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Howards Marks' anatomy of an unexpected rally

Graham Hand

Throughout the COVID-19 pandemic, we have checked the latest memos to clients written by Howard Marks, Co-Chairman of multibillion-dollar asset manager, Oaktree Capital.
Marks recalls the recovery from the 23 March low resulted in the biggest three-day gain in more than 80 years, which built into a rise of 45% by 8 June. In fact, after Marks' note was published, Wall Street closed its best quarter since 1987, so it is timely to review his *anatomy of a rally*.

How can the market recover when the economy is much worse than before?

Prior to the pandemic, says Marks, an all-time high had been achieved when the economy was strong and the outlook good. Yet the market has recovered close to that level when economic conditions are much worse. He lists the reasons for the optimism as:

- Investor confidence in the Fed and Treasury to bring about an economic recovery by doing 'whatever it takes'.
- Some improvements in the number of COVID-19 cases and deaths, especially no shortages of hospital beds and optimism on vaccines and treatments.
- The market's ability to look beyond the crisis, supported by improving economic statistics, to a recovery in GDP and corporate earnings in 2021.

Investors became convinced that the Fed would ensure markets continued to rise, with seemingly little concern for debt levels. The Fed did not even require strong creditworthiness in corporate bonds purchased. With ultra-low rates, the discounted present value of future cash flows rises. Low returns start to look relatively attractive, argues Marks.

He has been asking his team: can the Fed keep buying debt forever?
When bullish market moves began in late March, investors who have little regard for value, such as index funds, ETFs and other automatic traders, perpetuated whatever is set motion. Then behaviours such as FOMO replace the previous greed. He adds his voice to the impact of new retail investors:

"Retail investors are said to have contributed substantially to the stock market's rise, and certainly to its most irrational aspects … large numbers of call options have been bought in recent days, and it was reported that small investors accounted for much of the volume. Developments like these suggest the influence of speculative fever and the absence of careful analysis. There's a widely held theory that government benefit checks have been behind some of the retail investors' purchases. And that makes sense: in the last three months, there've been no games for sports bettors to wager on, and the stock market was the only casino that was open."

He acknowledges his usual cautious approach generates many opposites to the points made above (as described in his previous memos), but it depends what weight the markets gives to each at a point in time.

How to make sense of what is happening

Marks says it is futile to expect the stock market to operate with a universally accepted and reliable way to value companies without bouts of optimism or pessimism. The market can swing quickly between 'flawless' and 'hopeless'.

"But the most optimistic psychology is always applied when things are thought to be going well, compounding and exaggerating the positives, and the most depressed psychology is applied when things are going poorly, compounding the negatives. This guarantees that extreme highs and lows will always be the eventual result in cycles, not the exception."

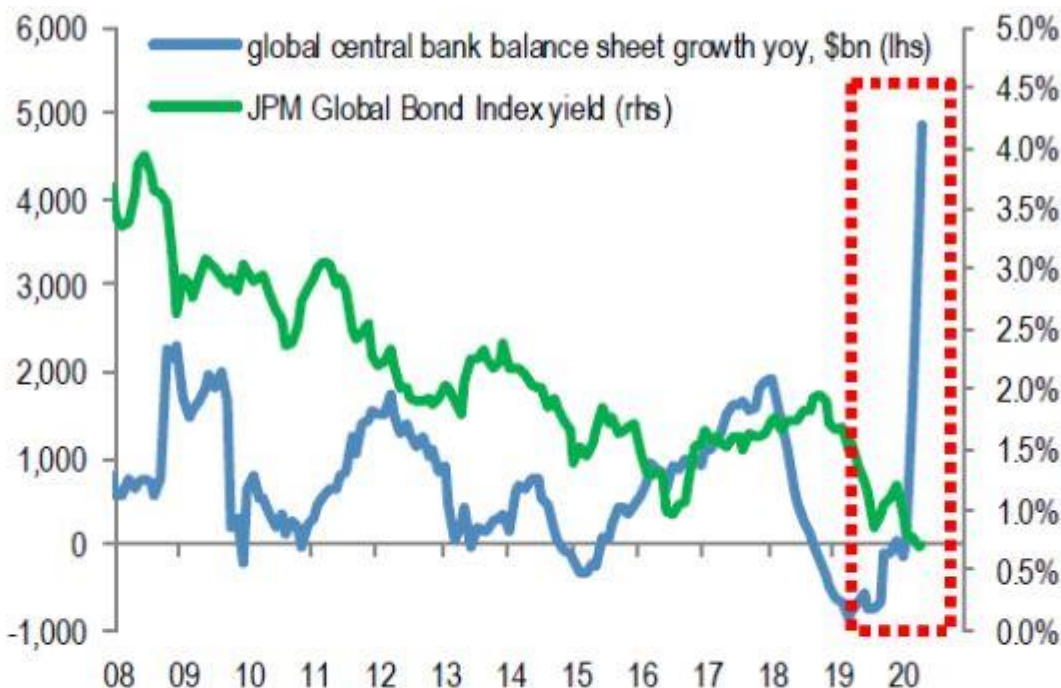
He appeals to a few time-honoured standards in the three stages of a rally:

- the first stage, when only a few unusually perceptive people believe improvement is possible
- the second stage, when most investors realise that improvement is actually taking place, and
- the third stage, when everyone concludes everything will get better forever.

Around 23 March was the first stage, when few people focussed on economic improvement. Stage two happened quickly and we went straight to stage three. It feels to him that the market is too focused on the positives.
"I had good company in being sceptical of the May/June gains. On May 12, with the S&P 500 up a startling 28% from the March 23 low, Stan Druckenmiller, one of the greatest investors of all time, said, 'The risk-reward for equity is maybe as bad as I've seen in my career.' The next day, David Tepper, another investing great, said it was 'maybe the second-most overvalued stock market I've ever seen. I would say '99 was more overvalued.'"

And after these two spoke, the market continued to run. So his bottom line is similar to his last few memos, that investors are not compensated for risk:
"the fundamental outlook may be positive on balance, but with listed security prices where they are, the odds aren't in investors' favour."

Footnote (not from the Marks article). This chart from JP Morgan shows the rapid growth of major central bank balance sheets as they print money, and how their bond purchases have pushed down global bond rates.



Source: J.P. Morgan

Graham Hand is Managing Editor of Firstlinks. Howard Marks is Co-Chairman of multibillion-dollar asset manager, Oaktree Capital, and [here is the full text](#) of his latest memo. This article is general information and does not consider the circumstances of any investor.

Why are we convinced 'this time it's different'?

Don Stammer

We're at the stage of the investment cycle where, in times past, many investment advisers would be quoting with enthusiasm a comment John Templeton had made many years ago:
"The investor who says 'this time is different' … has uttered among the four most costly words in the annals of investing."

Templeton was alerting investors to the dangers of the recurring view in markets that, because the big influences on investments are seen to have changed fundamentally, the future for investors will be very different from the past.

Some things are different, some are familiar

For young investors, I should point out John Templeton was an outstanding investor and fund manager—and a generous philanthropist—who did much in the 1950s to set up and popularise managed funds. In 1999, *Money* magazine called him "*arguably the greatest stock picker*" of the twentieth century.

And like Warren Buffett, John Templeton had studied at Yale under Benjamin Graham, the great teacher of value investing. His 16 rules for investment success, first outlined in 1933, also included his famous aphorism:
"Bull markets are born of pessimism, grow on scepticism, mature on optimism and die on euphoria."

These days, many investors believe that COVID-19 has profoundly and permanently changed how investment markets work. In my view, this prevailing sentiment is over-stated: some things will be 'different' while others will stay familiar.

COVID-19 is the worst pandemic in a century and the first to occur in our now highly globalised world. The initial panic was heightened when some major health institutes projected multiple millions of deaths, and the future course of the pandemic is highly uncertain.

