

Bryce Doherty's Top Articles from the archive

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Summer Series Guest, Bryce Doherty

At a time when we are overwhelmed with the negative views surrounding the financial services industry, it is important to take stock, reassess and ask ourselves: 'How did we find ourselves here?'

As an individual with kids of school age who needs to look beyond the here and now to the future, a key takeaway from the Royal Commission is how paramount financial literacy and sound and transparent financial products and advice is for all Australians to prepare for their futures. The amount of information or maybe disinformation available nowadays is overwhelming. Educational, well explained and accurate pieces are increasingly hard to come by for all investor segments.

Hence when Cuffelinks approached me to be a Guest Editor this year, I instinctively was drawn to pieces which seek to educate, with these five examples.

1. Superannuation planning is not a simple thing, and while Australia is well ahead of most developed countries in terms of planning for one's retirement, Wade Pfau & Jeremy Cooper's ['The Yin and Yang of retirement income philosophies'](#) (21 November 2014) highlights the basic principles to retirement planning. Despite its 2014 vintage, the article still drives home for me why every Australian needs to understand the basics to achieve their end retirement/wealth accumulation goal.

2. Don Ezra's 10 November 2017 piece titled ['Three crucial mistakes about life expectancy'](#) builds on the above fundamentals, "I've found that many people have a vague idea about how long life expectancy is, and that is typically underestimated." This basic mistake can be a fatal one in retirement planning, another issue I think all Aussies need to give serious consideration to when they are looking to plan for their futures.

3. Moving on from the basics now into portfolio construction there are a number of articles which resonated with me. As CEO of UBS Asset Management in Australia, portfolio diversification and optimisation is something that we are very focused on. Typically Australian investors are heavily weighted to onshore equity products, hence multi asset portfolios, emerging market portfolios, infrastructure portfolios and even portfolios which focus on factor investing are increasingly becoming the basis of our discussions as investors shy away from the big 4 Aussie banks.

A good bridge into this topic of portfolio diversification is via Jim Masturzo and Jonathan Treussard's '[Building portfolios: diversification without the heartburn](#)' (5 October 2018). It highlights why diversification is important, and importantly that diversification is a balancing act.

4. And finally building on this diversification topic is Warren Bird's '[A journey through the life of a fixed rate bond](#)' (March 5, 2015) and ...

5. Greg Goodsell's '[Three Drivers of Attractive Infrastructure Opportunities](#)' (21 April 2017).

These latter two are great examples of potential diversification sectors and why people shouldn't be shying away into the less 'glamorous' areas!

Bryce Doherty is Head of [UBS Asset Management](#), Australia and New Zealand.

The Yin and Yang of retirement income philosophies

by Wade Pfau and Jeremy Cooper on November 21, 2014

Within the world of retirement income planning, there are two major opposing schools of thought: probability-based and safety-first. Understanding the distinctions and thought processes of both schools is important in achieving the best outcomes.

Separating accumulation from drawdown: the difficulties of retirement income planning

In defined contribution schemes, there are differences between the wealth accumulation phase and the income distribution phase. One important difference is that the investing problem fundamentally changes in retirement.

The traditional goal of wealth accumulation is generally to seek the highest returns possible in order to maximise wealth, subject to the investor's risk tolerance. After retiring, however, the fundamental objective is to sustain a living standard while spending down assets over an unknown, but finite, length of time.

Investing **during** retirement is a rather different matter from investing **for** retirement, as retirees worry less about maximising risk-adjusted returns and worry more about ensuring that their assets can support their spending goals for the remainder of their lives.

The two schools of thought

As an introduction to these schools, consider a simple example. Suppose a retirement plan has a 90% chance of success of providing income for a retiree taking into consideration longevity and market risk. Both sides will have dramatically different interpretations about what this number means.

From a probability-based perspective, 90% success is a more than reasonable starting point. It is likely to work. Safety-first advocates, however, will not be comfortable with this level of risk, focusing instead on the 10% chance of failure. They will seek a solution that removes the impact from any possible failure.

The probability-based school of thought

The probability-based approach is closely associated with the traditional concepts of wealth accumulation. In this frame, people do not differentiate between essential needs and discretionary expenses. Rather, people operate on a total budget concept.

Probability-based approaches are based closely on the concepts of maximising risk-adjusted returns from the perspective of the total portfolio. Different volatile asset classes, that are not perfectly correlated, are combined to create portfolios with lower volatility that provide the highest 'expected return'. It is an assets-only analysis, and the investor's spending needs are not relevant to determining the appropriate asset allocation.

For retirement planning, spending and asset allocation recommendations are based on mitigating the risk of wealth depletion that is inherent in drawing down a portfolio of volatile assets (ie due to sequence of returns and market risk). The failure rate is the probability that wealth is depleted before death, or before the end of a fixed time horizon.

Table 1: Retirement income philosophies

	Probability-based	Safety-first
How are goals prioritised?	Retirees have a particular lifestyle goal in mind and not meeting this overall goal indicates failure. Lifestyle goals are not prioritised between essentials and discretionary.	Goals are prioritised. For instance, the funding hierarchy could be: (1) basic needs, (2) contingency fund, (3) discretionary expenses, (4) legacy goals.
What is the investment approach?	Usually a total returns perspective framed in the same terms as pre-retirement accumulation using techniques such as portfolio diversification. The focus is wealth management for the financial portfolio.	Asset-liability matching. Assets are matched to goals so that risk levels are comparable. Lifetime spending potential over an uncertain horizon is the focus, not maximising wealth. There is a wider role for products to hedge interest rate risk and provide longevity insurance.
What is the role of an account-based pension?	The account-based pension is all that is needed for an outcome that will probably work. They are flexible enough to make whatever adjustments are required.	The account-based pension can be utilised after the safety requirements have been met. It can then deliver aspirational or discretionary spending.

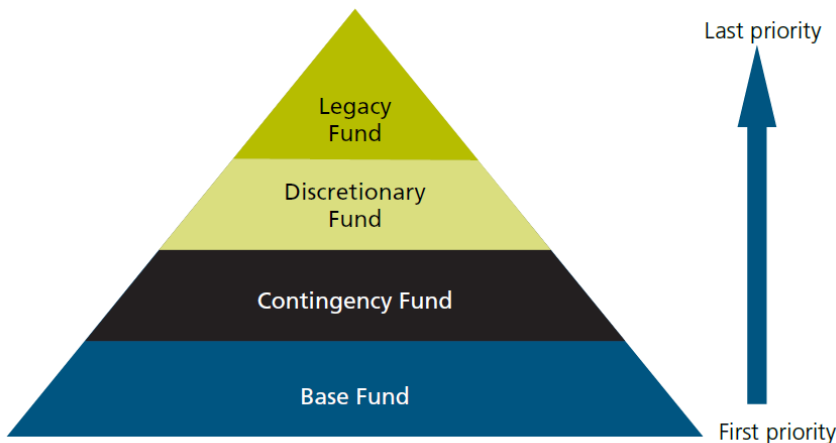
Probability-based advocates tend to focus on the potential of equities to provide positive real returns and to outperform bonds over the long run. Retirees are thus advised to take on as much risk as they can tolerate to minimise the probability of failure. This has led advocates of the probability-based approach to use more and more aggressive asset allocations.

The safety-first school of thought

Advocates of the safety-first school of thought view prioritising retirement goals as an essential component of developing a good retirement income strategy. Prioritisation will be very important because the investment strategy is to match the risk characteristics of assets and goals.

Retirees’ spending priorities are prioritised like the pyramid in Figure 1. Essentially, spending is required to satisfy basic needs, with additional spending on discretionary items after basic needs are met. The pyramid model requires each goal to be properly funded before continuing to the next level.

Figure 1: Modern Retirement Theory hierarchical pyramid



Source: Branning and Grubbs www.modernretirementtheory.com

The general view of safety-first advocates is that retirees only have one shot at getting sustainable cash flows from their savings. This means they must develop a strategy that will at least meet their needs, no matter the length of life or the sequence of post-retirement returns.

Retirees often have little leeway for error, because returning to the labour force is not a realistic option for many retirees. Volatile investments like stocks are not appropriate when seeking to meet basic retirement living expenses. Volatile (and hopefully, but not necessarily, higher returning) assets are suitable for discretionary expenses and legacy, where the spending is more flexible.

