Cuffelinks
Connecting investors with ideas

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## This Week's Top Articles

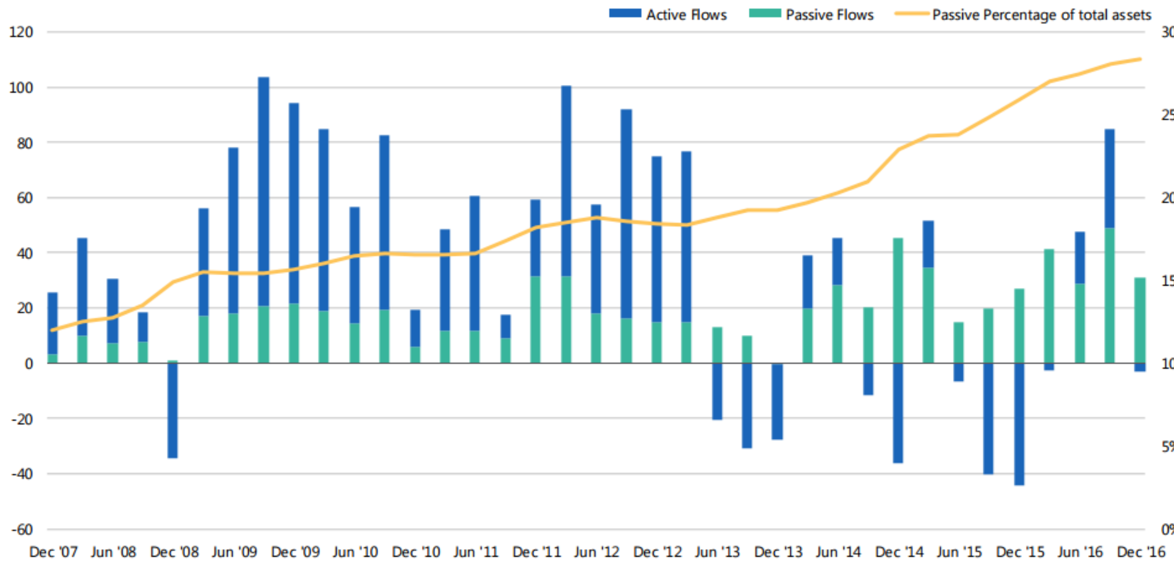


## Market's biggest names weigh into indexing debate

Graham Hand

In the last two weeks, the active versus passive arguments rose to prominence again with heavyweights **Warren Buffett**, **Jack Bogle** (Vanguard Founder), **Raphael Arndt** (CIO of the Future Fund) and **Manny Roman** (PIMCO CEO) weighing in. It's far from a settled debate despite index investing winning the money flows. Morningstar estimates that in the US in 2016, US$340 billion poured out of active funds while index funds rose $505 billion.

**Active v passive quarterly flows into taxable US bond funds, 2007 to 2016**




*Source: Morningstar Direct, as at 31 December 2016, data for US flows.*

Even in bond funds, where active managers have a much stronger track record of outperforming their indices than equity funds (more on this later), low fees are attracting the flows despite the performance. Passive's share of bond fund assets has risen from about 12% to around 28% over the last decade. In fact, despite rising rates, passive funds have not had a single quarter of net outflows, while most active funds are losing balances, as shown above.

Let's check what each of these big four names said on indexing recently.

**Warren Buffett, Chairman, Berkshire Hathaway**

At the Berkshire Hathaway AGM last weekend, Warren Buffett again advocated index investing for most people, arguing it has saved them 'hundreds of billions' in fees. He even called out Jack Bogle for a standing ovation. His annual letter to shareholders is linked here, although sections of it are starting to sound repetitive. It's somewhat ironic that Buffett himself supports indexing for the masses while outperforming with a 19% pa return since 1965 versus the S&P500 (including dividends) at 9.7%. Obviously, he's a special case.

On indexing from his newsletter:

"Over the years, I've often been asked for investment advice, and in the process of answering I've learned a good deal about human behaviour. My regular recommendation has been a low-cost S&P 500 index fund. To their credit, my friends who possess only modest means have usually followed my suggestion.

I believe, however, that none of the mega-rich individuals, institutions or pension funds has followed that same advice when I've given it to them. Instead, these investors politely thank me for my thoughts and depart to listen to the siren song of a high-fee manager …

That professional, however, faces a problem. Can you imagine an investment consultant telling clients, year after year, to keep adding to an index fund replicating the S&P 500? That would be career suicide. Large fees flow to these hyper-helpers, however, if they recommend small managerial shifts every year or so. That advice is often delivered in esoteric gibberish that explains why fashionable investment "styles" or current economic trends make the shift appropriate...

In many aspects of life, indeed, wealth does command top-grade products or services. For that reason, the financial "elites" – wealthy individuals, pension funds, college endowments and the like – have great trouble meekly signing up for a financial product or service that is available as well to people investing only a few thousand dollars ...

The likely result from this parade of promises is predicted in an adage: "When a person with money meets a person with experience, the one with experience ends up with the money and the one with money leaves with experience."

**Jack Bogle, Founder, Vanguard**

Jack Bogle, credited with starting the index fund movement with the launch of what became the Vanguard 500 Index Fund in 1975, released an essay called *The Road Less Travelled* on how the index fund industry developed, linked here. It's the first time he has recorded the history of his idea and his 66 years in the industry. Vanguard's numbers are extraordinary - $4 trillion in assets, 23% market share of assets, $304 billion in 2016 cash flows (171% of industry cash flows).

Here are some extracts:

"For surely fate would have eventually awakened the investment world to this fundamental truth: before intermediation costs are deducted, the returns earned by equity investors as a group precisely equal the returns of the stock market itself. After those costs, therefore, investors earn lower-than-market returns. Fact: The only way to maximize the share of the financial market returns earned by the 100 million families whom the fund industry serves is by minimizing the costs borne by fund shareholders ...

Recent data from Standard & Poor's reaffirms the tough job facing active managers. For the first time, S&P SPIVA ("Index Versus Active") produced comparative data for the past 15 years on a broad matrix of funds. On average, the indexes outperformed an astonishing 90% of all actively-managed mutual funds. Over the 15-year period, the passive indexes outperformed the average actively-managed funds by 1.5% annually, a cumulative enhancement of almost 25% for capital accumulation, simply by the use of passive market indexes.

