Cuffelinks
Connecting investors with ideas

Edition 225, 3 November 2017

This Week's Top Articles

My four enduring lessons from the 1987 crash

Ashley Owen

Late October 2017 was the 30th anniversary of the 1987 crash and much has been written about it already. There are two key questions relevant for investors today:

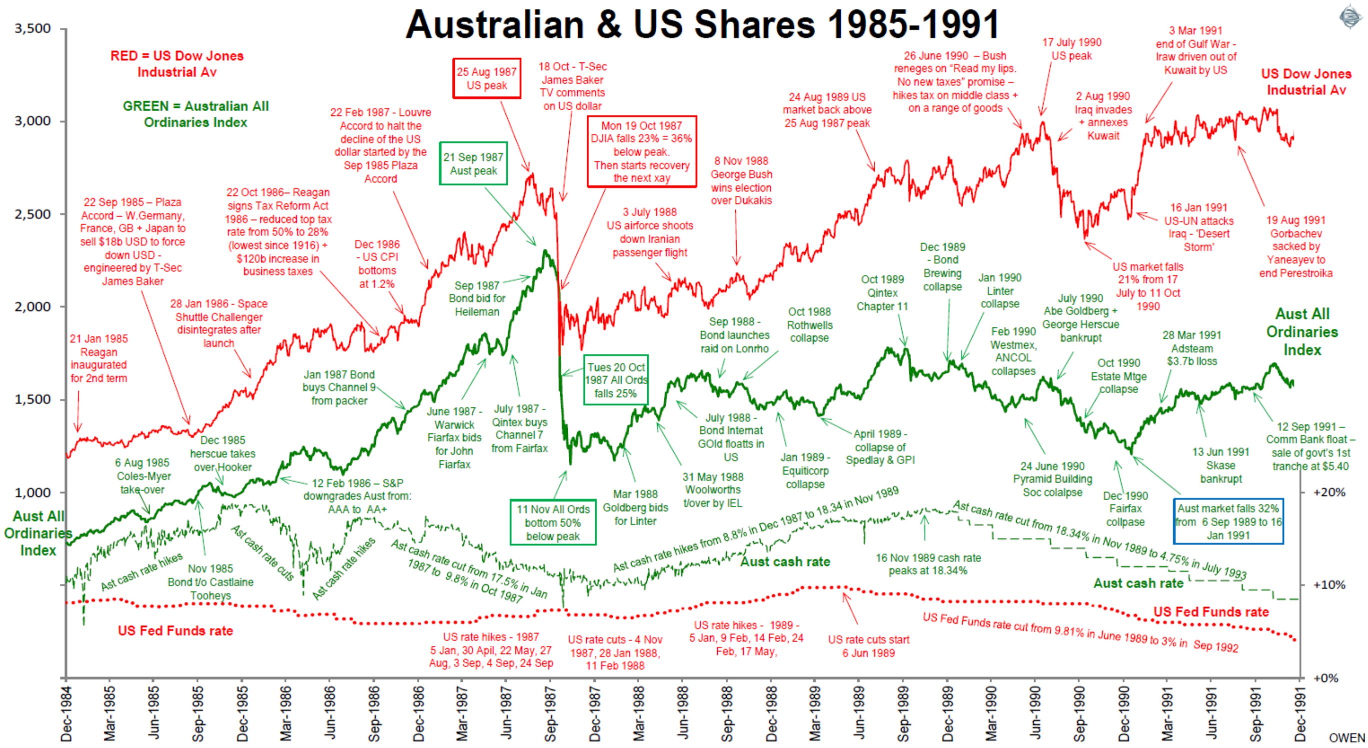
1. Are we in a bubble like 1987 that is about to burst? and
2. Why did the Australian market crash further and take longer to recover (10 years) than in the US (2 years)?

The two questions are related.

The debt-fuelled takeover binge

I have studied every cycle in the Australian and US stock markets since the 1800s and it is clear that the overall Australian market prior to the 1987 crash was the most expensive and vulnerable to crash that it has ever been in its history. There have been bigger bubbles and busts, but the 50% fall in 1987 in only 19 trading days (including a 25% fall on 20 October) was the steepest.

The main causes were loose lending, lax accounting and straight out fraud in many cases. The final trigger was the US/German/Japanese currency war, but the real problem was the extreme level of overpricing. This was worse in Australia than in the US or elsewhere. Most commentators cite the 'price/earnings' (PE) ratio of 21 as high. But a 'price/earnings ratio' is meaningless because the 'earnings' side of the equation was grossly inflated by fraudulent accounting, dodgy valuations and tame, conflicted auditors.



It was the age of the debt-fuelled corporate raiders with bankers throwing money at them. Alan Bond (Bond Corp, Media, Brewing), Robert Holmes à Court (Bell Group, Resources), Ron Brierley (IEL, Brierley Investments), John Spalvins (Adsteam), John Elliott (Elders IXL), Larry Adler (FAI), Russell Goward (Westmex), Chris Skase (Qintex), George Herscue (Hooker), Bruce Judge (Ariadne), Kevin Parry (Parry Corp), and many others. Most collapsed into bankruptcy in the 1990-91 recession, and some went to jail. Many of the big listed companies were caught up in the debt-fuelled takeover fever - even BHP, two of the big banks, the big retailers (Coles, Myer, Woolworths), the TV stations (Nine, Seven, Ten), Fairfax, the brewers, and several raiders themselves. It was all fuelled by ultra-loose lending from the big banks (with the notable exception of NAB) and from the state banks as well (the 1980s lending binge destroyed the State bank of every State except Qld which no longer had one).

At the top of the market the raiders were still cheap with low 'price/earnings' ratios: Elders was on 13, Bell Group on 15, IEL on 19, Bell Resources on 12, Adsteam on 11, Hooker on 15, Bond Corp and Ariane on just 9, and FAI on 7! Bargains! PE ratios were meaningless. The problem was in the quality of the reported 'earnings'.

Are we in a 1987-style market bubble now? No.

Lessons from 1987 have stayed with me

The experience of 1987 affected me personally and it is at the core of my investment philosophy. 1987 serves as a reminder to ignore finance theory and focus on what happens in the real world. Finance theory likes nice neat lines, it assumes markets are always stable and static, that buyers and sellers are perfectly rational, and that returns are 'random' and 'normally distributed'. It dismisses major events like the 1987 crash as random anomalies, simply ignoring them as irrelevant outliers and placing little importance on them.

