a Morningstar company

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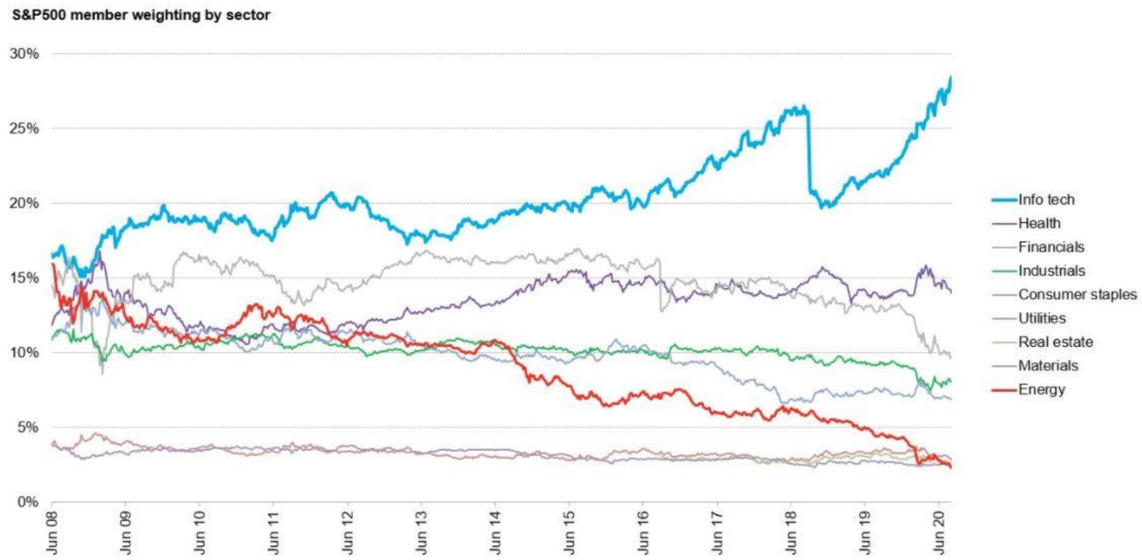
Editorial

It was an historic sign of the times this week when the company with the longest record in the Dow Jones Industrial Average (DJIA), **ExxonMobil**, was replaced by a software company, **Salesforce**. Amazingly, as recently as 2013, ExxonMobil was the largest company in the world. The DJIA has great significance as the first stock market index, introduced in 1896. **Charles Dow** chose the 12 most influential companies of the day, added up their stock prices and divided by 12. The index increased to 30 stocks in 1928 where it remains today, still carrying strong influence.

Only one company, **General Electric**, in the original stocks in the index even exists today, and it is no longer in the DJIA. How many of the current 30 DJIA companies listed below will drop out or cease to exist in coming decades? We think of them as a permanent part of the industrial landscape.

The DJIA currently comprises: Salesforce, Procter & Gamble, DowDuPont, Amgen, 3M, IBM, Merck, American Express, McDonald's, Boeing, Coca-Cola, Caterpillar, JPMorgan Chase, Walt Disney, Johnson & Johnson, Walmart, Home Depot, Intel, Microsoft, Honeywell, Verizon, Chevron, Cisco Systems, Travelers Cos, UnitedHealth Group, Goldman Sachs, Nike, Visa, Apple, Walgreens Boots.

Many companies decline or disappear over time, and 'set-and-forget' investing is more problematic than ever.



A better representation of the broad US economy and now more-frequently quoted is the S&P500 index, and the sector weightings below confirm this rapid change of fortunes. Technology is the big winner and energy is the big loser. Any fund manager on the wrong side of that trade should no longer have a job.

Two substantial changes this week by central banks show how they can support the economy without lowering interest rates. Australia's **Reserve Bank** increased the size of the Term Funding Facility (TFF) used as a low cost funding source by banks, supposedly to finance business loans. Total funds available at a fixed rate of 0.25% for three years are now $200 billion, currently drawn to $52 billion. With bank coffers already full from retail term deposits, we can safely expect no funding problems for our banks for many years.

In the US, the **Fed** signalled rates close to zero for many years as it relaxed its inflation target. It forces investors into other asset classes to achieve decent returns and will further support the incredible run in tech stocks.

The fires of the superannuation debate continue to burn as we covered [two weeks ago](). **Paul Keating** turned up the gas this week by claiming the Liberal Party wants to end compulsory super:

"Not take a chink out of it, but to actually destroy it. They intend to do this in two ways. That is, they want to drain money out of the bottom of the system, and stop money coming into the top of the system ... This malarky they talk of, 'if they take it in super, they won't get it in wages', there's been no wages growth for eight years and there's not going to be."

As another Labor ex-PM, **Kevin Rudd**, also weighed in, Senator **Jane Hume** took to the airwaves, referring to Labor opening a crypt (clearly a reference to dead bodies) to bring out former leaders to support the super system. The arguments have a long way to play out.

In a hectic week, we also saw the final vestiges of the once-dominant bank position in wealth management sold off when **NAB** disposed of **MLC** to **IOOF**, and the capital raising from retail investors (a subject we have covered here and here) had the usual twist. In raising $1 billion overall, IOOF would double its capital base at $3.50 a share, a discount of over 20% to the $4.51 price at the time of the issue. IOOF is only looking for $50 million in the retail SPP, but as the shares closed on Wednesday at $3.53, smaller investors are not missing much this time.

Then the new chair of **AMP**, **Debra Hazelton**, wasted no time putting her stamp on the business by announcing a complete portfolio review *"to ensure we appropriately assess all options to maximise shareholder value in a considered and disciplined manner."* Everything for sale at a price.

Here's a personal footnote. About 35 years ago, when I was running New Issues at **Commonwealth Bank**, many of our bond counterparties were Japanese, and we decided we should hire someone who could speak Japanese to assist in negotiations. We advertised widely and a school teacher who taught Japanese applied. She had no financial markets experience but was clearly smart and she worked with me in Sydney for a couple of years.

Then the bank transferred her to the Tokyo office, where a few years later, she became Treasurer of the local office. I visited her there on business, and she kindly showed me around the bars and karaoke rooms. Later, she returned to Sydney to head the office of **Mizuho Bank**.

As the new chair of AMP, Debra replaces **David Murray** who was CEO at Commonwealth Bank when we hired her. Best wishes to my former colleague in her challenging new role.

Back to investing basics ...

This week's edition includes a couple of articles which experienced investors can share with those who may be at an earlier stage in their investing journey.

Thomas Philips was asked by a friend to draw on his many years of investing and provide a simple guide based on what he had learned. Such was the enthusiastic reaction that we felt it warranted a larger audience. Likewise, **Robin Bowerman** looks at inexperienced investors entering the stock market for the first time and warns about their speculating.

Emma Rapaport delves into a new report on investing by SMSF trustees during the pandemic, summarising changes in five key charts. Then **Peter Moussa** offers his strategies for the uncertain markets we are facing, with some ideas more suitable for a sophisticated investor.

The combination of market and legislative changes, early super withdrawals, people working longer, and contribution levels is having a profound impact on retirement savings. **Erinn Cullinane and Nick Callil** create specific examples to show how much longer people may need to work if super balances do not meet retirement needs.

A change of pace to **Michael Collins** on the nature of US-China relations and the extent to which a new 'cold war' may eventuate, then **Mark Mitchell** says the role that fixed interest played in portfolios has completely changed. How much can it protect falls in stock markets?

This week's White Paper from **Vanguard** looks at whether active equity managers can be cloned using inexpensive factors that drive stock market returns. If returns can be mimicked by simple factor strategies, often available using ETFs, investors may lower costs and demand more from their managers.

Everything my friends need to know about investing

Thomas Philips

This article started its life as a note written in response to a friend’s question about how he ought to invest his savings. He, like many people I know, found finance mysterious.

My friend was not persuaded by my argument that finance is a far easier subject than he imagined, and that he is more than capable of investing his savings on his own. He merely wanted some sympathetic and thoughtful guidance, along with some actionable advice, not a ramble through dense thickets of theory. And most importantly, he wanted to be able to ruminate on, and explore, the logic underlying the advice.

Here, I start by setting out my views and beliefs, and end with actionable advice.

I loosely follow the style of John Fowles’ book *The Aristos*, in which the author sets out his beliefs on a wide range of topics in a series of terse paragraphs separated by spaces, allowing each thought to stand on its own. Fowles merely states his beliefs with no evidence in support of them, and leaves agreement, disagreement, or even disproof, entirely to the reader.

My views, on the other hand, while similarly set out, are backed by a substantial body of theory and evidence that I have deliberately chosen to exclude in order to stay within my self-imposed limit of 1,000 words. They invite spirited discussion and, yes, dissent.

