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Editorial

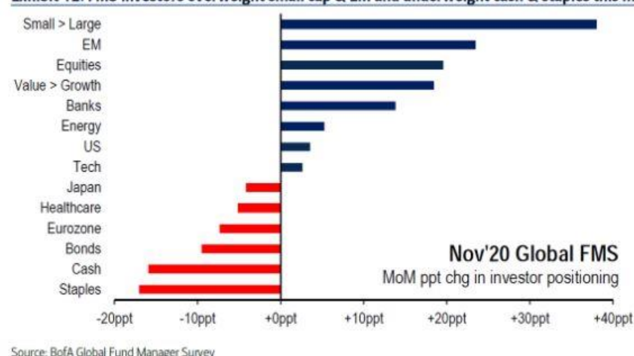
We are publishing a day later than usual this week. I moved my home for the first time in 31 years and it was a once-in-a-lifetime opportunity to rationalise everything from books to documents to furniture, much of which we would have kept until death do us part without the move. It also forced a journey down memory lane in the house where we brought up a family, and the exit consumed far more emotional energy than I expected. Oh, the stuff you accumulate when you have the space.

It also made me feel great sympathy for those people who are unwillingly forced to move accommodation regularly, such as renters subject to the short lease conditions in Australia. We had months to plan our move, but regularly relocating lives and schools at a month's notice must be draining. It's another dimension to the value of owning your own home which does not feature in the debate on early access to superannuation.

Most people read our articles but probably then don't go back to check the comments. Last week, our pieces on the **Retirement Income Review** drew over 50 comments showing the strong feelings on the Review's conclusions. This week, **Jon Kalkman** continues our study of the Final Report by asking whether the panel members really understand the consequences of their findings for retirees who aspire to more than the age pension.

Our feature article is investing guidance from **Hamish Douglass** from the sidelines of the recent Morningstar Individual Investor Conference, with three short videos and transcripts with **Lex Hall**. It's a fascinating time for investing with great optimism around vaccines, a clear Biden win, signs of strong growth in Australia and the question of whether 2021 will reward different styles than during the pandemic.

The latest **Bank of America** Global Fund Manager Survey (FMS) suggests professionals are positioning for change. As the chart below shows, the big moves over the first half of November 2020 were into small caps over large caps, into emerging markets, more value than growth and less defensive in cash, bonds and staples. Energy was back in favour. These moves are counter to the best positioning in 2020. The FMS growth outlook is strong, with managers rotating into previously hard-hit companies and sectors.



Also this week, we dive into the new numbers on the cost of running an SMSF versus fees on retail or

industry funds. Turns out the break even is around $250,000 based on administration costs rather than investments.

Still on SMSFs, **David Macri** suggests that while trustees might handle their own cash and domestic equities, there are particular types of investments worth leaving to the professionals for a better outcome.

Building on this theme, the White Paper this week from **BetaShares** shows three global tactical trades that can be executed using ETFs listed in Australia.

When we hear an investing term such as 'growth' or 'momentum' or 'quality', it's tempting to put all funds into one bucket and assume they will perfrom in a similar way. **Zunjar Sanzgiri** takes a look at a popular segment of the Exchange Traded Fund (ETF) market and shows how funds with the same name differ markedly.

Then **Aaron Minney** makes a great point about retirement planning, showing why using average life expectancy produces misleading outcomes. All retirees and their financial planners need to consider this piece.

Finally, **David Walsh** delves deeper into the numbers which are supposed to show that local and global markets are seeing a big wave of Zombie companies propped up by supportive government policies.

Finally, with Australian states reluctantly opening their borders as community-based transmission is negligible, no such caution for Thanksgiving Day last week in the United States. **Flightradar24** monitors jet movements, and millions of Americans honoured the tradition of celebrating the harvest. While Australia can afford to take its time watching the encouraging test results, the vaccine cannot come too quickly in a country with 280,000 deaths and 14 million cases.

Hamish Douglass on big tech and life after COVID

Lex Hall

Hamish Douglass: 'We're lucky this pandemic hit when it did'

Lex Hall: We're on the sidelines of the Morningstar Individual Investor Conference. And you mentioned in your presentation that kind of this year reminds you somewhat of 2000. Can you expand on that a little bit?

Hamish Douglass: Yeah, the comment I was making early on about 2000. Obviously, we've got a market that's been dominated by technology companies, 20 per cent of the S&P 500, which is the main US index, is comprised of five or six companies, that's higher concentration than we had back in 1999-2000. The difference, of course, these companies are earning a lot of money, and they're very proven business models. Way back in 1999-2000 many of the companies weren't earning anything. And many of them had very questionable business models that were unproven. But we do have companies that have been very highly valued in the technology space. So, I wouldn't say those proven business models, but in unproven business models, where the markets putting extraordinary valuations on companies that really may never work out. And that's how caution is, it is one thing about, Alphabet or Alibaba or Microsoft is doing really well, and therefore there's this younger company, let's get on board and its share price’s going up. You know, there is some warning signs out there for us that people are not discriminating very well, between the true winners and the wannabes.

Hall: It seems to me that, you know, the pace of change in technology has just been so rapid, I mean I remember when I got my first iPhone, and now it's ubiquitous, and the change that has occurred in that period, is staggering. The Magellan…

Douglass: Lex, I'd just say we're absolutely right. You know, we're on a webinar, we're on a Zoom link at the moment. [If] we went back five years ago, how would have this world coped from a business perspective? Even five years ago in terms of bandwidth and everything else to carry on our lives. So, you're right, the rate of change … we're very lucky, this pandemic hit when it did. Five years earlier, the damage to the world because of the loss of total productivity of service industries would have been extraordinarily large.

Hall: Hamish, you've just I mean, all that you're saying just sort of brings up so many questions. And what you've just said then makes me think of "COVID-20". Will we approach it differently? Will we say, 'hey, we're not going through that again? We'll do it differently this time'?

Douglass: Yeah, it's a very good question. Yeah, as bad as COVID is, we're very lucky that the mortality rate is actually pretty low. If we had an airborne virus that had a mortality rate like MERS had, it would have been truly frightening. And frankly, you couldn't have let anybody out of house, you know, we would have had a total lockdown until we had some way out of it, because the mortality rates of that are up at 50 per cent or 60 per cent instead of point something of 1 per cent. And you asked whether or not we will change, and we'll learn things. I hope so because at some point in human history, we will get a coronavirus that comes from an animal that is both very contagious, most likely by airborne transmission, and deadly. And you know, this is a dry run for something that could be much, much worse. I know it sounds very bad at the moment, but there could be something that literally could be a threat to humanity. And I hope we're going to learn the lessons out of this, and we will find ways of dealing with it much more quickly.

The one thing I'd say both central banks and governments responded actually fairly quickly, well the response hasn't been perfect around the world. I think Australia and New Zealand and Taiwan got a close to perfect responses in terms of managing the health care side of it. Many countries haven't and they've let politics get in the middle of it. If this was more deadly, and we had that going on, it worries me. I hope we will have better sort of PPE reserves and things in the world. I hope we will have very good game plans worked out. Certainly, the fiscal and monetary response came hard and came early and that was very, very worthwhile.

Hamish Douglass and big tech

Lex Hall: Let's talk about while we're on—while we were on tech. You don't own, if I'm not wrong, in the Magellan Global Fund, you don't own all the FANGs, do you? And which ones don't you own and why?

Hamish Douglass: No, we don't at the moment; we don't own Apple at the moment, but we only sold that recently. And that was purely on valuation grounds. We actually, you know, we like to be very disciplined at Magellan; we think it had gone ahead of our view of value, it's a wonderful company. You know, we bought it at less than $100 a share, when it was out of favour; we made a lot of money, and it just got beyond our valuation. Rightly or wrongly, we haven't owned Amazon ever. It is one of the best businesses in the world: the AWS business, their cloud business is extraordinary. Their ecommerce business is deepening their economic moat and competitive advantages, but really it was the valuation; we struggled to actually understand the valuation of the business. It wasn't about the business or the business quality, but unless we have a very firm view around there's a margin of safety in the values there, we won't buy notwithstanding we actually would probably put it in the top five businesses in the world.

