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Contents

How the Reserve Bank scuppers retail depositors   Peter Sheahan

Minister Jane Hume on SMSFs and superannuation reform   Senator the Hon. Jane Hume

How decumulation in retirement differs from accumulation   Richard Dinham

Why we see opportunities in consumer-related stocks this year   Kent Williams

Eight steps to expect when seeking financial advice   Tim Fuller

Marks and the tax system explained in beer   Graham Hand

Principles and rules to guide retirement strategies   Geoff Warren

Editorial

The **Reserve Bank of Australia** (RBA) is putting borrowers ahead of depositors despite declining incomes for millions of savers and retirees being a drag on economic growth. The focus is on the cost of debt, even if low rates feed into strong residential property prices and do first-home buyers no favours. In fact, the RBA Board seems relaxed that retirees are taking more risk to generate income. The latest Board minutes say:

"Members also discussed the effect that low interest rates have on financial and macroeconomic stability. They acknowledged the risks inherent in investors searching for yield in a low interest rate environment, including risks linked to higher leverage and asset prices, particularly in the housing market. The Board concluded that there were greater benefits for financial stability from a stronger economy, while acknowledging the importance of closely monitoring risks in asset prices."

How does the RBA '*closely monitor risks in asset prices*'? Bitcoin at US$50,000? Surging home prices? Equity markets at all-time highs during a pandemic? Our quotes on expert warnings are becoming tiresome, but here's another from **Mohamed A. El-Erian**, Chief Economic Adviser to German investment giant **Allianz** in Politico last week:

"We are now living through the greatest disconnect between financial markets and the real economy that we have ever seen. And we now have younger retail investors who have disposable cash, are savvy at social media and have cost-free platforms."

There was also a subtle change in the RBA minutes, moving from the 2020 message of "*the Board is not expecting to increase the cash rate for at least three years*" to the latest wording of "*2024 at the earliest*".

The price of money is only half the problem for investors who want a safe deposit haven. The RBA is pumping so much cash into the system that banks do not need customer deposits.

I sat down last week with someone who has been at the centre of liquidity flows, central bank policies and interest rates for decades. I worked with **Peter Sheahan** at **CBA** about 35 years ago and I asked him to explain the impact of RBA policies on bank funding and retiree savings, and he went even further. He believes central banks have delivered a liquidity nirvana to financial markets that will underpin asset prices for a decade or more.

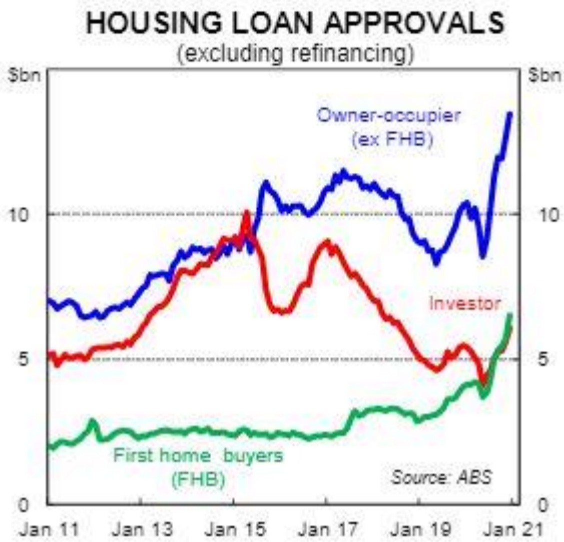
Contrasting opinions make a market. Peter takes the opposite view to those saying the market is too frothy and due a correction. The RBA and other central banks will save us, notwithstanding the recent drift up in bond rates. The Board minutes also announced an extension of the government bond buying programme once the original $100 billion finishes in April 2021 when the RBA will buy another $100 billion of bonds. You be the judge on how long this support can hold up asset prices despite an inflationary threat.

In another note of optimism, **Kent Williams** highlights the pent up spending power of the Australian consumer, and like Peter, draws on the massive increase in bank deposits as proof consumers have plenty of firepower.

With so much money floating around and banks eager to lend, CBA economists came out on Monday with a new prediction for house prices:

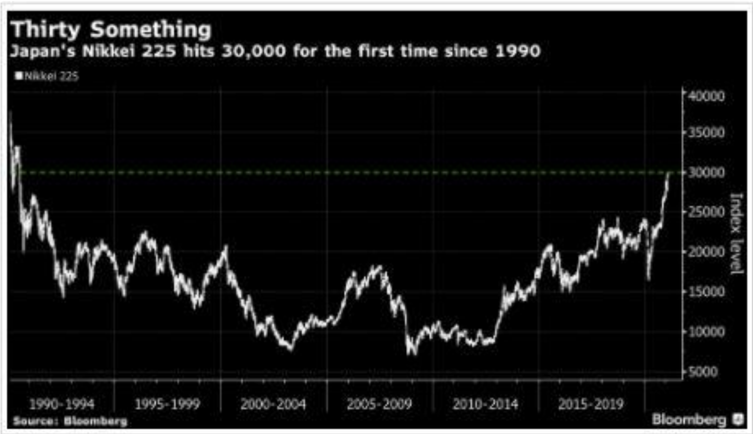
"We expect strong growth in national dwelling prices of ~14% over the next two years (8 capital city basis). A critical assumption underpinning our forecasts is the cash rate remaining at its record low of 0.1%, which is in line with RBA forward guidance ... Our forecast profile is centred on prices growth of 8% in 2021 and 6% in 2022. The risks are skewed towards stronger outcomes given the strength of the demand impulse from the reduction in mortgage rates over 2020."

14% in two years from a group of economists who a year ago were predicting price falls. With the relaxation in the responsible lending laws and borrowers eager for sub-2% rates, little wonder housing loans are growing rapidly.



Anyone saving to buy their first house can blame the RBA for higher prices.

Even the Japanese equity market, where a generation or two of investors are really learning that "*time in the market, not timing the market*" is a guiding principle, has finally returned above 30,000 for the first time since 1990.



Not only were an incredible 90% of IPOs in 2020 in the US made by companies which are not making a profit, but executives and board members within companies do not even believe their own optimistic stories. Insider buying of shares is at its lowest level in a decade, as shown below.

Senator Jane Hume, Minister for Superannuation, Financial Services and the Digital Economy, spoke at the Association of Superannuation Funds of Australia (ASFA) conference last week. She said superannuation is the *"most frustratingly partisan sector of financial services"* and she criticised the industry's reluctance to support a reform agenda. In what may be an election year, it is important for retirement plans and super policy to know what the Minister is thinking, so we reproduce another speech she made this week to the SMSF Association. She gave a strong endorsement of SMSFs and raised the importance of the Retirement Income Covenant. The Treasurer also introduced the **Your Future, Your Super** legislation this week.

Only about 20% of Australians have a financial adviser, yet almost everyone heading for retirement would benefit from professional advice given the super, estate planning and social security opportunities later in life. **Tim Fuller** takes us through the steps to expect in the advice process to encourage a few more people make a call.

Last week's article by **Dr Rodney Brown** created a lively debate about inequity and taxing the rich, and it reminded us of a famous tax example quoted by **Howard Marks** that we published a couple of years ago. To round out the debate, here is Marks again.

Richard Dinham explains why the decumulation stage of retirement, when people start spending money in the absence of a salary, differs from the prior accumulation period, and how retirees can adjust.

Geoff Warren is a leading researcher on retirement and superannuation, and he has provided a summary of his latest work. Technical in parts but it gives insights into how to set a portfolio for minimum income, target income and funding bequests.

