

### This Week's Top Articles

- **Kitces Part 2: Where advice went wrong and where to now** *Graham Hand*
- **Give me the long-term predictability of shares, at any age** *Peter Thornhill*
- **Will the success of non-residential real estate continue?** *Adrian Harrington*
- **Five challenges for post-retirement products** *David Bell And Estelle Liu*
- **Let's refocus the active v passive debate** *Sean Henaghan*
- **Four checks for a financial fire drill** *Nigel Stewart*
- **A checklist for buying LICs at a discount** *Julia Stanistreet*

### Kitces Part 2: Where advice went wrong and where to now

Graham Hand

#### Introduction to Michael Kitces (MK), interviewed by Graham Hand (GH)

*Michael Kitces is recognised as the publisher of the #1 financial planning industry blog in the United States, based on awards and surveys. His website, [kitces.com](http://kitces.com), is also home to the popular Nerd's Eye View. He speaks at 50-70 conferences a year, consults widely to financial planning groups, and is a Partner and Director of Wealth Management with Pinnacle Advisory Group (Washington DC).*

*I met with him at The Portfolio Construction Forum's Finology Summit 2018, where he presented two keynote addresses including 'Robo-advisors are NOT the future (but technology is)'.*



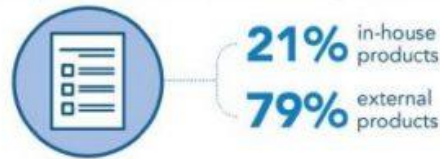
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**To give some context before the interview:** In Australia, the [Future of Financial Advice](#) (FoFA) reforms implemented in 2013 required financial advisers to act as fiduciaries and put the best interests of clients ahead of their own. The reforms also addressed conflicted remuneration and banned commissions paid to advisers by product manufacturers (such as asset managers). Similar legislation has yet to be passed in the US, and some of Michael Kitces comments should be viewed in this context.

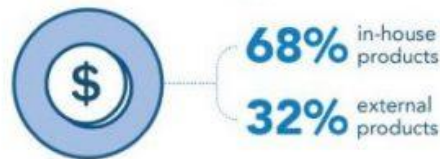
However, in a report called '[Financial advice: vertically integrated institutions and conflicts of interest](#)', issued in January 2018, ASIC reviewed the quality of personal advice in the largest licensees in the four major banks plus AMP. While the conclusions have been criticised by parts of the industry, ASIC found that clients were invested heavily in in-house products after receiving advice, and the quality of advice was often non-compliant, as shown in the graphic below.

### Proportion of funds in in-house products

#### Composition of advice licensees' product lists



#### Where customers invested their money after receiving personal advice



### Quality of advice on in-house superannuation platform



We give this background to the interview with Michael because many financial advisers will argue that FoFA fixed the main problems, that much of the Australian advice industry has moved to fee-for-service, that advisers are leaving the large institutions and that his comments relate only to the US. ASIC's research suggests many of these issues remain relevant in Australia, although clearly many financial advice firms have adopted high standards.

**GH:** How do you see the changes brought on by the ban on financial advisers accepting 'conflicted remuneration' or commissions from fund managers?

**MK:** I wrote an article maybe five years ago with predictions on how the Australian market might play out under FoFA based on what we'd seen in the US. A major theme was the expansion towards more independent advisers and platforms because it's much less compelling for large vertically integrated firms to provide wealth services when they just get paid for the advice. They cannot be vertically product distribution channels any more. I hear now a few of the large firms are spinning off their wealth management businesses.

**GH:** Why can architects and lawyers charge \$10,000 to do a job but most people will not pay a financial adviser such amounts?

**MK:** We're terrible as financial advisers at explaining our value proposition. We don't target well. Clients say, "What are you going to do for me?" We say, "I'll help you with whatever you need." That sale only works with people who think they are so incompetent at managing their own personal finances that they need an adviser.

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Most people have not become so destitute about their own competency that this is a valid value proposition. And then we make it worse with impossible brand promises.

Surveys in the US show there are two primary ways financial advisers differentiate themselves. Number 1, my ability to understand the needs of my clients. As if anyone would ever say they don't understand. Number 2, 72% said they differentiate on the breadth of my expertise. NOT the depth. So my marketing brand promise to clients is that I know more about everything than anyone else, which is not even believable. And it's not possible for 72% of advisers to be above average. The math doesn't work. We struggle to make any differentiating statements, they are barely table stakes.

When the product goes away and advisers have to sell the advice itself, they are still figuring out how to do that. The worst paid people in any knowledge profession are generalists. Specialists get paid more. That is the evolution we are making. For example, I know what a brain surgeon does. When I've got that problem, I'll pay a lot of money for that solution.

**GH:** So if you have an adviser client who has this communication problem, what do you tell them to do?

**MK:** Advice should be about deeper niches and specialisations. That's the evolution of the next 15 to 20 years. Down that road, you can market and differentiate more effectively. You can create more tangible advice outcomes relating to the exact type of people you are working with, and better client experiences. It's easier to do when all your clients are the same. You gain efficiencies because you don't need to look up new things about how to handle the next client. You become the leader and expert in that niche. You can sit across from people and give \$500 an hour advice off the top of your head. Right now, you can't do that so you have to price in the time it takes to research, and the time it takes you to market and find clients because you're not recognised for any expertise.

**GH:** Why can I go into a Ford car dealer and accept that he will only sell me a Ford, and nobody questions that? But if I go into a financial adviser, and they sell me the in-house product of the vertically integrated wealth business, that is unacceptable.

**MK:** Because Ford does not market itself as a comprehensive automotive consultant. They are Ford car salesmen or women. I know what I'm going to get. Here's an analogy: if I go into a butcher's shop, they will sell me meat. Everybody understands that, they don't advertise themselves as dietary nutrition experts who happen to always sell meat. The problem is not the nature of the product sale. The problem is we've attached the label 'advice' to product sales. Technology is making it easy to sell products so we can't get paid for products. Now we get regulatory conflicts when sales people give advice. It's a global issue as countries define a fiduciary rule.

**GH:** What's wrong with saying, "I sell my own products, and they are high quality and competitive"? We simply accept it's sales, not advice.

**MK:** It's the label problem. If we said, "This is my annuity sales person, would you like to talk about our annuity product?" then all of these problems go away.

**GH:** So why don't we do that?

**MK:** Because advice sells better. You can sell more annuities or investment products or insurance or whatever proprietary thing you want under the guise of advice. The industry did their marketing studies and found when you put 'financial consultant' on the business card, people buy more. But the sales industry took it too far, consumers complained to the regulators, who said they will now regulate advice.