By early March, COVID-19 was already bringing about the quickest and deepest economic downturn in history, and one which would worsen as lockdowns and social distancing requirements were introduced. Around the world, governments and central banks announced an unprecedented easing in fiscal and monetary policies.

In five weeks from 20 February, average share prices plunged more than a third from record highs. Between 23 March and mid-June, much of the heavy drop in share market indexes was recovered, mainly at times when rates of new infections from COVID-19 in the US and Europe were falling. Share markets have been volatile and unusually uneven by sectors and across individual stocks.

As well, the pandemic has worsened the already tense relations between the US and China, and contributed indirectly to social unrest and riots, notably in the US.

John Templeton frequently reminded investors that share markets have a long history of over-reacting, both in the tough times and when investors turn optimistic. And Howard Marks, deservedly now one of the most-quoted by Australian investors, recently reminded us:
"… the most optimistic psychology is always applied when things are thought to be going well, compounding and exaggerating the positives, and the most depressed psychology is applied when things are going poorly, compounding the negatives. This guarantees that extreme highs and lows will always be the eventual result in cycles not the exception."

Three reasons it's not just the Fed

As well, the long-familiar view 'Don't fight the Fed' has had another airing. Certainly, the switch to a more positive sentiment in stock markets in late March owed a lot to the Fed's aggressive programme of buying bonds. The further uptick in stock markets during June was attributed to the Fed's direct purchases of a wider range of corporate debt including low-rated borrowings.

But investors seem to be exaggerating the role of the Fed. This time around, relatively little attention has been paid to at least three other influences that affect share prices.

One is the massive fiscal boosts most countries have implemented, which will likely be extended on only a slightly reduced scale into 2021.

Two is that the early indications that the hit on global GDP from COVID-19 will be milder than expected earlier provided there's not a second wave of infections in Europe and the US. High-frequency data suggest both the US and Australian economies have passed the low points of their slowdowns. Retail sales in May rose by 18% in the US and by 16% here.

Three, it appears to this elderly scribe that there is another familiar reprise. It's that this time any recovery in overall economic conditions won't be V-shaped but instead will be more configured like an L or a W. Similar comments were made during economic slumps in 2009, 2003, the second half of the 1990s, 1983, the 1970s and even in Australia's recession of 1961 (which at the time was said to mark the end of our post-war prosperity).

What to watch

Market sentiment will likely continue swinging widely in coming months. Gloom will re-appear whenever, for example:

- the pandemic gathers momentum
- well-liked companies report unexpectedly weak earnings
- a cluster of reports is released with disappointing economic figures.

But share prices could well resume their bumpy recovery as investors recognise the global economic slump is somewhat milder than was feared and expected, particularly if the fiscal boosts are tapered rather than suddenly removed. Of course, share markets could move up noticeably if a vaccine is discovered.

Investors should reflect on John Templeton's advice when the prevailing market view is 'this time it's different' and also bear in mind another of his investment principles: *"Don't panic. The time to sell is before the crash, not after."*

Don Stammer has been involved with investing for many decades as an academic, a senior official of the Reserve Bank, an investment banker and the chairman of nine companies listed on the ASX. He currently writes a fortnightly column on investments for The Australian and is adviser to Stanford Brown Financial Advisers. This article is general information and does not consider the circumstances of any investor.

Why women are most hurt by financial pandemic

Erica Hall

The impact of COVID-19 has shone a light on a weakness in household finances. Whilst it would have been difficult to anticipate the pandemic and the subsequent government response of a nationwide shutdown, many lack emergency funds to manage through a disruption to their income.

People were living pay cheque to pay cheque and perhaps not expecting to need something for a rainy day. It's understandable, given Australia had just experienced a long period of economic prosperity. However, with financial stress a leading cause of anxiety, not being in control of your finances can harm your health and well-being. ur health and our finances are interrelated, providing additional compelling reasons why we need to get on top of our personal budget.

Is it a knowledge gap or an implementation gap?

How do we solve this? It is both an education issue and an action issue. It is like dieting. If we want to lose weight it is conceptually quite simple: eat less and move more. Most people know this yet struggle to lose weight. Why? It's not a knowledge issue, it is the implementation that's the hard part.

It's the same with finances. Conceptually it is not really that hard: spend less, save more and pay down debts; but like dieting, it is the implementation that is difficult.

From little things big things grow

The positive message is implementing changes requires no monumental shift in behaviour. The key is to make some small changes. Incremental changes can add up and make big impacts in the long term. My grandmother used to say, "*save your pennies and your pounds will look after themselves*". Skip buying that extra cup of coffee, don't pay for parking, walk more and make your lunch rather than buying it. All of these little changes will save money, which can add up to a lot over time.
Edward Lorenz, who discovered Chaos Theory, posed this question "*Does the flap of a butterfly's wings in Brazil set off a tornado in Texas?*". This neatly captures his discovery that one small action can cause a powerful reaction. Chaos Theory is sometimes described as the science of surprise as it captures those non-linear, unpredictable outcomes that are complex and chaotic because of the many moving parts within an ecosystem. This resonates in many aspects of life including investment markets. The butterfly effect is applicable to your personal finances, including the small changes you make can add up to really big changes in the future.

There was a great study recently undertaken by behavioural economists Shlomo Benartzi, Hal Hershfield and Stephen Shu titled Temporal Reframing and Participation in a Savings Program: A Field Experiment. The study found that people were four times more likely to save if the saving was presented, or in economics terms, 'framed' as a smaller amount of $5 a day rather than $150 a month. These dollar amounts are the same, but to the participants in the survey, $5 a day seemed a more achievable undertaking versus $150 a month. That is a lot of money to many people.

So simple things like breaking your savings goal into bite-sized chunks are more likely to garner success. It reminds me of the quote: "What's the best way to eat an elephant? One bite at a time." Framing it in a way that shows that it's doable encourages people to just get started. To save successfully doesn't require big amounts, it doesn't have to be thousands of dollars. The key is to just get going and you can build from there. There is an old Chinese proverb that says, "When is the best time to plant a tree? Twenty years ago. When is the second-best time? Now."

Financial literacy is low and women are most affected

Studies have shown there is a financial literacy knowledge gap in Australia. Melbourne University's Household Income and Labour Dynamics in Australia survey (HILDA) surveys 17,500 people or 9,500 households. They ask basic questions around financial concepts such as interest, diversification and inflation to gauge the level of financial literacy in the community. They found that while half of male participants could answer basic financial questions, only 35% of women could answer the same questions correctly.

Women are at a disadvantage not only from a financial literacy perspective but also because of wage inequality and higher instances of career breaks to have and care for children. And then because they're not earning as much, they're less willing to take as much investment risk, and there's a link between risk and return in investing. To generate a higher return you typically need to take on higher risk, facing a loss along the way. Because women have less to start with and earn less, if they do experience a loss it has a much bigger impact as it takes longer to recoup that loss than if they were earning more. So they are more cautious.

Lower income means lower appetite for risk. Additionally, women's superannuation savings are lower because their income is lower and because of the career breaks. Women also have a higher propensity to work part time. It's a perpetual circle of disadvantage for women.

Sure, education is part of the problem but it's also a structural issue relating to access to affordable childcare, equal wages, workplace flexibility and unconscious bias. It's a policy issue since workplaces and superannuation are set up for full-time employees who don't take career breaks.
The good news is the superannuation sector is well represented by women in senior management and they recognise the shortcomings of the current system and are lobbying for change to make it fairer for women. KPMG has also highlighted that the current retirement income policy needs some structural changes to help women better navigate retirement. This is crucial as older women are becoming homeless at a faster rate than any other cohort.

