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Reflections on four decades of investing

James Swanson

Looking back over my many years in the investment management industry, the importance of a handful of themes jumps out at me. First, technology has been, and always will be, an incredible driver of change. Next, understanding the human condition is as important as any investment analysis. And while market cycles today tend to be longer than they have been historically, cycles are not yet a thing of the past. Additionally, free cash flow and dividends are critical elements in sustained investment success. Finally, at this stage of the market cycle, investors may want to focus on the margin of safety rather than concentrating purely on profit margins.

Technology: From mainframes to blockchain

During my professional lifetime, technology has dramatically impacted the way markets function and allowed for much deeper securities analysis than ever before. The ability to gather and aggregate market data exploded in the 1980s, making fundamental analysis quicker, easier and better.

Early in my career, mainframe computers were the heavy iron we used to analyze companies and markets. And to illustrate just how much more productive we've become over the past few decades, when my dad retired from the largest maker of mainframe computers in the 1980s, that company employed around 375,000 workers. In contrast, today's tech giants make do with workforces a fraction of that size. The combined workforce of Apple, Alphabet, Microsoft and Facebook is roughly equal to that of the mainframe maker.

The 1990s saw the widespread adoption of personal computers, driving an explosion in online day trading, while the New York Stock Exchange moved to trading stocks in increments of a penny, down from typical spreads of 1/8 of a dollar. These are huge changes that have made for deeper, more efficient markets.

This century ushered in the introduction of high-frequency, algorithmic trading, the rise of dark pools and the increasing use of "big data." Artificial intelligence is on the horizon, and it has the potential to disrupt our business and many others, if it achieves its full promise. Disintermediation is a continuing trend, and the prospective widespread adoption of blockchain technology in the coming few years could streamline our industry, cutting out middle men, squeezing yet more cost out of the system, advantaging asset owners.

Emotions don't make for efficient markets

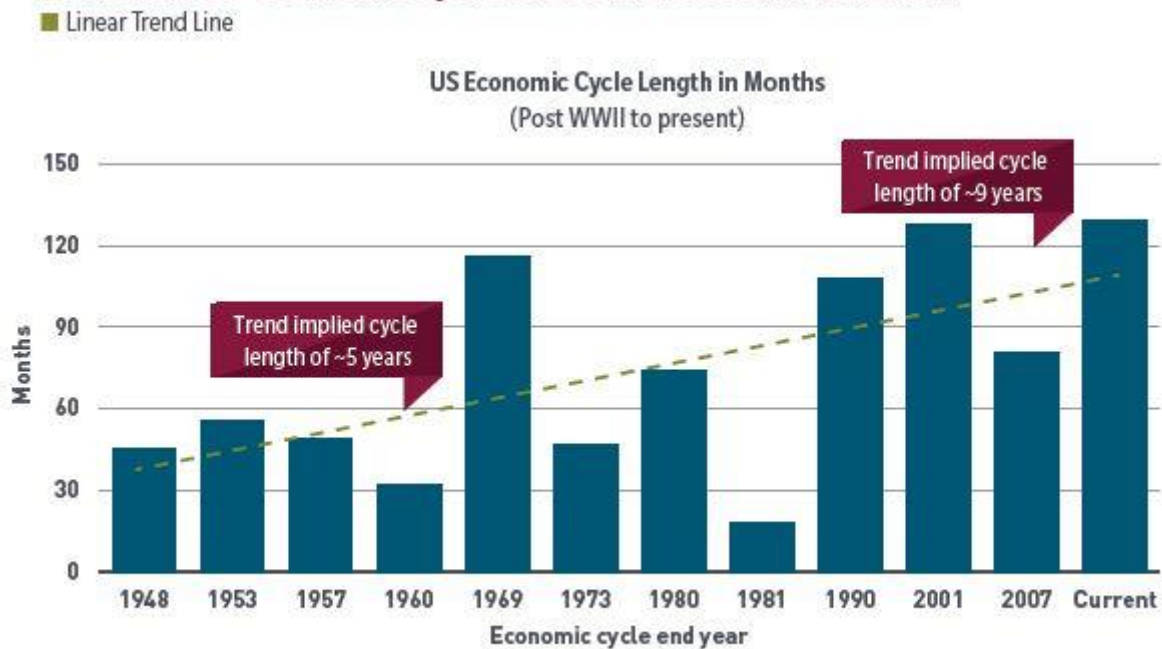
My biggest regret as an investor is that I didn't study psychology as much as I could have. When I was training, I was taught that the capital markets were efficient, that investors act rationally and that market prices fully reflect all available information. However, in recent years, Nobel Prize-winning behavioral economist Daniel Kahneman has dispelled that notion. His seminal work, *Thinking, Fast and Slow*, points out that people have built-in biases that can distort their perception of markets.

The idea that we all have inherent biases is particularly salient as we approach the widespread adoption of artificial intelligence. Consequently, it's imperative that investors guard against the possibility that their biases will be exploited by others in the marketplace.

Cycles have been getting longer but still come to an end

In the United States, economic cycles have been growing in length. A diversified economy, better inventory management and central bank intervention have all likely contributed to these longer economic cycles. Expansions tend to be smoother and longer while contractions tend to be short and abrupt. That said, business cycles are still likely to continue. In my view, higher interest rates and overconfidence will continue to exert themselves and may lead to many more business cycles.

Exhibit 1: US economic cycles have increased in duration



Source: National Bureau of Economic Research as of 30 September 2018. Economic cycle length calculated from prior cycle peak to the following peak. Dates shown represent the year end of economic cycles.

However, my greatest concern about these elongated cycles is that they tend to coincide with a significant buildup in debt, calling into question the quality of underlying growth. This debt buildup, economists believe, creates a drag on potential growth, thus amplifying the importance of central bank policy in each succeeding cycle. The mounting debt overhang escalates the odds that to rekindle growth when the current cycle inevitably ends, that monetary authorities will be forced to resort to using what were once unconventional policy tools, such as quantitative easing.

Dividends matter ... a lot

The great mathematician Albert Einstein is reputed to have called compound interest "the most powerful force in the universe". Whether Einstein said it or not remains in dispute, but it is hard to dispute the power of compounding over long investment horizons. Earning interest on your interest and dividends on your dividends by reinvesting them can make your investments grow exponentially over long periods of time. According to our calculations, since 1970, around 65% of your total return if you'd been invested in developed-market equities would have been driven by the compounding of dividends.

Exhibit 2: MSCI World Index Cumulative Return



Source: Morningstar as of 30 September 2018. PR = price return, NR = net return, which includes dividends after the deduction of withholdings taxes. NR used as a proxy for Total Return, a investment term used to describe equity indices which include the reinvestment of dividends. MSCI World Index used as a proxy for developed market equities. MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across 23 developed market countries and covers 85% of the free float-adjusted market capitalization in each country. is not possible to invest directly into an index. Past performance is no guarantee of future results.