I would prefer not to see uniform fiduciary standards across financial services, I prefer a 'truth in advertising' control of titles that says 'sales person' on the business card. I know when I go to The Gap and they say the jeans look good on me, that they work on commission. I know how to judge that advice. We understate how knowledgeable consumers actually are about basic relationship dynamics like advice versus sales. The dilemma is that the regulators have come in and said if those are the titles you're going to use, we're going to regulate you.

*Graham Hand is Managing Editor of Cuffelinks.*

## Give me the long-term predictability of shares, at any age

Peter Thornhill

*As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates.*

*It is a terrible mistake for investors with long-term horizons – among them, pension funds, college endowments and savings-minded individuals – to measure their investment "risk" by their portfolio's ratio of bonds to stocks. Often, high-grade bonds in an investment portfolio increase its risk."*

*Warren Buffett, 2017 letter to Berkshire Hathaway shareholders, published 24 February 2018.*

I noticed with sadness that an [article promoting 'life cycle' investing](#) was published in Cuffelinks last week, pushing this asset allocation technique as a sensible retirement alternative.

In 2015 Glenn Stevens, the then Reserve Bank Governor, pointed out the huge cost required today to produce a reasonable level of income and, more importantly, generate a sustainable income for longer retirements.

*"In a low interest rate world, the problems of providing retirement incomes will become ever more prominent. The very low level of yields on fixed income assets means that it is very expensive today to purchase a secure stream of future income, which is what someone who is retiring is usually seeking. And there are more of such people, living longer.*

*The retiree can of course respond to this by holding more of her portfolio in dividend-paying stocks – accepting more risk. She may hope for a dividend stream that is fairly stable from year to year but that tends to grow over time."*

*Glenn Stevens, 'The Long Run', address to the Australian Business Economists, 24 November 2015*

Put simply, from the heady days of the late 80's/early 90's where a \$1 million dollar bank deposit would have produced around \$140,000 income a year, on this same amount we have seen the income fall to around \$30,000 in 2018. I refer to this as the 'cash crash'. If the sharemarket fell by 80%, can you imagine the outcry?

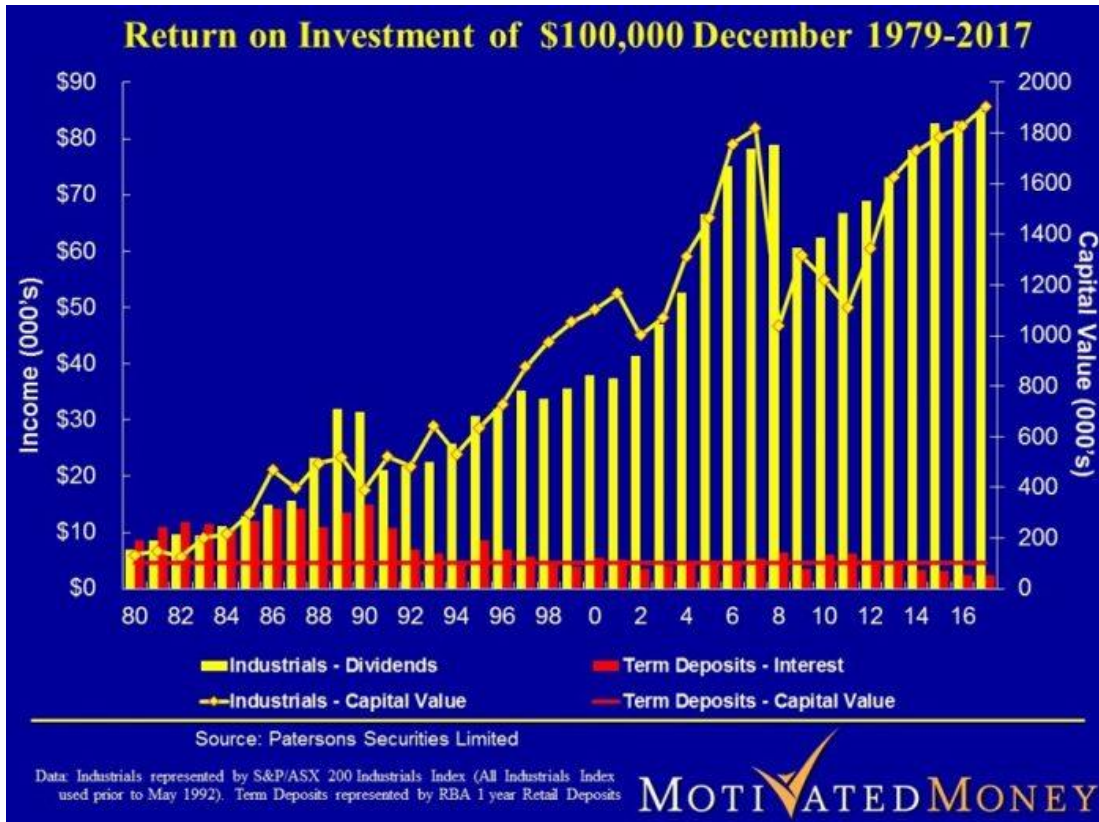
### **Challenging the definition of 'risk'**

Investing is about survival and we are living a lot longer in retirement than most people imagine or plan for. The greatest danger is locking into artificially low rates of return for long periods, such as with bonds, term deposits or annuities. I am reminded of the Law of Unintended Consequence when seeking the 'security' of cash instruments.

Stevens also reinforced my theme when talking about people facing retirement today when he said; *"They have to accept a lot more risk to generate the expected flow of future income they want"*. I accept that he is using the traditional measure of risk and is referring to the volatility of capital. I, however, will not accept that volatility of capital is a satisfactory measure of risk provided one is a long-term 'investor'.