Australia has a financial literacy pandemic; women are more adversely affected than men; and encouraging people to make small changes can have surprisingly large future impacts.

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What is happening with SMSFs? Part 2

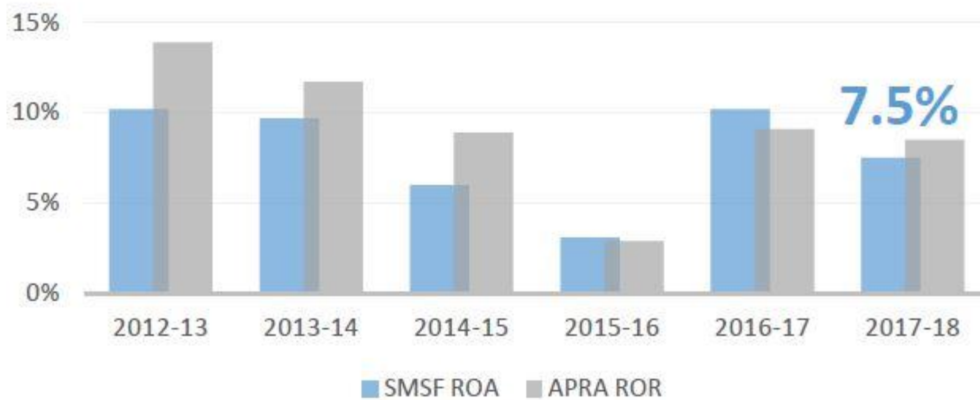
Franco Morelli

The ATO's 2017-18 statistical overview of SMSFs provides a first look at the impact of the significant superannuation changes that took effect on 1 July 2017.

The primary source of data is 2017–18 SMSF annual returns. The key limitations associated are their frequency (annual) and their currency – the returns are not due until a long time after the end of the financial year. However, the ATO has used 2018–19 information for registrations, wind-ups, total populations, demographic data, estimated total SMSF assets and asset allocation, and auditor contravention reports (ACRs).

Part 1 of this article can be viewed here. It includes a granular examination of the costs of running an SMSF.

In the 2017-18 financial year, SMSFs made an average return of 7.5% compared with the 8.5% return for large Australian Prudential Regulatory Authority (APRA)-regulated funds. This continues the strong run of positive returns for SMSFs and according to this data over the last three years, comparable performance to the APRA funds.

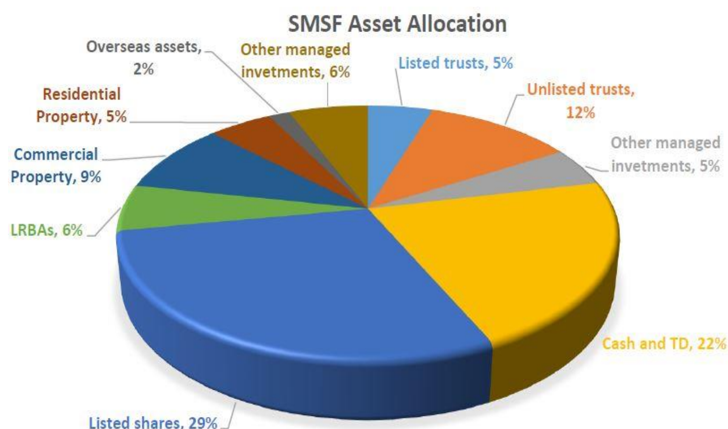


The SMSF Association has highlighted the difficulties in comparing return data, particularly due to definitions and member cohorts. The impact of COVID-19 will be interesting to watch over the coming reporting years.

Asset allocation in tax returns

(Editor's note: we have previously explained the shortcomings in the ATO asset allocation statistics, especially the reporting of 'Overseas assets' (see here and here). The data only represents direct investments in foreign stock exchanges when most Australians hold their foreign assets through listed and unlisted funds).

The below graph details the asset allocation of SMSFs in the ATO returns as at 30 June 2018.



While this is some time before the COVID-19 pandemic, our understanding is that the asset allocation of SMSFs has not changed significantly between 2018 and 2020.

Therefore, going into the pandemic, SMSF asset allocation held a significant proportion invested in listed shares and cash. The key drivers for this asset allocation include:

- Tax preferences for domestic equities – fully refundable franking credits increase the after-tax return for domestic equities, especially for those in retirement phase.
- A desire for liquidity to pay pensions in retirement – this is especially relevant to the SMSF sector where 42% of funds are in retirement phase.
- Cognitive biases that drive allocation to assets trustees understand, especially blue-chip Australian companies.

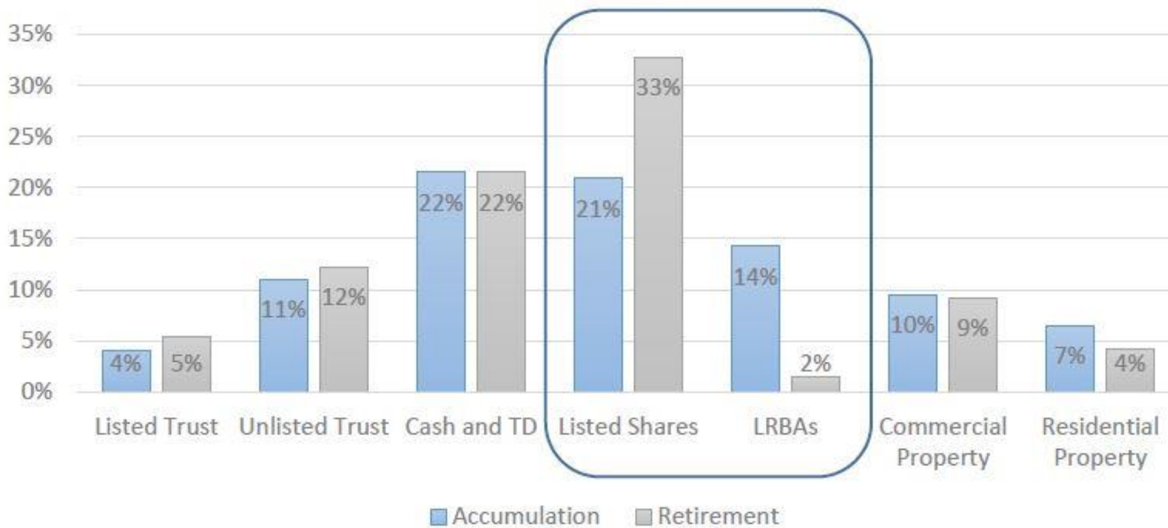
A positive for the sector is that many SMSFs should be able to navigate through this pandemic from a better starting point than some of their counterparts.

Using an SMSF to meet pension requirements

The older cohort of investors requires more liquid assets to service their retirement living expenses. The benefits of the popular financial advice about holding two years of income in cash should bear fruit for many SMSF trustees.

A risk commonly raised in discussions on SMSFs is limited recourse borrowing arrangements (LRBAs). There is no doubt that in the current economic climate, where rental incomes may be reduced or suspended, some SMSFs with property may be facing unexpected risks. However, from a broader picture, the 2017-18 statistics highlight a flattening of LRBA growth and an acceptable level of LRBAs.

The graph below details the asset allocation of SMSFs by fund phase. When SMSFs enter the retirement phase, they are generally doing so without LRBAs and by holding more liquid assets, especially shares.

