Cuffelinks
Connecting investors with ideas

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Gemma Dale's Top 5 Articles from the last 5 years

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Welcome to this Summer Series edition of Cuffelinks. In theory, this time of year gives us an opportunity to take a break and come back refreshed and renewed for the new year. It is often also a time when we have the opportunity to read, think and consider more deeply those ideas and insights that may not get our closest attention during busier times. These moments away from the noise are wonderful for giving perspective, helping to consider what is most important to us, and how to improve in the year ahead.

In the spirit of reflection, and improving oneself, the five articles I've found most valuable to reconsider start with **Cuffelinks Special 200th Edition** article, collating the two most valuable pieces of advice that over 30 investment professionals would give their 20-year-old selves. This piece becomes richer with every read, and is peppered with gems that will help to improve my decision making for decades to come.

Having spent many years in the public eye as an SMSF specialist, I am regularly asked about property investment within superannuation. The borrowing rules and their application continue to inflate – and then dash – investor hopes and understanding how it works is still limited. **Monica Rule**'s excellent piece on how those rules apply to property development continues to hold true.

For those contemplating retirement, an investment concept that garners insufficient attention is sequencing risk. It's the risk of poor market performance early in the investment period, reducing the potential for longer term performance. **Kevin O'Sullivan**'s article should be read by all investors and professionals dealing with retirement.

I recently re-read **Roger Montgomery**'s piece, *Bubbles and the corruption of risk*, quoting Stanley Druckenmiller, formerly of the famous George Soros' Quantum Fund. Druckenmiller references raisings for credit of dubious quality and Montgomery points to stretched equity valuations as having the potential to create a 'phony asset bubble'. Nearly three years since this piece was written, equities have rallied strongly and credit markets have suffered no significant correction, but the warnings are there.

And finally, life is not all spreadsheets, as **Jack Gray** reminds us in *Poetry for Investors*. Sometimes the greatest insights come from the least likely sources.

A final honorary mention for Alex Denham's powerful article on the aged care experience of her father. Alex has spent much of her career dissecting the complexities of the legislation governing super, tax, social security and aged care for financial planners and their clients. Utimately what matters is the experience of your loved ones, and how we care for them.

Gemma Dale, Guest Editor

Gemma Dale is Director, SMSF & Investor Behaviour at nabtrade.

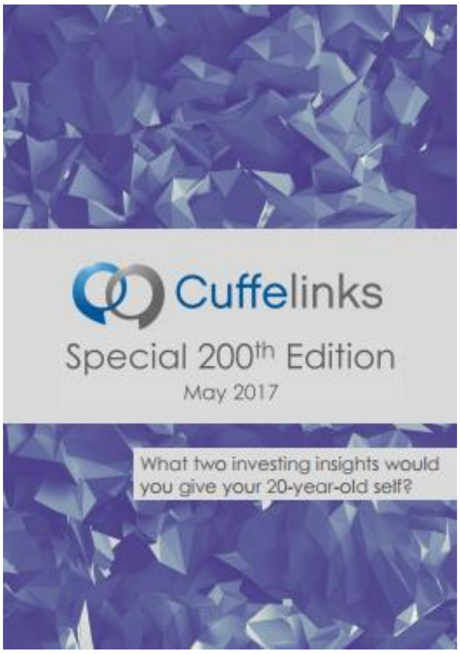
What two investing insights would you give your 20-year-old self?

by Cuffelinks on May 4, 2017

To mark our 200th edition, we asked investors and market experts for the top two investing insights they would give to their 20-year-old selves if they could go back in time.

Contributors: Hamish Douglass, John Pearce, Alex Denham, Shane Oliver, Chris Stott, Roger Montgomery, Andrea Slattery, Rob Prugue, Warren Bird, Jeremy Cooper, Monica Rule, Karl Siegling, Rodney Comegys, Geoff Wilson, Judith Fox, John O'Connell, Noel Whittaker, Don Stammer, Olivia Long, Alex Vynokur, Jonathan Rochford, Phillip Ruthven, Besa Deda, Peter Thornhill, Hugh Dive, Graeme Colley, Rachel Lane, Greg Paramor AO, Paul Moore, Crispin Murray, Jo Heighway, Bryce Doherty, David Bell, Ashley Owen, Leisa Bell, Graham Hand, and Chris Cuffe.

Due to the length of this piece, please read from the website, or download the eBook:



SMSF borrowing for land development is not fertile ground

by Monica Rule on February 7, 2014

The ability of SMSFs to borrow money for investments and especially property has led to many client enquiries on how the limited recourse borrowing arrangements (LRBA) operate under the superannuation laws.