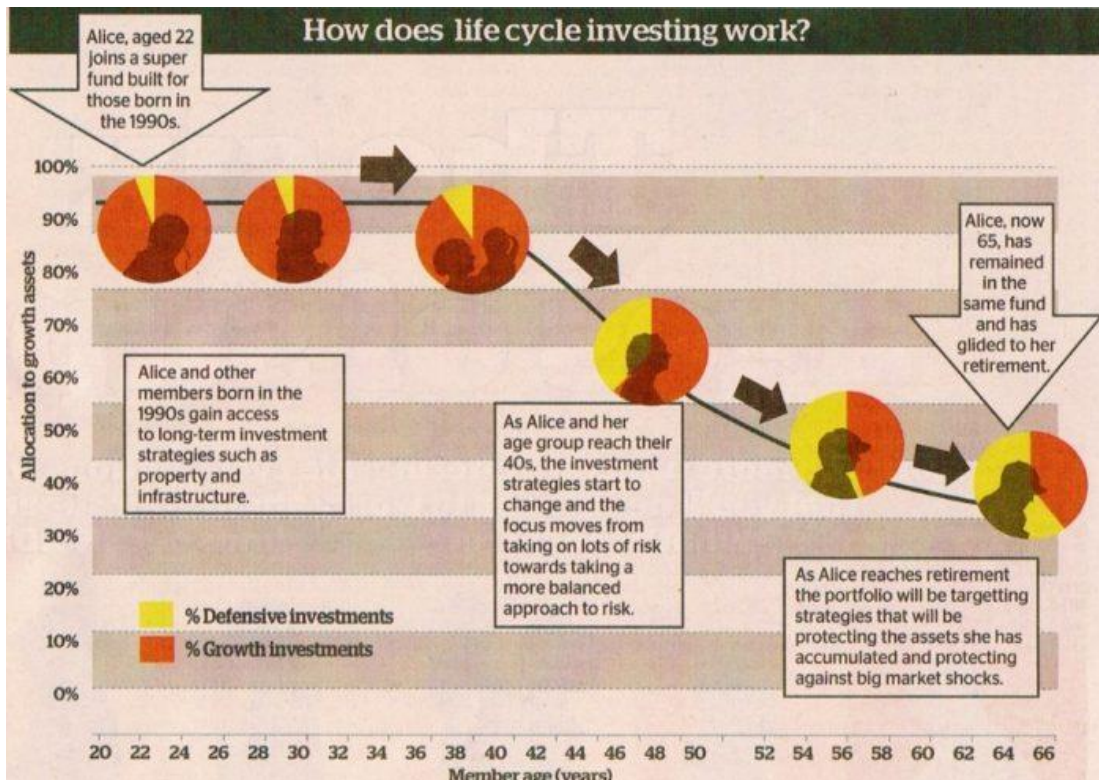
On the basis that a picture is worth a thousand words, the 'mothership' (as I call it) chart below, comparing cash deposits with industrial shares over 37 years, hopefully speaks for itself. This example shows \$100,000 invested in both industrial shares and term deposits in 1979, with all income from both investments spent and not reinvested. After receiving interest payments every year, a term deposit is still \$100,000 after 37 years whilst shares, in addition to the income received, are now worth \$1.9 million. I must add, as with the interest, no dividends have been reinvested during this period.

This is why I prefer the safety and security of the sharemarket to risky assets like term deposits. I can live with short-term volatility over 40 years. It is my friend during accumulation phase as I inevitably buy more when the market is cheap and less when it is expensive. In retirement, I want income and for me, the volatility in the value becomes a non-issue.



**The life cycle investing argument**

In the same vein as the Cuffelinks article on life cycle investing, an article titled, 'Your super can grow old gracefully' in the Sydney Morning Herald in 2015 caught my eye. The chart below from the article explains graphically how an investor can automatically be transitioned from 'risky' growth assets into more conservative investments as they approach and then enter retirement. It is posited as a sensible and conservative approach.



Source: Sydney Morning Herald, 5 March 2015

Proponents of this strategy explain that this will ensure the security of your financial future. Thankfully, the authors of the article raised legitimate concerns but what annoys me about this simplistic approach is that it intimates an 'account value' without splitting it into the two components of capital and income.

It should be clear from the two charts above that theirs is the antithesis of mine. According to the second chart, as one grows older, investments will be shifted away from the yellow in my chart and more into the red so that by the time retire comes, having invested for 40 or so years, the retirement future is now jeopardised. In addition, the entire account balance in the life cycle fund will be substantially less than mine as 'they' will have been selling shareholdings over the years and switching to cash.

To quantify the disparity, or opportunity cost, associated with this strategy, consider the following. To give you a sense of the compounding effect during the accumulation phase of life, if I had reinvested the interest and the dividends, the account balances would be **\$1.3 million for cash** and **\$12 million for shares** over the 37 years. Let's take it a step further. You are now about to retire, and the account balances above can be used to produce an income. So, looking at the chart above, in retirement, your starting point for cash remains the \$1.3 million whilst your starting point for shares will be \$12 million.

The thought of this life cycle model being applied to our adult children strikes fear into my heart. If 'Alice' had stayed in the yellow, as per my chart, for all of her working lifetime, her eventual retirement pot would have been substantially greater than the outcome as proposed in the shifting asset allocation of the second chart. She, like my wife and I, would have no need for cash as a buffer to smother the volatility. The opportunity cost of the life cycle strategy will be huge. It's the opportunity cost that no one talks about and the largely irrelevant volatility. When one hits retirement, one simply stops the reinvestment and turns on the dividend stream from a substantial asset base as a pension.

### **Why sell off the best compounding asset?**

Commentators are always banging on about compounding, the '8th wonder of the world'. So why do the supporters of life cycle investing undervalue it in the latter stages of the accumulation phase of our lives? They are going to guarantee that as you progress through your working life, the strongest compounding (income-producing) asset will be sold off to buy something that will produce the lowest income stream.

The irony is that we are only now beginning to recognise the longevity risk, and retirements stretching out to equal our working lifespan. With most of your retirement fund in 'defensive' investments for 30-40 years, the experience of the last 37 years, as displayed in my 'motherhood' slide, being applied to your retirement years should hopefully ring warning bells.

There is nothing conservative or defensive about term deposits or bonds, in fact, quite the opposite. In the longevity stakes they rank as the riskiest asset you can hold. Why must we cling to the outdated concept promulgated as 'modern portfolio theory' from the 1940's? Volatility does not measure risk, it merely indicates the high level of liquidity.

Personally, I refuse to expose my family to these risky deposits, preferring instead the boring predictability of shares.

*Peter Thornhill is a financial commentator, public speaker and Principal of [Motivated Money](#). This article is general in nature and does not constitute or convey specific or professional advice. Formal financial advice should be sought before acting in any of the areas discussed. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon.*

## Will the success of non-residential real estate continue?

Adrian Harrington

Seven years into an upcycle, Australian non-residential real estate returns have stabilised according to the latest PCA/IPD Australian Property Index published by MSCI. The Index, which tracks the performance of more than 1,470 institutionally owned office, retail, industrial, hotel, and medical properties, generated a total return of 11.9% in the year to December 2017. This is below the peak of 13.7% recorded in the year to 31 March 2016 but is still above the 5- and 10-year averages of 11.5% and 8.3% respectively (Figure 1).