And I would say it's not just FANG; you have to add the Chinese. We own the two big Chinese companies; we own Facebook and Alphabet, which owns Google. Not normally put in the FANG is Microsoft and it should be in the FANG, you know, it's depending on Apple's share price on the day, it's the second largest company in the world now. You know, it's $130 odd a share and we bought it at $22 a share when it was deeply out of favour, maybe it was $24, between $22 and $24, back in 2014. And there's one other where we may have bought that we will disclose, but we're very disciplined in price.

These companies are extraordinary, they have very powerful what's known as network effect, you know, they tend in almost winner takes all, not Amazon, but most of the others are almost winner takes all markets because of the power of network effect operating here. Of course, that's going to attract regulators, they are attacking very, very large global markets, and because they are digital goods effectively, you can attack markets globally with this. They are massively disruptive, like the entire advertising markets moving from sort

of all television stations, and all newspapers and all sorts of other forms of radio advertising, which we just to a few players in the world, which is extraordinary, and very, very large shares. You know, these big cloud platforms, there may be four hyperscale players in the world. We're going to move all the computing power of the world, and there's going to be so much more data in the world and so much more software. You know, software's going to eat the world as we start digitalising everything and all this is going to be hosted on maybe four companies' platforms in the future, on a global basis.

Hall: Perhaps that's a good time to mention regulation, does that spook you at all?

Douglass: No, we expect regulation. Wherever you get a company, which has very high market share in an important industry, you have to expect regulators will come in and look "are consumers being protected?", and what's the—are they shutting out competition from competitors in that?" So, it is logical for the regulators to come in. First of all, I would say is, you know, the seven or eight sort of technology companies we own, most of them are facing either limited or very different technology risks. You know, we own Visa and Mastercard, they've been regulated in the past, they're facing some disruption risk from things like open banking and real-time payments in their debit franchises, in the long term. It's kind of not regulated; the regulators are changing the rules to open up the system. Microsoft really isn't facing much regulatory risk; the Chinese companies are deemed as national champions in the payment space yes there's some regulatory risk, but in the ecommerce space there is very limited regulatory risk there, they don't have the same privacy risks.

And then you really come down to sort of Alphabet and Facebook. If we owned Apple and Amazon, they're the four that are really getting caught up with the regulators. We own two of the four, you know, combine they may be 12 per cent of our portfolio or so and they have different risks. We understand the risks. We spend a lot of time speaking to people in Europe and in Washington, including, you know, former chairs of the Federal Trade Commission were the ones who have been investigating Facebook. We spend a lot of time with the Department of Justice in trying to understand the break-up risk in there and the other issues going on with Alphabet. We speak to politicians in the United States and elsewhere and it's a very, very public debate that's happening. So, we're unlikely—we will get regulation, but we're unlikely to get surprises of what the boundaries of that regulation could be. And then we look at the price compared to what we think the realistic regulatory intervention is going to be and the cost of that on the business.

Hamish Douglass: Winners and losers in the covid era

Lex Hall: What sort of opportunities—we were talking about big companies—what are you seeing in smaller companies?

Hamish Douglass: Well, we tend to invest in big companies. So, we're managing nearly $100 billion. We don't tend to get in to small investments. We like investments with competitive advantages, as well, maybe different opportunities. Obviously, tech's been an area that's been very constructive. We've got quite a lot of consumer staples, more people are eating at home, Nestle's results and PepsiCo's results have been fabulous. People have been washing their hands more; we own Reckitt Benckiser and their sales have been sort of 13% per annum through this period. So, there are certainly winners that are occurring here, both in technology and in sort of consumption businesses. We've got benefits from lower interest rates happening here.

But there are losers, in the real estate world we don't own, but you know, do you want to own shopping centers in this world? There's been an acceleration to ecommerce. And we don't think that acceleration is going to go away. So, it's going to challenge what you can charge in rents in physical retail, because physical retailing is less valuable in the future. What is all this work from home and these flexibilities going to mean to office buildings? That we do not know the answer of.

Travel, travel is something we're spending a lot of work on, we haven't invested there. But there are a lot of travel-related stocks, that of people moving around the world, it could be payments, it could be airlines, it could be aircraft manufacturers, it could be online travel companies, software companies in this space. There is a broad spectrum of companies that are very, very leveraged to travel. American Express would be a good business. You look their volumes are down 20 per cent, largely because people are not travelling. And when people start travelling again, their earnings should come back very, very rapidly. But there is a question in

large business: how much of large business are going to stop their employees travelling in the future because of Zooming, doing it on video conference? That we don't know the answer to. But that is a very interesting area, particularly as we're going through a second wave of pandemic, these stocks are under pressure. And if you take a longer-term view, that could be an interesting area that isn't being valued by the market at the moment, I'm not giving any specific stock advice. And we haven't made any investments because we don't know all the answers yet.

So, you know, there's a lot of different things going on market. Some things are cheap, and they deserve to be (treated), just because some share price has gone down. Some of it may be telling you something; and there are other things that have gone down just because of uncertainty and they may be good places to invest and others that have gone up. People may go 'they're expensive, I'm not going to buy them', it could be that their businesses are accelerating because of what's going on, and they're not overvalued. So just looking at the share price doesn't tell you whether it's a good buy or not.

Hall: How long Hamish would you suggest people stay in the Magellan Global Fund to get the value add at a minimum?

Douglass: Well, we really talk about an economic cycle being seven years, you know, we really think that people should have a longer-term perspective, sort of that five- to seven-year period would be our view of the economic cycle. And I wouldn't say just in relation to Magellan, I would say almost any equity investment people should be taking a five to seven-year view. And if you're taking a five to seven view, largely what's occurring now in this pandemic and what's happening in the US election are largely irrelevant issues.

Lex Hall is Content Editor for Morningstar Australia. This article is general information and does not consider the circumstances of any investor.

Full reports and a free trial with instant access are available on Morningstar Premium at this link, including the portfolio management service, Sharesight. Premium includes Morningstar research on hundreds of stocks, both Australian and global. Firstlinks is a Morningstar company.

Cost of running an SMSF receives updated judgement

Graham Hand

When the superannuation system was designed for compulsory contributions starting in 1992, nobody expected SMSFs to become so popular. Over 1.1 million Australians hold $735 billion in their own funds, as shown below, running equal with the other success story, the industry funds, both well ahead of the laggards, the retail funds. An entire industry has sprung up to service the needs of trustees and members.

Former Prime Minister, Paul Keating, wrote in Firstlinks (then Cuffelinks) in 2013:

"I never expected Self Managed Super Funds (SMSFs) to become the largest segment of super. They were almost an afterthought added to the legislation as a replacement for defined benefit schemes."

Type of fund	Total assets ($billion)	No. of funds	No. of accts (June 19)
Corporate	57	18	0.3 million
Industry	748	35	11.3 million
Public sector	670	37	3.6 million
Retail	591	105	11.1 million
Funds with less than 5 members	735	594,992	1.1 million
Balance of statutory funds	63		
Total	**2,864**		**27.5 million**

Source: APRA Statistics – June quarter 2020 and APRA annual statistics for no. of accounts

As superannuation balances increased over the years, and especially as members headed into retirement, it became common to switch from a large institutional fund into an SMSF, much to the chagrin of the industry and retail funds as they lost clients at the point where they were the most valuable.

The SMSF move was encouraged by thousands of financial advisers and accountants who could see a steady stream of work from advising on structure and maintaining financial accounts. Over the years, specialist administrators improved the user experience and reduced the cost of running an SMSF.

It was initially argued by service providers that an SMSF allowed the major benefit of control over investments, but there has always been a debate about cost because it was never clear what components were included.

