Cuffelinks
Connecting investors with ideas

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10 cognitive biases that can lead to investment mistakes (part 1)

Hamish Douglass

To be a successful investor over the long term, we believe it is critical to understand, and hopefully overcome, common human cognitive or psychological biases that often lead to poor decisions and investment mistakes. Cognitive biases are 'hard wired' and we are all liable to take shortcuts, oversimplify complex decisions and be overconfident in our decision-making process. Understanding our cognitive biases can lead to better decision making, which is fundamental to lowering risk and improving investment returns over time.

Over two articles, I outline ten key cognitive biases that can lead to poor investment decisions. The first five are as follows:

1. Confirmation bias

Confirmation bias is the natural human tendency to seek or emphasise information that confirms an existing conclusion or hypothesis. In our view, confirmation bias is a major reason for investment mistakes as investors are often overconfident because they keep getting data that appears to confirm the decisions they have made. This overconfidence can result in a false sense that nothing is likely to go wrong, which increases the risk of being blindsided when something does go wrong.

To minimise the risk of confirmation bias, we attempt to challenge the status quo and seek information that causes us to question our investment thesis. In fact, we are always seeking to 'invert' the investment case to analyse why we might be wrong. We continually revisit our investment case and challenge our assumptions. It is much more important to ask yourself why you are wrong than why you are right. Charlie Munger, the Vice Chairman of Berkshire Hathaway and Warren Buffett's business partner, said: "Rapid destruction of your ideas when the time is right is one of the most valuable qualities you can acquire. You must force yourself to consider arguments on the other side."

In our view, the strength of many of history's most accomplished scientists and mathematicians has been their ability to overcome their confirmation bias and to see all sides of a problem. Carl Jacobi, the famous 19th century mathematician, said: "Invert, always invert."

2. Information bias

Information bias is the tendency to evaluate information even when it is useless in understanding a problem or issue. The key in investing is to see the 'wood from the trees' and to carefully evaluate information that is relevant to making a more informed investment decision and to discard (and hopefully ignore) irrelevant information. Investors are bombarded with useless information every day, from financial commentators, newspapers and stockbrokers, and it is difficult to filter through it to focus on information that is relevant. In our view, daily share price or market movements usually contain no information that is relevant to an investor who is concerned about the medium-term prospects for an investment, yet there are entire news shows and financial columns dedicated to evaluating movements in share prices on a moment-by-moment basis. In many instances, investors will make investment decisions to buy or sell an investment on the basis of short-term movements in the share price. This can cause investors to sell wonderful investments due to the fact that the share price has fallen and to buy into bad investments on the basis that the share price has risen.

In general, investors would make superior investment decisions if they ignored daily share-price movements and focused on the medium-term prospects for the underlying investment and looked at the price in comparison to those prospects. By ignoring daily commentary regarding share prices, investors would overcome a dangerous source of information bias in the investment decision-making process.

3. Loss aversion/endowment effect

Loss aversion is peoples' tendency to strongly prefer avoiding losses than obtaining gains. Closely related to loss aversion is the endowment effect, which occurs when people place a higher value on a good that they own than on an identical good that they do not own. The loss aversion/endowment effect can lead to very poor and irrational investment decisions whereby investors refuse to sell loss-making investments in the hope of making their money back.

The loss-aversion tendency breaks one of the cardinal rules of economics; the measurement of opportunity cost. To be a successful investor over time you must be able to properly measure opportunity cost and not be anchored to past investment decisions due to the inbuilt human tendency to avoid losses. Investors who become anchored due to loss aversion will pass on mouth-watering investment opportunities to retain an existing loss-making investment in the hope of making their money back.

In our view, all past decisions are sunk costs and a decision to retain or sell an existing investment must be measured against its opportunity cost. To increase our focus on measuring opportunity cost, we run the Magellan Global Fund like a 'football team' where we have the ability to put about 25 players onto the paddock at any one time. This forces us to focus on the opportunity cost of retaining an existing investment versus making a new investment in the portfolio. We believe many investors would make superior investment decisions if they constrained the number of investments in their portfolios as they would be forced to measure opportunity cost and make choices between investments. Buffett often gives the illustration that investors would achieve superior investment results over the long term if they had an imaginary 'punch card' with space for only 20 holes and every time they made an investment during their lifetime they had to punch the card. In Buffett's view, this would force investors to think very carefully about the investment, including the risks, which would lead to more informed investment decisions.

4. Incentive-caused bias

Incentive-caused bias is the power that rewards and incentives can have on human behaviour, often leading to folly. The sub-prime housing crisis in the US is a classic case study in incentive-caused bias. Notwithstanding that financiers knew that they were lending money to borrowers with appalling credit histories, and in many cases people with no incomes or jobs and limited assets ('NINJA' loans), an entire industry, with intelligent people, was built on lending to such people.

How did this happen on such a massive scale? We believe the answer can be found in the effect of incentives.

At virtually every level of the value chain, there were incentives in place to encourage people to participate. The developers had strong incentive to construct new houses. The mortgage brokers had strong incentive to find people to take out mortgages. The investment banks had a big incentive to pay mortgage brokers to originate loans so that they could package and securitise these loans to sell to investors. The ratings agencies had strong incentive to give AAA ratings to mortgage securities to generate fees, and banks had a big incentive to buy these AAA-rated mortgage securities as they required little capital and produced enormous, leveraged profits.

Buffett said: "Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behaviour akin to that of Cinderella at the ball. They know that overstaying the festivities – that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future – will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands."

One of the key factors we focus on in making investment decisions is our evaluation of agency risk. We evaluate the incentives and rewards systems in place to assess whether they are likely to encourage management to make rational long-term decisions. We prefer companies that have incentive schemes that focus management on the downside as well as the upside and encourage management to return excess cash to shareholders. For instance, executive compensation that is overly skewed towards share-option schemes can encourage behaviour that is contrary to the long-term interests of shareholders, such as retention of earnings above those that can be usefully reinvested into the business.

5. Oversimplification tendency

In seeking to understand complex matters humans tend to want clear and simple explanations. Unfortunately, some matters are inherently complex or uncertain and do not lend themselves to simple explanations. In fact, some matters are so uncertain that it is not possible to see the future with any clarity. In our view, many investment mistakes are made when people oversimplify uncertain or complex matters.

Albert Einstein said: "Make things as simple as possible, but no more simple."