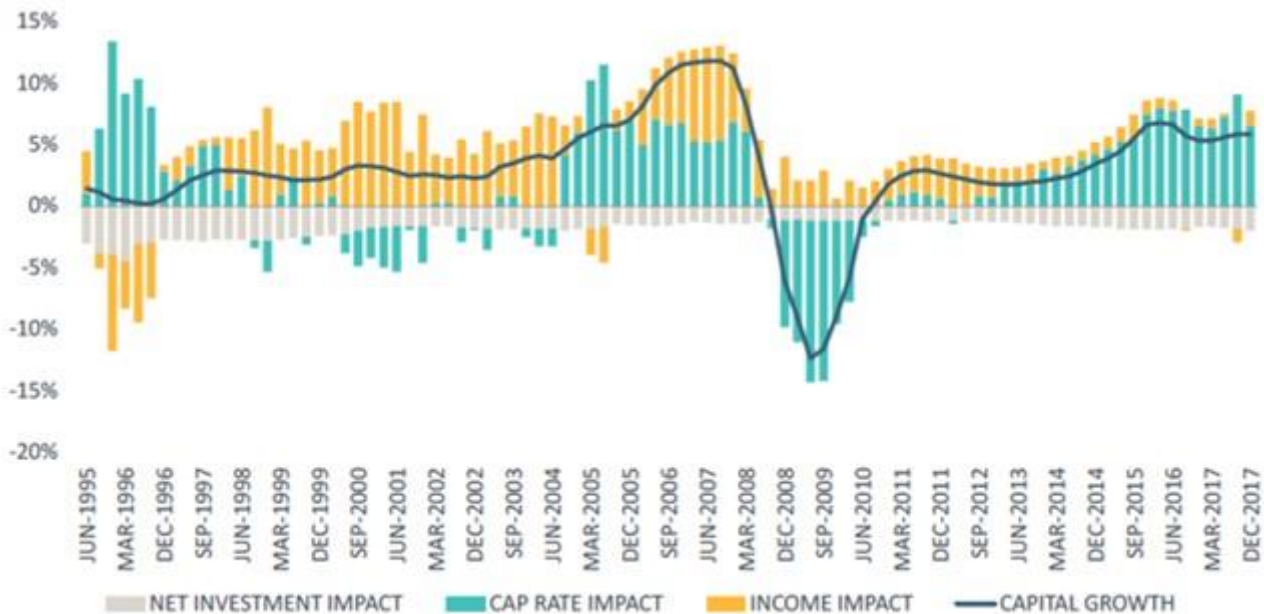
**Figure 1: Non-Residential Real Estate Total Returns: 2007 – 2017**



Source: MSCI

Non-residential real estate, like most asset classes, has been buoyed in recent years by bond yields falling to record lows. Most of the returns from real estate in the past few years has been due to capitalisation rate (yield) compression (as cap rates go down, values go up) rather than income growth (Figure 2).

**Figure 2: Drivers of Non-Residential Property Investment Returns: 1995 – 2017**



Source: MSCI

Direct real estate (returning 11.9%) and unlisted real estate (12.8%) typically have gearing between 20% and 50%, and they outperformed infrastructure (11.1%), listed real estate (8.5%) and bonds (5.8%), but underperformed equities (13.1%) during calendar 2017 (Figure 3). Investors hunting for yield were well rewarded if they invested in infrastructure and direct real estate with income returns of 8.6% and 5.8% respectively.

**Figure 3: Asset Class Returns: Year to 31 December 2017**



\* Direct = Property Council/IPD Australian All Property Index, Unlisted = Mercer/IPD Australia Unlisted Core Wholesale PFI, Listed = MSCI Australia IMI Core RE Index, Equities = MSCI Australia IMI, Infrastructure = MSCI Australia Quarterly Unlisted Infrastructure Index, Bonds = J.P. Morgan, GBI Global, Australia, Unhedged Index

Source: MSCI

**Sub-sector performance highlights demographic trends**

Drilling down into the various sub-sectors shows a wide variation in performance. The best performing sector was 'Other' (medical, health, seniors living, and car parks) with a total return of 19.8% in the year to December 2017 followed by hotels at 14.5%. Notably, both these sectors were also the best performers in 2016.

Health and medical assets are now well and truly on the radar of institutions, as are the other alternate assets like childcare, seniors living, student accommodation, and data centres. Medical and health centres are benefiting from the aging population, changes in the delivery of medical services, and their higher yield relative to office, retail, and industrial assets, although the re-rating of the sector has seen the yield gap narrow in recent times.

Hotels, particularly in the gateway cities of Sydney and Melbourne, are booming. Strong growth in international and domestic tourism and buoyant business conditions in both cities has occupancy levels and room rates at near-record levels. Sydney's average occupancy in 2017 was 85.9% (on some nights it was near impossible to find a room) and the average daily rate increased by 4.7% to \$230 per night. Melbourne's average occupancy in 2017 was 83.1%.

**Figure 4: Non-Residential Real Estate Sectors: Total Returns 2016 and 2017**

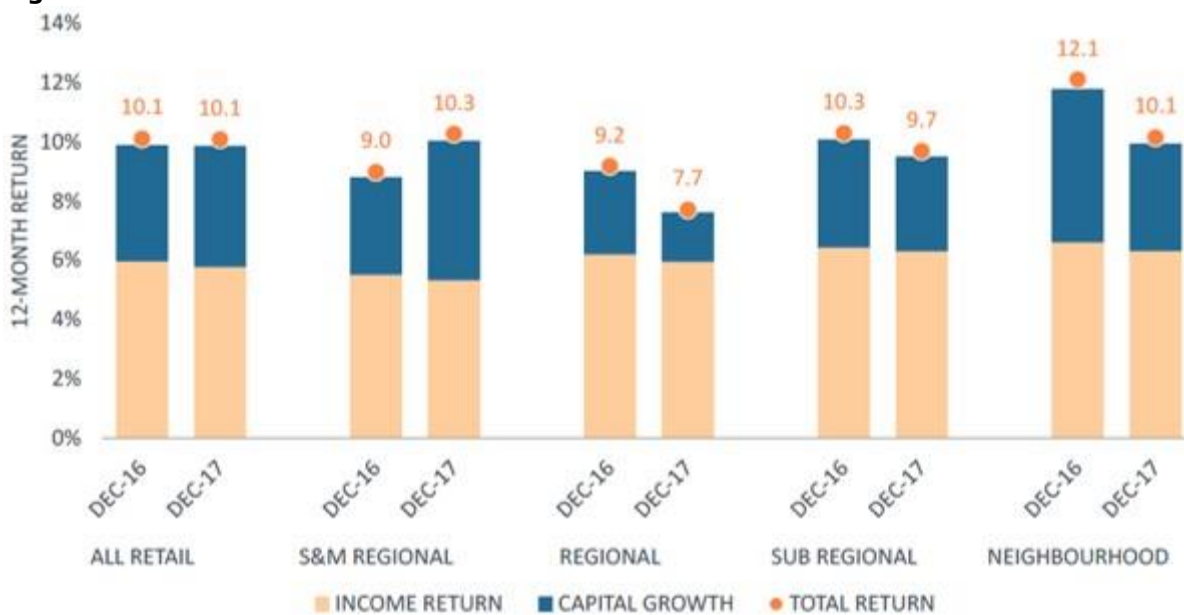


Source: MSCI

Retail real estate was the worst-performing sector with a total return of 10.1%. Given the challenges facing the retail sector, both structural (Amazon, on-line retailing) and cyclical (high household debt, low wage growth), many would be surprised that retail generated a double-digit return in 2017.

