Firstlinks
Connecting investors with ideas

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Sorry, there's no real place to hide

Graham Hand

Let's say you have saved $1 million to buy a home in a year, or you're a retiree who cannot tolerate losing any of the capital you live off. Where can you stash your cash safely and retain its purchasing power in real terms over short terms?

Sorry, there's nowhere.

Investing was once relatively straightforward for highly-conservative investors. As recently as 2012, the cash rate was greater than the 4% annual minimum drawdown required from a superannuation pension account. Further back to the 1990s, periods of double-digit cash and term deposit rates avoided the need to go into anything riskier than term deposits, although inflation was higher.

Official cash rate, 1990 to 2019

Source: RBA

Fast forward to now, as we enter the 2020s, there is nowhere to hide that gives capital security, a return greater than inflation and avoids a continual drawdown on a pension.

Many retirees cannot tolerate losses

Recent research by AllianzRetire+ reveals 79% of Australian retirees say they are responsible for their own finances and they need to feel in control of their money. However, only 44% feel secure in their current financial position, and:

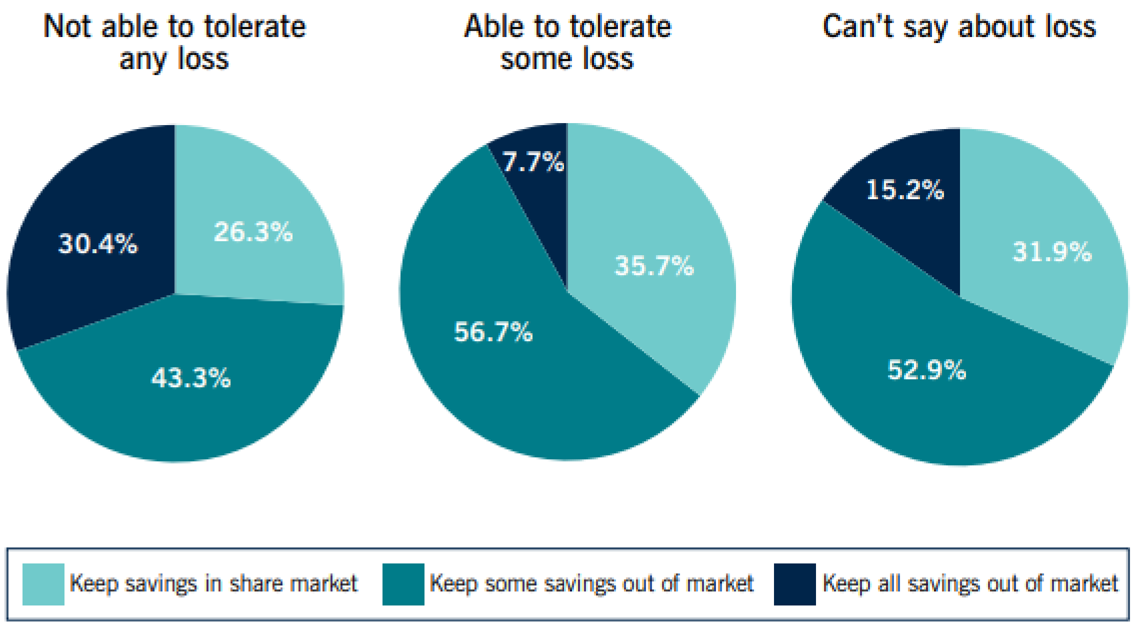
"The response from current retirees is to assume a frugal and conservative retirement investment approach to fund their retirement (75%)."

The consequence is that two-thirds of retirees are spending only on necessities, worried about unexpected costs and illness. This lack of confidence leads to a high allocation to deeply-defensive investments, but what exactly is defensive in the current market?

A 2018 National Seniors survey called '*Once Bitten Twice Shy*' shows a high 23% of older Australians cannot tolerate **any** annual loss on their portfolio, and only 25% can tolerate a loss greater than 10%. A decade on, the impact of the GFC looms large for many retirees, as the survey quotes a retired man aged 54:

"The main issue with the GFC for me was the reduction in my capital investments of approximately $30,000. Up until that point I would be considered a medium risk investor, however following my loss, I changed to a low risk investor and transferred much of my capital into cash. The income from the cash stream is considerably less than a shares portfolio however I was not prepared to suffer another loss of that magnitude. My attitude has not changed to this day."

Another National Seniors survey from March 2019, *'Feeling financially comfortable? What retirees say',* shows the intractable dilemma this creates. Over 30% of the 'not able to tolerate any loss' group keep their savings out of equities.



Although data on SMSF asset allocation is notoriously unreliable, they hold about 25% of their assets in cash and term deposits. That's nearly $200 billion earning a negative real return, an extraordinary loss of retiree income over recent years. Little wonder some economists question the stimulatory impact of lower rates. An estimated $1 trillion of superannuation is in post-retirement accounts.

The current annual CPI inflation rate is 1.7% or 1.95% 'excluding volatile items'. Many of the items in a retiree budget, such as health and utility costs, are rising faster than CPI. As the last two quarters have recorded 1.1%, let's say a positive real return requires an investment return of over 2% a year. It doesn't sound like much, only $20,000 on $1 million.

So what's available, beyond the spin of fund managers, brokers and advisers dressing up risk with words like diversification and low volatility, and misleadingly quoting last year's performance?

Current cash and term deposit rates

Three broad categories of short-term investments offer a high degree of capital protection:

1. Bank (or any Approved Deposit-taking Institutions (ADI)) term deposits

The government guarantee on ADI deposits is up to $250,000 'per entity per ADI'. Anyone wanting the highest protection on $1 million will need to invest with at least four different ADIs. According to Canstar, the highest term deposit rate for 12 months is 1.7% from a couple of small ADIs, ignoring the 2% from a new startup bank. The highest rate from a subsidiary of a major bank is 1.3%.

2. Online savings accounts

There is a wide range of online accounts paying around 1.5% and even up to 2% with so-called 'promotional and bonus conditions'. These include making a minimum number of 'tap and go' transactions a month, making minimum deposits with no withdrawals or using a related credit card. As they target genuine retail, there is sometimes a maximum amount, perhaps $100,000.

Anyone who can be bothered monitoring all the rules across multiple accounts can probably eke out 1.5% to 2%, after a heap of paperwork opening new accounts. Really, life's too short.

3. Cash or short duration government bond funds

Dozens of 'fixed interest' funds are now listed on the ASX, but there are only a few genuine 'cash' and very short duration government bond funds. Obviously, if they are investing in cash or government securities and taking out their own fees, they cannot achieve much more than the current cash rate.

The largest cash fund in the listed market is the BetaShares AAA ETF, which holds a healthy $1.8 billion at a fee of 0.18%. BetaShares does not pretend it is anything other than: *"competitive with 'at call' bank deposits and term deposits without the need for bank account opening or locking up capital".* The current interest rate is 1.22%. As with any fund, last year's rate of 1.9% is irrelevant. What's done is done, you can't invest in the past.

If you want the certainty of capital protection with no credit or duration risk, that's all you can invest in, folks.

What about all the other fixed interest products?

Surely, this is missing a wide range of products that have been launched recently and promoted as alternatives to term deposits. Fund managers have delivered a spate of Listed Investment Trusts (LITs), and bond funds and the like have been offered for decades.

For example, mortgage funds were widely offered as alternatives to term deposits even within the banks' own branch networks. Funds with five-year mortgage assets offering same day liquidity were an accident waiting to happen. When the GFC hit and investors wanted their money back, the funds were frozen until the loan maturity dates allowed repayment. In most cases, investor capital was not lost but pensioners needing the money waited for years.

Many of the new LITs are worthwhile additions to diversified portfolios, and we have written about them here and here. But the added return is available for a reason, and the investments are fine if this reason is understood and accepted.

Many of the conservative investors who have pumped billions into the new LITs and fixed interest ETFs are the same investors who cannot tolerate share market risk. They have traded one type of risk for another, albeit with less downside and less upside potential. But critically, downside potential there is, and it's not short-term capital preservation.

An adviser told me recently that some of his clients are using these funds for 'cash management purposes'. But how many retail investors understand 'spread risk', 'duration risk', 'default risk' or 'liquidity risk'? And what does 'mark to market' mean? What can go wrong?

