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Editorial

Most Australians hold their superannuation in a balanced fund, often 60% growth/40% defensive or 70%/30%. Lifecycle funds are also popular, where the amount in defensive assets increases with age. Employees who are not engaged with their super (and that's most people when they start full-time work) simply tick a box for the default fund selected on their behalf by the employer.

For example, **UniSuper**, the fund for the higher education sector with 450,000 members holding \$90 billion, says:

"Our Balanced investment option returned almost 6% in 2020. This is an important result because it's our default investment option and most of our members invest in it."

Of course, 2020 was no ordinary year, and UniSuper also reports:

"The difference between our best- and worst-performing investment options was about 60%. The reason for this is that our best performer, the Global Environmental Opportunities option, focuses on technology and decarbonisation. Our worst performer, the Listed Property option, is heavily invested in shopping centres, which have suffered during the pandemic."

What an amazing difference for simply ticking the correct box in an application form from a major superannuation institution. That 60% variation in money to live on can make a massive difference in retirement standards, and it shows the importance of asset allocation and fund selection.

Here is the strategic asset allocation of the UniSuper Balanced option (as at 1 October 2020).

Asset Class	Allocation
Australian shares	33%
Cash & fixed interest	30%
International shares	27%
Property	5%
Infrastructure & private equity	5%

It is common for a balanced option to hold 30% to 50% in cash and fixed interest, but with high-quality bonds and term deposits earning 1% or less, the composition of the 'defensive' assets increasingly varies between funds. We have [previously discussed how Hostplus](#) uses infrastructure assets rather than bonds in its defensive allocation.

Take another example, **Vanguard's** Diversified Balanced ETF. Sounds perfect for superannuation, as 'diversified and balanced' is a recommended long-term savings strategy. This is more a 50/50 fund and gains its exposure by investing in the following Vanguard sector ETFs.

Funds	Percentage
Vanguard Global Aggregate Bond Index Fund (Hedged)	35.1%
Vanguard Australian Shares Index Fund	19.9%
Vanguard Australian Fixed Interest Index Fund	15.0%
Vanguard International Shares Index Fund	14.6%
Vanguard International Shares Index Fund (Hedged)	3.6%
Vanguard Emerging Markets Shares Index Fund	2.9%
Total	100.0%

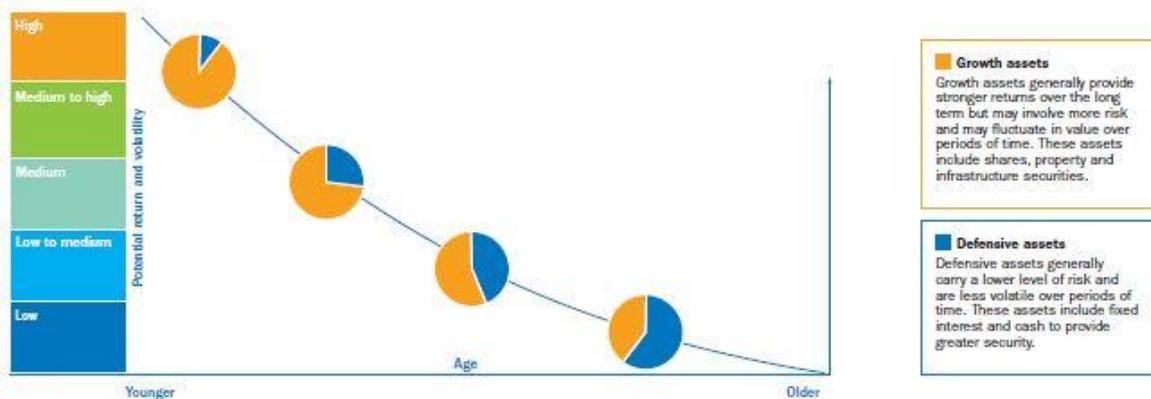
It's a solid retirement solution for many people, but let's delve deeper into the Global Aggregate Bond Index Fund, typical of where many super funds hold their fixed interest allocation:

- Number of issuers: 2,488, average credit quality AA-
- Number of holdings: 9,795 (That's what you call diversification. Negligible credit exposure to any one name, absolutely rock-solid credit risk).
- Yield to maturity: 0.92%
- Effective duration: 7.5 years
- Weighted average maturity: 9.2 years

With a duration of 7.5, if interest rates rose 1% across the rate curve, the bond fund would lose 7.5%. Or make 7.5% if rates fell 1%. Investors should know that a 1% rate move could wipe out 8 years of 0.92%. How many people in such a balanced fund realise half their allocation is earning less than 1%?

This is not a criticism of the product. It is typical, and simply a reflection of current market circumstances. Anyone who wants returns needs to take risk.

Colonial First State (CFS) offers lifecycle funds rather than a single balanced fund, and here are the five asset allocations in their FirstChoice Employer Super or Commonwealth Essential Super. More defensive assets with age.



At the moment at CFS, the defensive allocation for the older cohorts is a mix of multi asset, alternatives, credit, emerging markets debt, and 'total return' fixed interest in addition to regular duration Australian bonds plus cash. It's worth checking with your super fund what is in the defensive bucket.

This edition focusses on the asset allocation problem we all face, especially bonds versus equities. Many people use the rule-of-thumb of 'your age in bonds'. That is, at age of 70, hold 70% in bonds. But low interest rates means income is insufficient for the lifestyle many retirees want, and hence the debate about spending capital that Firstlinks has covered in detail. The challenge is to find assets that deliver returns with acceptable risk, or adopt other strategies such as working longer or part-time.

The **Reserve Bank's Head of Financial Stability, Jonathan Kearns** admitted a few weeks ago that the values of all investments are vulnerable to a rise in interest rates, and bonds may not provide the traditional hedge for other parts of a portfolio:

"Because risk-free sovereign rates effectively underpin the pricing of all sorts of assets, if you have a rise in yields because of risk premia then that can affect the pricing of a broad range of assets simultaneously. Investors who thought they perhaps had a hedge through owning bonds and equities can find that all of their assets fall simultaneously and then that can have negative feedback for the economy through wealth effects."

Three articles this week focus on the allocation issue, but first up, **Ross Clare** of the **Association of Superannuation Funds of Australia** (ASFA) says that contrary to the claims of the Retirement Income Review, the vast majority of Australians [die with little or no superannuation](#). The issue of whether they spend their super or pass it to their kids is not relevant for most people.

Then **Brad Dunn** looks at how an investor might achieve 5% in the current market, showing how [asset allocations have changed over time](#) to reach this income level. One way a portfolio can boost income without stockmarket risk is in bank hybrids, and **Campbell Dawson** describes the [extraordinary movements in this sector](#) in the last 12 months.

With the last 12 months delivering the biggest difference between world equity and world bond returns for at least 50 years, **Daniel Morris** says investors are faced with a decision to [rebalance if they are now overweight equities](#). It's not an easy decision as equities continue to run strongly and bond rates are so low, but by definition, rebalancing forces investors away from previous winners.

Then **Craig Stanford** shows how [correlations between bonds and equities](#) have changed. On the surface, falling sharemarkets suggest slower economic growth and lower interest rates (rising bond prices), such that bonds and equities should be negatively correlated. But where are we in these strange markets?

Obviously, no silver bullets for portfolio construction here, but this collection of articles at least gives you information to help your personal decision.

Moving on to other topics ...

It's hard to ignore the second-largest economy in the world and Australia's largest trading partner, and **Martin Lau** reveals [five trends in China](#) which are influencing his investing.

Then **Lawrence Lam** offers [eight observations about selling shares](#), saying we focus too much on the buying decision. My favourite is the insight that when it comes to selling, consider why you bought the share in the first place and whether anything has materially changed, or are you just reacting to a short-term market.

In [this week's White Paper](#), **Franklin Templeton** reflects on predictions of above-average economic growth, record fiscal and monetary stimulus and increased likelihood of inflation and says we are in an economic environment never seen before.