The goal is to have cash flows available to meet spending needs as required. Investment assets are matched to goals so that the risk and cash flow characteristics are comparable. This can include defined-benefit pensions, bond ladders, and fixed rate annuities.

The retirement income challenge

The essential difference between the schools of thought relates to the degree of comfort people have that equities will always perform well enough for a broadly diversified portfolio to meet a retiree's basic needs, without relying on more secure assets. With essentials-versus-discretionary, lifetime flooring protection is created for essential needs. This is really 'goal segmentation.' Systematic withdrawals generally leave the entire lifestyle spending goal at risk, since spending needs must be supported from a portfolio of volatile assets.

Concluding remarks

Super funds and financial advisers alike can help retirees overcome the complexities of generating retirement income by first understanding the different philosophical approaches to retirement. While neither a probability-based nor a safety-first approach is definitively right or wrong, different people will align more easily with one or the other. Nor is it an all or nothing approach. A fund or adviser shouldn't advocate for only safe assets and no risky assets. The safety first approach is about securing essential spending needs in retirement, with room for more probability-based approaches for discretionary spending.

The full paper by Pfau and Cooper is available [here](#). An extended version of this summary is [here](#).

Wade Pfau is professor of retirement income at The American College and hosts the Retirement Researcher blog at wpfau.blogspot.com. Jeremy Cooper is Chairman, Retirement Income at Challenger Limited.

Three crucial mistakes about life expectancy

by Don Ezra on November 9, 2017

I've found that many people have a vague idea about how long life expectancy is, and that it is typically underestimated. It's an important subject, because if you're going to plan to make your assets last a lifetime, you need to make some estimate about how long that lifetime may be.

Why do so many people misunderstand it? Is it the arithmetic or the concept? Let's take a look. (Spoiler alert: the arithmetic is simple.)

Let me make three points about life expectancy.

1. Most people misunderstand the arithmetic

Even if they have heard that in some country (call it Country A) life expectancy at birth is 80 years, they don't understand that if they have reached the age of 65, the average person can expect to live more than another 15 years (in fact, probably more like 20 years). Here's how the arithmetic works:

Suppose I asked you for the average of the numbers from 0 to 100. It's not a trick question. It's simple arithmetic. You know the answer is 50.

Now suppose we leave out the lower numbers and determine the average of the numbers from 40 to 100? Obviously, it'll be higher; in fact, the average now rises to 70.

It's similar with life expectancy.

Suppose we encountered a peculiar population of 100 people in which one person dies before the first birthday, one dies between ages 1 and 2, and so on, the last one dying between 99 and 100.

What would be the average age at death? Again, not a trick question: it's 50. Half the people will live longer than that, half won't reach it.

Now suppose we leave out all of those who die before age 40, leaving us with a smaller group. The average age at death of this smaller group is 70. Half of those alive at age 40 will live longer than that, half won't reach it.

So, what does this tell us about the life expectancy of this peculiar population?

It tells us two things. First, at birth, if we don't know which person we're talking about, all we can talk about is the average, and for the average person, then, the life expectancy is 50 years. Second, if we consider only those who have survived until age 40, and again we don't know which individual we're talking about, their average age at death is 70. Their *future* life expectancy, once they've reached 40, is another 30 years, because that's what 'life expectancy' means: it's the average number of *future* years to be lived by the average member of a well-defined group.

Notice that the people in the second group (those who have survived to age 40) are also members of the first group (the entire population). But the two groups are not the same, even though they contain some identical members. The second group excludes those who have already died before 40; that makes it a different group, and a longer-lived group. So, if we are to define life expectancy, it's important to define the group we're talking about very clearly.

OK, now let's go back to Country A, and interpret those numbers.

The numbers tell us two things. First, if you include the entire population, the average age at death is expected to be 80. Second, if you exclude those who have already died before age 65, and include only those who survive past that age, their average age at death is higher than 80; in this case it's around 85. And that's why the future life expectancy of someone in Country A who has already survived to age 65 (a smaller group) is a further 20 years, not the 15 years that people often misunderstand it to be.

Life expectancy tables vary by gender (typically, the life expectancy of a female is longer than that of a male), by country, by race – all kinds of factors, in addition to age. You may find a website with a calculator that helps you to estimate your future life expectancy. If your health isn't average (it may be better or worse), your doctor may be able to help.

2. Averages disguise the unpredictability

Talking about the average conceals the fact that, for any individual, the actual date of death is uncertain. For most people, until they're near death, their specific future life expectancy is still pretty much unpredictable.

When you make financial plans about the future, *it's important to take this unpredictability into account*. There are many ways to do so, the subjects of future posts.

3. The longer life expectancy of one member of a couple

More specifically, how long before the *second* death of the couple. Techies call this the 'joint and last survivor' life expectancy. It's important because it's necessary to provide for the longer-lived member of a couple, whichever one that may turn out to be.

Suppose there's a couple whose individual future life expectancies, at some point in time, are roughly 15 years and 20 years. How long until the second death?

Most people say: well, after 15 years you expect one to die, and after 20 years the second one will die; so, it's 20 years to the second death, right?

It actually turns out to be a little more complicated than that. I won't go into the arithmetic. I'll just tell you why the expected time to the second death is *longer* than 20 years.

The one with the longer expectancy has a 50/50 chance of living longer than 20 years. The one with the shorter expectancy has *some* chance (though much less than 50/50) of living longer than 20 years. Between them, they have a bit *more* than a 50/50 chance. And so for the couple together, *the average expectancy to the second death is longer than the longer of the two individual life expectancies*.

Don Ezra has an extensive background in investing and consulting, and is also an accomplished author. His current writing project, consisting of blog posts at www.donezra.com, is focused on helping people prepare for a happy, financially secure life after they finish full-time work.

Building portfolios: diversification without the heartburn

Jim Masturzo And Jonathan Treussard on October 4, 2018

Just as enhancing a meal with spices can cause indigestion and heartburn, adding asset classes to an investment portfolio beyond traditional core stocks and bonds can induce an uncomfortable reaction. To the degree our individual risk tolerance allows, however, the addition of diversifying asset classes can offer more rewarding long-term investment outcomes when compared to less-diversified portfolios.

Of equal importance, and of equal cause for heartburn, is holding on to those less familiar asset classes through periods of volatility. Yet, being able to stomach both potential causes of discomfort – adding the diversifying assets in the first place and then holding onto them – offers investors the potential to reap the benefits of diversification over the long run. The crucial ingredient to a diversifying strategy’s success is to find the diversifying mix an investor is comfortable with over the long term.

How much diversification is enough?

The most common objective of individual investors’ portfolios is to maximise after-tax net-of-inflation (or real) returns, so that those returns provide money for expenditures when needed. The most crucial aspects of diversification are that:

- diversification is **long-term**. Over shorter horizons, particularly in volatile markets, we must remember the long-term value proposition of diversification.
- diversification is **not** an all-or-nothing choice. We can put diversifying asset classes into the current portfolio mix to the extent we are capable of tolerating the inevitable short-term discomfort.
- finding the **right allocation** to diversifying asset classes helps avoid the costly but common practice of rotating into and out of diversifying strategies at the wrong times.

The asset mixes of a diversified portfolio

The [Asset Allocation Interactive](#) (AAI) tool on the Research Affiliates website can assist advisers and their clients in visualising the benefits of greater diversification in their current portfolio mix. AAI uses a common risk-and-return framework to identify efficient (from a return per unit of risk perspective) portfolios, which are well diversified for a range of target volatilities.

The following scatter plot from AAI shows the long-term real risk and return expectations in AUD (based on data as at 31 August 2018) for 27 global asset classes and four portfolios along the efficient frontier (shown below in the four black dots).

Portfolio and asset class expected 10 year returns as of 8/31/2018



Note: The term 'Linkers' refers to inflation protected bonds. Source: Research Affiliates, LLC, Asset Allocation Interactive Tool. Please see disclosure.

For illustration, look more closely at the 8% volatility portfolio. Over 72% of the portfolio consists of asset classes outside of developed-market equities and bonds. The equity allocation of 54% is invested 31% in emerging market equities. This outcome is driven by today’s valuation levels (as of August 31, 2018), which call for an efficiently diversified portfolio to step even further out of the mainstream than would otherwise be the case, given the better bargains that exist elsewhere in the capital markets. Note that the Credit category includes investment grade, high yield and Emerging Market bonds.

