Firstlinks
By Cuffelinks

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Elizabeth Bryan and Chris Cuffe on how good boards work

Graham Hand

On 22 August 2019, as part of its Professional Series, financial advice firm Stanford Brown hosted several experienced directors presenting their insights on how a company board should perform, with hints for prospective board members.

Elizabeth Bryan was the first woman to run a large financial institution in Australia at State Super from 1992. She is currently the Chair of Virgin Australia and Insurance Australia Group and a member of many government panels.

Chris Cuffe took Colonial First State from a start up to become Australia's largest investment manager during his 14-year tenure as CEO. He is now Chair or Director of several companies, including Australian Philanthropic Services. Chris worked with Elizabeth on the board of Unisuper, succeeding her as Chair in 2011.

The discussion was hosted by Vincent O'Neill, Director of Private Wealth at Stanford Brown. This is an edited transcript.

VO: The reverberations are still being felt from the recently-completed Hayne Royal Commission. Elizabeth, can I ask you about the changing roles and responsibilities of directors.

EB: The duties of directors pre-Hayne and post-Hayne have not changed. The duties of directors are to the company in perpetuity. At the beginning of his report, Hayne emphasised the values that should guide Corporate Australia. They are simple values about fairness, trust, transparency, obeying the law, doing the right thing. Nothing very complicated. They are the core values that reside in our society. In the complexities of some of the big financial companies, he felt that these values had become lost, leading to some the egregious situations outlined in his report.

There is a gradual change in society's expectations of big companies. Businesses provide many of the essential services of our society and people expect to be dealt with in a certain way. Customers don't want complexity, they want fair, honest and reasonable dealings with these big organisations.

And so the directors' job has changed because of high social expectations about what society wants from these large companies. And that's what you read about in the papers.

VO: Do you think there's been an awakening among directors of how expectations are changing?

EB: The perception that directors are either bad or asleep is not correct. Most directors of Australian companies are diligent, smart, hard-working people, and they do the best they can. But the expectation has shifted from maximising shareholders' funds to serving the needs of various stakeholders. And that's a big change.

VO: Can we focus on the transition from management into board life by exploring some of the motivations behind the move, and perhaps some words of caution.

CC: There are many motivations. Some people do it for the money, some for the power, and some to remain relevant. Not everyone wants to play golf all day at the end of their executive career. Some want to maintain contacts and networks. There's also a bunch of people, and I am one of them, who feel they have accumulated knowledge in a particular domain and we feel we can share that knowledge with other groups.

It's important to understand what your motivation is, but to be a director simply for the sake of being a director is not good. Some people treat being the director of a listed company as a trophy, but believe me, there are many obligations and responsibilities, and it can even be a bit scary.

VO: Elizabeth, what continues to motivate you in particular roles?

EB: It's important to consider what organisations do. I think I've got some frustrated public service policy role in me. I think companies in essential public services are worthwhile, so we put the hard work into getting them right. That's where I get my pleasure from.

VO: Many people serve on charitable boards. Is that a stepping stone to other professional boards?

EB: I'm not as experienced as Chris on charity boards, but as chair of a company, if somebody is brought to me for a non-executive director (NED) role, their participation on a charity board is of no consequence.

I'm looking for two things in an NED on a big public board. First, some kind of domain experience that is seriously relevant to the business and the needs of the board. A deep domain knowledge that the person holds. For example, as chair of an insurance company, it's really useful to have a few directors who have actually worked in the challenges of the insurance industry. And you need deep domain experience is a role such as the chair of your audit committee.

Second, you must have the ability to work with a small group. You have to have the personality, the breadth of knowledge, the willingness to be part of a team, and you have to have the EQ to sense what your role is in that group. The role of the chairman is very different from the role the NED, and the role of the brand new NED is different from someone who's been on the board for six years. You need the social skills to interact in a team environment of seven or eight people.

CC: I'll add that if you're considering a NED career, some people have deep domain skills and want to stay in that area, while others span across broader areas such as corporate governance. In my experience, I've tended to stay in the area of investment, superannuation and finance generally. I did step outside my expertise once but I found that I didn't really enjoy it because I was not adding the value I wanted to. I needed to know better what was fact or fiction.

VO: What key role does diversity play on a board? Elizabeth?

EB: You need to set up a collegiate atmosphere around a board table, where people respect and listen to each other but come at things from slightly different angles. That is diversity.

The second step some people take is that for diversity of thought, there needs to be diversity of background and diversity of experience. At some point, you have to realise that the board members must be able to talk amongst themselves. When boards are structured with one person from every state, and three of this and four of that, and someone representing something else, you never find a common ground.

VO: Have you had experience with poorly-functioning boards, perhaps where the line between management and board was unclear?

CC: Yes. When you first move from a CEO to a NED, it takes a bit of restraint. It's the role of a seasoned chairman, early in the piece, to take a new director aside and make clear where that line is. There's nothing worse than board members fiddling in management matters and management don't like it. It’s dysfunctional because everyone starts second-guessing. For me, the main role of the board is to support management, not try to catch them out.

EB: Boards can go wrong for many reasons, and directors should take a good look around the table at who they are working with. Are they the solutions or the problems? You have some individuals who want to dominate, or the chairman’s worst nightmare, the incessant talkers. There is no polite way to shut them up but you have to find a way to do it.

At the other end of the spectrum are people who never say anything or even worse, don’t say it at the meeting but talk about it afterwards. The social construct of a board is difficult, so you need the knowledge, the experience, and then you need a social construct that enables members to act effectively as a group of people. And that's the real seriously tricky part.

CC: I once served on board with Elizabeth when she was chairman and I was a new director, and she said the role of chairman was worth about twice any NED. Later I thought it’s at least two times, because you spend so much time on the EQ stuff. A chairman is like the conductor of an orchestra and you need to know how to play all the instruments.

EB: Can I add that boards in Australia are going through a difficult patch, as we’ve lost the high moral ground. Anyone thinks they can have a cheap shot and there's not that much you can do about it. But here’s my personal view. There’s been a change. We've had very high growth rates out of profit-maximising capitalism, but what it's done to our income distribution, to our service levels, to the kind of values that exist in some parts of the business community and society, is questionable. And I personally think we're seeing the customer turn. With the companies that I work with and advise, my energy goes into getting ahead of the wave on these issues, thinking how you can find something that blends with your business model but also contributes to a wider group of stakeholders.

If you just go for either platitudes or philanthropy, you don't have something that's sustainable. In my view, the key for all leaders in the business community now is to understand the business deeply enough to know what they can do that makes a wider contribution to their societies, but also works with a business model.

CC: I agree but smaller companies are more about surviving. If you’re on the board of a small company, worrying about the community or whistleblower policies or cultural statements can waste a lot of time. You have to pay the wage bill next month. It's horses for courses.

EB: Yes, I was talking about large companies. I add that you must be very careful with buzz words like sustainability, transparency and the one I hate most, agility.

Graham Hand is Managing Editor of Cuffelinks and he attended the presentation as a guest of Stanford Brown.

Bulls, bonds and brain damage

Roger Montgomery

There’s a dangerous impulsivity evident in both private equity markets and parts of the bond market that suggests a boom has morphed into a definable bubble. Whether it is from these markets that the next black swan or contagion emerges remains to be seen but bubbles they are, without doubt. In the first instance investors could do worse than rebalancing portfolios by reducing weights to these classes.

When the unthinkable become routine

Persistent negative yields on a growing quantum of sovereign bonds has captured the financial media’s attention. Today, US$17 trillion of sovereign bonds, or about 20% of global GDP, are trading with negative yields. Bonds issued by countries including Switzerland, Japan, Germany and the Netherlands now have negative yields and even dodgier credits such as Italy have negative shorter-term rates.