I believe in the exact opposite - that the extreme outliers are actually the cornerstones of our experiences, they define our lives, and can create or destroy wealth - much more so than so-called 'normal' markets.

I was lucky enough to be on right side of both the 1987 boom and the crash. I had started out in the early 1980s as a lender with Citibank and Midland Bank (now HSBC). I learned about booms and busts first-hand by cleaning up the aftermath of bad lending in the late 1970s building boom which collapsed in the early 1980s recession. (Yes, you can lose money in housing - big time - just wait for a recession! Remember them?).

By 1986 I was running a bank financial control operation. Markets were booming again and I was young and single with no debt so I left the safety net of a salary, moved to Sydney, teamed up with three other characters and we set up a boutique investment bank. We were a motley bunch and I was the youngest, a bank financial controller with a couple of law degrees and a speciality in spreadsheets (remember *Lotus 1-2-3*, the forerunner of *Excel?*). This picture of me is from a 1987 prospectus.

My four fundamental rules

Rule 1: recognise when you are in a bubble or a bust. Easy enough from a distance but it's harder when you are actually in it at the time.

Rule 2: never buy in a bubble - sell instead. Likewise: never panic sell in a bust - buy instead.

Rule 3: If you're in a bubble and have nothing to sell, build something and sell it, assuming you have the skills and background to do it quickly. In 1986-87, we built and listed four companies - two gold refineries, a finance company, and a 'cash box' (a cash box is the ultimate bubble stock - there's nothing in it except cash but in a bubble people bid up the price anyway).

Rule 4: never use debt (very unfashionable in the debt-fuelled 1980s. Debt was like big shoulder pads and skinny ties - everyone had them!)

In 1986-87, there were signs of a bubble everywhere - 'hot stock' shows on TV, talk back radio, magazines, newspapers (there were no blogs or social media or internet back then and not even mobile phones). There was even a tax-driven reason to lure investors into the market as franking credits were introduced in July 1987. Stock brokers ran seminars in the suburbs convincing people to gear up and buy shares to get access to the hot new toy called franking credits! The same thing happened in the 2007 boom when hundreds of seminars in the suburbs encouraged people to gear up into superannuation to take advantage of the '$1 million contribution window'. Thousands of people borrowed money at the top of both of the booms, threw it into the market, and promptly lost most it in the crashes that followed immediately after.

Don't lose control of your own destiny

The other half of Rule 2 is that in a bust, buy when everybody else is panic selling. If you have no debt (Rule 4) you can survive even the worst crash and retain control. It is sad to see people sold up by margin lenders in busts. When you borrow money, you give control to the lender, and they will sell you up at the worst time.

The All Ordinaries index collapsed by 50% from 2,306 on 21 September 1987 to 1,151 on 11 November 1987 but that masks the fact that hundreds of stocks were left completely without buyers. The true market had probably collapsed 70% or more if there were any buyers to set market prices. We picked over the ashes and bought one of the Elders group companies for $1 (not $1 per share, $1 for the lot, with no debt). It had 35 subsidiaries and we spent the next couple of years sorting through the ruins

1987 was a great learning experience for me. I do have regrets. There were a few things we developed that went nowhere, but if you have no debt the downside is limited. Also, I was probably too careful and should have taken more risk at the time. You can always make more money if you borrow - but I'm too cautious and not that greedy.

The lessons and the same four rules have applied in every cycle since. And because all markets are driven by human fear and greed, hard-wired into human nature, the same four rules will probably apply to all cycles in future as well.

Ashley Owen is Chief Investment Officer at advisory firm [Stanford Brown](#) and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

How state charges can kill investment returns

Graham Hand

One of the reasons residential investment property is popular is that many people do not realise the full extent of the costs. They often fall in love with a place without checking all the expenses, and estate agents quote gross returns and go unchallenged. While investors may be familiar with (often understated) strata and council fees, the state government charges such as stamp duty, land tax and car space levies can come as a shock.

Even the Defence Housing Authority, a statutory authority and a major Government Business Enterprise (GBE), responsible for providing housing to defence members by selling property and leasing it back, quotes gross yields, as in the example below. Net yield before borrowing cost may be only 1%, as we'll show later.

KELLYVILLE, Sydney - Richmond, NSW

PHOTOS FLOOR PLAN MAP

UNDER OFFER

4 bed 2 bath 2 car

Price	$1,080,000
Rent	$675 per week
Gross Yield	3.25%
Lease	9 + 3 years
Property type	House
Constructed	2016

We have previously discussed the many costs in property (for example, here and here), and we will not repeat those points, except to note that NSW stamp duty on a $1,080,000 house would be a chunky $45,000.

This article focusses more on two other state charges which are often overlooked by investors.

Parking space levy

The property pages in our newspapers love a good car park story. It might be only 14 square meters of concrete, but it can cost over $200,000. They rarely mention the car space attracts council levies and strata fees, although there will never be a garbage collection. At least there are no water rates. A check of real estate pages reveals these gems:

***$222,000** Undercover security carspace in Potts Point*

"Very tightly held, this carspace is situated in 'The Chimes', a secure building accessed via McDonald Street, just off Macleay Street on the northern end of vibrant Potts Point. This space is of special interest to local businesses, local new development investors and owner occupiers wanting a car spot in Potts Point."

***$190,000** Rare separate title car space in security building*

"Situated in 'St Killian' a secure building which is conveniently located between Victoria Street and Macleay Street. This is an ideal opportunity to add a car space to your apartment or business."

These high prices are usually paid by people who want to park near their home. But in many parts (see map here) of the City of Sydney, North Sydney, Milsons Point (Category 1) and Bondi Junction, Chatswood, Parramatta and St Leonards (Category 2), investors face a parking space levy. It creates a two-tier market with owner occupiers given an advantage as they are exempt from the levy. It's the same in some other states.

Before you think a slab of concrete sounds like a solid investment, let's look at a specific example away from the glitz of Potts Point.