I sent my note to my friend, and to my delight, it satisfied him. It has since satisfied numerous friends and relatives. They have implemented its recommendations without difficulty and are happy with their results. I hope it satisfies you as well.

Theory and beliefs

1. Investing is putting your savings at risk: no risk (e.g. cash under your mattress), no reward; good risk (e.g. stock and bonds), good rewards; bad risk (e.g. gambling), bad rewards. You'll earn about 4% each year with

moderate risk over the long term if you buy and hold a globally diversified portfolio of stocks and bonds. That's about 2% better than inflation, which runs about 2% each year.

2. If I knew how to earn 15% each year with no risk, I'd tell you. I don't, and neither do the charlatans who claim that they do.

3. While financial markets offer investors a dizzying array of investments, and while salespeople routinely promise the sun, the moon and the stars, you'll do just fine by ignoring them and investing in a globally diversified portfolio of stocks and bonds through exceptionally low cost mutual funds known as *index funds*, which simply buy and hold all the stocks or bonds in the market and don't trade them other than to rebalance.

4. But isn't it better to identify, and invest with, the next Warren Buffett? It absolutely is, if you can identify the next Warren Buffett! But it's exceptionally hard to prospectively identify great investors, who are a rare breed. What about retaining a consultant who identifies great investors? Great idea if you can reliably identify great identifiers, but they, too, are a rare breed! In short, non-index investing is best left to the few investors who have a proven record of success. Index funds work best for everyone else.

5. The benefits of global diversification are underestimated. You'll do yourself a huge disservice by investing only in your home country and in a few stocks, as it's incredibly hard to tell in advance which countries, regions, sectors and companies will do well and which will do poorly.

6. The powers of disciplined saving and compounding are also underestimated. If you save $1 for retirement in each year that you work, over half your retirement savings will come from contributions you made before you turned 40.

7. With social security as a backup, you need to save approximately one-sixth of your income each year for retirement. Furthermore, you can spend about 3% of your savings each year once you retire.

8. Stocks generally outperform bonds over the long term but stock prices are volatile. Don't get starry eyed when they rise and don't despair when they fall.

9. You won't go too far wrong by investing half your savings in stocks and half in bonds, half domestically (i.e. in your home country) and half internationally. If you live in a small country, invest less than half (say a quarter) domestically and the rest internationally.

10. Here's why 50/50 is fine:

a. If the world fares well, so will stocks, and bonds will do you no harm.
b. If the world fares poorly, so will stocks, and bonds will preserve half your wealth.
c. If your home country fares better than the rest of the world, your domestic portfolio will do well even if your international portfolio doesn't.
d. If your home country fares poorly relative to the rest of the world, your international portfolio will do well even if your domestic portfolio doesn't.

11. Avoid esoteric investments in real estate, private equity, hedge funds etc. Recall point three and tune out glamour, noise and fees, all three of which usually go hand in hand.

12. Stocks sometimes get overvalued (e.g. during the internet bubble in 2000), so it then makes sense to keep less than half your savings (say a third) in stocks. At other times (e.g. at the depth of the GFC in early 2009), they get undervalued, so it makes sense to have more than half your savings (say two thirds) in stocks.

13. It's *incredibly* hard to tell if stocks are going to rise or fall in the short term, and most periods of overvaluation and undervaluation are obvious only in hindsight.

14. Invest at the lowest possible cost. Your earnings belong to you, not to someone else. If you are paying more than 0.3% of your assets in fees each year, you are paying much too much. Ditto for sales charges of any kind. They benefit salespeople, not you.

15. Finally, never, ***ever***, burn with envy because someone you know claims to have effortlessly made a fortune. Virtually all such stories are the product of an active imagination aided by a selective memory.

Actionable advice

Diversified Exchange Traded Funds (ETFs) are a particularly useful starting point for investors as they package a mixture of stock and bond index funds into a single strategy.

(Editor's Note: Tom and I met by Zoom to discuss an Australian equivalent to his original US examples, and the following is an adaptation for an Australian audience).

A **single fund** with a 50% growth/50% income will work well for the rest of your life regardless of your age. A low-cost, all-in-one investment portfolio provides exposure to diversified assets in a single ASX trade. Here are two Australian examples:

Vanguard Balanced Index ETF (ASX code: VDBA)

VDBA can be purchased in the same way as any shares via a broker account. More details on the fund are available here.

For investors with less risk appetite who prefer a single fund with 30% growth and 70% income, the code of the Conservative version is VDCO. Investors wanting a more aggressive version with greater exposure to equities, a 70% growth and 30% income, can choose the Growth version, VDCO. The management fee on all these funds is 0.27%.

BetaShares Diversified Balanced ETF (ASX code: DBBF)

This is also a 50/50 fund, with more information here. The other BetaShares versions are Growth DGGF and Conservative DZZF and all have a 0.26% fee. Choose the relevant fund based on your risk appetite.

This single fund diversified solution is especially useful if you find finance intimidating and want to keep costs down. You can't beat it for simplicity and over time, you will be happy with the results.

Thomas Philips teaches Quantitative Portfolio Management and Valuation Theory in the Department of Finance and Risk Engineering at New York University's Tandon School of Engineering.

In 2000, he received the first Bernstein/Fabozzi/Jacobs-Levy award for his paper "Why Do Valuation Ratios Forecast Long Run Equity Returns" which appeared in the Journal of Portfolio Management, and in 2008, he received the Graham and Dodd Scroll Award for his paper "Saving Social Security: A Better Approach", which appeared in the Financial Analysts Journal.

He received his Ph.D. in Electrical and Computer Engineering from the University of Massachusetts at Amherst. This article is general information and does not consider the circumstances of any investor.

SMSFs and COVID: the biggest trends in 5 charts

Emma Rapaport

It's been a turbulent period for Australia's 1.1 million SMSF trustees. Just as they put the franking credit debate behind them, the coronavirus hit, causing the market to plunge almost 40% and slashing dividend payouts. Meanwhile, saving and term deposit rates are at record lows and income from investment properties has dropped amid pleas for leniency from distressed tenants.

Despite US indices erasing the losses, trustees have reported high level of concern and negative return expectations over the next 12 months.

The downturn also pushed some trustees to make significant changes to their portfolio. About 8% of SMSFs made substantial adjustments (50% or more of the fund) to their asset allocation in 2020, doubling the number who did the same last year (4%) and the highest level on record.

The 2020 Vanguard/Investment Trends SMSF Investor Report surveyed trustee's response to the pandemic market sell-off and asked how they're positioning for the future.

Here are this year's five biggest trends:

1. SMSF sector growth is slowing

The number of SMSFs continues to rise, reaching almost 600,000 in 2019, but the annual establishment rate has declined to a decade low. Last year, only 20,028 new SMSFs were set up, halving from a peak establishment rate of 42,033 in 2012.

Investment Trends Chief Executive Michael Blomfield attributed some of last years' slowing to the raging franking credits debate which permeated through the sector in the lead-up to the 2018 federal election. For several years, SMSFs have also expressed frustration at the increased complexity and expense of running a fund.

Blomfield expects establishment numbers to grow in the coming years and is keenly awaiting the response of trustees to the market sell-off. He says:

"What we saw following the GFC was a surge in establishment of SMSFs as people lost confidence in the value equation of paying for investment management. It remains to be seen this time whether that view is arrived that."

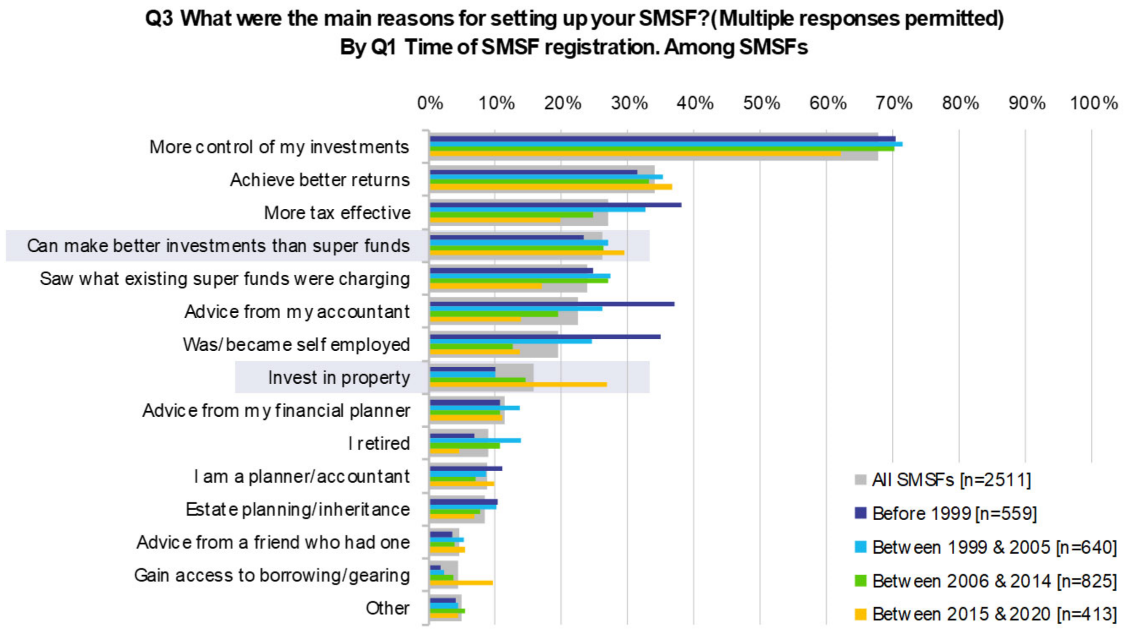
2. Desire for control drives establishment

There are two main factors driving establishment of an SMSF: first, the desire of trustees to gain control of their investments; and two, to achieve better returns. It seems that trustees believe they can do a better job than the nation's leading fund managers.