It has been enough to cause the central banks’ banker, the Bank of International Settlements, in the context of observing that monetary policy will become ineffective “should a downturn materialize” to note, “there is something vaguely troubling when the unthinkable becomes routine”.

Vaguely troubling is putting lightly when one looks at junk-rated corporate bonds trading at negative yields. Yes, you heard that correctly.

A bond buyer who holds to maturity can only receive the face value of the bond and the coupon or interest payments. If the premium they pay above face value is greater than the sum of the remaining interest payments, they are locking in a loss.

Of course, if the issued bond is CCC-rated, there is the real prospect that the issuer defaults on their obligation to repay the face value. Typically, this not insubstantial risk is compensated for through a higher yield.

So the buyer of a negative-yielding corporate bond will lose money by holding to maturity and could also lose money if the company defaults. Investors surely cannot be that irrational.

Something else is going on

What is going on is pure unadulterated speculation. The buyer of a negative-yielding bond is simply hoping that rates head even more negative. The only way that can happen is if a bigger 'fool' pays a higher price for the bond and accepts an even greater negative yield.

Nobody wants to hold these bonds to maturity, and the buyer is obviously not expecting the company to default while they own the bond. Everyone trading these securities must therefore be expecting to have one last dance before the barn burns down. They're expecting to be able to get out safely before they're consumed.

Of course, now that these bonds are already negative yielding, someone has to lose, therefore some will. Whether or not its brain malfunctioning, consensual hallucination or an intellectual short-circuit, it is rebadging speculation as investing.

So far of course, anyone who bought these bonds at higher yields have done well. In Europe, for example, according to the ICE BofAML Euro High Yield Index, the average yield on junk bonds is less than 2.90%. Anyone who purchased corporate high yield junk bonds back in 2012 when the index yield was at over 11% or in 2016 when the yield was above 6% has made a fortune.

To crystalise the profit, however, the owner has to sell and the new buyer must clearly believe yields will even be lower and more negative in the future so they can, in turn, sell to a similarly brain-dead or testosterone-fueled individual or institution.

European corporate bonds trading at negative yields this year include those issued by Ardagh Packaging Finance plc, Altice Luxembourg SA, Altice France SA, Axalta Coating Systems LLC, Constellium NV, Arena Luxembourg Finance Sarl, EC Finance Plc, Nexi Capital SpA, Nokia Corp., LSF10 Wolverine Investments SCA, Smurfit Kappa Acquisitions ULC, OI European Group BV, Becton Dickinson Euro Finance Sarl and WMG Acquisition Corp.

Elsewhere, it's the terms of the bond that produces a negative expectancy. By way of example, earlier this month, the owner of the Tinder dating website, Match Group Inc. saw its 6.375% unsecured note trading at 105.35 cents on the dollar.

If these bonds were held to maturity in 2024, they would yield approximately 5% but the yield achieved on these bonds could be much lower because the bonds became callable in June of this year. In other words, at any time, Match can redeem the bonds by paying investors a modest premium over face value. If Match took advantage of today's speculative frenzy to refinance the bonds, the actual yield would be minus 0.20%. For an online dating site!

Private equity values will come back to bite

The insanity being displayed among negative-yielding, high-yield bond traders is also evident among private equity and venture capital punters.

That Uber even exists is a function of equally brain-damaged altruists. Evidence that its model is broken is the popularity being driven by an underpricing its main service. There is a negative return on its investment in technology and a negative return to its owners. Uber won't exist in its current form in a decade.

You can predict a similar outcome for Tesla thanks to Porsche, Mercedes, Audi and VW's announcement of production-ready electric vehicles at this year's international motor shows. Tesla will be forced to cut prices in an attempt to maintain volume and losses will accelerate.

Then there's Peloton, a company selling US$3,000 stationary training bikes with a US$39 monthly subscription to an app that links you to your favourite spin class. Think Ab Blaster or thigh master meets Jane Fonda on roller blades with a Nintendo WiiFit in her hand. It's a fitness fad whose offer will be on the council collection heap in years to come, seeking a US$8 billion valuation.

Fortunately, the more recent cancellation of the WeWork IPO – US$5 million paid to the founder for the right to use the word 'We' anyone(?) – is evidence that the bubble may have been popped.

History is replete with examples of investors losing their minds and believing the unsustainable is permanent. How it plays out is anyone's guess but serious investors should look elsewhere. Cash may only offer a percent or two but that's better than minus 50%. It all reminds me of Herb Stein's quote: *"If something cannot go on forever, it must stop."*

Roger Montgomery is Chairman and Chief Investment Officer at Montgomery Investment Management. This article is for general information only and does not consider the circumstances of any individual.

Long lease property funds: follow the income

Adrian Harrington

In an environment characterised by low interest rates, yield-hungry investors are gravitating towards long WALE (weighted average lease expiry) property funds. The attractive long-term, sustainable and often inflation-protected income streams also enhance diversification in most investment portfolios.

Current long WALE property fund yields of 5.0%-6.0% show a 1.5% (150bps) plus spread to their funding costs (about 3.5%) and 4% (400bps) in excess of the long bond yield, which is below 1.0%.

Long WALE funds are increasingly viewed as a lower-risk, lower volatility property investment option, providing a bond-like alternative with the attraction of a relatively higher yield than most current fixed interest investments.

What is a long WALE property fund?

Long WALE funds have considerably longer lease terms with tenants, which reduces the near-term earnings risk of the fund. While a normal 'core' property fund might have an average lease length across the portfolio of circa three to seven years, a long WALE fund aims to have an average lease term of at least 10 years.

Funds with shorter WALE's are more susceptible to a higher turnover of tenants, loss of income through vacancy and higher leasing costs due to the more frequent leasing required in a building.

Long WALE fund leases generally have built-in annual rent escalators, either inflation-linked or fixed uplifts (i.e. 2.5% to 4.0% per annum), allowing the cashflow to grow over time. In an environment where income growth is highly sought, this is an extremely appealing attribute.

It's not just the length of lease that is attractive. Many corporates, in return for entering into long-term leases, want to retain control over the property they occupy for the duration of the lease. Hence, they usually enter into a '**triple net lease**' whereby the tenant is responsible for:

- all outgoings including insurance
- payment of most rates, taxes, charges and utilities, and
- structural repairs and maintenance.

For the fund, this provides greater certainty of income than a typical gross lease where the tenant pays rent and the landlord is responsible for the costs of operating and maintaining the asset.

Tenant covenant is critical

Given the length of an individual lease in a long WALE fund can range between 10 and 30 years at lease commencement, and the property is typically single tenanted, the strength of the tenant covenant is critical to the security of cashflow. A tenant with a strong credit profile, similar to an investment grade bond issuer, decreases the risk of default over the life of the lease.

It is therefore critical to assess the risks relating to both the corporate (tenant) and the industry in which they operate. Consideration needs to be given to such factors as:

- the financial strength of the tenant, including the quality of its profit and loss statement and balance sheet, its past financial performance, its capital adequacy and ability to source capital to grow the business
- the quality of management
- their position within the industry
- industry demand and supply drivers
- government policies relating to the industry, and
- industry financials, including return on capital employed, margins and earnings stability.

Property selection is not just about the cashflow

Investing in properties with long WALEs does not mean the underlying property decision-making process is any less important. A long-term lease is in effect a long-term partnership between the tenant and the property owner. The focus should be on acquiring those properties that are strategically important to the long-term operations of the tenant customer.