In 2004, the development of an old wool store at 360 Harris Street, Pyrmont included 425 parking spaces, with prices starting at $56,000 per space. The marketing said it was "the best investment you'll ever make", "amazingly affordable" and "unbelievably scarce". Two of our main newspapers helped with the marketing. A

Sydney Morning Herald article ('On the lookout', Domain, 1 July 2004) reported hundreds of calls and that over 200 sold before public launch:

"At prices of $56,000 to $70,000 per space with long leases in place, this unique opportunity should be rushed by investors."

The *Australian Financial Review* article ('Good places to park money for useful returns', 17 June 2004) generously quoted the agent saying:

"When something has a $56,000 starting price, it is not hard to imagine it doubling over time."

At the time, for any investor who cared to check, the parking space levy was $840 a year. A crystal ball might have shown billions of dollars spent a decade later in the adjacent Darling Harbour and the coming boom in property prices. Secure Parking offered long-term leases. What could go wrong?

The investment yielding … nothing but a capital loss

The state government needed money, disguised as "to discourage car use in leviable districts while attracting customers to public transport". From 1 July 2009, the levy doubled to $2,000, and it has since risen to $2,390.

Category 1 areas - Sydney, North Sydney and Milsons Point

For each parking space owned as at	Levy amount
1 July 2017	$2,390
1 July 2016	$2,350
1 July 2015	$2,310
1 July 2014	$2,260
1 July 2013	$2,210
1 July 2012	$2,160
1 July 2011	$2,100
1 July 2010	$2,040
1 July 2009	$2,000
1 July 2008	$950

In 2017, Secure Parking will pay gross rent for a car space at 360 Harris Street of about $4,000 a year (it was $3,600 in 2004). The investor pays $2,390 in parking space levy (reduced somewhat by the occupancy rate of the parking station), $680 in council rates and over $1,000 a year in strata fees. That leaves … not enough to pay the accountant to prepare the tax return.

And the value now of the car spaces that cost at least $56,000 in 2004? If you like the idea of buying a piece of Sydney real estate, right next to the new International Convention Centre and right next to the CBD, it can be yours for only **$35,000**. Here's the advertisement on Domain (no, it does not belong to me). Just like 13 years ago, it's amazingly affordable and incredibly scarce.

This development was clearly targeted at investors, and the increase in parking space levy was a material factor in destroying the value of these car spaces.

Land tax

Thousands of people own investment property, but how many realise that the next time they buy another, the land tax could remove almost half the estimated net return?

In New South Wales, the land tax is currently charged at:

Tax Year	Threshold	Rate
2017	$549,000	$100 plus 1.6% up to premium threshold.
	$3,357,000 and over (Premium threshold)	$45,028 for the first $3,357,000 then 2% over that.

The tax is paid on the combined value of all the taxable land owned above the threshold. Let's assume an investor already owns one property with a land value of $549,000, and buys the Kellyville house with a land value of $600,000. The annual land tax for the new property would be $9,000 a year.

Liability for land tax includes:

- Vacant land even if it is generating no income, and holiday homes
- Commercial and industrial property, including (wait for it …) car spaces
- Payable by the owner whether an individual, company, trust or trustee of a super fund.

The principal place of residence in excluded when the property is owned by a 'natural person'. This exemption is not affected by the size or value of the land, which is why some cash poor pensioners can sit on a $10 million harbour mansion, draw a full pension and not pay land tax.

Let's do some quick calculations on the Kellyville investment:

Cost of house: $1,130,000 including stamp duty $45,000 plus legals and inspections, say $5,000

Gross rent: $675 a week for 52 weeks (DHA guarantees no vacancy) $35,100

Annual costs (ignoring mortgage): Water $1,144, Council $1,285, DHA service fee $5,800, Repairs say $5,000 a year. Total costs $13,229

Net return before land tax: $35,100-$13,229= $21,871 on $1,130,000 = 1.9%.

In this example, the land tax of $9,000 then takes over 40% of the net return. **Final net: 1.1%.**

The investor is probably borrowing an enjoying the tax benefits of making a loss, but that's another story.

Go in with eyes wide open

Any time you buy property, open a spreadsheet and add all the initial expenses to the purchase price. When calculating income, assume one month a year of vacancy. Subtract every cost including agent fees, and allow for increases. In a new apartment, strata fees always rise as soon as the new strata committee sees the maintenance bills. Add the state levies.

Investment loans have become more expensive lately. Make sure you have other sources of income than rent because for most investment properties in Sydney and Melbourne, the net income will not cover the mortgage. You'd better hope the capital gain kicks in … and the government does not think up another tax.

Graham Hand is Managing Editor of Cuffelinks.

Will millennials change the investment landscape?

Harry Moore

Millennials recently became the largest demographic cohort, now 29% of the population was born between 1980 and 2000. By 2030, they will represent the largest source of income and consumer spending, earning two out of every three dollars in Australia. While much has been written about how the shift in spending patterns will change the retail landscape (online over brick and mortar and experiences over materialism) relatively little research has focused on the changes to investing and asset management. Over the next two decades millennials will not only become the largest earners but are also set to inherit significant wealth, further increasing their importance to the investment industry.