Notably, the response 'invest in property' has come to the forefront with trustees who established a fund over the past five years despite increased controls around SMSF borrowing.

There has also been a drop-off in the number of people establishing a fund on the advice on their accountant. In the early 2000s, almost 40% of respondents listed 'advice from my accountant' as the main reason for setting up an SMSF. Today, that number is less than 15%.

Over the decade, the number of trustees who use an adviser – including accountants for tax advice, full-service stockbrokers, private bankers and mortgage brokers – has soared. At the same time, the number of SMSFs using a financial planner has dipped.



Source: 2020 Vanguard/Investment Trends SMSF Report

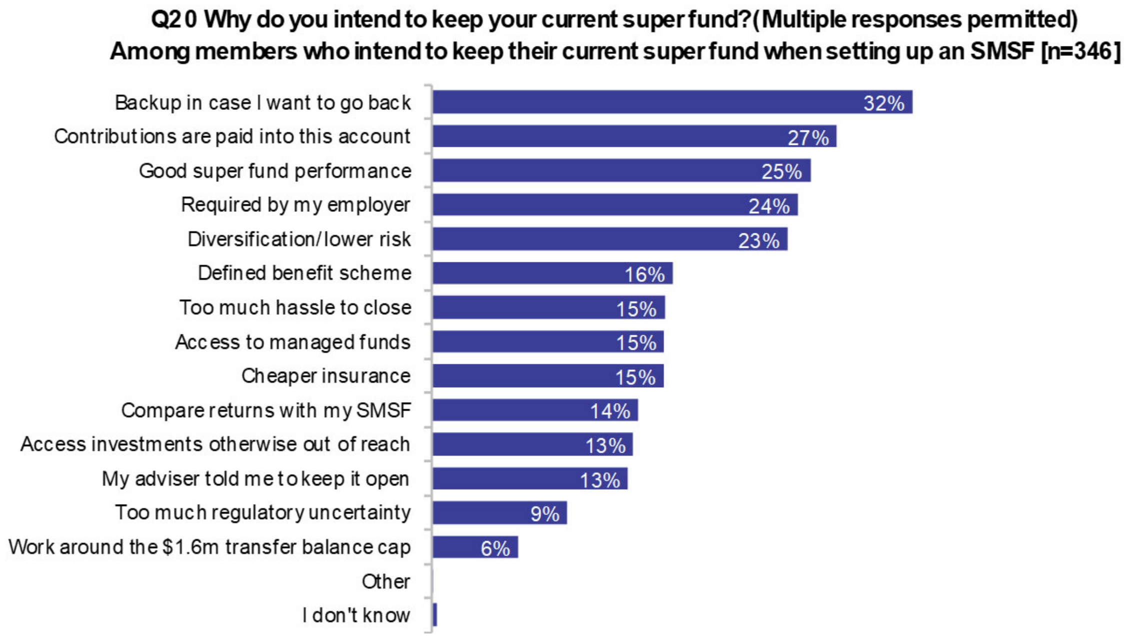
3. SMSFs have a back-up plan

It seems SMSFs want to have their cake and eat it too. In recent years, new trustees expressed an intention to hold on to their employer super fund – be it an industry, retail or corporate fund – when they establish an SMSF. And this trend is firming. Almost half of those who establish an SMSF said they intend to retain their APRA-regulated fund, up from 29% just four years ago.

There are several reasons for this. Firstly, trustees view their previous super fund as a 'personal insurance policy' in case of problems running their own fund. Secondly, as employer contributions are paid into the current super fund, trustees want to maintain this flow. Lastly, trustees want to continue accessing group insurance offered by regulated funds as these policies are often cheaper than those offered by external providers.

Blomfield views this trend as a positive for the industry and as a sign of a maturing market.

"We're seeing a more mature SMSF trustee market, using their self-managed fund for the reasons they value it but retaining professional advice and money management to lower their risk overall".

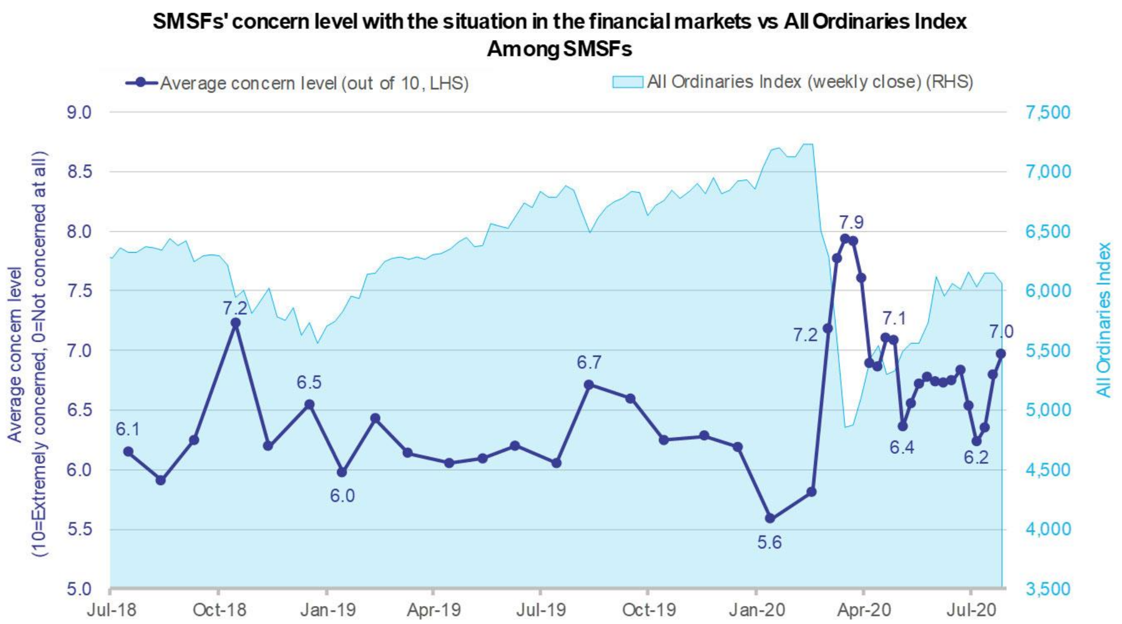


Source: 2020 Vanguard/Investment Trends SMSF Report

4. SMSFs worried during the height of Covid crash

Concern levels reached new heights during the pandemic, following the ASX200's 37% plunge from a peak of 7,255 in mid-February to lows of 4,564 by 23 March. Investment Trends measures concern levels on a scale of 0 to 10, on which Blomfield says: *"Zero defined as lying on the beach drinking a margarita and 10 defined as standing at the edge of a very tall building taking one last breath."*

During March and April, SMSF concern levels peaked at 7.9, up from 5.6 in January 2020. Concern levels are also volatile, as the numbers was down to 6.4 around April then back up again. Return expectations (ex-dividends) have also been volatile since the pandemic, rocketing from lows of -2% in early April to highs on 7.4% in May. Today they are about -1.1%. Trustees similarly reduced their dividend yield expectations, from highs of 4.8% in mid-February to around 3.1% today – or down 35%.



Source: 2020 Vanguard/Investment Trends SMSF Report

Despite high levels of concern, the response among trustees was not uniform. While almost half of SMSFs (44%) said they made a substantial change to their portfolio in the last 12 months (a substantial change is defined as an asset allocation change of greater than 10% of the fund) some trustees became more defensive (55%) while others saw the downturn as a buying opportunity (29%).

