Firstlinks
a Morningstar company

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Editorial

Our Prime Minister, Scott Morrison, is a marketing guy, including as a former Managing Director of Tourism Australia at the time of the 'Where the bloody hell are you?' campaign. He was Federal Treasurer from September 2015 to August 2018 with major responsibilities for superannuation. He was the main architect of changes such as the cap on super pensions, and even on this subject, he showed how nimble he can be with words. So why is super overflowing with unappealing terms few people understand?

For a start, we need another word for a superannuation 'pension' and reserve the word for welfare. It's confusing and inappropriate. A couple with $3.2 million in their pension accounts would not think they are living on a pension, but that's what the account is called. We have lived with CIPRs, or Comprehensive Income Products for Retirement, ever since the Financial Systems Inquiry in 2014, and words like 'salary sacrifice' send the wrong message. Sacrifice is always bad. And let's not start with ECPI and its segregated or proportionate methods (what?!) or NALI or NCC or LISTO or ... I have been at expert sessions at an SMSF Association conference where specialists were confused after half an hour, so what hope do mere mortals have?

You could get arrested in the wrong company by asking: "*Psst ... would you like some extension relief on your non-arm's length arrangement?*"

And now we have a Covenant for retirement income products. It sounds biblical or maybe a peace treaty. Why not a simple 'agreement'? And here is the definition of 'retirement income':

"Income during retirement, including income streams and withdrawals from superannuation, the age pension, and drawdown of non-superannuation assets."

Get that? Income is spending the capital from both super and non-super assets, not only the earnings. Treasury has released a position paper on the Retirement Income Covenant where members of super funds will be encouraged to spend more of their capital to live on. It's an 'income covenant' but does anyone think a return of capital is the same as income? It's more accurately a spending covenant. We explain how it works, including for SMSFs, and what the products might look like.

Still on retirement incomes, **Geoff Warren and David Bell** say major super funds will be forced away from navel-gazing to take action over their retirement offerings, but the capacity of members to engage with complex financial decisions is a worry.

Elsewhere last week, **The Wall Street Journal** noted a remarkable milestone and it shows the challenge of not only recognising a great company at an early stage but hanging on to the investment. From 1999 to 2001, Amazon stock fell in price by 95% as it lost money for 17 quarters in a row and investors ran out of patience. It is 20 years since the WSJ published this story, and the stock fell heavily on the day. Anyone who sold and never went back in is trying not to think about it.

Extract from The Wall Street Journal, 24 Jul 2001


Amazon Trims Loss; Sales Outlook Dims

Estimated '01 Revenue Gain Drops to 11%-16% Range; Stock Falls After Hours

By MYLENE MANGALINDAN
Staff Reporter of THE WALL STREET JOURNAL

Amazon.com Inc. posted a narrower net loss for the second quarter, its 17th consecutive unprofitable period, on sales that rose 16%. But concerns that the company was lowering its revenue projections for the rest of the year helped push the Internet retailer's shares down 7.5% in after-hours trading.

Just a few months ago, the company had predicted an increase in sales of 20% to 30% for 2001 compared with 2000. Now, Amazon says it is expecting about 11% to 16% sales growth in 2001 over sales in 2000, notes Arthur Newman, an analyst at ABN Amro.

or 47 cents per share, from $317.2 million, or 91 cents, in the year-earlier period.

Prudential Securities analyst Mark Rowen noted that Amazon had raised prices to improve its profit margins but may have gone too far, particularly in this economic environment.

Meanwhile, the company had forecast that it would reach profitability—based on its unique measurement that excludes a variety of items and costs—by year's end.

Progress Cited

Amazon said it is making progress toward those profitability goals. "We will continue to trade top-line growth for bottom-line improvement," said Chief Financial Officer Warren Jenson.

Sales in the Seattle company's main business of books, music and videos rose to $389.7 million during the quarter, a meager 1% in net sales growth from last year. As the oldest part of Amazon's business, books, music and videos have slowed considerably as the market becomes more saturated.