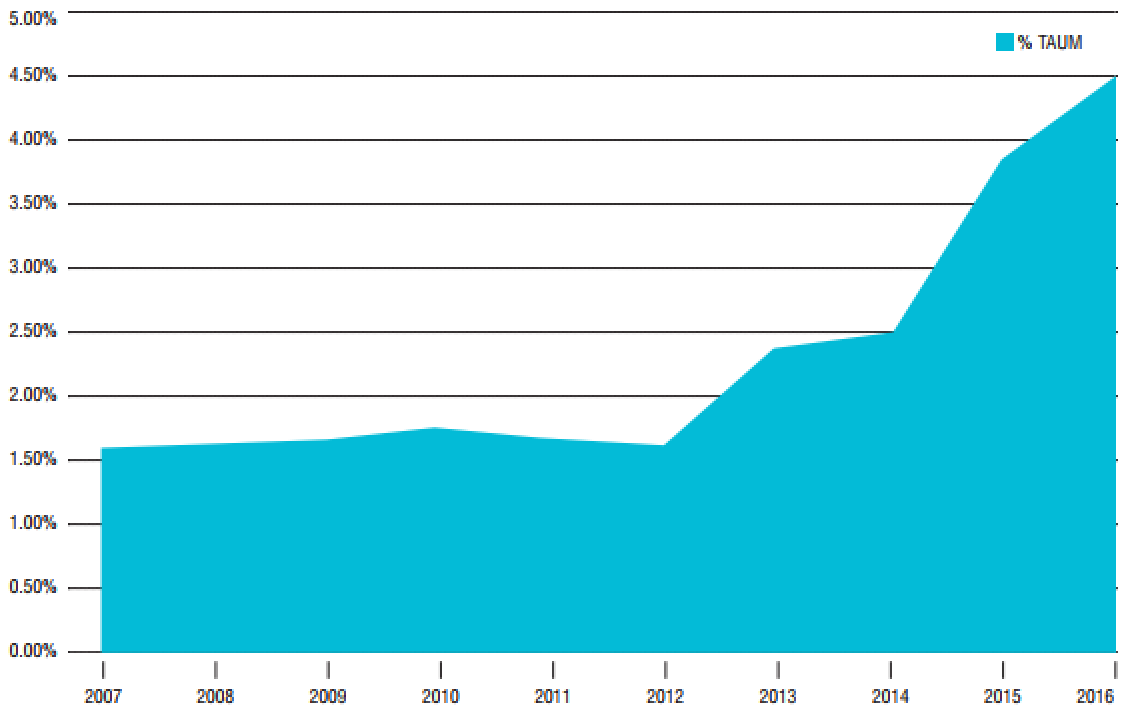
They are tech savvy, passivists

Much of the focus on the investments of millennials has to date revolved around the growth of passive/ETF investing (according to Commsec, Australian millennials now account for 25% of ETF trades) and the use of 'robo-advice'. Both have largely been driven by lower minimum investments and perceived low fees, making them attractive entry level propositions. While these trends are likely to continue, millennial investors are also likely to move into more traditional investment products as they build wealth over their lifetimes. Indeed, we are already beginning to see this, with Commsec finding that 50% of all new customers are under 35 years of age while millennial customers have increased by 51% over the last five years and now represent 28% of all active members.

… and socially responsible investment activists

With 87% of millennials believing that business success should be measured by more than just financial performance, one of the largest changes is likely to be the continued growth in responsible, sustainable or 'impact' investing. Growth in these strategies is accelerating in Australia, with rise in funds invested in 'core responsible investments' from $11.9 billion in 2006 to $64.9 billion in 2016 and reaching 4.5% of total assets, as shown below. Market share remained under 2% for the majority of the last decade, but have surged in the last few years.

Core responsible investment strategies as a percentage of assets under management



Source: RIAA, Responsible Investment Benchmark Report 2017 Australia.

With 85% of millennials interested in or currently using social impact investments, this trend is likely to accelerate further as they make up a larger proportion of the market. Additionally, 85% of millennials now consider investment decisions as a way to express their values. Financial investments will become more aligned with social, political and environmental factors.

At CFSGAM, we recently conducted a survey of our own staff (30% of whom are millennials) on the extent of their individual beliefs on responsible investment. The survey found that:

- 80% of staff believe considering ESG issues leads to more complete analyses and better-informed investment decisions.
- 85% supported the view that asset owners should, as part of their duties, consider both the direct and indirect ESG impacts of their investments.
- 75% believed that the risks and opportunities associated with ESG factors are not being captured in market values.

This tells us that millennials are ahead of the curve when thinking about the impact and implications of responsible investment strategies. Further, they are more likely to favour responsible investment strategies and are also more likely to believe that investing responsibly does not negatively impact performance. Indeed, there is strong evidence that utilising ESG factors improves performance, with a recent BofAML Report finding that they could have helped investors avoid 90% of bankruptcies.

The funds management industry will need to adapt and responsible investing will become increasingly mainstream and less of a niche or nice to have addition to traditional offerings.

Harry Moore is Head of Business Development for Australia and New Zealand at Colonial First State Global Asset Management, a sponsor of Cuffelinks.

Limits to a will's power over an SMSF

Mark Ellem

"Nominated de facto gets super over the deceased's natural children".

We've seen that headline before. It highlights the importance of establishing which assets are part of an estate and which are controlled by a super fund upon death. A will cannot direct the trustee of a super fund how the super should be paid upon death.

A recent case involved the tragic passing of a 40-year-old father of two young daughters. At the time of his passing, he was in a relatively new de facto relationship with a woman who was not the natural parent of the two girls. His will left his estate, including his superannuation, to his daughters. However, his de facto lodged a claim that she was his 'partner' and received the majority of his superannuation benefits. In fact, out of the $451,498 total superannuation death benefit, his daughters received only $49,664 each, with $352,170 going to his de facto.

Watch the limits of the will to direct super

There are similarities between this case and Katz v Grossman which was decided over 10 years ago, in 2005. Mr Katz was the sole member of his SMSF and one of two individual trustees, the other being his wife. On the death of his wife, his daughter, Mrs Grossman, was appointed as second trustee. Mr Katz's will left his entire estate, including his superannuation entitlements of about $1 million, to his two adult children, daughter and son, on a 50/50 split.

On the death of the father, the sole remaining trustee, Mrs Grossman, appointed her husband as the second trustee and they chose not to follow Mr Katz's wishes in his will, but instead paid the entire superannuation death benefit to Mrs Grossman. That is, the daughter received 100% of the father's death benefit and his son received nothing.

Whilst these cases are some 12 years apart, they highlight the importance of the assets under the authority of a will and those in a superannuation benefit. A will cannot direct the trustee of a superannuation fund in relation to the payment of a benefit from the fund upon death. An indication of how superannuation should be treated in a will can act as a form of non-binding death benefit nomination, which is merely a wish on the direction of the death benefit and nothing more. The provisions of the trust deed of the superannuation fund take precedence over any instructions given in a will.

Binding death benefit nominations

A validly-completed binding death benefit nomination (BDBN) will bind the trustee of a superannuation fund to the payment of a member's superannuation entitlement upon death. However, ensure that the BDBN has been correctly completed and that the nominated dependant(s) are also valid. Generally, a superannuation dependant is a spouse, child (of any age) or the Executor of the deceased's estate. There are also some other categories, such as 'financial dependant' and an 'interdependent'. Further, don't confuse a superannuation dependant with a tax dependant – that's for another article.