A key to successful investing is to stay within your 'circle of competence'. A key part of our 'circle of competence' is to concentrate our investments in areas that exhibit a high degree of predictability and to be wary of areas that are highly complex and/or highly uncertain. We believe that forecasting the volume growth for Colgate-Palmolive, Coca-Cola or Procter & Gamble is relatively foreseeable over the next 10 years and is well within our circle of competence. Investing in financials is far more complex and we are disciplined to try to ensure we do not overly simplify the inherent complexity of a major financial institution. If we cannot understand the complexity of a financial institution, we simply will not invest, no matter how compelling the 'simplified' investment case may appear. Notwithstanding that our investment team has over 50 years of combined experience in analysing financial institutions, there are many institutions that we believe are simply too difficult to assess.

In our view, the majority of the investment mistakes we have made can in large part be attributed to our cognitive biases, where we have fallen susceptible to confirmation bias, have oversimplified a complex problem or strayed outside our circle of competence. Unfortunately, these cognitive biases are 'hard wired' and we will make mistakes in the future. Our aim is to have systems and processes in place that minimise the number of mistakes we will inevitably make due to our cognitive biases.

Part 2

The remaining five cognitive biases of hindsight, the bandwagon effect, restraint, neglect of probability, and anchoring, will be covered in the second article next week.

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Bank collapse wakes up hybrids, but is subordinated better?

Ryan Poth and Justin McCarthy

Between the government levy on liabilities, the Standard & Poor's ratings downgrades, and general sentiment towards housing risk, the banking industry has been under stress since early May 2017. Whilst the Big Four avoided ratings downgrades in their senior debt, the ratings action was a shot across the bow for the entire industry, and major banks equity prices have fallen over 12% from their recent highs last month.

Relationship between bank shares and hybrids

Many commentators are claiming the banks are oversold and this presents a buying opportunity, but I am a fixed income professional so I'll leave that call for the equity pros. What I *did* notice is that the hybrid market had been entirely ignoring this price rout and most 'Additional Tier 1' hybrids continued to march ever higher in price … until last week when a Spanish bank collapsed.

Equities and hybrids are indeed different instruments in terms of risk and historical volatility. Hybrids sit above equity in the capital structure (as do all other liabilities) but there can be no doubt that significant price movements should be correlated, and history confirms that. The first chart below shows the NAB equity and NABHA Tier 1 hybrid price movements over the past 10 years, including the GFC, and clearly indicates a high degree of long term correlation. The chart axes have been normalised so the difference in magnitude of the moves isn't obvious (hybrids are naturally less volatile than equities), but the correlation can clearly be seen. We can observe the disconnect over the past month, where the equity fell but the hybrid moved higher.

NAB equity (dark line) vs NABHA Tier 1 hybrid (light line). Source: Bloomberg

Bear in mind that the NABHA is an 'old style' Tier 1 hybrid, and the grandfathering into Basel III for capital qualification drifts off between now and 2022. To a certain extent the same holds true for the Macquarie Bank MBLHB which is essentially the same structure. But the newer Additional Tier 1 (AT1) hybrids which are fully Basel III compliant are inherently more risky and as such the correlation to equity markets should be even higher. However, until recently this was not evidenced in the market – these securities were exhibiting the same disregard for the recent move in equity markets.

This dichotomy continued until Banco Popular Español collapsed last week, resulting in that bank's AT1 hybrids being written off entirely and the Tier 2 subordinated debt (T2) converted into equity (which was subsequently bought by Banco Santander for one Euro, ie effectively zero as well).

Suddenly the hybrid market sat up and took notice, and prices sharply corrected over the space of a few days as the reality sunk in that the equity selloff bears a level of correlation to the hybrid market. The following charts show the sharp reversal in share prices for two of the major banks (CBA and NAB) and a sample AT1 hybrid from each. ANZ and Westpac securities reacted similarly.

CBA equity (dark line) vs CBAPD Additional Tier 1 hybrid (light line). Source: Bloomberg

NAB equity (dark line) vs NABPC Additional Tier 1 hybrid (light line). Source: Bloomberg

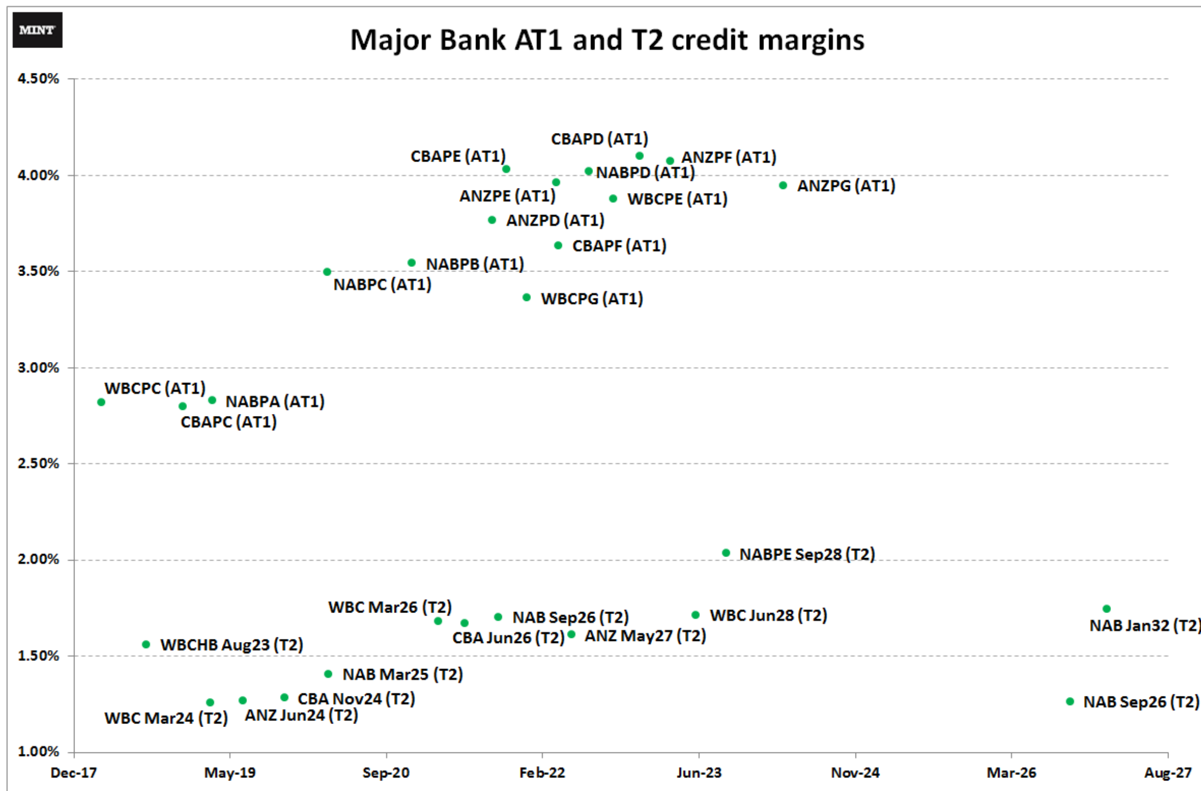
Where is the value in hybrids?