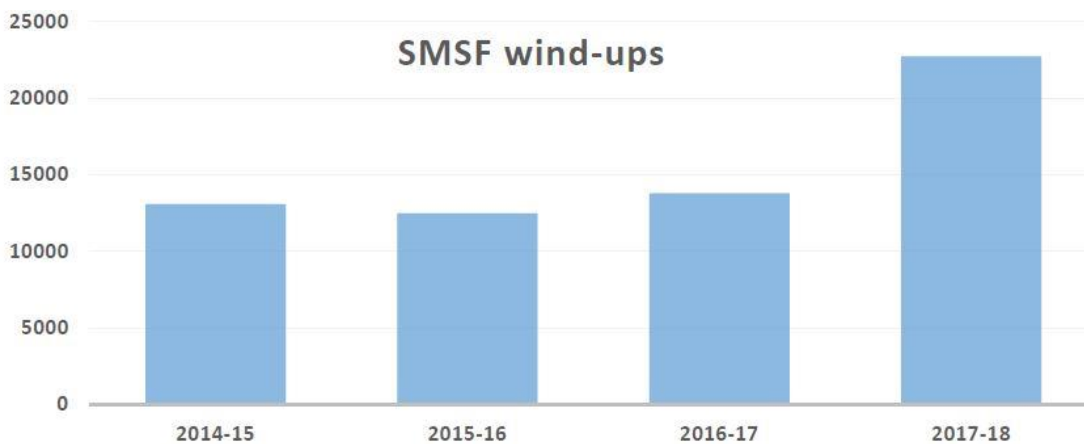


Growth, establishment and wind-ups

A significant takeaway in the ATO statistics is the increase in establishment balances for SMSFs in the last two years. It highlights that the majority of SMSFs were set up with an appropriate balance. The SMSF Association attributes some of this increase to the behavioural changes resulting in individuals establishing SMSFs with larger amounts due to the expected lower contribution caps allowed after 1 July 2017.

Promisingly, the 2017-18 statistics show the majority of SMSFs are being set up with a balance in excess of $250,000. Some SMSFs have been established with lower balances while expecting future contributions and roll-ins to be received within a short time frame.

In the five years to 2018, the number of SMSFs grew by an annual average of 2.9%. On average 28,490 new funds were established annually. However, the statistics show FY18 was the highest year on record for wind-ups.



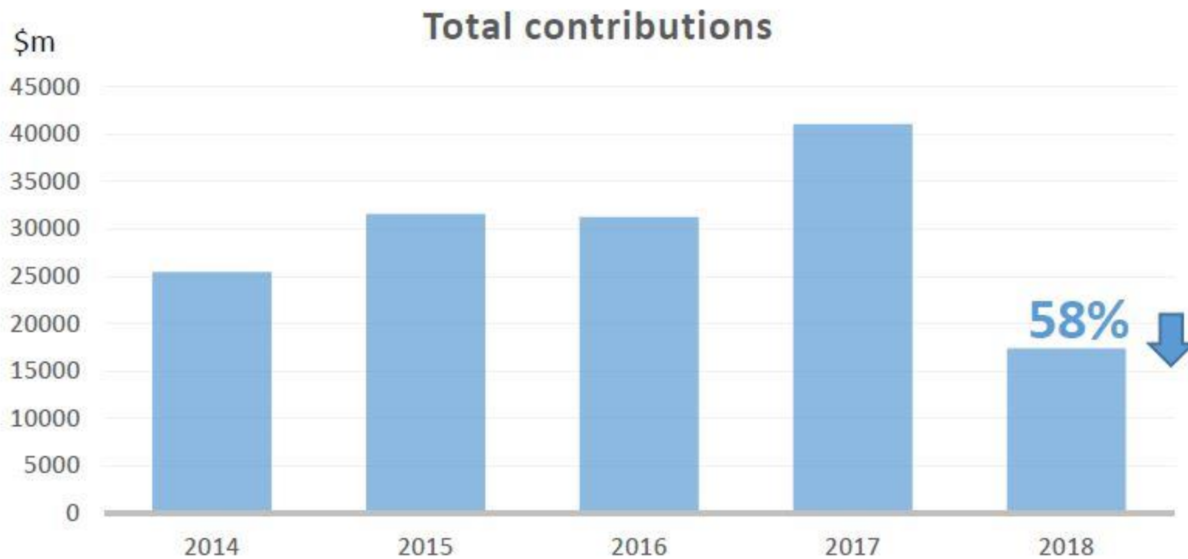
Early indicators suggest that the number of SMSF registrations has been increasing. The number of SMSF registrations received between July and December 2019 was 11,558. This compares to 10,954 for the same period the previous year, representing an increase of 5.5%. SMSF registrations for January and February 2020 were 3,246 compared to 2,807 SMSFs registered during the same period last year, an increase of 15.6%.

Contributions and benefit payments

In 2016–17, total contributions to SMSFs were $41.8 billion, while total SMSF benefit payments were $46 billion. These were both significant increases over the previous financial years, most of which can be attributed to a behavioural change resulting from the anticipation of the superannuation reforms taking effect on 1 July 2017.

With the release of the 2017-18 statistics, we now have a reversion to the norm.

- Total contributions to SMSFs peaked at $41.1 billion in 2016–17 before dropping 58% to $17.4 billion in 2017–18.
- The decline in contributions was most pronounced for member contributions, which peaked at $33.9 billion in 2016–17 before dropping 66% to $11.6 billion the following year.
- Total SMSF benefit payments decreased by 15% from $44.3 billion in 2016–17 to $37.7 billion in 2017–18.



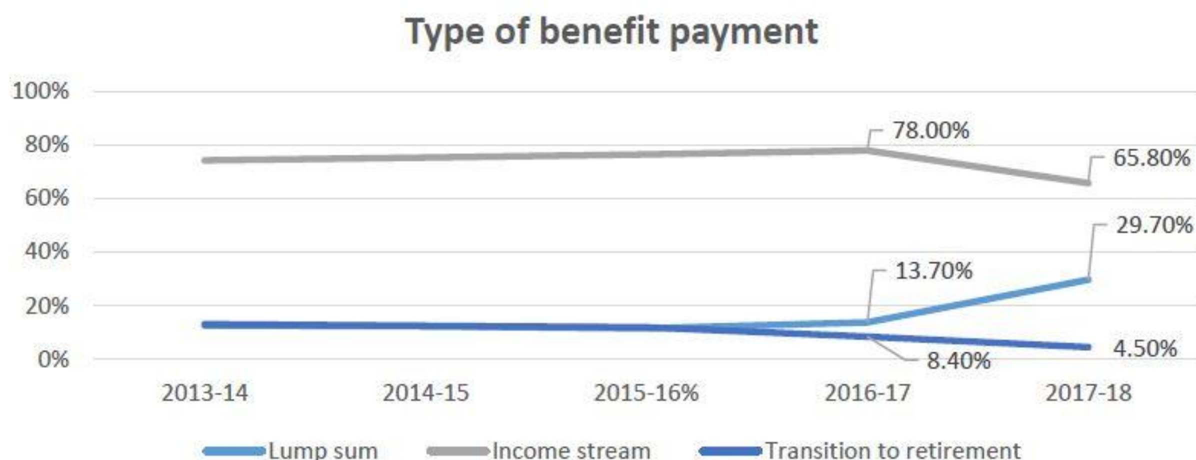
The decline in contributions was most pronounced for member contributions, likely due to many SMSFs using their three-yearly contribution bring-forward rule in the previous financial year.

Unfortunately, the statistics don't detail the amount of money that moved from retirement phase into accumulation phase because of the Transfer Balance Cap (TBC). The data relating to the retirement phase is recorded once all members of the fund receive at least one pension payment.

However, we can see some of the impact in the type of benefit payment taken by SMSF trustees, as lump sums more than doubled in the financial year.

In the 2017-18 financial year, there was a significant increase in lump sum withdrawals from SMSFs. As SMSFs moved money into accumulation phase and the TBC took effect, they took the opportunity to withdraw funds as a lump sum to keep a larger amount in retirement phase. If lump sums were taken from the retirement phase this would create debits to their TBC.