And check the latest **BetaShares** prediction on ETFs [linked here](#) as the sector officially exceeds assets of \$100 billion.

For our **Comment of the Week**, I never cease to be amazed by the quality of the feedback we receive. They really are worth going back and checking, especially those on [last week's piece by Jon Kalkman](#) which has received over 7,000 views.

Here is one from **Peter Henery** on **Hugh Dive's** [article on residential property](#):

"As a long term resi prop investor I salute your analysis. Very few 'get it' ...but you did pretty well. Here's what you missed! (1) You cannot save your way to wealth. You must use OPM (aka Other People's Money or leverage.) Name me one other asset where the banks 'fall over themselves' to lend you 80% LVR? (90%+ with LMI) And so long as you service the loan, won't make a margin call if the value falls! (2) Now work out the IRR when you only have 10-20% skin in the game and property rises just 3% per year. And that happens year after year and nobody blinks an eyelid! When we have a 'boom' year, the returns should be illegal! (3) Next, all the banks and all the gov't are 'in on the bet' and they are on your side. Just take VIC gov't income. Mostly land tax and stamp duty. Do they want property to keep going? What makes up the banks balance sheets? Do they want it to 'keep going'? The only game in town for dumb old Aussie battlers."

Peter is right about the leverage, but it's also the forced saving and compounding over decades which has made 'Aussie battlers' wealthy.

In fact, most people have no super when they die

Ross Clare

That Australians do not spend their super in retirement, and supposedly have more super and other financial assets when they die than when they retired, has become a trope in narratives about the strengths and weaknesses of the Australian superannuation system. For instance, the recent Retirement Income Review Report stated that:

"This [the findings of a number of studies] suggests that retirees tend to consume only the income derived from assets and not the assets themselves".

Despite such claims being widely quoted, there is little or no evidence that the typical Australian dies with around the same amount of financial wealth as when they retired, other than cases where there was not much financial wealth in the first place. Sadly, the main group having the same amount of superannuation when they died as when they retired are those who retired with no superannuation.

Australian Taxation Office data on superannuation balances

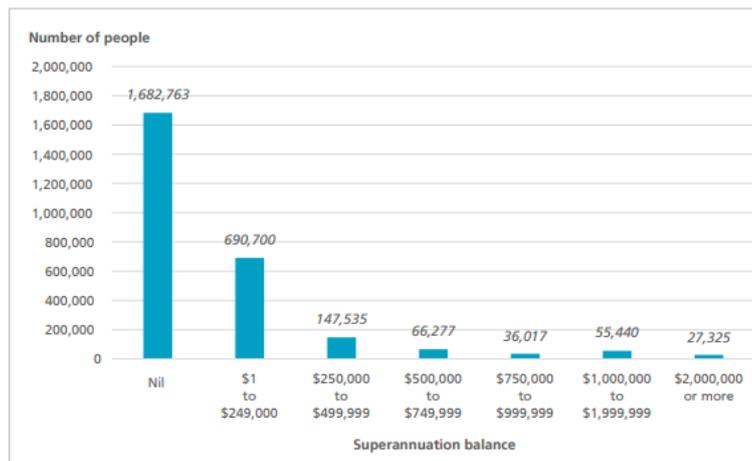
ATO data indicates that current superannuation balances for those aged 70 and over are, in most cases, quite modest (Chart 1 and Table 1).

The 1.02 million individuals with superannuation equate to around 37% of ABS estimates of the number of Australians aged 70 and over as at June 2018. Around 1.7 million Australians aged 70 and over have no superannuation at all.

For the minority aged 70 and over with superannuation, the median balance falls within the \$100,000 to \$149,000 range. Only around 185,000 individuals had a superannuation balance of \$500,000, with 27,325 individuals having more than \$2 million in superannuation.

Around 14% of those aged 70 and over with superannuation continued to receive the benefit of employer contributions.

Chart 1: Superannuation of individuals aged 70 and over (for 2017-18)



Source: ATO Taxation statistics 2017-18 Individuals: Super contributions, by total super member accounts balance range, taxable income range and age range.

Table 1: Superannuation of individuals aged 70 and over, positive balance less than \$250,000 (for 2017-18)

Superannuation balance	Number of people
\$1 to \$50,000	356,302
\$50,000 to \$99,999	118,099
\$100,000 to \$149,999	92,590
\$150,000 to \$199,999	70,445
\$200,000 to \$249,999	53,264
Total	690,700

Source: ATO Taxation Statistics and ABS estimates of population aged 70 and over.

The ATO statistics also show a fall in the incidence of superannuation that increases with age, particularly for females (Table 2).

As at June 2018, 54% of males aged 70 to 74 had superannuation, while only 29% of males aged 75 or more had superannuation. For females, 29% of those aged 70 to 74 had superannuation, falling to 17% for those aged 75 plus.

Table 2: Superannuation by age and gender, 2017-18

Age	Male			Female		
	Percentage with super	Average account balance \$	Median account balance \$	Percentage with super	Average account balance \$	Median account balance \$
55-59	97	272,207	148,424	88	198,512	100,711
60-64	88	344,718	163,985	77	279,167	128,507
65-69	70	399,872	178,326	61	358,055	171,679
70-74	54	445,538	185,237	29	387,284	177,449
75 or more	29	411,039	133,969	17	363,007	131,205

Source: ATO Taxation Statistics and ABS population estimates

In comparison, 97% of males and 88% of females aged 55 to 59 had superannuation.

Given that compulsory superannuation for employees has been in place since 1992 (with coverage rates around 40% before that), these falling rates of superannuation coverage mainly come from many individuals withdrawing all of their superannuation over the course of their retirement.

Only a very small proportion of people have substantial balances at any stage after age 70.

Evidence on superannuation balances shortly before death

ASFA also has investigated what sort of superannuation balances people have just prior to death.

Through making use of data from waves of the Australian longitudinal household survey, HILDA, it is possible to identify people who died and their age at death. It is also possible to track their last observed superannuation balances in a period of up to four years prior to death.

Table 3 shows the superannuation status of individuals in the HILDA survey sample who died at the age of 60 or older in the four years to 2018. Table 3 also shows the mean balances, the percentage of individuals with a positive superannuation, and for those with positive balances, the mean and median.

In the various tables the sample sizes for those who did have superannuation are of relatively small size. Accordingly, caution is needed in interpreting the mean and median figures for the relatively small proportion of those in the survey who still had superannuation prior to death. However, the pattern of these results makes sense with, for instance, declining proportions of those with superannuation in the older age groups examined.

The HILDA data in Table 3 shows that 80% of people aged 60 and over had no super at all in the period of up to four years before their death.

For the minority that still have superannuation, the amount can be substantial, with a mean balance of around \$500,000 in 2014 for those who died in the four-year period to 2018. This figure is well up on the figures for 2010 and 2006 (see the Appendix to this paper), reflecting the maturing compulsory superannuation system and that some individuals have very high balances.

Table 3: Last observed superannuation balance within up to 4 years before death (year of observation of superannuation balance is 2014)

	Age at death			Total (60 and over)
	60 to 69	70 to 79	80 and over	
% without super	53%	75%	90%	80%
% with super	47%	25%	10%	20%
Mean balance	635,608	429,432	375,096	502,008
Median balance	274,000	266,000	117,000	248,000

Source: HILDA unit record data.

As shown by Table 3, those who were aged 60 to 69 at the time of their death were more likely to have superannuation than older age groups.

Many in this age group would still be working and/or would have been drawing down on their superannuation for only a limited period. This younger cohort also would have had the benefit of compulsory superannuation for longer periods than older age cohorts.

However, people who die in their 60s often have medical issues impacting on their ability to work and any superannuation available is often taken as a lump sum retirement benefit or TPD release prior to death.