In 1980, equity fund assets were $44 billion. By 2016 these assets had soared to more than $8 trillion. Expense ratios of actively-managed funds had declined to 84 basis points, still 53% above the 1960 level. With the growth of lower-cost bond funds, the industry-wide asset-weighted expense ratio for long-term funds is now at 68 basis points, almost 25% above the 1960 level. With total fund assets averaging $17 trillion in 2016, fund advisory fees and operating expenses come to a total of $110 billion per year — 5,600 times the 1951 level of $20 million in an industry whose assets grew by 5,400 fold. Economies of scale for fund investors — zero."

**Dr Raphael Arndt, Chief Investment Officer, Future Fund**

Dr Raphael Arndt recently explained how the Future Fund's thinking about active investment has evolved over the last decade, in a paper linked here.

"Listed equity managers in general aren't particularly good at making macro calls. Likewise, when we analyse positions in our portfolio, we are increasingly discovering managers are knowingly, or unknowingly, taking significant factor positions …

Today, relative to a decade ago, we have technology available that means we can better analyse positions in our portfolio – to better understand underlying factor exposures, macro calls, style tilts or offsetting positions.

In short, the advances in technology enabling better understanding of underlying exposures, combined with lower forward looking returns means the world has fundamentally changed, requiring a new approach to active equities investing ...

I have talked a lot about the benefits of passive and low cost strategies and how they are playing an increasing part in our Listed Equities program.

However we continue to believe there is a role for active management and that it will continue to play an important part in our Listed Equities strategy. We call this our Global Alpha program.

Though this program we are seeking out managers who can add value through genuine stock picking skill that is uncorrelated to market returns, or beta.

We have reshaped our Alpha program – with the intention that we have a small number of managers delivering attractive risk-adjusted returns.

We are looking for true stock picking skill executed in a way where we are not paying for beta or for style or factor bets.

We also don't want active positions across different managers that offset each other at our portfolio level.

We envisage that pure stock-picking skill has the best opportunity to thrive when given the broadest canvas possible.

In our view, this is most likely to be found in relatively small capacity managers looking at global stocks with long-short market neutral mandates. In this type of strategy we are paying for pure stock picking alpha and the results are highly transparent.

Importantly we won't pay active management fees for the delivery of market beta or factor exposures, which we can purchase for a few basis points.

We are in an environment where sophisticated investors are no longer willing to pay active management fees for beta returns, or even for sensible positions from the managers' point of view but which cancel other positions at the portfolio level. Nor will investors pay for stock picking skill but receive only style factors or managers taking macro bets.

What does all of this mean for a long only active equities manager?

It means fund managers need to consider their value proposition.

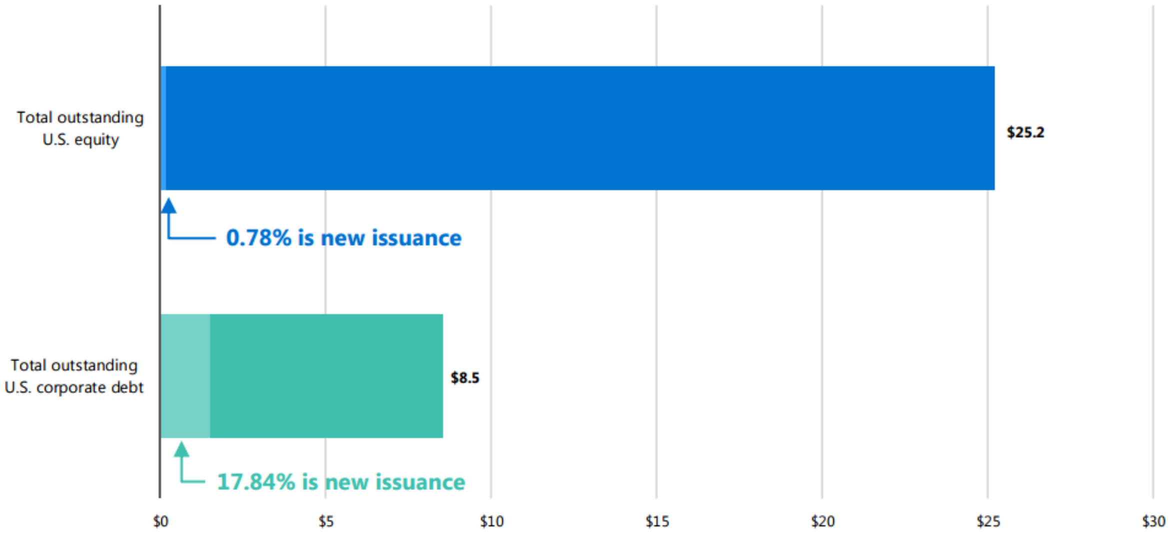
They need to take a good, hard look at themselves and their client's needs and understand how they are creating value and how much of that they are seeking to retain though fees.

In short – they have to confront the new reality."

**Emmanuel Roman, CEO, PIMCO**

At a Research Affiliates Conference I attended in Los Angeles last week, PIMCO Chief Executive, Manny Roman, explained why active bond managers have special advantages over indexers. He titled his paper, *Bonds are Different*. Among his evidence was this convincing chart.

**New issuance in US corporate bond market versus US stock market ($ trillions in 2016)**




SOURCE: SIFMA, Bloomberg; As of 31 December 2016
Note: Chart shows the extent to which new issuance affects the debt and equity markets U.S. companies access in order to finance themselves. The S&P500, which has a market capitalization of around $20tn, has a turnover of 4% a year, as company stocks enter and leave the index for reasons other than new issuance. Less than 1% relates to new issuance. Active equity managers are able to trade on the basis of this, as inclusion in the index can be a tailwind for a firm's stock price. By contrast, 22.2% of Bloomberg Barclays U.S. Aggregate was new issuance, in the period 31 Dec '15– 31 Dec '16.

Roman argued that due to bond maturities and rollovers and early calls with reissuance, annual new issues are a large 18% of the total outstanding debt in the US corporate bond market. To convince large bond fund managers to participate in new transactions, issuers often left some margin on the table for the buyer. In addition, new issues often require a cornerstone investor who is given a special rate to ensure the issue's success, or a borrower wants to raise money quickly and is willing to pay above market rates. He cited an example of a recent Deutsche Bank issue picked up by PIMCO at a margin of 350bp when the market level was about 150bp. This mirrors the experience in Australia when, for example, Unisuper agreed to buy $300 million of CBA PERLS 8 to give the borrower confidence to go to the public market.

In contrast, the graph shows new issuance represents less than 1% of outstanding US shares. While equity managers can achieve some improvement in prices by participating in a placement or attractive rights issue, it is a fraction of their investment activity.