One explanation is that Super and Major Regional Centres (the mega retail centres) comprise almost 60% of the market capitalisation of the Retail Index, and those centres generated an average total return of 10.3% for the year (Figure 5). Globally, institutions are lining up to buy these so-called tier one ‘fortress malls’. The rationale: they dominate their trade area and are perceived to create a community destination (retail, entertainment, restaurants, medical etc.) rather than just a shopping experience. Therefore, they are best placed, of all the retail centre types, to withstand the onslaught of on-line retailing.

**Figure 5: Retail Centre Total Returns: 2016 and 2017**



Source: MSCI

In November 2017, the AMP Capital Shopping Centre Fund and the AMP Capital Diversified Property Fund each acquired a 25% stake in Indooroopilly Shopping Centre in Brisbane with management rights, in a deal worth more than \$800 million on a yield of 4.5%. This was the biggest single-asset retail transaction and represented the first super-regional shopping centre to be sold via an on-market campaign since 2010. Other notable

transactions in 2017 include GPT acquiring the 25% interest they didn't already own in the 153,000 square metre Highpoint Centre in Melbourne for \$680 million from their JV partner, the Besen Family, on a yield of 4.25%. GIC, the Singaporean Sovereign Wealth Fund, exchanged a 50% stake in Queen Victoria Building, The Galleries, and The Strand Arcade, all in the Sydney CBD, for a 49% stake in the ASX-listed Vicinity's Chatswood Chase. The \$562 million deal was struck at a yield of 4.75%.

### **The easy money has been made**

Overall, at Folkestone we are underweight retail as we believe the headwinds will continue and there are better opportunities in other sectors. Deploying capital at this point in the cycle requires patience and discipline. With real estate yields across most sectors at record lows, the easy money has been made.

We expect the pace of cap rate (yield) compression to slow and the focus to move to asset-level income generation as the primary driver of non-residential real estate performance. Investors should recycle out of assets that have limited capacity to grow the cashflow and retain or buy assets where there are opportunities to actively manage, refurbish, or reposition to drive income growth. Asset specific factors will be critical including landlord tenant relationships, quality of tenants, lease expiry profile, location, and the active management of the building's facilities. With record high electricity prices and electricity being one of the major costs of operating a building, efficient operating of the building will be crucial to optimising the bottom line.

*Adrian Harrington is Head of Funds Management at [Folkestone](#), a sponsor of Cuffelinks.*

## **Five challenges for post-retirement products**

David Bell And Estelle Liu

The concept of a post-retirement investment product was flagged in the Super System ('Cooper') Review in 2009-2010, but accumulation was the main area of focus for superannuation at that time. The concept, and associated CIPR acronym ('Comprehensive Income Product for Retirement') was an important recommendation in the Financial System ('Murray') Inquiry in 2014. It was noted that a 15% – 30% uplift in retirement income was possible, based on modelling by the Australian Government Actuary.

CIPR is a good idea in concept. However, taking an idea from concept to in-practice in a big complex system is difficult. That is the challenge currently faced by the policymakers at Treasury. Where they land will have a significant industry and system impact one way or the other. The stakes are high.

There is a strong commitment to continue down the CIPR path (or MyRetirement, as the Government plans to name it). An important next step announced last week by Kelly O'Dwyer is the proposed development of a retirement covenant which would require superannuation fund trustees to design and offer appropriate retirement income solutions to their members. An advisory group of industry professionals has been created to provide feedback to the Government.

### **CIPR and the desire to pool risk**

The motivation for CIPR is that there is little pooling of longevity risk in post-retirement. Many people are frugal with their superannuation savings, a result of a combination of conservatism and an element of bequest motive. These savings were tax advantaged and remain tax advantaged while in an account-based pension. The outcome is a below potential post-retirement lifestyle and a tax advantaged bequest, neither of which meet the objectives of Government policy.

The concept of a CIPR is a default (i.e. unless otherwise selected by an individual) solution designed broadly to provide constant income for life, regardless of lifespan. This sounds intuitive, but as responses to the consultation paper identified, is difficult in practice.

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## What are the main immediate challenges?

I would summarise the main challenges, in order of priority as:

### **1. Reconciling the difference in objectives between policymakers and super fund trustees who act on behalf of their members**

The preferences of the Government implied by the consultation paper and the design of the proposed Actuarial Certification Tests (required to be passed for a post-retirement product to be certified as a CIPR) suggest a focus on expected retirement income with little concern for variability of outcomes, the value of residual benefits or access to capital.

In practice, a trustee of a super fund needs to respect these other preferences (variability, residual benefits and access to capital). Consider two examples:

**First**, a male primary income earner, who unfortunately dies in the first year of retirement (around a 1% chance) and the trustee's CIPR has no reversionary benefit for the surviving partner.

**Second**, a non-home owning member requires access to capital for one of many possible lifetime events, but unfortunately the trustee's CIPR provides no access to capital.

Surely, a trustee is obliged to consider these issues in the design of their post-retirement default solution. There has been case law in the UK which has confirmed as much.

Do these differences mean much? Resoundingly yes! I was part of an industry project to establish a sensible set of preferences for trustees to assume on behalf of their members. These preferences were then developed into a metric known as the Member's Default Utility Function (affectionately 'MDUF', see ['Utility function' research wins Retirement Innovation Award](#) for more). At Mine Super, we then used MDUF to calculate the benefits of CIPR and we found that the proposed CIPR framework actually subtracted from retirement outcomes (Mine's submissions are [here](#) and [here](#)).

A possible solution is that the trustee of a super fund must codify their own set of preferences that they assume on behalf of their members.

### **2. Incorporating the age pension into CIPR design**

The original CIPR consultation paper framed a post-retirement solution which focused on consistent income for life in absence of the age pension. In practice, this guarantees an inconsistent retirement income profile for households.

