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Alex Vynokur on how ETFs disrupted investing

Graham Hand

Alex Vynokur is Chief Executive Officer of BetaShares Capital, an Australian provider of Exchange-Traded Funds (ETFs).

GH: What was the ETF market in Australia like when you first started?

AV: We launched our first product in December 2010. We spent a lot of time explaining what an ETF actually is. Many Australian advisers, and certainly most self-directed investors, thought we were talking about electronic funds transfer. A lot of heavy lifting had to be done early. We also had to build trust in a new business and trust is something that takes a lifetime to build.

GH: What was the size of the existing ETF market at the time?

AV: I'd say about $10 billion, and now it's over $50 billion, so it's come a long way.

GH: You decided from the start that you had to spend a lot of money and resources on education.

AV: Our view is that making investors more informed makes them more confident. Whether that's trust or knowledge, education is critical. You must be a key participant in the market. Once the market exists and is thriving, it is easier for new participants to come in and launch niche products and benefit from the growth of the industry. But if you want to be an industry leader, you need to lead on education.

GH: Can you remember the business plan when you started, and what you forecast at the three- or five-year milestone?

AV: The three-year milestone was definitely not met, but we have been surpassing milestones since. More importantly, more than half of all financial advisers in Australia have adopted ETFs as part of their investment process versus well under 10% when we started. We're also seeing self-directed investors, SMSFs in particular, gain familiarity with ETFs. The message of both indexing and ETFs is translating into strong flows.

GH: We were slow out of the blocks with ETFs. Even now, while something like 35% of the US funds market is in index investing, it's about 15% in Australia. Is there something about Australian financial advisers and their use of active managers that has contributed to that?

AV: Yes. Historically, ETFs didn't have a level playing field here. ETFs never paid commissions to advisers and pre-FoFA, the adviser business model relied on receiving commissions via platforms. Only active managers were recommended. Since FoFA and the stronger interpretation by the Royal Commission, we now have a level playing field.

But I'm not an indexing zealot that believes the whole world should move to indexing. And what constitutes an index is being redefined to include smart beta, variants on factor-based indexes and thematic indexes. In fact, thematic is becoming a substitute for individual stock picking.

I believe the funds management industry is going through the most fundamental period of disruption that we've seen in 100 years.

GH: Including a lot of fund managers closing.

AV: Yes, similar to music, media, print. Those industries have gone through tough times. Spotify brought havoc to an industry that was cosy and comfortable for a long time and the funds management industry is going through its own Spotify moment. Some fund managers will emerge stronger but a lot are hurting.

GH: You as an individual and BetaShares generally have supported both active and passive investing. When you meet with a financial adviser, how do you reconcile supporting both?

AV: Yes, I believe in the coexistence of active and passive. I also believe that when 75% of active managers consistently underperform the benchmark over 1, 3, 5 or 10 years that, where a recommendation is on merit and in the best interests of the client, ETFs will do well and their growth will continue for at least for the next decade or two.

Funds management is bifurcating. The days of actively-managed funds which are actually index huggers are numbered. They face extinction. Market returns or beta will be priced at index fund fees. Those delivering outperformance or alpha have a strong incentive to deliver that alpha and not hug the index.

There's been a lot of beta dressed up as alpha historically, and ETFs are clarifying the conversations. Clients are allocating a significant portion of their portfolio to a core for beta and indexing. Those advisers or clients who are searching for alpha must make allocations to higher conviction, active strategies. These days, there's nowhere to hide and managers need to justify their fees.

GH: In the last year or so, a major competitor of ETFs, the Listed Investment Company (LIC) structure, has experienced some problems. The majority of LICs, especially in equities, are trading at a discount to NTA, with some quality managers at 10 or 15% discounts. Plus there's criticism that they still pay commissions as a way to circumvent FoFA. In that environment, has the experience with active ETFs been as successful as you hoped? The fund balances don't seem high enough to me.

AV: I think it's going pretty well. But on LICs, while active will thrive alongside passive but in a different equilibrium, I do believe that delivering strategies using an open-ended ETF is a more honest way rather than locking up money in a closed-ended vehicle. Investors cannot redeem LICs at fair value. Asset management is a business of trust with the client, first and foremost. All managers' future prosperity must align with the wellbeing of the clients. The client should be able to take their money at fair value. While this is a generalisation, the interest of the fund manager in securing permanent capital is often at odds with the interest of the investor.

The renaissance of LICs over the last few years was not just about the managers seeking permanent capital. It was also parts of the adviser community struggling to wean themselves off commissions. That conversation will play itself out over the coming months.

But I do accept with a LIC there is a legitimate use to hold assets which are not themselves liquid. ETFs are fantastic at delivering true to label returns for asset classes which are themselves liquid. If the asset is inherently illiquid, such as physical infrastructure, you cannot place a toll road in an ETF because we benchmark against having 100% of our assets redeemed on any given day.

But I take a critical view of regulatory arbitrage and bypassing the spirit of the regulation with strategies which are perfectly manageable in an open-ended vehicle

GH: Do investors understand active strategies within ETFs, not only the indexed versions?

AV: We have a world of changing consumer preferences. The old days of downloading a 50-page PDF, printing an application form, scanning it and sending it back to the fund manager - that user experience is outdated. The experience of owning an ETF, active or passive, is far superior, and investors would much rather have all their investments housed alongside their direct shares. That's a big part of the growth of active ETFs and the user experience will continue evolving.