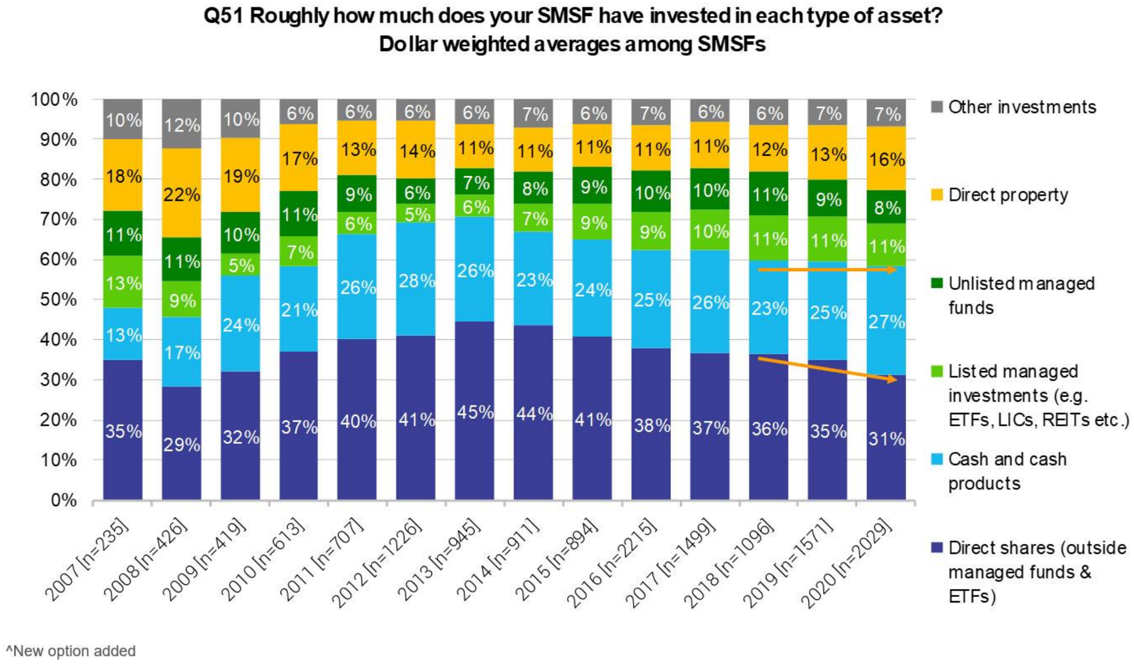
Blomfield was quick to note only a minority of trustees sold into cash following the downturn.

"Only 27% of trustees made changes to as much as 20% of their fund. The view that everyone sold out at the bottom and started to buy back in at the top is not supported by our research".

5. SMSFs moving from direct shares to property but not fixed income

For several years, SMSFs' allocation to direct shares has been in decline. This trend has accelerated following the pandemic.

In 2013, trustees allocated 45% of the portfolio to shares. Today, allocation is down to 31%. Property and cash assets now comprise a larger portfolio of balances.



Source: 2020 Vanguard/Investment Trends SMSF Report

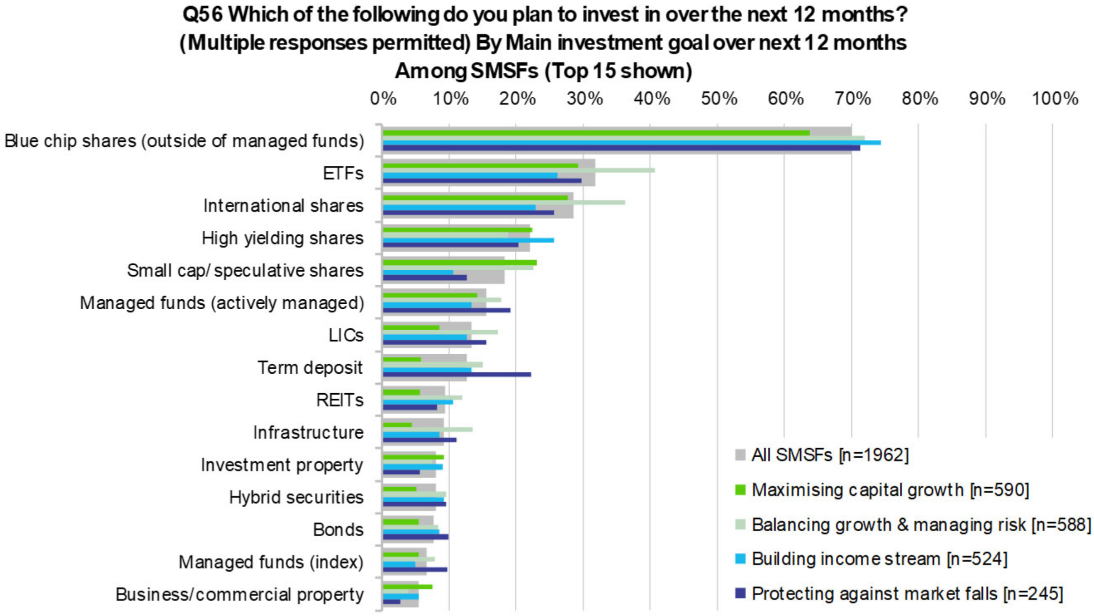
In the year ahead, more trustees than ever say their focus in on maximising capital growth, rotating into equities and increasing super contributions.

Despite expressing a desire for sustainable income streams, SMSFs have a lukewarm response to fixed income. Just 5% of trustees said they intend to increase their exposure to fixed income or bonds in the next three months, compared to 37% of trustees who are eyeing Australian shares. Instead, they are turning to the equities market and the hybrid market to access income. Blomfield says:

"Bonds are almost nowhere. In the absence of good fixed income exposure, people are still intending, even going forward, notwithstanding the volatility of the markets, to look for equity-based yield."

Those who do invest in the asset class, primarily to balance growth and manage risk, do so via bond ETFs (9%) or direct bonds (9%). From barely a dozen fixed-interest ETFs five years ago, there are now nearly 30 Australian and global funds, with more in the pipeline.

The biggest issues bonds face with trustees is the perception of low returns. Trustees are failing to appreciate the message that bonds exist as a truly defensive asset class in a diversified portfolio.



Source: 2020 Vanguard/Investment Trends SMSF Report

The 2020 Vanguard/Investment Trends SMSF Investor report surveyed over 3,000 SMSF trustees between February to May 2020.

Emma Rapaport is an Editor at [Morningstar.com.au](), owner of Firstlinks. This article is general information and does not consider the circumstances of any investor.

Retirement adequacy: COVID means we need to work longer

Erinn Cullinane, Nick Callil

As has been well canvassed, those who withdraw money from superannuation under the COVID-19 early access scheme will reduce the savings available to them and hence weaken their prospects of an adequate retirement.

But what of the other, broader, impacts of the COVID-19 pandemic on retirement savings?

Four factors drive retirement income variations

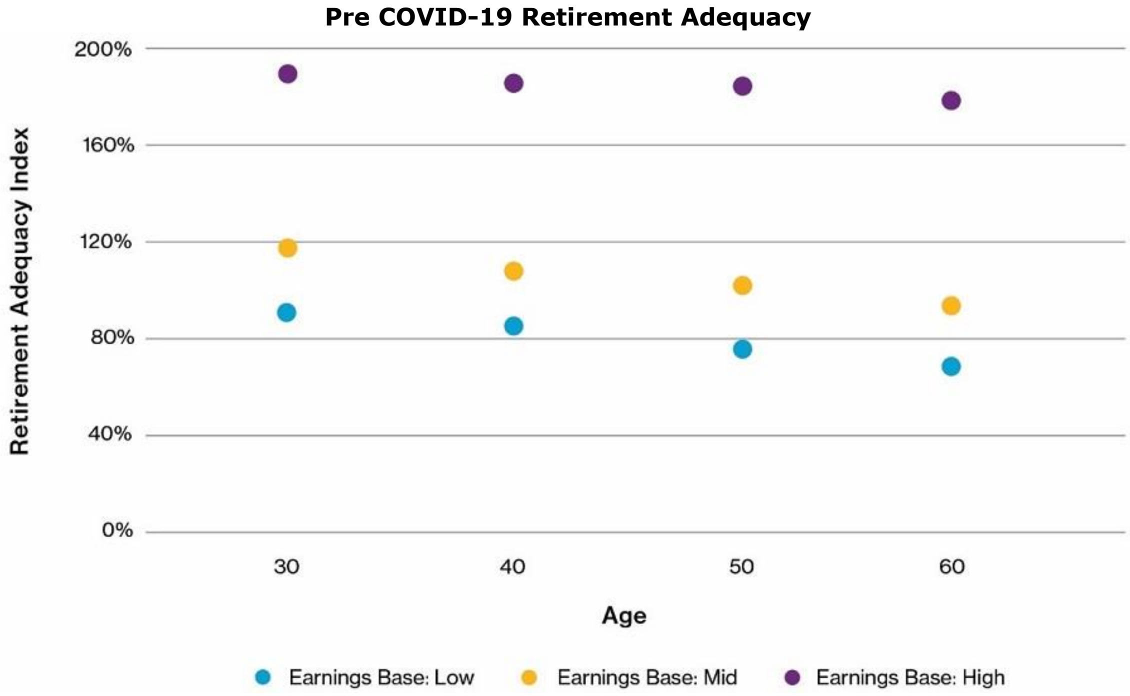
To demonstrate the possible impacts, Willis Towers Watson created 12 examples of people (we'll call them 'cameos') aged between 30 and 60 years and with various earning levels. We assume all 'cameos' work to age 67 with no career breaks, receive contributions at the legislated superannuation guarantee (SG) rates, invest in a balanced investment option throughout their working lifetime and retirement, and are married with a superannuation account balance equal to their spouse throughout retirement (for the purpose of Government Age Pension).

