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This Week's Top Articles

High price or low price, future returns will be low

Roger Montgomery

The higher the price you pay, the lower your returns. This is a fundamental truth of investing, a law, like gravity, and an impost that cannot be escaped. And yet it is always the case that when future returns are the least attractive, enthusiasm for assets is highest. The dichotomy is best explained by author and economist John Kenneth Galbraith's definition of a bubble at the beginning of section VII of his 1955 book, *The Great Crash 1929*:

"At some point in the growth of a boom all aspects of property ownership become irrelevant except for the prospect of an early rise in price. Income from the property, or enjoyment of its use, or even its long run worth is now academic … What is important is that tomorrow or next week market values will rise – as they did yesterday or last week – and a profit can be realised."

It is when the present value of a future income stream (intrinsic value) is ignored and 'investing' is replaced with uninformed speculation about (unjustified) price increases that we should be most concerned.

The conventional understanding of risk is that higher returns require the adoption of higher risks. But when share prices are low, as they were at the bottom of the GFC in late 2008, real risk is relatively low. It's only the perception of risk that is high.

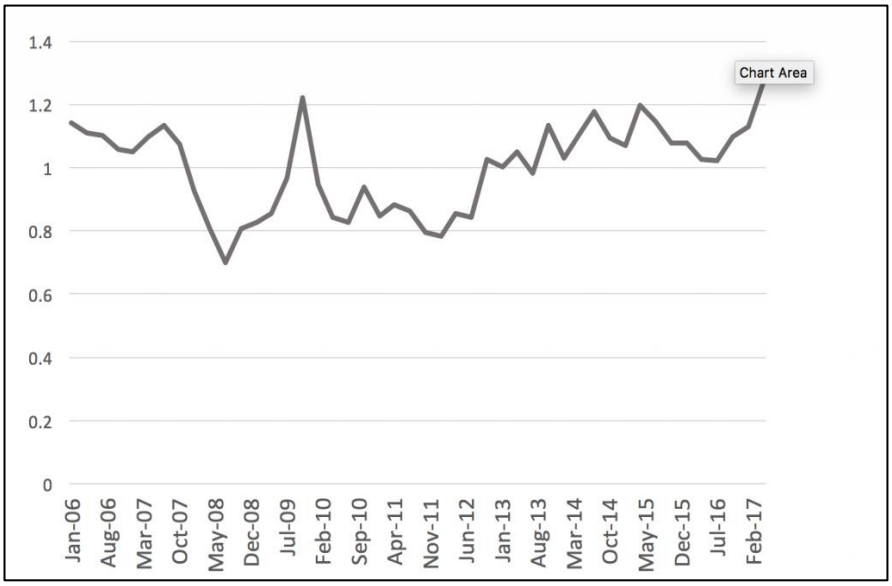
To complete the circle, I note that Seth Klarman from Baupost Group recently observed:

"When securities prices are high, as they are today, the perception of risk is muted, but the risks to investors are quite elevated."

Risk today, and why this time is not different

It's worth putting some numbers around the extent of risks in the market today. While many may respond by suggesting low interest rates justify the numbers, let's remember that this time is never different. The following chart reveals the S&P/ASX100 is now at its greatest premium, above our intrinsic value estimate, in a decade. This alone suggests that a dose of caution is warranted.

Indicative premium to intrinsic value S&P/ASX100 ex-resources



Source: Montgomery Investment Management Pty Limited

The next chart plots the Cyclically Adjusted Price/Earnings (CAPE) Ratio for the US market, using data from Robert Shiller's website. This time series goes back to the late 1800s, and being based on 10-year inflation-adjusted trailing average earnings, it removes some cyclical 'noise'.

Shiller CAPE Ratio S&P500

It also shows a market that looks expensive. Only twice since 1881 has the Shiller CAPE been above the current level; the first time just prior to the Great Depression, and the second time just prior to the Tech Wreck.

What about Jeremy Grantham's 'new plateau' statement?

Jeremy Grantham, of GMO fame, recently looked at the S&P500's PE ratio and proffered the suggestion that this time is indeed different: "very, very different." A close examination reveals the appearance of a regime change. Between 1970 and 1997, the PE averaged 13.95, but since 1997 the average PE has been 23.36 with higher highs and higher lows being recorded than the pre-1997 period.

In the Shiller CAPE chart above, prior to 1994, a PE above 20 looked to have been the level at which valuation became a concern, with the market mean-reverting and then trading below that level almost 90% of the time.

Since 1994, however, things have been different. In fact, during the post-1994 period the CAPE has been above 20 times for more than 90% of the time. Even in the depths of the GFC, it did not approach the low points seen regularly during the earlier period, and barely recorded any time below its longer-term average.

Grantham's regime change suggests that we might have a new average – one drawn from the data since 1994 or 1997 – depending on which version of the PE is used – and one that is much higher than any drawn from taking into account the entire period. Such a conclusion is tantamount to what might be described as a new 'permanently high plateau'. If that expression sounds familiar, it is because the last person who said it was Yale economist Professor Irving Fisher.

It was October 17, 1929 in the *New York Times* that Fisher wrote;

"Stock prices have reached what looks like a permanently high plateau. I do not feel there will be soon, if ever, a 50 or 60 point break from present levels, such as (bears) have predicted. I expect to see the stock market a good deal higher within a few months."

That was October 17. Black Thursday occurred on October 24, and the market dropped by 11%, followed four days later by Black Monday, when it fell another 13%, and the next day, Black Tuesday, it lost a further 12%.