In October 2019, when ASIC issued Information Sheet 206 to guide professionals providing advice on SMSFs, it shocked the industry by stating that it takes 100 hours and $13,900 a year to run an SMSF. It was based on Productivity Commission work (in a 722-page Report) that included Finding 2.6 which said:

"The SMSF segment has delivered broadly comparable investment performance to the APRA-regulated segment, but many smaller SMSFs (those with balances under $500 000) have delivered materially lower returns on average than larger SMSFs."

This set the bar at $500,000 which was much higher than most service providers had suggested to their clients. Furthermore, ASIC gave this threatening instruction:

"Compliance tip: We are likely to look more closely at advice to establish an SMSF, to consider whether the advice complies with the best interests duty and related obligations, if the starting balance of the SMSF is below $500,000".

That introduced risk for an industry previously satisfied with recommending SMSFs down to around $200,000. SMSF service providers pored over the numbers and found that less than 10% of the stated costs were attributed to administration, with the rest coming from investment management and items such as insurance. But still the debate raged.

What is included in these new numbers?

The starting point in reading any research is to know who is performing it. These latest numbers are co-presented by Rice Warner and the SMSF Association, supported by SuperConcepts, with the aim *"… to educate, inform and assist existing and potential SMSF investors decide if an SMSF is a suitable and effective retirement savings vehicle for them".*

In any comparison of SMSFs with retail or industry funds, it is essential know what is included. SMSF trustees can choose to outsource some or all of the administration and investing, and this makes a major difference in how SMSF costs are judged. Put simply, an SMSF with $1 million paying a fund manager a fee of 1% looks like a $10,000 cost, but that is paying for the investing skills, not the cost of running an SMSF.

As Rice Warner advises:

"Direct investment fees have been excluded from this analysis as they are dependent on the specific asset types chosen by specific SMSFs and cannot be estimated for a generic fund for comparison purposes."

A breakdown of the results

While the data can be cut a million ways, the new research reaches some broad findings that will please the SMSF industry, while admitting it is not possible to say one product is cheaper or better than another for a specific balance.

For example, the table below shows a range of costs for SMSFs of various balances and the colour coding indicates whether the cost is:

- Pink - Above the range of fees for equivalent balances held in industry or retail funds
- Grey - Within the range of fees for equivalent balances held in industry or retail funds (ie between the high and low fee for that account balance.
- Green - below the range of fees for equivalent balances held in industry or retail funds.

Under the two headings, SMSF Compliance Admin represents SMSFs that outsource only their compliance administration to a service provider and SMSF Full Admin outsources all their administration. The table below refers to accumulation accounts.

Like other tables in the report, the broad conclusion is that SMSFs of around $200,000 to $250,000 are cost-competitive with institutional funds, and at higher balances have lower fees.

Range of annual costs ($) accumulation account

Balance	SMSF Compliance Admin			SMSF Full Admin		
	Low	Mid	High	Low	Mid	High
$50,000	$1,189	$1,689	$2,453	$1,514	$2,134	$3,074
$100,000	$1,190	$1,690	$2,454	$1,515	$2,135	$3,075
$150,000	$1,191	$1,691	$2,455	$1,516	$2,136	$3,076
$200,000	$1,193	$1,693	$2,457	$1,518	$2,138	$3,078
$250,000	$1,194	$1,694	$2,458	$1,519	$2,139	$3,079
$300,000	$1,196	$1,696	$2,460	$1,521	$2,141	$3,081
$400,000	$1,199	$1,699	$2,463	$1,524	$2,144	$3,084
$500,000	$1,203	$1,703	$2,467	$1,528	$2,148	$3,088

SMSF Fee above range for Retail and Industry funds
SMSF Fee within range for Retail and Industry funds
SMSF Fee below range for Retail and Industry funds

Why such a difference versus the $500,000 ASIC and the Productivity Commission findings? Looking under the hood shows the Rice Warner numbers exclude financial advice, investment management and insurance, whereas ASIC captured these.

Rice Warner summarises as follows:

"SMSFs with balances of $200,000 or more provide equivalent value to industry and retail funds at all levels of administration. SMSFs with balances of $500,000 or more are generally the cheapest alternative. The majority of SMSFs with low balances either grow to competitive size or are closed."

If an SMSF has a simple range of investments, especially where trustees make their own decisions, it can be justified at around $200,000. Administration costs can rise for complexity, especially owning property in an SMSF, but fees are highly competitive from a wide range of service providers.

Importance of investment costs

When an industry or retail fund charges 0.75% on a balanced superannuation fund, a common price point, it includes all aspects of managing the superannuation, including investing and reporting. When an SMSF costs $3,000 to administer a $1 million fund, it is not comparable to say that is cheaper because that is only 0.3%.

The SMSF could invest in cash or term deposits for nil 'cost', or in Exchange-Traded Funds for less than 0.1%, or buy a residential property with higher costs. These are investment decisions made by the trustee independent of the 'SMSF cost' argument. The SMSF is the vehicle that facilitates it.

In commenting on the study, sponsor SuperConcepts said:

"On closer examination, SMSFs may be even more affordable than other institutional options because they can avoid significant investment management charges if necessary ... few SMSFs use structured products like managed funds, we know it is only about 20% of the money that is in the SMSF space is in those sort of products."

The ultimate answer to the question of whether the cost of an SMSF can be justified versus a retail or industry fund depends on the investment intentions of the SMSF's trustees and the amount involved. SMSFs are more suitable for large balances and active investor engagement while institutional funds provide solutions for smaller balances and less member involvement.

Graham Hand is Managing Editor of Firstlinks. For a copy of the full Rice Warner report, go here. This article is general information and does not consider the circumstances of any person.

Three areas SMSFs should consider outsourcing

David Macri

Just under one-third of SMSF assets (31%) are currently invested in direct shares, according to the 2020 Vanguard/Investment Trends SMSF Report. Direct property accounts for 16% of SMSF assets, while 27% of assets are currently held in cash and cash products.

By comparison, just 19% of SMSF assets are held in managed investments (11% listed, 8% unlisted). The bias towards direct ownership is understandable given the stated desire of SMSF trustees to have more control over their investments.

Here are three areas where it may make sense for SMSFs to outsource to external managers.

1. Global equities

SMSFs are often criticised for being underweight global equities relative to APRA-regulated funds. One often-cited reason is that international equities don't receive the franking credits that are applied to Australian shares, leading to an outsized 'home bias' to domestic equities among SMSFs. While franking credits certainly have value, there are broader diversification benefits to having exposure to share markets outside Australia.

For SMSFs that want to invest in global equities, it makes more sense to use an external manager than purchase shares directly (indeed, there is evidence trustees are already doing this). First, a well-diversified portfolio of international shares can be cumbersome and difficult to manage for an individual investor. Second, it can be tricky to get exposure across all markets. Finally, currency fluctuations need to be considered and managed.

2. Small and microcaps

Small caps have the potential to deliver higher returns to investors but, inevitably, the trade-off is higher risk. So it pays to choose a small cap manager with a proven track record of identifying under-researched and undervalued companies.

For example, the technology sector – including biotechnology or software – requires a nuanced understanding of the intellectual property behind the company. But more important is how the company will monetise the technology and what value the market will ultimately ascribe to it.

Professional managers have the time and resources to research and monitor many of the 2,000 stocks that sit outside the S&P/ASX200. So while it might make sense to go direct for the large cap end of the market, it could reduce headaches for SMSFs if they enlist fund managers to help with small and microcap stocks.

3. Responsible investment

This approach to investing money has performed strongly in recent years, particularly during the volatility of the first half of 2020. However, it is a resource-intensive approach to investment management that can be tricky for DIY investors to replicate.

Responsible investing is referred to by many different names: ethical investing, sustainable investing, Environmental, Social and Governance (ESG) investing – just to name a few.

While each strategy has its own features, most responsible investors are united by their decision to sign the international Principles of Responsible Investment. The principles begin by declaring that professional investors "have a duty to act in the best long-term interests of their beneficiaries".

Furthermore, responsible investors agree that traditionally non-financial issues related to the environment, society and corporate governance can affect the performance of investment portfolios.