Many SMSF investors believe they can borrow money to purchase vacant land and build a residential house on it. Some are even considering purchasing a property (i.e. house and land) with the intention of demolishing the existing dwelling and building a new house or rezoning to build residential units.

Under LRBA, the borrowed money can be used to purchase a single acquirable asset as well as to cover expenses related to the purchase, such as conveyancing fees, stamp duty, brokerage and loan establishment costs.

Borrowings can also be used to pay for expenses incurred in maintaining or repairing the asset to ensure its financial value is not diminished.

However, the borrowings must not be used to improve the single acquirable asset.

An SMSF trustee **CANNOT** enter into a LRBA to purchase a single acquirable asset that is:

- vacant land, then use some of the borrowed money to build a residential property on the land. This is because the building of the residential property would be an improvement to the single acquirable asset.
- vacant land, then use money accumulated in the SMSF to build a residential property on the land. Although you can use money in the SMSF for improvements, you cannot change the nature and character of the single acquirable asset so that it becomes a different asset. The property acquired under a LRBA will no longer be vacant land.
- a property consisting of a house and land, then use some of the borrowed money to demolish the existing house and build a new house on the land. Again, this is because the borrowed money is used to improve the property.
- a property consisting of a house and land, then decide to use the money accumulated in the SMSF to demolish the existing dwelling, rezone the land and build new units on the land. This would also be treated as an improvement to the single acquirable asset.

If a trustee wants to develop anything on vacant land purchased under a LRBA, demolish, rezone or build a new dwelling where it would amount to changing the nature and character of the acquired asset, then the loan under the LRBA must be fully repaid prior to making any improvements or changes.

The reason for this law is because improvements would fundamentally change the nature of the asset which is being held as security for the loan, and potentially increase the risk to the SMSF in the event of a default on the loan by the SMSF. Remember, the lender only has recourse to the asset which the borrowed money has been used for. If the lender seeks repayment of the unpaid loan, and the SMSF is not in a position to make any additional payments on the loan, the lender could seize the asset acquired. If that asset happens to have a brand new house sitting on top of it that's going to be a big problem for the SMSF.

Monica Rule worked for the Australian Taxation Office for 28 years and is the author of 'The Self Managed Superannuation Handbook – Superannuation Law for Self Managed Superannuation Fund in Plain English'. *She now runs her own business focussed on SMSF and superannuation education and consulting.*

Sequencing risk and ways to manage it

by Kevin O'Sullivan on March 6, 2013

'Sequencing risk' is the risk of experiencing poor investment performance at the wrong time, typically when the portfolio balance is at its greatest. In Jeremy Cooper's *Cuffelinks* article last week, he highlighted that "our defined contribution (DC) system was never designed to provide retirement income, but just a lump sum to retire with." In arriving at that lump sum to retire with, fund members must contend with sequencing risk, particularly late in their accumulation phase and early in the decumulation phase.

An example of 'sequencing risk'

When good or bad returns occur can be almost as important as the *size* of the returns. That is, the sequence of investment returns, not just the average of those accumulated returns, is critical. And unfortunately, no one has come up with an approach to affect or determine, before the fact, the sequence of market returns.

Let's consider two individuals who made net superannuation contributions of $10,000 per annum over a 20-year period. Let's also assume that, over that 20-year period, the average investment earning rate on the savings of both individuals was identical, say 7% per annum. And finally let's assume that the returns of each individual were identical in years 2 through 19 but individual 1 had a -10% return in year 1 and a +10% return in year 20 and individual 2 had the opposite returns, +10% in year 1 and -10% in year 20.

As individual 2 experienced the significant negative return in the final year, the time at which the balance was the largest (and closest to retirement), his account balance at the end was $402,634, **$81,000** lower than the $483,636 balance of individual 1 (as individual 1 experienced the significant negative return early on, with a much lesser impact).

This risk of experiencing poor investment performance leading up to or shortly after retirement ranks alongside market risk, inflation risk, longevity risk and liquidity risk as key risks to manage to ensure savings are adequate for sustainable retirement income.

When are individuals most exposed to sequencing risk?

It can be extremely disheartening when poor investment performance comes at a time close to retirement, when an individual's account balance may be close to a desired retirement amount. In addition to the losses, it can lead to actions that the individual would have preferred to avoid – working longer, reducing expenditures, possibly increasing investment risk to achieve higher asset growth. And it may be difficult for a person, once they have retired, to recover from poor investment returns or to buy securities at deflated prices.