The size and shape of the building, and the amount of surplus land (i.e.. is there sufficient space to allow the tenant to expand their operations down the track or can the surplus land be sold) will also form part of the functionality assessment when underwriting the property. While the near-term risk of vacancy is low, it is also important to take into consideration the alternate uses for the property and the value of the underlying land in the event that the tenant defaults or decides to leave the premises on/before the lease expiry.

Long WALE funds are not passive, and managers cannot take a set and forget approach. Recycling assets within the fund is also crucial to limit over-renting (where the market rental growth has not kept pace with rental growth of the asset), obsolescence and through time, the erosion of the asset’s, and therefore, the fund’s WALE.

How to access long WALE assets?

Government, education (childcare operators and universities), healthcare, logistics, pubs, bug box hardware and food manufacturers, are just some of the tenants who are willing to take on long-term leases and occupy an entire building. For these tenants, their premises are either highly specialised and/or the location of the property is critical to their business operations.

Sale and leasebacks are a smart way for long WALE funds to access long-lease properties. When a higher rate of return can be generated from their primary businesses than from owning the property, many corporates are currently taking advantage of the strong demand for assets at historically low cap rates to monetise their property assets. A sale and leaseback transaction effectively unlocks capital which can be redeployed into the business, pay down debt or fund a special dividend to shareholders.

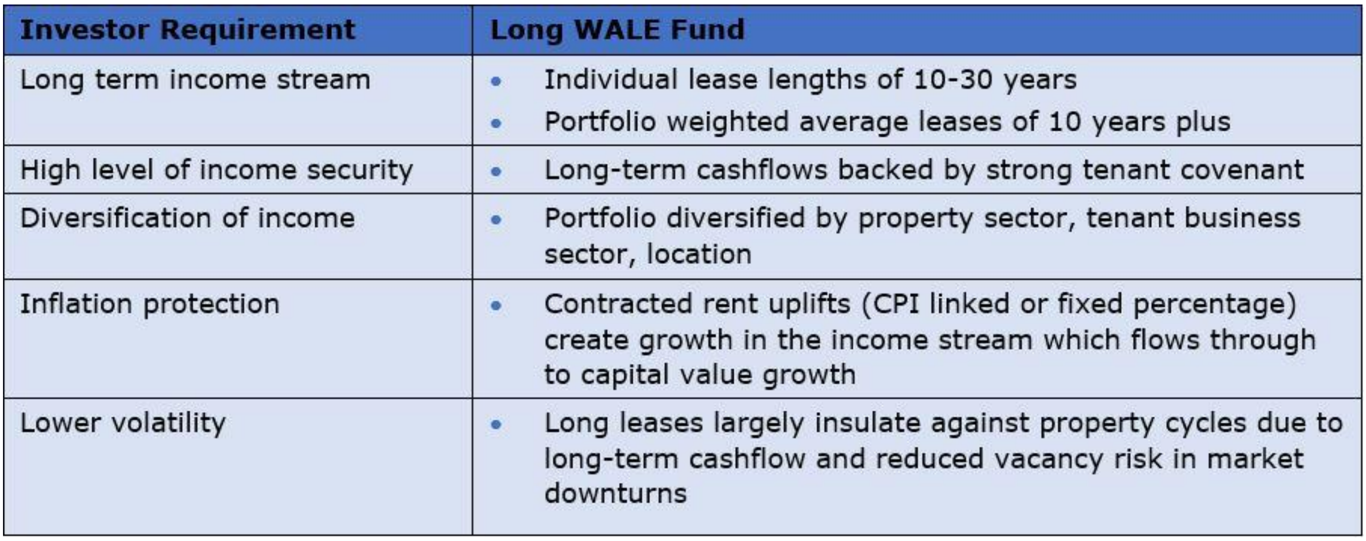
Recent examples of sale and leaseback transactions undertaken by Charter Hall with leading Australian corporates on long-term leases include:

- Telstra selling down a 49% interest in 37 telco exchanges with a WALE of 21 years
- Ingham’s selling down a portfolio of industrial assets related to the processing of poultry with a WALE of 24.6 years, and
- Bombardier Transportation’s Australian headquarters on a 20-year lease term.

Another way to access long WALE assets is to forward fund or forward purchase a pre-let property to a tenant on a long-term lease in advance of its completion. The tenant gets a purpose-built building and the owner receives substantial savings in acquisition costs and can generate a higher return on investment. Charter Hall secured Western Sydney University on a 40-year lease in return for developing and owning long-term, a start of the art vertical campus in the Parramatta CBD.

Benefits of long WALE funds

The table below summarises the benefits of long WALE funds:



Investor Requirement	Long WALE Fund
Long term income stream	• Individual lease lengths of 10-30 years • Portfolio weighted average leases of 10 years plus
High level of income security	• Long-term cashflows backed by strong tenant covenant
Diversification of income	• Portfolio diversified by property sector, tenant business sector, location
Inflation protection	• Contracted rent uplifts (CPI linked or fixed percentage) create growth in the income stream which flows through to capital value growth
Lower volatility	• Long leases largely insulate against property cycles due to long-term cashflow and reduced vacancy risk in market downturns

We expect to see continued appetite for long WALE property funds from a broad range of investors, including superannuation funds and life insurance companies keen to match their long-term liabilities with long-dated cash flows with real assets.

Adrian Harrington is Head of Capital and Product Development at Charter Hall, a sponsor of Cuffelinks. This article is for general information and does not consider the circumstances of any investor.

For more articles and papers from Charter Hall (and previously, Folkestone), please click here.

Growth and urbanisation create compelling opportunities

Andrew Parsons

One birth every one minute and forty seconds. One person arriving in Australia to live every 56 seconds. These are powerful numbers from the Australian Bureau of Statistics (ABS), which highlight the remarkable growth taking place in Australia.

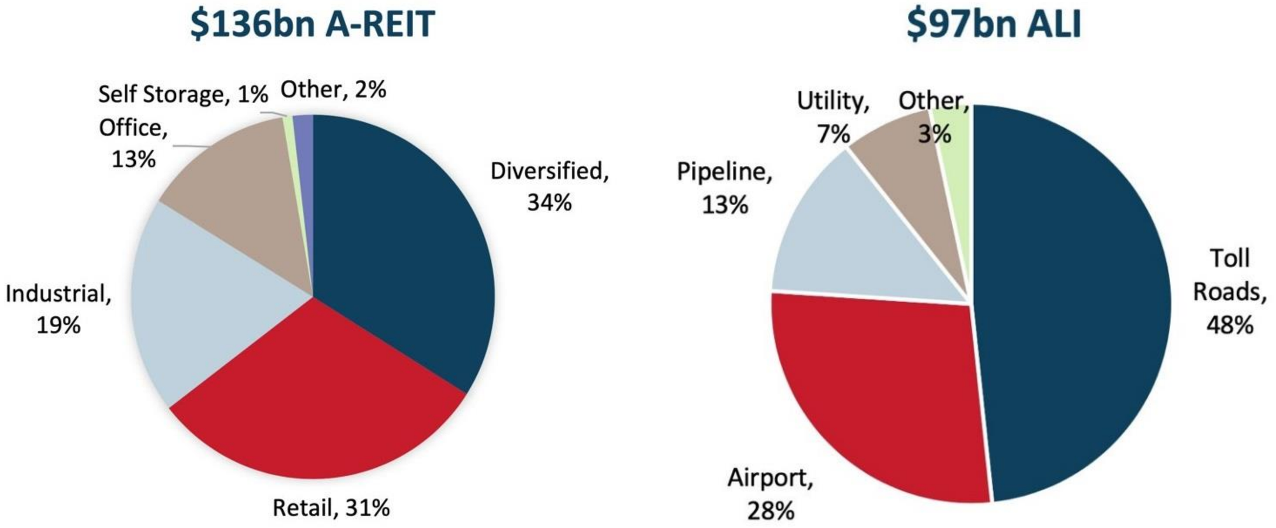
The ABS projects between 31 and 42 million people will call Australia home by 2056 compared with our current population of about 25 million. This growth rate makes Australia one of the fastest-growing ‘developed’ countries globally.