What is 'mark to market' and why does it matter?

A bond bought to yield 5% for five years and held to maturity will earn 5% each year for five years (assuming no default). What it says on the box is correct.

However, a bond fund is usually made up of hundreds of bonds, and funds offering daily liquidity must revalue the bonds every day to calculate the unit price or Net Asset Value (NAV). In the case of an ETF or unlisted managed fund, investors enter or exit at this price and there is no maturity date for the fund. If a bond is repaid, the fund manager buys another bond.

It is not possible to invest in a bond fund (other than a government bond fund with very short duration) or any of the recent LITs and guarantee that $100 now will be worth $100 in a year. It could be $105, it could be $100, it could be $95. This article is addressed to the large number of people who cannot accept the risk of $95.

Credit spread risk in corporate bonds

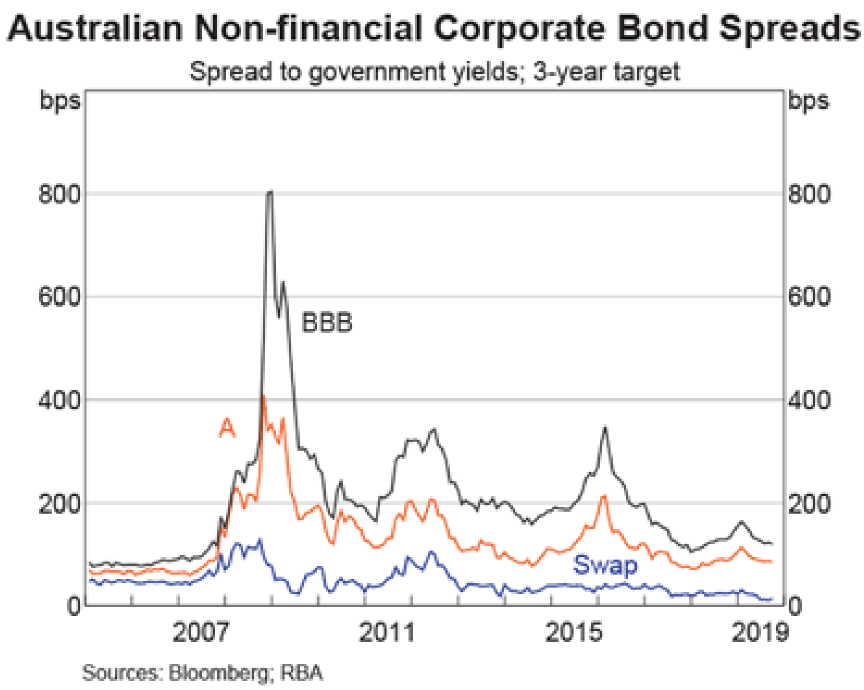
Most investors know about default risk, where a company cannot pay its debts when due. Many investors know about liquidity risk, where there is a poor market for the bonds in a portfolio and money cannot be withdrawn (or in the case of a LIT, buyers disappear). And there are other risks such as duration, where bonds of longer maturity lose more than shorter maturities when rates rise.

But for the purpose of illustrating the risk in many of the new LITs, let's focus on the credit spread risk in the corporate bond and loan market.

Let's say a fund manager buys a corporate bond yielding 5% for five years, and this is a spread of 4% more than a government bond. Even if interest rates do not move, a change in the market's perception of the company might lead to a sell off, and the yield might rise to 6%. That's a widening of the spread from 4% to 5%. The bond **price** would fall by about 5% (for simplicity sake, assuming a duration of five years, although duration is less with semi-annual coupons). It does not need the company to default for the bond to lose 5% of its value, and such spread widening for 'high yield' credit is common (non-investment grade or high yield bonds used to be called 'junk bonds' before the marketing people realised the obvious problem).

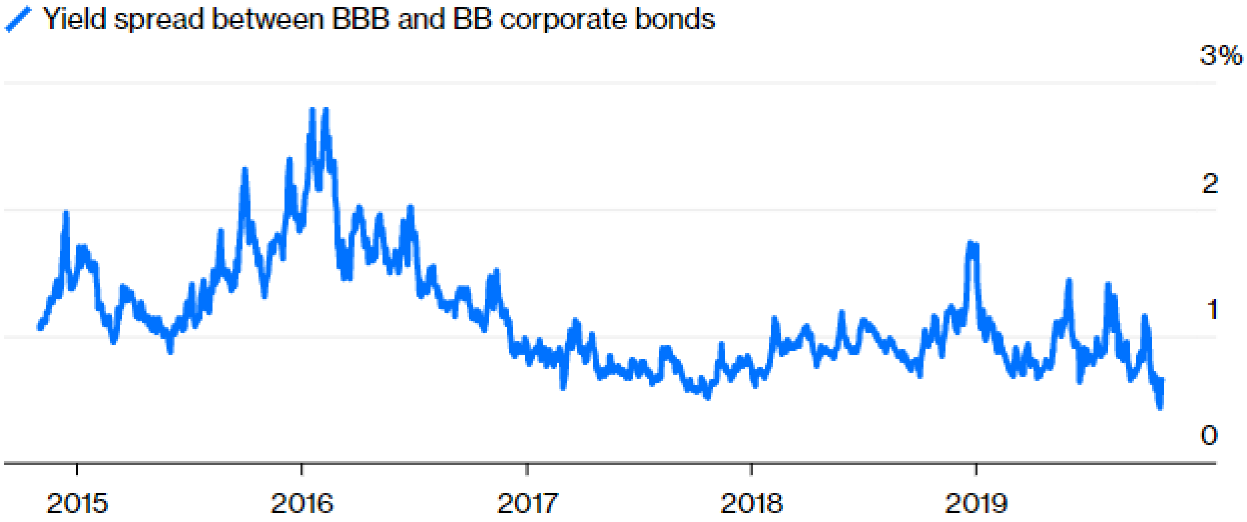
You may take comfort from the fact that the fund holds 100 companies, and a loss of 5% on one bond is only 0.05% on the whole portfolio. That is correct, but corporate credits spreads as a whole rise and fall depending on market factors.

The Reserve Bank of Australia chart (from 6 November 2019) on non-financial corporate bond spreads shows BBB spreads are close to their lowest for 12 years, since well before the GFC, and they move around.



The BBB rating is the bottom level of Standard & Poor's credit rating where the risk is still considered investment grade. The BB rating denotes 'high yield' or 'speculative'. As many institutional investors are not allowed exposure below investment grade, there is often a big divide between spreads on BBB and BB names.

However, in the global search for yield, investors are increasingly heading into riskier investments they may once have shunned. According to Bloomberg, the margin between investment grade and 'speculative' grade was at a new low at the end of October 2019. It is a reward for taking risk, but investors are buying BB bonds at a spread of only about 40 basis points (0.4%) above BBB. At the start of 2019, it was as high as 170 basis points (1.70%) and almost 3% in early 2016, as shown below.



Source: Bloomberg Barclays

Back to 'mark-to-market, the fall in both interest rates and spreads means bond funds which own BB securities have delivered excellent returns in 2019, and these results are often quoted in offer documents.

But this quoting of past returns is disingenuous on bond funds with rates and spreads at these historical low levels. What matters is the future risk of spread widening and interest rate rises.

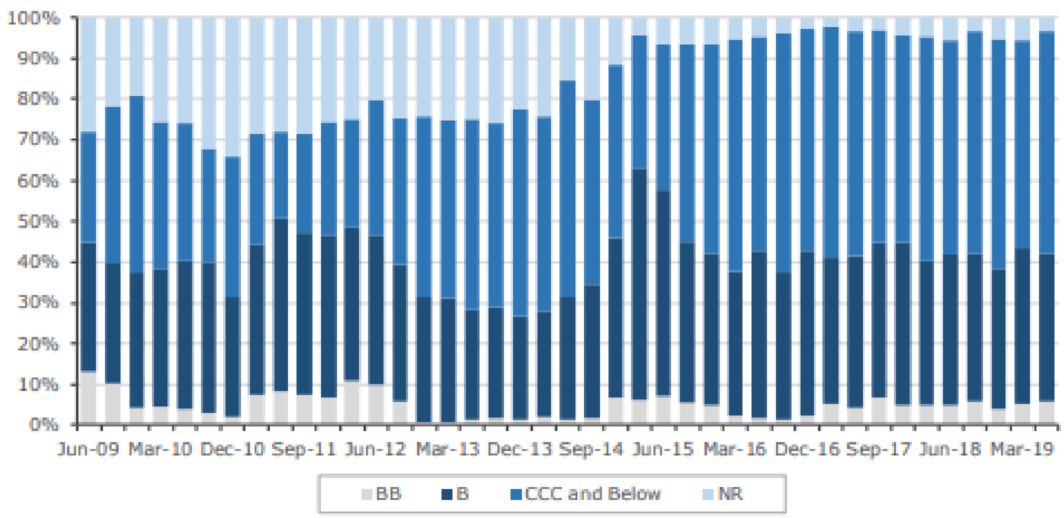
The credit deterioration in corporate bond funds is not confined to non-investment grade. In the investment grade bond index, BBB companies now make up over half the index for the first time in a decade.