I have always maintained that hybrids are neither good nor bad investments in their own right. It's a simple matter of risk vs return – are you getting paid appropriately for the inherent risk? In early 2016 when they were trading at credit margins of around 550 basis points (5.5%) on average, the relative value was outstanding. But at current levels 150-200 basis points lower, the trade-off is significantly less compelling, particularly given the weakness in the banking sector in general.

A useful reference point when assessing the relative value of AT1 hybrids are the two 'bookends' seen in recent years. Commonwealth Bank of Australia has the distinction of issuing at both the tightest and widest credit margin of the major bank AT1 hybrids in recent years. CBA Perls VII (CBAPD) were issued in October 2014 at a credit margin of just 280 basis points (not good value). Eighteen months later in March 2016 CBA Perls VIII (CBAPE) were issued at a margin of 520 basis points (excellent value). In the middle of that range was the March 2017 CBA Perls IX issue at 390 basis points (fair value).

The following chart plots the current credit margin for a variety of major bank AT1 and T2 securities. Note that the AT1 margins are some 60 to 80 basis points higher than just a few weeks ago, following the sell-off.

Major Bank AT1 and T2 current credit margins. Source: Mint Partners Australia



Where does this leave subordinated debt?

This Spanish real-life test of Basel III highlights something else that is being broadly overlooked in my opinion, which is the relative risk between AT1 and T2 (subordinated) securities. In Australia (currently) there exists on average about 200 basis points (2.0%) of credit spread premium on AT1 over T2, shown in the chart above. As Banco Popular has shown, once a bank is in deep enough strife to trigger AT1 write-offs, it is virtually too late to hope for any recovery value in the subordinated T2 debt.

There is a growing school of thought that this premium is excessive as investors in T2 subordinated debt fares equally poorly in a worst-case scenario. In other words, if investors are going to be exposed to Basel III non-viability risk, they may as well be getting paid for it through AT1 hybrids.

Additional factors to be considered though include lower historical volatility and fixed maturities on the T2 debt (vs a perpetual nature of the hybrids), although I would argue that the volatility aspect could easily disappear if and when markets come to the realisation that the ultimate risk between the two debt types is closer than previously assumed.

Hybrids in a diversified portfolio

Hybrids tend to be a much maligned asset class. They are not pure fixed income with price volatility often present. As primarily floating rate instruments, at least in Australia, they also tend to perform poorly in times of severe stress (as opposed to fixed rate bonds which typically benefit from falling yields). While we would never recommend an investor have all their 'fixed income' allocation in hybrids, at times they do provide returns that more than compensate for risk, as long as investors understand those risks.

For example, I like NABHA and believe that over the next few years it will trade into the 80's and even 90's, and expect it to be called at 100 sometime between now and 2022. However, the short-term risk of a retreat was too high a few weeks ago and I recommended investors pare back positions. At the time I wrote that if this equity sell-off continued - and especially if it manifested into a banking crisis - there was no doubt that the hybrid price would be adversely affected, giving an opportunity to reenter at a better price.

The predominately retail-dominated hybrid market is often inefficient as the delayed price movements in recent weeks have demonstrated, and this provides opportunities. Investors had a 'free kick' in being able to sell names such as CBA Perls VIII (CBAPE) at over $108.50 (or circa 320 basis points as a credit margin) in recent weeks while bank shares tanked. The same security is now trading at $105.05 (or circa 400 basis points) following the friendly reminder from Banco Popular Español. Not so 'popular' now.

Ryan Poth is Head of Portfolio Strategy and Justin McCarthy is Head of Research at Mint Partners Australia*. This article is general information and does not consider the circumstances of any individual. The views are the personal views of the author and individuals should make investment decisions in consultation with their own financial advisors.*

Is it time to review your superannuation pension?

Alex Denham

The financial media is replete with advice on the new super laws. Advisers, accountants, SMSFs specialists (myself included) and product providers are flat out getting ready in time.

The $1.6 million transfer balance cap is receiving most attention as existing pension balances will be measured on 1 July 2017. If your pension balance is under $1.6 million, you may think you don't need to worry about it, but what if you and your spouse have over $1.6 million between you?

Importance of dealing with transfer balance cap

In this circumstance, if one of you dies and the survivor wants to keep the assets in the advantageous superannuation environment, the transfer balance cap becomes very relevant.

Check how the pension is structured to be paid out after a death. Under the transfer balance cap rules, where the pension is not 'reversionary', but the surviving spouse elects to receive the benefit as a pension, the balance will count towards that spouse's cap straight away, and that could tip his or her pension transfer balance over $1.6 million. This will need to be dealt with as soon as possible.

In the past, a surviving spouse was able to roll over a pension from a deceased spouse (known as a 'death benefit pension') after a specified time period (six months from date of death, or three months from grant of probate). This provision has been removed and it will always be a death benefit pension and unable to be rolled over.

So, if you receive a death benefit pension from your spouse which results in you exceeding your $1.6 million transfer balance cap, the only way to keep the money in the superannuation system is to roll your own pension back to accumulation.

A 'reversionary' pension, on the other hand, will not be assessed to the surviving spouse for 12 months from the date of death, buying a bit of time before having to deal with the excess. The same issues arise, but you have a year to figure out what to do.

Correct set-up makes a difference

Hence, setting up the pension correctly while you're alive can make all the difference to your spouse on your death. Let me put that into a case study to illustrate.

On 1 July 2017, Brian, 76, has an account-based pension valued at $1,400,000, while his wife, Jenny's, 72, is worth $900,000. Both pensions are 'reversionary' to each other.

On 25 July 2017, Brian passes away. His pension is valued at $1,380,000 and continues uninterrupted to Jenny. Technically, Jenny's total pension balance is now over $1.6 million, however, the reversionary pension will not count towards Jenny's cap until 25 July 2018, giving her time to consider her options.