With population growth typically comes urbanisation. Despite our vast continent, 90% of Australians live within 100 kilometres of the coast, with over two-thirds living in our capital cities. For investors, population growth and urbanisation is an enticing investment narrative. How can we gain exposure?

Underpinning Australia’s growth

Two core elements which underpin any developed country’s growth are property and infrastructure.

For decades, Australian Real Estate Investment Trusts (A-REITs) have provided exposure to the property growth angle, delivering strong long-term returns. While we still believe high-quality A-REITs are sound investments, the 10 largest A-REIT issuers currently account for 86% of the S&P/ASX300 A-REIT Accumulation Index market capitalisation. Additionally, almost half of the underlying assets of A-REITs are now concentrated in retail real estate, a sector experiencing significant change due to the growth of e-commerce and changing consumer behaviour.



Source: S&P, Factset, Resolution Capital

When it comes to infrastructure, Australian Listed Infrastructure (ALI) provides exposure to monopolistic assets critical to the growing population such as toll roads, airports, utilities and pipelines.

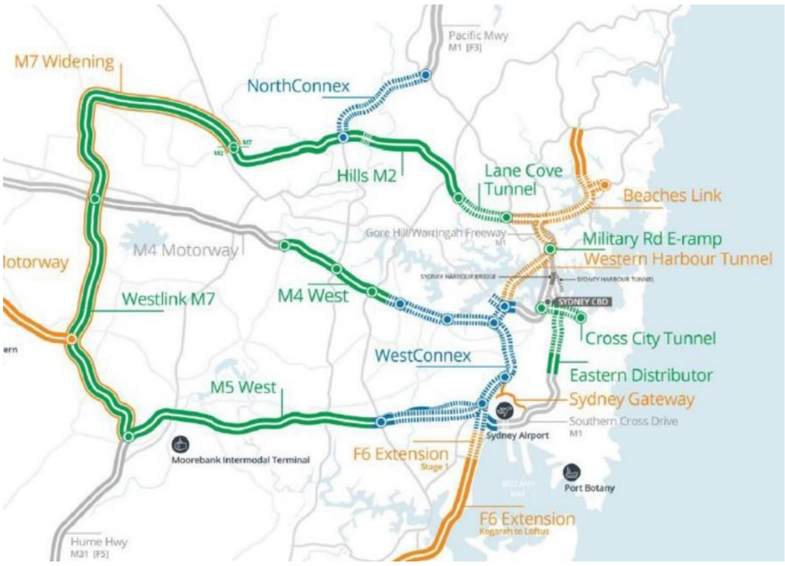
We view toll roads and airports as two sectors within ALI that are well positioned to benefit from ongoing population growth and urbanisation. Infrastructure assets share some similar attributes to REITs, in that the primary source of earnings is from assets which generate sustainable, often long dated, inflation-protected cash flow. However, there are many traits relatively unique to listed infrastructure. The most distinct is that many infrastructure investments provide exposure to monopoly-like assets with high barriers to entry for assets such as pipelines, toll roads and airports.

Infrastructure assets are typically regulated which ensures stable returns, while performance is generally not dependent on the short-term condition of the economy, making infrastructure returns relatively defensive.

High-quality Australian listed infrastructure

Transurban Group's (ASX:TCL) toll roads are critical infrastructure assets with high barriers to entry. Over three quarters of TCL's value comes from its Sydney and Melbourne road networks, with the remainder Brisbane, Washington DC and Montreal. Its Melbourne asset, CityLink, is a 22-kilometre road connecting the Monash, West Gate, and Tullamarine freeways. Cash flows from this asset (before any debt) have increased by over 9% per annum from 2014 to 2018. We expect a slight deceleration the coming years.

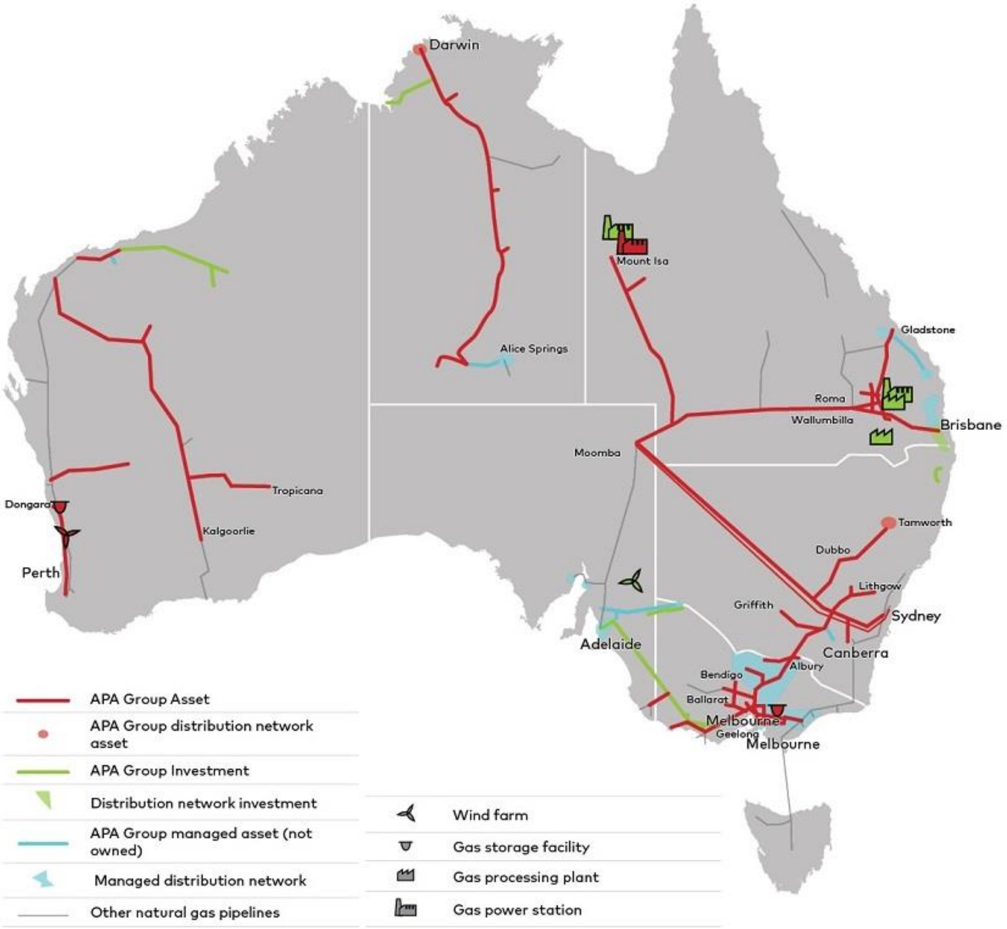
In Sydney, TCL's toll road assets are immense, as shown in the map below. Road users who value their time have few other options, plus a shareholder might feel (slightly) better paying the tolls!