The 8% volatility efficient portfolio asset allocation as of 31 August 2018

Asset Weight

AUD Cash	0.0%
> Equities	54.1%
> Core Bonds	1.0%
> Credit	29.2%
> Linkers	0.9%
> Cash	6.4%
> Commodities	3.2%
> Hedge Funds	0.0%
> Private Equity	5.3%
> Model	0.0%

Note: The term 'Linkers' refers to inflation protected bonds. Source: Research Affiliates, LLC, Asset Allocation Interactive Tool. Please see disclosure at end of article.

Diversification is not an all-or-nothing choice

To some, the 8%-volatility efficient portfolio may seem too alien and uncomfortable. We get it. Even though the rational side of our brain knows we should hold diversified portfolios, the discomfort of unfamiliar assets can lead us to gravitate toward a more familiar mix, such as a 60/40 allocation. The behavioural finance literature (e.g. French, Kenneth, and James Poterba. 1991. "Investor Diversification and International Equity Markets." American Economic Review, vol. 81, no. 2: 222–226) shows that investors are naturally predisposed to tilt their portfolios toward the stocks and bonds of their own country. Referred to as home bias, this tendency is often fueled by a preference for the familiar and an aversion to the unknown.

Our behavioural biases go even further. Investors can easily feel more regret when losing money in foreign markets than they do when underperforming in their home markets. For this reason, diversification is unfortunately sometimes referred to as 'regret maximisation'. So it's no surprise the predominant risk in most investors' portfolios is mainstream equity risk, and that the average asset allocations of financial advisers, wealth managers, and public plans are heavily weighted to mainstream stocks and bonds.

Yes, the urge to invest within the friendly confines of home is both strong and natural. But this doesn't mean we should sacrifice global diversification altogether. We can still harness the potential of diversifiers if we first accept that building and holding a diversified portfolio is not an all-or-nothing choice. We can successfully engage in the pursuit of diversification by building asset mixes that marry individual preferences or tolerances with forays into an expanded opportunity set. Even if diversifying assets compose a small portion of

our overall portfolio, any nudge in this direction puts us on a path toward better long-term outcomes gained by achieving the potential benefits of diversification.

Tracking error, or the volatility of relative returns between a portfolio and its benchmark, represents the risk taken by an investor who strays from the benchmark. Most investors don't think of their portfolio relative to an investment benchmark per se, but often benchmark their returns against their friends, family, or the market index. By keeping tolerance to discomfort in check, we can increase the likelihood of willingly holding the portfolio over a longer horizon.

Conclusion

A consistent diet of spicy food has been linked to health benefits, including a longer life span. For those who want these benefits, but are especially averse to the painful flames, do not despair. Simple remedies abound for those who want to ramp up their tolerance for spicy food. Ultimately, how much heat to ingest is a personal choice, the same is true when it comes to investing.

There are benefits for our investment health of finding the right level of asset class diversification. Beyond the obvious practical implications for customising client portfolios, the AAI tool can illustrate the trade-offs of greater portfolio diversification. This visual means of communication may be helpful in *extending the baseline tolerance level*, especially in times of short-term underperformance which is likely be beneficial in the long run.

Extending the adviser-client dialogue by illustrating the likely risk and return trajectories of a spectrum of diversified portfolios is a simple yet crucial method. The opportunity to encourage trust through greater understanding, while reiterating a few enduring principles such as the long-term value proposition of diversification, can help us steer investors to better long-term outcomes.

Jim Masturzo, CFA, is Senior Vice President, Head of Asset Allocation and Jonathan Treussard, PhD, is Director, Head of Product Management at Research Affiliates LLC. Research Affiliates will be hosting symposiums in Australia on 13 (Melbourne) and 14 (Sydney) November 2018. Financial professionals can learn more details, and request an invitation [here](#).

Disclosure

The figures are from the Research Affiliates Asset Allocation Interactive tool. All data presented herein are estimates and are based on simulated portfolios and do not reflect the performance of any product or strategy. Past performance is not indicative of future results. Please reference the important legal disclosures found at www.researchaffiliates.com which are fully incorporated herein.

A journey through the life of a fixed rate bond

by Warren Bird on March 5, 2015

"You never really know a man until you stand in his shoes and walk around in them." Atticus Finch, To Kill a Mockingbird.

Fixed income securities – or bonds – have the most predictable returns of any asset class, yet they are often maligned and misunderstood by market commentators who want to call them risky.

Rather than launching into a conceptual response to these scurrilous accusations, this article takes a leaf from Atticus Finch's book. It walks in the shoes of an actual fixed income security, one whose days on earth are just about over, but which has led a long and fulfilling life. It looks back on this bond since 2002, reflects on the fluctuations in its price and reviews how it performed for investors who owned it. Hopefully readers will feel that they then know the asset class much better.

The security in question is the Commonwealth Government Bond that will mature on 15 April 2015 at the ripe old age of 13 years.

Issued in May 2002, it promised to make two interest payments every year until April 2015, when it will return its face value to its owners. Its annual coupon rate was 6.25%, so the payments would be 3.125% of face value each in April and October. The rate of 6.25% was in line with market yields at the time, so investors who bought into the issue outlaid \$100 for \$100 face value (it was priced at par) and sat back to enjoy the steady income over the next 13 years.

The first year

The bond's price didn't stay at par for long. A fixed income security with over a decade until maturity is a frisky sort of animal and moves quickly if you prod it. Nowhere near as jumpy as shares, but still twitchy.

As it happened, over the remainder of 2002 bond yields fell, so our April 2015 security sharply appreciated in value. By its first anniversary in May 2003, it was priced to yield just under 5%, with a market value of nearly \$111.90 (see [Term deposit investors did not understand the risk](#) for a refresher on the link between bond prices and market yields). Two interest payments had been made, totalling 6.25% of the initial outlay, which when added to the mark-to-market gain of 12% made for quite a handsome return of 18% over 12 months.

Some investors bailed out at that point, locking in their gain. Those who bought the bond from them would now expect to earn 5% per annum over the next 12 years, with the 6.25% coupon payments being offset by the amortisation of the bond from \$111.90 to \$100 over that period.

That first year pretty much set the trading range for the first half of our bond's life. In yield terms, the market traded the April 2015 bond between 5 and 6% for several years.

Towards middle age

As the years went by, our bond became less frisky. To use the jargon of fixed income, it had a shorter duration. The next time the yield on the April 2015 bond got down to 5% was August 2005, when it had just less than ten years until maturity. Its price this time rose only to \$109.

It's as if during its life a bond looks more longingly at its destiny – par value at maturity – and starts to resist the pressure on its price that is exerted by fluctuations in market yields.

By the later months of 2007 and into 2008, investors wanted higher yields to compensate for higher inflation. The April 2015 was traded in the market at a yield above its coupon rate and its price fell below par. Around its sixth birthday in May 2008 the yield peaked at 6.5%, meaning that it hit the low price point in its life. The market at that time valued it at \$98.30.

Popularity explodes

Things changed quickly in the second half of 2008. As the global financial crisis unfolded the demand for government bonds exploded. Our April 2015, along with his longer term cousins, had never been more popular. As the world financial system risked collapse, and the global economy faced deflation risk, the yields investors were willing to accept from bonds plummeted.

During October 2008, we were once again back at 5%. This time, as our bond was older and thus getting shorter in duration, its price reached only \$106.

However, it didn't stop there. As support for financial corporation debt fell in the opinion polls to all-time lows, the 'yes' vote for government bonds kept climbing. The April 2015 yield fell further – to 4.5%, then to 4.0% and eventually to a new low of just 3.5% by January 2009. Even though our bond now had only six years and a bit to maturity, it still had enough vigour to respond to this fall in yields with a price appreciation to \$115. Heady days!

Popularity fades

However, after a while the smart money decided to move back into risk assets. Shares or corporate bonds – anything but government bonds yielding less than 4%. Just as quickly as our bond's popularity had risen, it dropped. By the middle of 2009 it was again yielding above 5% and its price had fallen below \$105. It would trade there for a couple more years, until the financial crisis mark II arrived.