For those aged 70 to 79 the incidence of superannuation starts to fall away with only around 25% still having superannuation in the period before death. Mean and median balances are also lower for those who still had superannuation.

For those aged 80 plus, the incidence of still having superannuation is quite low, with over 90% having no superannuation in the period of up to four years before death. However, a very small proportion still had superannuation, sometimes a substantial amount.

For the age 80 plus group, only 5% of that group had more than \$110,000 in superannuation in the period of up to four years before their death. The average superannuation balance for the 10% of this age group that still had superannuation is around \$375,000, reflecting the small number of retirees with high superannuation balances.

Men are more likely to have superannuation than women in the four years before death. For those who died in the period 2014 to 2018, only 15% of females aged 60 plus at death had any superannuation compared to around 25% of men.

The ages at which people die and APRA data on death benefits

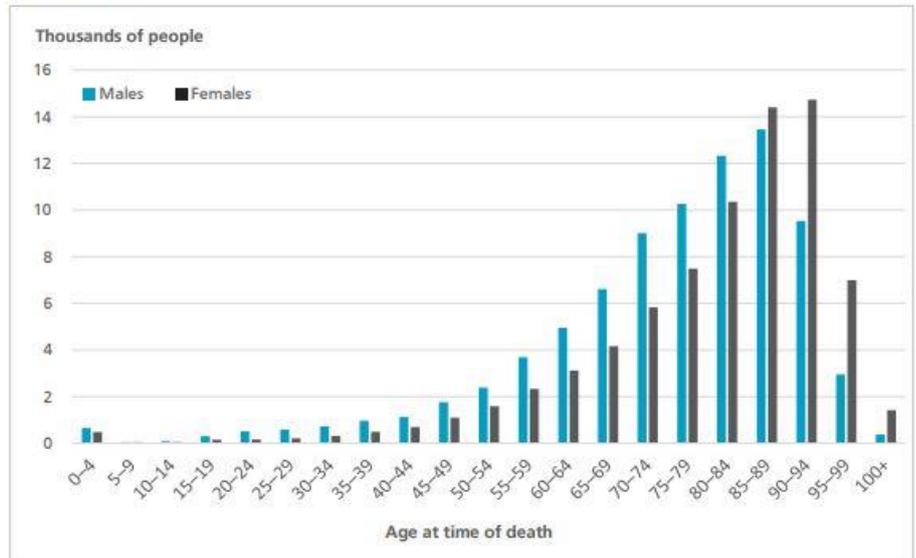
There are far fewer superannuation death benefits paid than there are deaths in Australia. As well, a significant proportion of superannuation death benefits from funds relate to individuals who have not yet retired. Insurance benefits in regard to such individuals also boost death benefit payments. For these individuals, having a significant superannuation death benefit available is a strength rather than a weakness of the superannuation system given that in most instances there will be a spouse, infant orphan or other financial dependent.

Most deaths in Australia occur after age 60, with around 87% of deaths occurring after that age (Chart 2).

Comparatively, in 2018 there were over 18,500 deaths of persons aged 20 to 59. The great bulk of this age group would have had a superannuation account or accounts, given the compulsory superannuation system and high levels of labour force participation of those in that age group.

APRA statistics indicate that in 2017-18 around 16,000 life insurance claims were paid. The great bulk of those would have related to those aged under 60 given that insurance cover generally ceases at age 65 and labour force participation begins to fall after age 60, leading to a cessation of insurance cover for those concerned.

Chart 2: Deaths by sex and age group (for 2018)



Source: AIHW National Mortality Database.

APRA statistics indicate that in 2017-18 funds with five or more members paid out 40,000 superannuation death benefits and a further 9,000 benefits linked to a terminal medical condition. This compares to around 157,000 deaths of individuals aged 15 and over.

The average benefits were around \$128,000 for death benefits and around \$90,000 for terminal medical condition benefits. These averages are boosted by the 16,000 or so accounts which had average life insurance payouts of around \$147,000.

After adjusting for deaths of the 18,500 individuals aged under 60 (the great bulk of which would have had a superannuation balance) and for multiple accounts, the APRA statistics are fully consistent with HILDA data with only 20% of those aged 60 and over having a superannuation account balance when they died.

The Retirement Income Review Report concluded that in 2019 one in five dollars of benefit payments from superannuation funds was for death benefits. The source of the data underlying that conclusion is not entirely clear. However, it is possible that it relates to the total death and terminal illness benefit payments as a proportion of total lump sum payments.

Calculations made by ASFA based on total benefit payments (including pension payments) and adjusting for death benefit payments (including life insurance payouts) for those who have not retired indicate that, for APRA regulated funds, in 2019 around one in eighteen dollars of total benefit payments were death benefits related to the superannuation of those who have retired.

While this ratio may fall to a degree in future, the calculation indicates that the superannuation system delivers benefits predominantly for retirement and related purposes.

Data on death benefits paid by self-managed superannuation funds (SMSFs) are not available.

Conclusion

The vast majority of people exhaust all of their superannuation well before their death, with a smaller proportion passing on some superannuation to their spouse and with a relatively small proportion undertaking estate planning which benefits other generations.

This is consistent with the lived experience of most people and their families.

As a result, here are a couple of policy implications:

- Given that a large proportion of current retirees have very modest superannuation balances, the case is strengthened for increasing the SG to 12% (as currently legislated) so that retirees can live in retirement with dignity.
- There is a small proportion of retirees who have superannuation balances greater than can be reasonably justified given the tax advantages provided to superannuation. ASFA recommends that individuals be required to withdraw any superannuation they have that is in excess of \$5 million.

Ross Clare is Director Research and Resource Centre at [The Association of Superannuation Funds of Australia Limited](#) (ASFA). This article is general information and does not consider the circumstances of any individual.

The risk-return trade-off: What's the right asset mix for a 5% return?

Brad Dunn

Most investors spend much more time assessing, calculating, comparing and pursuing returns than they do considering the other side of this same coin: the risks taken to achieve that return. However, in the current market conditions, investors – and particularly conservative investors – should consider the inevitable tradeoffs they are making when seeking to maintain certain levels of income.

This article explores two simple questions:

1. How should you invest to earn a 5% per annum return with the least risk?
2. Has the optimal mix changed over time?

To spoil the fun a little, the answer to Question 2 is yes. Optimal portfolio allocations have shifted considerably, but in essence, have done so due to the gradual but consistent fall in market interest rates.

This is important because, in addition to indicating the return available from cash and bonds, interest rates are also used to value cashflow producing assets such as shares, property and infrastructure. As the interest rate falls, the value of future cashflow rises.

While interest rates are a key driver, there are other important factors. The outcomes of an investment in a term deposit or government bond are predictable, but the future cashflows of a company or the prospects for an investment property can shift quickly.

The most common measure to represent this risk is volatility, but many investors find this statistical measure difficult to bring to life. Instead, for this article, we will represent risk in terms of the likelihood of a negative return over a 10-year period.