I stress that including some of these corporate bond funds as an allocation in a diversified portfolio may be appropriate. What is incorrect is to consider these funds as capital protection vehicles over a time period such as one year.

A specific example

Consider the recently-listed KKR Managed Fund (ASX:KKC) which has 60% exposure to 'global credit' and 40% to 'European direct lending'. It launched with a minimum target of $200 million and accepted $925 million. KKR is a major global player in corporate debt with a 120 person global credit team and about US$70 billion in credit strategies.

As shown in the chart below, about 50% of the securities will be CCC-rated, and the vast majority will be sub-investment grade. That's how the expected high returns are achieved.



Source: KKR Credit as at June 30, 2019

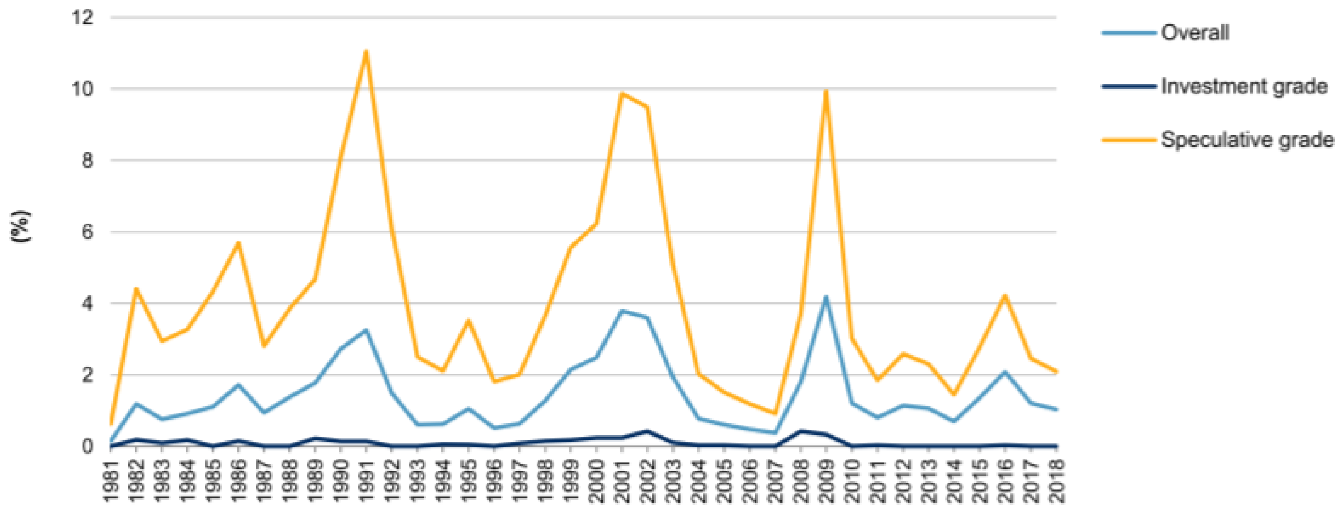
KKR discloses the risks, such as this from their offer documents:

"A KKR Managed Fund may hold debt investments that may be classified as 'higher-yielding' (and, therefore, higher-risk) investments. In most cases, such debt will be rated below 'investment grade' or will be unrated. Borrowers of this type are considered to be at greater risk of not making their interest payments or principal repayments. The market for high yield securities has previously experienced and may in the future experience periods of volatility and reduced liquidity. The market values of certain of these debt investments may reflect individual corporate developments. General economic recession or a major decline in the demand for products and services in which the relevant issuer operates would likely have a materially adverse impact on the value of such securities. In addition, adverse publicity and investor perceptions, whether or not based on fundamental analysis, may also decrease the value and liquidity of these high yield investments.

Commercial bank lenders may be able to contest payments to the holders of other debt obligations of the same obligor in the event of default under their commercial bank loan agreements".

S&P Global Ratings for 2019 show the following default rates:

Global Default Rates: Investment Grade Versus Speculative Grade



Sources: S&P Global Fixed Income Research and S&P Global Market Intelligence's CreditPro®.

This chart shows a portfolio of 'speculative grade' companies can have a default rate of 10%. KKR is highly-experienced and may or may not experience similar levels.

The fee structure includes a base management fee, a performance fee, a responsible entity fee, recoverable trust expenses and indirect costs, and in the example provided by KKR, it adds up to 1.58% per annum. In a low interest rate world, investors should consider if this is a disproportionate share of the return.

In the unlisted fixed interest market, in recognition that taking high fees from low rates is a hard sell, many fund managers are lowering their fees. In Australia in recent weeks, Nikko, Kapstream, Schroders, Legg Mason and Aberdeen Standard have dropped fees. Bond ETFs are widely available and cheaper.

Investors who take comfort from the current benign conditions in the bond market must accept conditions can turn quickly into a reinforcing spiral. As investors see capital values fall, more attempt to sell. During conditions of poor liquidity, prices fall as weaker investors panic.

I asked Anthony Doyle, a cross-asset specialist at Fidelity International, what he thought of retail investors buying low-rated corporate bonds. He replied:

"I worked on a bond desk for 12 years in the UK. I think that these high risk asset classes do well until they don't. It's important for investors to understand the risks that are involved in investing in essentially one notch above default corporate bonds in CCC."

Why do advisers and brokers put their clients into these funds?

Every relationship between an agent and client is different, and often there is a significant difference in expertise and knowledge which requires the client to trust an adviser. In most cases, this trust is justified.

Reasons why these newer-style exposures are selling by the billion include:

1. They are a legitimate part of a diversified portfolio. Fixed interest investments usually offer better defensive performance than equities, and the promise of 6% to 8% returns may be considered adequate compensation for the risk.
2. The fund managers coming to the market are among the largest and most experienced in the world, and their experts perform extensive due diligence before investing. For example, KKR has a strong private equity heritage and is familiar with corporate credits outside investment grade. By combining money into one fund, a wide diversity of corporate or loan exposures is delivered in one investment.
3. Some of the bond issuers are higher credit quality than KKR's fund, so the quality of the portfolio should be checked.
4. Or the elephant in the room is conflicted remuneration, where fees are paid to brokers and advisers to place clients into certain funds. This is a major subject in its own right and will be covered in another article.

Fixed interest for protection and as a risk diversifier

The traditional role of fixed interest, especially government bonds, was to protect a portfolio while providing some income. Investors could be confident in the low or negative correlation with equities. However, it is possible if rates rise on bonds (and prices fall), then equities will also see price falls.

Similarly, non-government bonds are subject to credit spread deterioration and credit default in the face of a declining economy.

There is a role for corporate credit in a diversified portfolio, especially with term deposit rates below 2%. But do not equate 'fixed income' with capital protection over a time period such as one year. There's a reason the government bond rate is called 'risk free'. Other bonds aren't.

Graham Hand is Managing Editor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

20 favourite investment and life lesson quotes

Shane Oliver

The world of investing can be confusing and scary at times. Fortunately, the basics of investing are timeless and some investors (often the best) have a knack of encapsulating these in a sentence or two that is insightful and easy to understand.

In recent years I've written several insights highlighting investment quotes I find particularly useful. Here are some more of my favourites.

The market

"Stock price movements actually begin to reflect new developments before its generally recognised they have taken place." Arthur Zeikel

This goes to the nub of how share markets work – they are forward looking. Regularly I have seen share markets bottom and start moving higher even when the fundamental news is still terrible, only to see the news improve and vice versa. This is why many often get wrong footed – selling at bear market depths because the fundamental news is so bad and buying at the height of a bull market because the news is so good.