Jenny cannot roll over any of Brian's pension, she can elect to roll over some or all of her pension to accumulation. She decides to roll over enough to bring her transfer balance cap to $1.6 million.

Jenny's Transfer Balance Cap

Date	Event	Transaction type	Amount $	Transfer balance account
1 July 2017	Pension balance counted	Credit	$900,000	$900,000
15 July 2018	Roll back to accumulation	Debit	($680,000)	$220,000
25 July 2018	Reversionary pension counted	Credit	$1,380,000	$1,600,000

Had Brian's pension not been reversionary, Jenny would have had to deal with this soon after his death, at a difficult time for her. Being reversionary also gives tax free income and capital gains for an extra year. Jenny has time to decide that the assets supporting her own pension should be sold before being transferred to accumulation.

If Brian's balance was over $1.6 million, Jenny would have no choice but to commute the amount over $1.6 million to a lump sum payment, and transfer her whole balance back to accumulation.

If both partners are still in accumulation phase, what happens if one dies? This is similar to a non-reversionary pension. If a surviving spouse elects to take the benefits as a pension, the value of the pension account will count immediately towards his or her transfer balance cap.

Can anyone be nominated to receive a reversionary pension on my death?

A death benefit pension can only be paid to a:

- Spouse, including de facto and same sex partner
- Person who was financially dependent on the deceased
- Person who had an interdependency relationship with the deceased person, and
- Child, including adopted, step and ex-nuptial, who is under 18, over 18 with a disability, or 18 to 24 and financially dependent on the deceased.

Next time you're in for an investment review, speak to your adviser about the structure of your pension. It may need some tweaking.

Alex Denham is a Senior Adviser with Dartnall Advisers. Prior to becoming an adviser, she spent 20 years in senior technical roles with several financial services companies. This article is general information and does not consider the circumstances of any individual and is based on a current understanding of the rules.

The value of Adviser's Alpha explained

Robin Bowerman

Adviser's Alpha refers to the added value that is demonstrated by a financial adviser's ability to effectively act as a wealth manager, financial planner and behavioural coach, rather than by overconcentration on investment selection.

Vanguard coined the term Adviser's Alpha in the US following an original research paper written by Fran Kinirry in 2013. This is a framework where the real value of financial advice can be understood to be more than simply pointing to a portfolio return number versus market benchmarks.

Recognise what helps clients most

Demonstrating value for advisers has become increasingly important as the compensation structure in Australia has evolved from a transaction-based system to a fee-based, asset management framework. However, providing a well-considered investment strategy and asset allocation is as important as an adviser's investment acumen and ability to deliver better returns than the markets.

Rather than investment capabilities, the Adviser’s Alpha model relies on the experience and stewardship that the adviser can provide. The model focuses on asset allocation, rebalancing, tax efficient investment strategies, cash flow management and, when appropriate, coaching clients to change nothing at all, rather than relying on market outperformance.

Historically, many advisers have sought to add value through active strategies such as tactical asset allocation, fund selection and rotation and securities selection, despite the mounting evidence suggesting that these efforts will help neither their clients nor themselves in the long run.

Guidance in controlling emotions

On their own, investors tend to chase performance. Twenty years of data illustrates how investors can pour money into the stock market after a run-up, only to sell their holdings when a downturn is well under way. Prudent financial advisers use a top-down investment approach by establishing asset and sub-asset allocations in line with their clients' goals and then periodically rebalancing those allocations. They also eliminate the emotional element, which many individual investors can't overcome.

In times of market shocks an adviser’s experience and stewardship can be particularly valuable to clients because if left alone, investors can make choices that impair their returns and put at risk their ability to achieve their long-term objectives.

In that sense, the Adviser’s Alpha framework suggests a better measure of an adviser’s value is to judge it against what an investor would likely do without professional advice.

Recently, an updated version of the research paper for the Australian market has been released and is available here, and on vanguard.com.au/advisersalpha

Robin Bowerman is Head of Market Strategy and Communications at Vanguard Australia, a sponsor of Cuffelinks. This article is general in nature and readers should seek their own professional advice before making any financial decisions.

Banks and bankers: why do we shoot the messengers?

Graham Hand

Before modern communications, messages were often delivered by hand, with envoys sent from one camp to another. If the message was unwelcome, the receiver might blame and even kill the messenger, who was little more than a foot soldier obeying orders.

Have we not moved on in the last century?

In the last few weeks, Roy Morgan Research has issued three reports relating to the finance industry. Australians give good ratings to banks and institutional super funds, but not to the people who work in them.

An ongoing pattern is that satisfaction with banks and superannuation funds is high while bank managers and financial planners have low ratings for 'ethics and honesty'. The employees in these positions are not setting policies or defining bank culture. That comes from many pay-grades higher. Retail super funds are overwhelmingly sold through financial planners, but we don’t rate financial planners highly. Bank financial planners sell from Approved Product Lists, operate under tight Statements of Advice, and have limited discretion over the advice. Bank managers have little power and try their best to deliver a service to their clients.

Why do we like the institutions and dislike their foot soldiers?