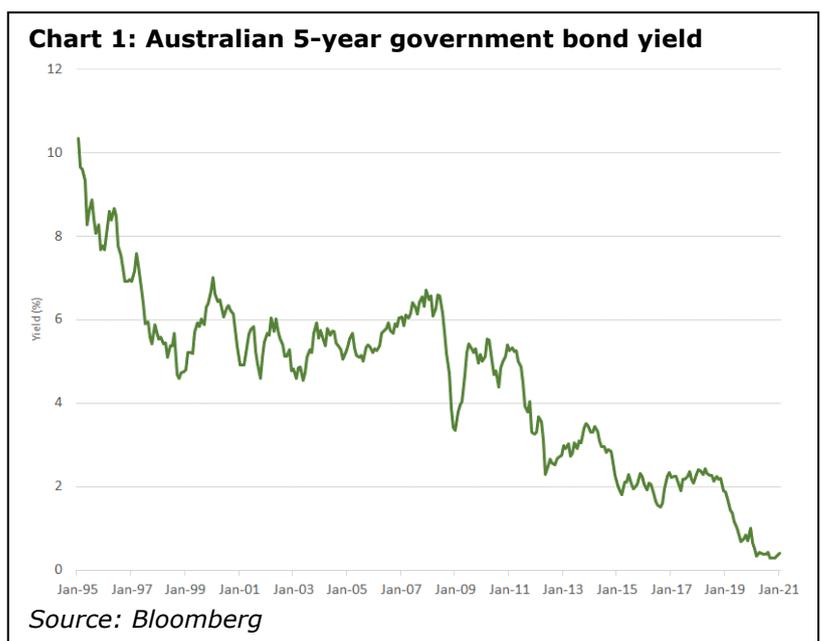


Table 1: Asset Class Risk Assumptions

Asset Class	Proxy	Likelihood of negative annual return
Cash	6-month term deposit	n/a
Fixed Income	Australia Broad Index	1-in-10 years
Property	Corelogic Australia Capital Cities Index	2.5-in-10 years
Equities	S&P/ASX 200 Index	3-in-10 years
Hybrids	Solactive Australia Hybrid Index	1.5-in-10 years

Source: RBA, ICE, Corelogic, Bloomberg

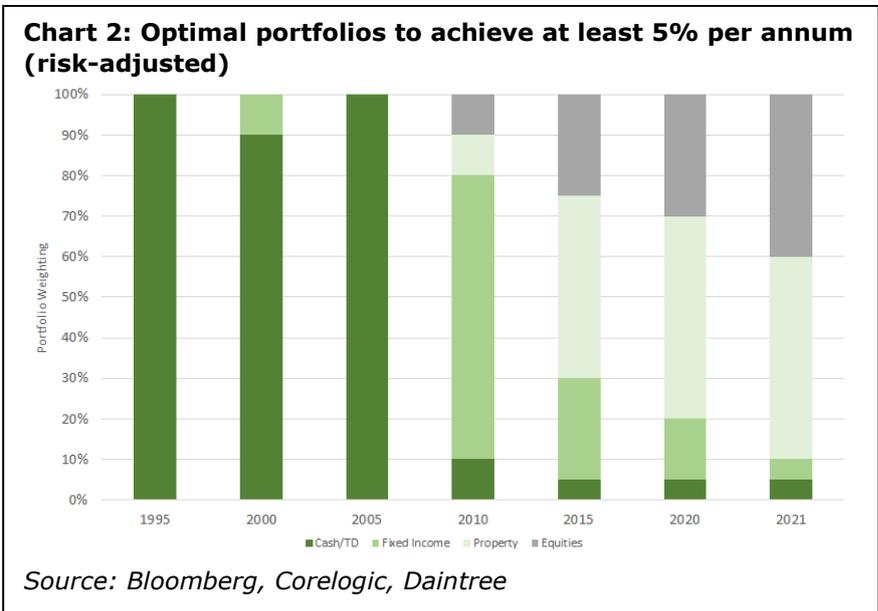
With the data and assumptions from Chart 1 and Table 1, we can now answer the first of our introductory questions.

How have portfolios changed over time to achieve 5%?

Chart 2 provides some important information on the '5%' portfolio.

First, there is a strong correlation between market interest rates and the composition of the portfolio. Second, our investor seeking 5% per annum is forced to take more risk to achieve the stated aim as the market interest rate has fallen over time.

In contrast to the turmoil of the 1987 stock market crash and the ensuing recession, financial markets of the mid-to-late 1990s were characterised by a general sense of calm. The RBA cash rate started the decade at 14-15%, but by January 1995 had fallen to 7.5%, with a 6-month deposit rate of 9.15% pa. This easily exceeds our requirements and the risk involved in earning that return would be very low.



By January 2000, interest rates had continued to ease, with the same 6-month deposit rate falling to 5.99%, still sufficient to meet our criteria. However, the yields on offer from fixed income were higher than those for deposits, and after accounting for the risk involved in a broad-based fixed income exposure, the optimal portfolio includes a small weighting to fixed income.

While cash rates were relatively stable through January 2005, the future returns available from credit fell considerably as longer-term interest rates fell. This drove solid returns from our small exposure to fixed income, but our investor was now faced with reinvestment risk. Therefore, in 2005 we could revert to bank deposits to achieve our goal, at the expense of potential further upside in asset values.

The following five years were eventful, to say the least, as the GFC created significant turmoil across the board. By now, our investor was being forced to deviate significantly from cash to attain their return target, with a significantly higher allocation to fixed income, property and equities, despite the lingering volatility.

By 2015 and continuing through 2020, apart from a nominal exposure to cash and fixed income, our investor had come to rely on growth assets such as shares and property to provide their return. Using our assumptions in Table 1 for the gross income return from a property or share portfolio, there is still some reliance on capital growth needed to achieve our goal.

Are there other options?

The analysis so far should make for uncomfortable reading for conservative investors. The prospect of cash or deposit rates rising to anywhere near 5% in a reasonable timeframe is remote.

In January 2021, the yield on a 6-month deposit ranges between only 0.3-0.6% pa. A broad fixed income index is offering 0.8-0.9% pa. The ASX 200 gross dividend yield is 3.6% pa, and the average gross yield from residential investment property is currently about 4% pa.

So apart from relying on capital growth or using leverage, no combination of these broad asset classes will achieve a 5% income return. Furthermore, interest rates cannot go much lower, removing one of the more reliable tailwinds for asset prices.

One asset class has not been included so far may improve overall outcomes by offering a predominantly income return at a manageable level of risk. Despite being a relatively 'young' asset class, hybrid securities are designed to have fixed income and equity characteristics. Specifically, income is paid periodically and there are defined call dates like many fixed income securities, while in certain circumstances hybrids can be converted to equity of the underlying issuer.

Importantly, observed volatility over time has tended to be a fraction of that of equities. On average, hybrid securities will register a negative return over a calendar year once every seven years. This equates to about one-third of the volatility experienced in equity markets.

In Australia, we have only seen three calendar years where hybrid returns were negative since the turn of the century, but on two of those occasions the maximum drawdown was less than 3%. Average returns, inclusive of franking, over this same period were approximately 6.5% pa.

With the inclusion of this additional data, optimal portfolio allocations would change to include hybrids in most time periods.

Hybrid securities have been a part of Daintree Capital's process for some time. We have identified the attractive return and risk characteristics of this asset class and have included them in our High-Income Trust since its inception in November 2018.

Implications for investors

The monumental changes in interest rates have forced all investors to revisit many fundamental assumptions about risk and return.

The seemingly unstoppable trend of falling interest rates has changed the game when it comes asset allocation and the role of different types of assets within portfolios. While we do not expect a reversal of these trends anytime soon, the zero lower bound presents a formidable barrier.

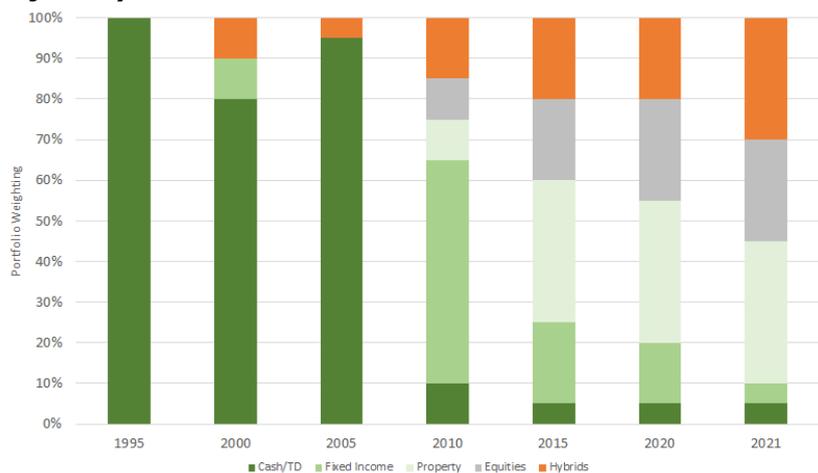
Conservative investors are now forced to choose between:

1. protecting capital in exchange for lower income;
2. drawing down capital over time to maintain a certain living standard; or
3. taking additional risk in search of higher yields.

