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Tony Togher on why cash isn't just cash

Graham Hand

Tony Togher is Head of Short-Term Investments & Global Credit at First Sentier Investors, which is responsible for about $60 billion of client investments. He started his career in 1983 in the Commonwealth Bank's Global Treasury Division and moved to Commonwealth Investment Management in 1988, which was part of the merger with Colonial First State in 2002. In 2012, Tony was appointed to the Market Governance Committee of the Australian Financial Markets Association (AFMA).

GH: What has been the biggest change in cash and liquidity management since the GFC?

TT: The trade-off between liquidity and returns has become a major part of decision-making. Before 2008, little, if any, margin was attributable to illiquidity. Investments like RMBS (*Residential Mortgage Backed Securities*) were paying single-digit margins above swap in mid-2007, as were long-term floating rate notes issued by banks. But they offered poor liquidity making them a buy and hold. Diversification was an important part of portfolio management but liquidity was often ignored.

We learned in 2008 that the requirement for liquidity should never be underestimated, especially its unavailability in times of severe stress.

GH: When the market for many securities simply closes.

TT: Yes. So now we have more decisions to make. For liquidity-style portfolios, exposures must be to securities which always have the best liquidity (we call it 'omnipresent'). Or, we can determine that a proportion of a cash portfolio can accept less liquidity, but we want to be paid for that.

GH: You need to be rewarded for less liquidity with better margins.

TT: I say to clients that we have a 'liquidity component' versus an 'income component' of a cash book. Some of the income securities do not have the same level of liquidity, and we benefit from our experience with the counterparties for various securities.

GH: Do all banks buy back their own securities to give investors liquidity?

TT: Usually, but it's best endeavours, they don't need to buy, but they want to honour the liquidity 'contract' and maintain a market in their own paper.

There is also now a clear distinction between a bank term deposit and a bank NCD (*Negotiable Certificate of Deposit)*. It's exactly the same credit and exactly the same term, it's exactly the same issuer under the Banking Act, but one has liquidity and the other doesn't. What price for that liquidity?

GH: And bank issuers are willing to pay more on TDs than NCDs?

TT: Yes, because bank liquidity regulations give the TD a benefit to the issuing bank. But for us as an investor, a TD is not 'repo-eligible', so we cannot sell to as a repo (*Editor Note, a sale and repurchase agreement generates liquidity for an agreed term*). And a second-tier bank outside the four majors will pay extra on a TD, tens of basis points depending on the institution, their credit rating and the tenor.

GH: The four majors all trade at the same rate?

TT: Yes, although we all know that of the $120 billion or so of NCDs on issue by the four majors, none of them could buy back all their paper tomorrow, but their NCDs are the undoubted liquidity in the market.

There are rarely questions about credit limits for the four major banks (and Treasury Notes if available) and everything else trades at a margin. This was one reason why the Council of Regulators reshaped the BBSW pricing metric to derive from transaction activity as opposed to simply posting bid/offer spreads where 10 or 12 providers were involved. We no longer have dealers simply transacting at BBSW, and all transactions are now negotiated with reporting obligations. So the transactions undertaken *form* the BBSW price.

GH: What other scope is there for extra investment returns?

TT: Well, an innovation we helped to develop resulted from the introduction of the Liquidity Coverage Ratio in 2012 and into 2014. New rules were imposed relating to the liquidity capital requirements banks must adhere to for all assets maturing in 30 days or less, so the non-call deposit developed, moving the maturity outside that window. Then these products moved from 31 to 35 days as banks worried about the one day 'cliff risk'. Then came the Net Stable Funding Ratio rules in 2018, where structures allowed a conversion into a longer-dated security after a call. This instrument gives liquidity through the converted security (normally NCDs).

GH: Do investors think about cash differently in the last dozen years?

TT: From a funds management perspective, the notion that cash is a temporary place while looking for a better opportunity has changed. For example, in 2007, many investment funds had a cash allocation of zero because they wanted to fully allocate into higher-returning asset classes. But post 2008 they realised they needed cash because there are a wide range of circumstances where cash is required to facilitate a transaction.

For example, on cash-collateralised derivatives, where counterparties must put up cash due to the change in the profile of a currency hedge. Every insto now monitors credit risk exposure on derivatives and may require a cash top-up based on the mark-to-market. There's much more focus now on reducing the credit risk inherent in any transaction.

GH: In the $60 billion or so of securities you hold, how do you assign between the income and liquidity portions you talked about?

TT: The trade-off is usually specified by the client. A client with good insights into their cash flow forecasting may allocate more to the income space. We also run pool products where we make an assumption on what is appropriate for most investors.

GH: Can we turn to the funds you have available to retail investors including SMSFs. What's in your Wholesale Strategic Cash Fund, available on many retail platforms.

TT: The dominant securities are NCDs of major banks. There is also an allocation to term deposits and convertible deposits (which convert to an NCD upon call) and Treasury Notes. There are floating rate notes, largely issued by banks but some corporate securities, and an allocation to triple-A mortgage-backed securities.

GH: And what return does an investor earn at the moment?

TT: It's about 0.5% above the cash rate on a gross basis, then depends what fees the platform takes. The gross running yield today is about 1.25%.

GH: You're also responsible for global credit, so same question, what returns does an investor achieve on the Wholesale Global Credit Income Fund at the moment?

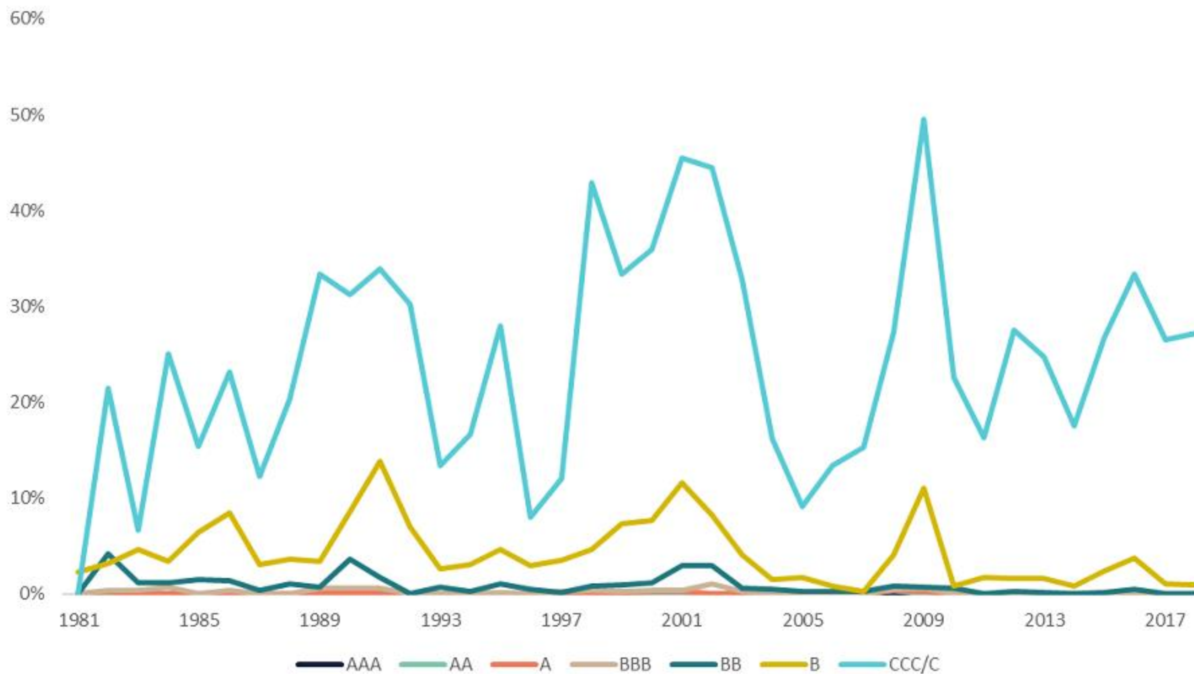
TT: It holds about 440 global securities and the goal is to swap back all returns to Aussie dollars and floating rate (*Editor note, short duration risk, not long term*). It's a widely-diversified allocation to global credit, given credit in Australia is highly concentrated in the financial sector. Our goal over time is to achieve a gross return of 90-day BBSW plus 150 basis points (1.5%), and we've achieved 157 basis points (1.57%) annualised over 20 years through the cycles. It has an allocation to both investment grade and high yield.