"It's a basic fact of life that many things everybody knows turn out to be wrong." Jim Rogers

This can't apply to everything – eg if it's raining outside then it is. But when it comes to investing this quote highlights how perverse it can be because when everyone is saying the same thing – like economic conditions are so bad shares can't recover - then maybe the share market has already factored it in, the crowd has sold and the cycle will soon turn up.

"That men and women do not learn very much from the lessons of history is the most important of all the lessons of history." Aldous Huxley

Which is partly why investment cycles perpetuate no matter how much regulators try and guard against a return to the behaviour which gave us the last boom and bust. The key for investors is to have an historical perspective, partly so they can filter the noise from what matters but also to help guard against being sucked up in periods of euphoria or pessimism.

"Cash is a fact, profit is an opinion." Alfred Rappaport

This is one reason why dividends are great – providing they are not being paid for out of debt, they reflect that companies are actually generating cash and so can afford to pay the dividend.

Contrarian investing

"Even the intelligent investor is going to need considerable willpower to keep from following the crowd." Ben Graham

When times are good the crowd is happy and fully invested. But it gets to a point where everyone who wants to buy has. This leaves the market vulnerable to bad news because there is no one left to buy. Similarly, after a sharp fall the crowd gets negative, sells their investments to the point that everyone who wants to sell has and so the market sets up for a rally when some good, or less bad, news comes along. So the point of maximum risk is when most are euphoric, and the point of maximum opportunity is when most are pessimistic. But for many investors trying to sell when the market is booming and all around you are euphoric is tough. As is trying to buy after the market has crashed and everyone is pessimistic.

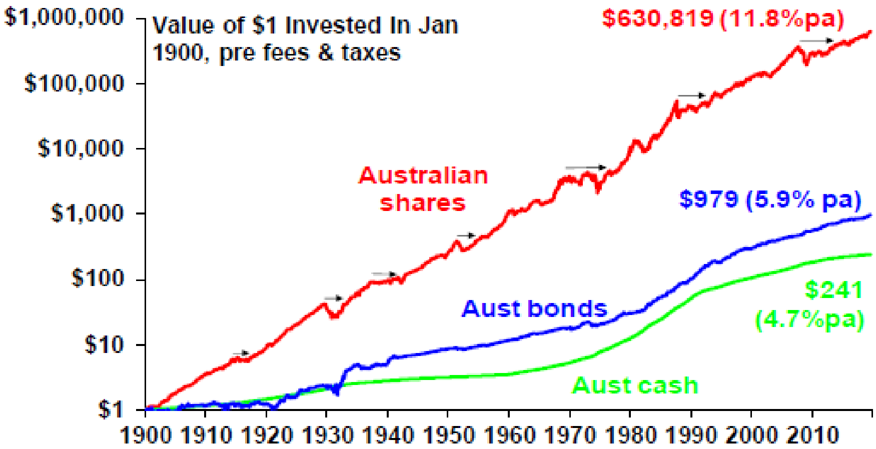
Having a goal and a plan

"Compound interest is the eighth wonder of the world. He who understands it, earns it…he who doesn't, pays it." Albert Einstein

Some may argue it was Patsy Kensit! But when it comes to investing, your best friend is time and the earlier you start, the better. This is the best way to take advantage of the magic of compound interest. (And the worst way to experience its downside is letting credit card debt build up!) The next chart shows the value of $1 invested in various Australian asset classes since 1900 allowing for reinvesting any income along the way. That $1 would have grown to $241 if invested in cash, $979 in bonds but a whopping $630,819 in shares.

While the average share return since 1900 is only double that of bonds, the huge gap in the end result between the two owes to the magic of compounding returns on top of returns. A growth asset like property is similar to shares over long periods. Short-term share returns bounce all over the place and they can go through lengthy bear markets (shown with arrows on the chart). But the longer the time period you allow to build your savings, the easier it is to look through short-term market fluctuations and the greater the time the compounding of higher returns from growth assets has to build on itself.

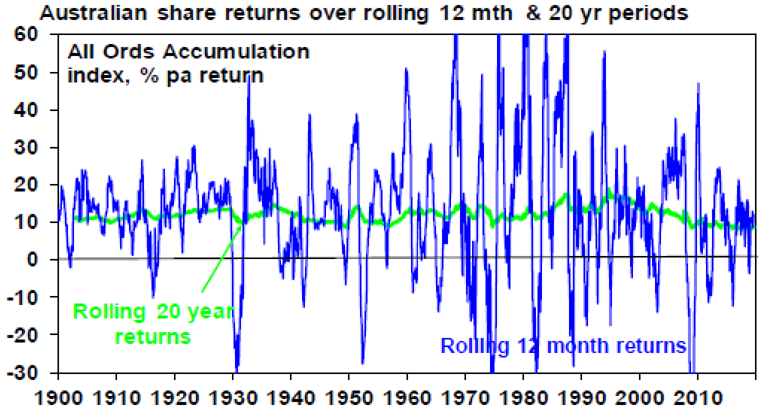
Shares versus bonds & cash over very long term - Australia



Source: Global Financial Data, AMP Capital

"Do not take yearly results so seriously. Instead focus on four- or five-year averages." Benjamin Graham

In the short-term, the share price for a company, asset class returns or returns from an investment product bounce around a lot. But this is mostly just noise and is no guide to the future and should be ignored. When it comes to share market returns the longer the investment horizon the better. As can be seen in the next chart while rolling 12-month share market returns are volatile rolling 20-year returns are solid and pretty stable.



Source: Global Financial Data, AMP Capital

Processes

"No matter how good the science gets, there are problems that inevitably depend on judgement, on art, on a feel for financial markets." Martin Feldstein

This is about having the right balance between science (to keep you disciplined and immune to market sentiment) and art (because quant models can be wrong too and won't know about everything impacting markets) in your investment process.

"If you aren't thinking about holding a stock for ten years, don't even think about holding it for ten minutes." Warren Buffett

Unless you really want to put a lot of time into trading, its best to only invest in assets you would be comfortable holding long term. This is less risky than constant tinkering.

"I have always told people who asked for a stock tip that unless they were prepared to ring me every week for a sell decision, a stock tip was useless." Nikki Thomas

Stock tips are interesting but unless you get them as part of a process with regular updates (including when to buy and sell) they are of dubious value beyond possible entertainment.

"Diversification for investors, like celibacy for teenagers, is a concept both easy to understand and hard to practice." James Gipson

But you gotta try because if you only have exposure to two or three shares in your portfolio you could be exposed to a very wild ride at times and even the risk of permanent capital loss.

Noise

"Based on personal experience – both as an investor & an expert witness – rarely do more than three or four variables really count. Everything else is noise." Martin Whitman

The information revolution has given us an abundance of information and opinion about investing. The danger is that information overload adds to uncertainty resulting in excessive caution, an overreaction to news and a focus on things that are of little relevance. So turn down the noise!

Pessimism

"Anything that can go wrong and doesn't go wrong is just waiting for a much worse time to go wrong." Anon

Those perpetually forecasting a crash in Australian home prices are an example of this sort of thinking. The human brain evolved in a way that it leaves us hardwired to be on the lookout for risks. So, it's easier to be sceptical and pessimistic. As a result, bad news sells and there seems to be a never-ending stream of warnings of the next disaster. But when it comes to investing, succumbing too much to pessimism doesn't pay. Since 1900 shares have had positive returns seven years out of 10 in the US and eight years out of 10 in Australia.

Self-perception

"Everyone has the brain power to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and [investment] funds." Peter Lynch

If you can't handle volatility in financial markets without making rash decisions, then either they are not for you or you should just take a long-term approach and leave it to someone else.

"If you have trouble imagining a 20% loss in the stock market, you shouldn't be in stocks." John Bogle

Ditto. Successful investing is all about knowing yourself. Smart investors have an awareness of their weaknesses and seek to manage them. One way to do this is to take a long-term approach. If you want to trade day to day then you need to recognise that this requires a lot of effort, a rigorous process and a willingness to go against the crowd.