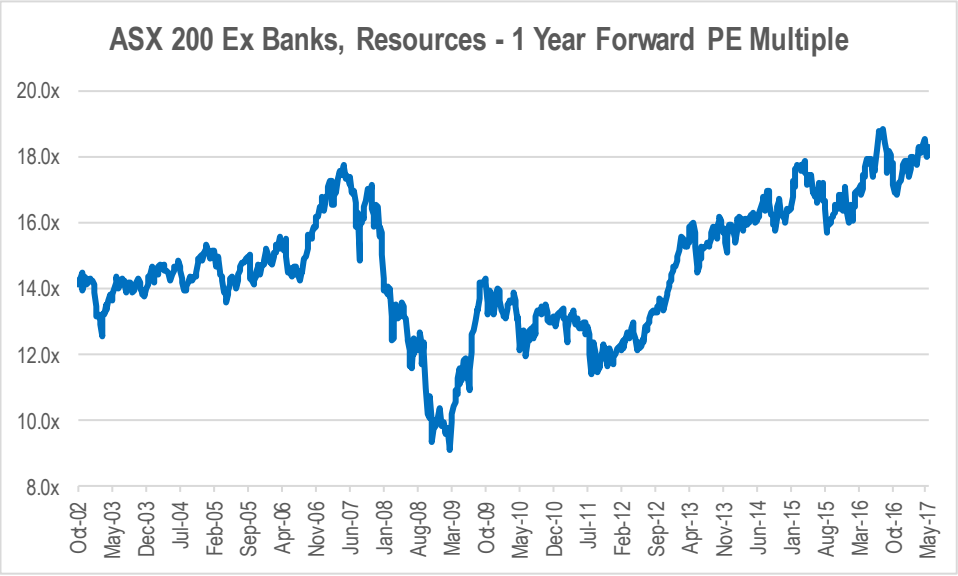
As an aside, Fisher was back at it again on November 14, 1929 suggesting:

"The end of the decline of the stockmarket will probably not be long, only a few more days at most."

As we end financial year 2016/2017, where is Australia?

I am not suggesting we are headed for anything like the circumstances during the Great Depression. I am suggesting that current valuations in Australia are not justified by near-term economic conditions, and more importantly, prospects for profit growth. It does not follow that overvaluation is immediately followed by a crash. However, flying in the face of conventional wisdom, it pays to be more cautious because real risks are higher than perceived risks.

Forward P/E ratio, ASX200 excluding banks and resource companies



This chart shows at the end of May 2017, the average PE for the group of Australian companies mapped was 18 times. Worryingly, growth in forecast earnings has contributed just 19% of the appreciation in stock prices over the last five years. Fully 81% of the market's performance over the last five years has simply been due to PE expansion, that is, investors' willingness to pay more for the same dollar of profits. If the outlook for longer-term earnings growth has improved materially over the same period, such optimism might be warranted. However, like many of our wealthy and experienced business and entrepreneur clients, we see darker tinges to the clouds forming on the horizon.

The average PE today is 7% higher than at the end of October 2007, the pre-GFC peak. Additionally, there are parallels to that period with global interest rates starting to rise following a period of aggressively accommodative monetary policy, and record high levels of debt in the Australian household sector.

The big difference for Australia this time however is that a slowing China, and contracting investment in resources sector capacity growth, will fail to rescue the Australian economy from any broader economic slowdown.

Prior to the GFC, forecast earnings growth was 10% higher than the prior corresponding period, underpinning the PE ratios investors were willing to pay. Today, not only is the market paying 7% more for each dollar of earnings than it was prior to the GFC, but earnings forecasts are only 3% higher than the same time a year ago.

It follows that caution may well be premature but it is nevertheless well founded because the higher the price you pay, the lower your returns and locking in low returns is in nobody's interest.

Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is for general information only and does not consider the circumstances of any individual.

10 cognitive biases that can lead to investment mistakes (Part 2)

Hamish Douglass

To be a successful investor over the long term, 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 10 key cognitive biases that can lead to poor investment decisions. The first five biases of confirmation, information, loss aversion, incentive-caused, and oversimplification tendency were discussed in part 1. Here are the remaining five:

6. Hindsight bias

Hindsight bias is a tendency to see beneficial past events as predictable and bad events as not predictable. In recent years, we have read many explanations for poor investment performance that blame the unpredictability and volatility of markets. Some of the explanations are as credible as a school child complaining to the teacher that 'the dog ate my homework'. While we have made mistakes, we will not blame our mistakes on so-called unpredictable events. In fact, every mistake we have made over the past five years could be attributed to an error of judgment. We have always sought to candidly outline our investment mistakes in our Investor Letters.

Hindsight bias clouds objectivity in assessing past investment decisions and inhibits ability to learn from past mistakes. To reduce hindsight bias, we spend significant time upfront setting out in writing the investment case for each stock, including our estimated return. This makes it more difficult to 'rewrite' our investment history with the benefit of hindsight. We do this for individual stock investments and macroeconomic calls.

7. Bandwagon effect (or groupthink)

The bandwagon effect, or groupthink, describes gaining comfort because many other people do (or believe) the same. Buffett tells a story about the oil prospector who dies and is in a large crowd of other oil prospectors who are all waiting at the gates of heaven. All of a sudden, the crowd disperses. Saint Peter asks the oil prospector why the crowd dispersed. The oil prospector said it was simple: "I shouted, 'Oil discovered in hell.'" Saint Peter asks the oil prospector why he would like to be let into heaven. After thinking for a while the oil prospector says, "I think I will go and join my colleagues as there may be some truth in that rumour after all."

To be a successful investor, you must analyse and think independently. Speculative bubbles are typically the result of groupthink and herd mentality. We find no comfort in the fact that other people are doing certain things or whether people agree with us. We will be right or wrong because our analysis and judgement is either right or wrong.

In avoiding the pitfalls of the bandwagon effect, I am reminded of the Robert Frost poem, *The Road Not Taken*, where he writes:

"Two roads diverged in a wood and I,
I took the one less travelled by,
And that has made all the difference."

While we don't seek to be contrarian, we have no hesitation in taking 'the road less travelled' if that is what our analysis concludes.

8. Restraint bias

Restraint bias is the tendency to overestimate one's ability to show restraint in the face of temptation. This is most often associated with eating disorders. Most people are wired to be 'greedy' and want more of a good thing or a 'sure winner'. For many people, money is the ultimate temptation. The issue is how to properly size an investment when they believe they have identified a 'sure winner'. Many investors have come unstuck by overindulging in their 'best investment ideas'. 'Sure thing' investments are exceptionally rare and many investments are sensitive to changes in assumptions, particularly macroeconomic assumptions.