Gross profit margin improved to 26.9%

Said the WSJ: *"You know the rest of the story. From that day through this week, Amazon has gained 29,345.1% cumulatively, or a 32.87% annualized total return. The S&P 500 has returned 440.1%, or 8.8% annualized, counting dividends."*

The market continues to throw up fascinating examples where it is prepared to pay for future growth as it looks for the next Amazon. The best examples are the growing number of unicorns or privately-owned (that is, unlisted) startups with a current valuation of over US$1 billion. That was once a lot of money, but based on fundraising valuations, a new unicorn has emerged **EVERY DAY** in 2021. According to cbinsights, there are now 771 unicorns with the largest Australian company, **Canva**, valued at about US$15 billion.

As investors are increasingly willing to put some of their risk capital to use in these growth dreams, **Andrew Mitchell** explains how to recognise the next great startups when conventional metrics are useless.

With interest rates so low, investors are increasingly turning to equites for their dividends, willing to take the risk to generate income. **Max Cappetta** shows which Australian companies are about to deliver handsome rewards for dividend investors, often from non-traditional sources, but stocks should not be chosen simply because they pay high yields.

But it's not stocks that determine the best portfolio returns but overall asset allocation, and **Damien Hennessy** says the conventional 60% growth/40% defensive mix has thrived in recent decades, especially as bond rates fell. However, the future will be more difficult and he offers ideas to hold up returns.

A new financial year is a good time to think about asset allocation, especially as many portfolios might be overweight equities after a long rally. Here is how **First Sentier Investors'** Multi-Asset team made adjustments to their portfolios in the first half of 2021. Less in bonds due to the downside risk, more in global equities and property due to growth prospects and a dabble in commodities.

Real Return Fund NAA	Dec-20		Apr-21	Change
Cash	5.0%	↔	5.0%	0.0%
Australian Government Bonds	12.0%	↓	9.0%	-3.0%
Global Bonds	33.0%	↓	26.0%	-7.0%
Credit - Investment Grade	0.0%	↔	0.0%	0.0%
Credit – High Yield	5.0%	↓	0.0%	-5.0%
Emerging Market Bonds	0.0%	↔	0.0%	0.0%
Global Listed Property	0.0%	↑	5.0%	5.0%
Australian Equities	18.0%	↓	16.0%	-2.0%
World Equities	27.0%	↑	37.0%	10.0%
Emerging Markets Equities	0.0%	↔	0.0%	0.0%
Commodities	0.0%	↑	2.0%	2.0%
Total	100.0%		100.0%	

On the global stage, we are reminded of the prospects for Japan by the Olympics and **Claire Gallagher**. She explains why Japan now offers value, diversification and the safe haven benefits after a time off the radar of most investors.

And in bonds, **Matthew Macreadie** uses **Virgin Australia** as an example for anyone looking to directly invest in a portfolio of corporate bonds. Despite good ratings before the onset of COVID, Virgin became a bad experience for bondholders showing the risk in a highly concentrated portfolio of a few names.

The final two retirement income ideas in our series of five (reviewed in more detail in the retirement income article lead this week) comes from **Caitriona Wortley** explaining protected income strategies using derivatives, while **Doug McBirnie** shows how pooling of longevity risk might be a solution for some large funds. Lots of new developments coming to retirement income in the next year.

This week's White Paper from **First Sentier Investors** looks at a part of the property market few people consider: ghost kitchens. The theme takes advantages of our rapidly-changing habits and the increase in ghost kitchen demand is encouraging investment in real estate in the new age economy.

Finally, last week's article by **Christine Benz** on her faux-retirement was very popular and drew some excellent feedback, but we have chosen **Martin Mulcare's** response to our thoughts on the politics of superannuation as our **Comment of the Week**:

"I agree, Graham, that the super industry has not sold itself well. I think this starts with the poor level of engagement that funds have with their own members. My wife and our three children are each intelligent, numerate adults but have no interest in their super because the communication of their various different funds is not at all interesting. I would be keen to hear other reasons for this but let me start with a couple:
1. Communication is compliance driven not customer driven
2. The owners of the communication have traditionally been technical people rather than people people
3. There are no 'diverse customer voices' being heard inside the funds."

Retirement income promise relies on spending capital

Graham Hand

Everyone needs to rethink what income means in retirement. That's the message from the Government, and it will soon impose obligations on all super funds, including SMSFs, to provide a plan to maximise this form of 'income'.