"A fanatic is one who can't change his mind and won't change the subject." Winston Churchill

Many let blind faith in a strongly held view ("debt is too high", "global oil production will soon peak", "paper money will lead to economic disaster", "Obamacare will destroy the US economy", "the digital revolution means this time is different") drive all their investment decisions. They could get lucky and be right at some point but end up losing a lot of money in the interim.

"If you don't like something, change it. If you can't change it, change your attitude." Dr Mary Angelou

Following on from the last quote, to be a successful investor you need to humble, flexible and accepting of the reality of investment markets. Tilting at windmills doesn't work.

Life balance

"Money is better than poverty if only for financial reasons." Woody Allen

Classic Woody. But he's definitely right.

"Money frees you from doing things you dislike. Since I dislike doing nearly everything, money is handy." Groucho Marx

That may be true for him. But some of the best things in life are free (well, they don't need money).

"Wealth consists not in having great possessions but in having few wants." Epicetus

There is much more to being wealthy than just having money and possessions. We often focus on getting great possessions and hence the financial wealth to obtain them, but numerous studies show that beyond a certain level, more money won't make you happier. And if we have fewer wants we are better able to focus on achieving those wants.

"Even right up to the end we found conflict with each other, which now means nothing. It just means nothing. If there is conflict in your lives – get rid of it." Barry Gibb (on his relationship with Robin Gibb after Robin's death)

Money often drives conflict. Try to make sure it doesn't.

Dr Shane Oliver is Head of Investment Strategy and Chief Economist at AMP Capital, a sponsor of Firstlinks. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs.

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We need national and personal visions for retirement

Emma Rapaport, Matthew Harrison

These two articles report on different results from the same research. The first is from Matthew Harrison, the second from Emma Rapaport.

The Federal Government's Retirement Income Review Consultation Paper was released recently. It has been widely welcomed as a positive step towards enhancing Australia's retirement system given the dramatic economic and social shifts over the past 30 years.

Interplay with perceptions of retirement

There is a definite need for an evaluation of the technical issues that are driving the system and the interplay between them. But we also need to look at the intangible elements that play an important role, in particular Australians' perception of retirement.

The Consultation Paper acknowledges that research shows Australians do not actively engage with their superannuation or long-term retirement planning. A key reason for this is the complexity of the system.

We believe the issue goes beyond this. Franklin Templeton recently released the findings of a major survey of Australians' attitudes and behaviours around planning for and living in retirement. This global survey was conducted in Australia for the first time with over 2,000 Australians aged 18 or older.

The survey revealed that retirement savings is increasingly becoming a driver of anxiety and distress for Australians, despite our world-class compulsory superannuation system. Australians are also largely attempting to navigate the complexities of retirement finance themselves rather than seek professional advice.

Overall more Australians reported experiencing stress or anxiety (70%) related to retirement savings than those surveyed in the US (67%), Canada (68%), and China (68%) [although *only pre-retirees were surveyed in the 2019 China survey, and retirees were excluded*]. Younger Australians (those under 40) are generally anxious about retirement savings even though they have the benefit of time to plan, save and invest accordingly.

Lack of choice to work longer

Potentially driving some of this distress is the fact that at least one third of respondents to the survey across each age group reported having less than $50,000 in total savings for retirement. More people are worried about running out of money in retirement than potential health issues.

Most people plan to work longer. As well as potentially denying themselves the freedom to pursue personal interests, the ability to 'extend' a working life to compensate for a lack of retirement savings is far from guaranteed. Indeeed, 31% of retirees said they were forced to retire due to circumstances beyond their control and 47% said this occurred earlier than expected.

Calls to enable older Australians to work longer may unintentionally fuel this idea. It could further undermine the idea of retirement as a stage of life that should be actively planned for. Of those surveyed, 62% do not have a strategy to generate income for retirement that could last 30 years or more. This figure is not in step with longevity predictions or anticipated rises in expenses.

A total of 51% of respondents said they are concerned about outliving their assets, and 53% have no idea how they will pay for medical expenses in retirement.

An inability to perceive retirement goals

People save when they have clear goals – like buying a house or taking an overseas holiday - because they can envisage a positive pay off. This motivates them. Right now, many Australians are not approaching retirement with clear goals and a positive vision, and this means they are either not doing enough to build their retirement finance, or worse, doing nothing at all.

This problem is also not helped by the vastly different projections about the amount of money a person will need in retirement.

Many Australians will spend a third of their life in retirement. There is strong potential for Australians to have a financially secure retirement, but sadly, only 5% said they would use the word 'energised' to describe how they feel about life in retirement. It's time we encourage people to be more excited about what this time of life could mean for them should they be willing to actively plan and work towards it.

Matthew Harrison is Managing Director at Franklin Templeton Australia.

Aussies shun advice in retirement

Australian retirees are turning away from financial advice and are even reluctant to include their own life partners in the retirement planning process, a global study shows.

Less than a quarter of Australian retirees seek financial advice, instead choosing to navigate their retirement finances alone, according to new research from global asset manager Franklin Templeton.

Only 24% of Australian retirees use a financial adviser, compared with 57% and 47% of this cohort who seek financial advice in Canada and the US.

But it's not just financial professionals that are being left out of Australians' retirement planning. More than 54% of respondents aren't coordinating their retirement planning with a spouse or partner—also the lowest among the three nations surveyed.

The results follow a series of scandals in the financial advice industry, which unearthed widespread misconduct and an erosion of trust in financial planners.

In the wake of this, some have warned the cost of advice could increase dramatically as the advice industry fractures and financial planners exit.

The latest Vanguard/Investment Trends SMSF report 2019 showed that overall satisfaction among trustees with financial planners has declined to a seven-year low. Primary reasons cited include a perceived lack of value-for-money and high fees.

"A lack of confidence in the expertise of advisers is now the number one barrier for SMSFs seeking advice on their unmet needs sitting at 32%, with adviser fees the second biggest barrier at 30%," Vanguard says.

Negative perceptions of advisers are also reflected in Morningstar Australia audience surveys. Some 18% of individuals surveyed shun financial advisers because they don't trust them, the Morningstar and Investment Trends 2018 Investment Product and Advice Needs Survey found. A similar proportion of respondents stopped using advisers because of poor outcomes, and 20% said they simply have no need for them.

Manuel Damianakis, Head of Retail at Franklin Templeton Australia, says that while everyone should be encouraged to take a strong personal interest in their retirement finance, the 'flying solo' approach comes at a cost, particularly in this low rate environment.

"81% of those retired have never developed a written retirement income plan and only 43% told us they have a strategy to generate income for retirement that could last 30 years or more. Given ongoing market volatility and protracted low interest rates, it would be unwise for retirees to adopt a set and forget approach to their savings and investments and this is often where those working without professional advice become unstuck."

Australian investors are struggling to manage their investments. One-in-five SMSFs trustees considered ditching their fund in favour of an employer superannuation fund last year, on the back of high costs and complexity.

Diversification also remains an area of concern for SMSFs, with just over 10% of their total portfolio to international assets. The number is much lower among those who don't use advisers—14% in 2019 who use advisers, 9% who don't.

SMSFs with no exposure to overseas assets are less likely to appreciate the importance of a diversified portfolio, emphasising their need for greater guidance on what to invest in and how, the report said.

Emma Rapaport is Editor at Morningstar.com.au. This article is general information and does not consider the circumstances of any investor.

Beware: the share valuations failing the commonsense test

Warryn Robertson

Why are interest rates so low? Ask this question to the man-on-the-street and they will likely tell you that the economy is struggling, and the world is facing great uncertainty.

Yet ask an equity analyst about low rates and many will tell you that they are great for asset prices and can propel equity markets even higher in 2020.

Unsurprisingly, there seems to be a disconnect here. Companies rely on the economies in which they operate to drive growth, and if global growth is low, the earnings outlook will be challenged.

So who is right about the outlook for 2020 and beyond? In my opinion, the common sense of the man-on-the-street may be closer to the mark than many professional investors. Growth prospects are *low* and uncertainty is *high*, which is not a great combination for many companies.

Some equity market investors are falling into the trap of thinking that interest rates are low purely for their benefit. We believe this is at the heart of why investors get their company valuations wrong.

Why is this wrong?

An investor's job can be simplified to two primary tasks.

First, to predict what a company's cash flows or earnings will be in the future.