Popularity returns

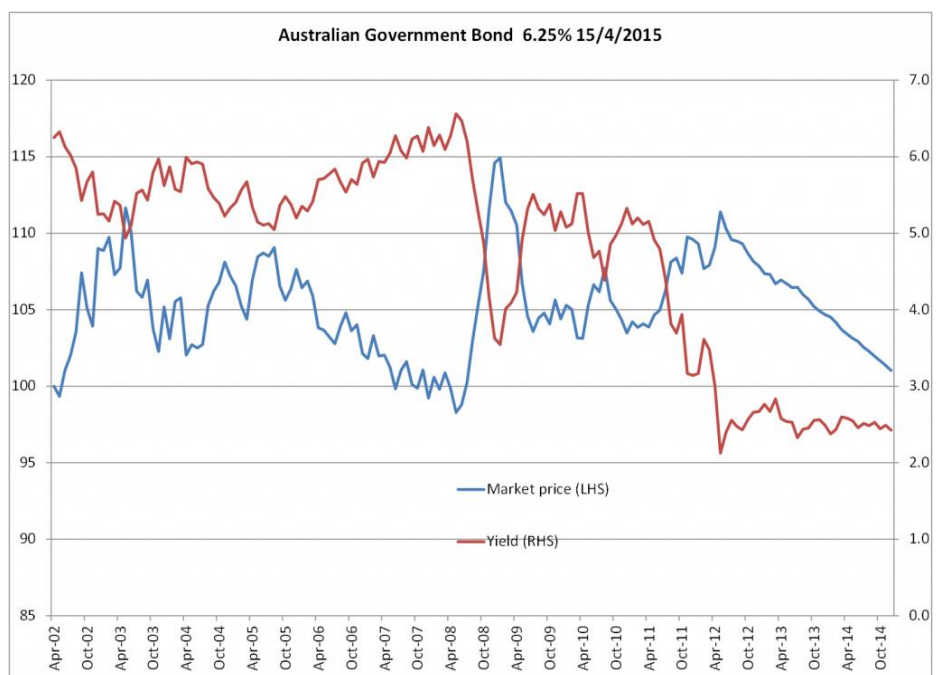
Our bond carried a AAA rating throughout its life which became highly valued by global investors from late 2011 when sovereign wealth funds and central banks were attracted like moths to a flame to the Australian government bond market.

Most of this demand was for securities longer than the April 2015, but our bond was carried in their slipstream back to lower yields. They reached 3.5% again around September 2011, though its vigour was beginning to fade and our bond could only rally to a price of about \$109 this time. It managed to appreciate a bit further over the next few months, hitting \$111 for its tenth birthday in May 2012. But it took an incredibly low yield of 2.1% to get it there.

Amortising to maturity

Since then, our bond has been enjoying a relatively lazy life. Its yield has traded around 2.5% for most of this time and its price action has been dominated by a steady trend towards par, where it will be valued when it retires in a couple of months. Its owners for these past three years have been receiving \$3.125 each half year in coupon payments per \$100 face value, but for that to yield them 2.5% pa there has also been a gradual decline in capital value of just under \$2 each half year.

The chart shows the price and yield history of the April 2015 bond in full.



A life well-lived

What have we learned from walking in the shoes of the April 2015 government bond?

First, that the life of a bond can sometimes be a wild ride. Its price fluctuated, sometimes rapidly, reflecting changes in market yields. Therefore its short term return also fluctuated. Rarely, if ever, was the annual return equal to the original yield of 6.25%.

Second, every time the yield got back to 6.25% it was valued at par, but as it happens this bond spent most of its life trading at a yield below that level and thus at a price above par.

Third, the fluctuations became smaller as maturity approached and the inexorable pull of par value became stronger. A yield that early in its life resulted in the price being well away from par produced smaller and smaller premia over time.

Fourth, the bond never missed a beat in paying the regular interest promised when it was first issued. Over the whole of its life, the April 2015 bond delivered. And from any point in its life, its new owners continued to receive the promised coupons plus a predictable rate of capital price amortisation. They could, therefore, easily predict the long term return they would make on their investment.

As its name implied, it provided its owners a regular fixed income. It's been a bond's life well-lived.

Warren Bird is Executive Director of Uniting Financial Services, a division of the Uniting Church (NSW & ACT). He has 30 years experience in fixed income investing, including 16 years as Head of Fixed Interest at Colonial First State. He also serves as an Independent Member of the GESB Investment Committee. This article is general education and does not consider any investor's personal circumstances.

Three drivers of attractive infrastructure opportunities

by Greg Goodsell on April 20, 2017

Infrastructure has become a hot topic in recent months. Donald Trump has promised a US\$1 trillion infrastructure investment programme, while in Indonesia immediately to our north, the Joko Widodo administration has committed to a doubling of infrastructure spending in 2017 compared with 2014.

Locally, the national political debate is escalating on the adequacy of South Australian and east coast electricity generation capacity, and how we might meet any shortfall. The latest plan from Prime Minister Malcolm Turnbull explores a \$2 billion expansion of the Snowy Hydro Scheme.

Increased investment in infrastructure is long overdue. This is true in both developed and emerging economies, and has become increasingly acute over the past 30 to 40 years. In the United States, for example, the recently released 2017 Infrastructure Report Card from the American Society of Civil Engineers (ASCE) gave America's infrastructure an overall score of D+, stating:

"... our nation is at a crossroads. Deteriorating infrastructure is impeding our ability to compete in the thriving global economy, and improvements are necessary to ensure our country is built for the future".

ASCE estimates US\$4.6 trillion is needed in US infrastructure investment between now and 2025, of which they estimate approximately US\$2.5 trillion is funded, leaving a massive funding gap.

The main factors driving the need for investment

Three main factors drive the escalating need for infrastructure investment around the world:

1. Long-term chronic underspend

A 2015 study by the B20 (the business arm of the G20) estimated that by 2030 approximately US\$60-70 trillion will need to be spent on infrastructure around the world just to keep up with demand. It believes only US\$45 trillion will be funded, leaving a gap of US\$15-20 trillion.

This spend is largely to bring existing assets up to standard and keep pace with growth, and would offer little expansion in the infrastructure stock.

2. A growing middle class, especially in emerging economies

The growth of a substantial middle class in emerging markets will demand not only more but better infrastructure to complement their improved living standards and increased disposable income.

3. Governments with limited funding capacity

Historically governments have been the primary provider of national infrastructure. However, in the post-GFC world, many governments are running substantial fiscal deficits and have fragile, highly geared, national balance sheets. Their ability to invest in public sector infrastructure is highly constrained. In fact, the demand to improve infrastructure comes at a time when governments' funding ability is at its weakest in a longtime.

Enter the private investor

Infrastructure assets possess a number of attractive investment characteristics including:

- long dated, resilient and visible cash flows
- regulated or contracted earnings streams
- monopolistic market position or high barriers to entry
- attractive potential yield
- inflation hedge within the business
- low maintenance capital spend
- largely fixed operating cost base
- low volatility of earnings.

These characteristics are ideally suited to both the listed and unlisted infrastructure markets where the quality and predictability of earnings are highly valued. The public, or listed, market also offers liquidity which allows entry into or exit from an investment more easily than in the unlisted market.

A current example in NSW is the State Government privatising its electricity assets with the proceeds to be recycled into new infrastructure investment. The Government is entering long-term leases of the energy businesses Transgrid, Ausgrid and Endeavour. The major purchasers of these assets have been superannuation and unlisted infrastructure funds, with some involvement from listed market investors.

Given the popularity of infrastructure assets amongst unlisted investors, demand currently far outstrips supply, meaning that investors in an unlisted fund can be waiting on the sidelines for some time before a suitable asset is secured by their fund, and their cash deployed for investment.

Regulated v user-pay assets

An important definition in the world of infrastructure investing is the distinction between *regulated* and *user-pay* assets.

Regulated assets are the typical essential service utility such as gas, electricity and water companies. Given the natural monopoly position they enjoy, a free market economy will typically 'regulate' the returns they can earn and rates they charge customers.

In contrast, *user-pay* assets, such as airports, ports and toll roads, typically operate under the governance of a 'concession deed' with a government authority. It is this deed that determines the scope and scale of the business emanating from it.

This distinction offers a different investment profile. In the current environment of strong global growth, user-pay assets should do relatively better as they are better positioned to immediately benefit from increased demand and pass through any inflationary pressures. Alternatively, in an environment of sluggish global growth and falling interest rates, regulated utilities would be preferred as their defensive, safe haven characteristics become more highly valued by investors.