GH: How do you decide the high yield allocation?

TT: It is dynamic. It can be up to 25% of the fund or as low as zero. I believe we have better insights and the ability to provide value in that sector than most of our clients. Simply put, as yields compress we tend to become far more selective, and as yields expand, we allocate more. It's not a trading mentality, it's more a 'value-for-risk' allocation. The gross running yield is about 2.20% at the moment.

GH: Do you see much 'reaching for yield' in your space, the quest for yield at the expense of quality?

TT: Yes, some people have been more willing to take on credit or illiquidity risk to achieve a higher return, but credit margins are not at historical lows. They were lower prior to 2007. Indeed, high yield is not as tight as it was in December 2018, since then it has moved out from about 300 to 380 over swap. In fact, during the Fed tightening phase in 2018, it blew out to over 500. It's also moved out in recent days due to the coronavirus implying a higher likelihood of default. It's a volatile spread and a manager must be very diligent in allocating capital to the sector. As a chart on default rates shows, investors should recognise that lower-rated issuers will have more defaults over time.



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

It's also important to focus on 'loss-given-default', that is, how much of your money you get back after default. There might be a default, but you get back 50% of your money.

GH: How long will cash rates remain below 1%? Is it five or 10 years?

TT: I don't think it will be a short period of time. The central bank accommodation is designed to re-inflate the economy, and the first sign of that happening will be wage inflation. Globally, I don't think having spent a decade trying to generate activity that central banks will rush to the table to stymie inflation. Anyone waiting for adjustments in rates upwards will need to be very patient.

GH: I have known you for over 30 years. One of the things that you say is that in this business, there are no degrees of honesty. What does that mean to you?

TT: That was a quote I heard when I joined the Commonwealth Bank as a fresh-faced new employee in March 1983. It always stuck with me as a truism. I've used it as a guide to what I am doing. Are we being open and honest? Would we be happy for this to be public knowledge? We are fiduciaries of client money.

GH: Final question, after nearly 40 years in a similar role with one company, what motivates you to continue?

TT: I guess the role is never similar, it evolves as dynamic markets change. I've worked with interest rates in the high teens and now sub 1%. This market is never boring, and the requirements of clients and investors are always changing. It's a constantly evolving process.

Graham Hand is Managing Editor of Firstlinks. He worked with Tony Togher in various roles including at Colonial First State before the platform and investment functions were separated. The funds management business became Colonial First State Global Asset Management, and following the sale by Commonwealth Bank to Mitsubishi UFJ Trust and Banking Corporation, it changed its name to First Sentier Investors, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

For more articles and papers from First Sentier Investors, please click here.

The power of letting winners run

Joe Magyer

Most investing missives focus on finding and backing winners. The logic makes sense. One of the better ways to enhance portfolio performance is to improve the feedstock of investments into the process. The downside is that strategy around portfolio management often gets short shrift.

A challenging aspect of portfolio management is the handling of extreme winners and losers. It tests both the process and psyche of portfolio managers but also how they manage the positions within the overall portfolio.

Dealing with extreme losers is the most common problem. A 2014 study by J.P. Morgan found that, over 25 years, 40% of all stocks in the Russell 3000 index suffered a catastrophic loss of 70% or more from their peak. Another study by Blackstar Funds found that 39% of stocks had a negative lifetime total return. Big losses happen with surprising frequency.

All those losses can make for a pair of silver linings, though.

The **first** is that, because losses occur so frequently, investors get plenty of experience on how to handle them and have developed clear frameworks for how to manage extreme losers.

The **second** is that, at least when wrong on the long side, the position size has shrunk and whether the portfolio manager decides to sell is of much less consequence.

The challenge with extreme winners

Handling winners is a more complex task, especially at the extremes. Conventional wisdom is keen on locking in profits with some form of the saying such as "You never go broke taking a profit."

But locking in profits on winners cuts against the defining advantage of investing in equities: losses are capped while gains are not. The lean-but-long right tail of winners overcompensates for the limited losers. The same J.P. Morgan study found that only a third of stocks manage to beat the benchmark. In other words, it's a small subset of winners that more than make up for a huge chunk of losers.

Closing out a winner purely for the sake of locking in a gain snuffs out the long tail of potential upside. For example, the BlackStar Funds study found that 6.1% of the stocks in its 24-year study of the Russell 3000 outperformed that benchmark by more than 500 percentage points.

Imagine having an approach to selling which embraces locking in a profit at a 50% gain only to find out that the sold stock then outperformed the benchmark by nine times the size of your profit. Even if the benchmark went nowhere, it would take another nine-plus 50% gains from other positions to make up for the forgone

gains. A fundamental approach that embraces locking in small gains in stocks can make for the worst of both worlds: it retains the risk of loss but eliminates the long tail of potential upside that more than offsets the regular flow of losses.

Worse, the odds of an investor catching lightning in a bottle with the proceeds of selling a winner are unlikely given that the base rate says that roughly two-thirds of stocks underperform their benchmarks. The more times that process is repeated, the more likely an investor cashing in winners is to generate benchmark-trailing results.

There are two other good reasons to err on the side of not rushing to sell winners.

The **first** is that study after study, including the beautifully titled *Trading Is Hazardous to Your Wealth*, reflects that portfolio turnover is inversely correlated to performance. On average, these studies all point to the average high-turnover investor underperforming the average patient investor.

The **second** is for tax: longer holding periods can allow for more favourable taxation on individual gains and make for fewer tax drag pit stops on the compounding journey.

Where the rubber meets the road

And so logic would say that letting winners run is a sensible plan for the typical long-term investor. As usual, though, the answer on whether and how far to let an individual stock run begins with an “it depends”.

For starters, know that having a long-term approach is not an excuse to not stay on top of new information and how a thesis is evolving, even if that investment is working out well. Indeed, as a position swells to take up more room in the portfolio, so should it gobble up more of the portfolio manager’s mindshare.

Investors who let winners run should also brace for a more concentrated portfolio as the winners expand and the losers shrink. Greater concentration typically also makes for greater volatility, which can unsettle some investors. I personally prefer backing my best ideas with conviction as it suits my temperament and is well supported by empirical research.

There’s also the matter of valuation. Almost every runaway winner looks conventionally expensive at some point, making for a greater chance of a drawdown. That said, outside of broad-based macro factors which affect most stocks (e.g. falling interest rates), companies that get re-rated higher usually do so for a very basic reason: the fundamentals have improved and are beating expectations. As a long-term, high-conviction investor, my Darwinian bias is to let such companies grow to be a larger part of my portfolio and let those that fall short shrink.