And what drives dividends? Free cash flow. One of the most fundamental lessons I've learned is the importance of free cash flow generation in choosing equity investments. Real — or inflation adjusted — cash flow yields are one of the principal building blocks I use when building portfolios. Over much of the past decade, coming out of the financial crisis, the free cash flow generation of S&P 500 companies was extraordinary. Globalisation constrained wage gains while low interest rates and capital-light strategies drove great gains in free cash flow yield. But today free cash flow yields have reverted back to average levels from the record levels following the GFC as labor costs rise late in the business cycle and profit margins contract. To me, that's a cause for concern.

Focus on the margin of safety

Globalisation was a big driver of profit margin expansion for much of this business cycle, but it appears that it may have peaked for the time being. Brexit and growing trade barriers are manifestations of the peak globalization, and the more constrained movement of people and products is likely to crimp profit margins as we move forward. Rising interest rates will pose challenges as well, affecting return on equity and lowering free cash flow yield.

Against the backdrop of a long, aging cycle, I think it's time to shift the focus from profit margins to the margin of safety. Be aware that the risks rise as markets become more expensive and the cycle ages, and this is the second-longest cycle in history. While we've experienced an extraordinary decade of equity returns, in my view, investors may want to begin moving their asset mix toward more defensive positioning, from risky assets to higher weightings of less volatile choices such as cash and high-quality bonds.

I hope you benefit from these parting thoughts, which summarise what I've learned working through five full business cycles and 33 years at MFS.

James Swanson, CFA is Chief Investment Strategist at [MFS Investment Management](#), a sponsor of Cuffelinks. This article is for informational purposes only and should not be considered investment advice or a complete analysis of every material fact regarding any investment.

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TV – the end of the world as we know it?

Roger Montgomery

We have seen this before – companies spending big, not to advance their competitive position, just to hold their current spot. Newspapers around the world tried the strategy but many ultimately failed. In Australia, the car industry, clothing and footwear manufacturers and video stores all tried to save themselves by spending more money. They collapsed, unable to stop a king tide from drowning them in losses. And while we have yet to see the final death throws, fossil fuel retailers may have already been handed their death warrant by advancing renewable technology and battery storage.

Struggling in a corporate death spiral

Throwing good money after bad seems like the only strategy when an industry is in a 'death spiral' but history proves it's often a waste of shareholders' and lenders' money. Of course, the alternative of accepting inevitability in a particular industry requires companies to abandon everything, including their revenue, while terminating the vast majority of their employees.

Checkmate.

While disruption is just another buzzword for 'change', there is no escaping the profound impact it has on old technology, incumbent businesses and legacy revenue models. And often, the disrupters are no better off.

When a technology advances, bringing down prices, it opens new markets. Increasing customer utilisation reduces the price even further, opening up still newer markets, increasing demand, reducing the price further and so on ... until of course another newer technology replaces it. Businesses caught up in the cycle must run faster just to stay in the same competitive position.

Where does it leave television?

In the television entertainment industry, video streaming technology has fragmented audiences and squeezed margins by driving down consumer prices and driving up content production costs.

Scale and globalisation are important and the largest companies in the communications industry are colliding or competing. The growth of Netflix is the best evidence of a changing dynamic in content creation and distribution.

This year, Netflix, Amazon, NBC Universal, Warner Media and CBS will collectively spend US\$7 billion *more than last year* on content. The 'food fight' or 'hail Mary passes' in terms of creating unique scripted content is exploding with the new businesses disrupting the traditional studios by going directly to talent and bidding against each other. Viewers are demanding shorter product lifecycles and cheaper prices.

And while industry chiefs addicted to legacy affiliate fee^[1] revenue suggest that content owners prefer to be aggregated in a bundle of channels and, as a result, to receive affiliate fees, they ignore the fact that viewers are ditching traditional cable and satellite packages at the new record rate of over one million per quarter.

Perhaps cable operators aren't listening to consumers who are voting with their wallets. Just as we have already seen in the music industry, consumers don't want to pay for an entire album – they just want to buy the songs they like. A 'pick-and-pay' or 'skinny bundle' model in television offerings, where consumers only pay for the channels they want, seems logical but the consequences for legacy revenue streams are terminal.

Recently, cable industry veteran and Liberty Media Chairman John Malone warned his industry brethren that they must morph from being bundled retailers of video services to bundled providers of interactive Over-The-Top (OTT) TV services^[2] as well as devices that will inevitably be connected to the internet of things.

Most content owners do not want to launch a direct channel and be forced to win viewers one-at-a-time through an OTT TV service, and there are alternatives. They include nano piracy networks, the private networks where applications are used to stream live or recorded content to the public or a defined group of viewers. Remember what Napster did to the music industry?. Content producers may need to reconsider their current distribution models anyway. Indeed, the Diffusion Group estimates that every major TV network will offer an OTT service in just three years.

New competition with different models

The financial implications of the shift are not confined to the traditional content producers and aggregators. Netflix holds hundreds of millions of direct consumer relationships and their credit card details, but emerging competition from Apple, Facebook Watch, YouTube TV and Disney, is forcing Netflix to lower prices while spending more seeking new revenue streams overseas. In its most recent quarter, Netflix reported record negative free-cash-flow.

For example, Apple wants to develop a direct-to-consumer entertainment service beyond music. Like Netflix and Amazon, Apple has an estimated 700 million direct consumer credit card relationships. It would be relatively easy for Apple to offer a service, whether subscription based or free and supported by advertising. It is reported that Apple is having conversations with the content industry and wants to drive its ecosystem into the living room through video.

According to *Variety Magazine*, rising competition has meant higher salaries for actors, directors and production staff, which has increased the cost of producing a high-end drama for either cable or streaming from between US\$3 million per hour in 2013 to as much as US\$7 million today.

Meanwhile, younger, mobile-savvy consumers are leading the exodus from cable TV subscriptions. According to Deloitte, Gen Z, Millennials, Gen X, Baby Boomers and mature-aged consumers are all reducing their subscriptions to Pay TV. In the case of Millennials, those reporting a household subscription to Pay TV in the US has fallen from almost 75% in 2013 to approximately 50% in 2017.

Higher costs and lower subscribers (cable TV subscribers are being lost at the rate of 11,000 per day) mean business survival demands existing subscribers pay more. This can only accelerate the exodus to cheaper and more convenient alternatives, checkmating traditional operators who cannot remain in business without raising prices.

Impact on investment markets

The S&P500 Media & Entertainment index recently slid 15% from its all-time highs. Investors who are aware of the common traits seen in industry death spirals are better positioned to avoid falling for a potential value trap. Like many history-changing technologies before – think motor vehicle manufacturing or air travel – it is often the consumer that wins, not shareholders. In fact, in some industries today such as TV, the best opportunities might come from short selling.

Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](#). This article is general information and does not consider the circumstances of any individual.

[1] Mainstream television content development is funded by affiliate fees, which are the 'share' of the subscription fees paid to cable or satellite operators that are 'rebated' or distributed back to the content producer/owner/distributor on a per subscriber basis. By way of example, ESPN – as content owner – can negotiate high affiliate fees because, at least for now, a cable or satellite operator would appear insane offering a television bundle without ESPN included.