The global listed infrastructure market will grow rapidly over coming decades, along with its unlisted cousin. Public equity markets will form a crucial component in the funding solution for how the world meets its acute and rapidly growing infrastructure needs.

Greg Goodsell is Global Equity Strategist at [4D Infrastructure](#), a Bennelong boutique. This article is general information that does not consider the circumstances of any individual.

10 reasons the '10 Best in Show' is ill-suited

Graham Hand

The Productivity Commission (PC) Report to assess the efficiency and competitiveness of the superannuation system has pushed the wealth industry into a spin since its release last week. The full 700-page Report is an impressive piece of work, [linked here](#). Its key conclusion is that structural flaws are harming millions of Australians, and fixing the problems could give a new job entrant today an extra \$533,000 by the time they retire in 2064.

Here are a selection of the headlines the PC Report has generated, showing both support and opposition to the recommendations.



Source: Stephen Huppert

This article focusses on the proposal for a single shortlist of Best in Show funds for new superannuation members. An independent expert panel would select 10 top-performing superannuation funds, and the two-thirds of new workers who don't know what to do with their super would be handed this list to choose from. The list would be updated every four years, and according to the PC: "Our approach is one of employee (rather than employer) choice."

Superannuation industry reaction

It's not often that the Financial Services Council (FSC) representing retail funds, and the Australian Institute of Superannuation Trustees (AIST) representing industry fund, agree. Change often benefits one over the other. In this case, both want to protect their clients, and choosing only 10 winners undermines most of their members. Chief Executive of the FSC, Sally Loane, said:

"Taking default superannuation out of the industrial relations system and putting choice into the hands of consumers should be the cornerstone of a modern superannuation system. The FSC is very concerned about the potential unintended consequences for the economy of a '10 best in show' model because it could create a monolithic concentration of funds, stifle competition and create huge barriers for innovative new products."

AIST's Chief Executive, Eva Scheerlinck, dislikes the denial of default status for 90% of funds:

"It will remove many high-quality funds from the default system, which may also disadvantage members in these funds."

Let's look at some reasons why the PC's recommendations are unlikely to work.

1. The focus should be more on the worst funds, not the best

In diverting most attention to how the Best in Show will be selected, the PC creates the wrong emphasis. Although it acknowledges that many funds are poor performers, with low scale, high fees and inadequate compliance, its primary solution is to pick the 10 best and hope members gravitate towards them. However, the list is overwhelmingly for new super members who do not make a choice, and their balances are tiny in the super pie. The vast majority of members will not change, so the proposal will do little for the estimated five million members in poor funds who are victims of the 'unlucky lottery'.

For example, on scale, 93 of the 198 APRA-regulated funds have less than \$1 billion in assets. The PC estimates cost savings of at least \$1.8 billion a year if the 50 highest-cost funds merged with 10 of the best. Then it admits switching between funds is modest, and most people do not understand performance, fees and charges and therefore will see no incentive to change.

The PC is aware of the case for 'lopping off the tail' of poor funds but dismisses it in favour of Best in Show. On page 539 of the Report, Geoff Warren of ANU is quoted:

"The performance benchmarking analysis is notable for revealing what appears to be a tail of poorly performing funds. It is not clear that the remainder of the industry is delivering anything different from random variation around their benchmarks."

The main way to help people in poor-performing funds is not to take the hazardous path of picking 10 winners from 198. It will not matter much over time if a member is in the 11th, 15th or 30th fund. They are all likely to be acceptable as the better funds among 198. The main point should be rationalising the sub-par funds.

2. Change will be extremely slow

In fact, change in super fund allocations will be much slower than most commentators are suggesting. The Best in Show list is only a 'nudge' (to use the PC's word). Another recommendation to only have one default fund for life will increase the likelihood that people will not change. Members are not forced to select a new fund, the Best in Show is targetting new employees who do not make a choice, employees can continue to choose from the wide set of MySuper funds or select their own SMSF.

The PC's own numbers are as follows for contributions each year:

- New workforce entrants: \$1 billion
- Job turnover or workforce re-entering: \$16.5 billion
- Voluntary switching: \$2.2 billion
- Stay with existing fund: \$128 billion

All this fuss is for a few billion in a system with \$2,700 billion in balances and \$150 billion in new contributions a year. New workforce entrants are the lowest-paid employees, and most higher-paid employees are generally disengaged and will not even notice there is a Top 10 list. How will anyone make them care? Are we having this Top 10 debate over the \$1 billion from new workforce entrants each year?

3. This year's winner is often next year's loser

Fund performance comes from asset allocation, stock (or manager) selection and fees. Even where two funds make exactly the same proportional allocation to, say, Australian equities, there will be a significant difference in the stocks held, directly or indirectly. Super funds either insource stock selection to an in-house equity team, pick active managers or select index funds. Some funds have a value bias, some growth, some large cap, others small/mid cap.

Consider the Morningstar data for sector performance to 30 November 2018 for Australian equities and property in percent per annum:

These are all Australian equities. In large caps recently, a growth style has outperformed a value style, but over longer terms, value normally does better. In small and mid cap companies, the distinction is even larger between growth and value. A mean reversion might occur at precisely the wrong time for a fund selected based on recent success.

Style	1 year	3 years	10 years
Large Cap Value	-7.9	3.3	8.4
Large Cap Growth	-5.6	4.5	8.2
Mid/Small Value	-4.0	8.0	12.0
Mid/Small Growth	-8.5	5.4	11.7
Real Estate	0.7	6.4	9.9

Industry veteran and former CEO of Lazard Asset Management, Rob Prugue, wrote on the PC's recommendations in LinkedIn:

"I guess the authors of the productivity report have never heard of mean reversion? Even indexes, when thrown into an investable universe, mean revert. When I was a manager, return-based 'fund awards' used to scare me as more often than not, these awarded funds would likely mean revert. Never met a portfolio manager whose stock selection criteria was based on the historically best-performing large cap names with low margins. Yet it seems ok for members to choose their super funds accordingly?"

4. Large inflows (if they occur) may lead to average performance

Let's accept the Best in Show change might generate large flows, since many prominent people are arguing this. For example, former Labor Minister and Chair of IFM Investors, Greg Combet, said funds not selected will be "just left to die on the vine".

A fund receiving massive inflows faces a continuous problem sourcing attractive investments. They will need to operate in the most liquid, highly-researched and transacted sectors to find assets in large volumes. Any of the CIOs of a large super fund will say there are certain asset types, such as hybrids and small caps, that they cannot access in large enough volumes to make investment worthwhile. Imagine a \$100 billion fund buying a \$10 million parcel. It is only 0.01% of the fund, so even a doubling in value will have negligible impact on performance. It's not worth making a phone call or undertaking the research.

(As an aside, one of my past roles was to select fund manager relationships, and often these were new businesses. Performance invariably fell with volume, as a manager with a small portfolio can concentrate on a few best ideas, but then must add less convincing ideas as the money pours in).

In 2016, when John Pearce of Unisuper wanted to buy CBA's PERLS8, he dealt directly with CBA and underwrote the issue to the tune of \$300 million. If he had waited for the secondary market, he would have moved the price buying as little as \$1 million. In fact, one of the reasons Unisuper is not public offer is they do not want the fund to become too large and force it to compete even more for scarce quality assets.

Across asset classes such as infrastructure, small to mid cap companies and corporate bonds, the larger super funds like AustralianSuper (holding over \$100 billion in assets) and benefitting from the Royal Commission focus on retail funds, and are already coping with massive inflows.