The period of greatest risk is typically considered to be the last 10 years of the accumulation phase and the first 10 years of the decumulation phase (although some studies postulate that it begins earlier than 10 years before retirement). The sequence of returns during this period will have a significant impact on the sustainability of a retirement income, leading to an increase in the probability of 'portfolio ruin' post retirement.

Whilst few Australians buy an annuity on retirement, sequencing risk can be even more acute in countries where individuals must purchase an annuity at the time of their retirement. They may also be exposed to buying an annuity at a time when market prices for annuities have increased significantly due to reductions in future yields on securities that insurers use to back the annuities. For example, at present, some lifetime annuities in Australia are priced using a negative implicit real return.

How to mitigate the risk

There's much good research on this topic but no perfect solution to mitigate the risk. And market timing is clearly not a viable option, even if it may have worked for some.

In considering their members' best interests, trustees of large superannuation funds should consider how they can help members to manage sequencing risk. This might include segmenting members based on age and account balance, using target date funds, improving communication of the risk and provision of downside protection for members in the retirement risk zone.

How might individuals mitigate the risk, knowing there is no perfect solution?

- **Reduce the level of investment risk as retirement approaches.** The aim is to lower the chances of significant losses on a retirement nest egg, but when should an individual start to de-risk? What are optimal levels of risk to accept? As most individuals' superannuation savings will remain invested for many years after their retirement, should they de-risk as much as occurs in some target date funds? If they take too little risk they may end up with insufficient retirement income. With too much risk, poor returns can erode their savings and jeopardise the sustainability of their retirement income.

- **Increase the level of diversification in the savings portfolio**. But even with greater diversification, poor performance still can occur. Also, at times of stress in the markets, assets previously considered to be uncorrelated may follow each other down.

- **Buy annuities and/or deferred annuities.** This can address post-retirement sequencing risk but doesn't address pre-retirement sequencing risk. Also the market for annuities in Australia is still relatively small and individuals could be exposed to high annuity prices at time of retirement.

- **Spread contributions more evenly over a working life.** Risk could be more evenly spread if contributions were high initially and decreased as one approaches retirement, but individuals would likely be reluctant to put more money into super when they are younger.

- **Adjust asset allocation over a working life.** Higher exposure to growth assets in the early years than occurs with typical exposure levels by investing mostly in equities (or achieve even higher than 100% exposure using call options or gearing) when younger but switch to less volatile assets when approaching retirement.

- **Keep sufficient assets (about two years of expenditures) in a liquid fund.** This would allow an individual to avoid the need to cash out investments after a significant fall in the markets, before markets have had time to recover. But this does not provide protection from risk on the balance of the portfolio.

And finally, individuals could choose to defer retirement or save more! That is, an individual could target a retirement funded ratio – a Defined Benefit (DB) concept – of greater than 100%, where a target is set greater than expected requirements. This provides a buffer where, faced with one or two years of poor investment performance around retirement, the retiree would have a greater chance of funding the desired post-retirement lifestyle.

Use of a target funded ratio approach could also lead an individual to consider whether it is necessary to take as much risk close to retirement. More employer sponsors of DB funds are doing this as their funded ratios improve towards 100% or more.

To summarise, dealing with sequencing risk is important for people who generally want to save enough to have a retirement income greater than the age pension. Besides considering actions whilst they are approaching retirement or shortly thereafter, individuals need to take some steps at a younger age – start earlier, save more, lower their risk as assets grow, understand their retirement objectives and the consequent saving needs.

Kevin O'Sullivan is Director, Actuarial & Benefits Consulting at Russell Investments.

Bubbles and the corruption of risk

by Roger Montgomery on February 26, 2015

I have previously warned that the combination of the demographic avalanche of retiring baby boomers, low interest rates and a disproportionately large amount of their wealth in cash would mean that stocks and property would continue to rise for a while. I call it 'The Boom We Have to Have.' But like all booms, this one will also bust.

These conditions, especially low rates forcing a big part of the population into riskier products, corrupt investors' sense of risk. Rising prices amid a wave of buying reinforces the behaviour of investors and their brokers who believe their thesis is correct.

New listings and credit point to problems

I am not alone in the view that at some point in the next six to eighteen months, there is a real chance that baby boomer retirement plans may sink thanks to their inability to avoid repeating the investment mistakes of their past. Stanley Druckenmiller is an American hedge fund manager, famous for being the lead portfolio manager for George Soros's Quantum Fund. In 2010, Druckenmiller handed back the billions he had been managing for 30 years through his firm Duquesne Capital. He remains a noted philanthropist, keen golfer and speaker on the global investment and macroeconomic circuit.