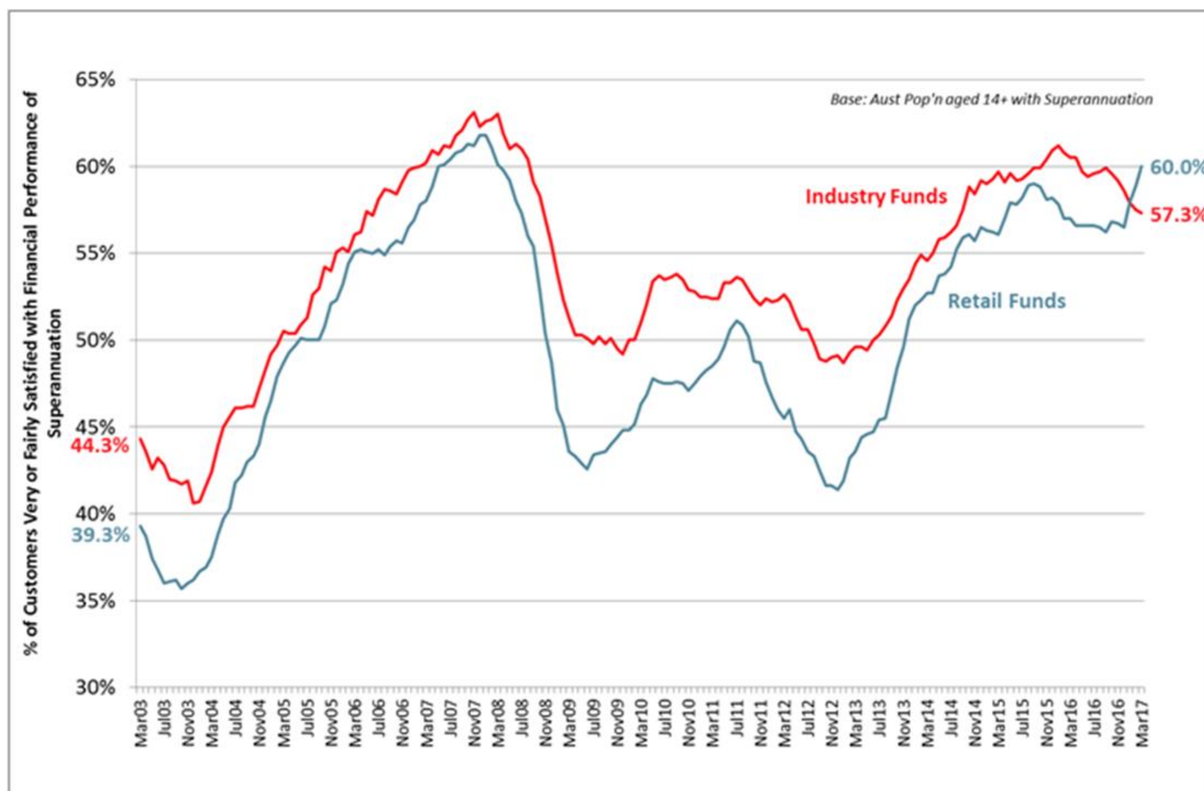
1. Satisfaction with financial performance of superannuation funds

Since this survey began in October 2002, industry funds have always outrated retail funds, but with industry funds down and retail funds up, they have switched places in the last six months. Both are well up since the start of the survey, and the fact they took a battering around the GFC shows the ratings are a reflection of the overall market.

Roy Morgan believes retail funds are more sensitive to market performance, improving strongly when the ASX rose 48% between 2012 and 2015. Retail funds hold a big lead for balances under $100,000, while in the larger balances, especially over $700,000, industry funds have a big lead. Norman Morris, the Industry Communications Director at Roy Morgan, said of the rise of retail among lower value clients:

"This is possibly due in part to the introduction of the no-frills, low-cost MySuper products over recent years which appears to be mainly impacting on the less engaged, lower value customers who didn't actively select an investment option but are now more satisfied with their returns."

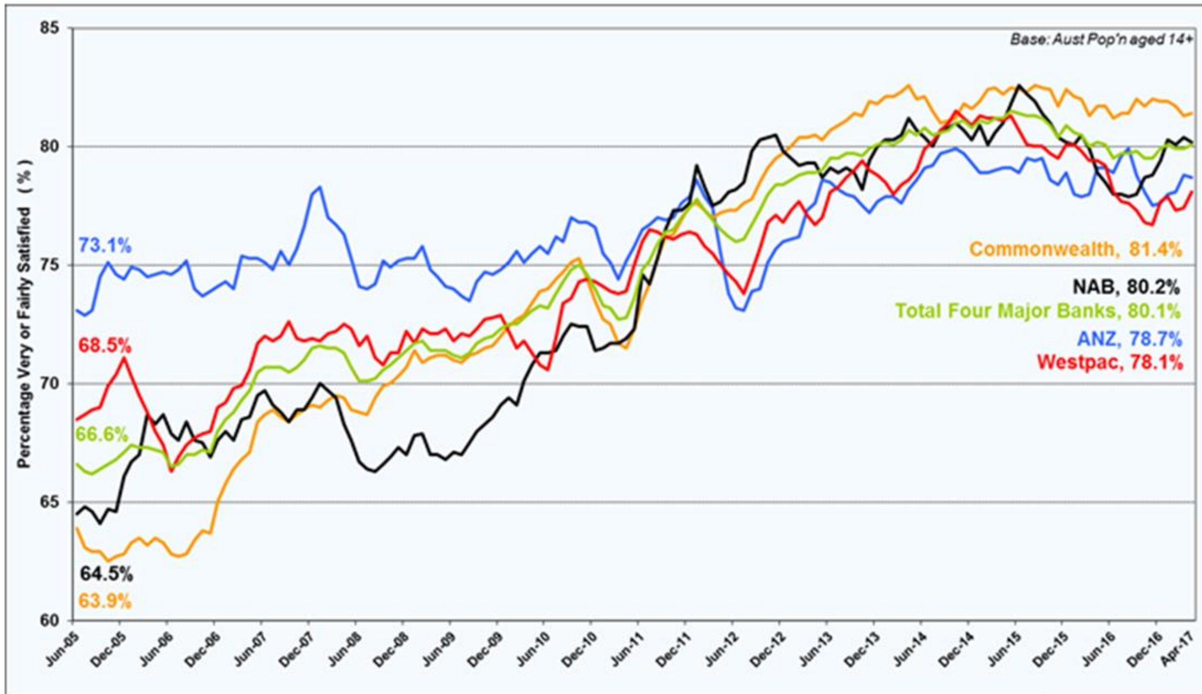
Not shown on the chart are SMSFs, way ahead with a satisfaction rating over 76%. I guess it's easy to rate yourself highly when the markets have done well.



Source: Roy Morgan Single Source (Australia), six months rolling October 2002 - March 2017. Average sample n=18,442. Base: Australian population aged 14+ with superannuation

2. Consumer banking satisfaction – big four banks

Surely Australians love to hate banks. High CEO salaries, exorbitant profits, out-of-cycle mortgage rate increases, terrible deposit rates. While the ratings are off their highs, they are significantly higher than long-term averages, with CBA under Ralph Norris streaking it. Anyone who was subject to his 'Sales & Service' regime (which annoyingly for many non-retail executives, put everyone in the bank through the same service programme – hard to get FX dealers interested at 7am). Generally, mortgage customers rank banks well below non-mortgage customers.