5. There are many definition problems

It is extremely difficult to compare super fund performance, if for no other reason than they all take different risks. The PC has made a good attempt at it. SuperRatings current Top 10 funds ranked by returns in the Balanced Option (60% to 76% growth assets) category are shown below:

Rank	Fund Investment Option	Return	Return Period
1	Hostplus - Balanced	8.82%	5 year
2	AustralianSuper - Balanced	8.49%	5 year
3	QSuper - QSuper Balanced	8.43%	5 year
4	Cbus - Growth (Cbus MySuper)	8.41%	5 year
5	MTAA Super - My AutoSuper	8.09%	5 year
6	Sunsuper for Life - Balanced	8.00%	5 year
7	CareSuper - Balanced	7.98%	5 year
8	Mercy Super - MySuper Balanced	7.93%	5 year
9	Intrust Core Super - MySuper	7.89%	5 year
10	Catholic Super - Balanced (MySuper)	7.85%	5 year

The inclusion of certain assets in 'growth' is controversial and left for the super fund to determine, rather than following an industry standard. Is a BB-rated corporate bond 'defensive' because it is a bond, or 'growth' because it is non-investment grade with price volatility typical of an equity portfolio? Are infrastructure assets 'defensive' due to their long-term inflation-linked monopoly structure, or 'growth' because they are listed equities? What if they are not listed and are revalued infrequently?

There is a lot of subjectivity and apples/oranges comparisons in fund return numbers. Issues include listed versus unlisted, smoothing of returns, arbitrary and opaque discount rates on assets, arbitrary and convenient selection of revaluation cycles, switching of different valuation techniques when conditions change, etc.

Where do Environmental, Social and Governance (ESG) issues sit against performance and fees? If a fund has a strong ethical tilt and excludes many companies from its portfolio, should this influence the selection process? And whose ethics are we considering in a default fund?

What weighting is given to the insurance offer? For example, many members of a super fund like Mine Super work in mining with dangerous occupations, and Mine has negotiated special group cover for them. If Mine is not in the Top 10, would new workers in mining be denied such cover?

Trustees with responsibility for their own members can make these decisions, but the selection committee cannot cover the complexity for all members.

What might happen at a quality fund like Unisuper? It is not public offer, and would be overlooked by the selection panel although its performance would make it a contender for a Top 10 position. Would new university workers be pushed away from Unisuper despite its long-term track record and other features such as high-quality advice?

KPMG Superannuation Advisory Partner, Adam Gee, told the *AFR*:

"It is not so much the constitution of the panel that concerns us, it is more so the ability of the panel to undertake an appropriate assessment of the best-in-show list, as well as the criteria that will be used to select these funds."

6. It should be about risk and retirement as much as performance and accumulation

The wide range of risk-taking in superannuation funds is rewarded or punished according to market conditions.

In mid-2018, as equity markets continued the bull run of many years, the Chief Investment Officer of an industry super fund told to me that the trustees of his fund required him to hold risk at the bottom end of the 60-80% growth band in which his fund was judged. Consequently, his fund was in the bottom quartile on performance, and depending on definitions of growth, some of this competitors were arguably 90% growth and delivering great results. His relatively poor numbers did not reflect well on him as CIO.

This was not his fault, as he was following instructions, and indeed, it is inappropriate to criticise the trustees. They had decided their primary role was to protect the capital of their members, and naturally, this come at the cost of performance in a strong market. It's a reasonable position with many members in retirement, who are likely to be more concerned about preserving their wealth than an extra 1% on the earnings.

In different circumstances unrelated to investment prowess, the CIO would look like a hero. He would be fated in the media, featured at conference for his foresight, and qualify as Best in Show.

The PC recommendations focus too heavily on the accumulation of super over a lifetime, rather than preserving wealth in retirement or drawdown. For retirees, the main destruction of living standards comes not from losing a small amount of performance due to not being in a Top 10 fund, but from high risks in a collapsing market. They face 'sequencing risk' issues where their balances are at their maximum, as they do not have the time to contribute more to recover losses. A National Seniors survey in July 2018 called 'Once Bitten, Twice Shy' showed 23% of retirees claim they cannot tolerate any 12-month loss on their retirement savings.

The best example in Australia of a fund that took excessive risk is MTAA Super, which delivered exceptional results in the five years prior to the GFC. Their exposure to commercial property in particular was then severely punished in the crisis and they delivered years of poor performance, yet they may have been on a Top 10 list selected in 2007.

7. Unwelcome consequences of a fund dropping out off the list

Consider the SuperRatings list in section 5 above for a five-year term, and then check the names in the same category based on 1-year returns, as shown below.

Rank	Fund Investment Option	Return	Return Period
1	Media Super - Balanced	4.20%	1 year
2	NGS Super - Diversified (MySuper)	4.16%	1 year
3	Hostplus - Balanced	4.10%	1 year
4	QANTAS Super Gateway - Growth	4.09%	1 year
5	Club Plus Super - MySuper	3.93%	1 year
6	HESTA - Core Pool	3.89%	1 year
7	Sunsuper for Life - Balanced	3.80%	1 year
8	Mercy Super - MySuper Balanced	3.76%	1 year
9	Equip MyFuture - Balanced Growth	3.66%	1 year
10	Cbus - Growth (Cbus MySuper)	3.59%	1 year

Only four super funds make both lists. As expected, the majority of funds do not retain their status into subsequent time periods. The PC is recommending a review every four years, and turnover of names is inevitable.

So then a new list is issued, potentially creating switching out of the underperforming fund, which will need to liquidate assets to meet redemptions. This comes with costs such as brokerage and spreads. I was once involved in the closure of a fund and as money transitioned from one manager to another, hitting the bid to sell shares at rapidly-falling prices was far more expensive than we expected. The market knew we were selling and a significant cost hit fund members.

Generally, industry funds invest more than retail funds in illiquid assets (such as roads and airports) as they expect to remain in inflow, but a loss of status could impede their cash flows. Will they be forced to sell illiquid assets? Will the market anticipate these changes and sell down the assets?

Imagine the frustration of doing well against the vast majority of your peers, delivering excellent results for your members from 198 APRA funds, but coming 11th in the beauty contest.

And what happens if a Top 10 fund does really badly? It will reflect poorly on the entire selection process, and further undermine public confidence in the superannuation system.

Darren Stevens, Mercer's Head of Corporate Superannuation, warned a Best in Show list would result in funds copying the investment strategies of leading funds, over-exposing millions of members to particular investments or cycles.

8. Top quality staff are essential for ongoing performance

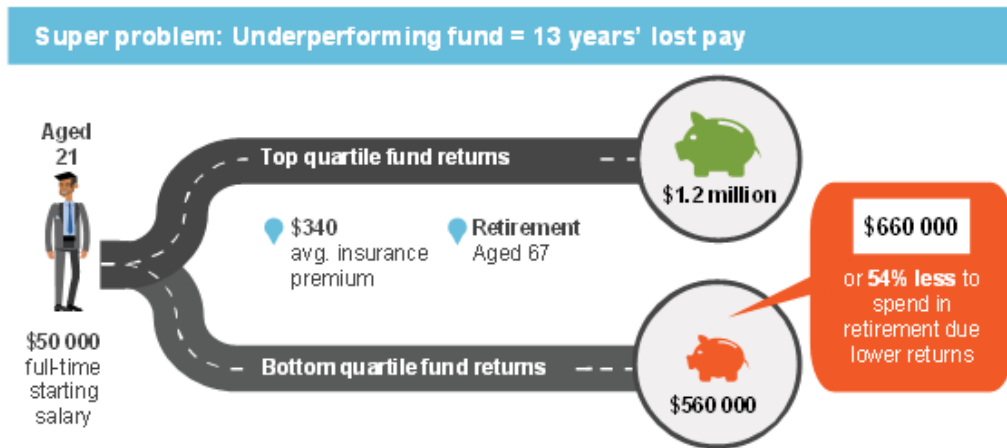
Outperformance of the market in investment management is limited to a few talented individuals with special skills. Overall, most active managers do not match the index. Every institutional fund has a Chief Investment Officer and a few key staff, and although trustees and boards play a role, they are often guided by the views of the CIO. These individuals are keenly sought by competitors and their abilities would be a major consideration for the panel selecting the Top 10 funds. What happens to a nominated fund if the CIO leaves?

9. The gains in final superannuation balances are too optimistic

It is obvious that if an investor always holds money in the top-performing fund throughout their life until retirement, then their balances would be significantly higher than if they had stayed in an underperforming

fund. But funds cannot be selected in hindsight. The much-publicised \$500,000+ extra that has featured in the headlines is the difference in final retirement amount between the bottom and top quartiles of 53 funds surveyed by the PC.

Cameo 1 Underperformance compounds to substantially lower retirement balances



Source: Productivity Commission Report on Superannuation, Overview, page 11.