I see a day where the distinction between listed and unlisted funds is lost and it will be all about the user experience. Transparent pricing, ability to buy and sell at any time, availability across platforms, index supplemented by quality active offerings.

GH: How do you choose a new ETF? BetaShares now has more than 50, and at the time of launch, I've wondered about demand for some of them.

AV: We start with the needs of clients, and they vary significantly. Australia has a large retirement savings pool with investors both young and old. Risk appetites vary tremendously. Also, a portion of the market takes advice from financial planners and full service brokers, while a significant portion is completely self directed. Our product range includes core building blocks for portfolios across many asset classes. And at the same time, you'll see products which are more satellite or tactical, such as global thematics, cyber security, agricultural, healthcare. The Australian exchange is highly concentrated in financials and materials and we need funds for greater diversification.

GH: And fixed interest availability has undergone massive change in the last couple of years.

AV: Yes, cost-effective access through ETFs has become good. Traditionally, investors shied away from fixed income in the Australian market because it's was more complicated to understand and hard to access. And in the past, most superannuation investors were young accumulators. You could get away with a heavy equities portfolio because you had the time horizon to ride out the storm.

Today, the superannuation cohort is approaching or at retirement and issues such as sequencing risk and volatility affect how people sleep at night. The term deposit is good at preserving capital but there is not the negative correlation of different types of bonds versus equities.

GH: And in specific equity segments. I remember talking at conferences when NDQ (the NASDAQ100 ETF) was launched as a way to invest in Facebook, Google, Microsoft, Apple, etc on the ASX. It was launched a few years ago at $10 and it's now $19, right?

AV: We believe the story of technology is long term and an allocation to the NASDAQ100 is sensible. But we also know investors cannot always rely on the sunny days of equity returns. If you had said three years ago that the top funds for flows would be fixed income, you would have been laughed out of the room.

GH: Of the 50+ ETFs you have, can you identify one that's done a lot better than you expected and that you're particularly proud of, but also one that you're disappointed with?

AV: Let me reflect on that (*long pause*). The cash ETF (ASX:AAA) has seen a level of adoption that has surpassed what we thought might be possible. A lot of people say they just leave cash in AAA. It's very humbling. We were aware of the opportunity on platforms because they were well known for not being generous on cash balances.

GH: Yes, and there's been more said about that in the media recently where platforms pay poor rates or nothing on cash.

AV: One that's surprised on the downside for us is the RAFI (fundamental indexing) product based on smart beta methodology. It's done okay, close to $300 million in assets, so not a poor performer, but we expected a greater level of adoption.

GH: We see ETFs close in Australia sometimes, although none by BetaShares. Do you have a critical mass target or something that says a fund is not worth doing any more?

AV: We always think about our range and we have good economies of scale with $8 billion under management. We take a long-term view rather than looking for quick wins. I don't see closing products as negative but more a sign of a maturing industry. Traditional managed funds open and close regularly, it's accepted as the norm. We don't feel a need to close any of our funds. There have been instances, such as with our gold ETF, where

there was little interest for years and nobody wanted to talk about gold. Then suddenly, over the last six months, there's more activity than we've seen before.

GH: Can we turn to the recent ASIC announcement on pausing the issue of new actively-managed ETFs. To quote:

"ASIC has requested that exchange market operators do not admit any managed funds that do not disclose their portfolio holdings daily and have internal market makers while it undertakes a review during the remainder of this calendar year."

What is the issue here?

AV: Traditional ETFs which follow an index disclose their portfolio every day to allow market makers to buy or sell units on the exchange. But active ETF managers are concerned about protection of the intellectual property in their portfolios and want delayed transparency. This concept has been accepted globally. In some parts of the world, a model sometimes referred to as the 'Canadian model' allows the investment manager to disclose the components of the portfolio to market makers provided they sign a confidentiality agreement. They are then able to make a market in the same way as a traditional index ETF.

The 'Australian model' is where only one market maker undertakes the role and it is the same entity as the investment manager and the responsible entity. In other instances, such as with BetaShares which is not the investment manager, we partner with active managers and market makers so there is some separation. Our view is that the 'Canadian model' has merit. The existing model here is workable but can be improved with disclosure to multiple market-makers.

GH: What is ASIC's concern? How might an investor be disadvantaged when the investment manager and market maker are the same?

AV: ASIC will look at potential conflicts, for example, the market maker may have an incentive to set spreads or otherwise transact for its own benefit rather than the investment fund. With our active funds, we are not the investment manager and use an agent broker to conduct market making. We have no incentive other than ensuring investors are treated fairly. This is a matter of seeing if the framework can be improved. It's a complex issue but we like a model where active ETFs and passive ETFs have market making done the same way.

GH: Last question. Australian ETFs are now well over $50 billion. Where will it be in five years?

AV: Closer to $150 billion, maybe in seven as opposed to five.

Graham Hand is Managing Editor of Cuffelinks. Alex Vynokur is Chief Executive Officer of BetaShares Capital, a sponsor of Cuffelinks. This material has been prepared as general information only, without reference to your objectives, financial situation or needs.

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Six market themes for the next five years

Jeremy Podger

Disruption is an overused word but we know that geopolitics will continue to dominate markets, including the rise of protectionism and de-globalisation. There will also be far-reaching implications on markets from an increasing focus on ESG factors.