Second, to work out how much to pay for those earnings.

In our valuations, we link nominal GDP growth, which is the key driver of earnings, with nominal risk-free rates, which is the key driver of multiples or discount rates. If you lower the discount rate (because bond yields and rates are so low) but maintain trend earnings, it is mathematically possible to justify some of the multiples we are seeing in global equities.

However, at some point, we believe there will be a reckoning. Either earnings are going to disappoint (because growth is lower) or over time, rates must rise. Either way, this will be painful process for the share price of many companies, particularly overvalued companies.

Exhibit 1 is a universe of 250 of the world's highest quality global companies (based on criteria we use to identify businesses with strong economic moats and predictable earnings), as at 30 September 2019. We have ranked them according to their potential upside, with reference to the differential between their ascribed 'intrinsic value' as determined by our fundamental analysis, and the current prevailing market price.

Exhibit 1 shows there is a relatively small number of stocks that will produce strong expected returns over three years, assuming shares trade at our valuation in three years' time (above zero are companies with positive expected returns, below the line are negative expected returns). Worryingly, for less valuation-sensitive investors, we are ascribing large negative expected returns for many companies (the right-hand side of chart). The lesson here is that buying generally highly regarded companies can lose you money if brought on the wrong valuation.

Each bar represents an individual stock's expected return per annum for the next three years. This is based on a comparison of Lazard's Global Equity Franchise team's intrinsic valuation of the stock three years out, the market price of the stock today and the interim forecast dividends.

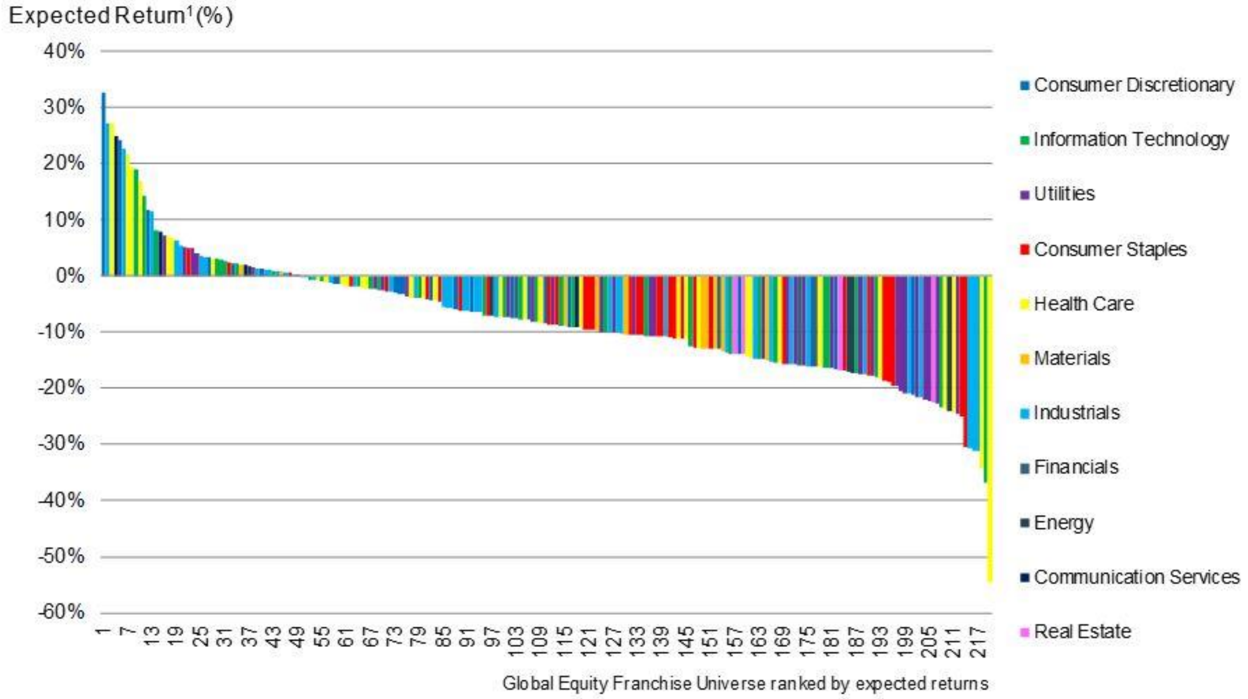
The largest and most expensive stocks have fared the best

Many of the world-leading companies in the above chart have driven the bull market in 2019. While we acknowledge that some of these technology stocks, in particular, are high-quality businesses with powerful competitive positions, many of them are now trading on multiples that we cannot justify.

The outperformance by the largest stocks in the market is unusual in an historical context. The largest 40 stocks by market cap globally have outperformed recently. This is a reversal of the historical trend where these mega caps normally underperform the broader market.

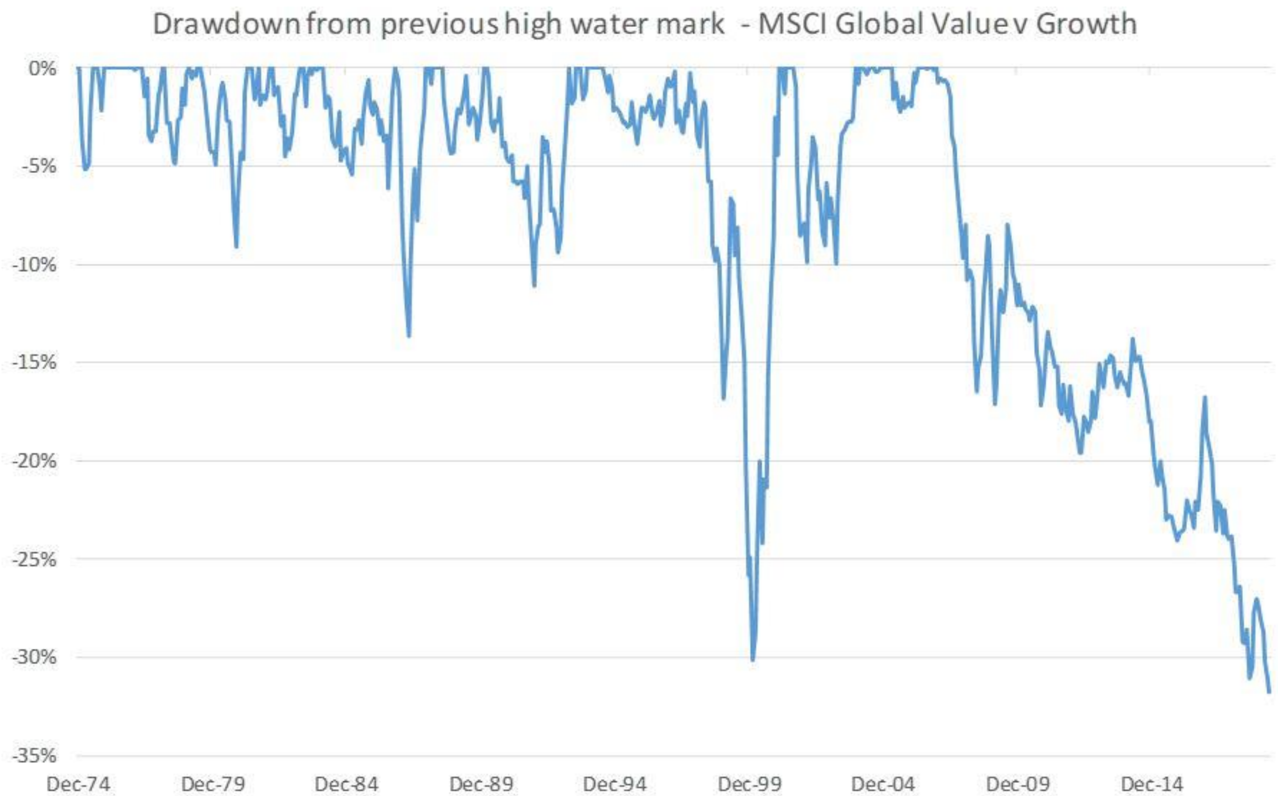
Related to this has been that the most expensive stocks have also outperformed less expensive stocks, consistent with a momentum driven market.

Exhibit 1: A high quality universe of global shares, value ranked by sector



The opinions and estimates contained in this graph are based on current information and are subject to change. It should not be assumed that any investment was, or will be, profitable. Expected returns do not represent a promise or guarantee of future results and are subject to change. Shown for illustrative purposes only. Currency: AUD.