Druckenmiller should be heeded. He observed that low rates have skewed peoples' sense of risk, particularly in two markets – new share listings (IPO's) and credit. He pointed out that 80% of companies listed in 2014 have "never made a dime". In 1999, just before the tech crash, that number was 83%.

(As an aside, over the Christmas break, I read *You Only Have To Be Right Once: The Unprecedented Rise of the Instant Tech Billionaires.* Including Twitter, Facebook, Instagram, the book was a who's who of the world's biggest tech companies and the backgrounds to their stunning rises. But I couldn't help noticing that all the references to billions had little or nothing to do with profits or in some cases even revenues. Some of the businesses discussed, which were sold for billions, not only had no revenue but no revenue model either).

Druckenmiller had another warning on credit markets. Last year, speaking on CNBC, Druckenmiller said, "When I look at credit … corporate credit is growing at a record rate, far faster than it grew in 2007. And S&P pointed out that 70% of debt issued has a B-rating or worse. To put that in perspective, in the '90s, that number was 31%. Do you remember the hullabaloo in 2007 about covenant-light loans? Companies issued $100 billion of them in 2007, and 38% was B-rated. This year we're going to $300 billion, up from $260 billion last year and $90 billion a year earlier, and 58% of them were B-rated."

At the more recent speech, Druckenmiller also observed, "There are some really weird things going on in the credit market … but there are already early signs starting to emerge. And if I had a message out here, I know you're frustrated about zero rates, I know that it's so tempting to go ahead and make investments and it looks good for today, but when this thing ends … I think it could end very badly."

Why is Druckenmiller so worried? It's simple. If interest rates rise, many investors in corporate debt will want to exit at the wrong time. Australian investors in bank hybrids and corporate bonds (G8 Education is a recent example of a popular corporate bond issuer) should consider the warning too. And if interest rates don't rise, but the economy weakens significantly, then some industries will be unable to cover their debt costs. Either way, investors will face problems at some stage.

Low rates support asset prices

Low interest rates are here to stay for a while and that will support asset prices. Eventually however the price of those assets (stocks and property) will be pushed way too high (we think a strong bull market is likely for some part of this year) as people panic buy amid a fear of missing out when their income is eroded from low rates on cash. After that, a large number of investors will, sadly, suffer financially again – from buying too late and paying too much.

There is a way to avoid it. You must be invested in high quality businesses with bright prospects and buy them when they are cheap. We can think of only a handful of stocks that meet this criteria currently. When we cannot find such opportunities, the only safe alternative is cash (even though rates are low) and we are 20-30% invested in cash at the moment.

If you are invested in a high-performing fund that is fully invested in stocks like REA Group (P/E ratio 44 times), Dominos Pizza (68 times), or many of the expensive stocks below, consider switching at least some of your retirement nest egg to a larger cash weighting. The cash won't make your investment 100% immune to a declining market but it will allow additional purchases at cheaper prices, which offers the opportunity to significantly reduce the time to recovery. In Table 1, PER is Price to Earnings ratio.

Table 1. Expensive stocks? You be the judge…

Name	PER	Name	PER
Ramsay Health	42	3P Learning	42
Bursons	53	Aristocrat	46
TPG	33	Blackmores	28
Dominos Pizza	68	Invocare	33
ARB	20	Dulux	21
Cochlear	44	Carsales	26
Corporate Travel	60	Boral	41
REA Group	44	Beacon Lighting	28
Freedom Foods	39	Bega Cheese	38

Of course if interest rates stay at zero, the party could last a while yet, but as I have warned previously, be sure to be dancing close to the door in case you need to leave. Druckenmiller refers to a "phony asset bubble", with a bunch of investors ploughing money into assets which will "pop". Then we'll see how many people are still enjoying the party.

Roger Montgomery is the founder and Chief Investment Officer of Montgomery Investment Management.

Poetry for investors

by Jack Gray on May 16, 2014

In the heady 1960s, students demanded an injection of culture into the narrow training of economists, engineers and other technocrats. Courses such as *Poetry for Physicists* flourished as part of a utopian vision that humanities would sensitise future leaders, a vision whose minimal expectation was that technocrats will at least have read a novel.