Six major investment themes expected to unfold over the next five years are:

1. Growth or value?

The past few years have seen some marked stylistic trends within markets. Notably 'value' has significantly lagged 'growth'. In fact, over the past five years we have seen the cheapest stocks (on price/earnings ratio) get

cheaper and the most highly-rated stocks become dearer. Clearly this is a trend that cannot persist for ever - and reflects both low prevailing interest rates and increasing uncertainty over the direction of economies.

Once again, it may be instructive to look at Japan to see how markets can behave in lower growth periods. Take, for example, the period from 1995 to 2005 (which straddles the technology bubble and avoids the later financial crisis).

Over this period, the Topix 100 Index was essentially flat but there were some very big winners and losers. However, there were no clear sector patterns. 'Value' type sectors such as financials, autos and homebuilders had both extreme winners and extreme losers. This emphasises the message that in times of weak growth, it is most important to identify companies that can deliver solid profit growth. This is irrespective of whether they appear to be 'value' or 'growth' - not forgetting that highly rated stocks often fall further if they fail to deliver according to expectations. In other words, stock selection is key.

Current market conditions are beginning to look like those around 2000 when valuations became even more polarised than they are now and after which 'value' had a huge rebound. Having said that, if the next five years have a lower global economic growth background then it will be difficult to see a sustained reversal in favour of 'value'.

Our approach is therefore to be specific in our selection of such stocks and apply very disciplined hurdle rates and a thorough risk assessment but to be prepared to step up when we see very high potential returns from 'value' situations. As always, investing in equities does involve taking calculated risks.

2. Domestic economic policies

In terms of the control of money supply, central banks have some serious unfinished business. This dates from the financial crisis now more than 10 years ago when emergency levels of interest rates were applied by central banks to stop the system collapsing. Unfortunately, these rates persisted even when it was clear that the immediate danger was over.

Only the US felt strong (and brave) enough to move towards 'normalisation', and even here the direction appears to be reversing. Meanwhile cheap money everywhere has helped sustain questionable capital projects and increase asset prices, most conspicuously in real estate. This in turn means that most people now entering the workforce despair of ever owning their own house while those older established property owners control a disproportionate amount of the nation's wealth.

So, given this background, we are likely to see more creative responses from both central banks and governments to any signs of economic downturn. We may see further bouts of quantitative easing on the one hand and creative fiscal stimulus on the other - for example directed towards large infrastructure projects. But governments could also decide to levy new forms of taxation to help level the playing field.

3. Geopolitics and trade issues

The high current level of geopolitical uncertainty looks likely to stay with us over the coming five years. In the case of the US and China, it is clear that there are some issues that will take years to work through.

More flare-ups in various parts of the world are easily conceivable but equally unpredictable, and this uncomfortable environment means that investors should make sure they have adequate geographical diversification over the coming years, while active managers should be prepared to shift when the political environment turns in an unhelpful direction - as has been shown in the case of the UK and its notable underperformance over the past three years.

As for the ongoing question of the UK and Brexit, we will leave fuller discussion of this to another time. But suffice to say the equity and currency markets have very clearly continued to swing more and less negatively with news suggesting a greater or lesser likelihood of a 'hard' exit. There seems little reason to disagree with markets on this one.

4. De-globalisation

Leading on from trade issues there is the likely interruption in what has for decades seemed to be an inevitable trend towards increased globalisation. It is not just trade but also increased focus on economic self-sufficiency and the growing ascendance of protectionism in various forms. Furthermore, there is more and more government focus on data and privacy, so we should expect to see more legislation to prevent personal data crossing borders.

All other things being equal, deglobalisation could increase cost on some companies and squeeze margins. We need to be wary of this when we select new stocks for portfolios.

In theory, just as increased globalisation has been deflationary, a backlash against this could be inflationary provided economic growth does not slow too much. Most commentators see very little risk of increased inflation. But most developed economies now have apparently very tight labour markets. If in the next five years we see governments deciding to increase borrowing and ramp spending, then inflation could rise. In this case, we should look for the beneficiaries that have true domestic pricing-power.

In general, these forces could tend to favour large companies which offer geographic diversity and greater control of their costs and supply chains. The next five years could be a tricky time for small-cap investors.

5. Disruption includes second order effects

The last five years have seen disruption challenge a large number of sectors, from traditional finance to utilities and of course retail (not to mention specific industries such as restaurants, taxis and many others). This will surely continue in the next five years.

But we should be wary of second order disruption effects. Innovation has happened at such a rapid pace that governments have struggled to keep up. For example, regulators still have not got to grips with new monetary tokens and cryptocurrencies. So, we should expect more government moves to check the untrammelled progress of disrupters who have been taking away parts of the value chain previously occupied by traditional operators and in some cases quickly building quasi-monopolistic positions. In addition, high profile disrupters and innovators could themselves be disrupted (think of perhaps AOL Online, Nokia, Monster.com, TripAdvisor, eBay and Just Eat as examples - there are many more).

So once again this global force is one that we need to consider as a risk factor in most industries we may invest in. And the clear message for those who want to invest in disrupters is to be very wary, particularly when they are valued at a level that implies everlasting superior growth.