Roman argues other factors such as bond investors with 'non-economic' incentives, including pension funds matching long-term liabilities rather than maximising returns, and issuers with bonds in different countries at varying margins due to local regulations, give large global managers a competitive advantage. He claims active bond management should deliver at least 1.5% over index after fees.

**BetaShares Australian ETF Report April 2017**

Finally in this indexing summary, as a sign of the rising popularity in Australia, BetaShares' latest ETF Report, attached here, shows balances reached a record $28.3 billion at the end of April 2017, with new money flows of about $400 million for the month.

**My conclusion on active versus passive**

Investors can choose the best of both worlds. Identify a group of talented managers who are genuinely smart and do not follow indexes. Complement them with direct holdings and index funds (either unlisted or ETFs) to reduce costs and gain the appropriate asset allocation for your portfolio. Avoid concentrated cap-weighted funds such as those based on the S&P/ASX200, since 40% of the exposure is to banks and miners, especially where they significantly replicate your direct portfolio.

*Graham Hand is Managing Editor of Cuffelinks.*

# Index funds lack valuation checks for stocks they buy

## Roger Montgomery

Two years ago in Cuffelinks, I wrote an article entitled Index funds invest in the bad and the good, and said; *"The blind buying of mountains of stocks simply because they are in an index will drive mispricing that active managers can rely on to outperform the same index. As more investors flock to the index, the argument trotted out that most active fund managers fail to beat the index will become less true, if not false. The hitherto reason for investing in the index will break down, just as active managers reward their investors with greater outperformance over the long run."*

I also added; *"Index investing, in particular when it is directed to cap-weighted equity indices, is dumb investing. When Warren Buffett recommended index investing to the masses, he made the point that it suits the 'know-nothing investor'. That is, the investor who has no interest in understanding a business or valuing it."*

**Low interest rates drive higher prices**

Since then, some infinitely smarter and more influential researchers have warned investors against index investing. In late 2016, Steven Bregman of Horizon Kinetics presented at the Grant's Interest Rate Observer Conference a paper entitled, *Indexation: Delivery Agent of The Great Bubble*. He warned investors that their switching of trillions of dollars from actively managed funds into index ETFs was driving them back towards the same idiosyncratic risk they were seeking to avoid by selecting passively managed index funds.

[A 40 minute video of Bregman's presentation is linked here].

Bregman noted, as I have here and here at Cuffelinks, that the reluctance to hold cash has "very likely created balance sheet bubbles." There is no doubt in my mind that the lowest interest rates since Captain Cook first crossed the Antarctic Circle have driven the record prices in everything from collectible cars and low digit number plates to wine, art and Brisbane apartments.

But in addition, many investors have simply given up on direct equities and even actively managed funds and opted, instead, for cheaper alternatives such as index ETFs. These index funds ignore the long-term drivers of returns, such as 'value' and 'quality' and buy all the stocks that make up the index the fund seeks to track.

Coincidently, the low interest rates and flat yield curves that have driven investors out of cash and up the risk curve have also reduced incentives for companies to invest for growth and incentivised the payment of dividends. Of course, high-dividend payout ratios mean low rates of reinvested profits, which translates to record high PE ratios coinciding with low growth.

**Little or no earnings growth**

If Australia's largest companies are paying the bulk of their earnings out as a dividend, the corollary is they expect little or no growth in earnings. Telstra's earnings per share are little better now than in 2005 and the S&P/ASX200 is no higher today than it was on 16 February 2007 — 10 years ago.

The economics of Australia's biggest listed companies will not turn significantly more positive in the next 10 years so why should the indices they contribute to produce returns any better? The S&P/ASX200 index fund is not constructed with long-term returns in mind. It merely reflects the trading activity in Australia's largest 200 companies.

But what if inflows into index ETFs stop flowing in and start flowing out? This is the question Bregman asked in October last year.

The business of ETFs looks good when funds are flowing in. Bregman noted there were 204 ETFs in the US in 2005 but by 2015 there were 1,594. In Australia, there are 179 ETFs. Low fees are one of the carrots used to attract investors to index investing. The other one is selective time frame comparisons of returns. It is true that many actively-managed funds underperformed the index in 2016, but over five years and since inception, many active managers in Australia beat the S&P/ASX200.

**Focus on big stocks**

The large ETFs tend to concentrate their activity among the big stocks. In the US, this has produced some curiosities. For example, Bregman notes ExxonMobil is "25% of the iShares US Energy ETF, 22% of the Vanguard Energy ETF, and so forth, [but] ExxonMobil is simultaneously a dividend-growth stock and a deepvalue stock. It is in the US quality-factor ETF and in the weak-dollar US equity ETF. Get this: It's both a momentum-tilt stock and a low-volatility stock. It sounds like a vaudeville act."

This might not seem significant to an Australian investor, but in the past three years, the oil price is down 50%, Exxon's revenue is down 46%, its earnings per share is down 74%, the dividend-payout ratio is almost 3x earnings and total debt up 129%. Yet the stock was up 4% from the second quarter of 2013 to the second quarter of 2016. Bregman called it "an exercise in levitation" thanks to the distortion of prices by index investing buying.

In Australia, despite, or perhaps because of, our relatively smaller size, the iShares Edge MSCI Australia Minimum Volatility ETF, the Russell Investors Australian Responsible Investing ETF, the Russell Investors High Dividend Australian Shares ETF, the Russell Investors Australian Value ETF and the UBS IQ MSCI Australia Ethical ETF all have Telstra and the big four banks in their top 10 or 15 holdings. Indeed, all the above ETFs held CBA and WBC as their top two holdings and the big four banks as their top four holdings.

The scaling requirement has produced other curiosities in Australia. Funds that label themselves ethical or responsible hold Rio, BHP, Woolworths, and Woodside.

Bregman notes that in the US, the annual share turnover of ExxonMobil is 90% and IBM Corp 128% but the turnover of the SPDR S&P500 ETF was 3,507% or 100% per day! In other words, the average holding period is just one week. What do you think might happen to share prices if ETF inflows turn into outflows given turnover of an ETF is dozens of times higher than that of the underlying securities? On 24 August 2015, Bregman observed a dress rehearsal of what might transpire. On that day, the price of the iShares Select Dividend ETF fell 35% while the NAV dropped just 2.5%.

Could it be that the idiosyncratic risk investors sought to diversify away from by investing in index ETFs is the same risk they are unwittingly heading headlong into, while the indexes are fully invested and shares are at record price to earnings multiples?