This week's Sponsor White Paper from **First Sentier Investors** (a finalist in the **Morningstar** Fund Manager of the year Awards 2021) gives an overview of three key issues due to changes sparked by the pandemic. It includes case studies from investment teams on how they are responding.

How the Reserve Bank scuppers retail depositors

Peter Sheahan

The Reserve Bank of Australia (RBA) and Amazon have a lot in common in 2021. They have both positioned themselves as the premier high volume, low price, low margin product provider. They are redefining logistics in their distribution channels. Their current market position on price competition and sheer scale of influence unleashes factors of productivity improvement and makes it difficult for others to compete on traditional business models.

The message of 'lower for longer' interest rates has been heard loud and clear from a cheerful and optimistic Governor of the RBA, Philip Lowe, including an unrelenting expansion of its balance sheet. Last week alone it grew by another $10 billion to $344 billion. This is $66 billion higher since 30 June 2020 and deposits from Australian banks (in the form of Exchange Settlement balances) have risen by a $94 billion.

The banking system is literally awash with cash and banks are turning away deposits while rapidly reducing the rates paid to savers. A cash flow optimisation strategy by the Government to stimulate activity is the current modus operandi, and it's creating favourable conditions for risk assets.

RBA lavishes the funding

At the start of 2020, before COVID-19 struck, the RBA balance sheet was worth about 9% of Australia's GDP, down from a peak of about 13% during the GFC. Following a year of bond purchases to hold down the three-year rate and fund government expenditure, the balance sheet has doubled to 18% of GDP.

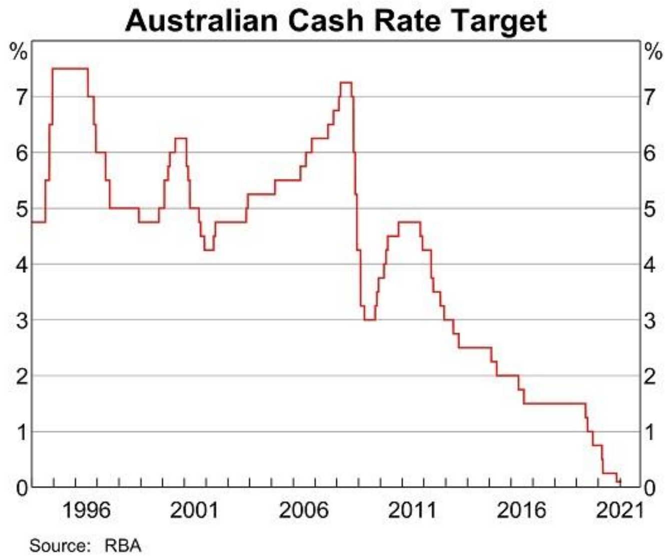
But the RBA's control of the supply and price of funds comes not only from the way it sets targets for low bond rates, but also its Term Funding Facility (TFF). It offers three-year funding to banks (actually, authorised deposit-taking institutions or ADIs) to reduce funding costs which are then passed on to borrowers. It is specifically aimed at ADIs if they expand their lending to businesses, notably small and medium-sized enterprises (SMEs).

The Reserve Bank largesse with loans and liquidity is changing the bank deposit market. The amounts involved are extraordinary, as explained by the RBA, with the funds available being:

"five times the dollar increase in SME Credit Outstanding from the three months ending 31 January 2020 through to the three months ending 30 April 2021"

Five times! And here's why retail deposit rates have fallen. The interest rate for the TFF for three years is only 0.1%.

There is so much liquidity in the banking system that the bank bill rate, the benchmark against which many other facilities and securities are priced including bank term deposits and hybrids, is only 0.01%. That's right … one basis point. Easy monetary policy has reduced the burden for borrowers and is now driving up residential house prices, but it has not helped the millions of savers and retirees who live on deposit income. As recently as a decade ago, term deposits offered a reasonable 4-5%.



An example of a big winner is Judo Bank, which made a pre-tax loss of $50 million in 2020. Judo Bank will draw on $2 billion of the TFF from an allocated allowance of $6 billion. Judo's substantial growth of $1.3 billion in SME lending in the year ending 31 January 2021 has been multiplied by the factor of five and a supporting internal securitisation framework acceptable to the regulators has been reached. Judo is a startup bank but it will not have any funding problems for years.

Reducing Judo's cost of funds will materially improve its profit as it has been competing aggressively for retail deposits, previously its main source of funding. It is currently paying up to 1.2% for retail deposits and attracting strong inflows as deposits up to $250,000 are protected under the Australian Government Guarantee (the Financial Claims Scheme).

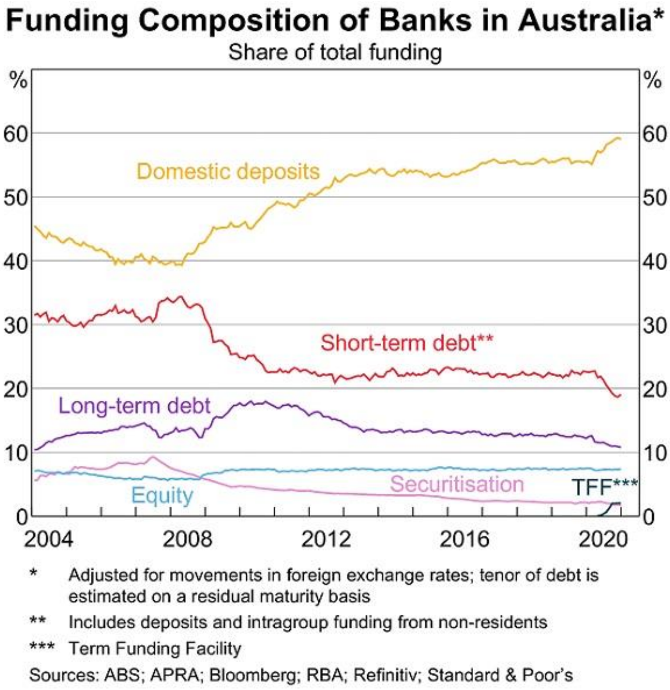
Joseph Healy, CEO of Judo Bank, told [Banking Day] on 3 February 2021:

"Our focus on marketing term deposits of more than 12 months duration will continue but accessing the TFF will reduce our appetite for deposits of shorter duration."

Judo Bank has a real economic advantage now to reduce its cost of funds and recalibrate its wholesale and retail pricing, probably to the disadvantage of current investors. However, actions will be tempered by the desire to build long-term relationships on both sides of the balance sheet to prepare for the day when the RBA is not as benevolent.

Banking system awash with cash

One reason the major banks have not tapped into the TFF in a bigger way is they are flooded with cheap retail deposits. The banks are literally saturated with deposits and are turning away institutional money so they can provide some capacity to their retail customers. As the chart below on bank funding shows, domestic deposits are now satisfying more of the funding needs of Australian banks than ever before.



What do banks do with their surplus cash, since they cannot lend it quickly enough? They deposit with the RBA at 0%. Funds on deposit at the RBA at 0% are $160 billion and rising rapidly, and we estimate they could rise to $360 billion by 1 October 2021. The RBA balance sheet is set to grow from $344 billion to a forecast $500 billion over the same time.

Traditional lenders to banks such as councils are finding it difficult to place their money. Each bank is travelling a slow, last kilometre in heavy congestion to position their middle market and retail pricing at the 'what we can get away with' level. The correct pricing and allocations of quotas to identified 'customers of the future' take up most of the strategic decision-making of bank treasurers and liability management committees at the moment.

Price discouragement strategies are the new playbook.