Transition to retirement income streams were also out of fashion in the 2017-2018 financial year. This can be attributed to the loss of tax exemption status for these income streams.



In the 2016-17 year, $31 billion was paid out in income stream payments. In the 2017-18 year, this fell to $20 billion.

Franco Morelli is Policy Manager at the SMSF Association. This article is general information and does not consider the circumstances of any investor.

Super fund performance and rank depends on risk

David Carruthers

Stock markets around the world crashed in response to the COVID-19 pandemic. Bad would be an understatement, but such falls are not without precedent. Many of today's market traders probably weren't born in October 1987, when the stock market dropped by over 40%. However, the GFC won't be such a distant memory, when the equity market was down by 40% for 2008.

While no one predicted a global pandemic, many were nervous about equity levels before the crash occurred. Investing in 'risk' assets like equities is, by definition, risky. Downturns are expected, and history has shown they are more than compensated for by good returns in subsequent periods.

In this article, we analyse the effect of the market volatility on superannuation funds. In particular, we examine which funds achieved good relative performance both when the markets were strong and in more volatile periods.

Recent fund performance

Last year was good for superannuation investors, with the average fund (as measured by SuperRating's SR50 Balanced) returning 14.7% for 2019. The top 10 performers earned over 16.5%, as highlighted in Table 1. The table then tracks their performance in the downturn of the March 2020 quarter and the bounce back in April.

The performance of the highest returning funds for 2019 was mixed in the March quarter of this year. They averaged a return of -10.4% for the three months, no better than the average fund, highlighting the danger of choosing a fund based on short-term performance.

With markets again strongly positive in April, some funds bounced back, while others continued to lag.

UniSuper and smartMonday both had great returns in 2019, were near the bottom of the peer group for the March quarter, and then back to the top in April. In contrast, LGIA and First State Super were near the top of the peers for the quarter but then lagged when markets bounced back in April.

None of these funds was above median over all three periods. Cbus was the only fund in SuperRatings SR50 balanced universe which managed to achieve that outcome.

Table 1: Top SR50 balanced funds for CY 2019

Fund – Option	Return (Rank)		
	2019 Year	March 2020 Quarter	April 2020 Month
UniSuper Accum - MySuper Balanced	18.4 (1)	-12.1 (40)	5.7 (1)
AustralianSuper - MySuper Balanced	17.0 (2)	-10.7 (28)	3.4 (19)
Aust Ethical Pers - Balanced	16.8 (3)	-7.9 (5)	3.0 (29)
smartMonday PRIME - Balanced Growth - Active	16.4 (4)	-13.9 (47)	4.7 (4)
SD Bus - Multi-manager Balanced	16.3 (5)	-12.2 (43)	2.8 (34)
Mercy Super - MySuper Balanced	16.3 (6)	-10.5 (23)	2.7 (37)
IOOF Employer Super Core - IOOF MultiMix Balanced Growth	15.9 (7)	-7.6 (2)	3.1 (27)
LGIAsuper Accum - Diversified Growth	15.9 (8)	-8.5 (7)	1.4 (45)
First State Super MySuper - Life Cycle Growth	15.8 (9)	-8.8 (8)	2.3 (43)
Mercer Super Trust - Mercer Growth	15.6 (10)	-12.1 (42)	3.5 (15)
Median	**14.7**	**-10.5**	**3.1**

Source: SuperRatings

Chart 1 below highlights the universe of all SR50 Balanced funds with their performance for the March quarter compared to their return in April 2020.

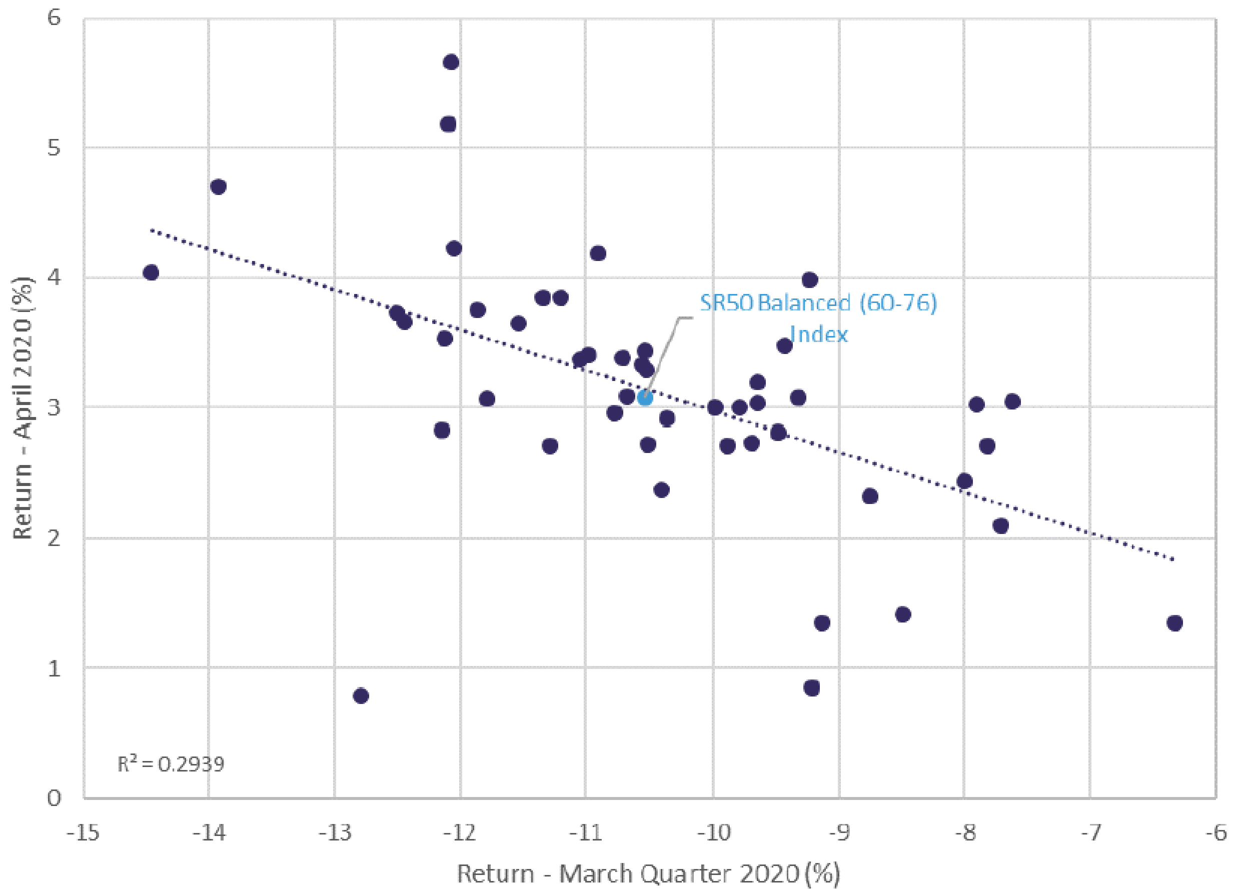
The upper right quadrant of the chart is the best place to be, outperformance in both periods. The place to avoid is the bottom left quadrant, underperformance in both periods. As can be seen, these are the quadrants with the fewest funds – just six outperformers in both periods and five underperformers.

Most funds, perhaps unsurprisingly, outperformed in one period and then not the other.

This is highlighted by the trend line in the chart, showing a strong negative correlation between performance in the two periods.

Any fund which was running higher risk than peers will have performed well in 2019, poorly in the March quarter and then well in April. These funds appear in the top left of Chart 1. For these funds, this greater risk may explain some of their good historic performance.

Similarly, those funds which had less risk will have struggled in 2019, performed well in the March quarter and then lagged again in April. These funds are in the bottom right of Chart 1.



