPI+5% consistently will be tough. Investors will likely be episodically biased to equities over bonds, need to be aggressive in managing asset allocation around these trends, and use active management at the asset-class level to gain higher returns. The risk to delivering return objective consistently is to the downside.

Simon Doyle is Head of Fixed Income & Multi-Asset at [Schroder Investment Management Australia Ltd](). Opinions, estimates and projections in this article constitute the current judgement of the author. They do not necessarily reflect the opinions of any member of the Schroders Group. This document should not be relied on as containing any investment, accounting, legal or tax advice.

Meeting the retirement outcome challenge

Graham Hand

For a while now it seems Jeremy Cooper (Chair of the Super System Review and now at Challenger) has been trying to remain both positive and patient with the super industry as it faces up to the retirement outcome challenge and securing retirement income streams for members. Jeremy has lamented about the 'CIO Problem' and suggests that super funds should think about appointing a 'CRIO' (Chief Retirement Income Officer). These views were formalised in a recent thought piece produced by Challenger and KPMG (linked here).

Harry Mitchell is the recently appointed CEO at Mine Wealth + Wellbeing while David Bell is their CIO.

GH: Harry, do you have a 'CIO Problem' at your fund?

HM: Is there something you know about David that I don't know, Graham?

GH: Well I have worked with David on and off for well over a decade. I can tell you a few stories …

HM: The 'CIO Problem' is based on the premise that CIOs have historically, due to their analytical skillset, been heavily involved in 'version 1' retirement solutions. I call these 'version 1' solutions because they have generally been investment-based solutions. This can only get you so far. Jeremy is referring to the need for what we call 'version 2' and 'version 3' solutions. 'Version 2' is product based but accounts for investment and mortality risks. 'Version 3' is holistic. It would have a greater degree of personalisation hence brings in all capabilities of a super fund – from digital and analytics to communications and advice, to governance and administration capabilities that act as enablers.

GH: So what is the role of your CIO then?

HM: In our case David has two responsibilities. First he leads our investment activities. Managing risk to achieve investment outcomes will always be a crucial function of any leading super fund. A small amount of extra annual return delivered over time can have a significant impact on the retirement outcomes of our members.

However, David is also responsible for our retirement outcomes modelling unit. We established this area nearly two years ago. You know that David went back to uni six years ago to gain the research skills to meet the retirement outcome challenge. I think he initially thought that he would be building all the complex models himself, however he has matured (a little!) and realises that his role is to oversee this function. He has hired some great academic talent in this area. We have an agreed IT modelling platform (MATLAB) and have fully built out our modelling and testing environment.

GH: This is all starting to sound complex.

DB: It is. The complexity of the retirement outcome challenge cannot be denied. At a minimum you need the following: a stochastic framework that accounts for variability in investment and mortality outcomes and integration with Age Pension, and a clear set of objectives. From there you can begin to innovate. If a super fund can't meet the complexity of the problem then they are likely to fail to meet the retirement outcome challenge.

GH: Surely the objectives are not that hard to land on?

DB: It is more complex than you think. The industry as a whole is only just now working out an objective (a recommendation of David Murray's Financial System Inquiry). Think about income in retirement: people want higher income; they would prefer an income stream which is smooth and not bumpy; they would be upset if they outlived their retirement savings; and a bequest is worthwhile. We also know that people are generally risk averse – the pain of a lower outcome is larger than joy of an equivalent higher outcome.

Some of these features pull against each other: income level versus bumpiness, longevity risk versus bequest and so on. We have spent the last year working through all these issues with a collection of industry experts and academics and have packaged this up into a mathematical function. We now have what we call a 'better scoreboard' for assessing retirement outcome solutions and services.

GH: This sounds exciting but where does it place you in the super fund pack?

DB: Actually we will be sharing all of this work with everyone – industry, academia, regulators and policymakers. There is a bigger issue at play - nationwide retirement outcomes - and we want to contribute. We will make sure you get a media pass Graham when we release all this work.

GH: Won't most people find this complex modelling a bit confronting? How do people know it is not just gobbledy-gook with some pretty pictures?

HM: I trust Dave and his team. They do a lot to test their models, including the use of external testers, and are active collaborators with the academic world which also acts as a control. Their commitment to education of our Board, our Investment Committee, our Executive team and our staff has really helped us along our journey.

GH: Well why don't you call David your 'CRIO'?

HM: We are uncomfortable with the concept of a dedicated CRIO. Delivering good retirement outcomes is at the heart of what we do as a firm. This makes me, in my role as CEO, effectively the CRIO that Jeremy refers to. It is my role to make sure that all my teams are collaborating, and that we engage with industry and regulators. It is my role to make sure we deliver the best possible retirement outcomes to our members. So my core responsibility is the delivery of retirement outcomes regardless of its complexities.

DB: I think you may see variations to this model. QSuper has a similar model to us. Some funds, particularly those with a defined benefit legacy such as UniSuper, have internal actuarial teams which could do the heavy lifting on the modelling side. Perhaps funds that don't quite know where to start could create the role of a CRIO.

GH: I haven't seen much evidence to suggest that other super funds are doing similar work. Do you think this will lead to further industry consolidation?

HM: Who knows what motives will drive the next wave of industry consolidation. We like the idea of merit-based mergers, and we hope that as the industry becomes aware of the work we are doing, they would like to collaborate and work with us in a variety of ways.

Harry Mitchell is Chief Executive Officer (the unofficial 'CRIO') at Mine Wealth + Wellbeing. David Bell is Chief Investment Officer at Mine Wealth + Wellbeing and is working towards a PhD at University of New South Wales. Both Mine Wealth + Wellbeing and Challenger/Accurium are sponsors of Cuffelinks.