However, a BDBN is not the 'be all and end all' of estate planning for superannuation.

Another relevant case, particularly for SMSFs, is that of Wooster v Morris in 2013. That case involved a two member-SMSF. The husband provided to the trustee a BDBN, nominating his two daughters from a previous marriage as his dependants to receive his superannuation benefits upon his death. He died and his second wife (not the natural parent of the two daughters), together with her son (not the deceased's son) decided to disregard the BDBN and effectively pay the death benefit to herself. Some years later, the court affirmed the BDBN as valid, however, legal fees mounted and the second wife died, leaving her own estate bankrupted.

In the end, the eventual payment to the daughter is well short of what they would have received had the BDBN been accepted in the first instance.

It's all about control

Remember that saying 'possession is nine-tenths of the law'? Well, when it comes to death benefits paid from an SMSF, who controls the fund on death can be everything. If the father in the Wooster case did not want his second wife to receive any of his superannuation on death, maybe he should have considered not having her as party of the fund, either as trustee or member/trustee. A well-constructed BDBN can help provide sound succession planning and inter-generational wealth transfer. However, when it involves an SMSF, knowing who is in control of the SMSF at the time of death is paramount.

Time for a review of your estate plan

Whilst the thought of our demise is not one we wish to dwell on, it is important that we have in place our estate plan. This plan is not simply a will, but starts with the overall view of what we want to happen to our assets in the event of our death. For example, who do we want to benefit and how are they to benefit, and do we pay in a lump sum of assets or an income stream? Once we know that, we can engage professionals to arrange the relevant documents, including:

- Will
- BDBN
- Enduring Power of Attorney
- Testamentary Trust provisions in a will
- Superannuation Proceeds Trust provisions
- Any special provisions in an SMSF Trust Deed.

Superannuation is often the largest asset in an estate and it is important, in fact it's our duty, to preserve it for those who we want to benefit from it (assuming we haven't spent it all!). A will does not, on its own, provide the mechanism to ensure that the distribution of superannuation as intended actually takes place.

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.

Quality ingredients improve both cooking and investing

Sam Morris and Adrian Warner

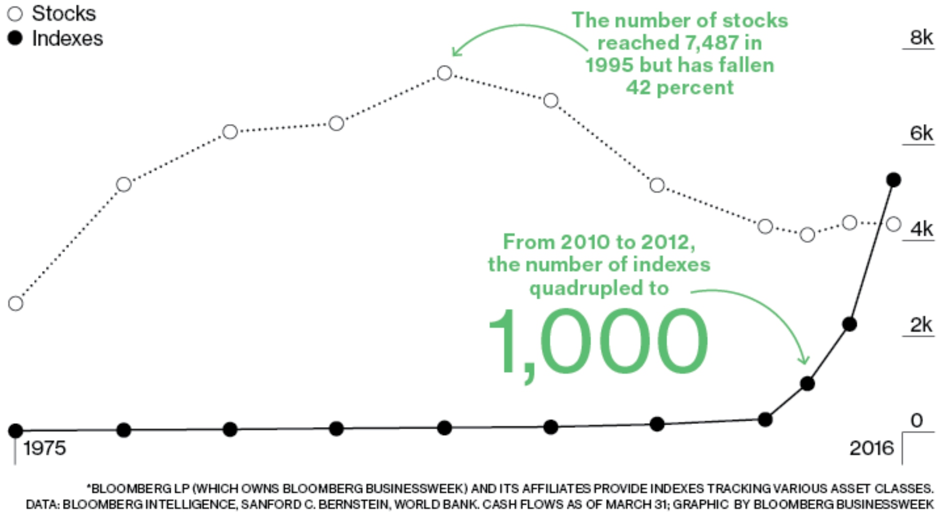
The patient preparation of a home-cooked meal with carefully selected ingredients is a rewarding endeavor. Knowing what's in the meal should make it healthier and well-balanced. Pre-packaged takeaway is convenient but usually less satisfying beyond the immediate need to relieve hunger.

Trends in investing are similar. Indices are essentially investment shopping lists prepared by someone else that help save passive investors time and effort in deciding what to buy or give benchmark-aware fund managers a starting point to decide what to put in their trolleys.

Changes in investing habits

Yet in 2017, the number of stock market indices exceeded the number of stocks in the US, expanding the proverbial supermarket of investment 'takeaway' offerings.

The rise of the benchmark



Source: https://www.bloomberg.com/news/articles/2017-05-12/there-are-now-more-indexes-than-stocks

What does it say about our investment eating habits when the number of shopping lists exceeds the number ingredients? In our rush to embrace convenience, are we losing sight of selecting quality underlying ingredients and carefully preparing healthy, well balanced portfolios?

Many products in the new financial supermarket are built on the assumptions and 'theories' of markets - that humans make rational economic decisions and that price should always reflect the intrinsic value of the investment. Yet humans, and therefore markets, are not perfectly rational, particularly in the short term.

The 2017 Nobel Prize for Economic Sciences, awarded to Richard Thaler, recognised this as much, acknowledging his research which demonstrated,

"…that, unlike members of homo economicus, members of the species homo sapiens make predictable mistakes because of their use of heuristics, fallacies, and because of the way they are influenced by their social interactions."

Holding period returns

Value investing, like cooking, should be an exercise in careful selection, patience and conscious avoidance of biases. To this end, compelling research released last year from active management academics Martijn Kremers and Ankur Pareek looked at the relationship between holding period (duration), degree of 'activeness' and returns for thousands of US retail and institutional funds over nearly three decades. This sample set included US equity retail mutual funds from the largest database of returns, the Centre for Research in Security Prices (CRSP), and a sample of all aggregated institutional investor US equity portfolios as inferred from their quarterly 13F statements. It covered a 24-year period from 1990 to 2013 for retail and 1984 to 2012 for institutions.

Among high 'active share' mutual funds, those with **patient investment strategies** (average holding periods of more than two years) were able to generate average alpha of 2.05% per year in the study.

At the other end of the spectrum, irrespective of how dissimilar their portfolios were relative to their benchmarks, highly-traded mutual funds with **short stock holding periods** underperform, with average annual net alpha of negative 1.44%.

The lesson is that active investors must have conviction and be patient. What is good takes time to prepare and is best savoured, not quickly devoured. And the key to the success of high conviction, patient value investors is, funnily enough, … valuations.