Perhaps policymakers are frustrated at the current status quo of using an account-based pension and relying on the age pension for longevity insurance. However, ignoring the existence of the age pension risks over-insuring against longevity risk especially for members with lower retirement savings and experiencing lower income as a result. I believe that the age pension should be incorporated into CIPR design.

### **3. Interaction with the means testing for social security**

Concurrently, the Department of Social Security (DSS) is developing means-testing rules for lifetime income stream products such as life annuities, deferred life annuities, and group pooling equivalents. The proposed rules appear fair in isolation but deeper analysis at Mine Super suggests that the treatment of account-based pension solutions is much more generous.

When we account for the new rules, incorporate the age pension, and assume the sensible preferences of MDUF, we find no rational demand for lifetime income stream products. In fact, the optimal solution would be not too dissimilar to the status quo (use the account-based pension in conjunction with the age pension).

Hopefully DSS and Treasury will together find a solution so that this issue does not become a sizable disruptor to the intentions of CIPR.

### **4. A reassessment of the realistic gains from CIPR**

When the Murray Inquiry suggested that a CIPR could deliver a 15% – 30% uplift in retirement outcomes, I was perplexed. Eventually we got to the bottom of this claim: it was based on a hypothetical product design and only assessed retirement income with no value placed on residual benefits or access to capital. I feel the hypothetical product would not be acceptable to the public and could create risk for any trustee who used it.

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A realistic improvement in retirement outcomes (using a more holistic measure, such as MDUF) would be in the order of 5% – 10%, still a large number at a system level.

## 5. Industry cost and ability to opt out

The cost and effort of developing a CIPR could be large, much larger than that associated with MySuper. But would this 'retirement covenant' allow for some funds to opt out and not offer a CIPR? What would happen to members of those funds at retirement? Would these funds be allowed to be specialist accumulation-only funds? Could the covenant be used to drive further consolidation of the super fund industry?

CIPR could provide a high-quality safety net but it could prove under-utilised as members leave for reasons such as becoming more engaged or after receiving financial advice. It could be a lot of industry expenses if many people opt out, and getting the system-level cost/benefit analysis correct is a difficult challenge.

### Overall

These are exciting times for retirement planning. While some people may feel regulatory fatigue, I find the opportunity to be part of a system delivering good retirement outcomes a great motivator.

There are complex issues to be resolved. Broadly, everyone is pushing in the same direction but there remains a large dispersion amongst stakeholders. With such a complex area, there is the chance of a policy mistake. The welfare cost and industry cost of a policy mistake could be large. This risk is partly reduced by the quality of the advisory group which has been assembled.

*David Bell is Chief Investment Officer at [Mine Super](#). Estelle Liu is a Quantitative Analyst in Mine's Investment team. Together, they led the working group which generated the Member's Default Utility Function, an award-winning, freely available, advanced framework for assessing retirement outcome design. The views expressed in this article are their own and may differ from those at Mine Super, a sponsor of Cuffelinks.*

## Let's refocus the active v passive debate

### Sean Henaghan

*How did we find ourselves here?* It's a question I ask myself whenever I read an article or when I'm drawn into a discussion comparing index fund returns with the after-tax returns of active fund managers. And I'm asking it a lot lately.

I head up AMP Capital's Multi Asset Group. The debate is usually misdirected by the time it gets to me, given that the multi asset management process picks from different styles and strategies – including low-cost index strategies where it makes sense – to come up with a blended approach designed to meet an outcome for investors.

I'm an advocate for investing in index funds in the right place at the right time when it is appropriate for the investor's goals. I enjoy a thoughtful discussion about the role both active and passive strategies play within a portfolio to help clients meet a desired outcome. Our returns are judged after fees and it's in our interests to keep costs down.

However, as someone who works within a traditional active funds management business, I find myself addressing some of the inconsistencies in this well-worn 'for and against' active versus passive argument, and invariably I'm left frustrated by where the debate ends up.

### The wrong argument

What clients really need from asset managers is help delivering their financial goals. Financial goals, in my experience, are absolute and relate to growth in capital to fund retirement. They're about delivering a level of income every year or over whatever period with confidence. As investment managers, we need to deliver this with limited surprises along the way.

Rather than focus on goals, the industry has instead taken on this benchmark-aware mindset, mainly because it's an easy way to compare ourselves to our peers.

The funds management industry has gone so far down this benchmark-aware path that we've not only convinced ourselves but also our clients that we're only doing a great job if we're beating the benchmark. We've created this narrative at the expense of explaining what really matters to clients, which is their goal.

It's unrealistic to scrap benchmarks totally as they do have merit. They are best used as a performance measurement tool rather than a metric for client success. I'd like to see more fund managers reposition the performance component so it's more about whether a client outcome has been reached. This will take some time. I believe, though, it will also have the positive effect of encouraging greater client engagement.

Clients are moving away from that middle ground best described as 'core benchmark-aware products' where they were paying a high management fee for something that's essentially the benchmark. It was not great value for them. They are rightfully moving into either very low-cost products or, at the other end of the scale, cost-effective but much more differentiated products where they also get value for their (typically higher) management fees.

### **Trust is key**

The problem facing the funds management industry is one of trust. Active fund managers are not always trusted to deliver performance because some managers dressed up essentially index funds as actively-managed and charged 1% or more in fees for the privilege.

The only thing clients can trust is cost. It's the only tangible thing they have.

In reality, there are far more opportunities to deliver great outcomes for clients beyond focusing on cost alone. If we design great products to meet client goals and get the alpha component right, we can deliver much more beyond the savings investors are seeking by shunning active management and marching into passive funds.

More than a few things have gone right for the index funds' recent narrative, which has fuelled investor demand for low-cost passive funds. However, I believe we're now entering a period where investors need active management.

Until recently, the time was right to own the benchmark. Share markets were driven by the actions of central banks globally printing money and leaving interest rate setting at their most accommodative. Correlations between shares and sectors were unusually high as the market's momentum trumped anything related to earnings.

There was a change between 2016 and 2017. Calendar 2016 was tough for active managers, driven primarily by the risk-on and risk-off market environment (examples being China RMB devaluation, capital control and Brexit) rather than company fundamentals. This changed in 2017 where companies that grew their earnings were rewarded. You can see this in the average stock's pair-wise correlation (that is, correlations between different pairs of stocks) which returned to a normal level in 2017 in comparison to 2016 where it was elevated.

In 2018, with inflation back on the horizon and with many tipping four rate hikes this year from the US Federal Reserve, investors should think about what outcome they are investing for, and which managers are best placed to deliver it.

I am not suggesting we stop the discussion on active versus passive. I am suggesting we change the debate on performance, slowly and surely, to talk about what's really important for clients. As fund managers, we need to take responsibility for this and as a collective talk more about whether our products are meeting client goals, not just beating a benchmark.