We consider four factors to show how retirement outcomes might be affected by the pandemic:
1. Investment returns
2. Switching behaviour
3. Early release payments
4. Periods of unemployment.

Before we can quantify the pandemic's impact, we need to establish a baseline. We have determined the retirement adequacy for the 12 cameos on a pre-COVID-19 outlook as at 31 December 2019. We measure retirement adequacy using an index calculated as the ratio of prospective retirement income (including age pension) to the ASFA Comfortable Standard.

As expected, younger members benefiting from a full working lifetime of SG contributions are projected to achieve a higher Retirement Adequacy Index (RAI) than older members.

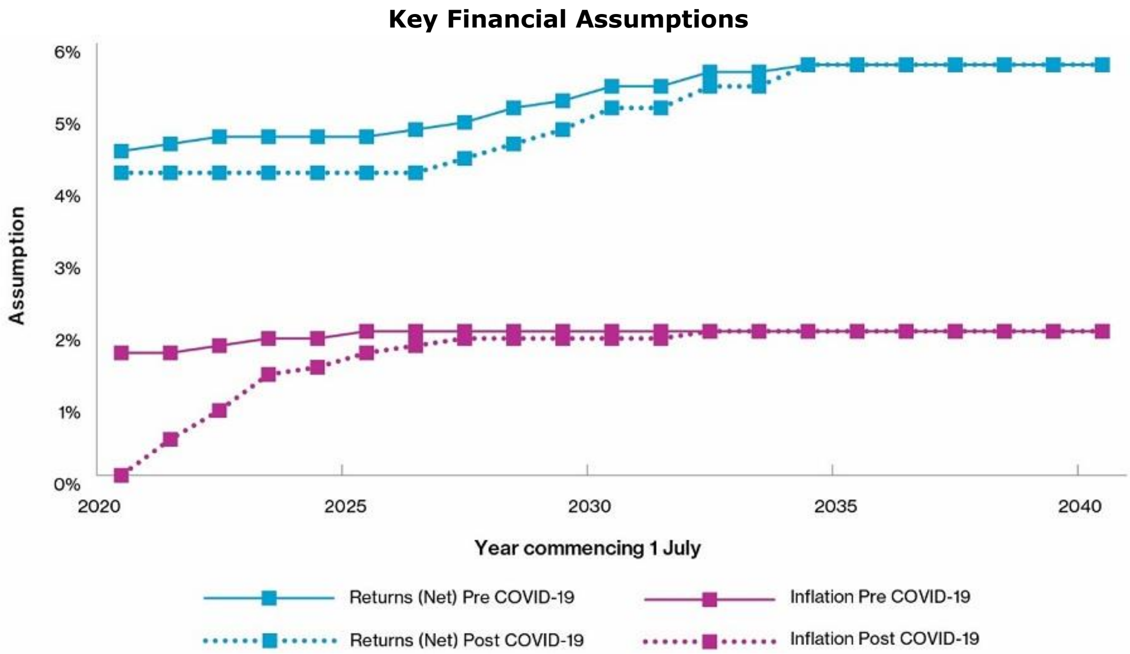
For each cameo, the RAI has been redetermined after allowing for each of the pandemic-related stresses.



1. Investment returns

COVID-19 saw markets tumble globally in the March 2020 quarter. While markets partially recovered over the ensuing months, Balanced options still recorded losses for the six months ending 30 June 2020, with a median return (SuperRatings) of -4.9%.

While acknowledging the unpredictability of markets, the investment return stress comprises both the impact of the (lower than anticipated) returns to 30 June 2020 and assumptions reflecting lower expected inflation and investment returns in the medium term due to the ongoing effects of the pandemic.



2. Switching behaviour

Throughout March and April 2020, many funds reported members shifting to cash and low growth investment options in response to the market downturn. Similar patterns were observed during the GFC in 2008-09, after which many members did not return to their previous investment options for some time, if at all.

The 'switching' stress assumes a switch to cash at 31 March 2020, following the most significant COVID-19 related investment losses, returning to a Balanced investment option after 10 years, to illustrate the impact of a long delay before reinvesting.

3. Early release

The special provision allowing the release of up to $20,000 (two payments tranches of up to $10,000) from superannuation accounts was introduced as a pandemic stimulus measure. Over $30 billion had been released by 16 August by over a million individuals.

Our 'early release' stress allows for two early release payments of $10,000, up to the value of the current account balance. We have allowed for the timing of many tranche one payments, which occurred immediately following the poor investment returns of the first quarter of the year, and hence reduced the exposure to the subsequent market recovery.

4. Periods of unemployment

The shutdown imposed to restrict the spread of COVID-19 in Australia has resulted in a significant spike in unemployment, with Treasury forecasting an unemployment rate of up to 9.25% in the December quarter 2020. Large numbers of Australians will see little to no contributions coming into their superannuation accounts over the next few years.

Our 'unemployment' stress allows for a three-year period of unemployment to illustrate the potential impact of a period of sustained unemployment, after which time the individual is assumed to return to their previous level of earnings.

Impact of COVID-19 on retirement adequacy

The reduction in Retirement Adequacy as a result of each stress, both in isolation and collectively, is shown below.

Earnings Base	Low				Mid				High			
Age	30	40	50	60	30	40	50	60	30	40	50	60
Pre COVID-19 RAI	91%	84%	75%	68%	117%	107%	102%	94%	190%	186%	184%	179%
Returns	0%	-1%	-1%	-1%	-2%	-1%	-1%	-2%	-7%	-7%	-7%	-12%
Switches	-2%	-3%	-3%	-5%	-6%	-4%	-6%	-18%	-18%	-28%	-35%	-58%
Early Release	-1%	-2%	-3%	-2%	-3%	-2%	-2%	-2%	-5%	-4%	-3%	-1%
Unemployment	-1%	-2%	-1%	-1%	-3%	-3%	-3%	-2%	-12%	-9%	-7%	-3%
Post COVID-19 RAI	87%	77%	67%	59%	103%	97%	91%	69%	150%	139%	132%	105%

Those in the low earnings band incur the smallest reduction in adequacy across the board, due to retirement income being buttressed by the age pension.

The greatest adverse impact comes from switching. While the proportion of members that switch to cash is still reasonably small across the industry, the analysis demonstrates that it can be very damaging and is particularly acute for older members, reflecting the importance of investment returns in the 'retirement risk zone' (the years immediately preceding and after retirement date).

The impact of early release is greater for younger members. The exception is those with a low earnings base and account balance, where withdrawals are significantly less than the maximum $20,000. And younger members are most affected by periods of unemployment, with lost income in the early years leading to the largest impact at retirement through the power of compound interest.

So, what can individuals do to offset these impacts? Some, particularly higher earners, may choose to retire with a slightly lower retirement income if they are able to maintain their desired lifestyle with the funds available.

For others, the most obvious action is to contribute more by way of voluntary member contributions. However, at a time where unemployment is projected to reach its highest since the great depression, many will not have the ability or inclination to do this.

Those unable or unwilling to make additional contributions may be forced to work past their preferred retirement age – if such an option is available to them. The below table illustrates the additional number of years an individual would need to work to achieve their pre COVID-19 adequacy. Clearly, for those approaching retirement for whom additional work for up to eight years is required, this approach may not be feasible.

Additional working years required to restore Pre COVID-19 Retirement Adequacy

Earnings Base	Low				Mid				High			
Age	30	40	50	60	30	40	50	60	30	40	50	60
Additional years required	2	3	4	8	3	3	3	7	3	3	4	8
New Retirement Age	69	70	71	75	70	70	70	74	70	70	71	75

By using this analysis to understand how different cohorts have been affected by the pandemic, investors and service providers can better understand the impact of policies, unemployment and investment returns and how to respond sensibly.

Nick Callil is the Head of Retirement Solutions and Erinn Cullinane is Associate Director, Retirement at Willis Towers Watson Australia. The full report is available here.