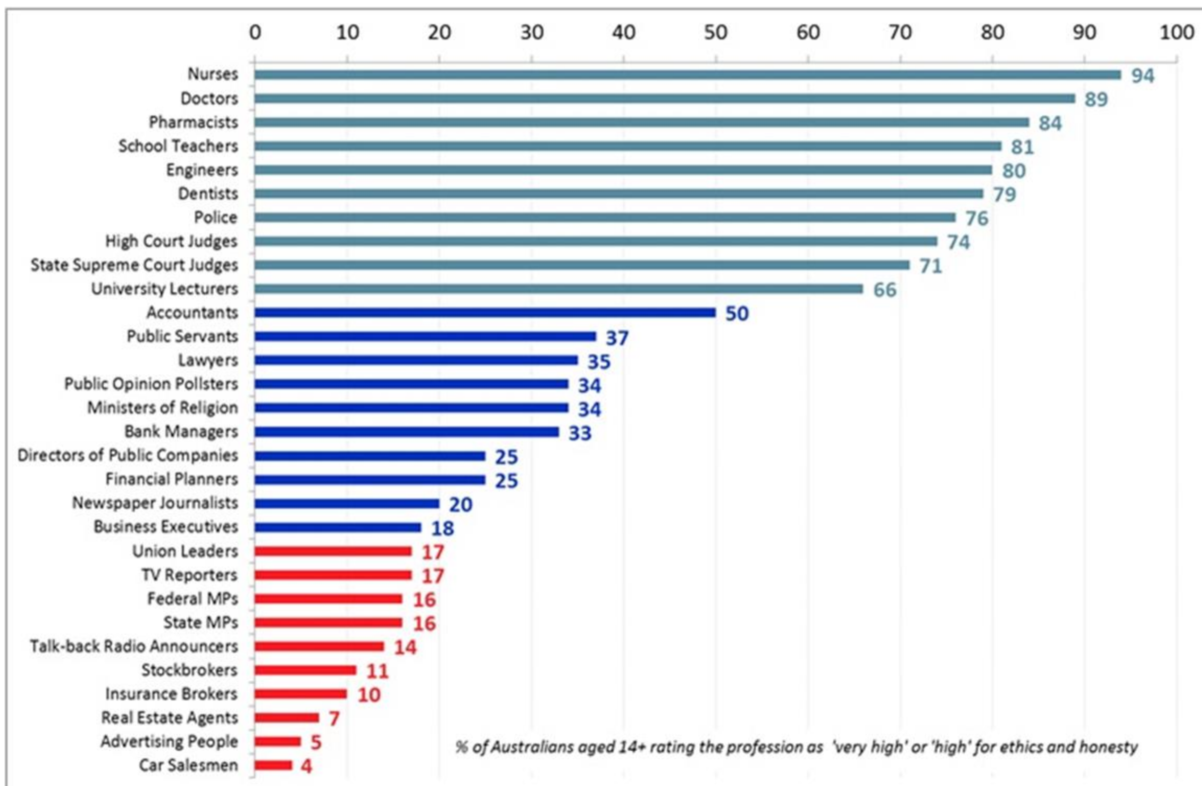


Source: Roy Morgan Consumer Satisfaction Report, April 2017, average 6-month sample n=25,000.

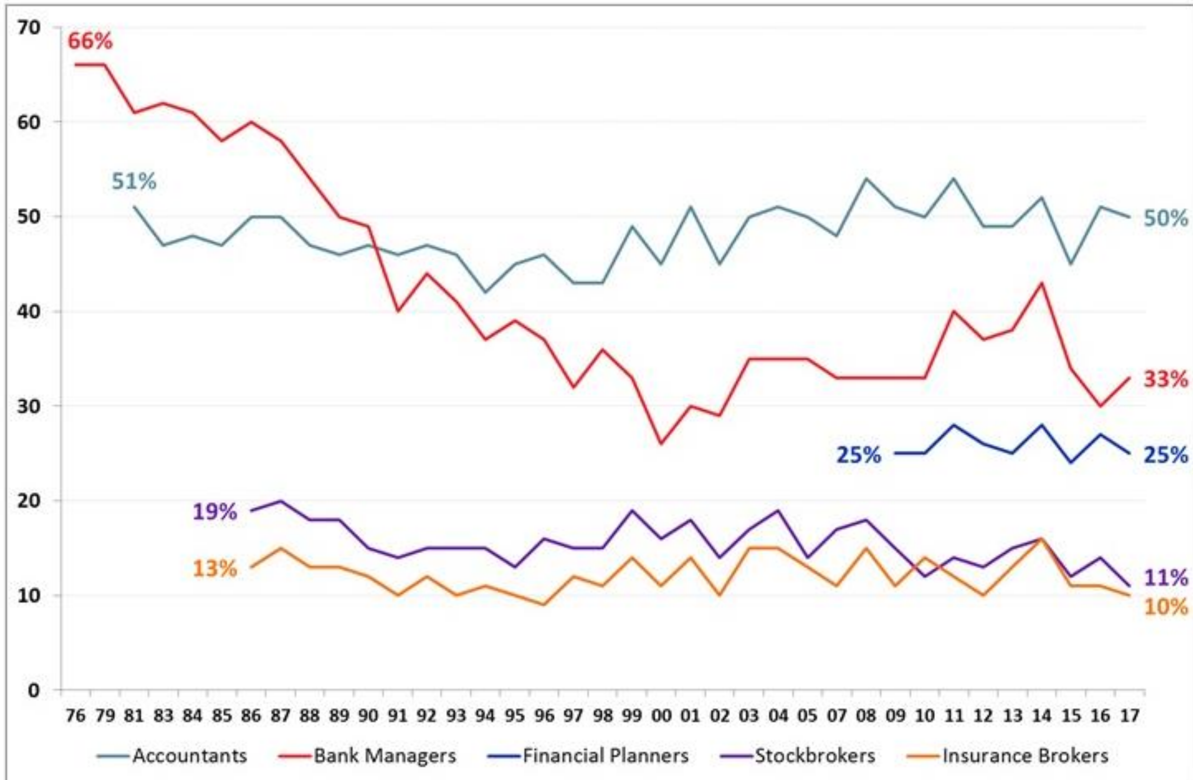
3. Image of the professions

This survey asks whether certain professions are rated 'high' or 'very high' for 'ethics and honesty'. Health professionals have always done best, especially nurses and doctors. Good to see the big improvers are school teachers, up 4% in the last year. Not an easy or well-paid job. Engineers have continued a steady rise, from 53% in 1976 to 80% in 2017. Police are also at a record high.

2017 Image of the Professions, Roy Morgan Research



Source: These are the main findings of a Roy Morgan telephone survey conducted on the nights of May 22-24, 2017, with 648 Australian men and women aged 14 and over.