Source: Frontier, SuperRatings

Longer-term performance

While interesting, there is a danger in reading too much into short-term performance.

The analysis in Chart 2 considers the performance of balanced funds over the past 10 years. Every month is classified as an 'up' month or a 'down' month dependent on whether the median fund was above/below CPI +3% pa (calculated monthly). An individual fund has outperformance in an up month if it then exceeded the median fund (SR50 Balanced) in that period (and vice versa).

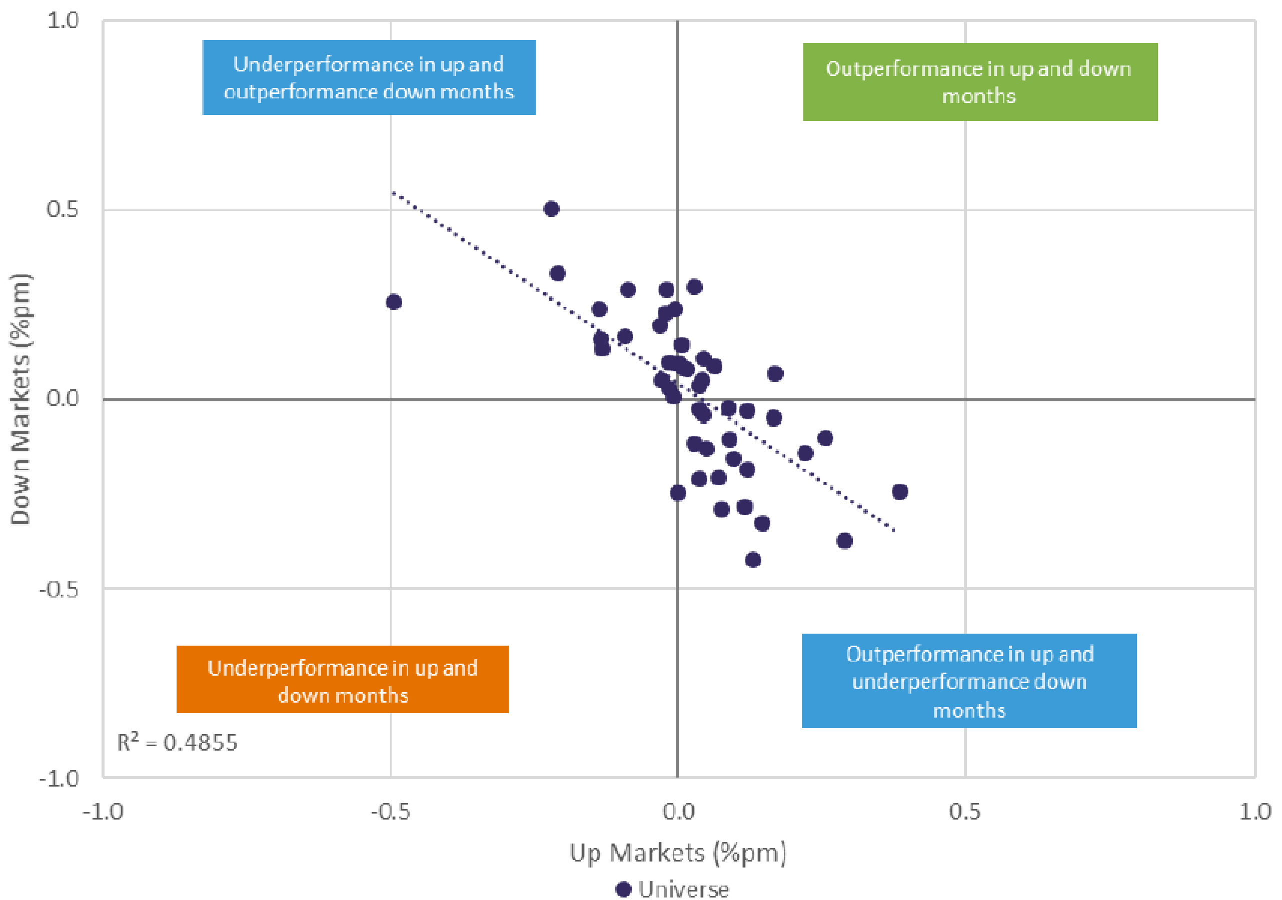
Chart 2 shows most funds are close to zero. That is, on a monthly basis, they neither out nor underperform by too much. This is expected. A fund that consistently outperformed by +0.5% each month would exceed the median fund over a year by more than 6%.

Most funds either:

- Outperform in up markets and underperform in down markets (40% of funds), achieved by taking more risk than the average fund, or
- Underperform in up markets and outperform in down markets (33%), achieved by taking less risk than the average fund.

Being higher risk or lower risk is neither a sign of a 'good' nor a 'bad' fund by itself. It may be that the fund has explicitly taken this approach in response to the demographics of its membership.

Again, it is noteworthy that there are few funds that outperform in both up and down markets. Fortunately, there are no funds that consistently underperform in both market conditions.



Source: Frontier, SuperRatings

Risk prediction

At Frontier, we examined various metrics to understand the risk level different funds were taking. In this section we consider two of those measures:

- Growth/defensive assets ratio - a simple measure used in APRA's heatmap calculation, and
- Standard deviation - the traditional investment risk measure.

An important characteristic of any risk metric is predictive. Does it provide early warning signals?

In normal periods, when markets are rising, we expect funds with higher risk to produce higher returns. However, in negative markets, we would expect higher risk funds to perform worse.

To test the predictive power of the two risk measures above, we compare the risk result for each measure against each fund's performance in the March 2020 quarter. If the risk measure has predictive power, it should show those funds with a higher risk performed worse in the March quarter than those with a lower risk.

As expected, there is a negative relationship between a fund's growth/defensive ratio and its performance in the March quarter. However, the relationship is not strong. There are many funds with high ratios which performed relatively well in March, outperforming funds with lower growth exposure. Indeed, the two worst performing funds over the quarter had growth ratios in line with the average fund.

Using standard deviation of returns as the risk measure reveals a negative relationship between the risk measure and the return for the March quarter. But in this case, the relationship is much stronger. The funds with the highest standard deviation are those with the worst performance, and those with the lowest standard deviation had the best performance.

There are still exceptions to the rule, with a few funds performing well despite an average level of risk. However, standard deviation was a considerably better predictor of a fund's outcome in the March quarter than the fund's growth/defensive ratio. This is expected given five-year and March quarter performance were both largely driven by listed equity market behaviour, although a faster shift in unlisted asset valuations during COVID-19 compared to prior stressed periods is a noteworthy development.

APRA heatmap used to assess fund performance

APRA has identified the need to assess investment performance on a risk—adjusted basis to ensure differences across superannuation fund strategies are considered. They have chosen is the growth/defensive ratio as a proxy for risk.

APRA's heatmap was released in December 2019, based on performance to June 2019. The three and five years to June 2019 were 'normal' markets where risk was rewarded with higher returns.

Chart 5 shows one of the heatmap metrics, comparing the growth/defensive ratio (as defined by APRA) against performance for each MySuper fund.

This chart shows a strong, positive correlation between risk and return.

Any fund with performance above the trend line in Chart 5 received a 'white' heatmap outcome for this metric. A fund below the line received a red or yellow outcome, depending on the extent to which they underperformed peers.

We noted in our previous paper that another characteristic of a good risk measure is that it is comparable both between different entities and over time. APRA also identified an aim of the heatmap was to improve transparency, providing "credible, clear and comparable information for all MySuper products".