Our analysis shows that when it comes to the third option, the amount of additional risk that must be taken is rising over time. Therefore, we believe it is becoming increasingly important to prioritise risk management as part of the portfolio construction process.

Brad Dunn is a Senior Credit Analyst at [Daintree Capital](#). This article contains general information only as it does not take into account the objectives, financial situation or needs of any particular person. The article is intended to illuminate broad market trends and should not be treated as an exhaustive analysis of the topic.

Chart 3: Optimal allocations including hybrids (risk-adjusted)



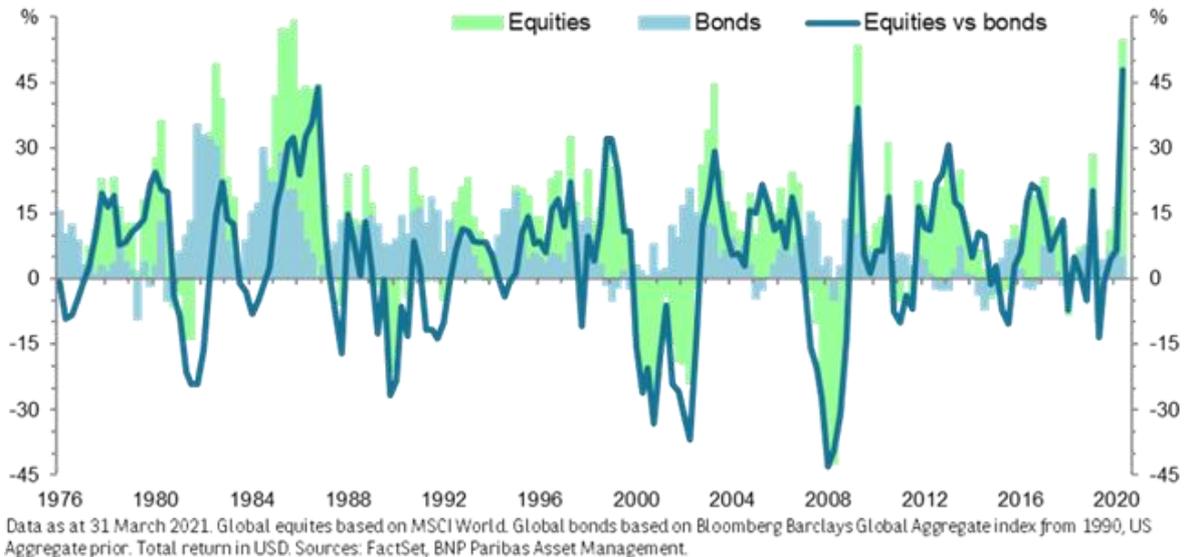
Source: Bloomberg, Corelogic, Daintree

Mind the bond/equity rebalancing gap

Daniel Morris

At the end of the first quarter of 2021, the MSCI World equity index had returned 55% (total return in USD) over 12 months, while the return of the Bloomberg Barclays Global Aggregate (bond) index was just 4.7%, giving equities a 48% outperformance (see Exhibit 1).

Exhibit 1: Returns for global equities and bonds for the 12 months ending 31/03/2021



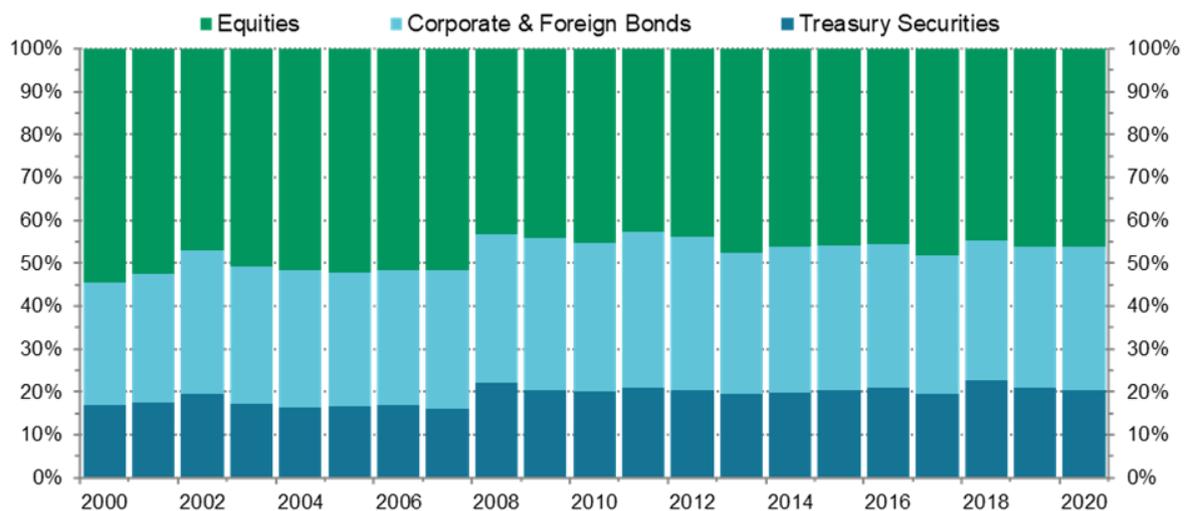
Rebalancing required

The quarter-on-quarter gap between equity and bond returns through the end of March 2021 was 9.2% compared to 12.4% in the previous quarter. The most significant change in the pattern of returns is that the equity outperformance over the last year came primarily in 2020, while the underperformance of bonds was greatest in the first quarter of 2021.

This divergence will require many institutional investors to rebalance their portfolios to attain their preferred allocation. This will be particularly true for insurance companies and pension funds that typically follow quite closely to a 50-50 split between bonds and equities in their allocations.

In the US, this split has rarely varied by more than a few percentage points and the allocation to corporate bonds and US Treasuries has been similarly stable (see Exhibit 2).

Exhibit 2: US institutional investor allocation to bonds and equities



Given that equities generally outperform bonds over time, achieving this target allocation (instead of maximising total returns) inevitably requires redemptions from equities and purchases of bonds.

Indeed, since the GFC, institutional investors have bought bonds every year, but they bought equities only twice and then only in small amounts (see Exhibit 3).

Exhibit 3: US institutional investor fund flows



Data as at 31 March 2021. Includes insurance companies and state and private pension funds. Sources: US Federal Reserve, BNP Paribas Asset Management.

No meaningful impact

What might we expect in terms of fund flows in the upcoming quarter as US insurance companies and pensions align their allocations with the allocations they had at the end of 2020?

Assuming funds flows in the first quarter of 2021 were the same as in the last quarter of 2020, and applying the relevant index returns to the existing asset base, in the absence of rebalancing, we estimate allocations to:

- equities would be 0.4% above target
- corporate bonds would be 0.3% below target
- Treasuries would actually be in line (the decline in the value of the Treasury portfolio due to rising rates has largely been offset by new bond purchases).

To restore the allocations, US institutional investors would need to buy about USD11 billion in Treasuries, USD58 billion in corporate bonds and redeem USD69 billion in equities.

These figures are only a percentage of typical purchases and redemptions, so we do not expect a meaningful impact on the market from institutional investor portfolio rebalancing this quarter.

Daniel Morris is Chief Market Strategist at [BNP Paribas Asset Management](#). This article was first published on 6 April 2021 on [Investors' Corner](#).

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Do bonds still offer a buffer to equity volatility?

Craig Stanford

The relationship between bonds and equities is a feature of all balanced portfolios, especially how the price of one moves in relation to the other. Correlation is a measure of the strength of the co-movement, with a positive correlation indicating prices usually move in the same direction.