Pacific Mwy
M1 [F3]
M7 Widening
NorthConnex
M7
M2
Hills M2
Lane Cove Tunnel
Beaches Link
Gore Hill/Warringah Freeway
M1
Military Rd E-ramp
Western Harbour Tunnel
Motorway
M4 Motorway
Sydney Harbour Bridge
Sydney Harbour Tunnel
Westlink M7
M4 West
Sydney CBD
Cross City Tunnel
ern
WestConnex
Eastern Distributor
M5 West
Sydney Gateway
Southern Cross Drive
M1
Sydney Airport
Moorebank Intermodal Terminal
F6 Extension
Stage 1
Port Botany
Botany Bay
F6 Extension
Kogarah to Loftus
Hume Hwy
M31 [F5]

Source: Transurban Group

TCL has an intimate understanding of road traffic volumes. Importantly, the majority of its tolls escalate at around ~4% per annum, which is above inflation and offers real price growth in the current low economic growth environment. Furthermore, population growth in both Sydney and Melbourne is expected to remain strong in the coming decades, which should provide further patronage for TCL's roads. When considering the valuation of toll roads, investor should analyse three factors; concession length, traffic growth and toll price growth.

Another infrastructure with similarly powerful monopolistic traits is APA group (ASX:APA). APA has an around 60% market share of Australia's gas transmission market and average contracts lengths are over 12 years with investment grade tenants. This picture shows how vast APA's pipeline network spans.


Darwin
Mount Isa
Gladstone
Alice Springs
Roma
Wallumbilla
Brisbane
Moomba
Tropicana
Dongara
Kalgoorlie
Perth
Tamworth
Dubbo
Lithgow
Sydney
Griffith
Adelaide
Canberra
Albury
Bendigo
Ballarat
Melbourne
Geelong
Melbourne
APA Group Asset
APA Group distribution network asset
APA Group Investment
Distribution network investment
APA Group managed asset (not owned)
Managed distribution network
Other natural gas pipelines
Wind farm
Gas storage facility
Gas processing plant
Gas power station

Source: APA Group

Other high-quality ALI stocks include Sydney Airport (airports), Auckland International Airport (airports), Atlas Arteria (roads) and Ausnet Services and Spark Infrastructure (both energy transmission and distribution).

Airports exhibit high barriers to entry and in Australia and New Zealand there are limited effective substitutes for air travel. Road and train travel between major cities is less prevalent than in Europe, underpinning airport passenger growth. Historically, air travel growth in Oceania has proved to be resilient to external shocks and growth has over the long-term exceeded GDP growth.

Sydney and Auckland Airports are both leveraged to population and wealth growth in Asia Pacific, because with increased wealth more air travel will follow. Both airports generate around half of their revenue from their aeronautical businesses and these are subjected to regulatory oversight. The other half of their revenues is derived from non-aeronautical related activities, comprised of rent on highly productive retail shops in the terminals, including duty-free hotels, airline lounges, commercial office and logistics properties and car parking. Interestingly, Auckland Airport has immense land holdings which has enabled it to become one of the largest developers of industrial real estate in the country.

AusNet and Spark are owners of critical infrastructure assets including electricity distribution (poles and wires) and transmission networks (high voltage power lines) that effectively transport power from the generation sources to consumers and businesses, neither are susceptible to fluctuations in energy usage. Naturally, the forces of population growth and urbanisation create greater need for energy transport infrastructure.

A key positive theme for both AusNet and Spark is the decentralisation of electricity generation. This involves the retiring of coal-fired power plants replaced with new renewable power generation sources such as solar and wind farms. These renewables require energy transmission infrastructure to be built to integrate them into the electricity grid, providing a growth opportunity for both AusNet and Spark.

Australian infrastructure stocks have outperformed A-REITs over the long term, mainly because A-REITs were ill-disciplined in the lead up to the GFC, resulting in the need to repair their balance sheets at a low point in the market. Pleasingly, the sector seems to have learned from its mistakes, and the balance sheets and strategies are currently in good shape.

Property and infrastructure benefit from growth and urbanisation

We believe the best way for investors to gain exposure to Australia's growth and urbanisation narrative is through a diverse portfolio of high-quality A-REITs and ALI.

Combined, A-REITs and ALI make up a $233 billion investment opportunity in 'real assets'. Investing in the offices, roads, warehouses, airports, pipelines and shops that underpin our nation is an opportunity for all investors to gain from Australia's continuing economic growth.

Andrew Parsons is Chief Investment Officer at Resolution Capital. This article is general information and does not consider the circumstances of any investor.

Three strategies for retirees to spend their super

Nick Callil

It is remarkable that, more than 25 years after the key planks of today's superannuation system were put in place, we still have not defined the purpose of superannuation, despite recent unsuccessful attempts to legislate an objective.

Indeed, a better aim for our politicians might be to establish an objective for the overall retirement income system, encompassing age pension and related benefits, and compulsory and voluntary superannuation. Looking at the whole system, rather than just superannuation or any other component, would help promote better integration of the various components over time. We hope to see this matter addressed by the upcoming Retirement Income Review.

More focus needed on the spending phase

In the meantime, it should not be contentious to assert that superannuation savings accumulated during working years should be spent down (ideally, as a regular income) in the years after employment ends. But too often even this limited purpose is not reflected in public discussion of superannuation and the retirement system. Often there is an assumption that assets accumulated for retirement are not to be drawn down during the retirement years, but instead act as a 'capital base' to generate investment earnings which can be spent but otherwise should remain untouched.

We saw this thinking in the discussion of Labor's policy to discontinue refunding of excess franking credits. It was clear many retirees or their advisers considered their 'retirement income' to be the dividend stream (including franking credits) generated on their share portfolio.

An unrealistic strategy

We should be wary of allowing a 'spend the income' mindset in retirement to take root for a good reason – for most retirees, it is simply unrealistic. Living off the interest income from term deposits or the dividend income from a share portfolio sounds attractive but for most retirees (who have little in the way of income-producing assets outside superannuation) this strategy is unlikely to produce an income they might regard as adequate, as shown in Table 1 below.

Table 1: **Achieving a target retirement level using a 'spend the income' strategy**

Target retirement level (ASFA Comfortable)	**Required balance if invested in**	
	Term deposit	**Australian share portfolio**
Single ($43,601)	$2,777,000	$703,000
Couple ($61,522)	$3,919,000	$992,000

Notes:
- Term deposit rate: 1.57% pa (average of advertised rates for 12-month term deposit on $100,000+ for the four major banks in September 2019).
- Dividend yield: 6.2% pa (average gross dividend yield on ASX200 over 12 months to September 2019, including franking credits).

To achieve an 'ASFA Comfortable' income a couple adopting a 'spend the income' strategy would need to have a retirement balance of $3.9 million if investing in term deposits, or a lower amount of around $1 million if invested in a higher-yielding (but riskier) Australian share portfolio.

Table 2: **Median superannuation balances in retirement**

Age	**Males**	**Females**
65-69	$172,914	$165,857
70-74	$182,272	$170,885
75+	$132,324	$131,061

Source: ATO Taxation Statistics 2016-17

These amounts are well above the median superannuation balances by Australians of retirement age, as shown in Table 2. This strategy makes sense only for the relatively wealthy few.

Minimum drawdown rules, OK?

The minimum drawdown rules (MDRs) that apply within the superannuation environment are designed to ensure account balances (including capital) are spent over the pension phase.

While MDRs only specify a minimum amount, many public offer funds still offer little guidance on drawdown strategy in retirement beyond disclosing the relevant percentages. Many retirees commence drawing down their account at the MDR, and a high proportion of members draw down at minimum rates throughout the pension phase, particularly for members with balances at or below the median.

Some funds cite concern about regulatory constraints on providing advice and limited information about their retirees as constraints on offering more tailored drawdown guidance. However, in many cases, a minimum drawdown strategy is actually too conservative, deferring spending that could contribute to the quality of life in early retirement and increasing the chance of leaving unnecessarily large amounts behind on death.