On the asset side, expect marketing campaigns on credit availability and price to be sweetened with loyalty recognition in many forms. St George's "Switch banks, get a $4k thanks" campaign is the latest one.

Plenty of money to finance asset price surge

Cash investors realise they have no pricing power these days and they are evaluating their alternatives. Watching the billions of dollars of cash looking for a home each day leads to the view that the current debate raging around speculative asset bubbles is far too early in the investment cycle. We are now only emerging from a pessimistic phase and are in the early stages of an optimistic mindset. The euphoric phase is much further into the future.

Those wary of inflated prices should be more worried at the end of Governor Lowe's three-year timeframe. The real economy will be the major beneficiary of all this liquidity and lending capacity over the next few years, until 2024 at least.

The post COVID-19 recovery period could parallel two key economic periods in our past: the 'Roaring Twenties' of a century ago and more recently, the post-WWII recovery period of the 1950s to early 1970s. Financial markets were heavily regulated and the real economy was the powerhouse of the global economy. In the latter stages inflation surged with the oil price shock of 1972 and interest rates violently adjusted to dizzying heights over a span of nearly two decades, but the inflationary consequences of central bank expansion are not on the short-term radar at the moment.

Retirees planning for spending in retirement who once believed the bond or term deposit part of their asset allocation would deliver income to live on now need to go up the risk curve, or draw down their capital. Banks will be awash with liquidity for years and will not compete for the retiree dollar.

Even the new banks who once paid up for deposits now have retirees in a judo hold with the RBA providing another source of cheaper funds. The RBA has become the equivalent of an online retailer who undercuts all other prices in the market.

Peter Sheahan is Director, Interest Rate Markets at Curve Securities Australia, with input from Graham Hand, Managing Editor at Firstlinks. This article is general information and does not consider the circumstances of any person.

Minister Jane Hume on SMSFs and superannuation reform

Senator the Hon. Jane Hume

Senator the Hon Jane Hume
Minister for Superannuation, Financial Services and the Digital Economy

Address to the Self-Managed Super Fund Association Annual Conference

Tuesday, 16 February 2020

Introduction

Thank you, it's terrific to be joining you again. This conference is always a great way to start the year and a welcome opportunity to outline the Government's plans for the self-managed super sector.

But first I want to recognise and acknowledge the Self-Managed Super Fund Association's work — particularly during the COVID-19 pandemic — in representing an integral part of the superannuation ecosystem.

As at September last year, there are more than 591,000 self-managed super funds accounting for $728 billion or around a quarter of funds under management.

As your research shows, the driving force behind these numbers is Australians' desire to be 'masters of their own destiny' to control their own personal retirement incomes. That's something we as a Government wholeheartedly endorse. We **want** more people to take an active interest in their personal finances and retirement savings.

Establishing and running a Self-Managed Super Fund is a significant undertaking. It is also rewarding and provides trustees with greater flexibility and control over their savings.

Self-Managed Super Fund trustees take personal responsibility and maximise their choices to achieve comfortable living standards after life-long efforts and hard work.

I am encouraged to see ASIC's new estimates of the cost for the average user have been refined and are more in line with people's expectations. We also now know that costs of running a Self-Managed Super Fund have **decreased** since 2013. Rice Warner's report found Self-Managed Super Funds with balances as low as $200,000 are now able to be cost competitive with APRA-regulated funds.

I'm pleased to say that developments in technology and the fintech sector have been driving many of these costs down. And they will continue to do so. Fintech solutions lower administration and costs - and in turn - the lower the costs of running a Self-Managed Super Fund becomes, the more people are attracted to the sector and the bigger and more vibrant the sector becomes.

Taking factors such as flexibility and costs into account, all people should have the ability to make choices about what suits them — and our compulsory super system should allow them to be as engaged as they wish.

The Government's role in this is to get the policy settings right. So today I will discuss some recent developments and what's coming up for the Self-Managed Super Fund sector.

Recent reports

The Retirement Income Review, which was released in November, confirmed the importance of superannuation to our retirement system.

It found that the system – based on the three pillars of the Age Pension, compulsory superannuation and voluntary savings (including home ownership) – is delivering adequate retirement incomes for the majority of Australians, and will be viable for generations to come.

The Review found that the current system is effective, sound and broadly sustainable. But it also confirmed there is room for improvement.

One of the key Government policies the Review highlighted was the Retirement Income Covenant.

Having postponed the introduction of the Covenant during the COVID-19 response last year and to allow time for further consultation, the Government is continuing to progress this important reform, and we look forward to working with the Self-Managed Super Fund Association on the Covenant in the near future.

It's imperative that trustees of all funds support their beneficiaries by developing strategies that carefully consider the retirement income needs and preferences of different cohorts of their members.

That is what the Covenant is about. Having a strategy for retirement is as applicable to Self-Managed Super Fund members as it is to members of large funds. Indeed many Australians choose to set up a Self-Managed Super Fund precisely at the point of entering retirement when they have more time to manage their savings.

Of course, trustees don't need to wait for the Covenant to be legislated to take action. There's nothing stopping trustees from developing strategies that meet their members' retirement needs now, and I'd encourage them to do so.

The Covenant is just one of many measures this Government has delivered to directly assist Australians to engage with their super outcomes, maximise their savings, and secure their standards of living into the future.

The Government has legislated to eliminate exit fees and protect superannuation savings from excess charges and costs: such as by making insurance an opt-in for accounts with balances less than $6,000 and for individuals under 25. And, providing choice of fund to all Australian workers - including the right to direct contributions to a Self-Managed Super Fund - via the 'Your Super Your Choice' legislation passed last year.

One announcement you may have missed which is pertinent to many, in December 2020, the Government stated it would be amending the law to ensure retirees who have commuted and restarted certain market-linked pensions, life expectancy pensions and similar products are treated appropriately under the transfer balance cap.

As you may recall, the changes the Government made in 2016 resulted in an unintended outcome that meant individuals who commuted and restarted one of these products may have been inadvertently caught in a perpetual excess transfer balance cap position which could not be resolved.

This measure will enable retirees with these products to make the necessary partial commutation to remove the excess. The Government will also ensure that excess transfer balance tax for retirees in this situation will not apply until after the amending legislation has received Royal Assent.

Your Future, Your Super

Of course the big ticket reforms that will be the feature of the early part of the parliamentary year will be the "**Your Future Your Super**" changes.

It's estimated these important reforms contained in the **Your Future, Your Super** package will benefit members by around $17.9 billion over the next 10 years.

From 1 July this year:

– Accounts will follow employees as they change jobs, thus minimising the creation of those unintended multiple accounts.

– It will be easier for account holders to choose better funds with a new interactive online **YourSuper** comparison tool that will encourage funds to compete harder for members' savings.

– Funds will be accountable for persistent underperformance by requiring MySuper to meet an annual objective performance test. Those that fail will be required to inform members and persistently underperforming products will be prevented from taking on new members. This measure will be extended beyond MySuper products to Trustee Directed Products in 2022.

– And for those of us gathered today, the element of the **Your Future, Your Super** package that is particularly relevant to Self-Managed Super Funds is the best financial interests duty.

Best financial interests duty

Superannuation funds should be held to the highest standards of accountability and transparency and Self-Managed Super Fund trustees are no exception.

To that end, the best interests duty will be amended to the best *financial* interests' duty, to remove any doubt about how super fund trustees should use members' money.

This change will ensure super funds are more accountable for their decisions and prioritise members' financial outcomes.