6. Climate change and sustainable investing

Finally, and most importantly, is the unstoppable force of sustainable investing. Climate change itself brings huge threats as well as opportunities to companies around the world. Green power is now becoming cost competitive with fossil fuel-based electricity generation. Here, at least we appear to have reached a clear tipping point. The next five years are going to be exciting and transformational as more renewable projects come on line and large users strike contracts for the supply of sustainably generated energy.

With regards to the trend - currently led by European investors - towards sustainable or ESG investing, this too appears to have reached a tipping point. There has been much statistical analysis to examine the question of whether applying an ESG framework to investing in the past would have produced superior returns. In most cases, there was simply too much noise in the data to draw any definitive conclusions.

Regardless, we take the view that we have a duty to our investors to incorporate ESG principles into our consideration of investments in our portfolio. In this regard, we continue to constructively engage with senior management of the companies we invest in to encourage them in their efforts to improve their ESG credentials.

Given the increasing focus on ESG and the weight of money moving in this direction, it seems highly likely that sustainable investing will derive a meaningful performance advantage in the next five years as highly compliant companies see their cost of capital driven down in the markets relative to non-compliant companies.

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Risk and reward in three high-income investments

Vivek Bommi

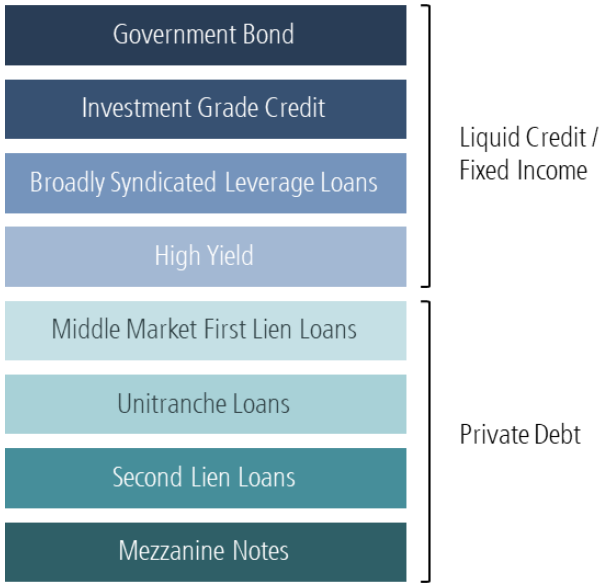
Investors are currently faced with challenges when it comes to portfolio construction. The macro uncertainty caused by slowing economic growth in the US and China has created a higher level of disruption, noise, and equity market volatility. Investors seeking stable growth and income in their portfolios are rethinking their asset allocations.

The search for high income

Fixed-income assets have become an area of increased focus given their attractive level of income and lower sensitivity to interest rate risk. In the following sections, we discuss three different types of fixed income and highlight the key risks and benefits:

1. High yield bonds
2. Leveraged loans
3. Private debts

Fixed income spectrum overview



1. High yield bonds: an evolving market

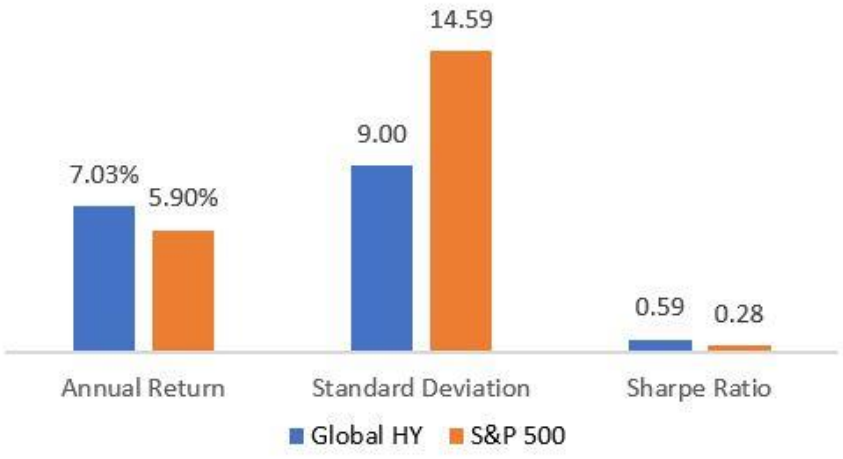
High yield bonds are corporate bonds rated below BBB- or BBa3 by credit agencies, such as Moody's and Fitch. They offer higher yields than investment grade corporate bonds based on the risk profile of the company.

Investors often label high yield bonds as 'junk bonds'. This may have been an apt description in the 1980s when small and speculative companies dominated the sector, but the market has matured dramatically since.

The high yield market has evolved into an international financing mechanism widely used by fundamentally sound companies looking to diversify their funding mix away from bank debt or shareholder equity. The market has grown significantly to approximately US$2.8 trillion with more than 2,000 issuers across the globe, including Netflix, Hertz, Fiat, and Mattel, and large players in the telecom and internet sectors.

Over the long term, high yield bonds have provided attractive total returns, outpacing equities after adjusting for volatility. Due to income and a high position in the capital structure, high yield bonds have generally outperformed equities during economic downturns while retaining some potential upside during economic recoveries.

The chart below highlights the performance of high yield bonds and US equities for the past 20 years (performance in USD, June 1999 - June 2019).



(The Sharpe Ratio is a measure of the return of an investment compared with its risk).