Just *how* large a position size that is tolerable for an individual investor is a function of that person’s individual circumstances, including their willingness and capacity to take that risk. What suits me may not suit you. Big picture, though, long-term investors would do well to ponder what kind of returns they may be leaving on the table by ‘locking in a profit’ next time around.

Joe Magyer is the Chief Investment Officer of Lakehouse Capital, a sponsor of Firstlinks. This article contains general investment advice only (under AFSL 400691) and has been prepared without taking account of the reader’s financial situation. Lakehouse Capital is a growth-focused, high-conviction boutique seeking long-term, asymmetric opportunities.

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NAB hybrid: one says buy, one says sell, you decide

Graham Hand

Two prominent fixed income analysts have opposite views on NAB National Income Securities (ASX:NABHA). Differences of opinion make a market as each side determines whether NAB is likely to call the bond. The debate is heightened by the recent decision by Macquarie Bank to call Macquarie Income Securities (ASX:MBLHB).

MBLHB call at par bodes well for NABHA

Justin McCarthy, BGC Securities

After the market close on 30 January 2020, Macquarie Bank announced that it will call/redeem the legacy Tier 1 Macquarie Income Securities (MBLHB) for $100 (par) plus accrued interest on 15 April 2020.

The MBLHBs traded at $93.00 prior to the announcement but promptly moved to ~$100.00 the next day, where they have remained.

The MBLHBs join a long list of legacy securities that have been called in recent years as the capital treatment towards regulatory ratios falls in line with the Basel III transitional rules. All legacy/non-Basel III compliant Tier 1 and Tier 2 securities will become completely ineligible for regulatory capital from 1 January 2022.

Macquarie Bank noted in its call announcement that only $94 million or 23.5% of the MBLHBs were counting towards Additional Tier 1 (AT1) ratios at present which would have been a strong reason in favour of the early call.

The MBLHBs were issued in 1999, as were the similar NABHAs, which were both classified as 'Income Securities'.

The call at par of the MBLHB follows last year's call by ASB Bank (a subsidiary of CBA) of two NZD legacy Income Securities which were trading at ~NZD82.50 and ~NZD85.00 prior to the announcement.

Our opinion and base case is that NAB will likely call (or possibly roll over into a new capital security) the NABHAs in early 2021. Whilst MBLHB is only counting 23.5% towards Macquarie Bank's AT1 ratios, NABHA is considerably higher at ~62% in 2020, suggesting they still have a meaningful contribution to NAB's AT1 ratios. From 1 January 2021, the contribution falls to just ~31% and then 0% from 1 January 2022.

The call announcement of the MBLHB strengthens our already high confidence that the NABHAs will be called before 2022. Following the Macquarie Bank announcement, the NABHAs jumped $2.55 or ~2.7% to a high of $95.45 (at the time of editing on Tuesday, they are $95.35).

The following table details the yield to February 2021 call and November 2021 for various purchase prices (dirty price).

Purchase Price	Yield to Feb-2021 Call	Yield to Nov-2021 Call
$93.50	9.13%	6.06%
$94.50	8.06%	5.44%
$95.50	7.00%	4.83%
$96.50	5.96%	4.22%
$97.50	4.92%	3.62%
$98.50	3.90%	3.03%

Given our base case is for a call in early 2021, we believe the NABHAs still exhibit good value. A call in 2020 (and hence higher returns than in the table above) can't be ruled out either with hybrid refinance conditions currently favourable and new issue margins near post GFC lows.

NAB has also been proactively buying back their legacy Tier 2 USD 'Discos' issued in the US market despite the very cheap credit margin of just 15bps (0.15%).

This recent announcement from Macquarie Bank also continues to support our strategy of investing in well-priced hybrids and securities from best-of-breed companies but down the capital structure. Many of our best-performing recommendations have been from the maligned hybrid sector, including SVWPA, MXUPA and MBLHB which have now all been called at par despite trading in the $70s just a few years ago.

NABHA perhaps *not* on road to redemption

Simon Fletcher and Charlie Callan, BondAdviser Hybrid Research

NABHA was issued in 1999 and was originally due to be called on the 29 June 2004 but, at its discretion, NAB decided to leave it outstanding. Unlike the NAB Convertible Preference Shares or the more recent Capital Notes,

this security has no conversion features or triggers embedded in the documentation and therefore we are much more comfortable with the security from a structural perspective. However, as was evident during the GFC, the capital value of this security is still subject to significant volatility during a period of stress.

As a perpetual security (meaning it has no defined call date or maturity date), it is difficult to put a true valuation on it. Due to the effect of changes in what now qualifies as regulatory capital, we do expect it will be redeemed or exchanged within a reasonable time horizon (before or during 2022). The reason we have identified this timeframe is that although the contribution to regulatory capital value is still high (2019/2020), it will rapidly decrease and will reach zero at the start of 2022.

We have revised our recommendation on NABHA to **Sell**, as the Notes rallied strongly in response to Macquarie Bank announcing that MBLHB will be repaid.

Following the introduction of the Basel III regulatory scheme, APRA bundled several NAB securities issued under Basel II together, permitting NAB to use $6.05 billion of its Basel II capital as Tier I under Basel III. Under the scheme, the Bank is required to reduce the Basel III contribution by 10% per year, with the allowance reaching 0% in 2022.

However, with a number of the securities in the initial pool having since been redeemed or refinanced, the share of NABHA that counts as AT1 capital has not progressively reduced. Rather, in 2019 ~90% counted toward AT1, up from ~80% in 2018, a result of the redemption of securities in the initial pool of Basel II Notes. This will reduce to ~60% in 2020, ~30% in 2021 and finally to 0% in 2022.

From a NAB Treasury perspective, NABHA appears to be cheap relative to any refinancing alternatives, and as such we estimate that NAB will have incentive to leave the Notes to run for longer than current market-consensus.

Furthermore, with the Bank facing significant refinancing hurdles in the near-term, opting to redeem an additional $2 billion through repaying NABHA would be relatively surprising in 2020. Given the above, as NAB leaves the Notes running, and assuming market consensus consequentially becomes more aligned to ours, we would expect the Notes to sell off in the shorter-term but we are reasonably confident that NAB will eventually redeem the securities.

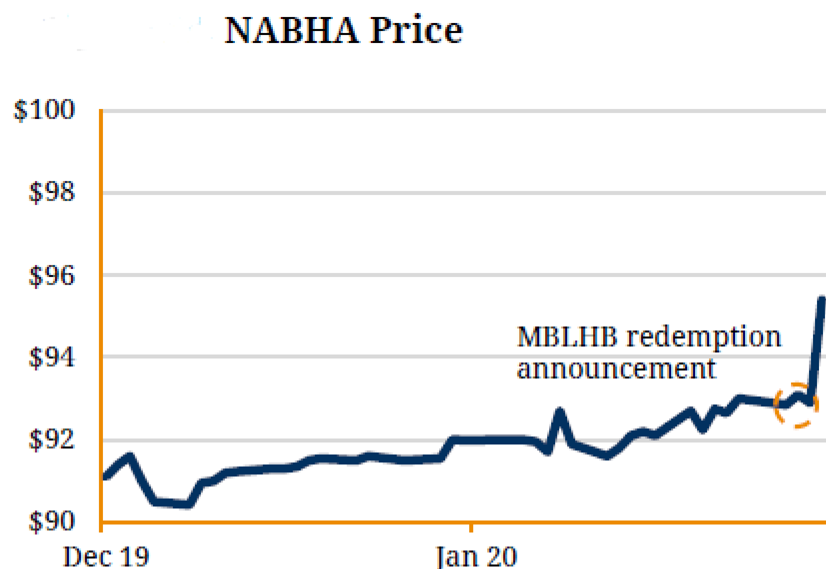
If the security is called, the capital upside to investors is significant and the biggest driver of the Bank executing this call option is a lower marginal cost of funding. We continue to believe the cost will remain low enough over the coming years to warrant replacement but following strong price returns and margin compression since 2017 (which we captured with variable Buy recommendations), we believe the wider market is under-estimating the chance NAB may choose not to redeem NABHAs in the next few years.