Valuations at time of entry remain key

According to Bank of America Merrill Lynch analysis from 1971 to today, valuations at the time of purchase have explained 80-90% of returns from the S&P 500 over a 10-year horizon. The research, ironically, comes from a major investment bank which is part of an industry that prospers by encouraging short-term trading.

True value investors should focus on valuation as it maximises the chance of outperforming the market on a long-term basis. This can be hard to justify to investment oversight committees where peer comparison and human bias demand immediate action and results. It is understandable why so much of the retail and institutional funds management industry trends towards career-risk driven mediocrity and hugs the benchmark. Good investing, like good cooking, doesn't benefit from having too many chefs in the kitchen. Too many investors trade too frequently, do not properly anchor assessments in fundamental, long-term reasoning, or fire their fund managers too quickly.

Cooking at home is more challenging as we become time poor, yet it is increasingly satisfying for the same reason. We believe patience and high conviction as sources of excess return and they are likely to persist due to the unchanging nature of human psychology.

Sam Morris is an Investment Specialist at [Fidante Partners] and Adrian Warner is CEO/CIO of [Avenir Capital]. Fidante is a sponsor of Cuffelinks. This article is for general information only and does not consider the circumstances of any individual.

Consider a strategy change for retirement pensions

Paul Taylor

Superannuation fund trustees face a challenging objective for pension options to achieve relatively strong investment returns while managing downside risks. However, the different circumstances of pension options – including different tax rates relative to accumulation options – present an opportunity for trustees to tailor investment strategies to better meet retiree member needs.

Opportunities for super trustees

Broadly, we see three main opportunities:

1. Investing a slightly higher portion of equities in Australia (relative to the accumulation period) to take advantage of franking credit benefits

2. Reducing pension option volatility to improve the likelihood of meeting (after tax and fees) return and risk objectives, which could include:

   – investing in assets that have more downside protection (which may give up some return)
   – reducing equity exposure
   – increasing exposure to lower volatility strategies (for example, low beta equity or alternative risk premia strategies)
   – consideration of derivative strategies (for example, put options, cash plus call option strategies, which could be implemented across equities, interest rates, volatility and credit default swap markets)

3. Increasing portfolio diversity to improve risk and return outcomes, such as a higher or lower exposure to illiquid assets.

Separation of accumulation and pension strategies

It would be ideal for accumulation and pension sections to be managed separately to ensure that all matters, especially tax, are appropriately considered for both phases.

This is not always happening but is starting to evolve. Funds are introducing a variety of approaches including:

- A 'bucket' approach – where several investment pools are created to reflect different time horizons
- A 'life-cycle' approach – where exposure to growth assets typically reduces as a member's age increases
- An 'income' approach – including offering annuities (or income-focused investments) to members to meet the need for a stable income
- An alternative 'static' approach – adopting a traditional strategic asset allocation but specific asset classes or strategies are tailored to better meet retirement needs (e.g. low volatility equity strategies).

Risk, returns and sequencing

In terms of return objectives, superannuation fund trustees can look at a range of options for pension members, including **income-based** objectives (once they have made the distinction between investment income and retirement income), a **cash +x%** objective (if this approach can keep up with the rising costs of living) or a **CPI +x%** objective.

We believe the latter approach is the most appropriate for the majority of pension assets.

Another key consideration is the **sequence of returns** in the pension phase. As superannuation fund members enter the pension phase at different times, it's impractical to eliminate sequencing risk but it is important for it to be appropriately managed. In particular, the key focus should be to limit both the frequency **and** magnitude of negative returns.

While the industry-developed Standard Risk Measure (SRM) gives some indication of the potential risk of an investment choice option, the measure has several flaws, such as not considering the magnitude of losses or inflation impacts. Using the SRM in isolation as a risk objective for the pension (or accumulation) phase is of limited benefit.

We advocate a greater focus on the risk of not meeting the return objective and ensuring that any under-performance against the return objective is limited to the extent possible.

Investment strategy for retirement

The investment objectives of pension options should be broadly similar to accumulation options. It makes little sense spending your entire working life targeting one set of investment outcomes, only to change the target when retirement hits.

A typical 'growth-oriented' accumulation investment option might look like the below.

Asset class	Exposure
Australian shares	27%
Overseas shares	26%
Property	9%
Infrastructure	5%
Alternative assets	13%
'Growth' assets	**80%**
Bonds	16%
Cash	4%
'Defensive' assets	**20%**

Based on our modelling of very long-term asset class returns, the expected characteristics of the above portfolio are set out below (assuming a return objective of CPI+3.5% pa after tax and fees). We have shown this for both the accumulation and pension phases:

	Accumulation phase	Pension phase
Expected long term return (pa)	7.4%	8.5%
Expected long term return (real)	4.8%	5.9%
Expected return in a poor year	-11.6%	-12.7%
Frequency of negative returns (over 20 years)	4 years in 20	5 years in 20
Range of expected five-year returns (pa)	-1.3% to 15.6%	-1.3% to 17.5%
Average return when under-performing objective over five years (pa)	+3.0%	+2.9%
Probability of meeting CPI+3.5% objective	**59%**	**66%**

For investment options with the same asset allocation, the expected outcomes for accumulation and pension members are different. Specifically, for any given asset allocation, a pension option typically has higher risk and return characteristics than the equivalent accumulation option, simply due to it not being subject to tax.

Some superannuation funds have adopted an approach of adding a margin to the return objective for their pension options, to allow for the higher expected returns. Others have kept the same return objectives as the accumulation options but have accepted that there is a greater likelihood of meeting the return objective for the pension option than for the accumulation option. We believe a better approach would be to directly consider the precise circumstances of pension options, rather than constructing pension fund objectives by making spurious adjustments to accumulation option objectives.