To overcome our natural tendency to buy more and more of our best ideas, we hardwire into our process restraints or risk controls that place maximum limitations on stocks and combinations of stocks that we consider carry aggregation risk. The benefit of risk controls to mitigate the human tendency for greed is well captured by the quote from Oscar Wilde: "I can resist everything except temptation."

9. Neglect of probability

Humans tend to ignore or over- or underestimate probability in decision making. Most people are inclined to oversimplify and assume a single point estimate when making investment decisions. The reality is that the outcome an investor has in mind is their best or most probable estimate. Around this outcome is a distribution of possible outcomes, known as the distribution curve. The shape of the distribution curve of possible valuation outcomes can vary dramatically depending on the nature and competitive strength of an individual business.

Businesses that are more mature, less subject to economic cycles and have particularly strong competitive positions (examples would include Coca-Cola and Nestlé) tend to have a tighter distribution of valuation outcomes than businesses that are less mature or more subject to economic cycles or competitive forces. Examples in our portfolio include Wells Fargo, eBay and Alphabet (the owner of Google). In our portfolio-construction process, we distinguish between different businesses to account for the different risks or probabilities of outcomes.

Another error investors make is to overestimate or misprice the risk of very low probability events. That does not mean that 'black swan' events won't occur but overcompensating for very low probability events can be costly. We seek to mitigate the risk of black swan events by including in the portfolio a meaningful proportion of businesses (purchased at appropriate prices) where we believe the distribution curve of valuation outcomes is particularly tight. We term these businesses as high-quality long-cycle businesses. We believe the risk of a permanent capital loss from a black swan event in this part of the portfolio is low. If we have real insight that the probability of a black swan event is materially increasing and the pricing is attractive enough to reduce this risk, we will have no hesitation in making a change to the portfolio, particularly our holdings of shorter-cycle businesses. The issue for investors is assessing when the probability of such an event is materially increasing. It is usually not correlated with the amount of press or market coverage on a particular event. Buffett once said: "The worst mistake you can make in stocks is to buy or sell stocks based on current headlines."

10. Anchoring bias

Anchoring bias is the tendency to rely too heavily on, or anchor to, a past reference or one piece of information when making a decision. There have been many academic studies undertaken on the power of anchoring on decision making. Studies typically get people to focus on a totally random number, like their year of birth or age, before being asked to assign a value to something. The studies show that people are influenced in their answer, or anchored, to the random number that they have focused on prior to being asked the question.

From an investment perspective, one obvious anchor is the recent share price. Many people base their investment decisions on the current share price relative to its trading history. In fact, there is an investment school of thought (called technical analysis, an amusing term in itself) that bases investing on charting share prices. Unfortunately, where a share price has been in the past presents no information as to whether a stock is

cheap or expensive. We base our investment decisions on whether the share price is trading at a discount to our assessment of intrinsic value and we have no regard as to where the share price has been in the past. We also have little regard to the prevailing share price in deciding to invest the time to research a new investment opportunity. Share prices change and we want to have a range of well-researched investment opportunities so that we can act on an informed basis when prices move below our assessment of intrinsic value.

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Why 10/30/60 is no longer the rule

Aaron Minney

The 10/30/60 rule has become one of the stalwarts of investment advice in superannuation. The rule was developed by Don Ezra with his colleagues at Russell investments, at a time when double-digit equity return expectations were common.

Ezra explains through this rule that, on average, for every dollar of income spent in retirement (from retirement savings), 10 cents came from contributions, 30 cents was from investment earnings in the accumulation phase, and 60 cents was earned in retirement while capital was being drawn down. It's a stunning idea.

Sadly, today it's no longer true.

Low returns require higher contributions

In the first version for defined benefit funds in 1989, he noted that 20% of payments typically came from contributions, which could fall to 10% when returns were high. In today's low rate environment, high investment return assumptions are unrealistic. Ezra himself noted this back in 2011 when he suggested that a '15/30/55' rule would be more appropriate. Without the higher returns, more money needs to be contributed to produce income later in life.

Indeed, in the Australian context, using averages of 6% net returns and 2.5% average inflation since the start of the superannuation guarantee in 1992, the result would be a 15/31/54 split, close to Ezra's modified rule.

This is a great example of the power of compound interest and it highlights the leverage provided by contributing early and regularly to super. It highlights the benefit of (and need for) high returns in retirement. In practice, it is more to do with 'money illusion' and the fact that inflation skews the way we count the money.

For example, let's assume that the return environment will be broadly similar to the last 25 years, with returns at 6% with inflation at 2.5%, or the 15/31/54 rule. 'Notional' is the key word here because the 15 cents to the 25-year-old who makes their first contribution is worth a lot more than the 15 cents they spend as a retired 80-year-old, 55 years later. Treating the two amounts as equivalent is where we fall for the money illusion.

It is simple to model the rule if returns are assumed constant. The rule still 'works' when they are not, but only on average. A bad sequence of returns can prematurely end the income, producing something like 15/31/21, and retirees feeling seriously short-changed.

Ezra's rule depends on the impact of inflation. But what happens when you take inflation out of the equation?

Keeping it real by thirds

In real terms, the rule is starkly different. With a real return of 3.5% (and real salary growth of 1% also in line with historical achievements), the rule becomes 32/33/35, or roughly a third, a third, a third. That's right - in real terms, each component makes an equal contribution to the end result. Rule 101 of pension finance is to think in terms of today's dollars or real income in the future. In other words, we should think about our retirement income through the lens of today's purchasing power. ASIC requires that forecasts of retirement income streams be in today's dollars in order to take into account the assumed change in the cost of living over the relevant period.

Maintaining the balance

The lop-sided nature of a 10/30/60 rule makes it seem that contributions are not really significant and that if all else has failed, a retiree will be able to make up for everything if they can just get high returns in retirement. While some like to imagine retirees sitting on a beach (or a yacht) while their investments do the hard work, this is probably as close to reality as a Monty Python skit. As the Black Knight in *Holy Grail* found out, things do not always end well.