As this relationship drives the performance of superannuation for many Australians, it's useful to know how the correlation between bonds and equities has varied over longer time periods. This article also looks at some of the key drivers of the correlation structure, and how different levels of correlation impact a portfolio's performance.

Correlation between bonds and equities over longer time periods

Questioning the persistence of the negative correlation between equity and investment grade fixed income price returns (that is, when equities rise, bond prices fall and rates rise, or when equities fall, bond prices rise and rates fall) has become timely because of the intersection of a few topics.

In particular, co-movement of the equity and sovereign bond markets during the March 2020 market sell-off reignited the concern about the hedging potential offered by fixed income assets. This led to a reinvestigation of the sovereign bond-equity correlation relationship, a relationship that has been negative over the past two decades. Many argue that much of this negative correlation can be attributed to the lowering and persistently low levels of inflation over this same period.

While stock and government bond prices have been moving in opposite directions since the beginning of the new millennium, the correlation prior to around 1997 in the US, as seen below, was broadly positive for more than a century. Using data going back to the mid-19th century, the correlation between equities and bonds has been mostly positive, making the recent and consistent stretch of negative correlation the anomaly, rather than the rule. (EMA=Exponential Moving Average).

How do different levels of correlation impact returns?

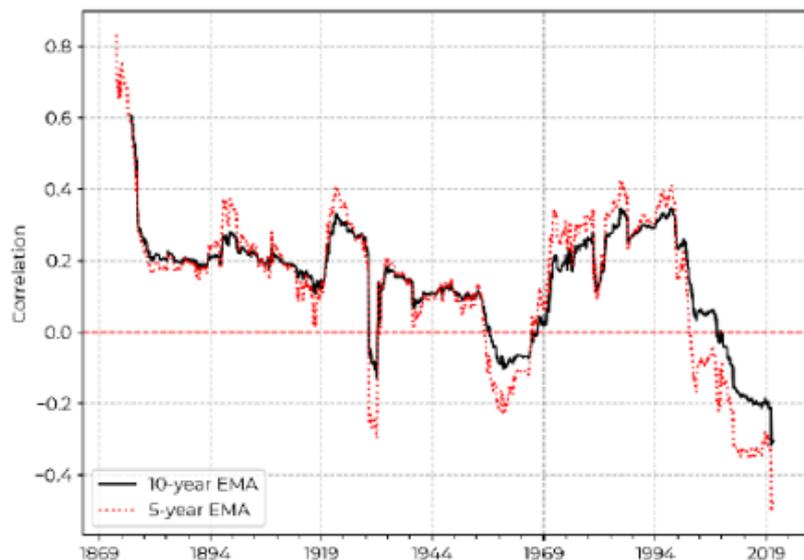
Investors use the Sharpe ratio as a measure of risk-adjusted returns, or how much excess return you receive for taking more risk. You would expect a higher return from an equity portfolio than a bond portfolio over time because equities are more volatile (and, by this measure, riskier).

The table below shows the Sharpe ratios of a 60/40 portfolio in three different time periods: 1980-today, 1980-1998 and 1998-today.

The latter two periods are characterised by the flip in correlation that occurred in 1997. In the first column of the table, we assume an arbitrary -0.4 correlation between equities and bonds and recalculate the Sharpe ratios. We repeat for the second column with an arbitrary +0.4 correlation.

What is striking is the increase in pre-1998 Sharpe ratio from 0.78 to 1.14 by flipping the correlation, and from 0.40 to 0.51 following the same flip in sign for the period post-1998. So the

Long-term evidence of positive correlation between bonds and equities



Source: Global Financial Data, CFM

	Negative Correlation (-0.4)	Positive Correlation (+0.4)
1980 - today	0.74	0.54
Pre-1998	1.14	0.78
Post-1998	0.51	0.40

Source: Bloomberg, CFM

risk-adjusted returns of a 60/40 portfolio are very sensitive to the level of correlation between equities and bonds!

How have other 'safe-haven' assets performed in difficult markets?

Asset managers have become accustomed to being able to rush into the safest and most liquid of assets, typically US treasuries, as a hedge when equity markets sell-off.

The 'protective' property of so-called 'safe-haven' assets such as US treasuries (and other low risk sovereign debt, gold, and especially the currencies of the US, Japan, and Switzerland) has been called upon to hedge equity exposure in periods of high (and often continued) market stress and significant drawdowns.

However, this market feature, looking back over the past 60 years, has only recently been available to all investors. In the table below we show all equity drawdowns (market falls) greater than 10% since the 1960s. We tabulate the total return of the S&P 500 from peak to trough, along with the comparative total return of US treasuries along with other major safe-haven assets. There is a distinctive pattern, corresponding with the correlation structure of equities and bonds as discussed above.

Before the end of the 90s, bonds typically moved in lockstep with equities, offering no protection to investors during these, the most severe drawdowns. Even in the couple of cases it did, the returns were marginal. However, after the end of the 90s, the pattern changed markedly, when, in most cases, bonds acted as an effective hedge against the equity sell-off.

	Event	Peak	Trough	S&P 500	US 10-year	Gold	US Dollar	JPY-USD	CHF-USD
Negative Correlation	GFC 2007-2009	10/10/2007	09/03/2009	-56.8	19.6	25.0	13.3	18.5	2.2
	Dot.com bubble	27/03/2000	09/10/2002	-49.1	30.0	12.3	2.1	-13.3	9.7
	Covid-19	20/02/2020	23/03/2020	-33.9	8.1	-3.6	2.8	0.1	-0.1
	Fed hike	21/09/2018	24/12/2018	-19.8	3.3	5.1	2.8	1.8	-2.8
	China market turbulence	22/05/2015	11/02/2016	-14.2	5.5	3.5	0.3	7.7	-3.7
	NFP scare	29/01/2018	08/02/2018	-10.2	-1.6	-2.3	1.3	-0.1	-0.2
Positive Correlation	1973-74 Oil crisis	12/01/1973	03/10/1974	-48.2	-14.9	137.5	-7.1	0.8	27.8
	1968-70 US recession	02/12/1968	26/05/1970	-36.1	-21.7	-10.5	-0.5	NA	NA
	Black Monday	26/08/1987	04/12/1987	-33.5	-2.4	8.4	-7.6	7.8	10.2
	Carter stagflation	01/12/1980	12/08/1982	-27.1	-8.0	-46.0	34.8	-17.7	-19.5
	Iraq war	17/07/1990	11/10/1990	-19.9	-4.7	6.8	-8.2	13.9	9.7
	LTCM / Russia default	20/07/1998	31/08/1998	-19.3	5.5	-6.4	-0.4	0.2	5.0
	Secular bear	11/10/1983	24/07/1984	-14.4	-17.4	-15.6	11.0	-6.2	-14.5
	Inflation fears	19/07/1999	15/10/1999	-12.1	-3.9	24.1	-6.8	14.7	8.2
	Asian contagion*	08/10/1997	27/10/1997	-10.8	1.2	-6.1	-0.1	0.3	0.4
	Friday the 13th	10/10/1989	30/01/1990	-10.2	-4.9	15.2	-6.8	-0.8	10.6
	??	26/09/1967	05/03/1968	-10.1	-2.1	0.7	1.9	NA	NA

Source: Bloomberg, CFM

Our conclusions

Given these observations, both the return and hedging potential of bonds are reduced when interest rates are low and correlations are positive.

If bonds become a less effective hedge for portfolios, investors will be left with few choices other than an expensive portfolio of options. We think they would be better advised to look for alternatives to bonds for diversification in the current environment.

Craig Stanford is a Director of [Capital Fund Management](#). This article is general information and does not consider the circumstances of any investor. Any description or information involving investment process or allocations is provided for illustration purposes only. There can be no assurance that these statements are or will prove to be accurate or complete in any way. All figures are unaudited. This article does not constitute an offer or solicitation to subscribe for any security or interest.