[2] Over-The-Top (OTT) refers to content providers that distribute streaming media as a standalone product directly to viewers over the internet, bypassing other broadcast platforms that traditionally act as a controller or distributor of such content.

8 hints for any SMSF in both accumulation and pension modes

Melanie Dunn

The transfer balance cap applies from 1 July 2017 and places a \$1.6 million limit per person on the amount of savings that can be moved into the tax-free retirement phase of superannuation.

This means retirees who have balances in excess of \$1.6 million will likely have both a retirement phase pension and a non-retirement phase accumulation account unless they withdrew the excess from the superannuation system.

For some SMSF retirees, this may be the first time since moving into retirement that their fund has had an accumulation interest. It may also be the first time the fund has had a mix of pension and accumulation balances.

Here are eight things you need to think about when running an SMSF that is not solely in retirement phase due to the transfer balance cap.

1. Separate accounts for pension and accumulation

Where a member has both pension and accumulation accounts in the SMSF, the trustee must allocate fund income and expenses on a fair and reasonable basis between the two accounts and members in the fund. They also need to keep track of an accumulation account and a pension account balances for the members. This does not mean the trustee needs to allocate specific assets to belong to each member or account, and indeed, from a tax perspective the trustee is not allowed to segregate assets.

2. The fund may be eligible to claim a tax deduction on some fund expenses

General fund expenses that must be apportioned can only be claimed as a deduction in the annual return to the extent they were incurred in producing assessable income. Now the SMSF has an accumulation interest, it is likely to have assessable income and so the trustee may be eligible to claim part of those expenses as a deduction to offset taxable income in the annual return. A common industry approach is to use (1 – actuarial exempt income proportion) as the deductibility proportion. Tax Ruling 93/17 also provides another method and further information on apportioning expenses.

3. Capital losses can be carried forward

Capital gains and losses on assets solely supporting retirement phase income streams are generally disregarded. This means gains are exempt from tax but also that capital losses cannot be carried forward to offset future capital gains. Where an SMSF with an accumulation interest realises a capital loss that is first offset against any current year capital gains, and if the result is a net loss this can be carried forward to future years to offset against future gains.

4. Strategic thinking is required when taking benefit payments from the fund

When a payment is taken from the SMSF, the trustee will need to identify what interest the withdrawal was taken from, either pension or accumulation. There are pros and cons to each option:

- A minimum payment must be made from each pension as a pension payment in order to meet the legal requirements of having an income stream eligible for an exemption from income tax. So at least one payment in the year needs to be a pension payment and it must be enough to meet the minimum payment standards.
- Where a member wishes to draw above their minimum requirement in a year then they should consider taking that additional amount as a lump sum from their accumulation interest. This means a larger balance stays in the tax-free retirement phase, reducing the SMSFs future tax bills. For members under age 60 lump sums paid up to the lifetime low rate cap (\$205,000 for 2018-19) are tax free.
- Payments can also be taken as a lump sum payment from a retirement phase pension. This payment does not count towards minimum pension requirement and is treated as a lump sum for tax purposes. Lump sums paid from pension accounts will be debited from the individual's transfer balance account, meaning more room under the \$1.6 million cap if needed in the future (e.g. receiving a death benefit income stream). Lump sums paid from retirement phase pension must be reported under the transfer balance account reporting requirements.

5. Consider opportunities to even up retirement phase balances to reduce taxable accumulation interests in the fund

Each member in the SMSF has the lifetime transfer balance cap of \$1.6 million. Where one member has a large balance which exceeded the \$1.6 million cap resulting in an accumulation interest, but the other member has a balance in retirement phase under \$1.6 million, consider moving some of those accumulation assets into retirement phase for the other member. The member would need to be eligible to make/receive contributions and consideration needs to be given to whether it is appropriate for the first member to give up their entitlement to those assets. That is, as part of the other member's interest, those monies would be payable to their beneficiaries on death not those of the original member. But for some couples looking to maximise exempt

income in their SMSF, this may be a strategy to help maximize the value of superannuation in retirement phase. Take care not to fall foul of the complicated contributions and transfer balance cap rules.

6. Accumulation accounts will still form part of your superannuation death benefit but cannot be taken as a reversionary income stream

An accumulation account is a separate interest to any retirement phase pension in the SMSF. As such, a separate superannuation death benefit will be payable when a member passes away. It can be documented as such so that the accumulation interest is paid to a different beneficiary to the retirement phase pension if so desired upon death. However, an accumulation interest can only be taken by beneficiaries as a death benefit income stream or lump sum. It will not form part of a reversionary income stream, even if the pension from which the accumulation balance was commuted was a reversionary pension. The beneficiary will also not have the 12-month grace period under the transfer balance cap rules like that received from reversionary income streams. The beneficiary will need to decide as soon as practicable whether to take the death benefit as a lump sum and withdraw it from super, or as a death benefit income stream subject to their own transfer balance cap.

7. Franking credits can be utilised

Under the Labor Party proposal, franking credits would be lost if fund assets were solely supporting retirement phase income streams producing exempt income. However, where a member has an accumulation account, franking credits can be used to offset the tax liability on the remaining assessable income.

8. Income earned on fund assets will not be 100% exempt from tax

The SMSF is likely to have disregarded small fund assets and as such be required to use the proportionate method to claim exempt current pension income (ECPI). This means that an actuarial certificate is required prior to completing the SMSF annual return. The actuarial exempt income proportion will identify what proportion of the fund's assessable income will be exempt from income tax.

A fund has disregarded small fund assets where it has a retirement phase account in an income year and so is eligible to claim ECPI, however at the prior 30 June any member in the SMSF had a total super balance in excess of \$1.6 million. This total super balance includes accumulation and retirement phase accounts both in the SMSF and elsewhere in superannuation.

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Global investor survey and Aussie differences

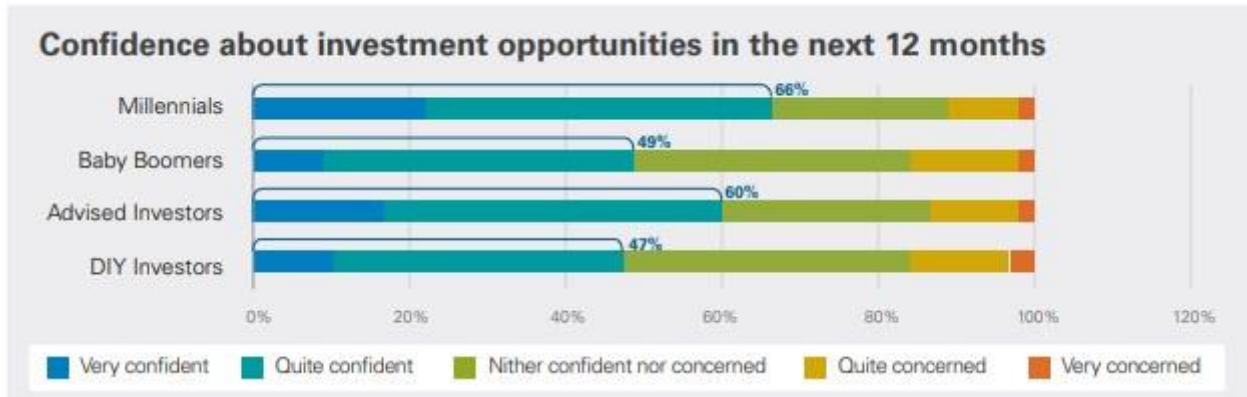
Graham Hand

For the past six years, the Legg Mason Global Investment Survey has revealed investor sentiment and behaviour across 17 countries, including Australia. In 2018, almost 17,000 people with at least €10,000 (in local equivalent, or US\$50,000 in the US) to invest in the next year were in the survey, including 1,000 in Australia.