In the real world, the final outcome needs a balance. Money needs to be saved (contributed to super) to build a decent savings pot, and investing early in super makes sense due to compounding. Investment returns needs to be generated in both the accumulation and the retirement phases. The difference will be in the way risks are managed. In the accumulation phase, the investor has the time to recover from swings in the market. In retirement, that luxury is diminished and the risk of a bad sequence means that retirees have to balance the need for return against managing the risks.

Just like the optical illusion replicated here, inflation can skew our perception of the relative size of objects that are equal.

What does all this mean for superannuation funds and retirees? In real terms, with good investment returns, workers can expect to spend $3 in retirement for each dollar they contribute while working.

Aaron Minney is Head of Retirement Income Research at Challenger Limited. This article is for general educational purposes and does not consider the specific needs of any investor.

Source: Source Pinterest (ankeshkothari.com)

When no decision is the right one for super

Robin Bowerman

Superannuation is awash with choices and opportunities to engage with your retirement savings.

You can usually choose which fund you want to contribute to. You can choose from an array of investment options, salary sacrifice extra contributions or make voluntary contributions from your take home pay. You can even choose to split your super contributions with your spouse, perhaps the ultimate test of a successful domestic partnership.

Or, you can choose to do nothing … and let the default MySuper option of an established super fund do the work for you.

The majority of Australian workers actually choose the last option and accept the super fund selected by their employer.

Insights into super members

Vanguard recently partnered with one of Australia's largest multi-employer super funds, Sunsuper, on a major research project titled *How Australia Saves*. This research uses the same methodology that underpins a benchmark research publication in the US titled *How America Saves* which has been published for the past 17 years.

How Australia Saves covered the 1.1 million members of Sunsuper using member level transactional data for the five years ended June 2016. The objective of the research programme is to provide deeper insights into the member experience.

Given that it is mandatory for all employers to contribute 9.5% to super for their staff earning at least $450 per month, it is no surprise that the majority of people in the study did just that. The study showed 83% were

invested in the Sunsuper lifecycle default option at June 2016 compared to 5% in the diversified balanced options. Only 12% took the self-directed route and selected their portfolio from the 30+ options on the menu.

Our super system is often questioned for what is perceived to be the lack of engagement of the majority of members.

The comparison is made with the system in the US called '401(k)', which is a voluntary system - both for employers and employees - and hence US workers ostensibly need to be more 'engaged' in the decision to both join the fund and select their level of contributions. As a result, employers in the US and the retirement plan sponsors put a lot of effort into designing the 401(k) plan including options such as auto enrolment and auto escalation of contributions. Both of these options are on the rise in the US system and somewhat paradoxically rely on the inertia of investors to be increasingly effective.

Different outcomes from investment options

One of the key pieces of analysis in *How Australia Saves* was to understand how individual members fared within their various investment options.

For the majority of members invested in the default lifecycle option, the return was a very uniform 8.3% p.a. over the five years. The returns that members received were tightly clustered as you would expect from a pooled fund where most members had the same asset allocation. Any dispersion came from the Sunsuper option managing members' risk as they get closer to retirement. People over age 55 receive a progressively more conservative asset allocation (less equities, more fixed income) in order to reduce their market risk as they approach retirement.

The second category of investment options was a single diversified fund that suited members' risk profile, including conservative, balanced or growth. These members had a wider range of returns from 5.9% to 8.3%.

The third category of investors were those who had opted to take the self-directed route.

The choice architecture of the super system is fundamentally important in a mandatory system as it gives people the ability to tailor their super portfolios based on their individual circumstances. But with this level of engagement comes responsibilities and risks, demonstrated with a much wider dispersion of returns from 5.1% to 8.4% p.a. for the self-directed members in our research sample.

The members who opted to select their own investment options may well have had good reasons for doing so and are comfortable with their decision. However, when looked at on a risk/return spectrum and in aggregate across the whole membership, the stark result is that the default lifecycle option delivered higher returns at a lower risk than those achieved by nearly all self-directed investors.

DIY super takes time

While involvement and engagement with your super fund are generally regarded as a fundamentally good thing there is a flip side, as people who set up a self-managed super fund understand all too well. The onus is on you to monitor and adjust your portfolio as markets inevitably move around.

One of the advantages of the default and the diversified options of large super funds is that the portfolios are implemented and monitored by the investment professionals that work for the fund. The asset allocation is regularly rebalanced, for example, to stay within the tolerances the fund has set.

When you take the self-directed route the portfolio management responsibilities rest with you. And managing your super portfolio is not most people's full-time job and neither should it be. There are plenty of life's short-term priorities - the day job, raising families, studying, taking holidays - that can easily turn the attention away from the super portfolio.

Not all default funds are created equal, so it pays to understand how your default fund compares and what the costs are. But one of the lessons out of the *How Australia Saves* research is that, if taking a direct hand in managing your investment portfolio inside super doesn't appeal to you, letting the MySuper default system work for you may be one of the best decisions you never have to make.

Robin Bowerman is Head of Market Strategy and Communications at Vanguard Australia. This article is general information and does not address the circumstances of any individual.

Does DIY super make sense?

Rosemary Steinfort

The benefits of investing through an SMSF include control, cost efficiency, tax management and flexibility but issues such as underperformance and viability due to size should also to be considered.