Drawing down well

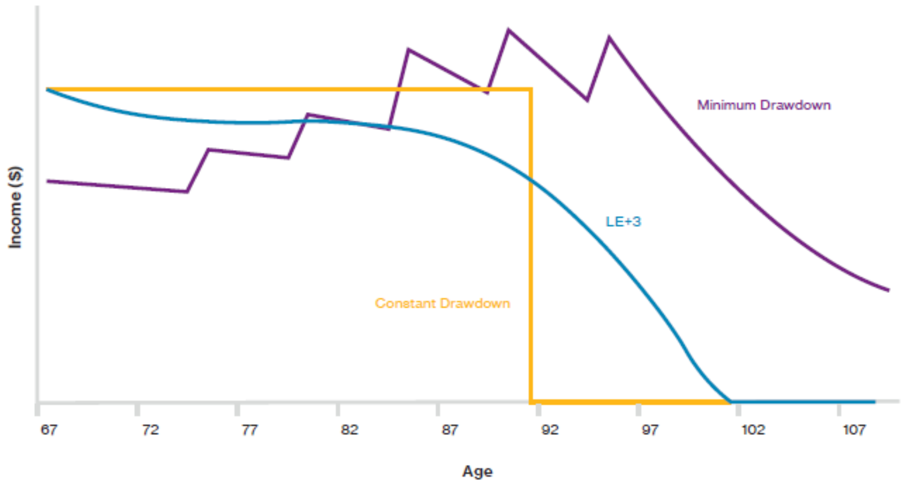
While longevity protection solutions (more on these later) can address underspending more directly, it's possible to improve things with careful design of the drawdown strategy used by members.

Consider the following three strategies to drawing down from an account-based pension:

- In line with the MDRs **(Minimum Drawdown strategy)**
- A constant drawdown each year, set at a level expected to last until age 90 (i.e. life expectancy plus 3 years) **(Constant Drawdown strategy)**
- In line with a modified set of drawdown factors based on life expectancy at each age + 3 years, but with a limit on the amount by which the drawdown reduces over any year **(LE+3 strategy)**.

Chart 1 illustrates the pattern of income expected to emerge under each strategy (the actual drawdown level will vary depending on actual returns rather than the constant return used in this illustration).

Chart 1: Patterns of income under three drawdown strategies



The Minimum Drawdown strategy provides lower income early in retirement but lasts longer than the other strategies. While ensuring income is available in advanced old age is a desirable feature, many retirees may prefer to bring more income forward to the earlier, more active years of retirement.

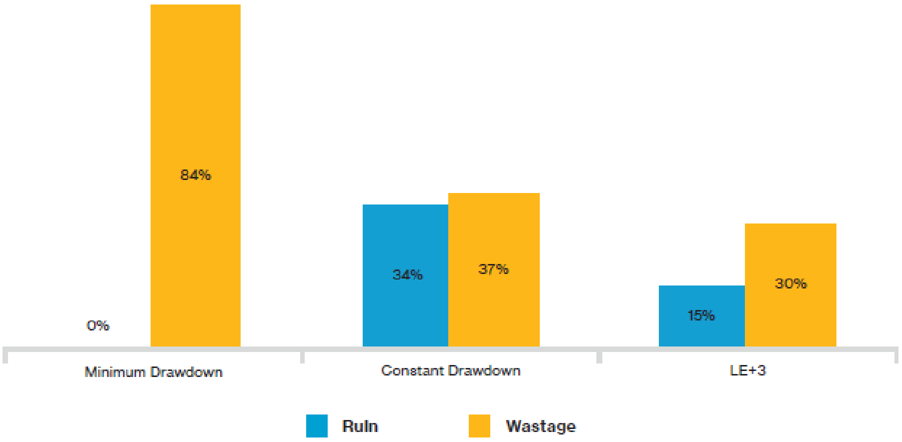
Of course, there is a trade-off: a faster spending strategy means retirees can enjoy more of their savings, but equally increases the chance that they will be left without retirement assets if they live longer than expected. Setting an appropriate drawdown strategy can be seen as an exercise in balancing two risks to the retiree – running out of money before death, or **'ruin'**, and leaving amounts behind on death that might be regarded as excessive, or '**wastage**'.

These risks are shown in Chart 2 below, for each of the three drawdown strategies considered.

A Minimum Drawdown strategy, while having a zero risk of ruin, has an unacceptably high risk of wastage, whereas under a Constant Drawdown strategy, ruin risk becomes the concern. Many funds would still baulk at endorsing a strategy with a one-third risk of running out before death.

This suggests a middle ground, like the LE+3 strategy, can provide a better balance of these risks. Research we have conducted in this area shows that this strategy can be further improved by additional modifications to the drawdown algorithm (such as floors and ceilings to reduce large variations in year-on-year income).

Chart 2: Likelihood of 'ruin' and 'wastage' under different drawdown strategies



Notes:
- 'Wastage' defined as 50% or more of initial balance remaining on death
- 55% growth investment strategy – mean return 5.9% pa over retirement period
- Mortality ALT10-12 (males), with 25 year improvements

Ultimately, no strategy alone can ensure a stable income for life. Ideally, as well as developing a default spending policy for retirees, funds would offer a complementary longevity product (such as a deferred annuity) to provide ongoing income where a retiree outlives their savings.

So, what can be done?

Superannuation funds and the industry generally can promote spending down of balances smoothly during the retirement phase. Some ideas are:

- **A retirement income objective:** Developing an objective with substance will be contentious, as industry stakeholders and other participants will have differing views. For instance, should our system aim to deliver poverty alleviation, age pension supplementation or a standard of living defined by reference to working life earnings? Whatever benchmark is set, an objective should provide that retirement provision be in income form, and capital balances be spent down over retirement.

- **Retirement income estimates:** Providing estimates of projected retirement income during the accumulation phase (particularly as members approach retirement) promotes the primary aim of superannuation as spending in retirement. These estimates are currently provided by many funds but are not universal. Ideally, income estimates should be made mandatory, with some sensible limited exceptions at the fund and individual member level.

- **Careful use of the term 'income':** Language matters. In communicating with retirees we often see 'income' used to denote both investment earnings (such as dividends, rent, interest etc.), and the income received from a fund during retirement phase. This dual usage can cause confusion and promote the 'spend the earnings' concept described above. It's often better to use 'drawdown' or similar terms to refer to amounts paid to retirees in pension phase.

- **Well-designed drawdown rules:** Funds should review their default drawdown offerings to ensure they are not too conservative and do not promote inappropriately low spending by retirees.

- **Better retirement products:** Ultimately, most retirees with meaningful balances will spend their savings more confidently earlier in retirement only if they are sufficiently comfortable that they will not run out of money in advanced old age. The continued development and promotion of longevity protection products which can provide this comfort remains a high priority for the industry.

Nick Callil is Head of Retirement Solutions, Australia at Willis Towers Watson. The information in this publication is general information only and does not take into account your particular objectives, financial circumstances or needs.

Flexibility is the key in today's complex market

Adam Grotzinger

In today's low interest rate environment, fixed income investors are faced with the challenge of generating meaningful income while seeking to insulate their portfolios from the impact of market forces. In the past 30 years, the fixed income universe has seen profound changes as it has evolved in complexity and geography, and from generally higher yielding to the historically low yields seen today. Fixed income managers need to employ a greater variety of approaches and asset classes to achieve objectives for investors.

The evolution of the portfolio manager's role

At one time, bond managers could focus on a few indicators and markets to make their portfolio decisions. The landscape is far more complex now. European core market bond yields, for example, can have rapid impacts half a world away. And the amount of data out there is extraordinary. Managers need expertise in far more sectors and across far more geographies than before. Obviously, one or two professionals can't keep an eye on all of these inputs, so this has put a premium on team-building and coordination in managing investment portfolios.