Author of 1955 bestseller *The Great Crash,* John Kenneth Galbraith, explained the cyclical instability inherent in modern capitalism as stemming from the accumulation of excessive wealth and the fragile nature of the financial system. Galbraith noted, all stockmarket bubbles exhibit "seemingly imaginative, currently lucrative, and eventually disastrous innovation in financial structures". Bregman suggests the current fascination with index ETFs is a craze that will not end well.

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## Active vs passive: there's more to it

### Leah Kelly

After conversations with colleagues, I will admit that I am as guilty of this as most market participants – using the phrase 'active vs passive', when, strictly speaking, that is not what I mean. The problem with using those terms is it glosses over some important details. You can be a highly active investor using index funds and a highly passive investor using traditional actively managed funds, as a super simple example.

So what should the debate be focused on? There are three comparisons that immediately spring to mind:

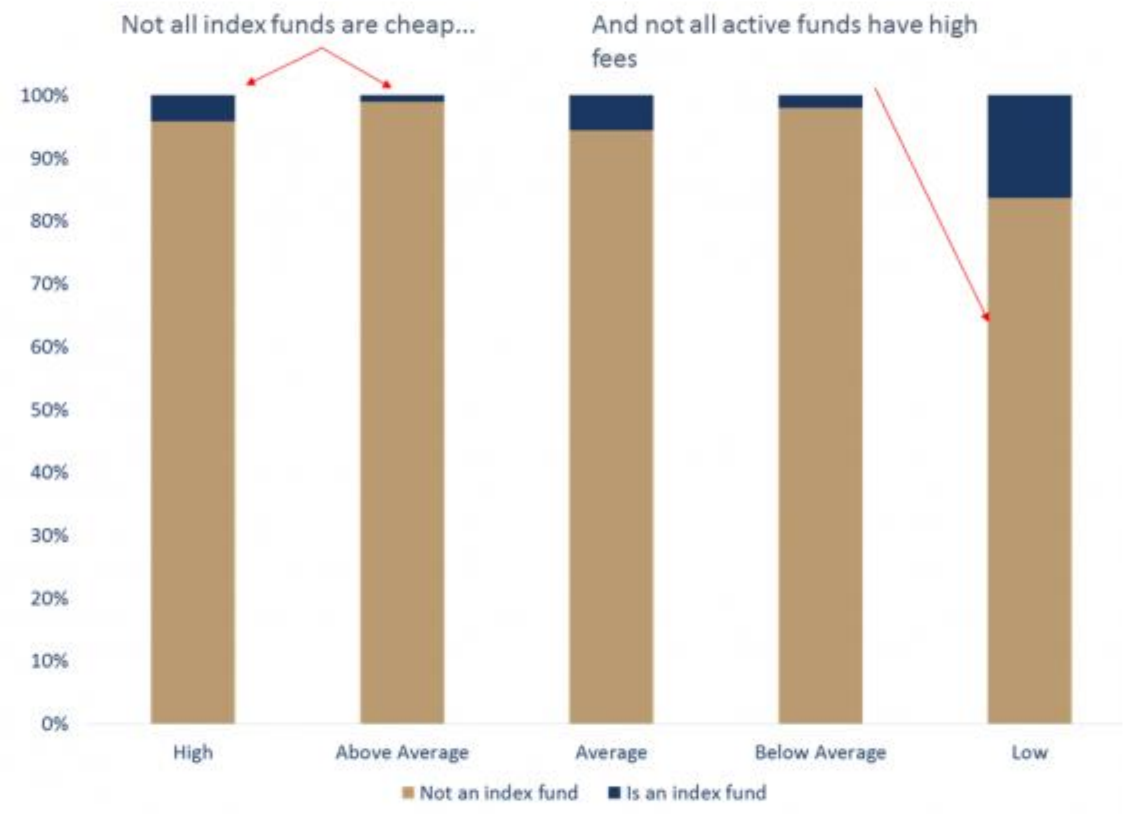
1. Low cost versus high cost
2. Low turnover versus high turnover
3. Rules based versus forecast based.

**Low cost versus high cost funds**

We have written (and spoken) at length about the costs of funds and ETFs. Costs are closely associated with performance. Numerous studies have found this, starting with the work of Nobel Laureate William Sharpe in 'Mutual Fund Performance', written in 1966. It is not as if the thought is new, rather the marketing of more expensive investment options has been very effective.

Why do costs matter so much? Fees are taken directly out of performance daily – as investors you never actually see them. The less you pay, the more you have in the end. It really is that simple.

**Figure 1: Costs matter**

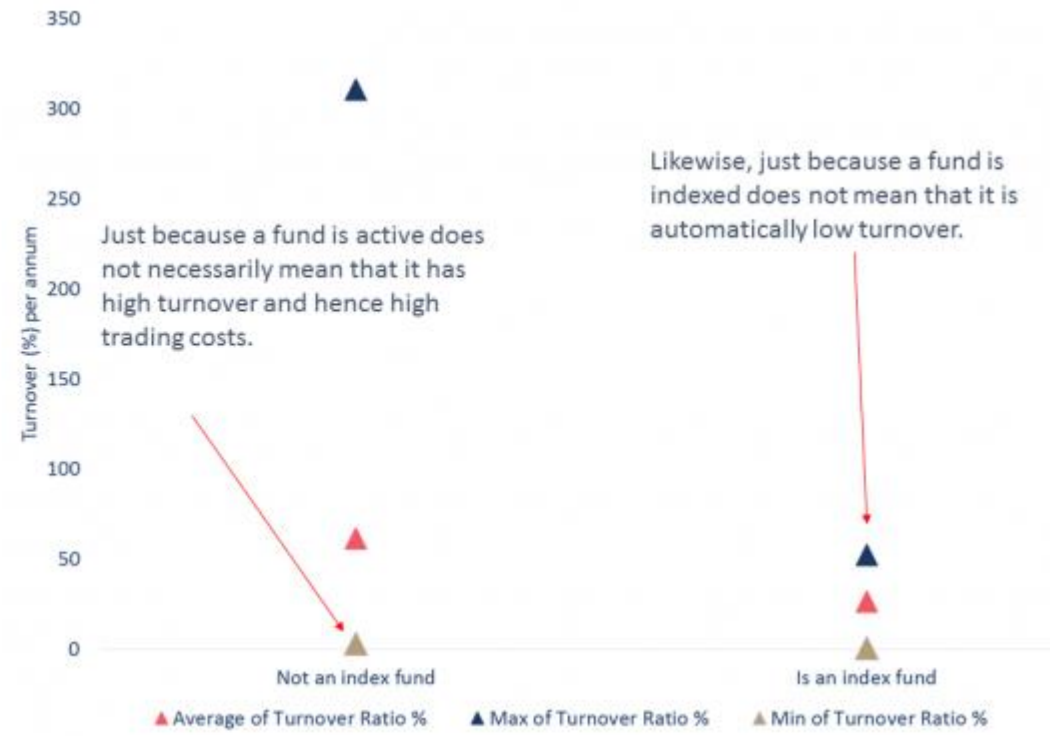



*Source: Morningstar, Owners Advisory, May 2017*

**Low turnover versus high turnover**

One metric that is often overlooked, but is extremely important particularly to after-tax returns, is turnover. Turnover measures the frequency in which securities are traded over a 12-month period and serves as a proxy for trading costs. Trading costs directly impact a fund's performance (and again, like fees, are taken out prior to performance is calculated, making it difficult to see). Not only is it trading costs, but capital gains can be locked in which are then passed through to the investor. Traditional active managers and indeed some rules-based approaches have very high turnover, which again you pay for, and again impacts directly the returns you realise.