Adopt a lower volatility option

An alternative approach could be to implement a lower volatility investment strategy for a pension option with a CPI+3.5% p.a. objective by increasing the allocation to defensive assets by 20%. The following results could be obtained:

	Accumulation phase	Pension phase (typical)	Pension phase (alternative[1])
Expected long term return (pa)	7.4%	8.5%	7.6%
Expected long term return (real)	4.8%	5.9%	4.9%
Expected return in a poor year	-11.6%	-12.7%	-7.9%
Frequency of negative returns (over 20 years)	4 years in 20	5 years in 20	4 years in 20
Range of expected five-year returns (pa)	-1.3% to 15.6%	-1.3% to 17.5%	0.5% to 14.4%
Average return when underperforming objective over five years (pa)	+3.0%	+2.9%	+3.7%
Probability of meeting CPI+3.5% objective	**59%**	**66%**	**69%**

1. The alternative asset allocation aims for a less volatile approach by increasing exposure to defensive assets by 20% and reduces exposure to higher risk assets.

The alternative allocation is based on a long-term, strategic view of investment portfolios, rather than a shorter-term tactical view. In the current environment, a 20% increase in exposure to cash and bonds would reduce the likelihood of meeting return objectives so we would advocate greater diversification of both growth and defensive assets to meet risk and return needs. This would include a higher exposure to investments with limited economic sensitivity and/or alternative risk premia strategies.

Compared with the previous pension portfolio, the updated pension portfolio has:

- A higher probability of meeting the return objective
- Materially better returns when under-performance occurs, and
- A lower frequency and magnitude of negative returns.

The overall expected return is lower than the more growth-orientated portfolio, but given the benefits above, we believe the updated pension portfolio is a superior asset allocation than simply using the same asset allocation as the accumulation phase.

A lower volatility portfolio may be more aligned to a pension option's investment objectives. This is not to move down the risk/return spectrum per se, but to create a portfolio that increases the likelihood of achieving performance objectives. We also highlight that the above analysis is based on long-term assumptions, meaning an immediate move to a lower volatility strategy may not be the most appropriate course of action, in the current environment.

Paul Taylor is a Senior Investment Consultant at Willis Towers Watson. This article is for general information only and does not consider the circumstances of any individual.

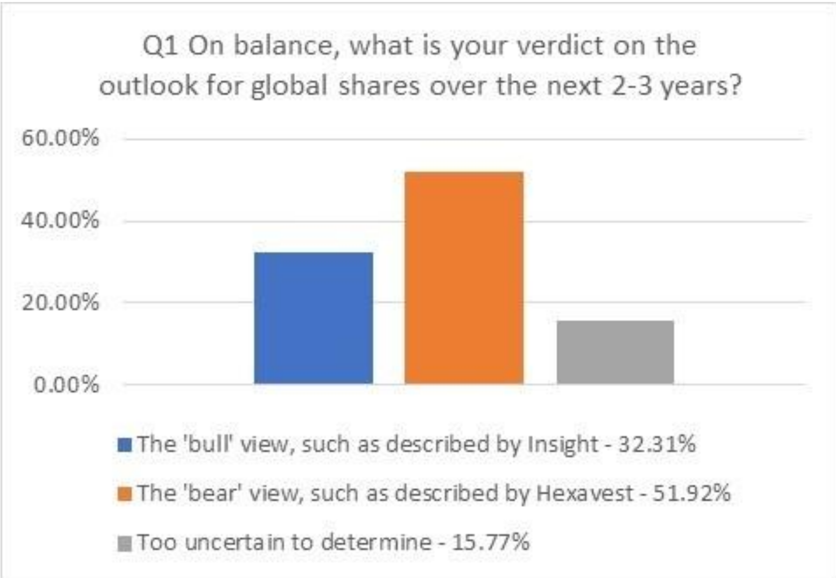
Survey results and your views on the outlook

Leisa Bell

Last week, we published two articles presenting opposing views on future potential of equity markets, the bull and the bear. We received a few hundred responses to the survey on reader opinions, with the results summarised below. We have also reproduced a range of comments. Our thanks to the participants.

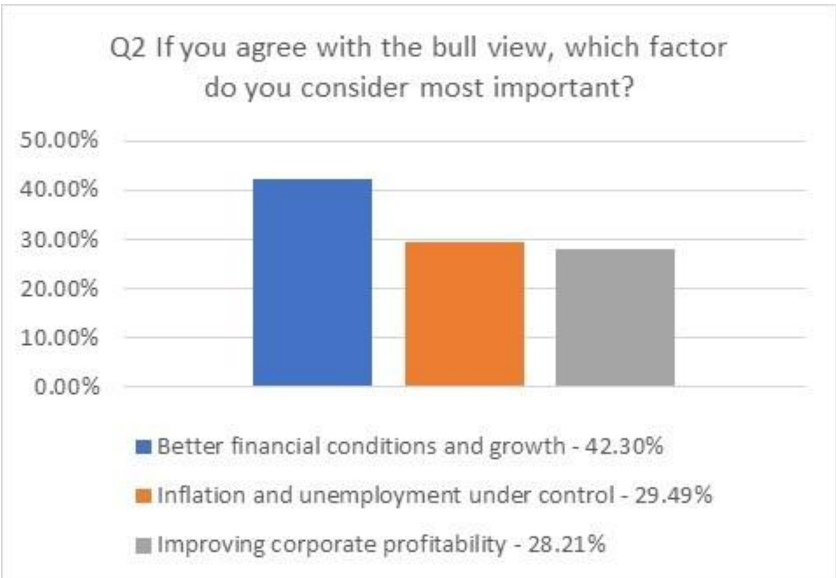
Question 1. On balance, what is your verdict on the outlook for global shares over the next 2-3 years?

Over half the responses backed the more pessimistic outlook.



Question 2. If you agree with the bull view, which factor do you consider most important?