Chart 5: : MySuper funds – Peer comparison for 3 years to June 2019

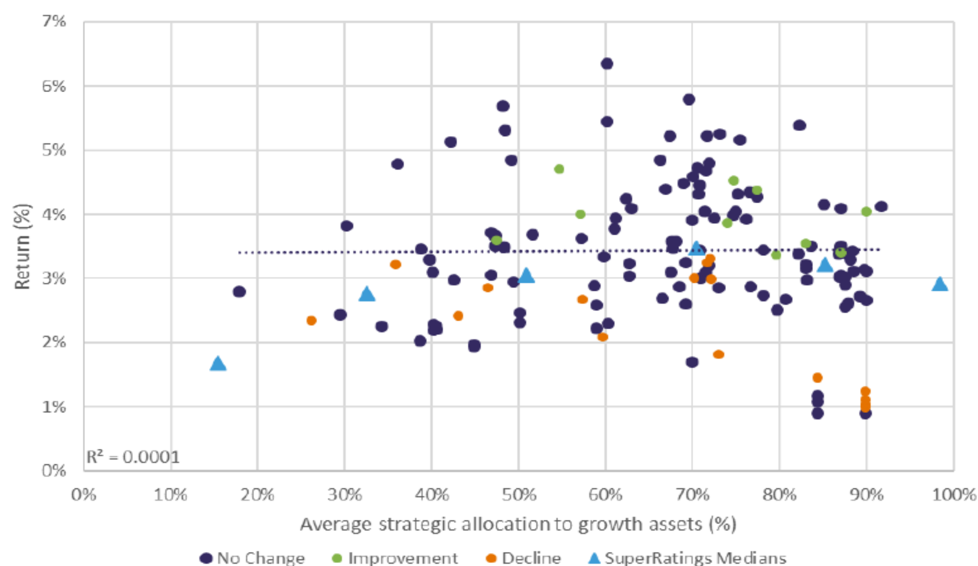
Source: Frontier, APRA, SuperRatings

Chart 6 updates this heatmap calculation to March 2020, taking into account the fall in markets since. Unlike Chart 5, Chart 6 shows no relationship between risk (as measured by the growth/defensive ratio) and return. Over the latest three-year period, the growth ratio was not influential in determining a fund's peer relative return.

If APRA was to recalculate their heatmap metrics as at March 2020, those funds below the trend line would receive yellow or red ratings.

Despite only nine months elapsing between the two calculation dates, funds will have moved from outperforming to underperforming and vice versa. Based on this analysis, almost one in five of funds will have changed its assessment on this metric.

Chart 6: : MySuper funds – Peer comparison for 3 years to March 2020



Source: Frontier, APRA, SuperRatings

Table 2: Heatmap peer results

Peer Heatmap Results	Proportion of MySuper Funds
Outperformance in both periods	41%
Outperformance to June 2019, underperformance to March 2020	12%
Underperformance to June 2019, outperformance to March 2020	7%
Underperformance in both periods	40%

Source: Frontier, APRA

The final word...

The recent market volatility has provided a good opportunity to better understand the true risk levels that different funds are taking. Funds which were merely taking more risk than peers will have performed poorly in the March quarter and then bounced back in April. Lower risk funds should have had good relative performance in the March quarter and then lagged in April. Few funds managed to produce good performance in both periods.

Similar results are found over longer periods. Very few funds perform well in both good and bad market conditions.

This has important implications for assessing the performance of funds.

In strong market periods such as we had seen up until earlier this year, those funds which are taking more risk will look better than peers. However, the results change when markets experience downturns like those we have seen recently.

While the APRA heatmap aims to create a risk-adjusted assessment of relative fund performance, this period highlights how difficult that can be using a single, indicative measure of risk.

Naively assessing funds' performance without a deep understanding of risk levels can lead to the wrong conclusions.

David Carruthers is a Principal Consultant for Frontier Advisers. A full copy of this report can be accessed here. This article is general information and does not consider the circumstances of any investor.

Coronavirus dampens retirement dreams of Australians

Matt Rady

COVID-19 is taking a harsh toll on the economic wellbeing of many retirees with new research showing it has shaken their confidence in the quality of their retirement and how long their money will last.

Many Australian retirees are downgrading their retirement expectations, spending less on luxuries, and are fearful and confused about the safety of their investments.

The Allianz Retire+ survey collated the views of over 1,000 current and prospective retirees nationwide in May 2020, to understand how COVID-19 was affecting their lifestyle, investment actions and retirement perceptions.

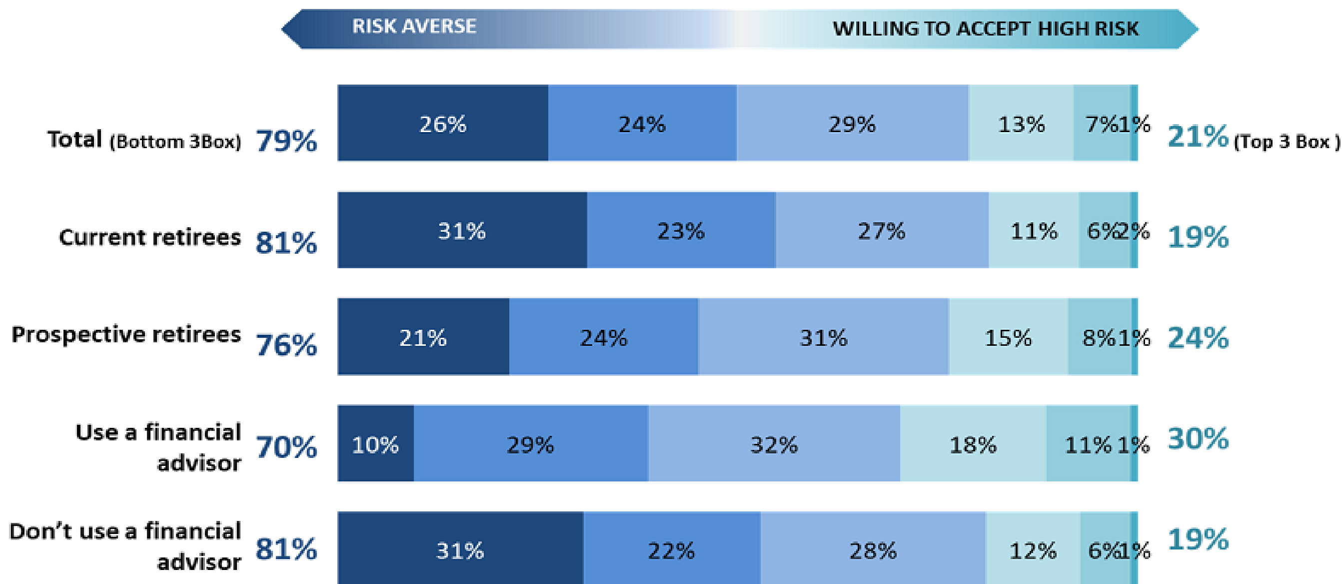
Only one-third of retirees feel confident in their financial position. In addition to health concerns about the virus and not being able to see family and friends as much, retirees are yet again suffering the sharemarket rollercoaster.

A total of 66% do not agree that Australia's superannuation system will provide them with a dignified retirement. It suggests the Australian superannuation system, which is lauded as one of the best globally, is not working for a great deal of the people it's designed for.

Moreover, COVID-19's impact has exposed systemic issues in the drawdown phase of retirement, highlighting shortcomings in retirement product design, access to financial advice and superannuation education.

In a previous study, 'The Next Chapter' undertaken by Allianz Retire+ in 2019, retirees reported feeling nervous and uncertain about what's ahead and lacked in investing confidence. Unfortunately, COVID-19 has taken that to a new level. On both occasions the research indicated retirees want safe, simple, low-cost retirement products with certainty a key feature. Unfortunately, the investment industry is not generally meeting that need.