**Figure 2: High turnover can impact performance**




*Source: Morningstar, Owners Advisory, May 2017*

**Rules based versus forecast based**

Rules-based investment strategies are what underpins nearly every smart beta offering or factor tilt investment strategy. Typically, rules-based approaches are based on academic research. Value, for example, is such a factor. Researched endlessly, in the early work by Fama and French, companies with low price-to-book ratios were identified as providing excess returns to the market over the long-term. Indeed, straight index funds, such as an investment that tracks the S&P/ASX 200 is another factor investment, but here the factor is beta or the market as a whole. These rule-based strategies do not care about the direction of the market; they simple follow the rules.

The problem with using the terms active and passive is it glosses over some important details.

On the other hand, forecast-based approaches are typically seen in the traditional active management strategies. Analysts work to identify the 'true' or 'fair' value of a security using some valuation method and then look to see where mispriced securities may be lurking. This is a tough gig, particularly as technology improves – a well-designed algorithm can identify mispricings much faster than a human can. The impact? To push prices to their 'fair' value faster than was once the case.

Using the phrase 'active versus passive' is an oversimplification of the problem investors face when thinking about how to implement their asset allocation. Really, what ultimately matters is returns individual investment vehicles deliver, not whether they are index investments or not.

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# How to preserve estate money in super under the new rules

Mark Ellem

The introduction of the biggest tranche of change in the super rules in a decade will impact the estate plans for many. Included are changes which will affect the amount of a deceased spouse's super that a surviving spouse can retain in super and the ability to transfer a death benefit pension to another super fund.

In the first of two articles, we will focus on the effect of the transfer balance cap (TBC) on the ability to pay a death benefit as a pension to a surviving spouse.

**What happens to a member's benefit on death?**

From a superannuation perspective, the death of a fund member is known as a 'compulsory cashing event'. The deceased member's benefit must be 'cashed' to a dependent, as defined under the superannuation law, as soon as practical, either as a lump sum or as a pension or a combination (although there are some restrictions on paying a death benefit as a pension).

**Who can receive a death benefit pension?**

Usually, only a surviving spouse is entitled to receive a death benefit pension. However, a child of the deceased can also be paid a death benefit pension, provided they are under age 18 or aged 18 to 24 and 'financially dependent' on the deceased parent. Once a child turns 25, any residual capital balance of the death benefit pension must be paid to them, unless they are 'disabled', as defined under the Disability Services Act 1986, then the pension can continue. According to the ATO, there are not many death benefit pensions being paid to children.

**What are the changes on 1 July 2017 to death benefit pensions?**

Firstly, where a person receives a pension due to the death of their spouse, the value of the pension will count towards their TBC. On 1 July 2017, everyone in retirement phase starts with a TBC of $1.6 million. In effect, the TBC restricts the amount of a deceased member's benefits that can be retained inside superannuation and paid to the surviving spouse as a pension or income stream. Currently, there is no limit.

**What if the death benefit pension breaches the TBC?**

If a person exceeds their TBC, the ATO will issue a notice advising of the excess, which will also include an amount of 'notional earnings', calculated based on the 90-day bank bill rate plus 7% (for example, it would have been 9.2% for 2015/16). The amount above the surviving spouse's TBC plus the 'notional earnings' must be removed from the death benefit pension account by way of a lump-sum benefit payment, that is, removed from superannuation.

Alternatively, if the surviving spouse has their own pension, they can partially commute it and they have the option of transferring the amount to their accumulation account or withdrawing it from superannuation as a lump sum. Income generated by the partially commuted amount, as part of the accumulation account, will be subject to 15% fund income tax.  However, it will not have been forced out of the superannuation fund. Further, the 'notional earnings' amount will be assessable to the surviving spouse and taxed. For a first-time breach of the TBC, the applicable rate is 15%, for a second and subsequent breach, the rate is 30%.

**Is there a different treatment for reversionary and non-reversionary pensions?**

A reversionary pension is one where a person receives an automatically reverted pension due to the death of a spouse who had already been in receipt of the pension at the time of their passing. There are two points to note about the assessment towards the surviving spouse's TBC:

- The value of the deceased member's pension at the time of their death will be the amount that is applied to the surviving spouse's TBC, and
- It will not be applied against the surviving spouse's TBC until 12 months after the death of the member.

This provides time for the surviving spouse to ascertain whether they have exceeded their TBC due to the death benefit pension and take appropriate action.

**Reversionary pension on death and TBC example**

Don and Hillary are members of their SMSF. Both are retired and have each commenced account based pensions. Each pension was established as reversionary to each other in the event of their death. The value of their pensions at 30 June 2017 are:

Don $1,250,000
Hillary $1,400,000

Soon after 30 June 2017, Don dies and his pension automatically reverts to Hillary. At the time of Don's passing his pension had the same value of $1,250,000. This will be the amount that will be a credit to Hillary's transfer balance account 12 months after Don's death and will count towards her TBC.

Hillary has already used $1.4 million of her $1.6 million TBC when she commenced her own pension and at the time did not think she would have a TBC issue. However, if Hillary takes no action, in 12 months there will be a credit of $1,250,000 in her TBC account, taking her to $2,650,000, exceeding her TBC by $1,050,000. The ATO will issue Hillary with a notice requiring her to remove the excessive amount from her pensions, together with an amount of 'notional earnings', that the ATO has calculated. For Hillary, as a first offence for exceeding her TBC, she will pay tax of 15% of the 'notional earnings' amount.