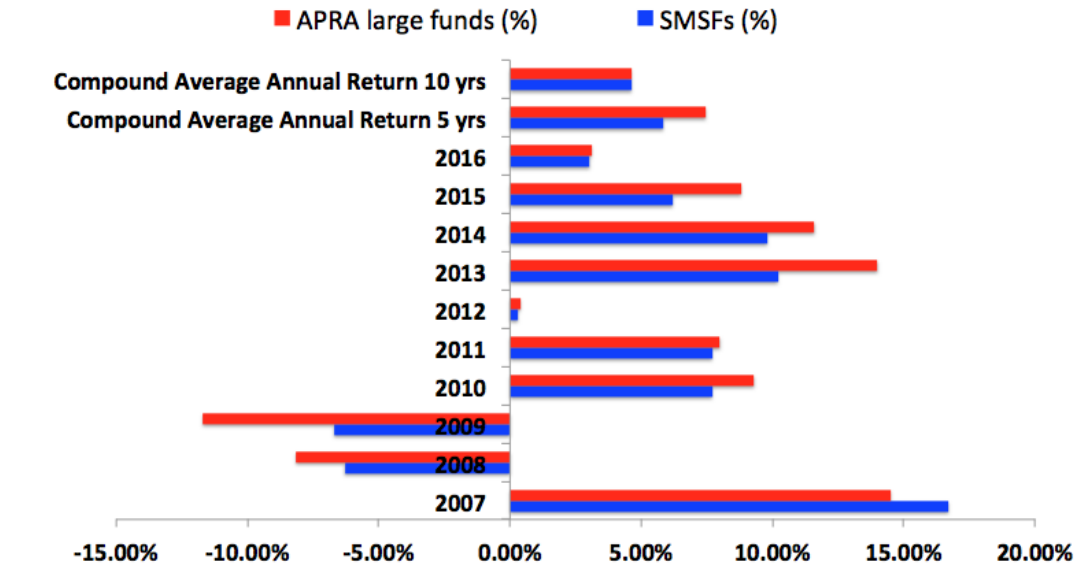
The massive inflows into the sector have meant that SMSFs are nearly 30% or $654 billion of total superannuation assets of $2.2 trillion. Is the increasing interest in doing-it-yourself (DIY) justifiable?

Size of SMSFs matter

According to ATO data, the APRA-regulated large institutional funds (including retail and industry funds) have outperformed SMSFs in seven out of 10 years to 2016. APRA funds' compound average annual net return (after fees) over 10 years is in line with SMSFs, but higher over five years, as shown below. The outperformance of SMSF's during the financial crisis years (2008 and 2009) helped support returns over 10 years, but once that outperformance disappeared, the APRA funds have done better. But, a statement in APRA's Annual Superannuation Bulletin that in their calculations "expenses are generally understated", suggests that APRA fund returns' may be inflated.

According to data from a report by SMSF Centre of Excellence, SMSFs holding over $1 million in assets were the best performers over seven years. Smaller SMSFs (under $1 million), retail funds and industry funds did not do as well as larger SMSFs.

Net returns of SMSFs and large funds over 10 years



Source: ATO Annual SMSF Statistics, APRA Quarterly Superannuation Statistics
Note: SMSF return data prior to 2012-13 does not include some non-deductible expenses

Assets are categorised differently

There are different sources of SMSF statistics. The ATO compiles the SMSF statistical data from SMSF tax returns, but some sectors are not accurately represented including property and international shares.

Last year I wrote about the fact that almost a quarter of SMSF portfolios are in property (see 'Property takes one in four SMSF dollars' (paywall) in The Australian newspaper). As the ATO makes the assumption that 'assets in trusts are treated as though half is invested in equities and half in property', then up to half of the 14% allocation to unlisted and listed trusts may be invested in property trusts (listed and unlisted). Additionally, there is the increasing allocation to "limited recourse borrowings" supported by the buying of investment properties. However, these numbers include business real property where professionals such as doctors and dentists sell their premises to their SMSFs and rent them to the business, rather than residential real estate.

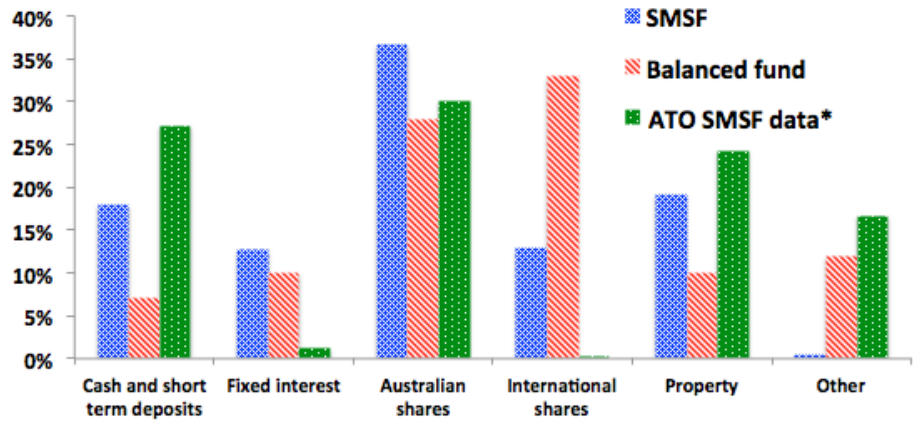
In the case of international shares, Graham Hand from Cuffelinks found out from the ATO that there is likely to be international shares allocations held by 'Listed trusts' and 'Unlisted trusts', as well as 'Other managed

investments' categories. These would substantially increase the low weighting to international shares that is reported.

SuperConcept's 'SMSF Investment Patterns Survey', which covers approximately 2,750 funds representing over $3 billion in super, provides SMSF asset allocation data, which may be closer to what SMSFs are really doing, as shown below. SuperConcept's inclusion of hybrid securities as fixed interest is debatable. Hybrids may pay a fixed interest-like return, but the securities also deliver downside risk rather than upside reward. During a market correction, the behaviour is more like shares, albeit with lower volatility than the underlying shares (see my article in Cuffelinks). So, more realistically SMSFs are most likely holding lower levels of fixed interest and higher levels of Australian equities than SuperConcepts' data. Their clientele also tends to be 'advised', with greater use of managed funds than the overall SMSF population.

According to 'Class SMSF Benchmark Report' dated March 2016, more than 40% of Exchange Trade Funds (ETFs) or $11 billion of the $27 billion ETF market, is held by SMSFs. Some of the reported Australian equity allocation held by SMSFs is really in international equity ETFs or managed investment trusts to gain international equity exposure. If SMSFs are investing in ETFs for international exposure, the allocation to Australian shares is not as top heavy as has been believed. The same could apply to other asset classes such as fixed interest.

Asset allocation of SMSF and a balanced (Industry) fund as at June 2016



Source: SMSF data from SuperConcepts Report as at 31/3/2016, Balanced fund data is from a 'typical' industry fund, ATO 'Self-Managed Fund Statistial Report' March 2016
*Note: ATO data category 'Property' adjusted to include all property. 'Other' includes half of isted and listed trusts, and 'Managed funds'

SMSF or APRA fund?