What we don't know: five strategies for uncertainty

Peter Moussa

Investors crave certainty and when we don't have a conclusive answer on a topic, our natural response is to sit on the sidelines. The coronavirus pandemic has raised uncertainty about markets. Few investors saw the March crash coming, which led to a 35% decline in equity markets. Even fewer anticipated the strength of the recovery that followed.

Market timing is too difficult

The lesson during this period is something we have heard all too often: markets are unpredictable and trying to time markets based on news and headlines does not work.

We don't like to hear that the future is uncertain, which is why many investors look for opinions from market commentators about what could happen, and this often leads to an attempt at market timing which is rarely successful.

There is a limit to how much information we can digest, and once we acknowledge that, we can look at strategies that allow us to generate returns without the need to time markets.

On the other side of the spectrum are investors who are too idle, often not investing whether markets are selling off nor when they are making new highs.

Avoiding markets when they make new highs may feel right intuitively. However, the reality is it often leads to missed opportunities and significant underperformance. Markets often continue to make new highs for an extended period of time and sitting in cash when rates are low can mean a negative return net of inflation.

Knowing what you don't know

We know little about the virus, potential mutations and sustainability of immunisations, how reopening economies will play out or how long developing nations might struggle with exponentially growing cases.

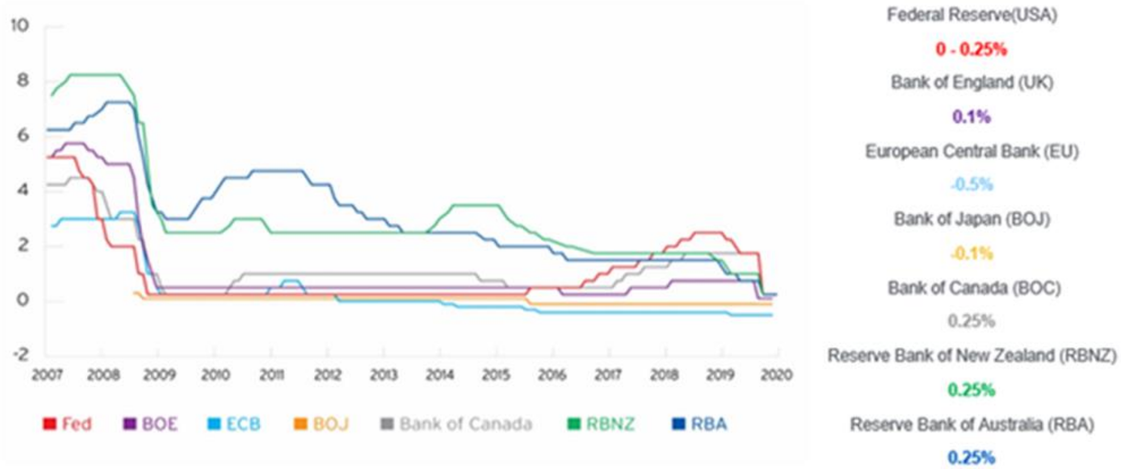
Warren Buffett's offsider, Charlie Munger, summed it up neatly: *"This thing is different. Everybody talks as if they know what's going to happen and nobody knows what's going to happen."*

Economic impact: What we do know

- Global GDP will shrink in 2020.
- Certain sectors won't go back to the way they were for a very long time, such as travel and tourism sectors while other sectors will benefit over the long term.

- Central banks will continue to support economies by any means necessary. The consequence of this is higher deficits and lower interest rates.
- Reserve Bank of Australia Governor, Philip Lowe, has made it clear that low rates are here to stay and while negative rates are "highly unlikely" the central bank will continue to use yield curve control as the preferred monetary policy tool.
- Looking at historical trends globally, following the 2008 GFC, central banks also lowered interest rates to stimulate the economy. The US lowered rates to near zero for eight years and while they raised them in 2016, they quickly went back down to zero. The European Union kept rates near zero since 2009 and went below zero in 2014. Japanese rates have been near zero since 1999 and went negative in 2016. If history is any guide, waiting for interest rates to rise may result in years of underperformance.

Major Central Bank Rates



Source: Bloomberg

Five strategies for uncertain markets

Here are some strategies that investors can employ that mitigate the risk associated with timing markets or remaining idle.

1. Invest with less directional payoffs: certain investments may allow investors to gain indirect exposure to equity markets while offering some degree of capital protection. These investments can be tailored to modify the risk return payoff of the underlying exposure. Structured notes are one such vehicle. One of the most popular structured notes allows investors to receive an unconditional coupon payment as well as profiting whether the chosen basket of shares go up, stays flat or falls by up to 30%. This means investors can choose stocks they see value in without having to time the bottom of the market.

2. Look for reliable income: There are certain investments that offer unconditional income, like corporate bonds or structured notes. This provides some certainty in an otherwise uncertain environment. This is a much more sustainable source of income for investors, provided the issuer does not default, when compared to dividends, which even for blue chip names may be cut or suspended during an economic slowdown.

3. Stay cautious and minimise cash investments: Central banks around the world have reacted in a coordinated manner and have successfully avoided economic disaster. The liquidity injection to date is approximately $US15 trillion, which is 17% of global GDP. One of the long-term consequences of money printing is the devaluation of currency values and over time inflation erodes purchasing power. Cash is especially problematic when interest rates are so low and likely to stay low for an extended period. The rate of return is negative net of inflation.

4. Consider absolute return strategies: this refers to the ability to generate a positive return even when equity markets are falling. They look beyond a basic equity and bond portfolio to include unconventional assets for uncertain times. These strategies typically generate a moderate return with lower levels of volatility.

5. Diversify across uncorrelated assets: when creating a resilient portfolio, investors need to look at asset classes that have low correlation for example, adding bonds and gold exposure to an equity portfolio can help cushion portfolios if there is a prolonged downturn in equity markets.

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To speculate or not to speculate

Robin Bowerman

"Tips! How people want tips! There is greed involved, and vanity."

-Edwin Lefevre, *Reminiscences of a Stock Operator,* published in 1923

The launch of electronic brokerages spawned day-trading for regular people back in the 1990s, and the advent of low-cost and free brokerage took things to a whole new level this year.

But speculating on markets goes way back. It was almost a century ago that journalist Edwin Lefevre wrote the investing classic *Reminiscences of a Stock Operator*, documenting the perils of stock market speculation.

And it has been more than 80 years since Ben Graham, the father of investing and Warren Buffett's teacher at Columbia Business School, first split the world of markets into two classes: investors and speculators.

Graham said an investor is someone who wants preservation of capital and an adequate return. Everyone else is speculating. It's a distinction that is more important than ever today.

The [Australian Securities and Investments Commission]() (ASIC) recently conducted a review into 2020's sudden surge in stock market speculation as ASIC grew increasingly concerned about the risks being borne by small investors.

The findings of the review were extraordinary

Not only are small investors trading more amid the COVID-driven volatility in markets, but many are setting up brokerage accounts for the first time. More people getting involved in markets is normally something for the industry to celebrate but there are some concerning features about the new generation's taste for risk.

For starters, the average daily securities market turnover by retail brokers has doubled this year. ASIC studied a period of six weeks at the start of the COVID-19 crisis in Australia when the Australian Securities Exchange indices fell by more than a third from their record high.

During the period, turnover from retail brokers hit a daily average of $3.3 billion, up from $1.6 billion in the previous six months.

More surprising was the finding that as the markets fell, retail clients were buying. Over the period, retail broker clients bought $53.4 billion worth of shares and sold $48.4 billion.

The net buying behaviour coincided with another interesting statistic: many of the buyers were in the market for the first time. ASIC tracks 'unique client identifiers' in the market. During the early part of the crisis, an average of 4,675 new identifiers appeared in the market every day. The rate of creation of new accounts was more than three times higher than before the crisis.

The results were clear: a heady combination of working from home, access to cheap broking accounts and volatile markets tempted many to try their luck.

But for most, it didn't work out. ASIC concluded that if all retail investors held all their positions for only one day, total losses for the six weeks would have hit $230 million.

It's a salient lesson and one Vanguard has been prosecuting for decades. Market speculation – whether through day trading or mere market timing – poses clear risks to financial health.

The first risk is that people are notoriously bad at timing itself. Timing the market is always tempting. If we could only pick the highs and lows, we could dramatically improve returns. But hindsight makes timing an illusion. The future remains uncertain and repeated studies have shown that even professional investors struggle to time the market.

The ASIC study bears this out. Two thirds of the days on which retail investors were net buyers were followed up by a day of falling share prices. Half of the days when they were net sellers were followed by an up day.

Here's another problem faced by many direct investors: concentration. People who take a trading approach to their investments can end up with a collection of assets that have been accumulated over time without regard to how they fit together as a portfolio.