SMSFs size

You may also recall that last September, the Government re-introduced a Bill to Parliament to increase the maximum number of members in Self-Managed Super Funds and small APRA funds from 4 to 6.

This measure is about increasing choice and flexibility, particularly for larger families who don't currently have the option of including all members of their family in their Self-Managed Super Fund.

As you will all be aware, families with more than 4 members must either create 2 self-managed super funds — incurring extra costs — or place their superannuation savings in an APRA regulated fund.

The Government understands that this is a barrier and is committed to seeing passage through the senate this year. This measure will support families of all sizes using Self-Managed Super Funds as a vehicle for controlling their own superannuation savings and investment strategies.

Closing remarks

As the Retirement Income Review pointed out, it's quite remarkable that a country the size of Australia – the world's 13th biggest economy and only number 52 by population - has the fourth largest stock of superannuation assets in the world.

Those Australian savers– including Self-Managed Super Fund members –collectively own close to $3 trillion in assets.

That's larger than the market capitalisation of the Australian Securities Exchange and larger than Australia's GDP.

Our retirement income system is well placed to deal with economic shocks – as we saw when the COVID-19 economic crisis hit.

For me the early access to super scheme rolled out during Covid-19 also demonstrated a strong and welcome indication that Australians are becoming more engaged with their superannuation and retirement planning.

We have a system we can be proud of but it's not perfect.

In the year ahead, the Government will continue to take a practical, common sense approach to policy with the best outcomes for super fund **members** front of mind at all times.

I'm honoured the Prime Minister has appointed me as Minister with responsibility for superannuation, financial services, and the digital economy. Each of these areas is critical to the future of our economy, especially as we continue to manage the COVID-19 pandemic. Our work continues, as does yours.

And I look forward to working with the Self-Managed Super Fund Association.

Transcript provided by the SMSF Association.

How decumulation in retirement differs from accumulation

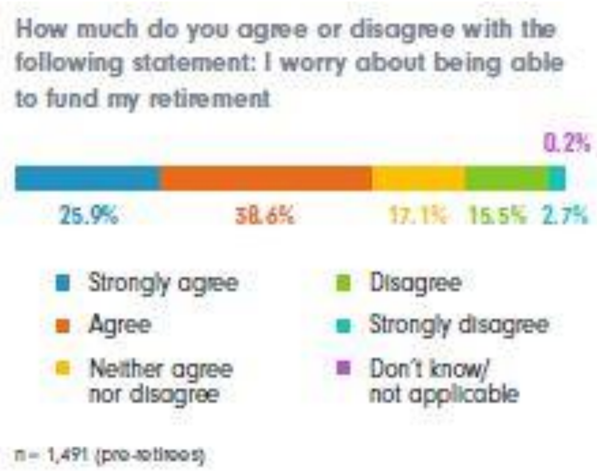
Richard Dinham

When it comes to retirement, people often experience a range of emotional and psychological fears. On top of this, once they have entered retirement, it becomes apparent that their financial and investment needs have changed.

Retirees view the world differently from when they were in the workforce and one of the single largest changes is how they observe and respond to risk. This is a key consideration when investors are shift from the accumulation to decumulation phase of their investment strategies.

Accumulation versus decumulation

Accumulation refers to strategies used by investors to accumulate, or build up, assets to save and invest efficiently over the long term. On the other hand, decumulation refers to retirees drawing down their assets and investments to generate an income and, ultimately, maintain their quality of life in retirement. Decumulation can also be described as the process of investors converting their retirement savings to retirement income.



Accumulation is an almost universal objective for all savers where they are looking to maximise the return on their savings over the period until their retirement. In our recent survey 'Building better retirement futures', the majority of pre-retirees worry about funding their retirement, and the risk/return decision is an important trade off.

But objectives in decumulation can be much less uniform with individuals having a wide variety of objectives depending on their circumstances and aspirations. It requires a strategic view on factors such as income sources, health care costs, tax, whether to dip into home equity and the like.

In accumulation mode, investors are better able to cope with risk because when markets fall, subsequent contributions are invested at cheaper valuations and become more valuable as markets recover over time. This saving pattern is known as dollar-cost averaging and works in favour of investors saving for retirement.

In contrast, dollar-cost averaging in decumulation - drawing an income in retirement when markets are depressed - works against retirees as drawing an income when markets are down leads to a permanent loss of capital. So, it is critical for retirees to find the right balance between taking investment risk with their retirement savings and protecting the capital from market volatility.

Retirees' risk requirement, tolerance and capacity

In the current economic environment, it is necessary for retirees to take some form of measured investment risk when it comes to their superannuation balances. If insufficient investment risk is taken, then it is much less likely that retirees will achieve their lifestyle goals. Sound risk management can therefore be an even more critical element for retirees to consider than for people who are still saving for their retirement.

However, people view risk in a unique way and more so in retirement. Even if retirees are emotionally and psychologically willing to take the risk, they may need guidance on just how much risk is appropriate for their goals.

Essentially, during the decumulation phase, retirees not only respond to risk differently, but they also face a host of other associated investment risks, with three main risks being:

1. Market risk and sequence of return risk

Market risk is inevitably linked to any type of investment strategy and is the risk of losing money when a market falls. But as retirees have a reduced risk appetite, they are more sensitive to falling markets. The GFC is an extreme example and resulted in a disruption of many Australians' retirement plans. Those in the early stages of, or approaching, retirement saw their capital depleted and some never recovered their losses.

Sequence of return, or sequencing, risk is where market risk affects retirees' portfolios by the order, or sequence, in which the market volatility is felt in a portfolio. For example, if a significant negative market event occurs just after someone retires when they have the largest balance and when they are having to take significant income from the portfolio, then this will have more negative impact overall than if the market event happened at another time when much less income was being drawn.

These risks can be mitigated and managed by the use of fit-for-purpose investments which provide exposure to the appropriate range of risk premia that are needed to provide the required returns over time whilst moderating the extent of market risk.

2. Longevity risk

We all aspire to live a good and long life. However, a common concern for retirees is the risk of living too long and not having enough money to support themselves later in life. Simply put, longevity risk is the risk that they will last longer than their savings.

With life expectancy increasing in Australia, longevity risk is becoming a growing issue for many. Investors, and especially women who have a longer life expectancy, are facing the task of generating income and accumulating enough savings in proportion to lifespan expectancy.

3. Inflation risk

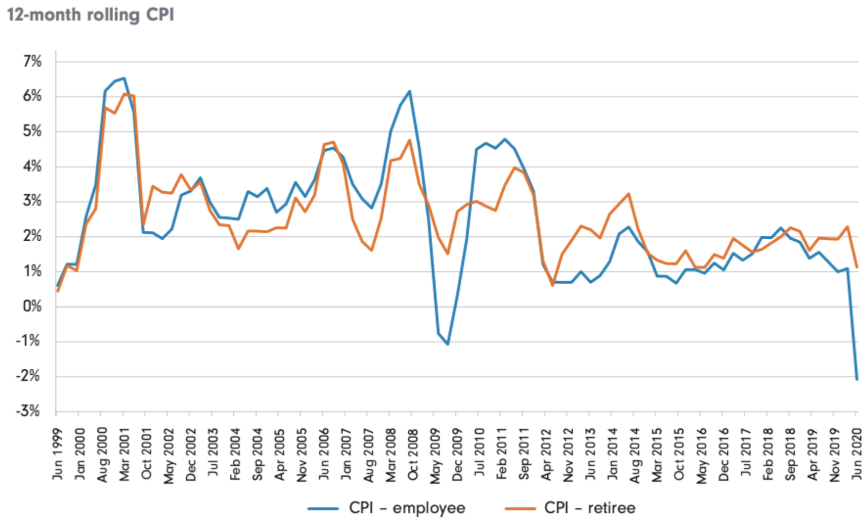
Inflation is the increase in the costs of goods and services over time. Ultimately people's income also needs to increase in order to afford these goods and services. If retirement savings do not keep pace with inflation, spending power will reduce over time and the standard of living will potentially fall.