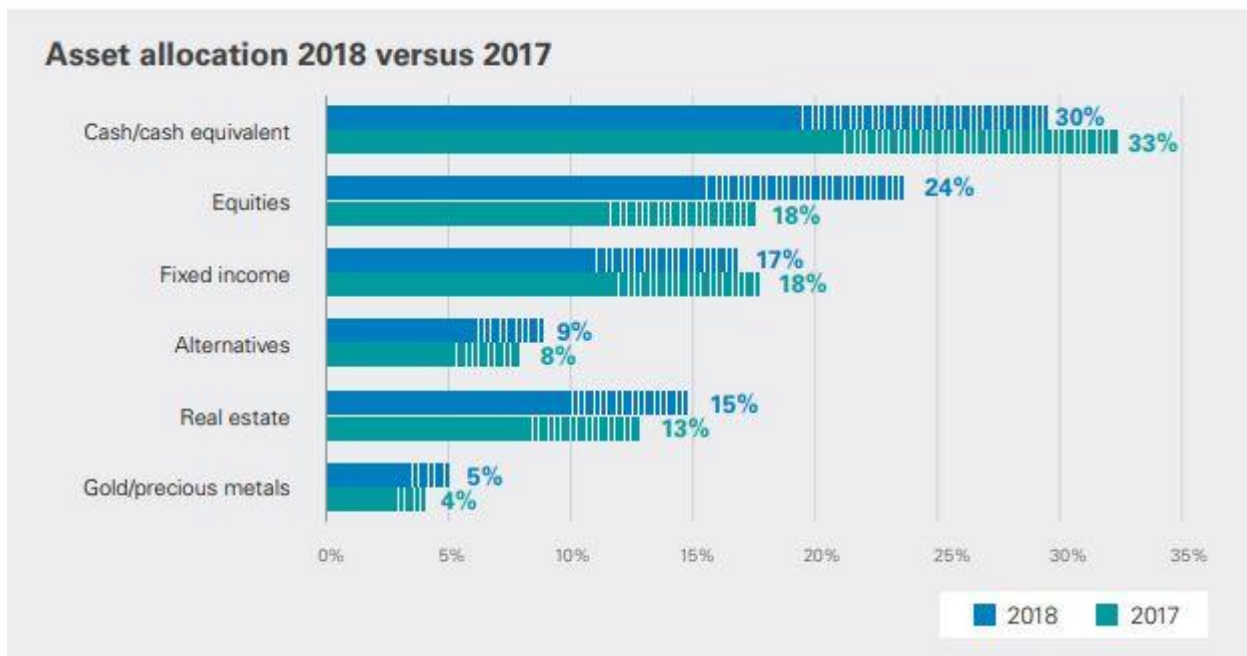
The timing of the fieldwork is important, as it took place in July and August 2018, before the recent market falls (but the market also fell in February 2018). Nevertheless, the optimism about equity markets shown in the results may not be as strong if the survey was taken now.

Key global findings

At the time of the survey, as shown below, most investors were optimistic about investment opportunities in next 12 months with only 14% being concerned. Millennials (18 to 36 years old) in particular were more bullish than Baby Boomers (50 to 71 years old).



There was a marked expectation of allocating more to equities and real estate and less to cash in 2018 compared with 2017. It will be interesting to see if investors have a reality check if the equity sell-off seen in October to early December 2018 continues.



Generally, in the global survey results, investors think technology will not replace human interaction in financial advice and customer service. Twice as many investors feel volatility can have a positive effect on portfolios if managed correctly, compared to those who worry about the risk. Using a financial adviser helps investors to be more diversified. Almost half of investors choose funds allowing for ESG considerations. Millennials feel increasingly confident about a comfortable life in retirement, yet they only have 21% of their portfolio in equities.

Millennials are approaching investing differently than their parents. They are more willing to embrace risk and use a financial adviser than Baby Boomers, are open to alternative assets and are led and influenced by their ethics. While we are still some way away from full service automated robo advice, investors are looking for the same level of convenience in their investments as they expect in other parts of their lives. Investors want to discuss their options with an expert, but less than half say they often or always use a financial adviser when making decisions about their investments.

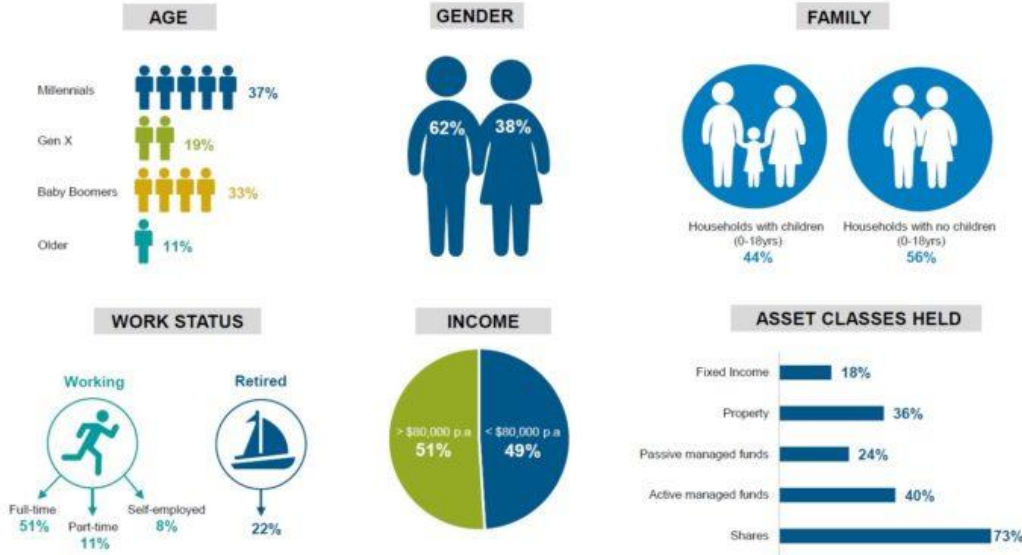
The internet remains the leading source of investment guidance for those investors who do not rely on a financial adviser. Ten years on from the global financial crisis, there remains a risk legacy. The risk concerns of many individual investors are macro-related, such as world economic instability, trade wars, global political instability and inflation.