This can lead to a portfolio that is overweighted to a particular asset type or industry, increasing the risk of permanent loss of capital should things go wrong.

ASIC also notes that many investors are being tempted into high risk products that use leverage to supercharge returns.

Geared products increase the profits from favourable market movements but magnify the losses when things go the wrong way.

ASIC says some 75% of trading in one geared exchange traded product earlier this year was by retail investors, who pushed it to become one of the most traded products on the market.

This appetite for risk also tempted some into volatile, speculative investments based on commodity prices. Some oil futures products lost 80% of their value in a few weeks, potentially wiping out investors who never intended to actually take delivery of the oil.

Have you been tempted by the wild west mentality of 2020? Have you found yourself straying from your investment principles and taking a punt?

Five simple rules for investors

Here are five ways to get things back on track.

First, remember the difference between investing and speculating. Investing means holding assets that will provide you with an adequate return over a long period of time in a mixture of income and capital growth. It doesn't mean chasing short term profits.

Second, revisit your original investment plan – or create one – and bring discipline back to your investing. Having clear, appropriate investment goals and a considered roadmap to achieve them is the core to successful investing. Portfolios need to be built from the top down – considering risk, return and diversification – and not built up as a collection of individual assets.

Third, be diversified. Diversification protects you against permanent loss from something going wrong in a single investment. Diversification means owning different investments in different industries, different countries and different asset classes.

Fourth, keep an eye on how much is leaking out of your portfolio in fees. Fees include brokerage, advice fees and fund manager fees. These all eat at your capital. Fees are the single best predictor of outperformance of a managed fund. The lower the fee, the better the outperformance.

Fifth, remember that earnings usually grow over time and that compounding works.

Sticking to the core principles of successful investing can get your investments back on track to deliver your goals.

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China and US 'decoupling' likely to be mild

Michael Collins

The 'Line of Actual Control' is the name for the unformalised border that separates Indian-controlled and Chinese-controlled territory in the disputed area where the Asian neighbours meet and where in 1962 the pair fought a war. In June 2020, violence flared up again and at least 20 Indian soldiers were killed. The response of India's government? New Delhi banned 59 Chinese mobile applications, including ByteDance's popular video-sharing TikTok.

Tensions but they still need each other

The incident was yet another to strain the relationships between China and the US and their respective allies. Tension between China and the US over data, Hong Kong, military reach, human rights, investment, the South China Sea, Taiwan, technology and trade is fashioning talk of a 'decoupling' between the pair.

If globalisation is the free flow of goods, capital, people, information and ideas, how to define a decoupling? One extreme would be another Cold War-like separation between the world's two most powerful countries and their allies where economic ties almost evaporate. The benign extreme might be a token split. The term could cover any division in between.

The China-US decoupling is likely to be a mild separation for five reasons, even if their antagonism flares at times.

First, their rupture is not the ideological and existentialist clash that was the Cold War of 1945-1989. The China-US tussle is more a mercantilist power struggle between economically interwoven and flexible countries that have different political systems and values. Such scuffles typically find an equilibrium where rivals coexist, even cooperate.

Second, it's an oversimplification to view the world as settled into two groups. The US and Europe have disputes over data privacy and the regulation and taxation of tech companies. It's a simplification, too, to talk of the Belt and Road Initiative as a China-led bloc. The countries involved have no common ideology.

Third, the fact that China and the US (and their allies) are so financially and economically entwined means it would be too costly, time-consuming and complicated for the powers to separate. The US relies on China to buy its government debt and for rare-earth materials. Western companies have production, commercial and investment ties to China. For its part, China depends on western banks, universities, agricultural produce, raw materials and tech parts such as microprocessors. Many Chinese companies depend on foreigners for much of their revenue. Chinese companies own or have stakes in many western household names.

Fourth is that China and the US face common financial and economic challenges. Both are keen to reinstall sustainable economic growth, repair their finances and trade with each other.

Fifth, the pair face common challenges away from finance and economics that can be better met in a cooperative fashion. These include the coronavirus pandemic, climate change, failed states, global terrorist organisations and nuclear proliferation.

A mild decoupling with ongoing strains

Even though the decoupling will be mild, it will consist of two noticeable tears. The first is broadly around technology and will be most noticeable in how the internet will segment. But the internet was rupturing anyway because governments were always going to extend regulatory powers and security measures to cyberspace. The fractured internet or 'splinternet' means that some countries could exclusively use US or Chinese tech for critical spheres.

The other tear, helped along by the pandemic highlighting the importance of 'health security', is that production will drift from China because western countries and companies are unwilling to rely for critical supplies on a country with divergent interests and opposing values. Over time, the production capacity shifted could be noticeable.

These tears come with costs. Western consumers will face reduced choice and higher prices as friendly companies producing essentials are protected and Chinese tech stars are blocked. Global production networks will be less efficient. Personal ties between China and the US will be lower than otherwise. The internet will serve national and regional interests, not global ideals. Cyberattacks might become even more common. Spikes in China-US tensions could trigger gyrations on financial markets.

Costs are likely to prove mild

People will know that, while insults and feints between China and the US might look divorce-like, the pair are likely to remain untrusting and squabbling competitors rather than turn into foes.

To be sure, the UK and Germany were each other's biggest trading partner before World War I. Like in 1914, miscalculations could trigger a proper decoupling nowadays. Other tears in the China-US relationship could be the Chinese public boycotting US brands, Beijing targeting specific items over alleged trade breaches and Washington, exploiting US dominance of the world's finance system, expanding financial sanctions on the Chinese – but these rips are unlikely to get too large.

Western companies were shifting production from China because Chinese labour costs have risen and concerns about climate change, tech advancements and other shocks to global trade could have hastened that trend anyway. Let's not mythologise globalisation pre-2020; there were many impediments to the free flow of things.

Even allowing for the barbs between Beijing and Washington, flashpoints over key technologies and the production of essentials shifting from China, it might be hard for most westerners to notice the difference in daily life of any China-US decoupling.

Michael Collins is an Investment Specialist at [Magellan Asset Management](), a sponsor of Firstlinks. This article is for general information purposes only, not investment advice. For the full version of this article and to view sources, go to: https://www.magellangroup.com.au/insights/.

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Red pill or blue pill: Navigating the matrix of fixed income

Mark Mitchell

In the film *The Matrix,* the hero of the story, Neo, has been unwittingly living in a dreamworld his entire life. He is eventually given the opportunity to free himself by taking either a red pill, which will allow him to learn the truth, or a blue pill, which will allow him to stay in his current, computer-simulated reality. As we all know, Neo chooses the red pill and must face the harsh reality of the world.

Past strategies unlikely to work in future

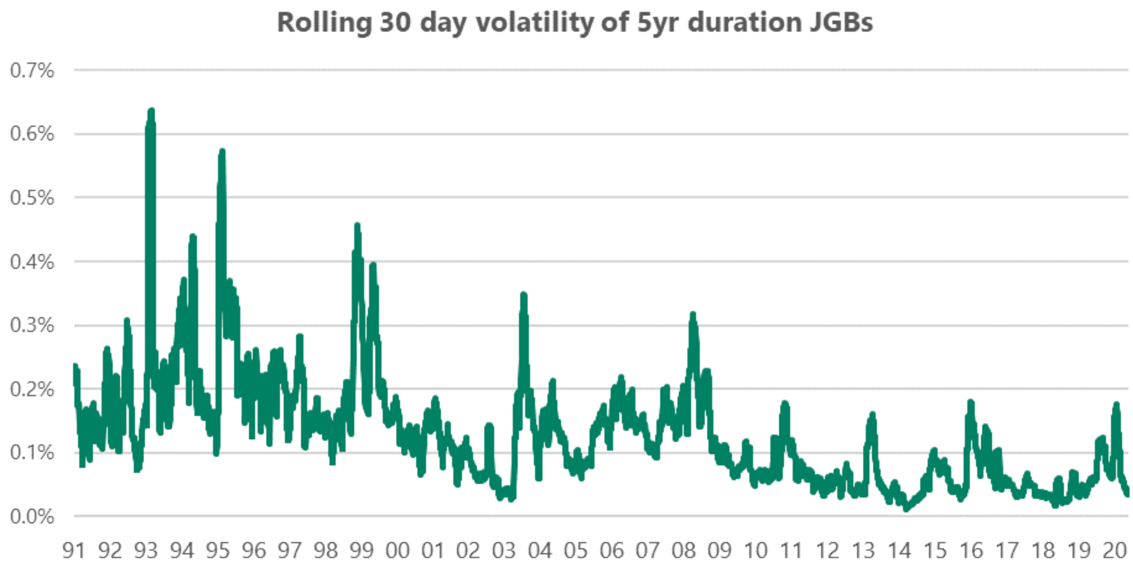
This is a fitting analogy to the world of fixed income investing. Fixed income investors have been living in a certain world for a long time, but that reality has now changed and investors are facing a tough decision: continue as usual or accept the new normal and learn to navigate a changed landscape.