Investor psychology also creates market hazards. As investors seek yield and move further along the risk spectrum, they go to places that are less comfortable for them. They are not in their usual habitat and are more likely to overreact at the first hint of volatility. Coupled with changing liquidity dynamics, these jittery investors can lead to sharp market responses, which should be considered when sizing positions, considering liquidity and choosing securities that have a better chance of withstanding short-term volatility.

How can fixed income assets provide significant yield at this point?

Commingled fund vehicles obviously come in many shapes and sizes. It's possible to invest in a single fund that provides exposure across the fixed income spectrum, or to narrow your choices to specific sectors. Which you choose will in large part depend on individual circumstances. In our view, investors should generally start with a portfolio that provides broad diversification of fixed income exposure across of range of sectors and exposures. This provides some of the key benefits of fixed income such as portfolio stability and diversification. Investors can then seek to improve their return/risk profile by adding positions in single sectors such as mortgage credit, corporate bonds, senior bank loans and emerging market debt (EMD).

Doesn't that add risks to a portfolio?

In some ways yes, and in others, no. For example, EMD, although a generally high-quality asset segment overall, will tend to add volatility to the portfolio. On the other hand, bank loans, whose yields are reset frequently, will tend to reduce overall portfolio duration (sensitivity to rate fluctuations) due to their floating rate character, they can provide some insulation from inflation and rising rates. Although below investment grade, they are typically secured against corporate assets.

Combining traditional investment grade fixed income sectors with a broader set of fixed income sectors has historically increased portfolio diversification while lowering overall volatility, improving the risk/return tradeoff. However, investors should avoid sticking too closely to broad market benchmarks. For example, passively taking exposure to the Barclays U.S. Aggregate Bond Index ('Barclays Aggregate') gives a heavy weighting to low-yielding US Treasuries and investment grade bonds, which reduces total return potential. These days, a fixed income portfolio needs to do more.

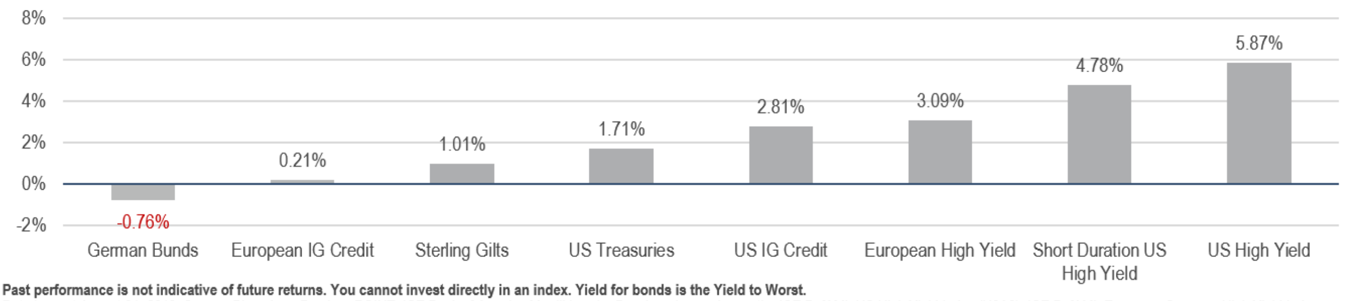
Additional choices in seeking better fixed income returns

There are benefits in investment strategies that afford portfolio managers increased flexibility in seeking returns and managing risks. In multi-sector bond funds, managers may invest in a variety of sectors, across the spectrum of credit, duration and geography. Such funds may also have the ability to take short positions, for example using derivative contracts to profit from interest rates increase.

A diversified relative value approach to fixed income investing capitalises on price anomalies across a broad range of fixed income sectors throughout the market cycle. A globally-integrated fixed income platform and a repeatable and robust process should identify relative value opportunities over time.

Asset prices reflect consensus expectations across various factors - the level and path of interest rates, the shape of the yield curve, credit risk, cash flow patterns, volatility, etcetera. At times, our expectations on these factors differ materially from what is implied by the consensus.

Asset Class Yield Comparison



Past performance is not indicative of future returns. You cannot invest directly in an index. Yield for bonds is the Yield to Worst.
Data is as at August 31, 2019. Source: Bloomberg Barclays POINT, ICE Bank of America Merrill Lynch. Benchmarks used were the ICE BofAML US High Yield Index (H0A0), ICE BofAML European Currency High Yield Index (HP00) USD Hedged, Bloomberg Barclays US Treasury Bellwethers Composite Index, Bloomberg Barclays US Credit Index, Bloomberg Barclays European Credit Index, and ICE BofAML 0-5 Year BB-B US High Yield Constrained Index (H4CD), Bloomberg Barclays German Treasury Index, Bloomberg Barclays UK Gilts Index. Yield shown in local terms.
Historical trends do not imply, forecast or guarantee future results. Information is as of the date indicated and subject to change without notice. Nothing herein constitutes a prediction or projection of future events or future market behavior.

How do you identify and capitalise on market mispricings?

There are three main questions in evaluating any fixed income asset:

(1) What are the market's expectations?

(2) Where do we have investment insight?

(3) How confident are we in our views?

The answer to the first question provides context, the second considers whether our views are different from market consensus, and the third measures our level of conviction for portfolio implementation.

The outlook for the fixed income market

From 2018 to 2019, the U.S. bond market moved from pricing a Fed tightening cycle to a significant Fed easing cycle, and interest rates on government bonds in Europe have moved into more extreme negative yield territory. Are these changes reflective of changing fundamentals that investors should embrace, or are they reflecting overblown fears of a global slowdown or recession?

In our minds, it's a bit of both. The Fed and ECB have shifted toward easing biases, yet it's largely due to how they want to respond to low inflation rather than significant fears about the growth outlook.

Our central view is that a global soft landing is more likely than negative scenarios. Across the U.S., Europe and Asia, consumption rates in the major global economies are stable, despite weakness in production and trade sectors. Ultimately, structural shifts in many major economies toward services-oriented consumption make them less prone to recession and hard landings over the next 12 months.

We believe that investors should continue to invest for a soft landing outcome but recognise that tail risks are rising and centered on trade policy. Given market volatility and slower growth, incremental sources of yield become an important portfolio contributor, especially over the long run. However, this just reinforces the need to be flexible and look for opportunities globally and across sectors to seek to enhance risk-adjusted returns.

Adam Grotzinger is Senior Portfolio Manager, Global Fixed Income at Neuberger Berman, a sponsor of Cuffelinks. Neuberger Berman is the manager for the listed NB Global Corporate Income Trust (ASX:NBI). This material is provided for informational 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.