A key issue is that, while the Reserve Bank of Australia targets a headline inflation rate of 2% to 3% a year, the specific inflation experienced by retirees can vary significantly from the headline rate. For example, retirees may initially spend more on luxury items than those still in accumulation phase and, when older, on healthcare. In contrast, employee households tend to spend more on housing, children's education and transport. This difference in household spending needs means that retiree households typically experience different price inflation than employee households, as indicated in the chart.

As one of the main aims of retirement planning is to maintain a certain lifestyle once retired, it is essential that the investment portfolio takes appropriate risk to help maintain the retirees' spending power.

Fit for individual purpose

The retirement life event is one of the most significant events in Australians' lives. As savers move from accumulation to decumulation, their feelings and views on risk will change, and the investment risks that are relevant to them will change. It is a certainty that retirees will need to take an appropriate amount of risk with their investment portfolios, or otherwise face the likelihood of not meeting their financial goals. With the help of an adviser, portfolios should include fit-for-purpose investments that increase the likelihood of meeting the financial objectives of each individual.



Source: Australian Bureau of Statistics 6467 – Selected living costs indexes, Australia, June 2020.

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

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Why we see opportunities in consumer-related stocks this year

Kent Williams

We believe those who view the exceptional profit upgrades from domestic consumer-related stocks over the last few months as being extremely short-term should consider the current spending capacity – and options for spending – of the Australian consumer.

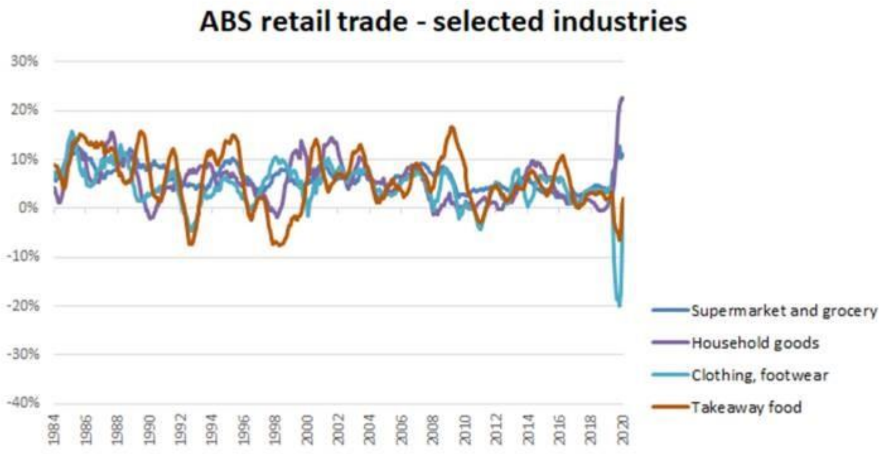
We believe there is a high level of spending capacity left in the domestic consumer sector which is supportive of consumer-related stocks outperforming for a longer period than is factored into current share prices.

The consumer has vastly higher savings, increased wealth via a buoyant real estate and share market, reduced spending options with the removal of international travel and relatively low unemployment on a global scale. Combined, we think these factors put consumers in a strong position for increased spending in 2021 and further into 2022. Couple this with a level of pent-up demand, and we see this as an excellent setup for domestic consumer stocks, either via retailers or domestic travel-related businesses.

Unprecedented retail spending

With increased time spent in lockdown, consumer spending patterns shifted at an unprecedented level, with an initial focus on pantry stocking, setting up the home office and turning to cooking and home improvement jobs. Key outperforming categories were liquor, food and household goods, with the services sector of restaurants and cafes hit the hardest, with many of these changes the largest seen on record.

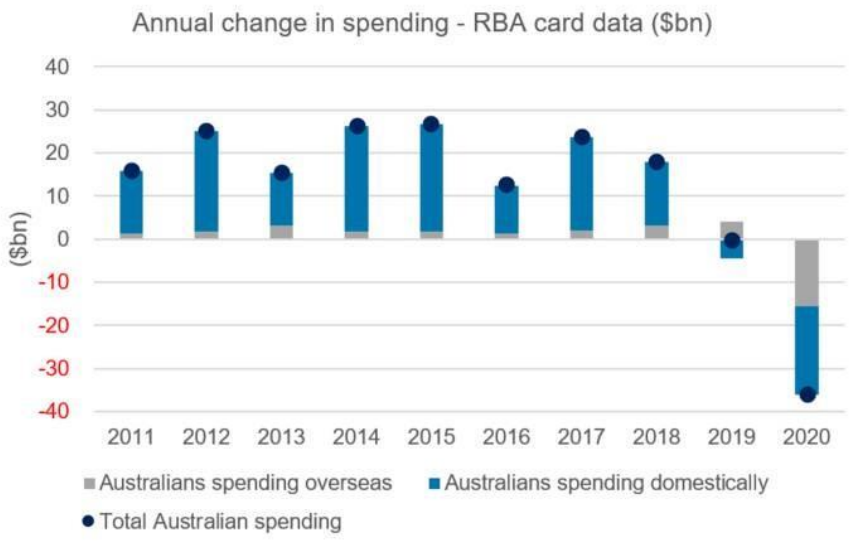
The consumer was forced to reallocate spending during COVID-19 in a short time period, with many out-of-home spending options removed overnight. Emerging from COVID-19 with limited long-haul travel options, there has been a sustained increase in auto related spending largely related to driving holidays.



Source: ABS, AMP Capital

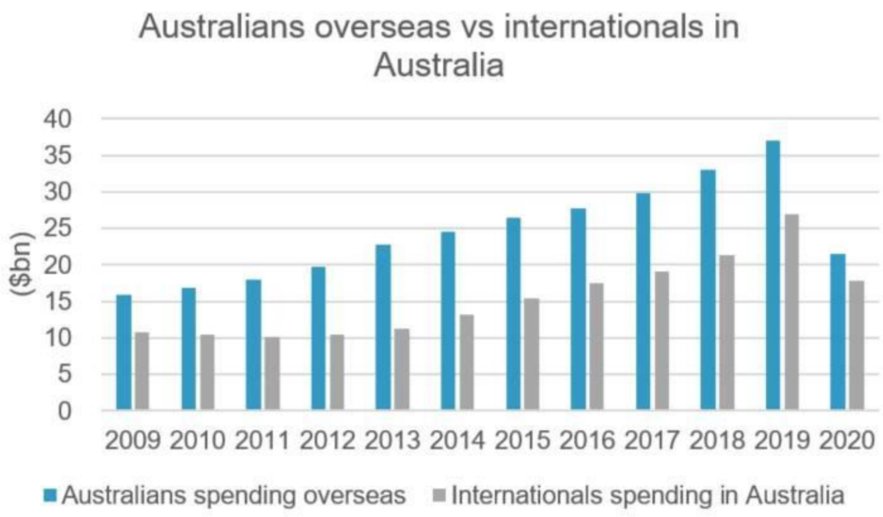
Limited spending options

Reduced spending options from COVID-19 via limited entertainment and travel – which also drove the unprecedented reallocation in retail spending – have resulted in Australians spending roughly $36 billion less in 2020, with $13 billion of the reduced spend coming from a lack of international travel. Note that international flights and accommodation booked through local travel agents or airlines are not captured in the $13 billion of international spend and therefore this number likely significantly understates the reduction in international travel spend.