Within 12 months of Don's death, Hillary has the following options to avoid exceeding her TBC:

*Option 1 — partially commute Don's pension*

Take a lump-sum death benefit payment of $1,050,000 from Don's pension (partial commutation). As Hillary was Don's spouse, she will pay no tax on the lump-sum death benefit payment. She will retain the remaining balance of Don's pension in the SMSF and receive pension payments, along with her continuing pension.

A year after Don's death, a credit of $1,250,000 will arise in Hillary's transfer balance account, together with a debit of $1,050,000 (the partial commutation of Don's reversionary pension), resulting in a net increase to Hillary's transfer balance account of $200,000. No excess will arise.

However, this means that Hillary has been forced to remove $1,050,000 from the superannuation environment, where income is taxed at no more than 15%. Being outside superannuation, income will be subject to the applicable tax rate, depending on which tax structure Hillary uses.

*Option 2 – partially commute her own pension*

Instead of commuting Don's pension, which requires the commuted amount to be withdrawn from superannuation, Hillary could partially commute her own pension to the extent of $1,050,000. As this is her own pension, **she would not be required to remove it from superannuation**, but retain it in an accumulation account in her name. This partial commutation of her own pension would also result in a debit to her transfer balance account, reducing her transfer balance account balance from $1.4 million to $350,000.

Hillary retains all of Don's pension, which reverted to her on his death. A year after his death, a credit of $1,250,000 arises in Hillary's transfer balance account, increasing her balance to $1.6 million but not in excess.

Again, income earned from Hillary's accumulation account will be subject to fund 15% tax, while income earned on her pension account and Don's reversionary pension will be tax-exempt. However, under this option, Hillary has retained all of her and Don's retirement capital inside of superannuation with a maximum tax rate of 15% on the accumulation account.

**Revision of estate plans for superannuation**

Although the introduction of the TBC did not initially affect Don and Hillary as they were both under the $1.6 million cap, upon the death of Don, Hillary had to deal with a potential excess-TBC issue. This leads to a review of estate planning for couples where their combined superannuation is more than the TBC, as the original plan may no longer be able to be followed due to the restriction of the TBC. So, dust off the wills, pension documents and death benefit nominations, and see if any changes are required to ensure that your estate plan can still be implemented under the new rules.

In our next article, we discuss the changes to the ability to transfer a death benefit pension to another superannuation fund.

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## Managing for retirement income

### Jim Parker

What can Australia learn from the US as the focus in retirement savings moves from lump sums to income?

Treasury, in a discussion paper late last year, described the introduction of new retirement solutions as critical to lifting the living standards and choices of Australians while ensuring the superannuation system remains stable into the future.

With the government planning to enshrine in legislation an income goal for super, Treasury wants to hear from the financial services industry and others by 9 June 2017 about what these comprehensive income (or 'MyRetirement') products might look like.

In its discussion paper, Treasury suggested that a MyRetirement product ideally should provide a balance of inflation-adjusted income, risk management, and flexibility.

*"Studies typically show that individuals want to maximise their retirement income while managing longevity, inflation, and investment risk and ensure they have sufficient access to their capital for lump-sum withdrawals or unexpected expenses,"* the paper says. *"Individuals are rarely willing to trade off one retirement objective for another."*

Treasury also highlights the importance of communication, allowing consumers to make meaningful comparisons between different products based on outputs (income, risk, and flexibility) rather than inputs (nature of the underlying component products).

**Learning from the US**

Many of these questions are being grappled with in other developed economies as governments seek to manage ageing populations and increasing pressures on already-strained public finances.

Like Australia, the US has a mature defined contribution framework and, through the contributions of such thinkers as the Nobel laureate Robert Merton, it also has been looking at how to shift the focus of the system from lump sums to retirement income streams.

*"The risk and return variables that now drive investment decisions are not being measured in units that correspond to savers' retirement goals and their likelihood of meeting them,"* Merton says. *"Thus, it cannot be said that savers' funds are being well managed."*

Global asset manager Dimensional, where Merton is resident scientist, has been prominent in the US discussion about retirement income goals. During a recent Australian visit, Dimensional's Senior Researcher, Massi DeSantis, told local fiduciaries that retirement solutions should help workers grow their assets but also plan the consumption that their portfolios will be able to afford in retirement.

Within this framework, Dr DeSantis cited three key elements:

1. Risk management that addresses the risks relevant to retirement income
2. Asset allocation that balances the trade-off between asset growth and income risk management
3. Meaningful communication that enables fund members to monitor performance in income units.

**Risk management around longevity and markets**

The first consideration regarding risk management is how long the members' accumulated savings are expected to support their consumption in retirement. That challenge is growing by the year. In Australia, the average life expectancy of a 65-year-old is 86 years, according to the federal government's Institute of Health and Welfare. By 2054-2055, the number of Australians aged 65 and over is projected to more than double, with one in every 1,000 people to be aged over 100.

De Santis said that, to account for uncertainty about life expectancy, a five-year buffer can be added to the average retirement horizon, resulting in a 25-year expected withdrawal period, assuming people retire at 65.

The next step is to identify the key drivers of income uncertainty over that withdrawal period, defined in terms of market risk (uncertainty of future stock and bond returns), interest rate risk, and inflation risk.

These risks can be reduced by computing the duration of the retirement income stream and allocating to a portfolio of inflation-protected securities that are duration-matched to the planned retirement horizon.

"This framework also helps to manage sequencing risk, as the level of retirement income that can be supported by the allocation to risk management assets is not very sensitive to market risk, interest rate risk, or inflation risk," Dr DeSantis said.

**Asset allocation: growth assets versus risk management assets**

Having identified an appropriate risk management strategy, the asset allocation question becomes a trade-off between allocating to growth assets versus risk management assets. The higher the allocation to the risk management assets, the lower the expected volatility of retirement income.

Dimensional in the US recently helped S&P Dow Jones Indices develop an indexing approach to managing the uncertainty of retirement income. The S&P Shift to Retirement Income and DEcumulation (STRIDE) index series uses this framework to seek to grow members' savings while managing retirement income uncertainty.

*"This entails a focus on asset growth early in members' lifecycles with a transition to an income-focused strategy over time,"* Dr DeSantis said. *"As participants transition into retirement, the majority of their assets are invested in inflation-protected government securities matched to their retirement horizon."*

Because this is a liquid investment strategy, it provides members the flexibility they need should they require periodic withdrawals in retirement.

**Meaningful communication**

The third element in the suggested framework for a retirement solution is that it should also allow superannuation fund members (and trustees) to monitor progress toward the retirement income goal. This can be achieved through information that translates the purchasing power of members' account balances in terms of estimated retirement income.