Investors in fixed income products generally fall into two categories. The first group are those that invest in the products because they want some level of income, modest capital return and capital protection. There are a range of products to choose from to target specific objectives and risk tolerance.

The second group are those that buy fixed income products because they believe these assets will perform well when there are corrections in their risk assets (mainly listed equities), helping to reduce their overall portfolio volatility. This second approach has worked reasonably well for the last 20 years or so, but we believe it is highly unlikely to work as well over the next decade or longer.

Understanding volatility and duration

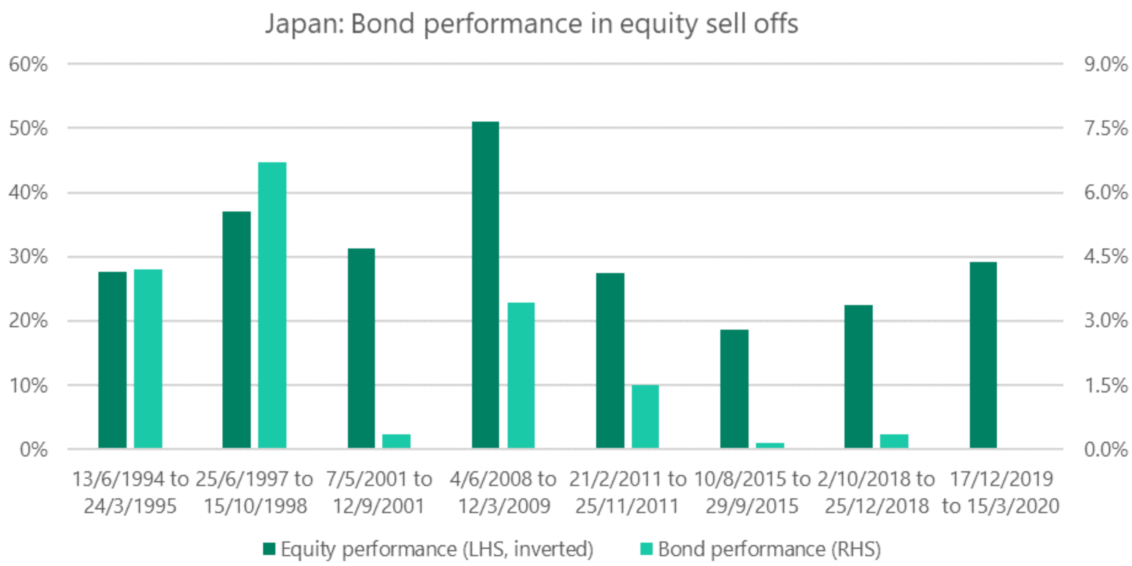
The chart below looks at the volatility of the Japanese Government Bond (JGB) market. Volatility has been steadily declining as the absolute level of yields has remained low and the local central bank has continued to increase its ownership of the market. We believe the US and many developed markets will increasingly look like this over time.



Source: Bloomberg

The following chart shows eight significant corrections in the Japanese equity market over the past 25 years. We have roughly divided them into periods of higher interest rate volatility (pre-2010) and lower interest rate volatility (post-2010).

The chart shows in a low volatility world the effectiveness of interest duration to hedge out equity volatility is substantially reduced. In the higher interest rate volatility environment, bonds on average rallied 3.7% when equities sold off 37%, but in the lower rate and volatility periods yields rallied on average only 0.5% while equities sold off 24%.

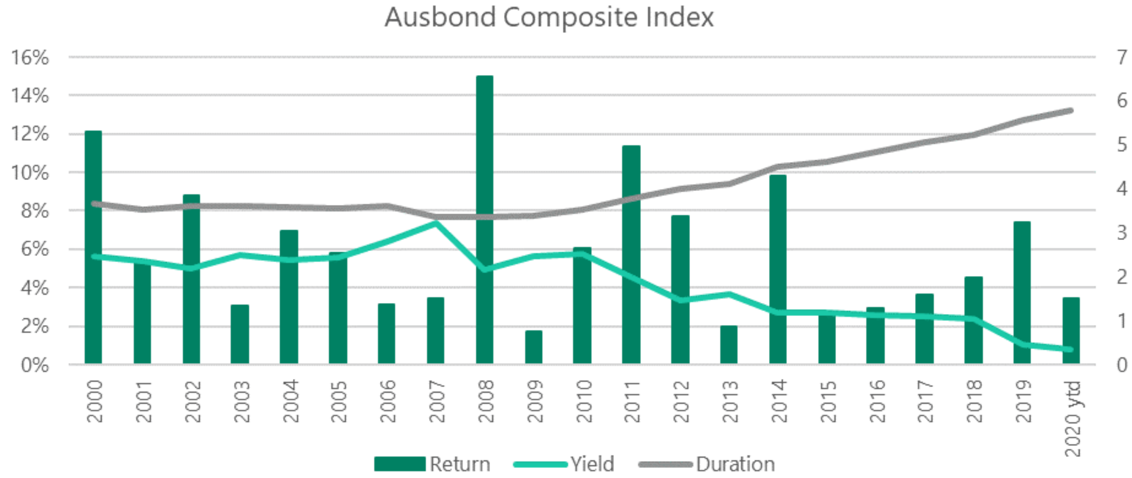


Source: Bloomberg

The problem with most places outside Japan is the future is not going to look like the past. We have moved into an environment of exceptionally low government bond yields and in many cases negative interest rates. Unfortunately, the new reality is likely to be with us for a long time to come.

We believe government bond yields have reached, or are close to reaching, a lower bound and it is will be difficult for individual long duration government bonds or funds to generate returns like they have in the past.

The chart below is a good depiction of the challenges faced by people investing in these products:



Source: Bloomberg

This chart looks at the return, yield, and duration of the Ausbond Composite Index, which is the reference index/benchmark for most long duration fixed income products in Australia. There are three observations to make.

First, the average yield on the index has dropped from around 6% in 2010 to around 0.8% today.

Second, the average duration (or interest rate risk) in the index has increased from 3.5 years to around 6.0 years today, a 71% jump.

Third, the drop in yields led to many years of reasonable performance with the index averaging 5.3% p.a. over the last 10 years. However, the only way that can continue is if bond yields drop another 5-6%, in other words, if they drop to below negative 5%.

For investors in funds that mirror long duration indices (regardless of whether the strategy is active or passive) with the intention of hedging out equity risk, the conclusions are pretty obvious: future expected returns will be much lower and there is a lot less protection against an equity correction at a much greater cost. This makes long duration bonds, such as government bonds, a much less attractive proposition.

Source: Bloomberg

The above chart looks at the volatility of interest rate markets. Volatility is at historic lows and given the unprecedented volume of purchases being undertaken by the world's central banks, we expect this to continue. To make money from trading requires volatility.

The simple 60/40 is facing extinction

The harsh reality of our new investment world is everyone will have to re-examine the tools and strategies they are using to try to hedge out the riskier assets in their portfolios. The idea of running a simple 60/40 portfolio and 'set and forget' is facing extinction.

So, the logical question is what can we do to hedge out equity risk?

Investors still want the higher returns equities tend to provide over time but would also like to reduce the risk associated with the allocation. There are several options investors can consider in this environment.

One compelling approach is to significantly reduce allocations to long duration government bond fund strategies and reallocate a portion of those funds into a low duration, investment grade credit fund.

A portion of the additional income earned by that switch could then be spent on a much more targeted hedging strategy to help protect equity exposure. A basic actively managed, short duration Australian credit fund can readily earn 1-1.5% more than the Ausbond Composite Index, without relying on yields moving lower to generate additional returns. This approach allows investors to use their fixed income allocation in a much more effective way than sitting in simple long duration government bonds.

Other approaches are much less straightforward and more costly. These may include:

- a more dynamic asset allocation and trying to time the market
- investing in 'safe haven' assets, such as gold, and Swiss Francs which tend to perform during an equity sell-off
- employing an option strategy, or
- holding a short equity position in your portfolio.

Fortunately, none of us live in *The Matrix* (at least I don't think we do) so our choices are not as dire as Neo's but we clearly need to change the way we look at the reality of the new investment landscape.

Some data suggests that about 40-50% of the money invested in fixed income products in Australia is invested in traditional longer duration funds (both active and passive). These investors might want to re-evaluate if these types of products still make sense for them in this new low-rate, low-volatility world. Hopefully, the red pill is not too bitter to swallow.

Mark Mitchell is a Director at Daintree Capital. Please note that these are the views of the writer and not necessarily the views of Daintree. This article is for general information and does not take into account your investment objectives, particular needs or financial situation.