Are members of SMSFs better off where they are or should they return to an APRA fund? Whether or not the SMSF is meeting the members' expectations may depend on why the fund was initially set up.

During the GFC, many APRA funds fell heavily, which may have encouraged the setting up of SMSFs, especially post-crisis. But SMSFs have their own idiosyncrasies including a home country bias to Australian equities, due to their familiarity, higher expectations of return, currency and costs.

Also, the allocation to cash and term deposits, despite record low interest rates, continues to be high compared with APRA funds. Around the time of the GFC in 2008, ATO data shows cash levels of SMSFs were around 29% and Australian equities 31%. Although the levels of cash were conservative, the high weighting to equities led to negative returns not to the extent of APRA funds.

Fees matter

The fees paid by SMSFs influence their returns over time. SMSFs with larger balances (over $1 million) are likely to be paying a relatively lower fee due to the fixed cost payable by all SMSFs. The average expense ratio according to 2015 ATO data for funds between $1 million and $2 million is under 1%, while smaller funds with less than $500,000 may be paying closer to 2.5%. Larger funds also have the advantage of economies of scale, enabling access to wholesale investment products with lower fees. A complete administrative package for an SMSF with many investments should cost less than $5,000 a year, which is only 0.5% on $1 million and 0.25% on $2 million.

If not for the years of 2008 and 2009, SMSF long-term performance might have been less attractive. A standout feature of SMSFs' asset allocation is essentially the split between three asset classes: cash, equity and property. Nearly 40% of SMSF members are over the age of 60 and transitioning to retirement or in retirement, which may support the need for liquidity in the form of cash for capital stability and franked dividends on Australian equities for income generation.

Rosemary Steinfort is a Research Manager with DirectMoney. This article is general information and does not address the circumstances of any individual.

Is passive investment outperformance merely cyclical?

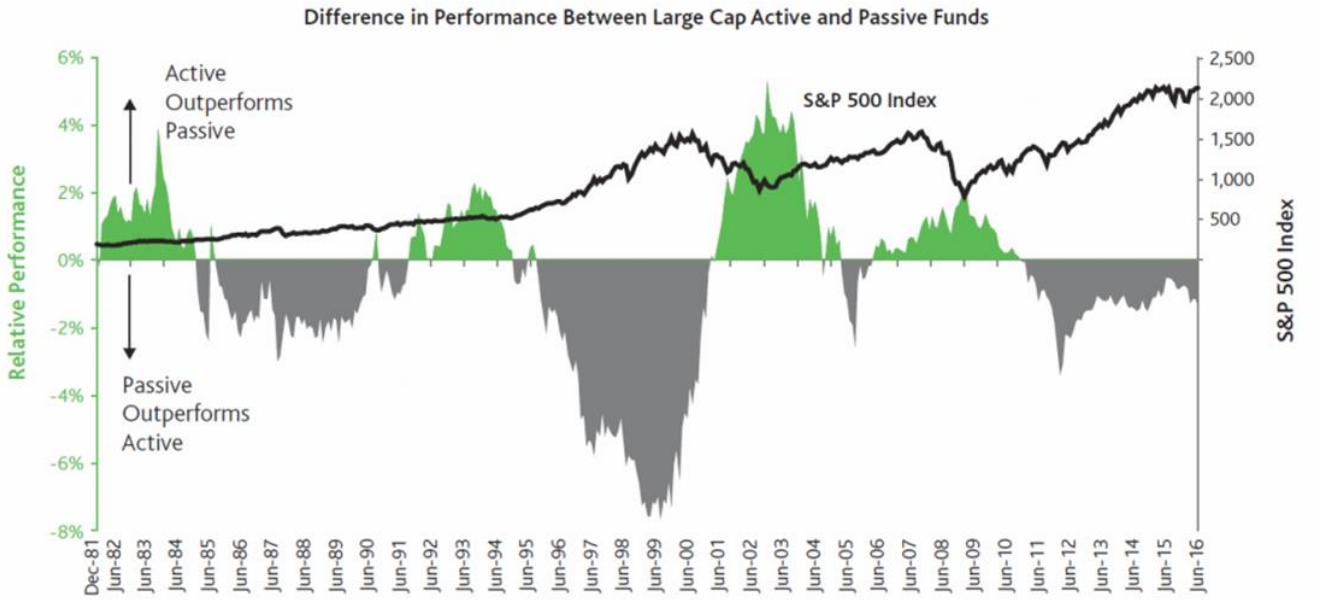
David Bassanese

A claim currently receiving renewed attention in the active versus passive investment debate is that the apparent outperformance of passive investment strategies is largely cyclical, and usually only takes place in the late stages of a bull market.

This article argues that while there may well be an element of cyclicality, it is minor in degree. What's more, the sporadic periods of active outperformance don't appear to provide much downside risk protection in bear markets and any such outperformance does not offset the much longer periods of active manager underperformance during bull market phases.

Active managers tend to do best in bear markets (but let's not get carried away)

Financial research across the world has long noted that active equity investment managers, on average, fail to beat passive broad market investment benchmarks over time. Yet a wrinkle on this general observation is best represented in the graph below from a US-based active-investment manager, Baron Capital. It shows that active investment performance tends to be cyclical, especially during the downmarket in the early 2000s and again during the 2008 financial crisis, active managers on average tended to outperform.



Source: Morningstar Direct, Baron Capital
The analysis is based on monthly rolling 3-year returns for the period 12/31/1981 to 6/30/2016. US OE Large includes all share classes in Morningstar's US OE Large Growth, US OE Large Value, and US OE Large Blend categories. The performance of passive funds is calculated as the average 3-year performance of all index fund share classes in each category. The performance of active funds is calculated as the average 3-year performance of all non-index fund share classes in each category. Results for each category are then averaged and the differences between active funds' averages and passive funds' averages are calculated.