We note NAB has two large, new-style hybrids to refinance in 2020 - $1.3 billion (NABPC) in March and $1.7 billion (NABPB) in December. In July 2022, NAB also has $1.5 billion to refinance (NABPD). It most recently raised $1.9 billion (March 2019) for NABPF.

We would likely revise our recommendation at a capital price lower than $90.

Investors should be aware the margin for this security has been volatile in the past, primarily due to the movement in the broader listed bank capital market (i.e. Tier 1 hybrids) rather than anything specifically related to this security or the Issuer.

This article is general information and does not consider the circumstances of any investor.



Source: Bloomberg, BondAdviser

Strong capital flows support non-residential real estate

Adrian Harrington

Deep pools of capital chasing prime non-residential assets combined with low funding costs will continue to be a feature of the Australian market in 2020.

Globally, governments have reverted to a more accommodative monetary stance amid the risks of slowing economic growth and muted inflation. This 'low for longer' theme supports investment fundamentals in real estate.

Institutional investors around the world dedicate an average of 10.4% of their portfolios to real estate, below the average target allocation of 11.4%. Allocations are rising, with just under two-thirds of the 154 institutions participating in the ANREV, INREV and Pension Real Estate Association (PREA) Investment Intentions Survey planning to ramp up their real estate exposure in 2020. About 95% intend to deploy new capital into the sector in 2020.

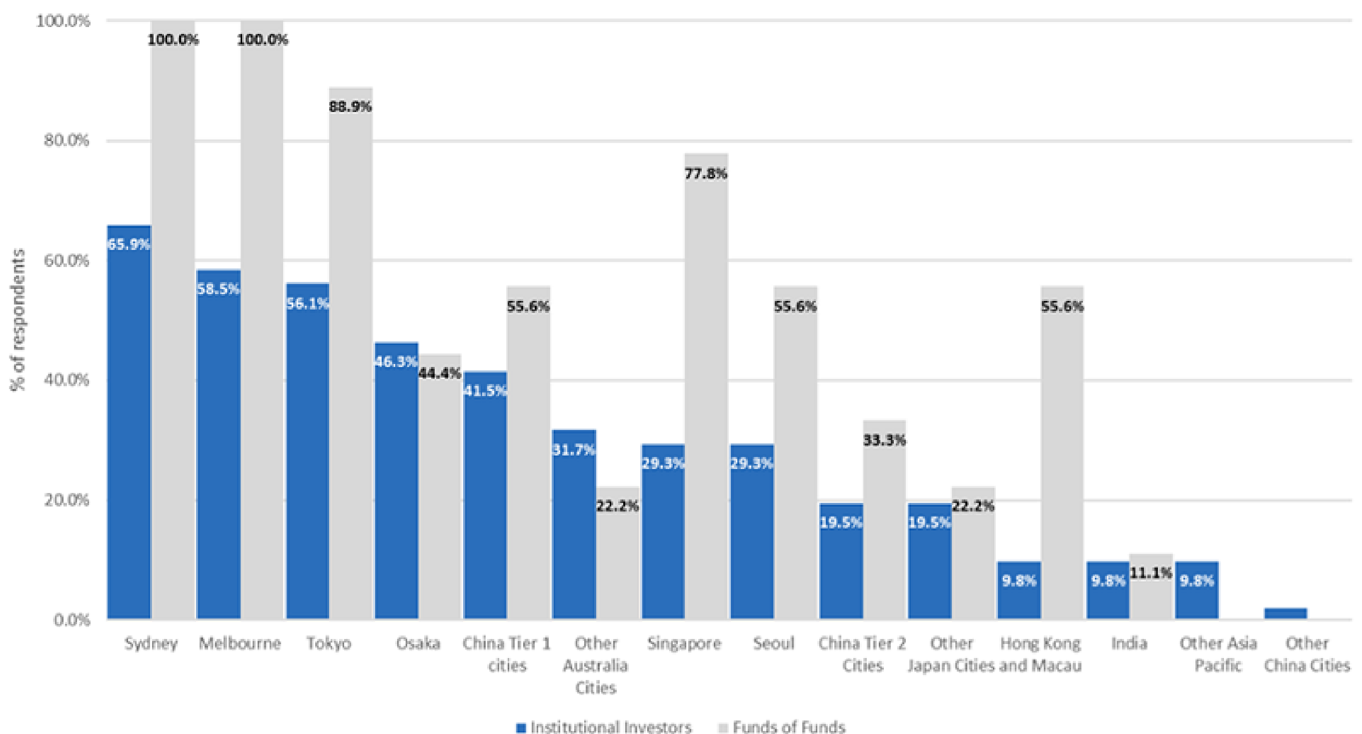
Popularity of Sydney and Melbourne

These global institutions expect to invest over US$100 billion into real estate in 2020 and Australia is well placed to capture a slice of this capital deployment.

In terms of investor's regional allocations, 77% plan to increase existing allocations to Asia-Pacific, with just under 7% expecting their current allocations to decrease.

Of those looking to invest in the Asia-Pacific region, Australia remains the preferred investment destination, with Sydney and Melbourne topping the list for the fourth consecutive year. The two Japanese powerhouse cities, Tokyo and Osaka, rounded up the top four investment destinations (Figure 1). Sydney was the overall top pick, highlighted by two-thirds of investors.