About 77% of investors are saving and investing with specific goals in mind, a trend that is even higher with Millennial investors (80%) or Generation X – aged 37 to 50 years – (80%). Inevitably, these investment goals are both short-term and long-term, depending on the generation and life stage of the individual.

A focus on the Australian results

The full Legg Mason survey results for Australia, the world and other individual countries are [linked here](#).

AUSTRALIAN RESPONDENT PROFILE



The findings for Australian and global investors in more detail start on page 68 onwards, and given the size of the global data set, the responses make fascinating reading. Here is a selection of five questions as an example.

1. Australians more confident about future investment opportunities.

Confidence about investment opportunities in the next 12 months

	Global	Australia
Very confident	15%	18%
Quite confident	42%	50%
Neither confident nor concerned	28%	24%
Quite concerned	11%	7%
Very concerned	2%	2%
Very/Quite confident	58%	68%
Very/Quite concerned	14%	8%

2. Australians more focussed on fees and past fund performance (up to three responses allowed).

Important criteria when selecting investments

	Global	Australia
Cost/amount of fees	41%	44%
Projected returns will meet my investment goals	35%	28%
Performance track record of the fund	29%	36%
Investment approach (e.g. value, growth or dividend paying companies)	25%	28%
Advice from a professional advisor	25%	24%
The provision of easy to understand information	24%	22%
Reputation of investment management company	22%	22%
Tax efficiency/management of the investment strategy	16%	20%
The active management of my investments based on decisions by an expert/team of experts	16%	16%
Country/region to be invested in	15%	18%
The investments/companies reflect my own personal values	14%	13%
Brand of investment management company	11%	9%
None of these	1%	1%

3. Australians less inclined to use a lump sum for short-term investments (up to three responses allowed).

Use of significant lump sum

	Global	Australia
Use for short-term investments	51%	42%
Top up pension/retirement savings	42%	43%
Go on holiday	30%	30%
Spend on property, e.g. apply for mortgage/pay off some of existing mortgage/buy a property outright	28%	26%
Use for living expenses	19%	18%
Pay off debts (other than a mortgage)	17%	27%
Give to a good cause, e.g. charity	15%	15%
Buy a car	15%	19%
Give as a gift to friends/family	13%	21%
Other	4%	3%

5. Australians more likely to buy dividend-paying stocks than bonds to produce income.

Allocation of assets used to produce income.

Average % (Base: all those with income-producing investments)

	Global	Australia
Dividend-paying stocks	41.9%	44.6%
Bonds	22.6%	14.6%
Rental property	19.0%	22.1%
Other	16.5%	18.8%

Another factor worth highlighting is that Australian investor bond allocations are low by global standards, and 58% of direct (unadvised) investors have no fixed income holdings. Conventional portfolio theory dictates that fixed interest should be part of a well-diversified portfolio and act as a foundation of a retirement savings pool. Only 12% of Australia’s self-directed super pool is allocated to domestic fixed interest, down from 14% per cent three years ago. Australians are more familiar with cash and term deposits. When these two are combined with domestic and global fixed income, the allocation is 31% compared with the average exposure for pension markets in OECD countries of 51%. Most portfolios would benefit from the protective and diversifying characteristics of high-quality fixed income.

Graham Hand is Managing Editor of Cuffelinks.

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7 retirement challenges need a different focus

Darren Beesley

In the past, most Australians have been in accumulation phase of superannuation, with the primary objective of building wealth. But that started to change in 2011 when the first of 5 million Australian baby boomers hit

4. Australians will increase cash or not adjust a portfolio, rather than move to multi-asset funds (up to three responses allowed).

Portfolio adjustments in reaction to financial market issues

	Global	Australia
Use multi-assets	32%	26%
Increase cash investments	31%	36%
Move money into something else, e.g. buy property	29%	29%
Invest more in equity funds	23%	19%
Use target maturity strategy	22%	15%
Increase alternative investments	19%	18%
Invest more in bonds	17%	18%
Other	2%	2%
I would not adjust my portfolio	14%	22%
Would adjust their portfolio	86%	78%

retirement age. Every day another 800 baby boomers retire, and the result is that a large proportion of the population now has significantly different investment needs than in the past.

Unfortunately, most funds are not sensitive to the unique needs and challenges of post-retirement. Super funds are offered indiscriminately to all investors, both accumulators and retirees, and simply focus on a total return outcome and attempting to beat their respective benchmarks.

Amid a suite of investment strategies and tactics, we believe there are seven key factors that are vital to shifting an investment approach's focus from accumulation to one more suitable for retirees.

1. Limiting large losses

While younger people can weather steep falls in markets and can even take advantage of them by buying low, retirees – with no future contributions to make and without the luxury of time to wait for markets to recover – could be forced to sell assets at low prices to fund their retirement.

Therefore, retirees (or their fund managers), need to be aware of how large negative returns could become in any single stress event and they need to be actively managing that downside risk, particularly at the start of retirement.

One way to do this is to invest in portfolio protection, typically in the form of equity options, which can help to mitigate the risk of a large loss by smoothing returns.

2. Managing behavioural risk

Human instincts can be our own worst enemy and the natural response of a 'flight to safety' can destroy significant wealth if applied to financial markets. To exacerbate the issue, non-advised investors can easily access and change their investment mix via super fund online portals or directly via SMSF structures, which means that investors managing their own investment strategy can more easily fall victim to their behavioural instincts.

In our experience, investors are much less likely to be reactionary if they have clear goals set for retirement, are aware of the types of losses they could incur in a single market event, have portfolio protection (as discussed above) in place, and are aware of other actions they can take to combat poor performance such as adjusting their lifestyle or potentially increasing their risk exposure.

3. Focussing on income over growth

An investment strategy that prioritises income over growth offers significant benefits to retirees.

The primary benefit is matching their cash flow needs with assets that continually produce cash flow via dividends, coupon payments or rent. Additionally, when income in equals expenditure out, investors have less need to sell underlying investments to fund their lifestyle, allowing them to ride out market volatility and reduce transaction costs.

However, investing for income can be overdone; what is needed is a balanced approach that invests in quality assets with resilient income streams and stable capital values.

4. Managing duration

Duration is an approximate measure of a bond's price sensitivity to changes in interest rates, expressed as a number of years. For example, if a bond has a duration of five years its price will rise about 5% if its yield drops by 1%, and its price will fall by about 5% if its yield rises by 1%.

As the objective of retirement savings is to fund the retirees' future outflows, it is essential to understand how both the value of those outflows and of the retirees' current assets would be affected by changes in interest rates.

To remove uncertainty around interest rates, the duration sensitivity of the assets can be matched with that of future consumption; this is referred as asset-liability matching. Or if there is an expectation that interest rates will rise in the future the portfolio can be actively tilted towards shorter-duration bonds, which have less interest-rate risk.

5. Inflation awareness

When in accumulation phase, inflation is not such a big threat because as the cost of living rises, so do earnings. But it's a different story for retirees as an inflation spike means they pay more for their basic living expenses, such as groceries and utilities, without a rise in income to help meet those additional costs.