In the US, the STRIDE indices include a monthly cost of retirement income called the Generalised Retirement Income Liability (GRIL) for each retirement cohort, which can be used to translate account balances to estimated retirement income. (GRIL is defined as the present value of $1 of annual inflation-adjusted income over 25 years starting at the target date. The interest rates used to discount these future hypothetical cash flows to the present are derived from the current US TIPS curve.)

If the GRIL rises, generating a given level of income becomes more costly, and the purchasing power of a given level of savings goes down. If the GRIL falls, the desired monthly income becomes less costly and the purchasing power of savings goes up.

Because of the risk management framework underlying the indices, uncertainty about members' future income is reduced over time so that communication in income units can be more meaningful.

*Jim Parker is a Vice-President and Regional Director, Communications for Dimensional. He adapted this article for Australian audiences from 'Next Generation Retirement Investing' by Massi DeSantis and published by S&P Dow Jones Indices in its publication 'Indexology'.*

# Productivity Commission: super efficiency but at what cost?

## David Bell

In March this year, the Productivity Commission released the Draft Report on stage 2 of its review into the superannuation system. The focus is on a range of alternative default models expected to deliver greater efficiency than existing default fund arrangements.

My greatest concern is that, if efficiency measures are implemented too soon, our retirement system may fail to successfully innovate and attain the level of excellence that our population deserves. We need a fundamental debate on innovation versus efficiency and when it is the right time to switch focus.

The great thing about reviews in Australia is that we are encouraged to share our thoughts via submission, and here is mine.

**Don't focus on efficiency at cost of innovation**

When I think about productivity two words come to mind: efficiency and innovation. There is some overlap between the two as, clearly, you can innovate to achieve efficiency. However, in superannuation, there are so many 'greenfield' innovation opportunities in the delivery of retirement outcomes that we can treat the two words as distinct. Both words can help drive a better, more productive system.

The Productivity Commission has focused heavily on efficiency versus innovation. This has been a common theme amongst nearly all superannuation system regulatory reviews ('Cooper' Super System Review, 'Murray' Financial System Inquiry and now the Productivity Commission). Why would this be the case? Cost savings are tangible whereas the benefits of innovation are less tangible. Additionally, cost savings are easily understood by people further distanced from superannuation such as politicians whereas the benefits of innovation become even more of an unknown and not well understood. This probably adds to the pressures faced by people running these regulatory reviews.

I believe that successful innovation provides the greatest potential uplift to retirement outcomes of Australians. In my submission, I estimate that the uplift through better retirement solutions is a multiple of what would be derived from efficiency measures.

But here is the catch: if we switch to a heavy focus on efficiency then the potential to innovate is restricted and many of the potential future innovation-based gains will be lost. Why? Because innovations cost money in the short term, have a failure rate, and deliver benefits in the long term. This does not fit well in a system with a primary focus on efficiency.

**There's a time to switch from innovation to efficiency**

One disappointing reflection on the overall good work of the Productivity Commission is their failure to establish a single aggregated measure of system performance. This makes it difficult to compare the benefits of efficiency versus innovation. The lens through which the Productivity Commission is looking at the complex superannuation system is potentially not completely clear.

If we don't want to stifle innovation, when is the right time to switch from an innovation focus to an efficiency focus? I argue that the optimal switching point is when the system has matured to the point where it has achieved the majority of its potential. Any earlier restricts the potential to successfully innovate in the future. When that maturity point is reached then efficiency techniques are highly appropriate.

What does this 'potential innovation-driven system' look like? To me it looks like a system with the following characteristics, largely driven through technology:

- A system which has a clear and quantifiable objective around the delivery of retirement outcomes. This measure is used as a driver of resourcing and prioritisation by super funds.
- A system which, starting with defaults, actively manages the two major risks which super funds should be managing for their members: investment and mortality risk.
- A system which uses technology to personalise solutions as much as possible, from defaults all the way through to advised members (and the segmentations in between). And it means making use of information and preferences.

- A system which provides outstanding engagement, again supported through technology.

The challenging question is whether the industry will reach this level of innovation-led excellence. If you believe that it will then the recommendations of the Productivity Commission represent a potential threat to the achievement of system excellence.

On this question, however, I find myself wavering between the words 'will' and 'can'. Will the system really get there? After all the Superannuation Guarantee celebrates its 25th anniversary this year, how much time does a system need to reach its potential? Across the industry I see agents, structures and objectives which don't necessarily align with what is required to deliver system excellence.

**Preoccupation with regulatory changes stifles innovation**

In defence, it is fair and accurate to state that the system has been held back by constant regulatory change. It hasn't really had a clean run at innovation. Perhaps super funds are not great innovators and require innovation prompts from the Productivity Commission.

I find myself uncomfortably settling on the word 'hope'.

In my submission to the Productivity Commission I make an alternative set of recommendations:

- I detail an all-encompassing measurement of retirement outcomes that could be used.
- I encourage a 3-5-year window for a clean run at innovation, after which the industry has either successfully innovated to reach system potential, or it has failed to reach its potential and presumably never will. Either way there must be a deadline for a system not running efficiently.
- I introduce the concept of innovation targets and prompts.

It is a crux time for the superannuation industry. The ability to focus on member retirement outcomes, measure these holistically and innovate to improve outcomes is of utmost importance. Unless we can deliver and demonstrate the benefits of innovation, there is a likelihood that the opportunity space for future innovation will soon shrink as we are forced to become a system focused on efficiency.

*David Bell is Chief Investment Officer at [Mine Wealth + Wellbeing]. He is working towards a PhD at University of New South Wales. These views represent the personal views of the author, and not necessarily his employer.*

## Not all equity income funds are the same

### John Moore

The equity income sector continues to grow as historically low interest rates globally means investors are hunting for yield. Not all equity income funds are the same and investors should be aware of the equity exposure a fund is taking to generate income. Investors need to consider their objectives and ongoing requirements, as taking on too much risk at the wrong time can prove disastrous.

Any assessment of the equity income space and products should identify traditional equity managers who invest in long-only dividend-builder type funds and generally have up to 100% exposure to equity markets. Generally, these consist of a portfolio of Australian shares that deliver dividend income plus franking credits and capital growth over the long term. Investing in shares for income works best if company dividends are sustained and growing. However, dividend growth isn't guaranteed in the face of falling profits and dividends alone might not meet an investor's need for income.

**The use of options**

It is important for investors who intend to use their shares as sources of income to consider other ways of earning income in addition to dividends and franking credits.

Over the past few years, we have seen the emergence of equity income funds which apply an option or risk overlay to enhance income and reduce the exposure to equity markets. These funds generate additional income by selling call options over the shares held in the portfolio.