Graphs sourced from multiple Roy Morgan Media Releases, June 2017.

But the finance professions are lagging, in some cases sadly. Accountants do reasonably well at 50%, and have led the way among finance professions for 26 years. Bank managers have improved 3% to 33%, still a miserable score. Financial planners have been around 25% since being introduced to the survey in 2011, while stockbrokers hit a new record low. They don't receive as much media criticism as financial planners, why are brokers so unloved? BTW, ministers of religion are also at an all-time low.

Graham Hand is Managing Editor of Cuffelinks.

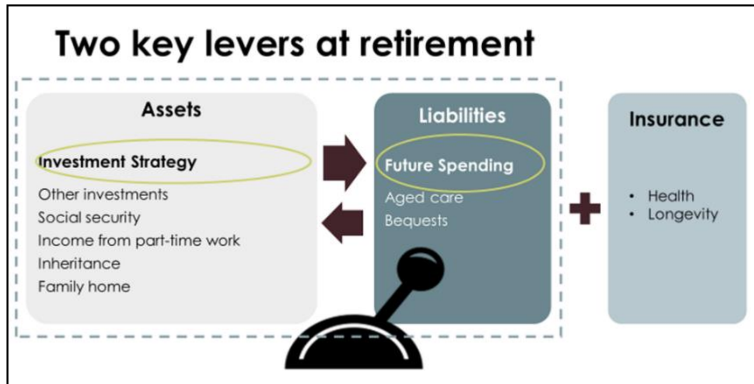
How to define spending goals in retirement

Jeff Rogers

Retirees looking to develop a sustainable financial plan face a challenging technical problem, so it makes sense to simplify some of the inputs. Those of us who focus on the production of investment returns for retirees' financial assets often choose to make simple assumptions about consumption patterns in retirement. A more detailed understanding of priorities for spending in retirement, however, can inform the design of appropriate investment strategies and improve confidence around attainment of goals.

Retirement risks, including longevity and health

The following schematic shows the risks a financial plan for retirement ought to address and some of the management choices.



Longevity risk means there is uncertainty around the duration of the planning horizon. Should a retiree look to insure, partially insure or self-insure against that risk? Poor health is another risk where timing of onset and financial impact is also subject to uncertainty and arguably best addressed through insurance.

Then there are the risks to the household balance sheet at retirement. A key ingredient for retirement planning is the spending strategy – which is represented as future liabilities on the balance sheet – as well as the investment strategy. By contrast, the focus is solely on investment strategy during most of the accumulation phase. It makes sense to manage the asset strategy and the spending strategy on an integrated basis, much like a defined benefit scheme or an insurance company managing its balance sheet.

There's also a considerable behavioural challenge to maintaining a retirement strategy in the face of market volatility, especially for retirees who are drawing down on their capital. The more confidence retirees have that their spending strategy is sustainable, the more likely they will stick to their investment plan and maintain focus on their personal goals.

Decide on the highest priority goals in retirement

A good place to start is to understand spending goals in retirement. While it is possible to simplify the analysis by assuming annual spending in retirement is constant in real terms over the planning horizon, this misses valuable information for many retirees. It doesn't allow for the capacity for a retiree to adjust their spending to create a more sustainable journey. Widespread capacity to adapt spending was demonstrated immediately after the GFC when a reduction in minimum payments from allocated pensions was allowed temporarily.

Not all spending goals are of equal priority and behavioural finance suggests creating separate accounts to fund different goals can assist in making the journey more sustainable. The priority of a goal informs the design of the investment strategy, including the interest rate and inflation sensitivities and the use of hedging and protection strategies. For high priority goals, there must be a low probability of failure and therefore limited capacity to take risk relative to the goal's cash flow profile.

The highest priority spending goals in retirement include covering the necessities of life such as food, health services and housing. The cash flows associated with essential goals can depend materially on personal circumstance. For example, a homeowner is likely to require less cash flow than a renter. An investment plan ought to reflect these differences in size and duration of cash flows, suggesting a suite of products is required to implement retirement plans.

If high priority goals are **needs**, then intermediate priority goals are **wants**. Goals associated with discretionary spending are important but not essential as failure to completely fund them, while disappointing, is not devastating. For such goals, there is more scope to be flexible through adjusting or deferring consumption.

Some people have sufficient assets in retirement to fund an aspirational goal to build a legacy for their family or a charity. This type of goal is not focussed on personal consumption over an immediate time horizon, which suggests there is considerable capacity for thoughtful long horizon risk-taking.

Surfacing and sizing goals

There are a variety of approaches to estimate retirement spending. Some old rules-of-thumb express spending as a percentage of final salary. ASFA has adopted a more granular approach and publishes a baseline standard for an average retiree that incorporates both essential and some discretionary spending.

It is widely observed that many retirees only take the regulated minimum payment from their allocated pension even though research suggests this is not their best spending strategy. A possible explanation is that this reflects self-insurance against longevity risk. Therefore, observed spending patterns may not reflect actual preferences.

There is great value in helping people identify and express their spending preferences. Technological developments can assist with this. Visualisation tools will soon enable people to better picture potential future lifestyles, helping them prioritise goals in retirement and perhaps triggering a change in behaviour around savings. Meanwhile increased access to large data sets should support a more accurate personalised estimate of desired cash flow given individual preferences and priorities.

Improving confidence in a retirement plan

If you are planning a journey and you know the destinations that are of most importance, then it is easier to create a suitable travel plan and stick to it. A deep understanding of goals in retirement and their relative priority enables the design of investment strategies that fit those goals and support a more sustainable journey.

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3 implications of retail disruption for emerging markets

James Syme

"Technological advancement, measured by the long-term change in the relative price of investment goods, together with the initial exposure to routinization, have been the largest contributors to the decline in labor income shares in advanced economies." – IMF World Economic Outlook, April 2017.

Whilst much of the focus for an emerging markets fund manager is on conditions and developments in the emerging world, we must not lose sight of how changes in advanced economies create opportunities and risks for our investments. The rapid rate of change in the US retail industry has both industry-specific and global implications.

Retail competition at peak levels

Calendar 2017 is proving to be the most brutal year for the retail industry since 2008. Credit Suisse estimates that there will be 8,600 store closings this year, compared to the 2008 historical peak of 6,200. High-profile bankruptcies and mass job layoffs have dominated the sector's news, yet the US economy remains relatively healthy. US retail sales (ex-food, auto dealers, building materials and gas stations) rose 3.4% in the year to March 2017, compared with an overall 3.4% fall in 2008. Consumer confidence is at its highest in 16 years. The problem is not one of demand, but of competition.