*Sean Henaghan is Chief Investment Officer and Director of the Multi Asset Group at [AMP Capital](#), a sponsor of Cuffelinks.*

## Four checks for a financial fire drill

Nigel Stewart

Ten years since the global financial crisis, the recent spike in market volatility after a long lull stirred uncomfortable feelings for many investors. This makes it a perfect time to put in place a financial fire drill.

Of course, no one can reliably predict when the next bear market will arrive. But as someone who worked through the 1974, 1987, 1999 and 2008 downturns, I can confidently say that while down markets are always tough, they are even more so for the unprepared.

Advisers and other fiduciaries should reflect on whether they have adequately prepared and educated their staff, clients, and centres of influence for the next downturn. And investors should check if their portfolios are positioned with the risks in mind.

### Lessons from history

In the early 1970s bear market, broking staff were laid off as there was no brokerage commission being generated. This was long before the fee-for-service model. Clients were frightened to buy, and the flood of doomsday news did a good job in scaring many into selling what they had.

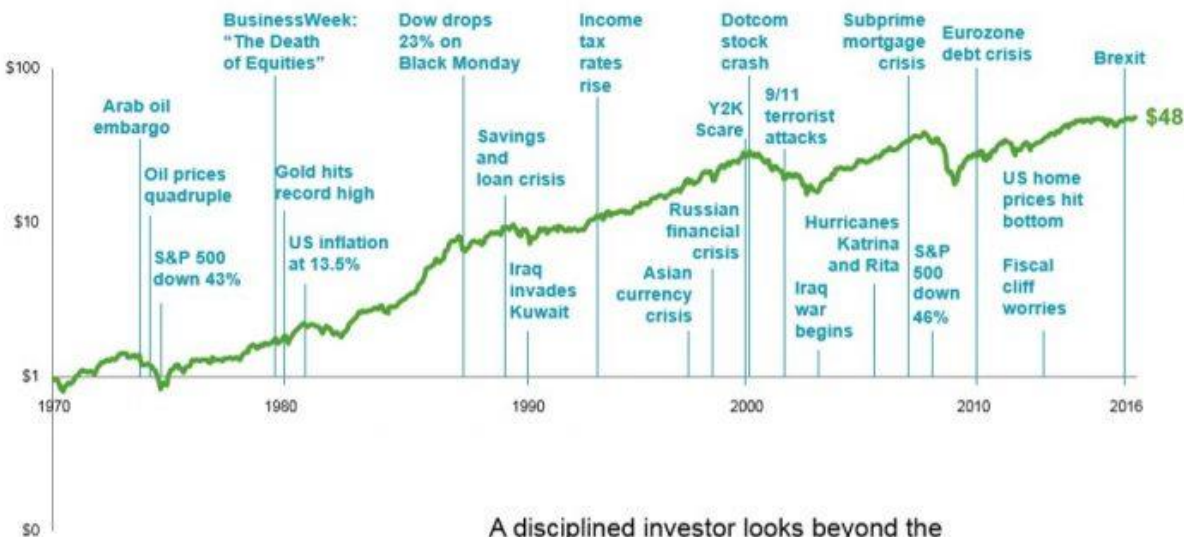
After much pain, investors resumed buying. But we have seen repeatedly that the net result from selling on fear and buying on greed is that investors end up with significantly less than the market rate of return.

The looming 10-year anniversary of the collapse of investment bank Lehman Brothers on 15 September 2008 and the unsettling events of October 2008 mean there inevitably will be a flood of stories in the media about the past financial crisis and the possibility of another.

However, there is unlikely to be much mention of how those investors who kept their nerve and stayed with their plan were rewarded for their discipline, as shown below. That reward is the payoff for having an investment philosophy and a plan to stick with through extreme volatility and uncertainty.

## Markets Have Rewarded Discipline

Growth of a dollar—MSCI World Index, 1970–2016



A disciplined investor looks beyond the concerns of today to the long-term growth potential of markets.

In US dollars. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. MSCI data © MSCI 2017, all rights reserved.

## Do the drill before the fire

Messages about the possibility of further volatility and the need for discipline are more likely to be assimilated during the upswings, when emotions are settled and minds are clear, than during the unsettling mood generated by downswings.

Having been trained in firefighting at the age of 16, I learnt it is not the time to develop mastery when faced with an emergency. That’s why firemen regularly carry out drills in which they rehearse their responses to a major fire. Being operationally prepared with a concrete strategy makes everyone feel more confident.

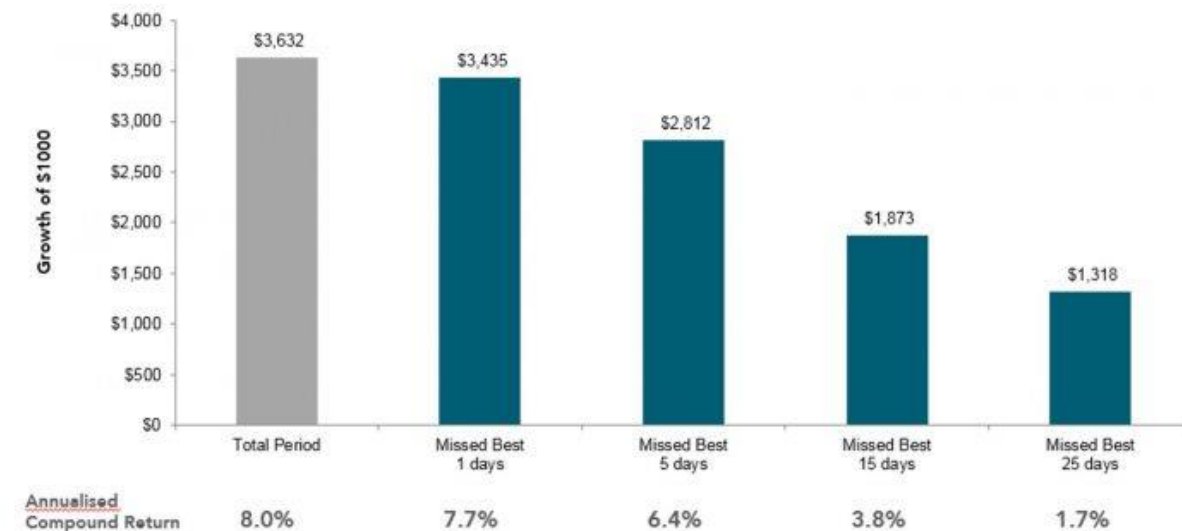
It’s similar for advice firms. The time for preparing for a crisis is not *during* a crisis. Instead of trying to predict when a downturn will occur, the focus for advisers should be on preparing an agreed strategy for when it does.