Exhibit 2: Ratio of total returns on value versus growth breaches low point



Shows the ratio between the total returns of the MSCI World Value Index and the MSCI World Growth Index. Source: MSCI

This has meant that the value drawdown versus growth has now exceeded the 1999 low, making it the biggest drawdown (relative loss) for value stocks in over 30 years, as shown in Exhibit 2. Our view is that this will likely return to an equilibrium level that is more consistent with what we have seen through history. This reversion has historically proven a powerful tailwind for valuation focused investors.

Pockets of opportunity

We are confident that value investors will receive some reward for their discipline as we enter a late cycle period. History shows that when these cycles reverse, they can do so aggressively.

Even in this expensive market, we are seeing some value opportunities. From a global point of view, we are seeking high-quality business that are facing some short-term issues, which for us is creating the value opportunity.

In this category, we would include leading marketing data collection and analytics firm Nielsen, lottery concession holder IGT and tax firm H&R Block. These companies may not be household names, but what they do share is a dominance within their given market and a strong economic moat.

In Australia, we see some value in quality resources companies with growth potential, including Rio Tinto and Woodside. The Lazard Australian Equity team also favours some domestic infrastructure securities for their defensive earnings including Transurban and some growth stocks that have fallen out of favour, such as Domino's Pizza.

In our view, passive indices and some active portfolios with a mega cap or growth bias will be challenged by a market that is focused more on fundamental valuation and less on momentum drivers. We also believe it is a mistake to use low rates to boost earnings multiples if you do not reduce growth expectations. These two numbers (interest rates and growth) must remain connected for a robust valuation framework.

Relative to fixed income and cash, equities can still make sense in 2020, but investors must be disciplined in their valuation frameworks and not overpay, particularly this late in the cycle.

Warryn Robertson is a Portfolio Manager/Analyst on the Lazard Global Equity Franchise, Global Listed Infrastructure and Australian Equity teams. This article is general information and does not consider the circumstances of any investor.

SMSFs the new battleground in family disputes

Sam Baring, William Moore

SMSFs are often the forgotten part of the succession-planning puzzle and are becoming a battleground for family disputes in Australia. SMSFs often hold the greatest pool of assets for the people in question.

We see cases where there has been little thought on key issues such as succession of control or passing of death benefits. These have the potential to snowball into major problems, as demonstrated by several recent court cases.

Many believe their affairs can be dealt with simply via a standard Death Benefit Nomination (DBN). These are easy to prepare, and while they work well in 'happy family' scenarios, they may not offer adequate protection when contested.

There are two main issues which have the most potential to create family disputes over an SMSF:

1. SMSF control

SMSF control is exercised by the fund's trustee(s), as appointed under the terms of the trust deed. But who is best to sit in this position?

A corporate trustee can make succession a smoother transition, provide a clear separation of assets, and give greater protection for directors and shareholders when compared to an individual acting as trustee. The corporate trustee should only act as trustee for the SMSF, to avoid confusion.

It is dangerous to assume a member's legal personal representative will take control of the SMSF, as superannuation law does not automatically require a legal personal representative to become a trustee in place of the deceased person.

Ensuring control passes with the intended beneficiary (where possible) is key. When using a corporate trustee, this means leaving the shares in the trustee company directly to the intended beneficiary, under the member's will.

This alleviates the intended beneficiary from having to handle complications, which may arise with a third-party trustee or, in some cases, no trustee at all.

2. Superannuation death benefit nomination

Many SMSFs are comfortable to permit the trustee, which is often the surviving spouse or partner, to decide where the super will be paid. In this case, a non-binding nomination is usually the best option.

When might a binding nomination be more appropriate? First, some questions:

- Are there children from an earlier or later relationship, which the SMSF wishes to give super?
- Do you want to give your super to a surviving partner or child, which might become problematic if the gift is made through your Will?
- Is the estate likely to be subject to a claim or litigation after death?
- Is there any chance that a trustee might not abide by your wishes?

If it's YES to any of these questions, a Binding Death Benefit Nomination (BDBN) may be more appropriate.

Importantly, the trust deed's terms must be complied with if the nomination is to be legally effective and valid.

Whatever your wishes, a DBN should sit together with your will so both documents work together and account for your assets as a whole, ensuring the intended beneficiaries inherit what they are entitled to.

Consequences of not having a clear BDBN

Let's consider two examples of the consequences of not having a clear and technically compliant BDBN.:

1. Re Marsella*:* The case Re Marsella, from 2019, shows a greater willingness by the Court to intervene.

Helen Marsella was survived by her husband and two children from her first marriage, Caroline and Charles. Helen and Caroline had established an SMSF as trustees, with Helen as the sole member. When Helen died, Caroline became the sole trustee of the SMSF.

After Helen's death, Caroline resolved as surviving trustee to pay the entire death benefit to herself, and also purported to appoint her husband as a trustee.

The Court intervened on the basis that Caroline had failed to inform herself of the relevant matters and thus had failed to actively and genuinely exercise her discretion. This situation could have been avoided if the right person was trustee, and a valid binding nomination was in place.

2. Munro v Munro*:* The 2015 case of Munro v Munro also shows how missing details in a BDBN's technical requirements can bring things undone. Precision is vital, and errors may be minimised by seeking independent advice.

Munro left a will naming his daughters as his executors, and a document, prepared by his accountants, purporting to be a BDBN, and nominating the 'Trustee of Deceased Estate' to receive the benefits.

A binding nomination can only specify dependants or the member's legal personal representative. This is required to fulfil *Superannuation Industry (Supervision) Act 1993* (SIS) legislation purposes, and for the purposes of the trust deed. A legal personal representative for SIS purposes means the executor of the deceased person's will (or the administrator of their deceased estate). This created a problem for Munro.

Munro's document did not nominate either a dependant of Mr Munro or his legal personal representative, which meant it did not comply with either the terms of the trust deed or the SIS legislation. It was therefore not a binding nomination for the purposes of the trust deed. This left the trustee (his wife from his second marriage) with discretion how to pay the death benefits.

If you are in doubt as to whether an appropriate structure is in place, we recommend seeking professional advice.

Adapting to changes

The introduction of the Transfer Balance Caps (TBC) from 1 July 2017 has potential to introduce more complexity into SMSF estate planning.

SMSFs are now limited by the TBC, and members have to consider what to do with the excess. Every situation is different but may involve

- reversionary pension nominations
- DBNs dealing with accumulation balances
- benefits passing to an estate or an individual
- testamentary trusts and superannuation proceeds testamentary trusts
- life interest pensions, and
- child pensions.

These options need to consider the family dynamic, including concerns about estate litigation and the ability of beneficiaries to manage their affairs. In some cases, the best strategy is one that does not provide the best tax outcome.

The key message for avoiding family disputes over an SMSF is to remember it's not as simple as having a death benefit nomination.

William Moore is a Partner and Sam Baring a Senior Associate at [Hall & Wilcox Private Clients](). This article contains general information only and does not consider the reader's individual circumstances.

Bankruptcy and trusteeship in SMSFs

Julie Steed

Bankruptcy affects people in many ways and superannuation is often an afterthought. However, having an undischarged bankrupt as a trustee, or director of a corporate trustee, of a superannuation fund can have significant implications for individuals with SMSFs.

Trusteeship

An undischarged bankrupt is a disqualified person under superannuation law and is not eligible to be a trustee of an SMSF. It is also not possible for an undischarged bankrupt member to appoint their legal personal representative as a trustee.

If an SMSF trustee becomes an undischarged bankrupt, they are required to notify the Australian Taxation Office (ATO) immediately and make alternative arrangements for their SMSF within six months. If alternative arrangements are not made, the SMSF fails the superannuation law definition of an SMSF and ceases to be eligible for any tax concessions. The fund will be taxed at the top marginal tax rate (currently 45%) and the tax rate applies to the fund's income and the market value of assets just before the start of the year, less the members' tax-free component. This is the last thing a person needs after becoming bankrupt.

In addition to the tax penalties, civil and criminal penalties may also apply.

Alternative arrangements

There are three primary alternatives to restructure an SMSF:

- Rollover to a public offer fund
- Convert to a small APRA fund (SAF)
- Meet a condition of release.