Source: RBA, AMP Capital

Additionally, Australians travelling overseas spend more than international visitors spend in Australia meaning there is a short-term net benefit to the domestic economy from the cessation of overseas trips.

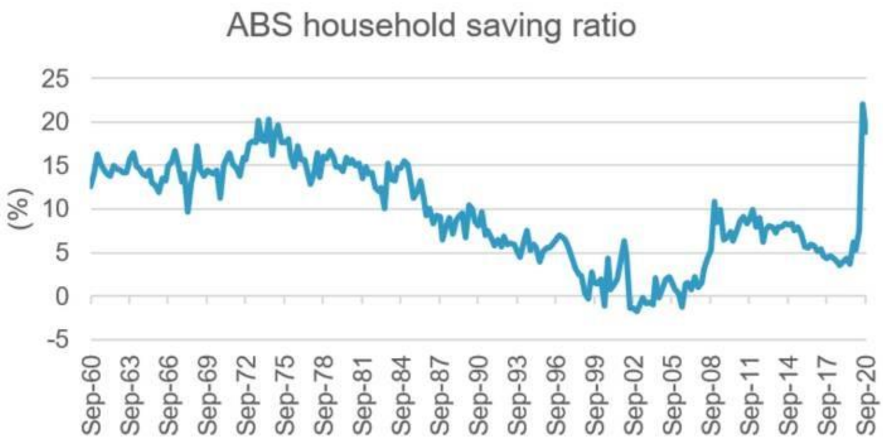


Source: RBA, AMP Capital

There is a risk the return to international travel once borders re-open may be slow or more difficult than pre COVID-19 given the risk of unexpected border closures, increased or inconsistent documentation requirements across different countries, as well as a potential period of limited travel corridors providing consumers with reduced travel options. This suggests a longer reallocation of consumer spending than may likely be anticipated by the market.

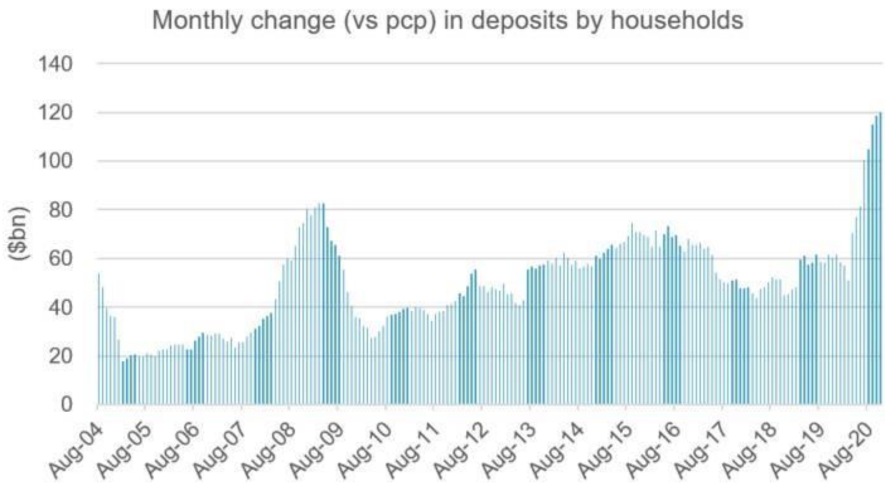
Record savings

The limited options for spending during the COVID-19 pandemic coupled with unprecedented government stimulus has resulted in consumers saving at record rates as evidenced by the household savings ratio which is at an all-time high.



Source: ABS, AMP Capital

Looking at savings in dollar terms using APRA data shows the huge spike in deposits, with the total level of household deposits increasing by $113 billion since end of 2019. For context, ABS retail trade data showed total retail trade spending in 2020 of ~$343 billion, meaning consumers have roughly one third of the total annual national retail spend sitting in additional bank deposits.



Source: APRA, AMP Capital

Concluding thoughts

In summary, while there are always risks to consider during a pandemic, we believe there are important investment themes this year in Australia:

1. Consumer savings are at record highs and the economic environment is strong.
2. There is pent-up demand from the consumer.
3. Australia's management of the virus is world leading, but international travel is unlikely for some time.

Kent Williams is a Small Caps Analyst at [AMP Capital](), a sponsor of Firstlinks. This article has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. For a list of sources and important disclaimer information, see the original article here.

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Eight steps to expect when seeking financial advice

Tim Fuller

Seeking financial advice can be a daunting task. With more than 80% of Australians not obtaining financial advice and 45% of the adult population calculated to be financially illiterate, work needs to be done to help more people with their personal finances.

This article is for those people who have never sought financial advice before and who are wondering how to do it and what to expect.

To start, a distinction must be made between general and personal advice. General advice is usually what you find online or from a help line of a product provider. It becomes personal advice once you have provided information about your personal circumstances which is then incorporated into the advice. Obviously, the outcome of meeting with a financial adviser in which you discuss your situation is personal advice.

Finding a financial adviser

Several factors come into play here. A conveniently-located office is appealing, but do not forget that with the rise of virtual communication methods, you can now search a much broader area for an adviser. A recommendation from a friend or family member can also be a good start, but consider your 'age and stage' to ensure a good fit for your demographic.

Crucially, check on the financial adviser's register on ASIC's Moneysmart website. This shows qualifications and licence status. The MoneySmart website also provides a detailed checklist for choosing an adviser. A simple web search to ensure that they have not crossed the law at some point is a good idea.

Once you have chosen an adviser and firm, book some time for an initial meeting. Allow an hour or more, depending on the breadth of content you would like to cover.

Here are eight factors in a typical financial advice process but advisers, like most professionals, have their own unique ways of collecting, processing and implementing the services they offer to you.

1. The initial meeting

Advisers need to properly assess your situation and investigate the work that needs to be done. An initial appointment may involve one or more meetings, and is an excellent opportunity for you to determine whether you feel that engaging this adviser will work for you.

Skillsets and experience are fantastic, but that is not all that may be involved in future interactions. Demeanour and personality, including their ability to explain potentially complex themes, are important to ensure that you both fully understand and are confident in going forward with their recommendations.

Often people seek financial advice with one clear objective in mind, which is a great start, but then through the explanation of other areas of their financial (and personal) life will uncover additional scopes of work, or find new areas that influence the original objective. Therefore being open and honest is crucial to ensure that recommendations do not conflict with something unknown to the adviser.

A simple example may be that you have had a significant health issue in the past that could affect your ability to apply for new insurance going forward. Good advisers will help guide the fact-finding to ensure that relevant areas are discussed.

2. Fact finding

An adviser will need to summarise your current financial position using a 'fact find' document, covering current financial holdings, loans, superannuation and investment accounts. This may also include an investment risk profiling to ascertain your appetite for volatility and time frames for objectives, and an insurance needs profile.

Some advisers offer this document to you to complete before the initial meeting. It serves the meeting well if you can take the time to fill it in. At the very least, it can help you take a quick stocktake of your current position and saves time at the meeting to focus on your goals and objectives.

3. Scoping of work and pricing

Once your objectives and current position have been ascertained, the financial adviser will step through the work that needs to be done. This is often where the connectivity between your original objective and other areas emerges.

You may find that there are high and low priority areas. The ability to scope out topics not immediately required to be addressed can be an excellent place to verify the advice is delivering on expectations. This type of advice, which allows less vital areas to be dealt with at a later date, is called episodal or staged advice.