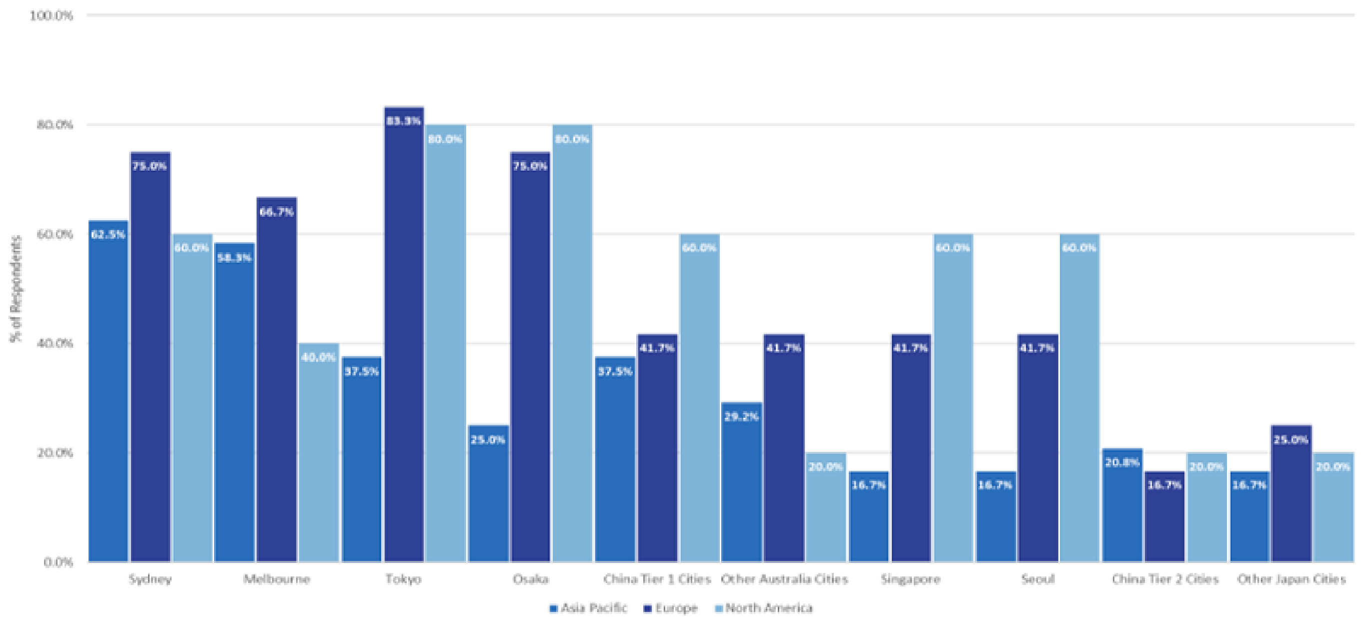
Figure 1: Preferred Asia-Pacific Investment Locations for 2020



Note: Based on sample of 50: 41 institutional investors and 9 fund of funds
Source: ANREV, INREV, PREA

When breaking down by investor domicile, European investors are more optimistic on Sydney and Melbourne than investors from Asia-Pacific or North America (Figure 2). The latter two are more focused on the Japanese cities of Tokyo and Osaka.

Figure 2: Top 10 Most Preferred Asia Pacific Locations for 2020



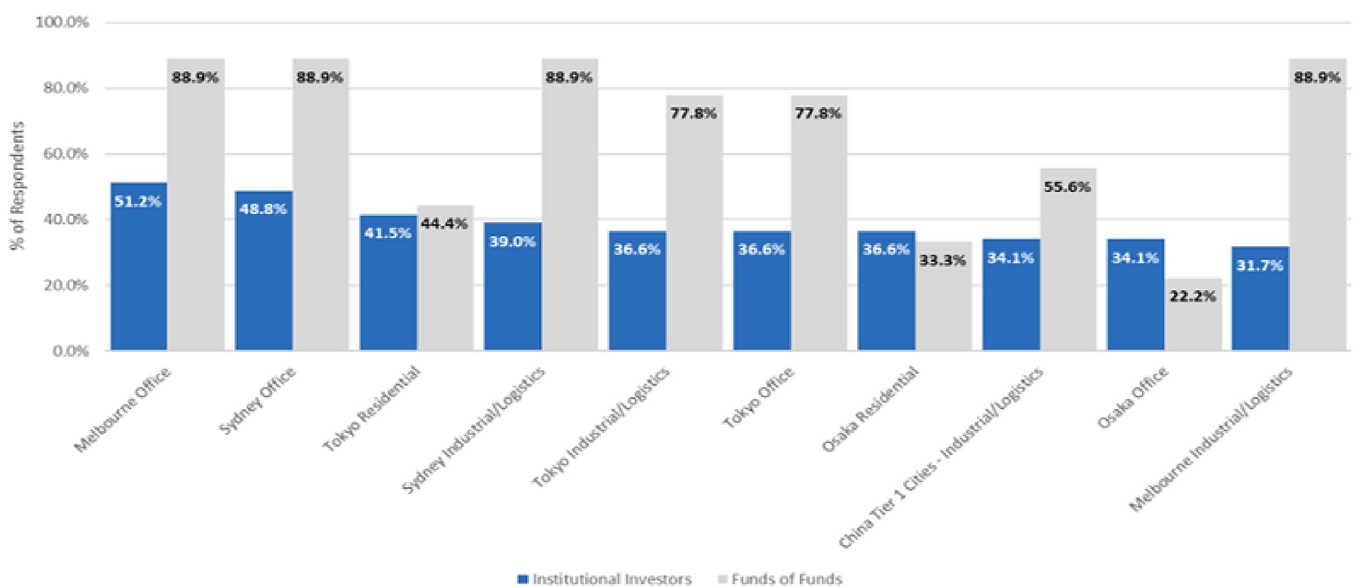
Note: Based on sample of 50: 41 institutional investors and 9 funds of funds
Source: ANREV, INREV, PREA

Office and industrial preferred to retail

Drilling down to real estate sectors, Asia-Pacific's top ten destinations are dominated by the Australian and Japanese markets, with Tier 1 cities in China being the only other location represented (Figure 3). In line with the 2019 results, Melbourne office followed by Sydney office remained the most preferred city-sector investment combinations. Sydney industrial/logistics ranked fourth while Melbourne industrial/logistics ranked 10th.

Notably retail did not feature in the top 10 city/sector combinations. With both structural (e-commerce, changing retail formats) impacting retail, the appetite for retail assets has substantially decreased amongst institutional investors.

Figure 3: Most Preferred City/Sector in Asia Pacific for 2020



Note: Based on sample of 50: 41 institutional investors and 9 funds of funds
Source: ANREV, INREV, PREA

Lower interest rates are supporting prices

Across most Australian sectors and sub-markets, with the exception of large retail centres, the underlying real estate fundamentals are good – positive demand, high occupancy, growing rents and limited supply.

For foreign investors, Australia offers the additional benefits relative to many other global destinations of stability, transparency and governance, and a falling exchange rate has seen currency hedging costs come down considerably in recent years.

Although the upcycle is now into its 11th year, lower interest rates will be supportive for non-residential real estate in 2020. The current yield arbitrage is significant. Australian bond yields are at record lows, with the 10-year bond yield compressing from 5.3% in 2009 to around 1.0% currently. Lower bond yields are flowing through to asset values via lower cap rates (yields).

The yield on non-residential property across most sector and markets is also at record lows. Yet the average premium to the 10-year government bond still offers a significant premium. As table 1 shows, for prime Sydney office the spread is 350 basis points (3.5%), for prime Sydney industrial its 388 basis points (3.88%) and for prime Sydney regional retail centres its 500 basis points (5%).

Back in 2007, the yield spread for prime office, industrial and retail was negative. In other words, yields on real estate were actually below the prevailing 10-year government bond yield.

With the cash rate at 0.25%, and term deposits and Australian government bonds paying between 0.25% and 1.5% per annum, non-residential real estate yields look comparatively attractive.

Table 1: Prime Yields – December 2019

	Yield Spread (%)	Average Spread to 10 Year Bonds (%)
Sydney CBD Office	4.25 – 4.75	3.50
Melbourne CBD Office	4.40 – 5.10	3.75
Sydney Industrial	4.25 – 5.50	3.88
Melbourne Industrial	4.75 – 5.50	4.13
Sydney Regional Centre Retail	4.10 – 5.75	4.93
Melbourne Regional Centre Retail	3.75 – 6.25	5.00
Sydney Neighbourhood Centre Retail	5.50 – 6.50	5.00
Melbourne Neighbourhood Centre Retail	4.75 – 6.50	4.63

Source: JLL Research, Charter Hall Research at Q4 2019

In this lower for longer environment, investors are recalibrating their expectations of the required rate of return from real estate. Assets will likely continue to trade on yields which were previously unheard of. There is also limited tier one investment stock to satisfy capital demand from both domestic and global investors, thereby putting further downward pressure on yields and pushing asset prices higher.