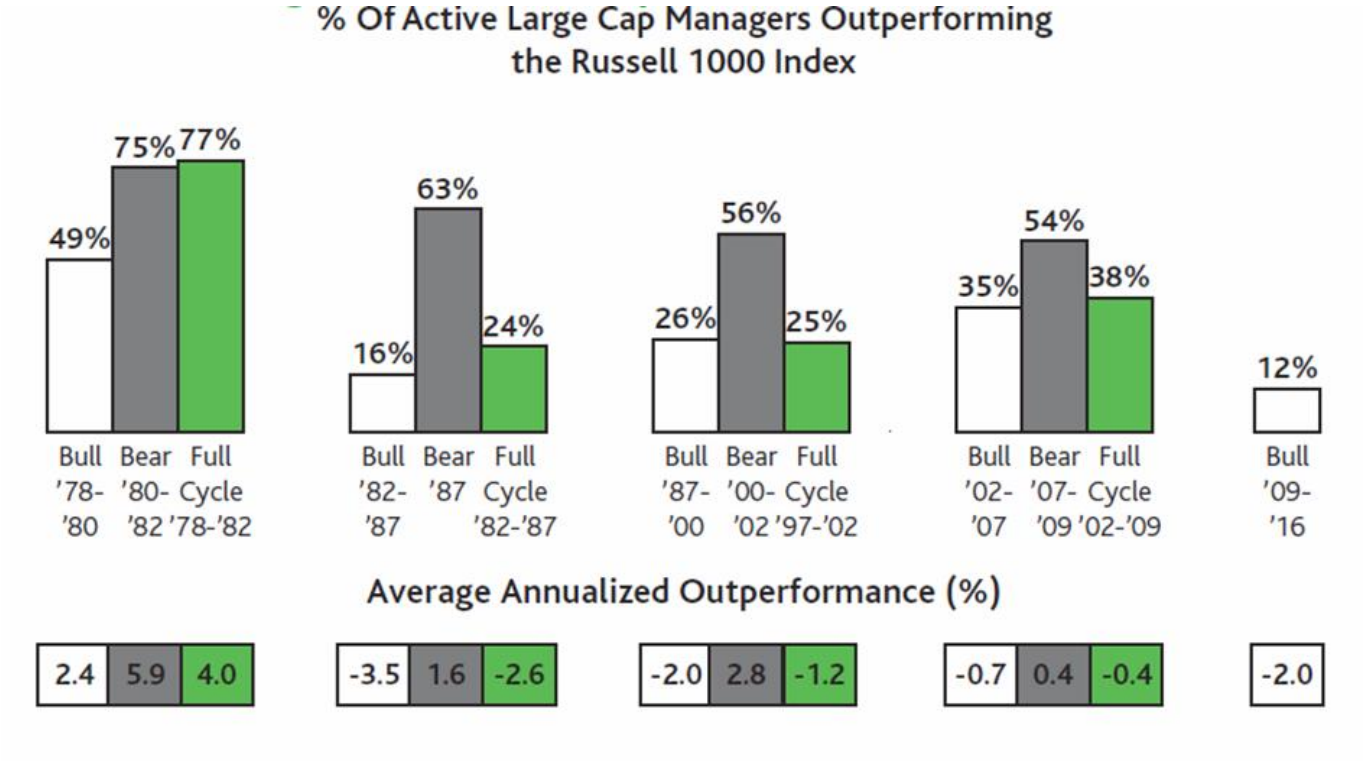
So far so good. At face value, this result seems to make intuitive sense: during strong bull market periods, popular large cap stocks with strong momentum may continue to perform well, even though an increasing number of active managers may feel they are overvalued and may reduce exposure to them. Passive indexing strategies which weight stocks according to their market capitalisation may tend to outperform more value-based active managers. When the bear market strikes, however, and once popular stocks fall out of favour, active managers then come into their own. Right?

Against this background, a generous theory could be that the recent extended period of active manager underperformance can be explained by the long bull market since the GFC. That is, the active manager underperformance is only cyclical, and will be corrected when the next bear market inevitably strikes. Sadly, the numbers don't quite bear this out…

In bear markets, active managers don't provide much downside risk protection

Even a cursory glance at the above chart should alert readers to one observation: the period of active manager outperformance (in green) tends to be milder and shorter than their periods of underperformance.

Indeed, also included in the research which produced the above chart was the analysis below, examining the *degree* of active manager outperformance in different stages of the past four US stock market cycles. Active managers tend to do best in bear market periods, with a majority of managers outperforming in each of the previous four bear periods. Yet at least over the past three market cycles, this degree of outperformance was more than fully offset by substantial underperformance during the preceding longer bull market periods. Active managers on average tended to underperform over the market cycle as a whole.



Source: Baron Capital

Not helping the active manager's cause was the fact that the excess annualised return during the last three bear market periods appears, on average, to be quite modest, at not more than 3% p.a. If an investor's active manager is down 27% in a bear market, however, it's not much solace to know their manager nonetheless outperformed the market's 30% decline.