SMSFs looking to make a positive impact with their investments as well as achieving strong returns should consider a responsible investment manager. But with the flurry of activity in this sector in recent years it can be hard to identify the right fund for you.

In fact, one of the difficulties for investors when choosing a responsible investment manager is deciphering how they implement non-financial analysis into their process, and how much impact this analysis *actually* has on the portfolio.

Morningstar's ESG Commitment Level

Helpfully, a new white paper from Morningstar has laid out the level of ESG commitment of 40 asset managers and 107 investment strategies. It aims to distinguish funds that "truly focus on sustainable investing" from those that incorporate ESG factors but in a limited way.

Morningstar's new qualitative ESG Commitment Level is entirely separate from the Morningstar Analyst Rating and is designed to be read in conjunction with the existing (quantitative) Morningstar Sustainability Rating.

Many investors, according to the report, "feel confused about the claims they hear and read in sales materials and are unsure about the many different approaches to sustainable investing".

It is pleasing to see Australian Ethical named as one of only six asset managers worldwide – and the only Australian investment manager – to receive the highest ESG Commitment Level of 'leader'. Fund managers in this category have been identified by Morningstar as having a long history of commitment to ESG investing, with these considerations "ingrained and pervasive" across the firms.

When outsourcing is your best bet

Many SMSFs relish the ability to control all their investments. For some asset classes that can make some sense, but when it comes to areas like international equities, small caps and responsible investment it's worthwhile to consider outsourcing to professional fund managers.

David Macri is the Chief Investment Officer of Australian Ethical Investment, a sponsor of Firstlinks. This information is of a general nature and is not intended to provide you with financial advice or take into account your personal objectives, financial situation or needs.

For more articles and papers from Australian Ethical, please click here.

Apparently, retirees should learn to SKI

Jon Kalkman

The Retirement Income Review regards the age pension as the mainstay of our retirement system, so the Final Report offers no incentives to decrease dependence on the age pension by encouraging personal savings. Indeed, it could be argued that with the harsh means tests, saving for retirement is actively discouraged. Greater savings result in the age pension entitlement being reduced or eliminated.

Enjoy a higher living standard in retirement

Retired Australians have a long history of dependence on government support. As at June 2019, 71% of people aged 65 and over received some form of pension payment, and over 60% of these were on the maximum age pension rate. As the age pension is regarded by many as adequate, especially for home owners, there is a reluctance to save without compulsion.

Therefore, the only way to improve retirement incomes generally is either to increase the Superannuation Guarantee (SG) or to encourage retirees to consume more of their own savings. A more efficient use of retirement savings implies that people consume some of the equity in the family home and spend more of their superannuation savings during retirement rather than leaving it as a bequest to their beneficiaries.

The Review notes many retirees die with a substantial part of their retirement savings intact. That seems irrational when they could SKI (spend kids' inheritance) and have a higher standard of living. Encouraging this would also mean a higher standard of living during their working life as well, as more of their income would be available for consumption rather than for retirement saving.

The counterproductive behaviour of conserving capital in retirement is explained in the Final Report in a number of ways:

- Complexity of government systems in age pension, super and age care
- Ignorance of the benefits of the age pension
- Ignorance of the government support provided for health and age care
- Focus on super balances rather than the income produced
- Poor financial literacy
- Poor access to financial advice.

Aspiration is not ending up on the age pension

As they are unable to return to work to rebuild their savings, self-funded retirees face many risks. These include market risk, inflation risk and longevity risk. Age pensioners, however, do not need to manage these risks. In addition, they face minimal costs for health and age care.

If retirees behaved rationally, according to the Review, they would use their assets (super and family home) more effectively to increase their standard of living. As the age pension is seen as the best way of managing those retirement risks, they could plan to end their lives as age pensioners because it provides adequate income and their retirement will be risk-free.

The flaw in this analysis is that while the age pension provides certainty, for many people it means certain poverty. It is a living standard to which not many independent retirees aspire. The reason should be clear. Wealth, and the income it produces, provides more choice in every aspect of life. The age pension may provide a basic retirement income, but it severely limits available choices.

In other countries, retirees have a pension paid for life by their previous employer or the government in defined benefit schemes. They can plan their expenditure in retirement with certainty. They seldom have access to lump sums and need never consider such far-reaching consequences.

In Australia, there is also a group of retirees, apart from age pensioners, who enjoy a risk-free retirement. They receive a guaranteed income for life, but frequently that pension has no residual value. Therefore, it cannot be included in a bequest. This group includes retired politicians and government officials, judicial officers, military and police officers, as well as university academics. The guaranteed retirement income removes almost all retirement risks and there is no impediment to spending.

Perhaps this influenced the members of the Review panel, all of whom belong in the above category, where spending all the available resources must seem obvious.

Holding capital in reserve is a rational choice

For Australian independent retirees, however, the retirement challenge is much more complicated. If they wish to achieve a higher income, they not only need to manage the above risks, but they also need to manage legislative risk. This is the risk that the government changes the rules as concessions are withdrawn or new taxes imposed.

Advisers often use life expectancy figures as a proxy for longevity risk. Life expectancy figures represent the median, not the average. By the time a cohort reaches its life expectancy, 50% of the cohort is still alive! Planning to consume all one’s resources by one’s life expectancy is inherently risky for half of the population! Longevity risk receives little attention because the age pension assumes the role of ultimate safety net.

The Final Report also overlooks fundamental human behaviour. We spend our lives trying to grow our wealth and our income to have greater choice. And yet, the Report suggests that people should voluntarily impoverish themselves as they age. Few people do this willingly unless they seek to qualify for that government funded annuity, the age pension.

It is not avarice driving this behaviour. In order to manage these retirement risks, retirees require an abundance of caution to navigate a retirement of uncertain duration and complexity. Therefore, the rational and prudent thing to do is to hold capital in reserve to meet unexpected liabilities.

The COVID-19 pandemic provides an excellent example of rational behaviour in response to uncertainty. This event generated great uncertainty about future income, particularly as the duration of the lockdown was unknown. The June quarter GDP figures showed a drop of 7%, the largest on record, but 95% of that fall was accounted for by a reduction in consumer spending.

Although there were reduced spending opportunities, most of that is explained by a determination to hoard cash as insurance against an uncertain future. The domestic saving ratio grew from 4% normally, to 20%, again showing that hoarding cash is a rational response to uncertainty. People were given early access to their superannuation savings of up to $20,000. Much of these superannuation savings went straight into bank accounts at a time when banks are paying almost nothing in interest. Indeed, banks report that savings accounts now stand at a record $100 billion. Economists expect this money to be consumed when confidence returns.

Company response was also prudent and rational

Due to the extreme uncertainty, many dividend distributions were withheld. In some cases, extra capital was also raised at low prices thereby diluting shareholdings. The rational response to uncertainty is to hold capital in reserve. For everyone, our confidence in the future determines our willingness to spend resources today.

During the pandemic, the assets and incomes of many businesses and employees were protected with a range of government initiatives, but independent retirees were left to manage this crisis alone. Market values of their assets were smashed by March 2020. The income they had relied on evaporated. Rental income stopped and bank interest rates were lowered. Arguably this was legislative risk writ large.

By contrast, age pensioners and retired government officials were completely unaffected. According to the Governor of the Reserve Bank, retirees just need to "suck it up".

Life as a self-funded retiree

The rational response then, is to self-insure against a very uncertain future. Indeed, a long-term psychological effect we should expect from this pandemic is that future independent retirees will hold even more capital as insurance against unexpected calamities.

Given the risks faced by independent retirees, it is not clear how more financial advice, knowledge of government services or increased financial literacy will change this behaviour. The Report demonstrates limited understanding of the risks faced by independent retirees, or indeed rational human behaviour in response to high risk and uncertainty. Wishful thinking will not change this behaviour.

To give retirees confidence to use more of their resources, we need to reduce risk in retirement so that they can plan with greater certainty.

Jon Kalkman is a former director of the Australian Investors Association. This article is for general information purposes only and does not consider the circumstances of any investor.