Focus on quality

In such an environment, investors need to remain cognisant of risk factors and maintain discipline in investment decision-making. Now is not the time to be chasing secondary assets which are trading at small discounts to prime assets. In every real estate cycle where capital is abundant, some investors desperate to get set misprice secondary assets providing little buffer when the cycle eventually turns.

Across the sectors, we anticipate continued strong demand for office, industrial and real estate backed social infrastructure assets (childcare, government leased, student accommodation etc).

Retail is expected to face further challenges, although those assets focused on convenience, non-discretionary spending (neighbourhood, supermarket anchored centres) will do better than the larger regional retail centres (department and discount department store anchored) that are more dependent on discretionary, particularly fashion, spending.

Ultimately, investing in the year ahead will come down to quality – the quality of the cashflow and asset. Investors should focus on assets in prime locations, with strong tenant covenants, attractive rent review structures and long-term leases. Quality will win in the long run.

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

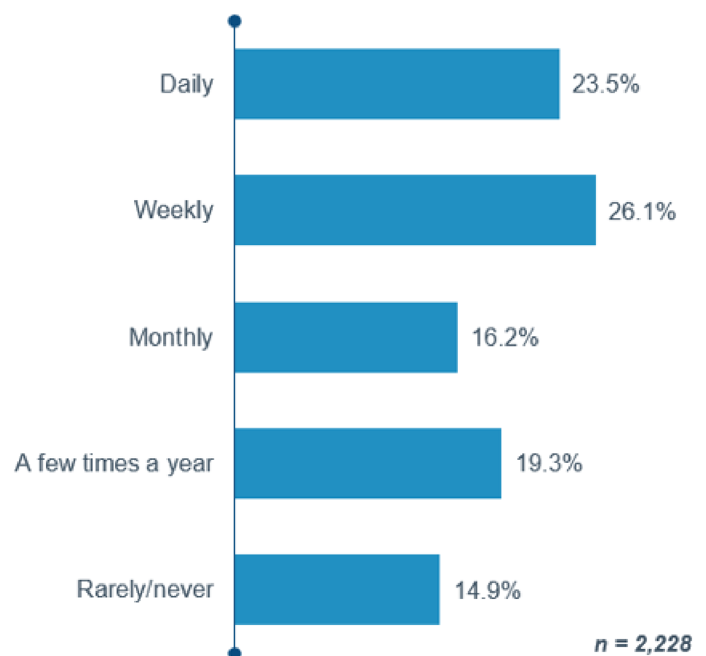
For more articles and papers from Charter Hall (and previously, Folkestone), please click here.

The link between financial and mental health

Alva Devoy

It may seem obvious that financial stress would have a direct impact on people's health and happiness. However, new research from Fidelity International suggests that Australians are not making the link between financial health and our overall wellbeing.

Fidelity's survey of over 2,000 Australians shows almost half of us worry about money at least weekly, with one in four worrying at least daily. And having money doesn't necessarily make people immune from anxiety. More than a third of Australians with more than $1 million of assets to invest still worry at least monthly.



So what are Australians worrying about?

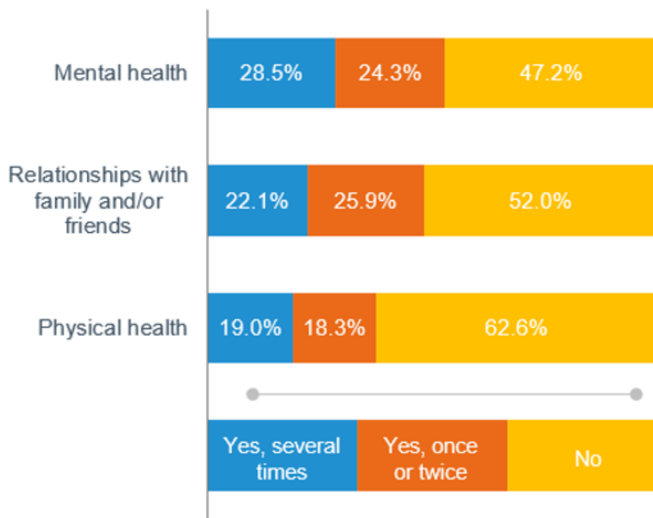
We have enjoyed more than 25 years of uninterrupted economic growth and Australia has not experienced a recession since 1991. Our superannuation system is the envy of many parts of the world and most people have now been accumulating savings to fund retirement since the Superannuation Guarantee started in 1991, a healthy last 28 years ago.

Despite this, less than one in five Australians rate their financial wellbeing as high or very high. At a time when the economic outlook is starting to look more uncertain, only one in five believe they would be financially stable if they were to lose their job tomorrow, with almost three quarters saying they could only manage for a short period or not at all.

Retirement is also weighing on people's minds. More than half of Australians feel they are not on track financially to have a retirement they are happy with. Around 50% worry they might not be able to live where they want to in their golden years and a similar number expect to have to keep working past retirement age to fund their retirement.

The adverse impacts are not only financial

Perhaps most surprising is the extent to which these sorts of financial issues affect all facets of our lives. More than half of Australians report that their mental health has been adversely impacted by financial issues, while others say their relationships and physical health have suffered.



The benefits of seeking financial advice

It's not all bad news. The survey suggests that the picture is improved for people who seek help with their finances. While 56% worry about money at least monthly, that number jumps to seven in 10 for those who do not receive financial advice.

Australians receiving financial advice are twice as likely to rate their level of financial wellbeing as high or very high, compared to those who are not receiving advice. And when asked how prepared they feel for retirement, 64% of people who are advised say they are either 'very' or 'reasonably' prepared, compared to just 26% of unadvised people.

Perhaps the most compelling finding was in relation to people's overall wellbeing, 50% of Australians receiving financial advice say their mental health has improved as a result of advice, while 38% reported their family life is better.

So with so many people reporting the benefits of financial advice, why aren't more people accessing it? Last year's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, which revealed practices that fell well short of the community's expectations, could be one reason. However, the survey shows it isn't the main deterrent.

A recurring theme among those who have never sought advice is they don't believe they can afford it or they don't believe their circumstances justify the need. And when people do seek advice, it is usually around a life event or milestone. Nearly a third of people first sought financial advice because they were approaching retirement, followed by a property purchase.

Don't wait for the financial trigger

The problem with this that by waiting for a trigger such as retirement to seek help, we may not be giving ourselves the best chance of being in control of our futures. It is only by starting the discussion early and making a plan that we will have control over when we retire, how much we will retire with and what our lives will look like after we retire.

And this is backed up by our survey. While around 26% of people overall say they are not prepared at all for retirement, that number drops to just 10% for those who are advised. And those people who have an adviser also about the positives for their overall quality of life. These include being able to live their desired lifestyle, not having to worry about money and improved mental health.

While much of the discussion around the benefits of financial advice focuses on the amount of assets we have or the financial returns that can be achieved, our research demonstrates the wider benefits and peace of mind it can provide. People who seek advice often leave with a much stronger sense of wellbeing and control over their future and that's something we can all benefit from.

Alva Devoy is Managing Director, Australia at Fidelity International, a sponsor of Firstlinks. *This document is issued by FIL Responsible Entity (Australia) Limited ABN 33 148 059 009, AFSL 409340 ('Fidelity Australia'), a member of the FIL Limited group of companies commonly known as Fidelity International. This document is intended as general information only. You should consider the relevant Product Disclosure Statement available on our website www.fidelity.com.au.*

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Are you caught in the 'retirement trap'?