This is wishful thinking. The top fund is highly unlikely to stay in the top quartile over the entire period, and investors continually switching into the Best in Show from the previous period are unlikely to keep backing winners. In fact, with the PC recommending a default fund only be chosen once over a lifetime, with the employee taking that fund everywhere they work, most people will stick with one fund. It might go well, or it might not.

10. Selecting the experts will be fraught

In 2016, the Financial Conduct Authority in the UK recommended reforms in the role of major investment consultants that advise the largest pension funds, saying they work under potential conflicts of interest and are “not effective” at selecting quality fund managers. These consultants are supposed to be the world’s experts at identifying good managers.

According to PC Report, selection of the panel would be decided by a group of non-super experts:

“The process could be overseen by the Governor of the Reserve Bank of Australia (as committee chairman), with the Chairman of the Australian Competition and Consumer Commission and the Parliamentary Budget Officer. The consumer representative could be decided by the selection committee chairman ... with heads of government agencies that are noted for their independence, judgment and intellect”.

The panel members themselves should be “free of direct conflicts of interest, and seen to be so by the public”. The obvious problem is this removes many people most qualified in superannuation and fund selection, since all come from a perceived vested interest. But then there is this statement which blows the field wide open to a range of experts from outside finance:

“To strike the right balance between expertise and independence, not all members would need to have a high degree of expertise in super. Some could be accomplished individuals with experience in collecting and evaluating evidence and advice, but who are also able to see beyond it (such as academics).”

Check the funds listed in the tables above and there is an obvious omission: none are for-profit retail funds. Will it be politically acceptable for an independent body to favour industry funds to the exclusion of all retail funds? The substantial businesses of Colonial First State, Macquarie, BT, AMP and MLC would be compromised over the long term. These funds handle the superannuation of millions of Australians, and while many of their legacy products should be mothballed, they have recently-developed offers which are competitive with industry funds.

In fact, it’s likely that the inclusion of some of these retail funds would be required for competitive and political neutrality. The PC itself acknowledges this:

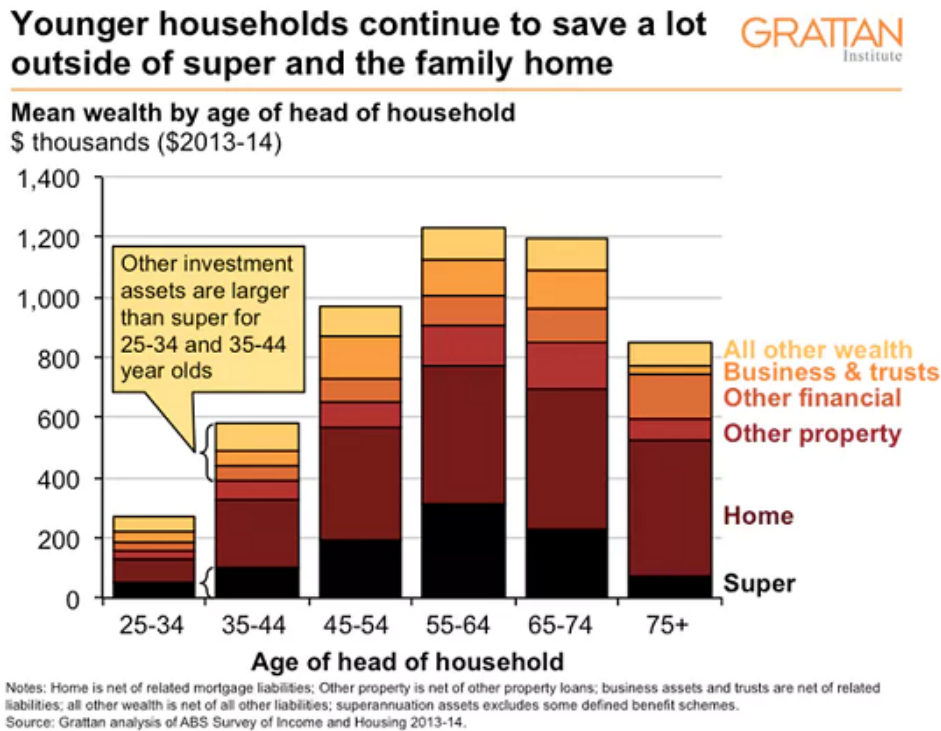
"the panel should always seek to ensure a competitive dynamic exists between funds, without compromising the integrity of the 'best-in-show' list".

Given the massive commercial implication involved in any selection of funds, with considerable powers in the hands of a few people, they will no doubt be subject to intense lobbying, political pressure and media scrutiny. Claims of conflict are inevitable, and the public is already tired of the superannuation industry arguing with itself.

A final word: superannuation is not the main game for wealth accumulation

While superannuation is a great political and social issue in Australia, especially because compulsory contributions are an alternative to wages, far more wealth is held outside superannuation, as shown in the chart below.

We do not interfere with individual selection of homes and other financial assets, we don't even offer decent financial literacy courses in schools and we do not require trustees of their own superannuation to meet any eligibility tests. There are 1.1 million Australians managing their own superannuation, free to invest in anything they wish.



Graham Hand is Managing Editor of Cuffelinks. This article is based on his reading of the PC Report on Superannuation, and readers are welcome to correct any misinterpretation. If is, after all, 700 pages, and it's impossible to do the issues justice in one article.

Uncertain times but be ready to lock and load

Peter Thornhill

[Editor's note: Peter Thornhill is an advocate of investment portfolios heavily dominated by shares, taking a long-term view and riding out the inevitable volatility. It's not suitable for everybody. His [previous article in Cuffelinks](#) showed his strong following from his books and years of presenting, and we have received requests such as this from Anthony for an update: "Hi Peter, I have a significant amount of funds to invest for income/growth to the amount of \$1m. What should I do in this moment, should I dollar cost average in or throw it all in one hit, or wait for a market crash?" Obviously, we do not give personal financial advice, but here are Peter's latest thoughts].

*"All the notions we thought solid, all the values of civilised life, all that made for regularity in the economy ... all this seems badly compromised ...
Never has humanity combined so much power with so much disorder, so much anxiety with so many playthings, so much knowledge with so much uncertainty."*

Paul Valery (1871-1945) French poet and critic

The quotation above is engraved on my mind. Despite the dating, it is as relevant today as when it was first written.

I am becoming increasingly aware of the fact that my naturally pessimistic nature about the affairs of the human race appear to be shared by others. Two articles in a row were sufficient to trigger this.

The first was [an edition of Cuffelinks](#) where Managing Editor, Graham Hand, eloquently spelt out my own lingering concerns about the global economy.

The second was [an article by Peter Hartcher](#) in the Sydney Morning Herald. Whilst domestically-focussed, it resonated with me. Despite the positive spin on several issues, all local, it was the bigger global issues that concern me.

Financial crisis as a buying opportunity

Don't get me wrong, all clouds have a silver lining and I have said many times that two global financial crises in a lifetime would be a blessing beyond belief. Post the GFC in 2007-2008, I'm on record when asked what was on my wish list for the coming weeks, I responded with a request for another financial crisis. When the interviewer asked why, I said that I would like to buy more CBA at \$26, more Wesfarmers \$13, etc.

A Black Swan event is an event in human history that is unprecedented and unexpected at the point in time it occurred. However, after evaluating the surrounding context, domain experts (and in some cases even laymen) can usually conclude: "It was bound to happen."

In all my presentations, I am at pains to point out that as humans fail to absorb and apply the lessons of history, they are doomed to repeat the cocktail with twists added by technological advances. As always, these are both a blessing and a curse in the affairs of humans. Technological advances resulting from two world wars enabled us to lift the number of those killed from around 40 million first time to around 80 million.

Technology enabled the US to export its fraudulent mortgage lending virus around the world, wreaking havoc on financial markets culminating in the GFC. This event raised the bar on government intervention to levels not experienced in living memory. We are now microbes in a central bank and government experiment.

Back further, prior to the GFC, we had the dotcom fiasco, and stories included:

'NASDAQ index had fallen 78% by October 2002'

'The Fed cuts interest rates to 1% to stimulate economic growth'

This was preceded by the first Gulf War in 1990 with the appropriate headlines:

'Airlines face fivefold increase in insurance'

'Bush Administration moves to distribute crisis across international community'

'US unemployment rate rises to two-year high in August'

The 1987 crash remains fresh in my mind as it coincided with my return to Australia. We had the largest peacetime one-day fall of 22% in the US triggered by concerns over insider trading and company takeovers using borrowed money. The collapses led the Fed and other central banks lowering interest rates sharply. Conventional economic theory has been applied on every occasion leading us to the cul-de-sac we are presently in.