7-point checklist for managing the uncertain timing of death

Aaron Minney

It has been said that the only certainties in life are death and taxes. I'll leave it to the accountants to discuss how taxes can be managed, but there is another problem with the uncertainty of death. No-one actually knows when it will happen. The problem with many financial plans is that they implicitly assume a particular age of death as if it is known in advance. There are several problems in this approach.

Average life expectancy is a poor measure

Consider 'Helen' who recently turned 66. Her life expectancy is currently another 24 years to age 90. This doesn't mean that she will live to exactly age 90 or even close to that age. Around two-thirds of females her age will live to somewhere between 81 and approaching 99. In fact, there is only about a 5% chance that Helen's or any particular 66-year-old female's life will end in the year starting on her 90th birthday.

Life expectancy is a case where the average is a very weak predictor of individual (as opposed to group) outcomes.

The Actuaries Institute recently recommended that life expectancy results be shown in a way that includes the range of probable lifespans. So, what everyone should be thinking, and advisers should be saying to 66-year-old females, is vastly different from 'your life expectancy is 90…'

A plan that only lasts up to the average life expectancy will disappoint every second retiree.

Exploring the distribution of actual lifespans

The distribution of actual lifespans can be seen in Figure 1 below, which shows the age of death for older Australians in 2018. The data in the chart are historical (i.e. the peak of the histogram reflects people who were 66 back in 1994) and don't capture the mortality trend for younger retirees but are still indicative. The highest point (at age 90) still represents less than 5% of over-66s, while the weighted average was only 85.

Figure 1: Actual age of death for Australian females aged over 66, 2018

Source: ABS Cat 3302.0

The charts shows how unhelpful life expectancy figures are in predicting an individual lifespan. Predictions of life expectancies bely a broad range of actual outcomes. With at best a 5% success rate, a plan that relies on a certain age at death, even if it is the correct life expectancy, has an almost immaterial chance of success. The projected lifespan will either be too short and leave a retiree to live only on the age pension or it will be too long and leave a lot of unspent wealth.

Another takeaway on the difference between actual lifespans and predicted life expectancies is that the most common age of death (or statistical mode) in 2018 was 90 for females. If the life expectancies being used in financial planning tools aren't at least as high as this, then there is an assumption that life expectancies will go down. This would potentially let down retirees and for advisers, nearly all of their clients.

The potential issues are even larger for an advice practice with say 1,000 retired clients. The distribution of their lifespans would look a lot like the chart above. For smaller shops, with only four of five advisers, the client mix might not match the pattern exactly, but it will still be close. The key point is that many clients will need a plan that extends beyond average life expectancy.

Life expectancy of couples

A significant majority (nearly 70%) of people enter retirement as a couple, and the life expectancy of a couple is actually greater than their individual life expectancies. This is because a couple is a pool of two people, rather than one. This increases the risk that one of them will live longer than their combined individual life expectancies. This needs to be factored into retirement income planning.

Wealthier people live longer

There is a well-known link between wealth and life expectancy. People with more wealth tend to have better health and live longer. Accurium studied the mortality of SMSF trustees. They found that SMSF trustees (aged between 55 and 75 in their study) were materially less likely to die than the rest of the population. This means that their life expectancy is longer than the average population.

Even the average client of a financial adviser is likely to be wealthier, and possibly better educated than the average person. As a result, they will also have a higher life expectancy than average. For an adviser, there is a 'selection bias' in that the people with enough wealth to seek financial advice are likely to be people who live longer than average.

Understanding longevity uncertainty

The uncertainty around life expectancy is significant. Most investors are aware that equity markets can be volatile. What they probably don't realise is that the variation around life expectancy is about the same as 10-

year equity market returns. For a retiree, the uncertainty around how long they will live is as big as the uncertainty around average real Australian equity returns over successive 10-year periods from 1900 to 1910 and so on through to 2010 (based on Morningstar data).

A longevity checklist

There are a lot of issues for the average retiree to understand. For both retirees and advisers, it is important that longevity risks are understood. The following checklist could help in that process:

1. Use up-to-date life tables - currently 2015-17 at aga.gov.au
2. Use an appropriate mortality improvement table – 25-year improvements (explained in 2015-17 life tables) which are the 'most optimistic' and hence safest to use
3. Never use a 'from birth' life expectancy. They are not relevant to retirees
4. Build in a margin of error – 50% of people will live longer than average life expectancies
5. Use a range when thinking about how long you might live
6. Remember the gender differences and plan for them
7. Remember the 'joint lives' issue – the age of the second death is potentially longer than each single life expectancy.

Aaron Minney is Head of Retirement Income Research at Challenger Limited. This article is for general educational purposes and does not consider the specific circumstances of any individual.

'Quality' ETFs under the microscope

Zunjar Sanzgiri

Co-Author | Kongkon Gogoi

Factor investing is an investment approach that involves focusing on certain drivers of returns across asset classes. Globally, it has made inroads into retail and institutional investors' portfolios alike, as a tool to enhance risk-adjusted performance in a relatively low-cost manner. The trend is alive and well in Australia.

Interest in the quality factor has been a recurring theme among the more popular factor ETFs, helped along by some attractive returns.

What is quality?

The quality factor is characterised by stable earnings, robust financial positions measured by leverage, and higher profit margins. However, strategies can interpret and apply the quality factor in different ways. The index provider upon which the ETF is based can define quality in its own way depending on the source of company data and the emphasis placed on each data point. And ultimately portfolio construction methods can vary.

A lack of consensus on a comprehensive quality factor-focused index means that two strategies targeting the same quality factor can derive materially different portfolio attributes. For example, when comparing the **VanEck Vectors MSCI Wld ex Aus Qlty ETF** (ASX:QUAL) with the **BetaShares Global Quality Leaders ETF** (ASX:QLTY), the former has a significant size tilt toward giant-cap companies (61.5% vs 40.0% in the latter). For Australian investors, quality ETFs offer greater sectoral diversification - they typically have higher allocations to technology and healthcare names, and lower allocation to financials and materials.

Market cap | QUAL v QLTY

	VanEck Vectors MSCI Wld ex Aus Qlty ETF	BetaShares Global Quality Leaders ETF	MSCI World Ex Australia NR AUD
Giant	60.63	40.08	47.40
Large	27.99	42.25	35.89
Mid	11.11	17.67	16.38
Small	0.13	0.00	0.30
Micro	0.00	0.00	0.00
Average market cap	*197.94 Bil*	*93.40 Bil*	*89.78 Bil*

Source: Morningstar

Quality factor ETFs in Australia

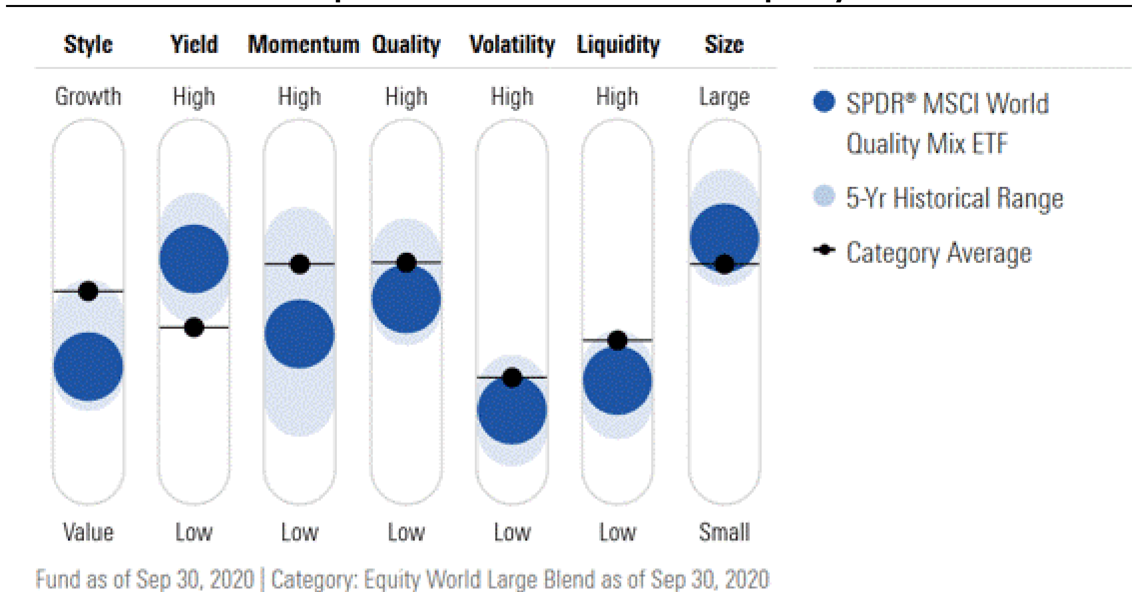
For investors wanting to incorporate quality factors via an ETF as part of their equity portfolio, there are two types of investment avenues:

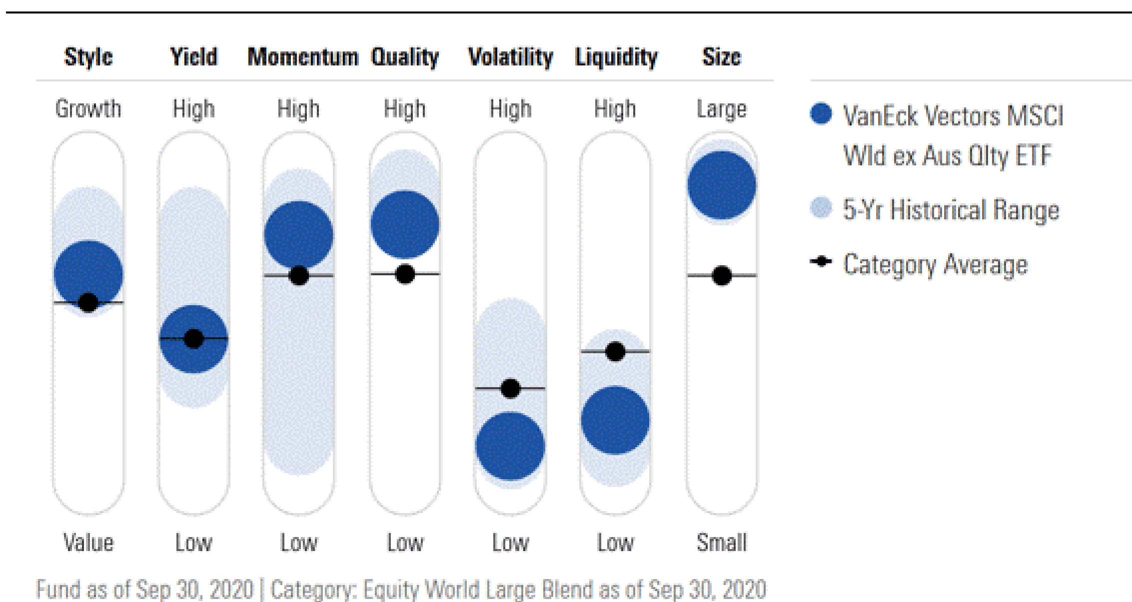
1. Pure-play quality factor strategies
2. Multifactor ETFs

The latter incorporates quality as one of the underlying factors in their portfolio construction. The two approaches can deliver noticeably different portfolio traits.

Morningstar's Factor Profile can be a useful guide for investors in assessing factor-based equity strategies, displaying a strategy's standing across seven investment attributes compared with its category peers and index, and thus helping to understand how different strategies can augment and complement their existing portfolios. Within the Morningstar Factor Profile framework, the Quality attribute is defined as a measure of profitability and leverage. We can see factor profiles of **SPDR MSCI World Quality Mix** (ASX:QMIX) (multifactor) and **VanEck Vectors MSCI Wld ex Aus Qlty ETF** (ASX:QUAL) (pure quality factor) in the Morningstar Factor Profile below.

Factor profiles of a multifactor ETF vs quality ETF



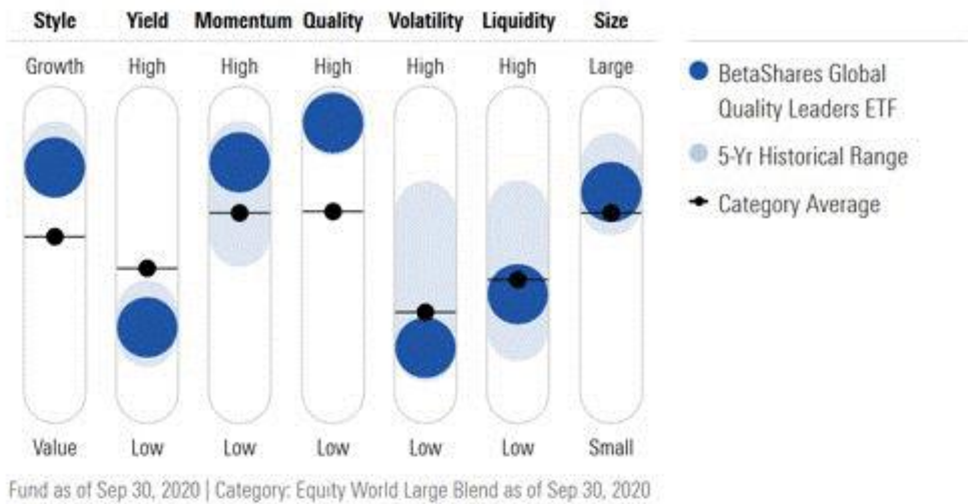


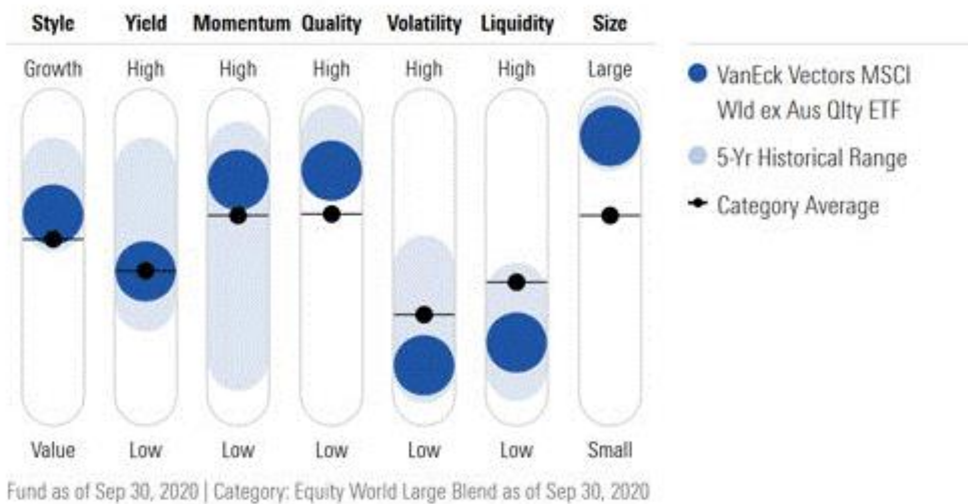
Source: Morningstar Premium

Defining quality

The Quality factor cohort is a small but heterogeneous group, and consequently the return profiles can be markedly different. The idiosyncratic return profiles are attributed to small yet critical divergences in certain portfolio traits that manifest based on the approach taken to define quality in constructing the portfolio.

To illustrate this point, **VanEck Vectors MSCI Wld ex Aus Qlty ETF** (ASX:QUAL) and **BetaShares Global Quality Leaders ETF** (ASX:QLTY) both offer investors the quality factor exposure to global equities, but their distinct approaches can lead to nuanced contrast in the other factor exposures. For their current portfolios this is particularly the case across the size, yield, and growth factors. Other differences can be seen when compared with MSCI World ex Australia Index and the Morningstar category average.