Rolling over

Individuals may choose to roll their SMSF over to a retail, corporate or industry fund. However, the rollover of the SMSF to these types of funds will trigger a capital gains tax (CGT) event. In addition, any ability to carry forward capital losses will be lost.

When the individual is discharged from bankruptcy and regains the ability to become a trustee, they may elect to roll the fund back to an SMSF and resume the trustee responsibility. However, this will also trigger a CGT event.

Retail and industry funds are also unlikely to be able to accept popular SMSF assets such as property.

Convert to a SAF

To avoid incurring CGT, trustees may choose to transfer the trusteeship to a professional licensed trustee thereby changing the structure of the fund from an SMSF to a SAF. Appointing a new trustee is not a CGT event; the fund (the tax paying entity) continues and therefore no CGT is incurred. Existing cost bases and any CGT losses can be carried forward.

When an individual regains their ability to become a trustee, they are able to convert their fund back to an SMSF structure without incurring any CGT.

A SAF is also likely to be able to accept property as part of a diversified investment portfolio of the fund.

Meet a condition of release

If an individual has met a condition of release they may be able to access their benefit and then wind the fund up within the six month grace period.

Case study - Lee

Lee, 45, is the sole director of the corporate trustee of his SMSF and he has just been declared bankrupt. Lee must immediately notify the ATO that he has become a disqualified person and must also make arrangements to wind up his SMSF.

Lee's superannuation assets include an investment property worth $500,000 along with shares, managed funds and cash valued at $1,100,000. The unrealised capital gains are $200,000 on the property and $150,000 on the shares and managed funds.

If Lee elects to roll over his fund to a retail, corporate or industry fund he will trigger a CGT event and the SMSF will need to pay tax.

In addition, Lee may have difficulty finding a retail, corporate or industry fund that will accept his investment property.

If Lee elects to transfer his SMSF to a SAF, there is no CGT event. Assuming that the trustee of the SAF accepts all of Lee's assets as acceptable investments, Lee will simply be able to appoint a new licensed trustee to his fund via a deed of retirement and appointment that will also convert the fund to a SAF.

Case study – Bel and Sy

Bel and her husband Sy are both 48 and are individual trustees of the B&S SMSF. Bel is about to be declared bankrupt. Bel must immediately notify the ATO when she has become a disqualified person and she and Sy must make alternative arrangements for their SMSF. They have three options:

Option one

They can transfer Bel's entitlement to another fund and have Sy continue as the sole member of the SMSF. Under this option, a CGT event will occur for Bel as her only option is to roll her fund over. She cannot utilise the change of trustee option since the B&S SMSF is continuing as an SMSF, with Sy as the sole member. Sy will need to appoint another individual trustee or be the sole director of a corporate trustee. If the B&S SMSF incurs capital gains, tax will need to be paid.

Option two

They can wind up the SMSF and each make alternative arrangements. Under this option a CGT event occurs for both Bel and Sy. Any capital gains will attract tax and any capital losses will not be able to be carried forward.

Option three

They can appoint a licensed trustee company and both continue membership of the B&S SMSF. The appointment of a new trustee to the B&S SMSF is not a CGT event. The fund will continue as a SAF rather than as an SMSF.

Summary

The consequences of bankruptcy can have a serious effect on superannuation where the trusteeship of SMSFs is involved. It is important that trustees understand the potential implications to their SMSF and act early to avoid serious penalties.

Julie Steed is Senior Technical Services Manager at Australian Executor Trustees. This article is in the nature of general information and does not consider the circumstances of any individual.

APRA's executive remuneration changes are unwelcome

Will Baylis

Australian Prudential Regulation Authority (APRA) is proposing to change remuneration requirements by de-emphasising the role that objective financial metrics play in determining executive compensation.

While well-intended, we believe the changes will have unintended negative outcomes which impact both investors and the wider public. We recently made a submission to ARPA outlining our concerns. We believe that rather than the proposed caps on financial performance metrics, 'active ownership' will ultimately see better outcomes for all stakeholders.

Background to the proposed changes

On 23 July 2019, APRA released for consultation a discussion paper, "Strengthening Prudential Requirements for Remuneration". The new prudential standard on remuneration (CPS 511) will address recommendations from the Financial Services Royal Commission.

The core elements of the changes to CPS 511 are to:

- Strengthen governance of remuneration frameworks and outcomes, in particular through an expanded Board role, where the Board needs to be active and have direct oversight.
- Set overarching remuneration objectives that inform design of all remuneration arrangements and influence remuneration outcomes.
- Limit the use of financial performance metrics (share price and profit-based).
- Set minimum deferral periods (up to seven years) for senior executives to provide more 'skin-in-the-game' through better alignment to the time horizon of risk and performance outcomes.

Changes that will help improve the resilience of the financial system and alignment between the interests of financial institutions and those of shareholders, customers and beneficiaries, regulators and the broader community are welcome.

However, the proposal to limit the maximum weighting of financial performance metrics to 50%, and for this to apply to all employees, will have unintended outcomes on APRA-regulated entities.

Financial metrics are more tangible and objective

We believe the majority of measures for both Short-Term Incentives (STIs) and Long-Term Incentives (LTIs) should be easily identifiable, measurable and relate directly to the company's performance. Non-financial metrics do not meet these criteria.

Non-financial metrics include, for example, customer outcomes such as loyalty and complaints, reputation and trust, alignment with firm values, employee engagement, teamwork etc.

With these qualitative, non-financial measures, there is difficulty in ultimately devising the correct metrics for each firm. This can create confused incentives, often leading to perverse outcomes.

In contrast, financial metrics which include relative Total Shareholder Returns (TSR), are tangible and objective.

A prime example of a poor application of a non-financial metric was the CBA's introduction of a 'people & community' metric in 2016. Absent of formal intervention by the Board in 2017, application of the 'people & community' metric for CEO pay would have resulted in an outcome that was outside the realm of reasonability given the AUSTRAC issues at the time.

By favouring all stakeholders, none benefit

Using non-financial metrics as proscribed by APRA means treating all stakeholders as equivalent. This will inevitability result in a 'tragedy of the commons' situation, in which a lack of clear direction leads to a degradation of the business's ability to focus on long-term value creation for its customers.

This contention is supported by academics. For example, expert in corporate governance and Professor of Finance at NYU Stern School of Business, Aswath Damodaran, predicts that "expanding decision-making to take into account the interests of all stakeholders will create decision paralysis."

In a world of global competition, a lack of focus at the board and executive level will inevitably lead to poor decisions and poor outcomes for all stakeholders.

We do see merit in using non-financial measures as key performance indicators for specific employee groups, such as front-line staff who interact with customers and suppliers. There are significant differences in staff's accountability and duty to customers compared to that of the CEO and Board accountability to their shareholders.

Qualitative measures are more easily rorted

Financial metrics such as TSR are not easily manipulated. Improvements in TSR is only achieved as a result of management efforts to deliver benefits to shareholders and stakeholders. However, if a minimum number of intangible measures are mandated by APRA, we expect management will find ways to ensure they are met.

We also have concerns that this could divert management's focus away from adhering to unbiased accounting practices, reducing financial reporting quality. This could lead to the exact opposite of what APRA is aiming for, and encourage excessive compensation and reduce the independence of Boards.

Should lawmakers decide that components of STI and LTI become increasingly non-financial by nature, we as shareholders will vote against such measures at company Annual General Meetings.

We believe that active ownership, through strong interaction with both Boards and management, will ultimately see better outcomes for all stakeholders. Existing incentive structures, while imperfect, are already highly focused on these outcomes.

Will Baylis is a Portfolio Manager with Martin Currie Australia, a Legg Mason affiliate. Legg Mason is a sponsor of Firstlinks. The full submission to APRA is here: Martin Currie Australia submission on CPS 511.The information provided should not be considered a recommendation to purchase or sell any particular security. Please consider the appropriateness of this information, in light of your own objectives, financial situation or needs before making any decision.

For more articles and papers from Legg Mason, please click here.

Additional information (not provided by Martin Currie)

Recruitment consultancy group, Robert Walters' paper, [Repair jobs at the banks](), makes for additional reading on the subject of wealth management and retail and corporate banking sub-sector wage growth.