Default is the largest risk to high yield bonds. A variety of factors, including uncertainty around trade wars, might bring disruptions to the global economy. However, we believe fundamentals supporting the global high yield market continue to be constructive. Corporate revenue and cash flow are growing modestly while leverage is declining. Operating performance of underlying issuers has been stable, revenue and EBITDA growth remain in the positive, and refinancing activity has significantly reduced the number of bonds maturing in the near term.

2. Leveraged loans: senior floating rate debt

Leveraged loans, also known as senior floating rate loans or bank loans, are made by banks to non-investment grade companies to finance various corporate activities, including mergers and acquisitions, leveraged buyouts, recapitalisations, and capital expenditures.

Leveraged loans are floating rate, which means that the coupons readjust every quarter to a spread over a base rate (typically LIBOR). If interest rates rise or fall, the coupon on these loans also rises or falls along with market conditions.

In addition, leveraged loans are generally secured, implying they are in the senior-most position in the capital structure. Therefore, holders of these loans typically have a first priority lien on the assets of the borrower and must be repaid before any other obligation, including bondholders or stockholders, in the event of a default.

In general, leveraged loans have protective covenants built into the contract for the safety of lenders, such as financial maintenance tests which measure the debt-servicing ability of the issuers.

Leveraged loans and high yield bonds share some similar characteristics in that both are issued by non-investment grade corporations and are subject to credit risk as well as changes in market sentiment. In fact, many non-investment grade companies will often have both leveraged loans and high yield bonds outstanding.

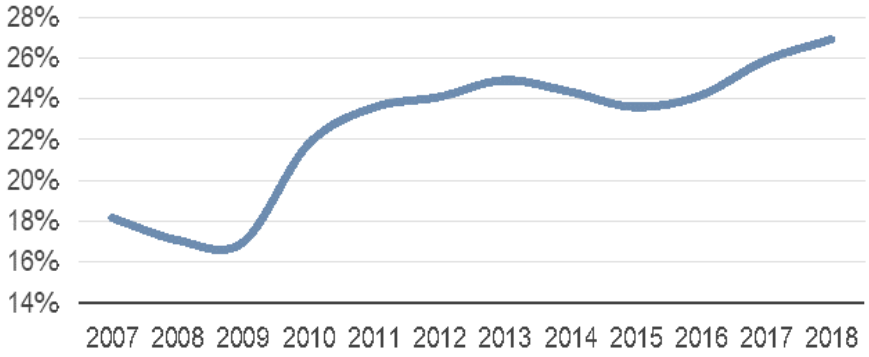
New risk rises amid growing loan issuance

While roughly half the size of the current high yield bond market, the leveraged loans market has grown significantly in recent years. With the rapid issuance, we are seeing new risks in the lower-rated segment of the loans market. Investors should fully consider the following:

• **Increase in lower-rated issuance.** Default rates grow exponentially at progressively lower ratings. Moody's notes that a record 43% of first-time issuers in the first half of 2018 were rated B3, which typically is the lowest rating acceptable to investors.

• **Smaller or nonexistent debt cushions.** Since the financial crisis, the share of debt cushion on outstanding covenant-lite leveraged loans has fallen from 35% to ~22%. Moreover, loans today are more likely to be structured as first-lien-only transactions (58% in 2018 versus 39% in 2012). These loans are the only form of debt financing in the issuer's capital structure.

• **Percentage of outstanding loans without a debt cushion**

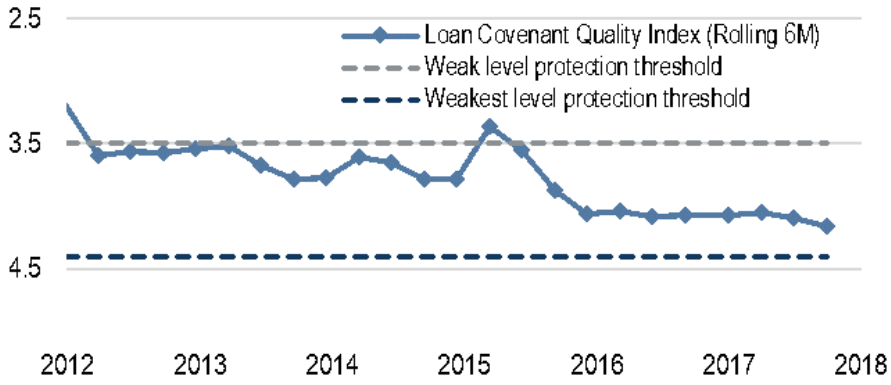


Source: S&P Capital IQ LCD. Data is as of June 30, 2019. Based on pro forma financials at the closing of each loan; debt cushion represents the share of debt that is subordinated to first-lien term loans.

• **Weaker loan documentation**. The typical loan credit agreement has become less restrictive for issuers, presenting a greater risk to lenders. In general, credit agreements have become more aggressive, allowing the issuer such leeway as asset transfers, greater incremental secured-debt incurrence, and an increase in the

retention of asset-sale proceeds. Such weakening covenant protections have the potential to dilute the position of first-lien loans at the top of the capital structure. As such, we are seeing the emergence of covenant-lite loans which typically require fewer financial maintenance tests. Companies provide greater flexibility and freedom to manage cash flows but offer less protection for investors.