Furthermore, impacting the long-term performance is the sector exposures disparity. **VanEck Vectors MSCI Wld ex Aus Qlty ETF** (ASX:QUAL) allocation to consumer staples is almost twice of the Morningstar category average whereas healthcare is twice of the category average in **BetaShares Global Quality Leaders ETF** (ASX:QLTY).

Sector exposure | QUAL v QLTY

	VanEck Vectors MSCI Wld ex Aus Qlty ETF	BetaShares Global Quality Leaders ETF	Category Average - Equity World Large Blend
Basic Materials	1.67	0.80	5.37
Consumer Cyclical	8.92	7.92	14.36
Financial Services	9.73	8.87	12.67
Real Estate	0.41	1.10	2.04
Communication Services	6.46	8.65	11.33
Energy	0.21	0.00	2.13
Industrials	11.70	14.27	9.23
Technology	28.98	27.63	19.06
Consumer Defensive	13.63	4.64	8.22
Healthcare	18.29	25.93	12.63
Utilities	0.00	0.18	2.97

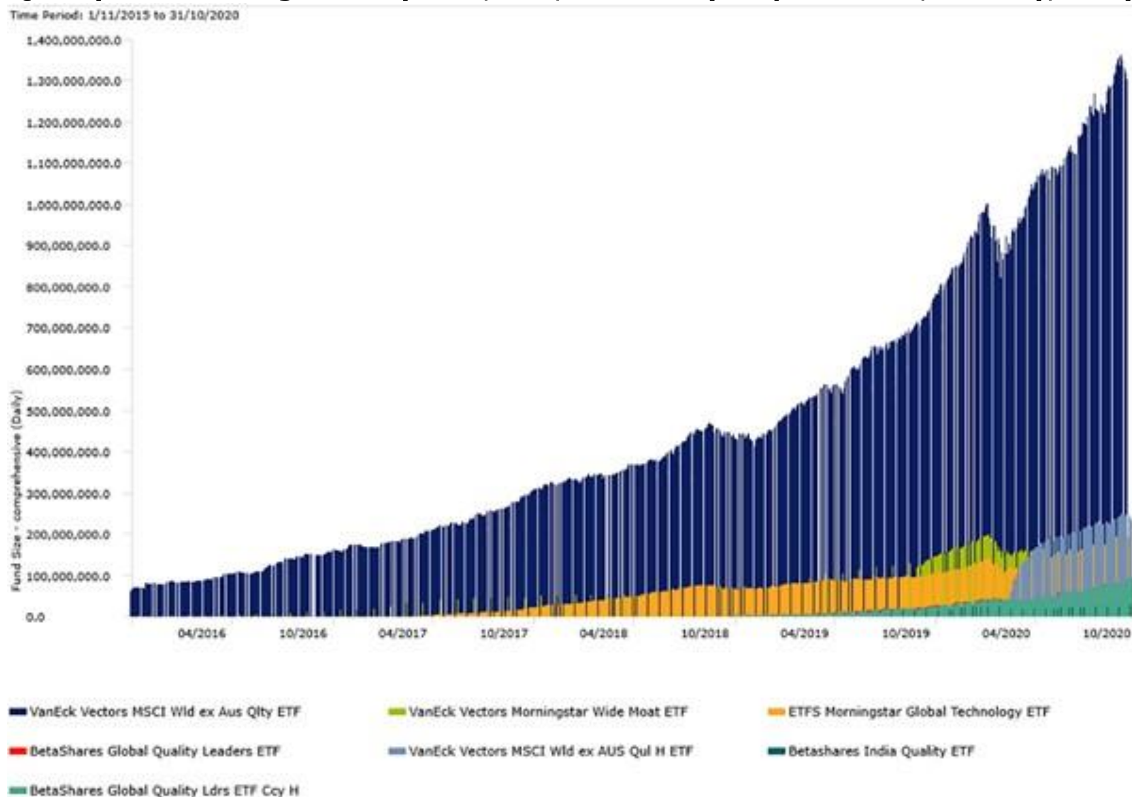
Source: Morningstar, AUD, as of Oct 31, 2020

Flows and outperformance

Based on net cash flow, investor interest in all factor ETFs in Australia has been subtle. However, assets in quality ETFs have grown markedly over the past three years, likely in part driven by strong performance. **VanEck Vectors MSCI Wld ex Aus Qlty ETF** (ASX:QUAL) dwarfs the similar factor funds and has the longest track record in which investors can take confidence.

In the domestic space, a pure-play Australian equity quality product is not yet available, so investors may look to a quality factor ETF via the multifactor approach offered by **iShares Edge MSCI Australia Multifactor ETF** (ASX:AUMF). Other highly niche products available are region-specific, such as China exposure with **VanEck Vectors China New Economy ETF** (ASX:CNEW) (Multifactor) and India exposure with **Betashares India Quality ETF** (ASX:IIND) (Quality).

Quality ETF market growth by fund, 5 Yr, fund size (comprehensive, monthly, AUD)



Source: Morningstar

Quality has been a clear winner in recent years, delivering impressive peer-relative performance across all three periods used for assessment. Specifically, the group's downside capture ratio during the first-quarter 2020 sell-off and upside capture ratio during the third-quarter 2020 recovery has been impressive.

Quality-based strategies have more than demonstrated their efficacy in withstanding the turbulent market conditions if recent times are anything to go by. However, investors should remember that all factors will have phases when they work and when they don't, and a balance across a range of factors will ensure healthy portfolio diversification.

Quality ETFs snapshot

Name	Ticker	Inception Year	Morningstar Category	Total Ret YTD (Qtr-End)	Total Ret 2019	Max Mgmt Fee	Fund Size (Month) 2020-10 ($m)
VanEck Vectors MSCI Wld ex Aus Qlty ETF	QUAL	2014	Equity World Large Blend	8.60	35.78	0.40	1,303.0
VanEck Vectors MSCI Wld ex AUS Qul H ETF	QHAL	2019	Equity World Large Blend	7.38		0.43	233.2
ETFS Morningstar Global Technology ETF	TECH	2017	Equity Global Technology	16.42	38.14	0.45	191.5
VanEck Vectors Morningstar Wide Moat ETF	MOAT	2015	Equity North America	-2.24	35.13	0.49	168.5
BetaShares Global Quality Leaders ETF	QLTY	2018	Equity World Large Blend	10.28	34.52	0.29	93.6
BetaShares Global Quality Ldrs ETF Ccy H	HQLT	2020	Equity World Large Blend			0.03	93.6
BetaShares India Quality ETF	IIND	2019	Equity World Other	-1.52		0.72	27.4
MSCI World Ex Australia NR AUD				*0.04*	*27.97*		
S&P/ASX 200 TR AUD				*-10.82*	*23.40*		

Source: Morningstar

Zunjar Sanzgiri and Kongkon Gogoi are Senior Manager Research Analysts for Morningstar. Additional reporting from Emma Rapaport, Editorial Manager, Morningstar Australia.

Is growth of zombie companies real or fiction?

David Walsh

Contrary to the popular belief that 'zombie companies' are increasing rapidly, the number has been relatively constant over the last decade, suggesting that the risk to portfolios is not as concerning as some might think.

Zombie companies are those that would normally have gone bankrupt or faced restructuring but have been kept alive by sympathetic credit policy and interest rates which are artificially low.

Zombies usually small companies

While some commentators have expressed concern about a rise in such companies in recent years, our recent analysis shows that this phenomenon has been remarkably steady among mid- and large-cap companies, and the descent into zombie territory is mostly confined to a long tail of small players.

In a paper from the Bank of International Settlements, Banerjee and Hoffmann found the percentage of zombie firms has been increasing steadily for many years to what appears to be alarming levels. In our new paper, we set out to test this conclusion with our own, broader data set and to see if this exposed our investments to significant portfolio risk.

We found that the problem was far less of an issue when low-quality 'penny dreadfuls' and other small firms were excluded.

Defining the data set

The Banerjee and Hoffmann dataset was confined to 14 countries and used all listed companies regardless of size, quality or whether they can be easily traded. This created a total of 32,000 that includes even the smallest firms.