Roger Cohen

Two primary goals of Australia's retirement savings system are to encourage financial independence and to reduce reliance on the age pension. However, for some retirees, the system works against these goals. For retirees caught in this trap, saving and investing more can actually result in a lower income in retirement.

The 'Retirement Trap' anomaly results from the progressive reduction of age pension entitlements as assets and income in retirement increase above certain thresholds. This trap affects retirees with superannuation balances between ~$350,000 and ~$600,000. It creates a bias towards short-term spending or directing resources into exempt assets such as the home, ahead of using assets to generate long-term additional income.

The current retirement system

Australia's retirement system relies on retirees drawing income from the 'three pillars', a combination of superannuation, the age pension and external assets. The pension is means tested, with the level of entitlement calculated using an income test and an assets test. As assets and income levels increase, pension entitlements are phased out. Above certain levels, all pension (and other entitlements) cease.

For an individual, there is an income range between $174 and $2,026 per fortnight where for every additional dollar earned, the pension is reduced by 50 cents. This effectively halves the value of additional earnings for retirees in this range.

On the assets side, for individual homeowners whose assessable assets are above $263,250, the pension is reduced by three dollars a fortnight (or $78 per year) for every additional $1,000 in assets. To offset this reduction, each $1,000, if invested, must generate an annual return above 7.8%.

Our work focuses on 'retirement age' using age 67, which will be the age at which Australians are eligible for the age pension in 2023, with savings of between ~$350,000 and ~$600,000. Increasing their savings may result in their income decreasing, and the effect also termed the 'Pensioner Taper Trap', has been illustrated and modelled by other researchers, such as National Seniors here and here.

Reductions in income can occur because such savings increases are unlikely to generate enough additional income to offset the pension entitlements that are lost.

The Retirement Trap

To illustrate the Retirement Trap, BetaShares introduced the concept of a pension multiplier. This is a number (greater than or equal to 1) which represents the current or future income stream a retiree can expect relative to the age pension. For example, a pension multiplier of 1.5 means that income of one and a half times the government pension can be expected in retirement. The Simulation of Uncertainty for Pension Analysis (SUPA) model, developed at CSIRO Data61's RiskLab, is used to calculate the resulting pension multiplier expected from various investment strategies.

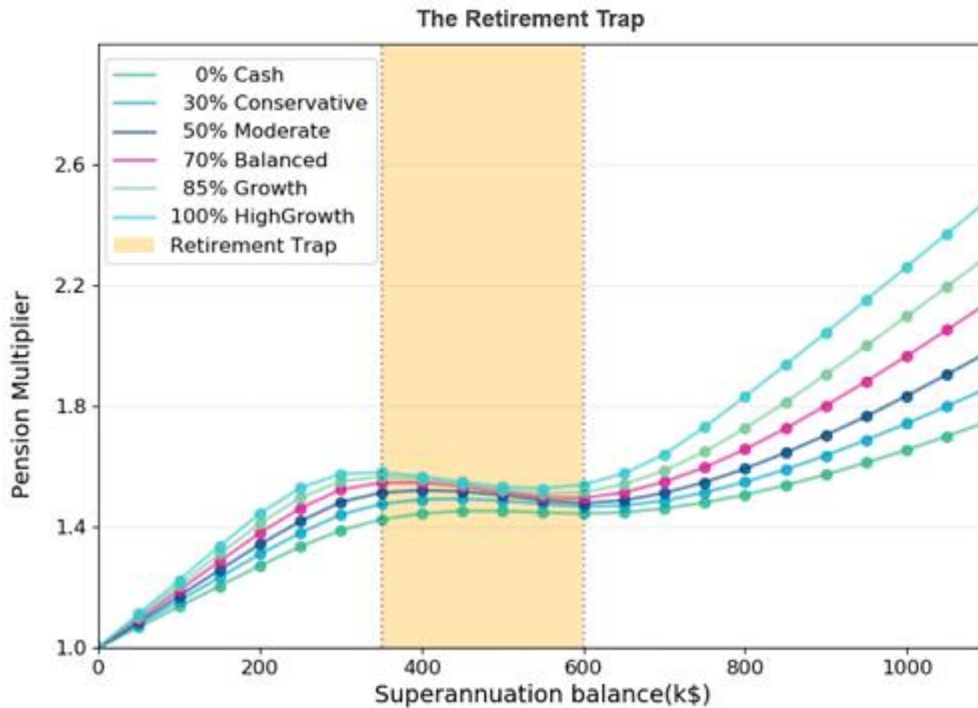
The SUPA model is a statistical tool which uses the behaviour of economic factors such as inflation, interest rates and asset returns to generate long-term forecasts. Around 100,000 forecasts for each investment strategy were used to generate the results shown below.

Five different investment strategies, ranging from 30% to 100% allocations to growth assets – Conservative, Moderate, Balanced, Growth and High Growth – were tested. Under all these strategies, the Retirement Trap can be observed in the graph below.

The chart shows that retirees with a superannuation balance of between ~$350,000 and ~$600,00 see their pension multiplier decrease as their superannuation balance increases.

The system therefore implicitly encourages these retirees to spend additional savings or redirect them towards exempt assets like their homes, instead of choosing to invest them to generate income.

If a retiree in this scenario does invest their additional savings, they must generate returns that are well in excess of 7.8% per annum to exceed the pension entitlements that are lost. This is likely to entail a level of risk which is well beyond what is normally recommended for retirees.



Source: CSIRO

The analysis illustrates that Australian retirees currently can escape the Retirement Trap only if they can accumulate well over half a million dollars. Above this point increased savings will lead to increased income.

Retirement Income Review

In September 2019, the Federal Treasurer announced a review into the retirement income system with the following intentions:

"The review will cover the current state of the system and how it will perform in the future as Australians live longer and the population ages.

The review will consider the incentives for people to self-fund their retirement, the fiscal sustainability of the system, the role of the three pillars of the retirement income system, and the level of support provided to different cohorts across time."

The consultation period for the Government's Retirement Income Review has just finished.

BetaShares made a submission to the Review Panel outlining the Retirement Trap anomaly, and proposing a new model for the retirement system where the age pension would become universal, with the means and assets tests discarded.

Compulsory superannuation contributions would be streamed into defined benefit schemes (to fund the universal pension) and defined contribution schemes (much the same as those which currently exist). This streaming would be based on age, income, asset balances and other factors. Where a retiree has not fully funded their pension through their defined benefit contributions, the shortfall would be funded by the Government. Within defined contribution schemes, individuals would still have flexibility and choice as to where their contributions are directed and how they are invested.

It would mean Australian retirees can choose to spend or save additional income or assets based on their personal circumstances, without that choice being distorted by the structure of the system.

BetaShares acknowledged that such significant changes to the superannuation system would be controversial, but argued that the proposed model would not only remove the distortions that discourage a certain group of retirees from increasing their financial independence, it would also reduce the financial burden on the Government.

The current structure of Australia's retirement income system can produce unintended and undesirable outcomes for certain retirees, due to the interaction between the eligibility for pension entitlements and the assets and income tests.

Dr Roger Cohen is the Senior Investment Specialist at leading ETF provider, BetaShares, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor.

The full BetaShares study provided to the retirement Income Review can be found here. For more articles and papers from BetaShares, please click here.