Five trends shaping investments in China: 2021 and beyond

Martin Lau

Given its size and influence, China remains a key investment destination despite ongoing trade disputes and diplomatic tensions with the US and Australia. With a GDP equivalent to around 70% of the United States, many global portfolios continue to feature Chinese equities.

Here are five insights into the current and future trends shaping the Chinese economy.

1. 2021 will see a strengthening economy in China

This year will provide an opportunity for more balanced market growth, perhaps including cyclical stocks and shares whose value took a hit last year. As the economy recovers, shares in a wider range of sectors will become more attractive. Last year, just a handful of companies accounted for the majority of the returns. We have already started to see signs of change, hence why we expect this year to be different from the last.

2020 was slightly unusual in that investors were very confident in the market despite the high valuations. As companies whose prices have increased 80- to 100-fold release their earnings, it will be interesting to see if they are able to meet expectations. We do not necessarily expect share prices to fall but believe returns may be lower than last year. As such, we will be conservative when deciding which stocks to purchase.

2. Equities are more attractively priced than bonds

Despite the expected economic recovery this year, no one is predicting higher interest rates, unlike in previous recoveries. This is because the economy is still in a precarious situation. Compared to bonds, we believe equities still offer better value for money. For example, the yield from a CK Hutchison Holdings bond (a global conglomerate) is around 1.6%-1.7%, but the dividend yield is more than 5%.

3. Chinese manufacturing and technology is more competitive than ever

The days of China being a cheap source of labour are gone but at the same time, the salary of a well-qualified Chinese engineer may be just one-half or two-thirds of the salary of a US-based engineer.

As a result, some sectors of the Chinese economy have started to grow quite rapidly, such as pharmaceuticals, software, semiconductors, and the automotive industry. China has been upgrading its manufacturing industry – a key aim of President Xi's latest and previous Five-Year Plans – which has benefited companies like telecoms equipment manufacturer Huawei.

On a similar note, almost 600,000 Chinese graduates return from overseas universities each year, boosting China's technological capacity. The R&D expenditure of Chinese tech companies has increased and it will be interesting to see the growth opportunities that result.

Our China tech investments are not restricted to internet companies. We expect to see new technologies in other sectors, such as retail and food, to cut costs and increase efficiency. In the future, the tech sector will become much broader as a result.

4. Trade sanctions may actually boost China's economy

There are historical precedents for the current political climate: in the 1980s the US levied high tariffs on Japanese car imports in a bid to protect its own home-grown car manufacturers.

The US is again in a political and economic wrestling match with its biggest rival – which was once Japan and is now China. As a result, we expect to see more policies from the US designed to limit China's economic rise.

However, the impact of trade sanctions on the Japanese economy were positive in some respects. Toyota, for example, remains the world's largest car manufacturer and even produces cars in the US. Toyota used local resources to support its global expansion and maintained its status as an industry leader.

We believe that in the short term, the Chinese government will support the economy through measures such as personal income tax cuts and private enterprise financing support. In the medium-to-long term, Chinese companies will be forced to strengthen their core competencies – those that are able to adapt to the new norm should emerge stronger over time, despite trade sanctions.

5. Chinese consumers will increasingly look for home-grown products

In China's latest Five-Year Plan, the government announced plans to reduce the country's vulnerability to, and dependence on, the global economy; achieve self-sufficiency; and boost domestic consumption. The government has also introduced subsidies to boost purchases of home appliances and cars.

We see these trends continuing over the next 5 to 10 years. As the Chinese economy develops and incomes rise, people will start to think about how they can improve their quality of life. We believe consumer spending, education and tourism are all poised for significant growth.

Related to this is the increasing popularity of domestic brands. As the younger generations see their living standards and incomes improve, they will start to become more confident about Chinese brands. You can see this in the success of domestic sportswear brands such as Li-Ning and Anta, or cosmetic brands such as Marubi and Pechoin. We predict this trend will continue – and there will be more home-grown brands such as Huawei or Xiaomi to help underpin a local consumer economy.

Conclusion

As President Xi rolls out the latest Five-Year Plan, we expect to see a number of secular trends take hold, which should help the Chinese economy maintain its growth. With an attractive base and a competitive, well-educated workforce, China's manufacturing champions should continue to advance its technology prowess and gain global market share. At the same time, China's population is looking inwards for local products and services, helping the country become more self-sufficient. Companies that can tap into these trends will be well-placed to ride the China wave into the next decade.

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The fascinating bank hybrid journey of the last year

Campbell Dawson

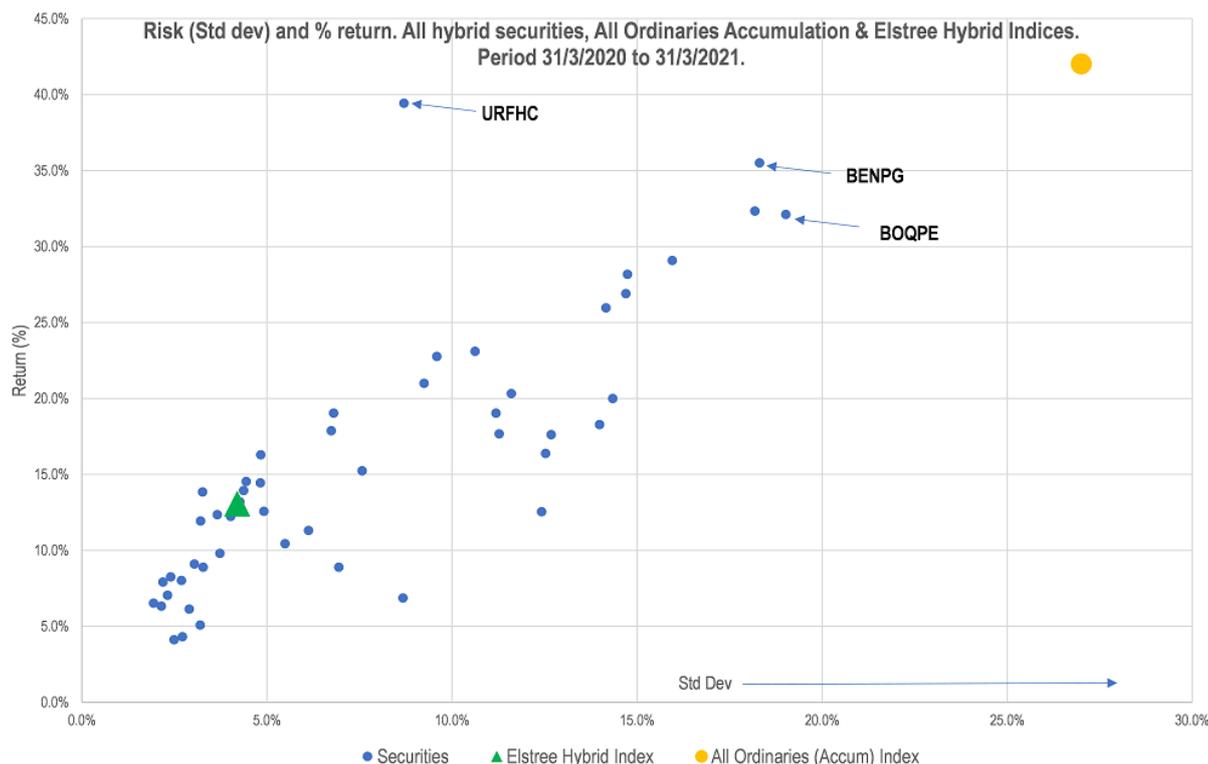
This time last year we were scrambling to figure out how best to explain the hybrid market's performance. From 2 March 2020 to the close of business on 23 March 2020 the broader market, as represented by Elstree Hybrid Index declined by a material 15.7%. By the month's end the index had managed to claw its way back such that it was down, over the month, by a relatively pedestrian 6.2%.