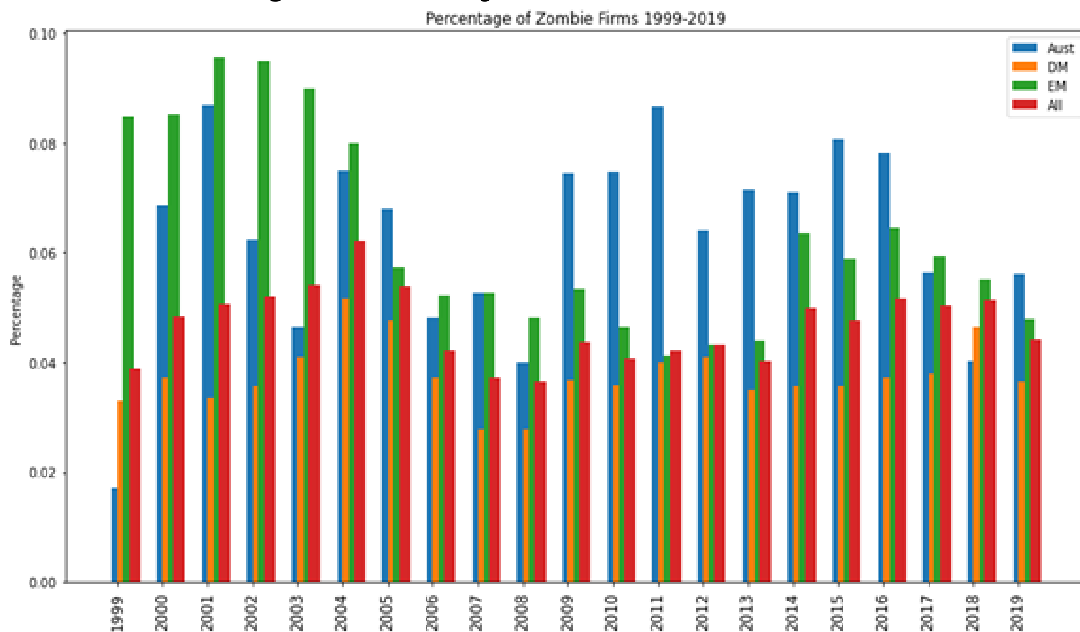
Our data set is broader, covering almost four times as many countries across developed markets (24 countries, 13,000 stocks), emerging markets (29 countries,10,550 stocks) and Australia (1,000 stocks), from 1999 to 2019. However, it does not cover as many names - we concentrate on larger, more investable stocks, with a total of approximately 25,000.

There are many ways to define a zombie firm, but our primary measure is closest to the 'narrow' definition of Banerjee and Hofmann and consists of:

- Three consecutive years of interest cover (IC) less than 1
- 'Tobin's Q', which is a ratio of market value (what the market thinks it's worth) to book value (its value as recorded in the financial statements). We looked at where this was less than sector average
- Firm age greater than three years.

Using this definition and our revised data set, we see that the number of zombie firms has actually been quite consistent over the last decade, as shown in Figure 1.

Figure 1: Percentage of Zombie Firms 1999-2019



Source: Realindex, data as at 31 December 2019

Note the data does not include 2020 and the stresses brought about by COVID-19. However, the definition of three years of consistent underperformance allows for one-off events to interrupt a company's operations.

Overall, these results provide some interesting insights:

- We do not see the increasing trend to zombie firms within developed markets that Banerjee and Hofmann see. The proportion is fairly stable over the last decade at around 4% of the universe in each year.
- Emerging market zombies were a large proportion of the universe in the early 2000s, but that trend has also moderated in the last decade.
- Australian zombies were a large proportion of the universe post GFC, but even that proportion has fallen in recent years.
- On average, Australian firms are more likely to be zombies than the other universes. (Full sample percentages: Australia 6.4%, developed markets 3.6%, emerging markets 6.3%, all stocks 4.6%, US 3.7%, Japan 0.8%). The data suggests this is largely a sector effect. The materials, energy and consumer

staples sectors all have a higher proportion of zombies, and these sectors are well-represented in the Australian market.

Overall, the lack of this previously observed developed market zombie trend is somewhat surprising, but should be comforting to economists and investors alike.

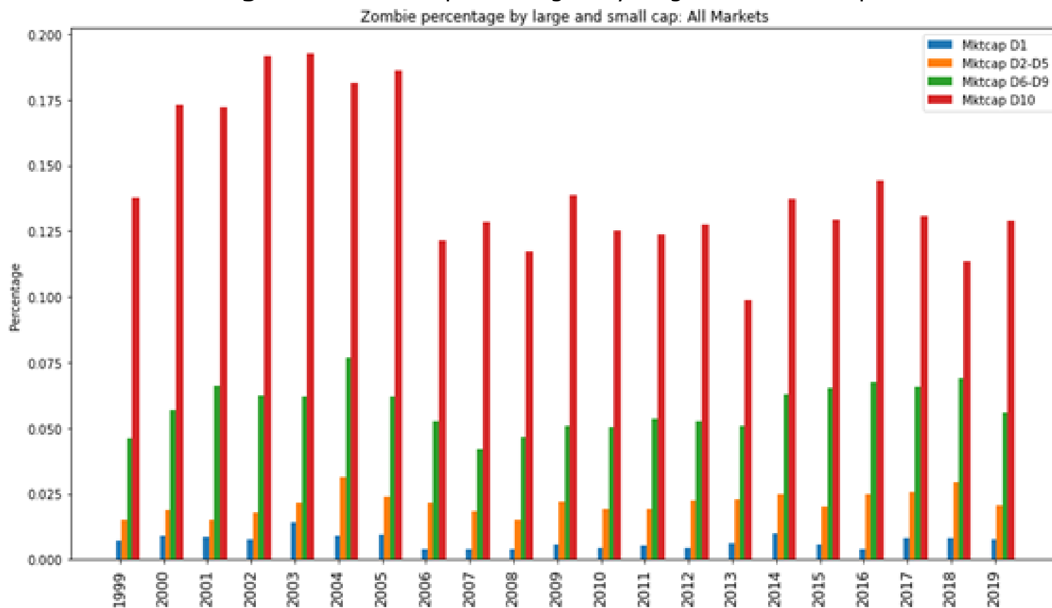
Size matters: smaller firms drive the 'undead' phenomenon

A possible explanation is the different data sets we use. The Realindex data set is across all 24 developed market countries and is probably much more large-cap focused than (for example) Banerjee and Hofmann. This size effect is examined below and this seems to yield a partial explanation for this difference.

To look at this, we divide our developed markets universe up into deciles (10 percent bands) by market cap at each year (as indicated in the Legend), and then calculate the zombie percentage in decile.

Figure 2 shows the results:

Figure 2: Zombie percentages by large and small cap



Source: Realindex, data as at 31 December 2019

Previous research has shown that the zombie firm effect has a significant small-cap bias, which we can also see here. In fact, the results are dominated by small caps. However, the recent *increasing trend* in zombie firms is only seen in the smallest 10% of developed markets stocks, which suggests that this effect is small cap only. The proportion of large cap firms which classify as zombies is small.

This is a useful insight when considering the risks posed to portfolios in a period of cheap, easy credit and generous government support. The key is to look to mid- and large-cap companies to avoid the risks of high debt, poor management and low earnings that combine to keep a company on life-support. Of course, this would be a useful approach in any investment process, regardless of the investment style.

This paper follows an earlier study entitled "COVID and Credit and Zombies" (Realinsights Deep Dive, 10-2020). Here, we use Realindex data to investigate some of the empirical nature of the zombie companies' phenomenon in more detail.

David Walsh is Head of Investments at Realindex Investments, a wholly owned investment management subsidiary of First Sentier Investors, a sponsor of Firstlinks. This article is primarily for information. It discusses ideas that are important to the Realindex investment process and clients but may not be affected in the ways discussed here.

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