Loan covenant quality index hovers near lows



Source: Moody's, as of September 30, 2018. Scores range from 1 to 5, with a higher score denoting weaker covenant quality

3. Private debt: selection is key

Disintermediation of the financial sector is encouraging companies that would normally have borrowed from banks to seek debt funding directly from investors.

Generally speaking, public debt securities are those that are registered with regulators. 'Traditional' fixed income asset classes such as investment-grade credit, agency mortgages, high yield bonds, and emerging markets debt all fall under the public umbrella. In contrast, private debt is either unregistered or registered under specific exemptions.

However, the key practical difference historically has been their liquidity profiles. Although private debts generate higher returns, they are considered illiquid investments due to long investor horizons and restricted access to investors. Investing in private debt securities require special expertise and robust research platforms, as the market is highly complex with high entry barriers.

Additionally, investors should be aware that there are limited details and a lack of transparency of these private investments due to their product structure and the nature of the agreement. As such, many of them are not rated by rating agencies. Furthermore, investors need to mindful about the valuation methodology to fully understand the risk involved.

Private debt is not homogenous. It now finances a range of investments, such as corporate, consumer non-residential, small-business, residential mortgage, and other more-niche categories of lending, which present investors with a differentiated opportunity set. The risks associated with each type of strategy can be very different. In fact, the majority of private debt funds were created after the financial crisis and many strategies are untested against adverse market conditions. To navigate this market, investors should be aware of the risks involved and extremely selective their choice of investments.

Conclusion

Historically, fixed income assets provided income and diversification benefits for investors. In the current low interest rate environment, high yield bonds, investor focus on leveraged loans and private debts is rising as the asset class offers unique opportunities to investors. However, investors must fully understand the risk and return profile of these fixed-income investments.

Vivek Bommi is a Senior Portfolio Manager at Neuberger Berman, a sponsor of Cuffelinks. This material is provided for information purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. It does not consider the circumstances of any investor. For more articles and papers by Neuberger Berman, please click here.

How to be a human be-ing, not a human do-ing

Julian Morrison CFA

We are so busy in our lives today. Decisions are made instantaneously, but knee-jerk reactions are often the wrong course of action. Taking the time to evaluate a situation can lead to a more informed decision and a better result in the long term. We are human be-ings not human do-ings; we don't always need to be active and taking immediate action.

Quick decisions are often made because of fear. We are scared of failing or losing control. Switching away from a poorly-performing investment is a case in point, as it is human instinct to not want to suffer through poor performance.

It is very difficult to not look at short-term investment returns. During these periods many investors may be tempted to take swift action and switch out of a poorly-performing fund into a fund that has performed better. Although this may appear to be a sensible way to generate better returns, switching funds during periods of poor performance can destroy the value of your investment.

In order to switch, you have to sell your units, which will usually incur 'friction costs' (all the direct and indirect costs associated with a financial transaction, such as transaction fees and taxes). It also locks in the underperformance of the fund that you are switching from. At the same time, there are no guarantees that the fund that you switch into will be able to repeat its recent strong performance. By switching you are often selling and buying at exactly the wrong time.

Managing the urge to switch

There are many reasons why we switch. Next time, before we do it, it is worthwhile considering the following three factors to judge how much of a role they play in the decision making.

1. Our emotions. Market volatility is part of investing and unfortunately so is underperformance. You would not be human if this doesn't create a sense of fear, or at least make you uncomfortable. These emotions often lead to taking action that will permanently lock in losses or missing the best time to invest.

Your role as an investor is to pick an investment such as a managed fund on the basis that it suits your needs and objectives and that you trust the fund manager – not solely on account of recent performance. If you can control your emotions, and hold on to that investment through the volatility, you have a better chance of achieving your objectives over the long term.

2. Forecasting. Driven by heavy doses of market commentary, investors often turn to macroeconomic factors to determine whether markets will deliver strong returns. However, various studies have shown there is no correlation between economic growth and share returns.

Using data from 46 countries, researchers from investment managers Vanguard found that the average equity market return over the long term of the countries with the three highest gross domestic product (GDP) growth rates was 4%. This was slightly below the average return (4.2%) of the countries with the three lowest GDP rates, despite a considerable difference between those GDP rates (8% a year versus 1.6%).

In the end, what determines the success of your investment is the price that you pay for an asset and how much return it generates for you.

3. 'Black Swan' events. In his 2007 book, The Black Swan, risk analyst Nassim Nicholas Taleb revived a metaphor first used by Roman poets. 'Black swans' are incredibly rare events that are difficult to predict and can have a major effect on markets and investments. Examples include natural disasters, or the September 11 attacks, and most recently, Brexit.

The impact on your portfolio from Black Swan events can be significant. They are highly unpredictable, however, and it is not a good idea to base your investment decisions on what could 'possibly' happen.

To benefit when switching funds, you have to be able to choose the best times to leave and enter the market. This is nearly impossible because markets can swing wildly from day to day in response to a variety of unpredictable factors.

Best action may be no action

Remaining invested when faced with poor performance will take strong nerves. But if you can steady your emotions and keep in mind the reasons why you invested in the first place, you can ride out a difficult period and hopefully enjoy good returns in the future. It would have been tempting to switch your investments in the final quarter of 2018 after a period of poor performance, but the S&P/ASX 300 Index was up almost 20% in the following six months.