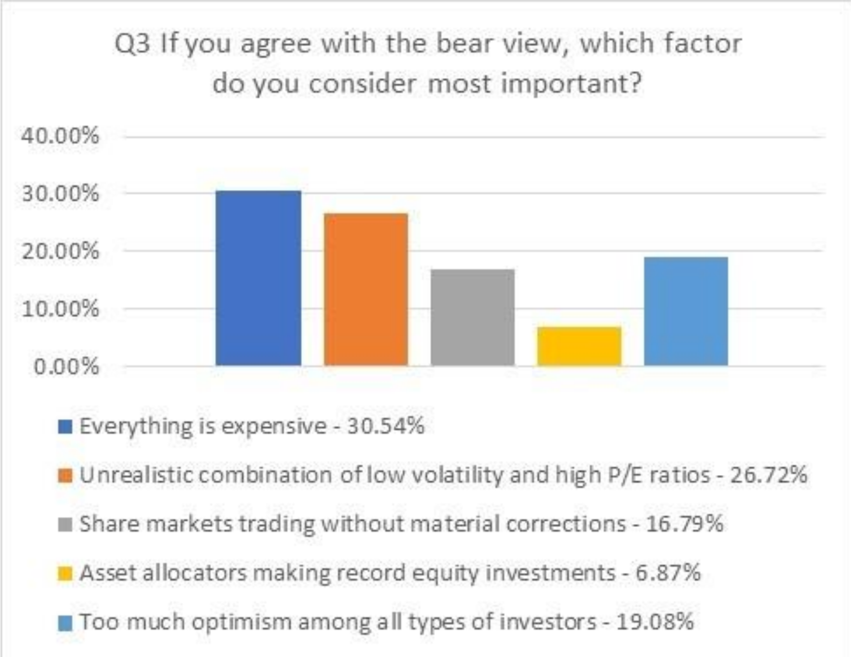
Most bulls consider better financial conditions and growth prospects to be the main drivers of the market's future prospects.



Other comments highlighted the high levels of cash looking for a home (i.e. yield), minerals demand from China, improvement in world-wide standards of living, and central bank policies pushing up asset prices.

Question 3. If you agree with the bear view, which factor do you consider most important?

Around one third of bears agreed that assets being too expensive is the biggest threat to the current market, closely followed by an unrealistic combination of low volatility and high PE ratios.



Other concerns centred around when currently low interest rates will increase, the adverse effects of having a high concentration of equities when markets crash, high levels of household debt, and global tensions.

Question 4. If you are undecided, what are the main uncertainties?

This was an open-ended question. A selection of comments is included here giving a good sense of the overall sentiment of respondents that remain undecided about where the market is heading.

Global politics

- The ramifications of Brexit or climate change. Can the EU (Germany) keep the PIGS etc countries bailed out? How will the refugee problems in Europe evolve?
- Uncertain global political state
- Too many disruptive forces in the world in government, it just takes one to create a black swan event.
- We cannot be sure of Korea and other world events
- Government action or maybe inaction
- threat of regional war, mass migration not able to be absorbed profitably
- Impact of Brexit uncertainty and Trump

Economy

- How sustainable is the so-called Trump lead US recovery, what will happen when quantitative easing is reversed, what will happen when interest rates eventually rise, what will happen when the debt and real estate and US share market 'bubbles' correct
- US tax changes
- I can't see any economic reason for either a bull or bear market.
- low inflation/wages growth
- economic indicators in many parts of the world look positive

Cashed-up fund managers

- Future Fund is 20% cash - and all is well. Mr Buffet is 40% cash- mother of all corrections imminent. I'm with Buffet.

Asset prices

- Bubbles in housing, tech stocks, some Asian markets etc
- earnings not keeping pace with valuations

Interest rates

- Interest rate rises.
- Long period of too low interest rates

Investor behaviour

- It is impossible to predict animal behaviour in the markets.
- Keynes: "markets can stay irrational longer than I can stay [on the sidelines]"
- Having endured a lifetime of up and down markets with boom and bust I still lean to a somewhat balanced approach albeit leaning towards being a bull.

Question 5. Any other comments?

We had many and varied comments for this question. Here are some responses:

- Rate of technical change and automatic computer trading worry me.
- A healthy correction (>10%) in the US - especially tech stocks, will flow on to other markets; flush out over run stocks and underpin the market for further growth. I worry if the correction does not come before the end of this year. There is some irrational exuberance building and it needs to be brought back to reality for sustainable growth and to avoid a bearish over reaction which will kill consumer and business confidence.
- Interest rates will remain low for longer, again. Economists have forecast 8 of the last 3 recessions and have been consistently wrong about interest rates for the past 3 years.
- End to bond buying by government
- History repeats time and time again. Debt remains, and it's not going away in a hurry. My economy would be pretty good with low interest rates and a visa that appears unlimited. I feel the 55-day interest free period will end within the next year.
- Emotive and media-influenced purchases now causing rallying which I presume will lead to subsequent correction as everything is too expensive now given the global risks and uncertainties around us at this time.
- Big crash still on the way
- The Trump bump may be followed by the Trump slump.
- Central bankers are making it up as they go
- Asset prices are high compare to Income/wages
- On historic terms the markets have run too hard too fast and are overdue for a correction.
- Such divided opinion would suggest we are in uncharted waters
- By the numbers, the Dow Jones is overvalued and a reversal is on the cards, but not yet.
- When the autopsy of the next market collapse is performed, I'm confident that Bitcoin will feature prominently in the Coroner's report...
- I expect low growth with a fully priced market and don't expect either a bull or bear market.
- I feel that it is unlikely that global sharemarkets will move in sync over the next 3 years. I would not be surprised if US markets collapsed whilst European and Asian markets improved.
- It always corrects sooner or later.

- US market will have a big drop -say 10-15%-other countries will not have such a big fall -interest rates must go up across the globe. China will become the dominant global leader-The rise of India will keep Australian mining at the fore and offset the decline in retail and the general phasing out of shopping centres as the proportion of online sales increases
- I do find assets over priced but then its relative to the low 10yr Gov Bond rate. Coupled with the unknown economic environment of record debt yet business as usual. I thought house prices would never get this high as a ratio to earnings, yet it appears the high real-estate valuations are here to stay.
- Overpriced US market could be an issue, but Aus market is close to historical averages and there is enough scepticism in the market to keep prices sensible. Any US led pullback should have limited impact here.
- Good well-run companies continue to make profits
- Personal debt may influence the outcome
- I am a Bear because I think that the psychology of the moment points that way rather than the data. It will take very little to happen politically somewhere in the world for sentiment to change overnight. Too many egos and no common sense.
- Australian efficiency and output needs to improve.
- US tax cuts being implemented will have an impact
- To be certain I expect change. I am bullish on new technologies, bearish on established businesses which can't/don't move with the times.
- There are many more factors to consider, and anyone can cherry-pick signals from the data available, but it comes down to when will sentiment change and that will be when interest rates change to an extent that people and companies cannot service their debt.

Leisa Bell is Assistant Editor of Cuffelinks.