Yet many retirees are invested in conservative and moderately conservative index funds which have a large exposure to government bonds and duration, which underperform when inflation spikes.

Instead, retirees should hold assets that work to combat inflation risk such as inflation-linked bonds (rather than nominal bonds) and tilt toward sectors that have revenues linked to inflation such as infrastructure, property, energy and agriculture.

6. Managing liquidity

For investors, liquidity is the ease with which they can exit an investment at a favourable price, with reasonable fees and in a timely manner, should they need their funds immediately. As unexpected costs do arise in retirement (often in relation to health) having a strategy to manage liquidity in retirement is important.

Given the illiquid nature of property and some annuities, the retiree's account-based pension is typically the first point of call for emergency funding. If invested in a managed fund, the retiree should check that it offers daily liquidity, can be sold at a reasonable 'sell spread' and 90% or more of its holdings are in liquid assets.

If, in addition, retirees hold direct investments, they should also be aware of their portfolio's combined liquidity profile.

7. Tax awareness

Some retirees might think that they don't have to worry about tax given they are no longer working, but by investing retirement savings in a tax-aware manner, the result can be a boost in income. To that end, there is a growing awareness of the role that franked equity dividends can play in a retirement strategy.

Franking credits – the tax credit investors can claim for tax already paid on a company's corporate earnings – became refundable in the early 2000s.

Investors who pay lower tax (including retirees) receive a cash payment for the difference between any franked rate of dividend income and their individual tax rate. For retirees on a 0% tax rate, they receive an uplift of up to 43 cents on each dollar of fully franked dividend. For every 70 cents of dividends, investors can receive a tax credit of up to 30 cents, which equates to 43 cents per dollar of dividends.

Final thoughts

During the dark days of the global financial crisis many retirees panicked and sold out of investments at the worst possible time. But even more concerning were the stories of retirees scrimping and living below the poverty line, worried about their future.

Our investment approach for retirement has for too long been modelled off the approach developed for younger accumulators, yet the risks that need to be managed are vastly different.

By considering these seven factors we will be more likely to have a generation of retirees who are confident in their investments, more likely to stay the course and able to enjoy the best retirement they can afford.

To view AMP Capital's new video on ESG investing, [click here](#).

Darren Beesley is a Senior Portfolio Manager at [AMP Capital](#). This article has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.

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Beyond financial solutions for longevity

David Williams

I appreciated Jeremy Cooper’s recent excellent article on meeting the challenges of longevity risk. Erudite actuaries and investment gurus have long sought investment products which guarantee income for the life of each investor.

While I support efforts to craft better financial products and solutions, we must also make more effort to educate our rapidly-growing older population. There is much they can do to reduce longevity risk themselves. The focus on financial literacy seems to have been most effective at younger ages but not as much beyond midlife. Reallocation of resources into greater longevity awareness is required.

What could be the key elements?

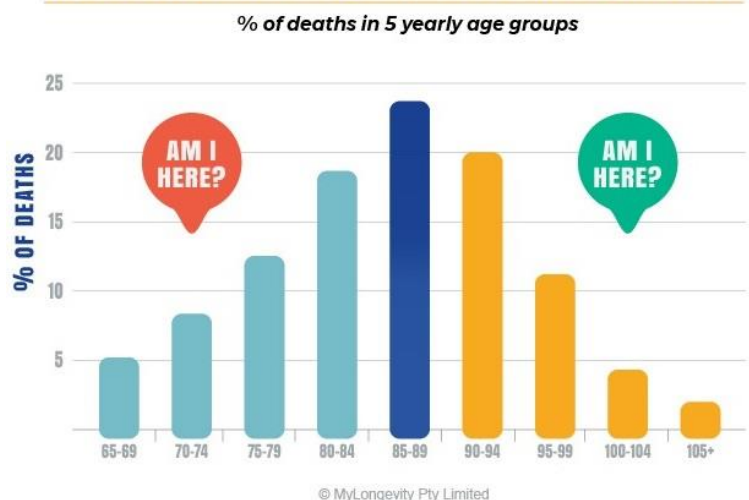
1. Realising that at age 65 (‘retirement age’), over 75% of people are not within three years of the number of years nominated in Life Table expectancies. As shown in the diagram below, there is an enormous range of mortality outcomes, making estimates of how long money will last much less realistic than most people appreciate.
2. Recognising that the rest of their life is likely to play out in three stages: 1) able, 2) less able but still independent, and 3) dependent. Life will be materially different in each stage. For a majority of people at age 65, for example, the able stage is over 10 years, prompting serious consideration of alternatives to stopping paid work too early. This may not be viable as dependency rises.
3. Understanding that the longer they live, the longer they are likely to live, but much of this extra life is likely to be independent. If their prospective lifespan increases, so their dependent phase is likely to reduce.
4. Appreciating that successful ageing is likely to reflect their personal focus on four main issues: 1) exercise, 2) effective social engagement, 3) diet and weight control and 4) appropriate mental challenges.
5. Knowing that indefinite extension of lifespans seems unlikely, but the cost of staying alive will rise to reflect increasingly expensive medical solutions.
6. Accepting that home-based aged care is inevitable for most, and that preparing family and dwellings for this eventuality should be a priority in the able stages of longevity, not when the need becomes evident.
7. Contributing to the debate on assisted dying, recognising the ethical, emotional and financial considerations and expressing a personal view in a way people close to you understand.
8. Factoring in that cognitive issues such as Alzheimer’s disease (now a major factor in the death of older people) appear to reflect earlier life behaviours which many people can address with the hope of deferring the onset.

Averages disguise significant variability

Only 200 years ago, the average baby would not live beyond 40 years old. Babies born today are on average expected to live beyond age 80. Society has made use of this – through better education, communications, infrastructure, laws and governance and greater wealth to invest in living standards. While most people realise this remarkable change is ongoing, few realise what it can mean for them personally.

If we look at a very large group of 65-year-olds in Australia, we know on average how long they will survive. This diagram below shows the percentage of deaths expected in groups of five years. The average survival is 21 years for a 65-year-old. It sits inside the blue column, which represents less than a quarter of the

Mortality of 65 year olds in Australia



total age group, so the average is not very helpful. At this age, men live about three years less than women.

Success in dealing with longevity risk is more likely to reflect management of the elements outlined above rather than hanging out for financial products which may be a partial solution but will not address the broader opportunities and risks in our longevity for the rest of our lives. People should be empowered to take more control of their personal circumstances, and better education is the key.

David Williams is Founder and CEO of [My Longevity](#). Try the [SHAPE Analyser](#) to focus on our own longevity.

Key themes likely to shape markets in 2019

Lee Mickelborough and Jay Sivapalan

Lee Mickelborough, Head of Australian Equities at Janus Henderson

We expect some of the dominant themes of 2018 to persist into 2019. The strong growth in the United States, which has been pushing up interest rates and inflation pressure, will continue.

On the political side, the trade tension between the United States and China, and the resulting slowdown in Chinese growth will also likely persist. In Europe, moderating growth and potential risks arising from the Italian bond market are significant, adding to a backdrop of potential risk events for 2019.