There was no reference to the increase in moral hazard every time the authorities reacted by cutting interest rates. On the contrary, there has been much back-slapping and high-fiving as they congratulated themselves on rescuing their economies from the downswing on each occasion. The smugness has been palpable. There is no acknowledgment of the asset bubbles this strategy has created.

The element I find intriguing is the ongoing fixation with the security of government bonds. I am being made to feel irresponsible for an asset allocation that doesn't include fixed interest investments.

The issue that exercises my mind in the current climate

I don't want to go through the detail of the relationship between bond yields and bond values, except to summarise that as interest rates fall, fixed rate bond prices rise and vice versa. With interest rates at current levels, we have had a bull market in bonds of unprecedented magnitude.

As a gentle reminder for those old enough to remember, the interest rates rise in the late 80s and early 90s led to a collapse in bond prices which led to many 'capital stable' managed funds becoming unstable.

The following is the opening paragraph of a 1994 Fortune magazine article:

"Wasn't this supposed to be the year Alan Greenspan got to triumphantly parade down Wall Street to the cheers of bondholders big and small? In many ways the circumstances seemed right. In January 1994, the 34th month of economic expansion, bond yields were historically low and inflation seemed negligible. Wages were going nowhere, and companies dared not raise prices. But within seven short months of that promising start, something fairly unusual happened. 1994 became the year of the worst bond market loss in history."

Does any of this sound familiar? If you are interested, [here is the article](#).

In the current climate, how do central banks and governments 'normalise' interest rates without triggering the next biggest "bond market loss in history". Unless of course, interest rates never go back up, so we can all rest easy!

What does this mean for me?

I remain, as always, sanguine, alert but not alarmed. Aware that if the bond markets tank, the inevitable reaction of the sharemarket will be panic.

Spend less than you earn and borrow less than you can afford. Lock and load for the amazing bargains that will present themselves.

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. 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, and consider financial advice.

Australian ETFs: end of year reviews 2018

BetaShares and Vanguard

BetaShares: Shaken, not stirred!

- Notwithstanding dramatic sharemarket volatility in the final few months of the year, the Global ETF industry recorded significant growth in 2018, receiving its 2nd highest ever level of net inflows (**US\$516B**). In total the global industry ended the year at **US\$4.8T** [ETFGI]. Total asset growth however was held back by significant asset value depreciation leading Global ETF assets under management to end up at approximately the same level as at end 2017.
- Comparatively, the local ETF industry's net flows were actually higher than the declines in asset values, leading the ETF industry to grow by **13%**, (**~\$5B**). In our view, given the prevailing environment, this is a very strong result and indicates the continued interest in the ETF product structure by investors even in the face of very volatile markets.
- The Australian ETF industry's funds under management ended the year at **~\$41B**, a touch below the record high of \$42B set in September, (2017 year-end AuM, \$36B)
- As a result of sharp market falls at year's end, **100%** of the year's industry growth came from net inflows, with **\$6.2B** flowing into the industry over the course of the year. In a similar result to the global industry,

this represents **the 2nd highest annual flows on record** (the highest being \$7.8B, in 2017). Importantly, this strong 'unit' growth means that if and when asset prices recover, we will see some "bumper" growth months in the year ahead.

- While asset growth and inflows were below record levels, the industry did break a meaningful record in 2018, with **ETF Trading activity levels reaching a fresh record high**, with **trading value increasing 14%** compared to 2017, and over \$36B of value traded. We expect trading values to continue to trend upwards as ETFs become an increasingly mainstream way to express investment views.
- Flows by ETF manager continued to be concentrated, and more so than last year, with the top two players (**Vanguard** and **BetaShares**) receiving 62% of the industry's flow combined (compared to 56% for the top 2 players in 2017)
- In terms of product launches, 2018 produced the **2nd highest number of new product launches** on record, with **38** funds launched – compared to 31 new products launched in 2017 and 40 new products launched in 2016.
- 7 products were closed in 2018, which is still a relatively small figure by global ETF standards. ETF issuers closing products were iShares and ETF Securities.
- By inflows, **passive products** captured the bulk of flows with **88%** share, however the Active ETF sector continued to grow its relative share with **12%** of flows vs. 8% in 2017.
- Within the passive category **vanilla index-tracking funds** once again dominated, with their share of flows remaining stable (78% of flows in 2018 v. 79% of flows in 2017), as did the share of flows in '**smart-beta**' products (9% vs. 8% in 2017).
- That notwithstanding, we expect both Active ETFs and 'smart-beta' exchange traded funds to continue to grow in popularity as new products are launched and the industry matures.
- The categories of ETFs capturing the largest amounts of new money over the course of 2018 were relatively stable compared to last year. For the 4th year in a row, **international equities** products ranked #1 for inflows, with **\$2.9B** of net inflows, followed by **Australian equities** at ~\$1.5B. The **fixed income** category continued to grow at a rapid pace, with **record flows to this category** in 2018, picking up \$1.3B in net flows (vs. \$1.1B in 2017) and ranking 3rd in terms of asset category inflows. We believe it's very possible that we could see this category grow to the #2 most popular category in 2019, given increased product innovation and a greater investor understanding of the role that fixed income can play in portfolios. Outflows were limited, with only two categories receiving net outflows, and both due to profit taking by investors given market conditions (U.S Currency ETFs and Short Funds)
- The **best performing products of 2018** were the Palladium ETF, followed by the Strong U.S. Dollar Hedge Fund (ASX: YANK) and Technology Equities oriented ETFs.
- The declines in asset prices muted the growth of the industry and therefore the 2018 industry forecast we made in our end-year 2017 review was not reached (forecast of \$47-\$49B, actual ~\$41B). That said, fundamental unit growth will continue to support the industry's rise, with extraordinary growth possible should asset values recover.
- We believe the industry will continue to grow strongly in 2019 – and forecast total industry FuM at end 2019 to be in the range of \$50-\$55B.

A copy of the *BetaShares Australian ETF Review – End of Year Review 2018* is [linked here](#).

Vanguard: Australian ETF market grows amid challenging investment environment

Australians have over \$40 billion of their savings invested in exchange traded funds (ETFs) according to the latest figures released by the Australian Stock Exchange (ASX).

While volatile markets resulted in a slight decrease in total ETF funds under management through the fourth quarter of 2018, inflows across the calendar year saw the market grow by \$4.7 billion, an increase of 13.2 per cent from 2017.

Industry wide cash flow was \$6.44 billion for 2018. While this figure is down from \$8.08 billion in 2017, ETF assets have grown at a compound annual growth rate of 32 per cent over the past five years.

Damien Sherman, Head of ETF Capital Markets said: *"Continuing the trend of recent years, investors sought out ETFs that provided exposure to international equities, with the asset class attracting nearly half (49 per cent) of net cash flows in 2018.*

"Despite the challenging investment conditions in 2018 investors continue to embrace the benefits of ETFs, spurring growth in the market, increased competition among issuers and rising trading volumes that have in turn driven down the cost to invest, allowing investors to keep more of the returns they earn."

In 2018 Vanguard became Australia's leading ETF issuer with \$12.07 billion in funds under management at 31 December. It was the fourth consecutive year that Vanguard led the industry for net new cash flow representing 41.5 per cent of all ETF flows in 2018.

"Investors faced challenging conditions across global equity markets in 2018, highlighting the importance of diversification across asset classes and the enduring role that fixed income plays- especially as a ballast during periods of equity market volatility," Sherman said.

It was a year of strong growth for Vanguard's range of Diversified ETFs that broke new ground in the Australian ETF market by offering investors the ability to buy a well-diversified, low-cost product that rebalances automatically across a range of asset classes. The four diversified ETFs (Conservative, Balanced, Growth and High Growth) ended 2018 with \$277 million in combined assets under management.

Vanguard's range of Australian and International Fixed Income ETFs saw combined net cash flows in excess of \$276 million across the year.

In 2018 Vanguard listed six new ETFs in Australia, including ESG and active offerings, bringing its total number of exchange-traded products to 28.

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