Finally, the work involved is priced, both for the preparation of the advice and any potential implementation that may be required. There may also be ongoing fees to ensure that the strategy remains appropriate.

As with all professional services, fees are normal. In the past, product payments and trail commissions have meant that the upfront cost of advice was often subsidised (or provided free!). Of course, this also raised the risk of conflicted advice that wasn't in your best interests. Whilst fees are higher now, at least you can be sure that the advice is benefiting the right person.

There are several ways that advisers will determine fees, with 'fee for service' now more prevalent. Expect a price for the initial advice and some discussion on the ongoing cost of maintaining the strategy.

Whichever pricing method the adviser has chosen, it needs to be explained to demonstrate the value and give you the confidence to proceed.

4. Financial advice strategy

Most pieces of financial advice will have a strategy. In many cases, you will have sought advice because the problem you would like to solve, or the objective you want to reach, is difficult to see simply. Therefore the strategy provides the pathway to success. It also gives you an ability to reflect on whether the recommended route is workable for you.

Often in the formation of this strategy, some advisers will call an interim meeting to discuss their initial thoughts to help zero in on the most relevant pathway for you to take. An example may be projecting your income for an extended period, but instead, you are considering a career change or a return to education. This may mean that a couple of scenarios need to be calculated and may help give you confidence in these future plans.

5. Research of products and services

Time needs to be taken to review your current financial products and holdings and research other options to meet your objectives. You should also expect that consideration of alternatives have been documented with reasoning as to why they were deemed appropriate for your circumstances.

Financial modelling is often used to project investment returns and insurance requirements. Ensure realistic return rates are used, particularly now that expected returns across all asset classes are significantly lower than in the past. One way to do this is to ask for historical average returns, then discuss the potential for lower returns going forward, and ask for an additional scenario to be modelled that reflects this expectation.

When recommending new products, mainly when replacing existing ones, there need to be clear and concise explanations of any benefits gained and features lost, including additional risks.

6. Presentation of financial advice

This work is then recorded and explained in a comprehensive document called a 'Statement of Advice'.

In addition to the recommendations, take note that the summary of your present circumstances has been reflected accurately. If you feel that something has been missed or has changed, you should immediately flag this with your adviser.

It is good practice for the adviser to explain how the recommendations and advice are in your best interests. This can give you comfort that the primary objective of the advice is to leave you in a better position if you follow the recommendation.

This advice may be presented to you at a subsequent meeting, perhaps by PowerPoint, diagrams or even a video presentation.

Most advisers have moved well beyond providing only investment advice and now assist with estate planning, social security and aged care, and can bring in other specialists on issues such as mortgage origination or property search.

7. Implementation of financial advice

Now you have the advice on hand and the pathway in place, it must be implemented. Depending on your own experiences and comfort level in implementing the strategy and setting up the products or services, it is usually advisable to allow the adviser to implement the recommendations. There may be an additional fee, or it could be included in the advice cost of the Statement of Advice.

8. Ongoing service agreements

Depending on the proposed strategy's length and complexity, some form of ongoing service agreement may be appropriate. This may take the form of a periodic review either annually or on an ad hoc basis as milestones are reached.

An exciting development in ongoing service arrangements is the ability to scope and personalise the level of continuing service you would like, and subsequently pay for, from the adviser. One option available is a subscription service that allows you access to the adviser and administrative elements (such changing bank accounts, addresses, married names etc.) but stops before the inclusion of personal advice.

This can be an effective way of retaining the adviser's services to an extent, whilst keeping annual costs down and still providing the ability to seek advice when required for a fee. This reactive instead of proactive approach gives you more control if you prefer it that way, whilst still ensuring that the recommended solution is monitored for you.

Conclusion

Seeking help about your financial future is a challenging task. It involves fees but can provide value, comfort and confidence that a professional service is assisting with your personal goals and financial objectives.

Tim Fuller is Head of Advice at Nucleus Wealth. This article is for general information only and does not consider the circumstances of any individual.

Marks and the tax system explained in beer

Graham Hand

As a follow up to Dr Rodney Brown's article last week on taxing the rich and the subsequent lively discussion, we republish Oaktree's Howard Marks and the popular 'beer' example to explain the tax system.

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The following explanation of the tax system has been popular for many years, and in his latest memo released yesterday, Oaktree's Howard Marks quotes it and says,

"I've been waiting a long time for a chance to use this. The numbers may not be exactly right but the idea is. The unarguable bottom line is that everyone's view of the fairness of the tax system - like most such matters - depends largely on the angle from which you look at it."

Here is an example of the beer explanation:

"Suppose that once a week, ten men go out for beer and the bill for all ten comes to **£100.** If they paid their bill the way we pay our taxes, it would go something like this...

The first four men (the poorest) would pay nothing.
The fifth would pay £1.
The sixth would pay £3.
The seventh would pay £7.
The eighth would pay £12.

The ninth would pay £18.
And the tenth man (the richest) would pay £59.

So, that's what they decided to do.

The ten men drank in the bar every week and seemed quite happy with the arrangement until, one day, the owner caused them a little problem. "*Since you are all such good customers,*" he said, "*I'm going to reduce the cost of your weekly beer by **£20**.*" Drinks for the ten men would now cost just **£80.**

The group still wanted to pay their bill the way we pay our taxes. So the first four men were unaffected. They would still drink for free but what about the other six men? The paying customers? How could they divide the £20 windfall so that everyone would get his fair share? They realized that £20 divided by six is £3.33 but if they subtracted that from everybody's share then not only would the first four men still be drinking for free but the fifth and sixth man would each end up being paid to drink his beer.

So, the bar owner suggested that it would be fairer to reduce each man's bill by a higher percentage. They decided to follow the principle of the tax system they had been using and he proceeded to work out the amounts he suggested that each should now pay.

And so, the fifth man, like the first four, now paid nothing (a 100% saving).
The sixth man now paid £2 instead of £3 (a 33% saving).
The seventh man now paid £5 instead of £7 (a 28% saving).
The eighth man now paid £9 instead of £12 (a 25% saving).
The ninth man now paid £14 instead of £18 (a 22% saving).
And the tenth man now paid £49 instead of £59 (a 16% saving).

Each of the last six was better off than before with the first four continuing to drink for free.

But, once outside the bar, the men began to compare their savings. *"I only got £1 out of the £20 saving,"* declared the sixth man. He pointed to the tenth man, "*but he got **£10!***"

"Yeah, that's right," exclaimed the fifth man. "*I only saved a £1 too. It's unfair that he got ten times more benefit than me!"*

"That's true!" shouted the seventh man. *"Why should he get £10 back, when I only got £2? The wealthy get all the breaks!"*

"Wait a minute," yelled the first four men in unison, "we didn't get anything at all. This new tax system exploits the poor!" The nine men surrounded the tenth and beat him up.

The next week the tenth man didn't show up for drinks, so the nine sat down and had their beers without him. But when it came time to pay the bill, they discovered something important - they didn't have enough money between all of them to pay for even half of the bill!

And that is how our tax system works. The people who already pay the highest taxes will naturally get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy and they just might not show up anymore. In fact, they might start drinking overseas, where the atmosphere is somewhat friendlier."

Principles and rules to guide retirement strategies

Geoff Warren

with Adam Butt and Gaurav Khemka

Managing assets during retirement requires a plan for both investing those assets and drawing down on them. Research by both ourselves (found here) and others has modelled 'optimal' drawdown and investment strategies for individuals with differing objectives, preferences and circumstances.