Sometimes there are good reasons to switch. For example, if your objectives, or the fund's objectives, change then your investment may no longer be suitable. You may have lost faith in the fund manager, or maybe you simply need to rebalance your portfolio.

Before making any decision, investing or otherwise, it is important to slow down, take time to re-evaluate the situation and focus on your long-term priorities. In today's world the urge to take immediate action can be overwhelming, but sometimes the best course of action is to do nothing at all.

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Should retirees spend more and worry less?

Erica Hall

Having enough income in retirement is a universal desire. As one adviser said to me, no matter how the question is framed, every single client essentially asks the same question: "Will I have enough?"

Research verifies this is a major concern. The lack of certainty around how much is 'enough' can cause anxiety and negatively impact on lifestyle. A study conducted by Allianz in 2010 titled Reclaiming the Future: Challenging Retirement Income Perceptions, involving more than 3,200 American participants ranging in age from 44 to 75, sought to determine people's preparedness for retirement.

A fear worse than death

Allianz found that 61% of people feared running out of money in retirement, more than they feared death. Just think about how serious that is. Furthermore, 31% were not clear on what their expenses were likely to be in retirement and 36% were not sure if their income would last. So, whilst this is incredibly sobering it also represents a huge opportunity for the financial advice industry. People clearly need a plan, guidance and advice to navigate their way to a happy and fulfilling retirement.

Locally, Milliman's study found more than half of retired Australians restrict their spending to less than what the age pension would provide, and many, possibly up to a third, live in poverty. This is not what successful retirement looks like.

Milliman made some suggestions as to why retirees were restricting their spending to such an extent. They were:

- self-insuring against longevity risk
- wanting to leave a bequest
- a conservative demographic that had lived through multiple recessions
- a function of the immaturity of the retirement phase of the superannuation system, or
- as an industry, we may have overestimated the cost of living and therefore income required in retirement.

All are plausible. Certainly retirement spending goes hand and hand with retirement income and Morningstar's Head of Retirement Research, David Blanchett has contributed to this part of the discussion via his piece "Exploring the Retirement Consumption Puzzle" published in 2014 in the Journal of Financial Planning.

What is the retirement consumption puzzle he refers to? His research found that in the US retirees are spending less than the models predicted. Traditional consumption models are potentially too simplistic, they assume straight line expenditure in retirement. As a result, pre-retirees may not need to accumulate as large a nest

egg as initially thought. Whilst every individual journey is different, Blanchett's research found that in retirement spending declines over time, but not forever.

After a period of declining expenditure, spending begins to increase again as the retiree ages, largely due to increased medical expenses. Blanchett suggests following his 'retirement smile' pattern (the visual of graphing how spending falls and then rises again - it looks a bit like a smile) would enable retirees to start their retirement with almost 15% less accumulated wealth. Current consumption assumptions may result in over-saving for retirement.

The retirement smile or at least the lack of straight-line spending in the real world, is something financial advisers have no doubt seen and can attest to already. It is important to get the saving/income/consumption equation right as it has large consequences to *when* you retire and your *quality of life* in retirement. People could be anchoring their spending expectations around a higher figure and this could be causing people to live more frugally than they need to.

Major decisions made sub-optimally

Living longer is great but it means we need to fund our retirement for longer. Defined benefits are almost a relic of the past as most of us are now responsible for choosing our own path to retirement. Inevitably, that will mean at some point in time we will need to navigate our way through market volatility.

Herein lies the challenge. Behavioural economists have uncovered that humans generally do not handle complex decision-making well. We behave in predictably irrational ways underpinned by our preference to avoid losses where possible. These 'cognitive biases' can cause us to make sub-optimal decisions that can have lasting ill effects.

Given these known biases, there is a real risk that people will not manage through episodes of market volatility well. History shows individuals tend to sell when markets are falling and buy when markets are rising. Buying high and selling low - and repeating the process - erodes wealth. It is classic loss-aversion behaviour and one of the reasons why people fail to capture market returns.

I am reminded of a comment by a presenter who worked for a company which sold annuities. He said: "People think they will live forever until they buy an annuity and then they think they might die tomorrow." This is also a classic loss aversion behavioural response.

What can people do to ensure they have enough?

The good start is to seek advice. A great financial adviser can provide clarity around the saving-income-consumption equation and help answer important questions such as: Are my goals achievable? Am I on track? Will I have enough? How long will it take me to reach my goals? When can I retire?

As humans we make both rational and emotional decisions, and financial advisers can help coach clients through periods of volatility before they make a decision they may regret. The average investor that works with a financial adviser can be significantly better off than those who go it alone. In the US, Morningstar has attempted to quantify the value financial advice brings in a white paper Alpha, Beta and now...Gamma, the value could be as much as an additional 29% more income in retirement.

Each person's journey is unique, and it was Benjamin Graham who said;

"Investing isn't about beating others at their game. It's about controlling yourself at your own game."

With the right guidance, retirees who are restricting their spending to less than the age pension might discover they have enough and perhaps they can live a retirement free of the burden of financial worry. Now that would be a successful retirement outcome.

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Why Grattan's got it wrong on super

David Knox

The Federal Treasurer recently announced a review of Australia's retirement income system. While the scope and details of this review are not yet finalised, it is important at this early stage to challenge and correct some of the recent findings published by the Grattan Institute.