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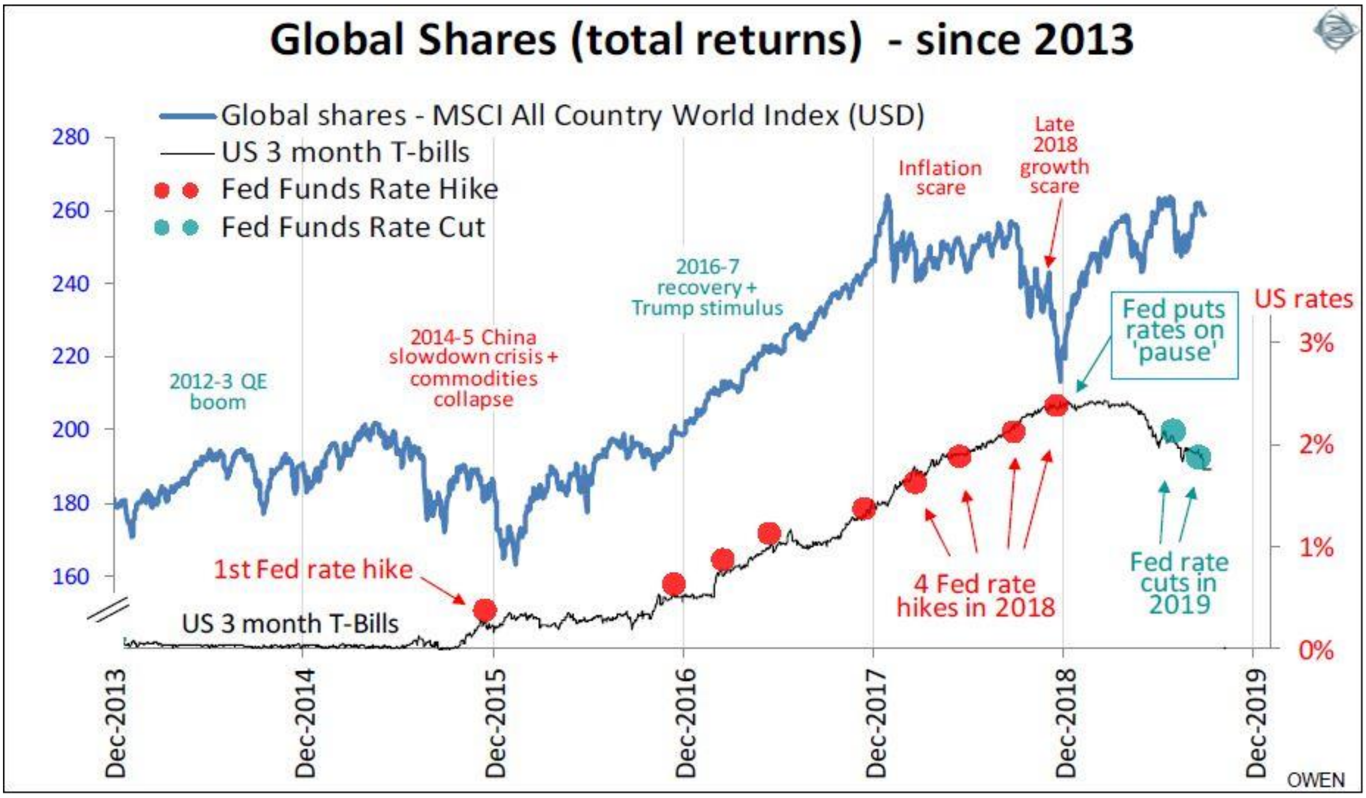
Markets relying on central bank sugar hits

Ashley Owen

Calendar year 2019 has been a tremendous year for returns from investment assets of just about every flavour except cash. The single most important driver of financial markets in Australia and around the world has been US interest rate policy. Share markets sold off sharply in late 2018 and the main cause was the US Fed's four interest rate hikes during the year, as shown below. Their stated intention was to continue raising rates several more times despite gathering signs of economic slowdown and fears of negative impacts from Trump's escalating trade wars.

Then from the start of January this year, the Fed suddenly did a backflip and put further rate hikes on 'pause'. Short-term rates started to drift down in anticipation of Fed cuts, and shares suddenly switched from the sharp sell-off to a strong rebound in 2019. The chart shows global share prices over the past five years through the US rate hikes (red dots) and now the rate-cut rebound (green dots).



The Fed is driving markets

Under intense pressure from President Trump, the Fed started cutting rates on 31 July. When it cut rates again on 8 September, Fed chair Jay Powell noted: '*Trade policy tensions have waxed and waned and elevated uncertainty is weighing on US investment and exports*' - without actually naming Trump. Ever since nominating Powell to the Fed role, Trump has attacked him for not cutting rates back to zero.

The Fed is also coming under pressure to re-start its 'QE' bond-buying programme. Trump's trillion dollar deficits need funding, and that means the government is scaling up the issue of new bonds. The sheer volume of new bonds, plus the fact that China is now selling US bonds, will put pressure on yields to rise, unless the Fed starts buying them again. Share prices surged during the last 'QE' boom in 2012-14, and the prospect of more QE is also supporting share prices this year.

In Europe, the central bank had ended its 'QE' last year but with European economies, inflation and jobs growth still stagnant, on 12 September the ECB resumed its rate cuts (further into negative territory) and announced a re-start of its 'QE' program of direct bond buying. It didn't work last time so there is little reason to think it will work this time. But it certainly did artificially boost returns from bonds and shares.

In Australia, the Reserve Bank has also cut rates three times more this year (including 1 October), bringing the total to 15 rate cuts in the current cycle that started in November 2011. It is running out of room to move. The banks are not likely to pass on any more rate cuts to borrowers as they are already facing margin squeeze and declining profits. The RBA has even talked up the idea of Australian 'QE' bond purchases.

Several other countries have also cut rates as Trump's trade wars continue to escalate and growth prospects dim. (There are exceptions to this global trend – Norway has hiked rates four times to try to rein in rampant debt-funded property speculation). With interest rates on deposits cut almost everywhere, investors have stampeded back into shares, commercial property, infrastructure and bonds this year – boosting returns on all asset classes – except cash.

Although investment returns have been boosted across the board this year, it is unsustainable of course because interest rates can't continue to be cut into negative territory forever.

What lies ahead?

Investors should not become complacent just because shares are doing well again. The rebound in 2019 has been due mainly to artificial and non-sustainable sugar hits from central banks. Meanwhile, out in the real world, economic activities like spending, lending, capital investment, trade and hiring, are slowing across the board.

It is true that Australia has managed to produce a rare budget surplus (and an even rarer current account surplus) but these have been due to unsustainable windfall gains from export commodities prices rather than spending cuts. On the contrary, government spending in Australia has increased at several times the rate of population growth and inflation, and in recent years the government has been the largest driver of employment growth. Outside of the government sector, the rest of the economy has been very weak.

What lies ahead is probably lower interest rates in Australia and in the major global markets - US, Europe and Japan – at the short end and also at the long end. This will most likely be accompanied by increases in government spending in Australia and the US, although there is less scope in Europe and Japan. These sugar hits will probably support asset prices as they have done in past rounds of rate cuts and QE. Governments cannot continue to increase their spending ahead of the growth in tax revenues required pay the interest bills.

There are two types of scares that rattle investment markets - inflation scares and slowdown scares. We have seen many examples of both types of scare in the past and we will see many more in the future. The difference between the two types of scare is their impacts on shares and bonds. Both shares and bonds suffer in inflation scares (both sold off in the February and October 2018 inflation scares), but in slowdown scares share markets fall but bond prices rise, as they did in the December slowdown scare. Inflation scares are the more difficult for investors as they hit both shares and bonds (including bond proxies).

The good news is that inflation scares (where both shares and bonds are hit) are less likely to be on a global scale now. The only risk of serious (say 5%+) inflation is in the US and Australia and some other small markets like Canada. We are unlikely to see serious inflation in Europe or Japan for many years – or perhaps ever, under their current political regimes. The problem (or *good* news for bond investors) is that Europe and Japan are dying – literally – with aging and declining populations, declining tax-payer bases, but rising welfare bills. One solution is immigration but this is proving politically impossible. The likely future is decay and deflation, not inflation.

On the other hand slowdown scares are more likely but they are less of a threat to investors because bonds (especially government bonds) tend to do well in big slowdown scares like the GFC, 2001-02 tech wreck and 1990-01 contraction.

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual.

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