Even by that low standard the movement failed as almost none took it seriously, neither physics students nor their teachers nor administrators. And today in a world where that ugly notion 'relevance' dominates institutions of supposed higher learning, the gap between the two cultures, the technical and the humanities, has widened, such as reported here.

Today, unfortunately, Finance is the prime path to financial success, a path that values culture even less than did engineering 50 years ago. One investment professional proudly declared his studied ignorance of any history because what happened in the past is *"boring, irrelevant and would clutter my mind."* Pity he hadn't listened to the Roman orator and writer Cicero (106-43 BCE) who understood the incipient dangers of historical ignorance, *"To not know what happened before you were born is to be a child forever."*

I hesitate to promote poetry on the grounds of relevance, nonetheless the following poetic statements do offer insights and provocations that can make for wiser investors. Hear how poetically the German thinker Wolfgang Goethe (1749-1832) hints at our (investment) biases, *"We know for certain only when we know little. With knowledge, doubt increases."* The notoriously difficult American/English poet T S Elliot (1888-1965) further captured the epistemological challenges investors face: *"Where is the wisdom we have lost in knowledge? Where is the knowledge we have lost in information?"*

The English sometime poet G K Chesterton (1874-1936) does seem to appreciate investing's central challenge, as evident by the sting in the tail, *"the real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest type of trouble is that it is nearly reasonable, but not quite. … It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait."*

With greater specificity the Russian Boris Pasternak (1890-1960) also warned of over-emphasising rigour, processes and (risk) measures, *"what is laid down, ordered, factual, is never enough to embrace the whole truth: life always spills over the rim of every cup."*

In a not dissimilar vein the prolific Greek C P Cafavy's (1863-1933) poem *Things Ended* reminds us of the limits and dangers of stress-testing,

"Engulfed by fear and suspicion,
mind agitated, eyes alarmed
we try desperately to invent ways out,
plan how to avoid the obvious danger
that threatens us so terribly.
Yet we're mistaken, that's not the danger ahead:
the news was wrong
(or we didn't hear it, or didn't get it right).
Another disaster, one we never imagined,
suddenly, violently descends upon us,
and finding us unprepared – there's no time now –
sweeps us away."

Herding, that most human of responses, offers a false sense of protection from those "dangers ahead". To be like others is the default strategy of (almost) all managers, consultants and super funds, and one that ineluctably results in following fashion. The wonderfully cynical Irish poet Oscar Wilde (1854-1900), captured the inherent short-termism in that behaviour through his aphorism, *"fashion is a form of ugliness so intolerable we have to alter it every six months."*

To avoid excessive herding requires sometimes choosing the road less travelled, as did the American poet Robert Frost (1874-1963) in his beautifully lyrical (almost) eponymous poem,

Two roads diverged in a yellow wood,
And sorry I could not travel both
And be one traveler, long I stood
And looked down one as far as I could
To where it bent in the undergrowth;

Then took the other, as just as fair,
And having perhaps the better claim
Because it was grassy and wanted wear,
Though as for that the passing there
Had worn them really about the same,

And both that morning equally lay
In leaves no step had trodden black.
Oh, I kept the first for another day!
Yet knowing how way leads on to way
I doubted if I should ever come back.

I shall be telling this with a sigh
Somewhere ages and ages hence:
Two roads diverged in a wood, and I,
I took the one less traveled by,
And that has made all the difference.

And when that path less travelled does lead to success (as surely it sometimes must) and when we then suffer from hubris (as surely we will) we should be reminded of the fate of Ozymandias (as surely we won't) so powerfully captured by the absurdly young English poet Percy Bysshe Shelley (1792-1822),

"I met a traveller from an antique land
who said: `Two vast and trunkless legs of stone
Stand in the desert. Near them, on the sand,
Half sunk, a shattered visage lies, whose frown,
And wrinkled lip, and sneer of cold command,
Tell that its sculptor well those passions read
Which yet survive, stamped on these lifeless things,
The hand that mocked them and the heart that fed.
And on the pedestal these words appear —
"My name is Ozymandias, king of kings:
Look on my works, ye Mighty, and despair!"
Nothing beside remains. Round the decay
Of that colossal wreck, boundless and bare
The lone and level sands stretch far away."

Perhaps in some small way poetry can help us transcend the accusation, *"what do they of investing know who only of investing know?"*

Dr Jack Gray is a Director at the Paul Woolley Centre for Capital Market Dysfunctionality, Faculty of Business, University of Technology, Sydney, and was recently voted one of the Top 10 most influential academics in the world for institutional investing.