In contrast, market timing is hazardous. The chart below shows that an investor who missed just the 25 best days on the Australian market from April 2000 to December 2016 would have been reduced to an annualised return of 1.7% against the market’s 8% return.

## Reacting Can Hurt Performance

S&P/ASX 300 Index Total Return

April 2000 – December 2016



In AUD. Daily Standard & Poor's index data is provided by SPICE. S&P/ASX data reproduced with the permission of S&P Index Services Australia. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio.

## Fire drill checklist

Drawing on nearly four decades of experience in wealth management, here’s my financial fire drill checklist:

### 1. Cash flows

Ensure sufficient cash flow to see through a downturn, such as 2-3 years in accessible liquid assets to meet day-to-day expenses without the need to sell growth assets.

### 2. Different outcomes

Prepare for a range of possible outcomes and the manifestation of those outcomes. Consider what happened in past bear markets and stress-test asset allocations to demonstrate extreme scenarios. If you don’t think you can withstand the pain of a 30%-40% downturn, consider reducing exposure to growth assets.

### 3. Communication

The greater risk for advisers and fund managers is *under*-communicating to clients. In previous major down markets, the efforts of managers who kept advisers informed with timely bulletins were appreciated. These lessons were absorbed by many and used in the 2008 crash. The message to clients should be that markets are forward-looking and already reflect known information.

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#### 4. Diversification

Ensure portfolios are well diversified. If it makes sense for an investor's age and circumstances, ensure portfolios include a risk-dampener, including cash and fixed interest. Focus communications and analysis on the total portfolio, including real estate. Otherwise, people can become preoccupied with individual securities or sectors in isolation, missing the forest for the trees. A balanced view is particularly important for those who have a Transfer Balance Cap (pension) which is mainly in growth securities.

##### Guidance for advisers

Advisers should be mindful of the tone of their communications. No one wants the fire fighter to panic. Be measured and reassuring, without seeking to downplay the natural anxiety brought about by difficult markets. It is easier for clients if the ground is prepared beforehand.

This means setting appropriate expectations and stress-testing asset allocations with each client, educating them about how markets work and reinforcing the benefits from your own experience of discipline, diversification and focusing on those elements within their control.

The payoff is that when the alarm *does* go off, you are calm and ready to offer reassurance and confidence to clients, so that they remain disciplined. If you succeed at this key task of stupidity prevention, your clients will be grateful and see your fee as a worthwhile investment.

*Nigel Stewart is a 40-year veteran of the Australian financial markets, a professional financial adviser and an Executive Director of funds management firm, [Dimensional Australia](#). This article is general information and does not consider the circumstances of any investor.*

#### A checklist for buying LICs at a discount

Julia Stanistreet

As a rational value investor, it makes sense to buy an asset at a price less than the tangible value of the asset with an expectation that over time, the value will be realised. Listed Investment Companies (LICs) trading at discounts to their net tangible assets per share (NTA) may present a value opportunity but if these discounts persist over time, then this value may never be released. Some LICs remain at a discount to their NTA for years.

Here is a very simple illustration of a discount and premium to NTA.

You have \$10,000 to invest in the stock market and you've decided to use a LIC to gain exposure to a particular equities strategy.

##### *LIC opportunity 1 with discount to NTA*

LIC 1 offers a basket of listed stocks, and 10,000 shares with an underlying market value of \$10,000 and NTA of \$1 per share are available for a 10% discount of 90 cents. You pay \$9,000 for \$10,000 worth of underlying stocks.

##### *LIC opportunity 2 with premium to NTA*

LIC 2 offers a basket of listed stocks, and 10,000 shares with an underlying market value of \$10,000 and NTA of \$1 per share are available for a 10% premium of \$1.10. You pay \$11,000 for \$10,000 worth of underlying stocks.

##### What causes this disparity?

These differences occur despite the NTA being readily identifiable from the issuer's website or ASX announcements.

For example, a LIC premium to NTA can exist when there is a lot of demand for the LIC for various reasons, or if the company is issuing more shares at a price greater than the NTA. However, if there is little demand for a LIC, selling activity can place downward pressure on the share price causing it to trade at a discount. If a

company issues more shares at a share price lower than the NTA, this can further exaggerate the discount. The management and boards of LIC need to closely watch the relationship between NTA and the price of new shares.

On first look, it seems the rational investor could take advantage of the discount opportunity, but the following is a list of the key items investors should consider, to gauge whether a LIC trading at a discount could move towards trading at NTA or even a premium.

What moves a LIC's share price or drives a Discount/Premium to NTA?	What to look out for?	How can this impact a LIC's share price?
Performance/Track Record	Long-term outperformance compared to relative benchmark	Apart from a rising NTA, strong performance can result in increased market awareness from the wider investment community which may attract more shareholders to the LIC vehicle, greater demand for the LIC can place upward pressure on the share price causing it to trade at a premium. If you find a LIC with a good manager track record trading at a discount, then this could be an opportunity.
Dividend Policy/History	Sustainable, growing dividends with tax effective income/franking	This should be positive for the share price as demand increases from existing and new shareholders (particularly SMSF investors) who are looking for tax effective income.
Profit Reserves	Healthy profit reserve accounts for years of softer performance. Look to the LIC annual report for this information.	This feature allows the LIC to set aside profits for future dividend payments. LICs with strong profit reserve balances (look for anything more than 12mths) can attract a premium as shareholders gain a level of certainty around the future of their investments' potential income profile.
Capital Management	Non-dilutive issue of new shares (DRP, SPP) i.e. the LIC will only issue shares when the share price is at or above NTA.	Issue of new shares at NTA shouldn't impact the share price one way or the other, however if shares are being issued above NTA then a premium can be created or maintained. Watch out for dilutive share issues i.e. issuing new shares for DRP or SPP when the share price is below NTA as this can create or exacerbate a discount.
Options	Check for outstanding options in issue. LICs trading at a premium tend to be option-free vehicles.	If a LIC has options on issue these can cause NTA dilution as on exercise of the options more shares are issued in the LIC at a price less than NTA (assuming the LIC is trading above the option issue price). The expectation of this can also contribute to a discount/downward pressure on share price. If the LIC is option-free then the risk of dilution from options is removed.
Marketing and Communication	Strong brand awareness, shareholder engagement, regular events open to shareholders and the wider investment community.	LIC market awareness can attract more shareholders and greater demand for the LIC shares can place upward pressure on the share price.

It's not an exact science but in our view, a LIC trading at a discount exhibiting many of the positive attributes mentioned above could present an opportunity to unlock value via the narrowing of the discount over time.

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