Where do you see the most important opportunities and risks within your asset class?

In Australia, the main area of focus for us has been on the slowdown in the housing market and the tightening of credit standards. This is particularly important for Australian equities given the dominance of banks in the benchmark and we are very cautious about this sector. Additionally, the Banking sector currently has very low levels of bad debts in the system, which on the one hand is positive, but from such a low base, means we are likely to see an increase in bad debts in 2019.

Mining, the other dominant sector in the Australian market, is one we are wary of due to the slowdown in China. Interestingly, while this slowdown has been occurring, iron ore prices have been consistently strong, which has been encouraging from a cash flow perspective for businesses like BHP and Rio Tinto, within which we have select investments.

Given the headwinds for the banks and miners, which together make up about half of the Australian equity market, we're looking outside these sectors for other opportunities. These include consumer staples players, like Woolworths. While this company hit a little bit of an air pocket in the middle of the year with a slowdown in sales, it is now re-accelerating. In our view, it is a very well-managed business, a dominant player in its market, and the balance sheet is very strong. We also anticipate some capital return at some point in the early New Year, so strong cash flows and capital returns are very positive in the context of a cautious backdrop.

We also like the outdoor advertising sector and have holdings exposed to the sector. Outdoor advertising is coming back into vogue as part of an advertiser's marketing mix given how it complements other forms of media. This is especially the case with the digitalisation of the sector, which is reducing the production costs associated with printing and installing advertisements, as well as enabling advertising to be more dynamic and varied by geography and time of day.

The outdoor advertising sector has also consolidated from a five-player market down to a three-player market, so we think returns and growth will be strong.

In a cautious market, we're looking for interesting bottom-up opportunities and generally if they've got some defensive characteristics or they've done a reasonable acquisition, we're interested in taking a closer look. We added Amcor, a packaging company, in the second half of 2018 as it is mainly exposed to the fast-moving consumer goods segment – a relatively defensive opportunity, which also benefits from a strong economy as well. Amcor has good US exposure and also just completed the acquisition of US competitor, Bemis. While Bemis has been very strong on product development and product innovation initiatives, it was not as strong on the manufacturing side, complementing Amcor, which was the opposite case.

Aside from defensive stocks, the Q4 market correction is throwing up a lot of really interesting opportunities from a bottom-up valuation perspective. With the market now trading closer to 14 times earnings, even though

the backdrop is cautious, we think a lot of it is priced in and we're finding really interesting opportunities in the market. Since the Global Financial Crisis, we haven't really seen that type of attractive earnings multiple.

Which chart do you think will be a key indicator for 2019?

I think the best indicator that you can focus on for 2019 is US 10 Year Bonds. It reflects what is going on in the interest rate markets, inflation and growth and also some of the geopolitical tensions that may occur in 2019.

If the bond yield is tracking higher, that would suggest inflationary pressures are building and we should be more cautious, growth will obviously be pretty strong in that environment. If it's chugging along and we've got good moderate growth and moderate inflationary pressures, that is an ideal situation for staying long stocks and if yields start to fall rapidly that is obviously where there has been a hiccup somewhere, growth has deteriorated or there's been a political issue.

Jay Sivapalan, Co-Head of Australian Fixed Interest at Janus Henderson

As we look forward to 2019, we see further divergence of what the US Federal Reserve (Fed) will be doing relative to other central banks in terms of tightening the various forms of monetary policy that have been employed over the last decade. The Fed will continue to tighten monetary policy toward neutral policy settings over 2019. One key theme we'll see is the impact from the unwinding of Quantitative Easing (QE) at a time of higher treasury bond supply.

A reassertion of inflation, especially wages inflation, will likely occupy the market's focus and will dominate the broader commonly assumed disinflationary themes of the past decade, such as demographics, technological change and disruption.

For the US, the markets will grapple with properly pricing in tight monetary policy that is above neutral cash rates. It has been forgotten over the past decade that monetary policy has two sides, easy and tight.

Overall, we continue to expect yields to rise further in 2019 and for the yield curve to become flatter as this occurs, but the broader trend is for a higher rates structure. Ultimately this is good for investors, but we do need to manage the journey along the way.

Where do you see the most important opportunities and risks within your asset class?

The key risk that needs to be watched and managed for fixed interest investors is interest rate risk, or more specifically, duration in a rising rate environment. In the case of Australian fixed interest, whilst we think this risk is relatively low given the Reserve Bank of Australia (RBA) is likely to be on hold over 2019 at a cash rate of 1.5%, Australian bond yields can lift in the short term on the back of rising US yields. This creates for us both a risk that needs to be managed, but also great opportunities to add duration to capture higher yields that may not ultimately be sustained in markets.

In credit markets on the other hand, participating in the income remains an important source of excess return for investors. But the manner in which we participate is important at this more mature phase of the credit cycle. Whilst we don't see credit markets as imminently risky, it is worthwhile continuing to be prudent when investing in corporate debt, favouring defensive sectors and being biased towards the higher credit quality spectrum. There have been some pockets of the Australian credit markets that have underperformed this year where we've had minimal exposure. One example is Australian AAA rated residential mortgage backed securities for obvious reasons. But at some stage, pricing is likely to get to levels where the breakeven returns are very much in favour of investors. This is an area we'll be watching with interest over 2019 and looking to exploit.

How have your experiences in 2018 shifted your approach or outlook for 2019?

In many ways, 2018 was a year when we witnessed the shift in market thinking from the past decade where ultra-easy monetary and fiscal policies had supported economies to one where, at least in certain economies like the US, the degree of policy accommodation needed to be reined in. We think this paradigm shift will accelerate through the course of 2019. As such, our portfolio strategies will take this dynamic into account and we think a very flexible approach when dealing with both interest rate and credits risks will be paramount in navigating 2019 and beyond.

Which chart do you think will be a key indicator for 2019?

The one chart to continue to watch in 2019 will be the wages inflation in each economy. It is the ultimate validation of the effectiveness of monetary policy – of course, this comes with long and variable lags.

Markets had incorrectly assumed in the post-GFC era that relationships, like the Philips Curve, are no longer applicable. 2019 should confirm that they are indeed valid relationships, where economies operating above full employment will in due course produce wages inflation, which the central bank will ultimately need to respond to.

Clearly this is very relevant in the US, but even in economies like Australia which of course is lagging the US in terms of the monetary policy cycle, it is important to watch wages as a barometer of the positive offsets of consumption, infrastructure and exports relative to the slowing housing construction story.

Even in Australia, markets could at some stage in 2019 start grappling with some form of tightening monetary policy cycle over the subsequent two to three years (2020 and 2021). These dynamics need to be managed and will likely create opportunities for active managers.

A surprise domestic growth slowdown

Bill Evans

Growth in the Australian economy slowed to 2.8% in the September quarter. There were a number of significant developments in the GDP report.