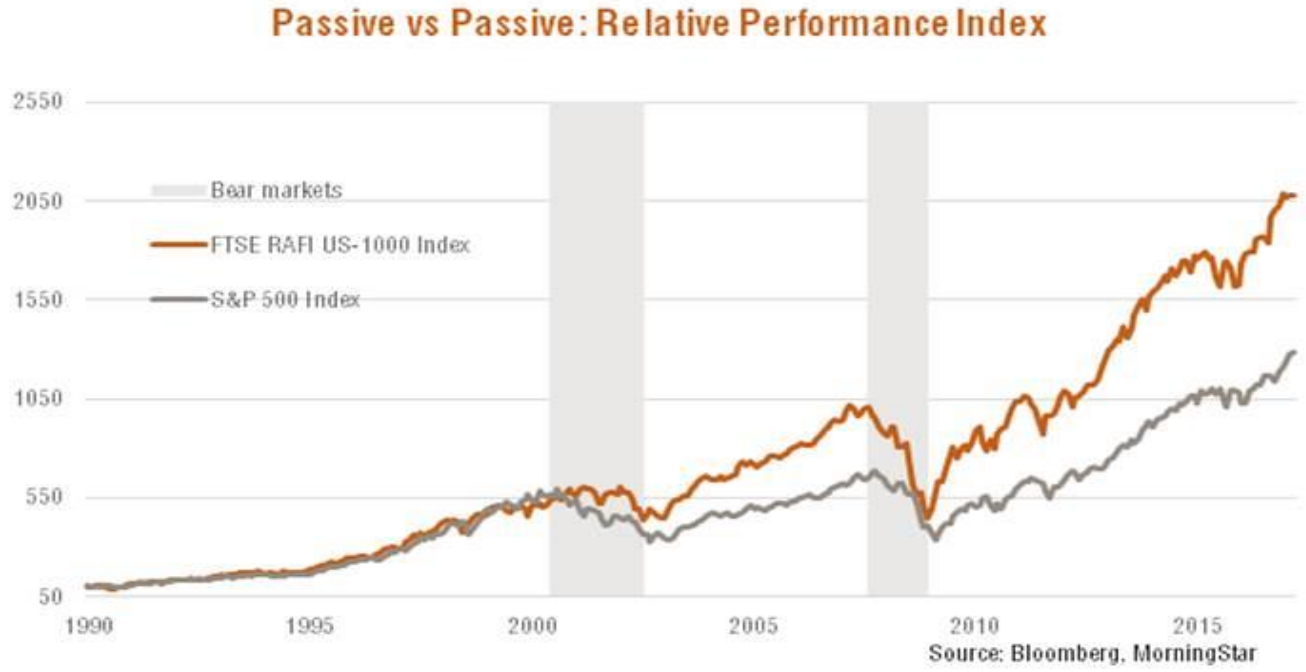
It's not surprising when active equity managers tend to have mandates requiring close to full investment in the market, with only limited ability to increase cash exposure. It's also consistent with the difficulty most investors – professional or otherwise – have in timing market exposure.

Better ways to 'index' and get downside protection

One of the implied criticisms of passive investment in the above discussion is that it tends to chase performance. Supposedly, it increases the weight to strongly-performing stocks which are rising in market capitalisation, irrespective of their underlying value, and reducing the weight to poorly-performing stocks that might be better valued. This is really a criticism of market-cap passive index weighting, rather than passive investing per se.

Indeed, as seen in the charts below, while active managers on average haven't beaten the market-cap weighted S&P 500 Index over time, an indexing strategy based on a company's non-price measures of economic size has outperformed the S&P 500 Index over the past 10 years, and by consequence, the average performance of active managers.

**Average active manager performance is defined as the equally weighted monthly performance of the median growth, value and blended large-cap US active manager in the Morningstar database.*



Investors should be aware that certain rules-based strategies exist which aim to provide a measure of protection in down markets, while still providing reasonably low cost, diversified exposure to equities. Such a

rules-based strategy forms an integral part of the BetaShares Managed Risk Australian Share Fund (ASX:AUST) and the BetaShares Managed Risk Global Share Fund (ASX:WRLD).

In summary, it is always important to 'look beyond the headline' and focus on the substance of an argument. There may well be more to it than meets the eye!

David Bassanese is Chief Economist at BetaShares. BetaShares is a sponsor of Cuffelinks, and offers risk-managed Exchange-Traded Funds listed on the ASX such as the 'fundamentally-weighted' BetaShares FTSE RAFI Australian 200 ETF (ASX Code: QOZ), and the BetaShares FTSE RAFI US 1000 ETF (ASX Code: QUS). *It contains general information only and does not consider the investment circumstances of any individual.*

Final sprint towards three major super changes

Simon Curtain

With a week to go before the 1 July superannuation changes, high net worth (HNW) individuals must act quickly or risk being caught short.

How the changes will affect you will depend on your age, the amount held in both yours and your spouse's (if relevant) superannuation pension and accumulation account, and potential for future contributions.

If you're already retired, super will still provide tax-free earnings for pension account balances under $1.6 million. Even if you have more than $1.6 million in super, tax on these surplus earnings is a low 15%.

If you're under 65 and still a few years away from retirement, you can still make personal, post-tax contributions of $100,000 per annum, or bring forward three years' worth of contributions in one year. They're an attractive opportunity to increase your superannuation balance before retirement.

If you're in the early or middle stages of your career and focused on building wealth, the reduction in contribution caps might prompt you to question how you'll accumulate sufficient assets within superannuation to meet your retirement needs. Many younger investors might also question whether super, as a long-term investment and with the level of Government interference we've seen recently, is the best place to build wealth at all. However, it remains the most effective structure to accumulate and preserve assets for retirement.

Investors should build their nest egg as early as possible by siphoning off a small amount of salary each pay into superannuation. You will be able to contribute up to $25,000 of your pre-tax salary to superannuation each year and pay only 15% tax on the contribution, as opposed to tax at your marginal rate.

Three key changes in superannuation

1. Transition to Retirement

   A Transition to Retirement (TTR) pension is an income stream paid to a member who has reached their preservation age (currently 56) but is still working. Although currently the investment earnings from superannuation assets used to fund a TTR pension are not taxable, from 1 July 2017, earnings will be taxable in the fund at regular superannuation tax rates.

   If you're affected by this change you will need to determine whether it makes sense to continue drawing a pension or commute (stop) the pension.

   It's also important to note that once you retire or turn 65 your pension is no longer considered a TTR pension and would continue to receive tax-free earnings.

2. Pension balances over $1.6 million

   If your superannuation pension balance is greater than $1.6 million you will need to move the excess amount from the pension to the accumulation part of your fund, to a spouse's fund, or out of superannuation altogether. You can still continue to have more than $1.6 million in superannuation so long as it is held in accumulation, rather than pension phase. Penalty tax rates will apply to pension amounts in excess of $1.6 million.

3. Capital gains reset

   If you're affected by the $1.6 million pension cap or TTR rule changes you can elect to refresh the cost base of assets in your fund. This would allow you to reset assets to their market value on 30 June 2017. If you have an SMSF with large unrealised capital gains, this could be a good opportunity to reduce future capital gains tax.

The strategies to manage the superannuation changes are complex. HNWs should seek advice from an independent financial adviser. If you are already receiving financial advice, but have had no communication about how the changes will affect you, you should be on the phone today.

Simon Curtain is a Director and Private Client Adviser at Hewison Private Wealth. This article does not consider the circumstances of any individual.