The current survey found that three in four retirees are not confident about how long their money will last in retirement and when asked about their investments during the pandemic, only 18% felt their investments would be safe in case of economic downturn. They also reported being largely risk averse, seemingly exacerbated by the pandemic.



Source: Allianz Retire+, 'Black Swan Research', May 2020

Nearly half of respondents said they were monitoring their investments much closer due to COVID-19 and just under a third of those surveyed were happy with the federal government's response to COVID-19 policies that affect their retirement.

The pandemic has brought many of the systemic issues back to the surface and there needs to be a greater sense of urgency in delivering change to the system.

Prospective retirees most at risk

The economic impact of COVID-19 was greater on prospective retirees (within seven years to retirement) than current retirees, the survey found.

Source: Allianz Retire+, 'Black Swan Research', May 2020

Vulnerability close to retirement

About 40% of prospective retirees said they lost money to date during COVID-19. Just over one in five said their employment status has (or may) change due to the economic downturn.

Falling retirement savings and rising job insecurity is a toxic combination. Around one in three prospective retirees now have more negative expectations of their retirement. And 77% of prospective retirees do not believe superannuation will provide them with enough money in retirement.

Those nearing retirement have been particularly hurt by the downturn. These investors tend to have more funds allocated to shares, so have higher susceptibility to market crashes. Typically, they are still working and need that income to build retirement savings.

This is where the impact of COVID-19 has shown the danger of 'sequencing risk', where the timing of poor market returns can permanently damage retirement savings. Prospective retiree investors can ill afford to have the share component of their superannuation crushed by market volatility. Many do not have enough time left in the workforce to rebuild their wealth.

With COVID-19 reinforcing the need for retirement-savings products that have a low-cost protection mechanism, around one in three prospective retirees said they would consider an investment product that 'insured them from market downturns'. Investing in retirement is very different to accumulation and retirees are realising diversification and asset allocation is no panacea to protect wealth during crises.

Lack of advice during the pandemic

Remarkably, the survey found 79% of retirees did not seek financial advice during COVID-19.

Only one in five retirees felt that they had easy access to professional financial advice and approximately a third felt financial advisers were 'for the rich'. Almost two-thirds of those without an adviser said they would not use one because the service was too costly.

The advice proposition is proven to be an integral part of providing individuals with confidence and certainty in retirement, with those who use an adviser stating more confidence and security in their financial position. And 68% of those who were advised during COVID-19 said they are sticking to their financial plan, meaning advice is definitely deterring people from making sub-optimal investment decisions based on fear or a lack of understanding. That fact alone proves there is a clear need to change the perception of financial advice among retirees and increase access to affordable advice.

About the survey
Allianz Retire+ commissioned research surveying 1,007 retirees in May 2020 to understand how the economic impact of COVID-19 was affecting them. The sample was split equally between current and prospective (retiring in the next seven years) retirees, and equally between men and women. Most respondents were aged 60 to 75 or over. The survey included responses from retirees in each State and Territory. About two thirds of respondents had an annual household income below $79,000.

Innovative retirement income products with in-built protection from sharemarket losses include Future Safe from Allianz Retire +.

Matt Rady is Chief Executive Officer of Allianz Retire+. This material is for general information purposes only. It is not comprehensive or intended to give financial product advice and does not take into account your objectives, financial situation or needs.

Common confusions with death benefits pensions

Julie Steed

There are a number of issues regarding the payment of death benefits that are widely misunderstood. In this article, we review the types of accounts that can pay a death benefit as a pension, minimum pensions, rolling over death benefit pensions and tax treatment.
Death benefit pensions

A common misconception is that a death benefit can only be paid as a pension if the deceased was in pension phase. However, provided that the super fund rules allow, a death benefit may be paid as a lump sum, one or more pensions or a combination of both a lump sum and pension benefits. This ability applies regardless of whether the death benefit is being paid from an accumulation account, a non-reversionary pension or a reversionary pension.

Death benefits can only be paid as a pension to a death benefit dependant, including a spouse, a financial dependant, someone in an interdependency relationship or a child of the deceased. However, where the beneficiary is a child of the deceased, a pension may only be paid if the child:

- is under age 18
- is age 18 to 25 and financially dependent on the deceased
- has a significant disability.

A child death benefit must be commuted by the time the child turns 25 unless the child is disabled.

Minimum pensions

If the deceased was in pension phase, the treatment of minimum pension payments varies depending on whether the pension was reversionary or non-reversionary.

If the deceased had a reversionary pension, then the minimum annual payment based on the deceased's age must be paid during the year. At the next 1 July, the minimum payments will be recalculated based on the recipient's age.

If the deceased had a non-reversionary pension, then there is no requirement to pay the minimum annual payment.

Rolling over

From 1 July 2017, a death benefit pension can be rolled over to another fund at any time. A death benefit pension always retains its identity as a death benefit. This is valuable because it means lump sum commutations from a death benefit pension are PAYG tax-free. However, death benefit pensions cannot be intermingled with other pensions and cannot be rolled back to accumulation phase.

The ability to rollover can be a valuable option in an SMSF where the surviving spouse may not wish to continue managing the SMSF on their own.
Taxation

All death benefit pensions are retirement phase pensions which means that the investment returns are not taxed.

The PAYG tax treatment of pension payments depends upon the age of the deceased and/or death benefit pension recipient and the tax components of the pension as outlined in the table below:

Deceased and/or beneficiary age 60 or over	
Tax-free component	Tax free
Taxable component – taxed element	Tax free
Taxable component – untaxed element	Marginal tax rate with 10% tax offset
Both deceased and beneficiary under age 60	
Tax-free component	Tax free
Taxable component – taxed element	Marginal tax rate with 15% tax offset
Taxable component – untaxed element	Marginal tax rate

The taxable component – untaxed element will generally only arise from a constitutionally protected fund that is taxed differently to most funds.

Lump sum payments

Any lump sum commutations from death benefit pensions are PAYG tax free. Where both spouses are under 60, there may be advantages of taking the required minimum pension payment and using tax-free lump sum commutations to fund any additional lifestyle needs.
Case study

Brenda dies on her 50th birthday and has a benefit of $1,000,000 of which $10,000 is tax-free component.

If Brenda's husband Barry who is also 50 were to take the death benefit as a pension and draw the minimum annual pension for 2020/21 of $20,000 (temporary minimum of 2%) his tax components would be as follows:

Component	Amount	Tax treatment
Tax-free component	$200	Tax free
Taxable component – taxed element	$19,800	Marginal tax rate with 15% tax offset
Total	**$20,000**	

If this was Barry's only income in 2020/21, he would not pay any tax on his pension income.

If, however, Barry needed $60,000 to live on he could take the additional $40,000 as a lump sum commutation PAYG tax free.

If he took the additional $40,000 as pension payments and this was his only income for 2020/21, he would pay tax (including Medicare levy) of approximately $1,941.

Assuming the death benefit pension was also $1,000,000 at 30 June 2021, if Barry was to draw the minimum annual pension for 2021/22 of $40,000 his tax components would be as follows:

Component	Amount	Tax treatment
Tax-free component	$400	Tax free
Taxable component – taxed element	$39,600	Marginal tax rate with 15% tax offset
Total	**$40,000**	

Assuming no changes in personal tax rates, if this was Barry's only income in 2021/22, he would pay the Medicare levy of $792.

If however Barry needed $60,000 to live on he could take the additional $20,000 as a lump sum commutation PAYG tax free.

If he took the additional $20,000 as pension payments and this was his only income for 2021/22, he would pay tax (including Medicare levy) of approximately $1,941.

Conclusion

Being aware of common misunderstandings in relation to the payment of death benefit pensions can assist in estate planning matters. Understanding the value of professional advice during difficult times can also greatly assist individuals to understand their choices and the tax consequences that follow.

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.

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