We have extracted some principles and decision rules from this research to assist in identifying appropriate retirement strategies. This article presents the highlights with the full note found here.

Retirement objectives might be characterised into these groups:

1. Whether there is a minimum acceptable income level that an individual can't afford to fall below.
2. The type of income they want to draw, with two alternatives:
    (a) Target income level (say an ASFA Standard or income replacement)
    (b) Maximise the income extracted from the assets.
3. Any bequest motive.

These objectives point toward the broad strategy, with the application moderated by risk tolerance. Our reference point is all assets available to fund retirement, perhaps after hiving off some precautionary savings, with the age pension forming part of the mix.

Minimum acceptable income

This relates to poverty avoidance and is tied to risk capacity rather than risk tolerance. If falling below some income level leaves a retiree destitute, any chance of this occurring should be eliminated if possible.

Principle *– Secure any minimum acceptable income, if possible.*

Decision rule *– Purchase sufficient annuities to secure the minimum, accounting for other available income.*

Two situations may negate the rule of purchasing annuities to secure the minimum. First is where there is virtually zero likelihood of falling below the minimum, e.g. available assets are more than ample, or the age pension suffices. Second, when available assets are insufficient to buy the required annuity, a choice arises between taking on market risk in a bid to reach the minimum if possible or buying annuities to lock in at least some income.

(Comments on annuities: These are defensive assets that facilitate securing some income for life. There is currently a concentration of providers, but reasonable demand should see more life insurance companies step up, leading to greater demand and better pricing. The value proposition relates to longevity insurance derived from pooling of mortality risk: annuities might be viewed as fixed income-like assets with longevity insurance attached. It is hard for individuals to unpack these features, but they might be able to determine if they need to guarantee some income for life, noting that no other investment products offer this attribute).

Income target

We initially convey and explain the principle that emerges, before moving to the decision rules.

Principle *– Invest with the aim of delivering the income target for as long as possible using a combination of annuities, growth and defensive assets. Then draw a sufficient amount to deliver the income target, until available assets are exhausted.*

When assets are so low that the target cannot be secured with annuities, it is better to invest in growth assets to maximise the chances of attaining the target for longer, notwithstanding the risk of running out if returns are poor. Once assets are sufficient, enough annuities are purchased to secure the target. As assets increase beyond this point, surplus funds are allocated to growth assets to pursue additional income (or bequests), confident that the target is secure.

Our modelling reveals a tendency for (inflation-adjusted) annuities to crowd out defensive assets such as fixed income, as they facilitate securing the target for life (assuming the provider is still around). Allocation to annuities depends on the desire to lock-in income, and often modest at around 10%-30%. Deferred life annuities tend to be favoured, with income supported in the interim by drawing on other available assets. This strategy provides longevity insurance at a modest cost, and offers potential for upside if returns are high. We also recognise that not everyone is comfortable with high growth asset exposure, so suggest setting it as high as can be tolerated.

This strategy provides longevity insurance at a modest cost and offers potential for upside if returns are high. We also recognise that not everyone is comfortable with high growth asset exposure, so suggest setting it as high as can be tolerated.

The drawdown principle implies drawing enough to reach the target after accounting for other income sources such as the age pension and any annuities, subject to the minimum drawdown rules. Once available assets are exhausted, income then declines to that arising from these other sources.

As an example, if the income target is $30,000 and other income sources deliver $24,500, then $5,500 is drawn until assets are exhausted. One reason behind this strategy is that, while drawing a below-target amount extends the timeframe over which the assets last, the probability that the income will never be enjoyed rises due to being less likely to be alive later in retirement. 'Better spend it while you can.'

Decision rules:

1. *Establish the annuity purchases required to secure the target income for life, allowing for the Age Pension and other income sources.*
2. *Purchase the required annuities, subject to not exceeding some upper limit of available assets.* We suggest a 60% upper limit on annuity purchases to retain some access to capital and flexibility.
3. *Where available assets are insufficient, scale back annuities to guarantee any minimum acceptable income.*
4. *Invest remaining amount in growth assets, as far as can be tolerated.*

Maximising income

Some individuals may wish to extract as much income as possible out of their assets, while managing the risk of income falling to undesirably low levels. This requires balancing the potential consequences of drawing too much earlier and/or poor investment returns, against not drawing enough and dying with large residual assets. (We agree with the Retirement Income Review that the goal should be converting assets to income, rather than spending investment income only and keeping the pot.)

In trading off these elements, the modelling generates time-varying drawdowns and investment strategies that mainly combine growth assets with annuities. Annuities are directed at smoothing and limiting the downside to income; and tend to crowd out other defensive assets.

Principle – *The drawdown and investment strategy should be jointly directed at converting assets into as much income as possible, while leaving behind no more assets than intended.*

Decision rules:

1. *Determine how much income to protect using annuities*. Decide the income to protect (in excess of the minimum), allowing for other income sources such as the age pension. This depends on risk tolerance, but we suggest an upper limit of 60%.
2. *Invest remainder in growth assets, as far as can be tolerated*.
3. *Establish an affordable drawdown strategy.* The 'affordable' drawdown assets remaining after annuity purchases is estimated and initially drawn. One approach is calculating the real drawdown amount that can be sustained to a certain age under the selected asset mix. (Our estimates suggest it might be something like 8% of initial assets.)
4. *Review the drawdown strategy occasionally* – The drawdown strategy is reviewed occasionally, including re-estimating the affordable drawdown.

The Actuaries Institute has proposed a rule for varying drawdowns with age and balance that might be surrogate for rules 3 and 4 above (found here).

Bequests

Adding a strong desire to leave a bequest to our models leads to substantial reductions in drawdowns, lower annuity purchases and greater growth asset exposure.

Principle – *A strong bequest motive implies restricting drawdowns to tolerable levels and directing the investment strategy towards building assets.*

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Decision rules:

1. *Use annuities only as far as required to secure any minimum acceptable income.*
2. *Drawdown only what is needed.*
3. *Invest in growth assets, as far as can be tolerated.*

Risk tolerance

Risk tolerance moderates how the principles and rules are applied, with higher risk tolerance associated with lesser use of annuities, greater growth asset exposure, more volatile drawdowns, and increased willingness to accept the possibility of lower income.

Principle *– An individual with high risk tolerance should reduce annuity use in favour of additional growth assets and use the opportunity to increase their expected income (or bequest).*

Under high risk tolerance, annuity purchases might be restricted to securing any minimal acceptable income, with drawdowns initially increased in line with the higher affordable drawdown.

While individuals should benefit from higher growth exposure, we add this principle to accommodate those with limited appetite for asset volatility over shorter periods:

Principle *– Set growth asset exposure at the maximum that can be tolerated.*

The growth asset weight might be set by (say) placing an x% probability limit of -y% loss over 1, 2 or 3 years. Alternatively, a bucketing strategy could be used to help individuals deal with short-term market fluctuations.

Final thoughts

The principles and rules do not in themselves deliver the specifics of strategies: we leave this for product designers and financial advisers. Nevertheless, they indicate the broad type of strategy that suit particular objectives and risk tolerance. We realise that we suggest some of the strategies are at odds with observed behaviours such as anchoring on minimum drawdown rules and widespread use of fixed income rather than annuities for defensive exposure. We offer them as a way of improving on existing practices, noting they are rooted in rigorous modelling.

Adam Butt is an Associate Professor and Head of Actuarial Studies, Gaurav Khemka is a Senior Lecturer and Geoff Warren is an Associate Professor and Fund Convenor, ANU Student Managed Fund at the College of Business and Economics at The Australian National University.