Grattan concludes that most Australians can look forward to a better living standard in retirement than they had while working. This conclusion is simply not true. Grattan has simplistically based its future modelling on a series of unrealistic assumptions that do not reflect the experiences of the average Australian.

A check on the assumptions

Take for example Grattan's assumption that we are single when we retire. In fact, 70% of us have a partner, a factor crucial to assessing the amount of age pension received in retirement, particularly in the early years. In short, most people will not receive as much age pension as assumed by Grattan.

Grattan's assumption that we will all work until the future pension eligibility age of 67 will also come as a shock to most Australians who retire a few years before the pension age and rely on their superannuation and other savings for income in these years.

And, what of the half of us who will live beyond 92 years, the age Grattan asserts we will no longer need retirement income, based on the average life expectancy for a 70-year-old in 2055? Grattan makes no allowance for regular income after that age.

For instance, Grattan bases its calculations on the average income received during the 25 years of retirement. Due to the wage indexation of the age pension, the real value of this income increases over time. This means that income in the early years of retirement is much lower than the figures quoted by Grattan.

Income replacement rates after work finishes

It concludes that the median income worker will have a net replacement rate (that is, the rate at which retirement income replaces earnings or income prior to retirement) of 89%, while the average full time income worker will have a net replacement rate of 78%, well above the objective of 70%. This is not a realistic scenario for most Australian households.

Mercer's figures suggest that the median income workers will have a net replacement rate in the order of 68% of their previous income, while the average full-time earner will have a net replacement rate of only 58%. These figures hardly suggest that Australian retirees will have a better standard of living in retirement than while working, as asserted by Grattan.

These revised net replacement rates, which allow for the legislated increase in the Superannuation Guarantee to 12% of earnings, provide a much more realistic picture of the future for most Australians entering the workforce today. While the median-income earner may be able to maintain their previous standard of living based on the 70% benchmark, the average full-time earner will need to save additional funds, over and above compulsory superannuation, to maintain their previous standard of living throughout retirement.

One final point: Grattan suggests that future income from superannuation can be replaced by increased age pension payments, with savings to the Government. This ignores the very human need for retirees to sometimes access finances in case of unexpected events. Unforeseen incidents and costs do occur during the retirement years, including changes to the age pension. Given this, it is vital that retirees have access to some capital, which the age pension does not allow for. Superannuation and the age pension are not the same.

Importance of the retirement review

The forthcoming review is an opportunity to consider the wide range of situations faced by Australians as they approach retirement. We cannot assume that everyone is a home owner, is single, will retire at the pension age and will live to 92. Accepting that policy development must rely on future modelling, it needs to be more comprehensive than the single cameo used by Grattan.

The review must also consider the objectives of the whole retirement income system and not restrict itself to superannuation. We need to review the integration of the various pillars of financial security in retirement - the

age pension, superannuation, voluntary saving and housing - so that the total system delivers improved outcomes for all Australians in a wide range of situations.

Dr David Knox is a Senior Partner at Mercer. See www.mercer.com.au. This article is general information and not investment advice.

Off target: Mercer misses the mark on our retirement modelling

Brendan Coates

Grattan research has shown that the conventional wisdom that most Australians don't save enough for retirement is wrong. The vast majority of retirees today and in future are likely to be financially comfortable. Our research seems to have come as a surprise to many retirement income researchers.

In a recent report, superannuation firm Mercer claimed Grattan's retirement incomes research was 'very misleading' and was based on assumptions that were 'not realistic' for the average Australian. This Grattan policy paper shows that the Mercer critique of our work misses the mark.

A clarification on our approach

Some of Mercer's claims result from an unfortunate misreading of our approach. Mercer mistakenly concludes that we model a decline in working-age incomes in the lead-up to retirement, when in fact incomes in our modelling peak just before retirement.

Mercer argues that retirement incomes should be assessed against the peak in earnings from ages 40 to 55, indexed forward by wages to age 67. But such a benchmark is 15% higher than Australians ever earn while working. It also ignores the fact that most Australians aged 40-55 are still incurring the costs of raising dependent children, whereas in retirement they are not. Spending by Australian households falls by about 15% between ages 45-49 and 60-64. Mercer's work falls into the same trap as much Australian research on retirement incomes: it makes assumptions about what retirees need without looking closely at what they spend, or what they earn while working.

And Mercer's preoccupation with ensuring all retirees, and especially wealthier retirees, are as well off in retirement as beforehand is a recipe for higher inheritances. Its approach would force low- and middle-income Australians to over-save for their retirement. Policy makers can justify lowering someone's living standards during their working life only if they're protecting them from even worse outcomes in retirement.

The real life experience

In contrast, our modelling is consistent with the lived experience of retirees today. Our 2018 *Money in retirement* report showed that most retirees today have a similar or higher living standard as they had while working. Most retirees today feel more comfortable financially than younger Australians who are still working. And retirees are less likely than working-age Australians to suffer financial stress such as not being able to pay a bill on time.

Retirement incomes policy needs to balance the trade-off between higher living standards when retired against lower living standards when working. And retirement modelling should reflect the reality of Australians' spending needs, in retirement and beforehand. Unfortunately, Mercer's critique of Grattan's retirement research does neither.

Brendan Coates is a Fellow at Grattan Institute. This article is general information and no personal advice.

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