Amazon stood out in the stream of negative news for competitors, announcing plans to hire 30,000 part-time workers at the same time as reporting first-quarter revenues of US$35.7 billion, up 23% on a year earlier. The online disruption in non-perishable goods, in terms of jobs, companies and properties, is severe, and this pattern is likely to spread to other industries in both the US and other countries.

Three important implications for investors in emerging markets

The **first** is to recognise the opportunity that online operators have in emerging markets. Three of the world's five largest internet companies are Chinese, with Tencent and Alibaba in particular going from strength to strength. We hold significant exposure to both.

In addition, we have holdings in Naver in Korea and Naspers in South Africa (which, as well as a stake in Tencent, has significant internet assets in other emerging markets, notably India). Where we hold retail-type companies, we have ensured either that they are predominantly in the safer perishables sector (such as Eurocash in Poland, and Lenta and Magnit in Russia) or have strong online presence (such as M-Video in Russia, and Haier Electronics in China, both of which specialise in logistics and delivery of electrical and electronic goods).

The **second** is to look at the technologies that support the online world. We have holdings in Samsung Electronics, SK Hynix and Taiwan Semiconductor, all of which have benefited from the significant demand for memory and processors in servers. We also own Lenovo in China, which took over IBM's x86 server business, and Reliance Industries which, as well as its energy and petrochemical assets, owns and operates India's first

4G telecom network, with mobile internet speeds of double its nearest competitor. We see mobile internet in India as one of the most exciting opportunities in the emerging world, and Reliance as a key beneficiary.

The **third** impact, which is more global in nature, is to recognise (as per the IMF quote above) that technology remains a major global deflationary force. If developed market growth is to be both slower and less inflationary than in the pre-2008 period, emerging markets, which variously offer higher growth rates and higher yields, are likely to be the recipients of significant capital flows from the developed world.

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Timing on transfer balance cap and CGT relief

Mark Ellem

The clock is ticking on two key super reform measures – the $1.6 million transfer balance cap and CGT relief rules – with an obligation to comply by 30 June 2017.

What does this mean in practice?

Will it leave trustees and their accountants or financial advisers battling late into the night of 30 June to comply, before the clock strikes midnight? I don't think so. After all, 30 June is a Friday and many will have better things to do …

So, let's take a look at how these two super reforms will work in practice.

Transfer balance cap

Those with pension holdings exceeding $1.6 million (excluding transition to retirement (TTR) pensions will need bring the value of their holdings under this threshold by 1 July 2017. Post 1 July, holdings in excess of $1.6 million will, in most cases, incur additional tax.

Can the excess be calculated on 30 June 2017?

The excess over $1.6 million can be calculated accurately only after 30 June 2017, as a member's 30 June account balance is determined by asset values on that date, including any tax liability or refund due for the 2016/17 tax year. Whilst it cannot be precisely calculated on the day of 30 June 2017, the required amount can be the value determined **as at** 30 June 2017. The actual excess can then be transferred from the member's pension account(s) to their accumulation account, also with effect as at 30 June 2017.

Isn't this backdating the transaction? Is it allowed?

No, it's not backdating and yes, it is allowed. Provided the member makes a written statement, by 30 June 2017, of their intention to comply with the cap as at 30 June 2017, the reduction in their pension holdings can be effected at a later date. If the member has multiple pension accounts, the written statement would need to include details of which pension is to be commuted (in full or in part) in order to meet the cap.

The ATO has issued Practical Compliance Guideline (PCG) 2017/5 that provides guidance for members affected by the cap. It acknowledges the practical problem of knowing the precise 30 June pension balance prior to that date. There is a process that must be followed. The relevant transactions must be recorded in the fund's 2016/17 financial statements. Any adjustment must be done no later than the due date of the fund's SMSF annual return.

Relief for excess amounts under $100,000

The new rules provide a safety net for those who may still exceed their cap at 1 July 2017, without penalty. An excess amount is disregarded if it is less than $100,000, is caused by pensions in existence on 30 June 2017 and the excess is rectified by no later than 31 December 2017.

Capital gains tax (CGT) relief

The new CGT relief rule enables the cost base of fund assets to be reset to market value in certain circumstances. The intent of the new rule is to provide CGT relief on gains made before 1 July 2017 so as not to disadvantage fund members who are required to commute a pension due to the new transfer balance cap (or the TTR tax changes).

The decision to reset the cost base is irrevocable and applies only for the 2016/17 income year.

The law requires the trustee to choose to have CGT relief apply to an eligible asset, and that choice must be made no later than the due date for lodgement of the fund's 2016/17 tax return. For most SMSFs, the lodgement date of the 2016/17 SMSF annual return will be 15 May 2018. The notification of the trustees' choice to apply CGT relief and, if applicable, a further choice to defer any notional assessable capital gain, will be made in the 2016/17 CGT schedule, which will accompany the SMSF annual return.

It is vitally important to note that the deadline for making the choice is the due date for lodgement of the fund's 2016/17 annual return, and not the actual date of lodgement. The due date for lodgement may not necessarily be 15 May 2018. For example, if the fund has a number of prior year returns outstanding, it may have a due lodgement date of 31 October 2017. A request for an extension of the due lodgement date can be made to the ATO.

For further explanation of the CGT relief rules, refer to my CGT relief explained article.

Does CGT relief apply to a fund paying a TTR pension?

A fund paying a TTR pension may also be eligible to apply CGT relief, due to the application of the integrity measures from 1 July 2017. Read my CGT relief and TTR pensions article for further information. Please note that subsequent to this article, the government has announced changes so that TTR pensions that have segregated pension assets will not be required to be partially commuted to be eligible for CGT relief.

Should I reset the CGT cost base for my super?

As with many questions, the short answer is 'it depends'. For further discussion on this, please read Graeme Colley's article Should I reset the CGT cost base for my super?

The most important thing to do ahead of 30 June 2017 is to ensure any notifications for the $1.6 million transfer balance cap have been completed by members and accepted by the trustees.

Once the clock strikes midnight on 30 June 2017, the work begins to adjust pension balances and decide which investments will have their CGT cost base reset before the fund is required to lodge its tax and compliance returns.

Mark Ellem is Executive Manager, SMSF Technical Services at SuperConcepts, a leading provider of innovative SMSF services, training and administration. This article is for general information only and does not consider the circumstances of any individual.

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