The pitfalls of Total Return investing

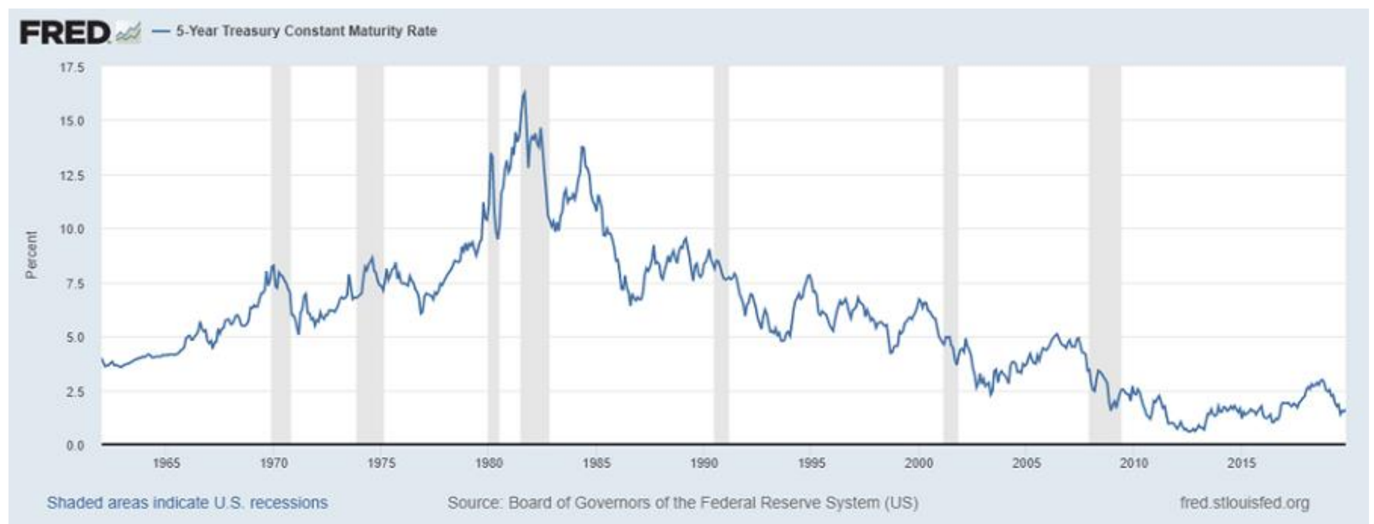
Peter Cook

In a former life, as a financial planner, I counselled my clients to consider the benefits of Total Return Investing (TRI). Forget about income, I said. Trust the academics, and the professionals (me). Today, however, I'm not so sure. TRI may in fact be doing investors a disservice. I say that because the global investment landscape has changed, and so have the risks.

The TRI theory holds that investors should build and learn to live off the total return of their portfolio, not just the income. In practice, this means investors sell appreciated assets when they need income above what is generated by the portfolio. And, where possible, live off dividend and interest income in the years when the portfolio declines.

The Total Return approach is elegant, it makes intuitive sense, and like so many investment strategies, it 'backtests' well – that is, it's done well in the past. There is, however, a fly in the ointment: the prevailing global low-to-no interest rate regime. The backtests in the U.S. occurred during periods when both stock and bond yields were much higher.

5-Year U.S Treasury yield (1963-2019)



Thus, the TRI theory is based on what we now know to be the luxurious presumption of earning income from fixed interest. No one has had the experience of funding a 30+ year retirement through a period of zero or even negative interest rates.

The short income squeeze

This lack of income is a critical weakness of TRI theory because the less income your portfolio generates, the more you are exposed to the pain of calling on your principal during market drawdowns - what I term a "short income squeeze risk".

Here's how it works: in the event of a market downturn, a lack of income creates, in essence, a short-squeeze situation. Retirees have no choice but to sell their investments and often at times when valuations dictate they should be buying or at least holding.

To date, this danger has been easy to ignore because returns have been strong and volatility relatively benign. However, there are reasons to believe it may not be in the future.

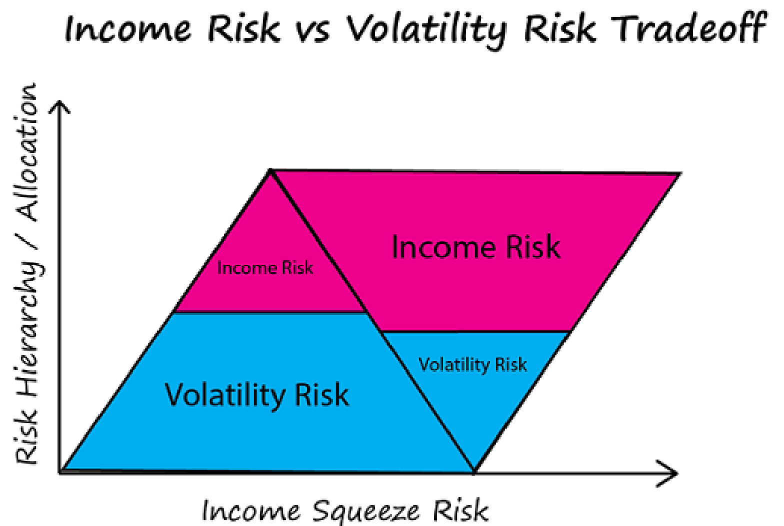
The new risk hierarchy - consistency of income trumps portfolio volatility

Intelligent investors think in terms of risk and then return, so it may be helpful to rephrase the issue in terms of a hierarchy of risk. In the past, the risk of an income squeeze could be easily subordinated to the risk of portfolio volatility because income was readily available. Today's environment calls for a rethink.

I contend that below a certain portfolio income threshold, maintaining a steady income is a higher priority than minimising volatility. This threshold will depend on several factors which may include:

- the degree of spending flexibility
- capital risk relative to income
- diversification considerations, and
- other sources of funds.

The degree of capital risk assumed relative to income obtained is also a critical consideration. Investors and their advisers should examine this new retirement risk landscape and re-calibrate their portfolios if necessary.



Sustainable income – mitigating income squeeze risk

One strategy to mitigate income squeeze risk is to increase the portfolio allocation to investments that offer sustainable dividends. Specifically, companies and credits with stable business models that rely on secular growth trends, such as population growth both in Australia and abroad.

The classic rejoinder to such advice is that it entails foolishly 'reaching for yield', i.e. unknowingly increasing risk by moving from lower- to higher-risk assets. And it is true, increasing your allocation to riskier assets will raise the volatility of your portfolio.

However, the paradoxical world created by low-to-no interest rates means that the income generated by equity-like dividends may come to be the only way to shelter retirees from an income squeeze. And as a result, spare them from having to erode their principal during a severe or even moderate downturn.

Thus, it can be argued that by taking more risk, you are making the conscious decision to reduce income risk (the income squeeze). The choice then is not a reach for yield but the inevitable by-product of all investment decisions, the exchange of one type of risk for another.

Recognising this, Legg Mason has created income solutions like the Legg Mason Martin Currie Equity Income and Legg Mason Brandywine Global Income Optimiser which are designed to invest in assets that hold out the prospect of providing sustainable income. As central banks continue to consign investors to a world without income, we believe these strategies will play an increasingly important role in clients' portfolios.

Peter Cook is a Senior Investment Writer at Legg Mason Australia/NZ, a sponsor of Firstlinks. This article contains general information only and 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.

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