Firstly, we saw the first 'negative' on new dwelling construction in the quarter following a particularly strong first half. Westpac expects this will be the start of a long run of falls in residential construction reflecting the downturn in dwelling approvals and the expected further contraction as tight funding conditions and falling house price expectations deter both demand and supply of new construction.

Secondly, we saw a particularly weak print on consumer spending reflecting weak income growth (real household disposable income was flat over the year to date) and a decade-low savings rate.

Wages growth is lifting only very slowly while strong employment growth is expected to slow in 2019 as political uncertainty and global tensions in trade and softening demand weigh on the confidence of business. There is also likely to be some wealth effect on consumption through 2018 H2 and 2019 as the impact of falling house prices on households' balance sheets plays out.

Non-residential construction is also falling – down from the surge in activity we saw in 2017, although we expect this to stabilise through 2019.

Weak second half of 2018 will feed into 2019

Overall, we expect growth in 2018 will print around 3% with the 4% annualised momentum in the first half slowing to 2% in the second half. That weak second half momentum will weigh on 2019. We expect growth to slow in 2019 to 2.6% following ongoing contraction from new dwelling construction; continuing below trend growth in consumer spending; and uncertainties around the Federal election and the global economy.

House prices will be important in 2019. Even though prices have fallen by 9.6% from their peak in Sydney and 5.8% in Melbourne, these adjustments follow cumulative increases in Sydney (40%) and Melbourne (32%) over the previous four years. Affordability is still stretched in both cities.

Unlike previous cycles where affordability was boosted by sharp reductions in interest rates and strong (4% wages growth) income growth, the necessary restoration of affordability in this cycle will need to come from prices.

The additional complication is that even if affordability has been restored and buyers are attracted back into the market, credit is being tightened by the major banks. As we have recently seen in Perth, affordability can be restored but prices can still fall further if credit is tightened.

On the positive side there are other construction cycles which are likely to continue to boost growth. Government infrastructure spending, in particular, continues to lift; we are at the bottom of the mining investment cycle and positive prospects particularly around iron ore and lithium are boosting investment plans.

The September quarter GDP print will come as a disappointment to the Reserve Bank. Recall that in the Governor's Statement on Tuesday, he noted that "one continuing source of uncertainty is the outlook for household consumption".

Note that the Bank's forecast for GDP growth in 2018 which appeared in the November Statement on Monetary Policy was 3.5%. With the first three quarters of the year totalling 2.2%, the December quarter would have to print growth of 1.3% (a 5.2% annualised growth pace) – a highly unlikely event. We can expect the Bank to lower its forecast for GDP growth in 2018 from 3.5% to 3.0% when it next releases its forecasts on February 8, 2019.

That forecast will then challenge the 2019 forecast of 3.25% which appeared in the November Statement. It was reasonable for the Bank to assume some slowing between 2018 and 2019 (Westpac's growth forecast for 2019 has been 2.7%) particularly with a more clouded outlook for global growth and a likely accelerated contraction in residential investment. That would immediately push the likely 2019 forecast back to around Westpac's forecast of 2.7%.

So, although we did not get a growth assessment from the Deputy Governor in his speech on Thursday, the GDP print is likely to change the Reserve Bank's growth rhetoric of strongly above trend to slightly above trend drifting back to trend in 2019.

Westpac has consistently forecast that the cash rate would remain on hold through 2019 and 2020. If we are right that the Bank will revise down its growth forecasts on the basis of this result, then lower expected growth momentum going into 2020 may also temper the Bank's attitude to rates in 2020 as well.

From our perspective, a central bank forecasting growth around trend rather than well above trend is much less likely to feel the 'responsibility' to normalise rate setting.

The market is too cautious on the Federal Funds Rate

With this domestic growth profile as a backdrop, we confirm our long-held views that the Reserve Bank will keep the cash rate on hold through 2019 and 2020. The RBA's on hold decision will also be backed up by slowing global growth, particularly in 2020 when the US economy will slow back to trend growth of around 1.75%- 2.0% from an above trend 2.5% in 2019 and near 3% in 2018.

Furthermore, the first half of 2019 will see markedly faster growth than the second half when, in particular, the interest rate sensitive parts of the economy (housing and durables) will be weak and employment growth will slow. Despite the fading of the tax cuts, we believe rising wages and strong employment growth will boost household incomes in 2019, supporting solid consumer spending, particularly in services.

Unlike current market assessments of a potential inverse yield curve, we expect that the Federal Reserve will be able to pause earlier than has been experienced in previous cycles ensuring that soft landing. With this growth profile in mind, we expect that the last hike from the FOMC will be in September 2019. By that time, employment growth will have slowed from 2% in the second half of 2018 to 1%, providing the FOMC with the opportunity to go on hold around a neutral setting – full employment; trend growth; and 2% inflation.

That timing implies four more hikes, beginning in December 2018. Markets are currently pricing one hike in December 2018 and less than one more through 2019, indicating that we expect a sharp market surprise around the policy approach from the Fed.

In turn, this 'surprise' is likely to see higher US bond rates and a stronger US dollar. We have slightly lowered our expectation that the US 10-year bond rate expecting a peak of 3.4% by the second half of 2019 and the USD Index will appreciate a further 3-4% by the September quarter. The time for a sustainable fall in bond rates and the USD will be around the time of the FOMC pause, rather than the current circumstances when the US economy is growing near 3% and wage inflation risks are apparent.

Trade policy and China are major risks

Markets are too influenced by the recessions that followed the last two rate hike cycles of the Federal Reserve. These resulted from unique imbalances – the bursting of the dot com bubble and the GFC. No such comparable risk presents itself in this cycle, including trade policy, although ongoing tensions will unnerve markets. It seems unlikely that the Chinese authorities will be prepared to make the specific changes to their industry and trade policy that would specifically satisfy the US needs. These would include changes to forced technology transfer,

intellectual property protection, non-tariff barriers, forced joint venture investment, cyber intrusions and government industry subsidies.

Consequently, trade disruptions are a certain theme through 2019 although President Trump and China are likely to find ways to avoid the US imposing tariffs on the remaining (around \$200 billion, mainly consumer goods compared to the current tranche which is only around 25% consumer goods) imported to the US from China that are not affected by tariff decisions to date. However, we believe the most recent 10% tariff on \$200bn will be increased to 25% before mid-year.

We have seen that trade concerns have also weighed on the Chinese economy. Other more significant drags on Chinese growth have been winding back the shadow banking system and pollution policy. Credit policies to direct more growth into the regulated banking system; a more liberal approach to pollution policy; and direct fiscal stimulus will all be used to maintain a managed slowdown in China. We are targeting a 6.1% growth rate in 2019 from 6.4% in 2018.

Other regions are less important to the overall global view. Emerging markets will suffer under the weight of rising US interest rates and a higher USD. Japan will be preparing for the introduction of a new consumption tax and Europe will be impacted by the China/emerging markets slowdown; supplemented by Brexit; Italian instability; political unrest in France and Germany; and a gradual tightening of monetary policy as the ECB halts its balance sheet expansion from the beginning of 2019.

Bill Evans is Chief Economist at [Westpac](#).

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