The benefits of options are threefold:

- to generate income from option premiums
- to manage the fund's exposure to the share market
- to reduce volatility and downside risk.

**Maximising income**

So how does it work in practice? To generate enhanced income, the fund buys a stock and sells a call option over that stock whereby the fund receives:

- any dividend paid during the period
- the option premium
- any franking credits associated with the dividend payment.

**Call options 101**

A call option gives the holder the right, but not the obligation, to buy a stock at a specified price (known as the strike price) within a specified time period.

- Buying a call option

When you buy a call option you buy the right to buy the stock at the strike price. You pay a premium for this right.

- Selling a call option

When you sell a call option you earn a premium. In return for this premium you have the obligation to sell the stock at the strike price if the buyer asks you to.

The following example provides more information on call overwriting strategies:

Starting share price = $100
Strike price = $110
Option premium = $2

If the share price falls, stays the same or rises but stays below the strike price of $110:

- The seller of the call option has earned a premium.
- The call option is worthless to the buyer as they can buy the shares for a lower price on the share market.

If the share price goes above the strike price, say up to $115:

- The buyer of the call option can make a profit (less the premium paid) by buying the shares for the strike price of $110 and then selling them in the market for $115.
- The seller of the call option has earned a premium of $2 and has also made a gain on the shares of $10 (the difference between the strike price and starting share price). However, if the option is exercised they will have to sell the share at the strike price, forgoing the extra $5 per share.

**Managing exposure to equity markets**

An equity manager that uses call overwriting to enhance income and reduce risk typically has an equity exposure of 60 to 80% of equity markets. The emergence of a new type of equity income fund that incorporates an index hedging strategy in addition to its call overwriting strategy provides an alternative as risk is often further reduced to 50% exposure to equity markets.

A useful way of comparing the risk of differing investment opportunities is to examine how each performs in a stress-testing environment. For instance, if we stress test an equity portfolio for a fall of -10% in the equity market, most equity funds with the same volatility and risk profile of the index and will perform in line with this move downwards.

An asset manager that dramatically reduces this risk through hedging and call overwriting could have outperformed this benchmark significantly (by up to 6.34%). Although investors can't totally avoid exposure to adverse market conditions (unless 100% invested in cash), a smaller exposure to negative returns avoid erosion of capital and a swifter recovery. Drawdowns are a useful way of comparing funds over time. Avoiding large drawdowns in down markets helps investments recover.

The GFC was a clear reminder that risk is equally important as returns. Recent market shocks like Brexit and doubts about the strength of the global economy (in particular, China) should encourage the conservative investor to focus on risk-adjusted returns. The fact that the VIX volatility index is at its lowest level since 1993 and corporate bond spreads have rallied strongly this year suggests a high degree of complacency has crept into market.

Conservative investing requires a balance between goals: too little risk means savings could be eaten away by inflation and too much risk could result in volatile returns which have the potential to destroy capital. Understand which equity income fund meets your needs.

*John Moore is a Portfolio Manager at Omega Global Investors, a global boutique fund manager. This article is general information and does not consider the circumstances of any individual.*

## Budget super changes will only impact at the margins

### Graham Hand

Compared with the drama and restrictions in last year's controversial Budget, superannuation came through mildly this year. There were two changes which on the surface were encouraging but the words 'devil' and 'detail' soon began to surface. The Treasury fact sheets are linked here.

Here's a look at the two policies with a few stings in the fine print.

**1. Reducing barriers to downsizing**

People aged 65 or older will be permitted to make non-concessional contributions to super up to $300,000 each from the proceeds of the sale of a family home. Some of the details include:

- No restrictions if the person already has more than $1.6 million in super
- No work test or upper age limit
- Applies per person, making it a potential $600,000 more in super per couple
- Home must have been owned for at least 10 years, which minimises the financial planning creativity of buying a home to sell with the proceeds going into super.

Questions are already arising, such as:

- Will moving money out of the exempt asset of a family home reduce or remove age pension entitlements and negate the benefits of having more in super?
- What happens if the family home is in the name of one member of a couple?
- A person may have substantial non-super assets and there is no requirement that the new home be a 'downsize', so can someone buy a more expensive house with other resources while putting sales proceeds of the old house into super?
- Will it be possible to repeat the exercise every 10 years?

This change appears little more than opening the door to more money going into super from people who would have sold their home anyway, while freeing up relatively little additional supply. Remember that most people below the $1.6 million transfer balance cap can still place up to $300,000 into super in a year after 1 July 2017 (using the three-year bring-forward rule) even without this new rule. It's more about the politics of seeming to do something about home affordability.

**2. First Home Super Saver Scheme**

To increase affordability, first home buyers will be allowed to make voluntary concessional and non-concessional contributions to superannuation which can be accessed to buy a home. Contribution limits are $15,000 per year up to a total of $30,000 per person. Money withdrawn from concessional contributions will be taxed at marginal personal rates with a 30% tax offset. This measure is available per person making the total amount a meaningful $60,000.

However, any amount will contribute to the annual $25,000 concessional cap, so a person earning say $110,000 with a 9.5% Superannuation Guarantee contribution of $10,450 will only have $14,550 left under the cap, not the maximum $15,000. Of course, any person salary sacrificing up to the $25,000 level at the moment cannot add any extra, but they will be able to access the voluntary contributions if they buy a first home. Contributions will be taxed at 15% which may be above the person's personal marginal tax rate (if, for example, the extra contribution money came from a wealthier family member).

The parking of money in a concessionally-taxed vehicle benefits high income earners the most. A $10,000 salary sacrifice would place $8,500 in accessible super rather than paying out say 39% (marginal tax rate plus Medicare Levy of 2%) or $3,900 in tax and having only $6,100 left over.

There will be mixed reactions to this policy, varying from those who praise the affordability assistance to arguments that anything that increases demand for houses will only bid up prices, and it's the supply side that needs addressing. While something had to be done on affordability in this Budget, the previous First Home Saver Account was not popular and was abandoned in 2015.

And let's not overlook the fact that this scheme violates the sole purpose test, and the government's stated objective for super.

These changes have yet to be legislated, although they are likely to be less controversial than last year with a greater chance of passing unscathed.

In summary, these new rules will have a marginal impact, one improving deposit balances but possibly negated by rising prices, and the other allowing money to flow into super but unlikely to materially increase housing supply. The budget cost is not significant, nor are the policy implications.

*Graham Hand is Managing Editor of Cuffelinks, and this summary is based on an understanding of Budget 2017 before the changes are legislated.*