Wow, that was some 12-month period!

On the 12-month anniversary of the biggest drawdown since the GFC, it's an interesting time to reflect.

Most risk markets, hybrid markets included, bottomed on or around 23 March before rallying strongly on coordinated government and central bank intervention. The rally that ensued produced extraordinary return outcomes – we might even go so far as to say 'ridiculous' return outcomes.

Over the year to end 31 March 2021 the hybrid market as represented by the Elstree Hybrid Index returned 13.32%. This compares (now) with an expected hybrid market return of cash +3% (i.e. 3%). Investors certainly should not expect those hyper-inflated return outcomes again any time soon. The chart below shows the returns on individual hybrids (vertical axis) and the standard deviation (horizontal axis). We've also shown the Elstree Hybrid and All Ordinaries Accumulation indices.



What does this tell us?

- Almost everything did well but the non-major bank hybrids did best with many producing around 30% returns.
- Volatility was relatively subdued given the return outcomes. Pretty much everything went up in a straight line.
- If you produced the same chart but started it at 28 February 2020, you would get different outcomes with hybrids still producing an acceptable return and risk profile with equities displaying more risk and less return.

What were the fascinating days?

- The hybrid market's worst day was a -6.1% decline on 23 March 2020. This was the day that the NAB announced that they were converting their maturing NABPB hybrid into shares via a VWAP (Volume Weighted Average Price) agreement with UBS. This 'option' is present in almost every hybrid document and it allows the issuer to raise \$1-\$2 billion of equity capital without the usual complexities. In this instance investors received their \$100 (for the note) and then the NAB 'on sells' the note to UBS and NAB then issues ordinary shares to UBS. The market erroneously interpreted the cleansing statement issued by NAB to mean that the maturing NABPB holders would not get \$100 and instead would receive NAB shares at an estimated 30% premium to the last traded price. Investors sold everything including equities. NABHA fell 12%, AMPPB fell 11% while the broader equity market declined by just under 6%.
- The hybrid market's best day was a mere two days later on 25 March 2020 resulting in a 3.8% return. This was the day investors realised they had sold for the wrong reasons and bought back the stocks they had sold. The market had a net gain of 3.9% for that week.

Probably the biggest lesson is that many investors don't understand the structures, and in a crisis, everyone panics first and thinks later.

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Eight quick lessons on the intricacies of selling shares

Lawrence Lam

When we think about investing, we always think about buying. We spend enormous amounts of time forecasting the future and distilling vast stores of information into one single click of a green button.

But what is commonly overlooked, is the other side of the equation - selling. It remains the poor cousin of buying, yet it shouldn't be. Selling is as important to investing as braking is to driving. But investors are speed demons. They glamourise the accelerator. In doing so, they give up much of the hard work they have put in to establish the buy thesis.

A surprising fact about institutional investors

It may surprise you to know institutional investors do not have an edge when it comes to selling. [Recent researchers](#) studied the outcomes of selling decisions and determined there was substantial underperformance over the long-term. So bad were the selling decisions they even failed to beat a random selling strategy. These weren't retail investors. The study reviewed professional investors averaging US\$600 million in funds under management.

What can investors learn from the mistakes of institutions?

1. Poor selling and ways it can hurt

Without an analytical framework for selling, investors use mental shortcuts which are susceptible to behavioural biases and lead to inconsistent results. Poor selling can hurt in two ways:

First, you can sell out of a great company too early. The seed of a Californian redwood tree is only a tiny speck, yet it has great potential beyond its appearance. Dispose of those seeds and you miss out on a giant.

Second, a weakness in the selling process can lead to prolonging a losing investment far too long. Cognitive biases can shroud judgement. We become committed to a previous decision and fail to see how changing circumstances no longer make an investment worthy.

2. Use heuristics carefully

Earlier I introduced the term 'mental shortcuts'. In psychology, these are known as heuristics. They're good for simple decision making, but detrimental when it comes to complex analysis required for investing. Without a system of thought, we gravitate back towards a structureless approach. And this is where it can go wrong for many sellers.

Even at the institutional level, cognitive biases creep in. Research found the most common being:

- *The [disposition effect](#)*: a reluctance towards selling losers, and inclination to selling winners.
- *[Overconfidence](#)*: assuming you will make the right decision to sell without any factual analysis.
- *[Narrow bracketing](#)*: looking at decisions in isolation without consideration for the broader picture. Analysts who focus on one geographic or sector are most susceptible to this.

This makes sense. Financial incentives of institutional investors are centred around investment prowess, not divestment skill, and individuals can outmaneuver institutions.

3. Easy come, easy go

Poor selling is correlated to a lack of conviction. If you don't have strong conviction buying into a stock, it will show in your sell decisions. This conviction when entering a stock also translates to better selling performance on exit. Think about those stocks representing the smallest proportion of your portfolio. These are the stocks you are most likely to make bad sell decisions with.

Dipping toes in waters is not the optimal way to invest. Concentration leads to outperformance as it encourages deeper analysis. Nothing like a big investment to ward off capriciousness. The benefit isn't only on the buy side.

4. Knee-jerks hurt

One of the main reasons institutional investors make bad selling decisions is because they react to price movements. All the fundamental analysis done when deciding to buy is not mirrored when they sell. Instead,

sell decisions are either automatically triggered via stop losses or auto-rebalancing strategies to capture recent gains. Either way, basing selling decisions purely on price is what leads to underperformance.

To counter a pure price focus, investors can change perspective with these mindset-centering questions:

- Have business prospects fundamentally changed for the future?
- Are customers migrating away from this industry?
- Does the company still retain its competitive edge?

5. Following the time of year

Calendar trades occur when professional fund managers decide to sell for no other reason than to realise taxable losses or crystallise their gains as they massage their financial year end results. Annual bonuses drive selling decisions which are proven to underperform in the long-term. From the portfolio manager's perspective, it may not matter if they are rewarded for these decisions so long as they achieve their end of financial year KPIs.

Knowing these weaknesses is one thing, mitigating them is another. It is only once these issues become known that addressing them becomes possible.

6. Incentives create value

The single hardest and simplest correction for most investors is to align your long-term incentives with your selling strategy. If your investment strategy is long-term and you want to compound your investments, then set up a framework that rewards careful, fundamental analysis before selling.

The same questions when buying should be applied to selling. Here is where private investors have an in-built advantage over institutions. They should innately possess the flexibility and natural incentive to perform over the long-term.

Institutional managers need to think as if they are the largest investor in their fund.

7. Stress and other suboptimal influences

When you're facing a 30-40% drop in prices, the stomach will take over the mind. Stress sets in, sometimes panic. This pressure is even greater for institutions who have to report back to thousands of clients. They become price-reactionary. Heuristics invade the decision-making process when time is pressured. Evidence points to the most severe underperformance on sales coming after extreme price movements.

When your gut is telling you to sell, think back to the mindset-centering questions above.

8. Creating a feedback loop

Institutions spend less time analysing the selling decision. They will meticulously track buying decisions, but they rarely analyse how selling decisions went. A technique I employ to improve selling decisions is to elucidate myself with iterative feedback. Track the results of selling decisions just as you would with buying decisions. Each iteration of feedback informs how a sell decision can be improved for next time. Without it, investors are blind to their own mistakes.

Evolving your selling

The evolution of any investor understandably begins with focusing on buying, but sophisticated investors that truly understand when and how to sell, transcend into becoming adaptive investors able to compound wealth in any market condition. Adaptive capital is where you ride each wave as it presents itself. To do that, you need to be skillful at braking, not just accelerating.

Happy compounding.

Lawrence Lam is Managing Director and Founder of [Lumenary](#), a fund that invests in the best founder-led companies in the world. The material in this article is for general information only and does not consider any individual's investment objectives. All stocks mentioned have been used for illustrative purposes only and do not represent any buy or sell recommendations.

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