In the Retirement Income Review papers released in July 2020, there is a definition which every superannuation trustee needs to understand. In future, it will guide retirement spending policies and determine how super funds communicate with their members.

"Retirement income: Income during retirement, including income streams and withdrawals from superannuation, the age pension, and drawdown of non-superannuation assets."

While a more common definition of 'income' is "*money that is earned from doing work or received from investments" (Cambridge English Dictionary),* add the word 'retirement' and 'retirement income' now includes:

- withdrawals from super
- age pension
- drawdown of non-super assets.

Yes, enter your retirement and draw $5,000 from a bank account to go on a holiday, and that's retirement income.

Get used to it.

The Retirement Income Covenant

The argument that retirees should draw income from assets has been taken further in the newly-released Retirement Income Covenant, operational from 1 July 2022. It requires every super fund to provide a document:

"… *outlining their plan to assist their members to achieve and balance the following objectives:*
1. maximise their retirement income
2. manage risks to the sustainability and stability of their retirement income; and
3. have some flexible access to savings during retirement."

And the use of 'retirement income' here is consistent and deliberate.

Retirees must spend their capital

A comfortable standard of living for a couple in retirement at age 65 according to ASFA needs $62,828 a year, assuming home ownership. If they have investible assets of $1 million and they do not want to spend their capital, that means an income of 6.28% per annum (present day) is required. That's a big ask these days without a fair amount of equity-type risk in a portfolio, which is where the drawdown of capital comes in.

Even if we accept the need to spend capital, there are many views on a safe withdrawal rate for a retiree not to run out of money. Traditionally, 4% was considered safe. The '4% rule' started in 1994 with an article published in the *Journal of Financial Planning* by William Bengen. He explained where the rate came from in this Firstlinks article and of course, interest rates were much higher 27 years ago.

As interest rates fell, many people argued for 3% or less, such as in 2016 when Anthony Serhan (then of Morningstar) wrote in Firstlinks about withdrawal rates and concluded: "*Safe withdrawal rates for retirees now need to start at 2.5%."*

Either way, there is no silver bullet. The Government will require trustees to educate their members about using their capital to live on, but trustees know they cannot guarantee their members will not run out of money using any traditional products.

The Covenant draws on the Retirement Income Review in making the case to retirees:

"Partly because they have only ever been primed to save as large a lump sum as possible, retirees struggle with the concept that superannuation is to be consumed to fund their retirement.

Because retirees struggle to develop effective retirement income strategies on their own, much of the savings accrued by members through the superannuation system are not used to provide retirement income. Rather, they remain unspent and become part of the person's bequest when they die.

Multiple studies have shown that retirees die with around 90% of the assets they had at retirement. Without a change in behaviour, it is expected that bequests from superannuation will grow. By 2060, it is projected that 1 in every 3 dollars paid out of the superannuation system will be a part of a bequest."

Research by David Blanchett and Michael S Finke supports the view that retirees fear running out of money. They show retirees will spend twice as much each year if they shift investment assets into a source of guaranteed income, finding:

- Longevity risk (the fear of outliving their savings) results in lower spending, and
- Behavioural preferences make retirees more comfortable spending from income than assets.

There is no more important statement in the 648-page Retirement Income Review than this:

"retirees die with around 90% of the assets they had at retirement."

It is the primary justification for developing policy requiring spending and not bequeathing. Yet Ross Clare, Director Research at the Association of Superannuation Funds of Australia (ASFA) wrote an article in Firstlinks called "In fact, most people have no super when they die".

It would be hard to find a bigger range from two authorities on the same subject than close to zero and close to 100%. Nevertheless, the Covenant will require all trustees to show members how to spend.

SMSFs are not excused

Just in case SMSF trustees think the deliberations are only for the consultants, professional fund managers and trustees of large funds, the Government makes it clear that SMSF trustees have obligations as well. It says:

"Trustees of SMSFs and SAFs (Small APRA Funds) with retired members should have a retirement income strategy ... (they) are not expected to develop their strategy for cohorts of their members, given their small size. However, if trustees of SMSFs and SAFs identify that their members need markedly different approaches to balance the objectives under the strategy, they are not precluded from developing their strategy for cohorts of their members."

The Covenant provides few clues

For all its arguments about the benefits of providing members with retirement products tailored to their needs, the Covenant provides few hints on how to achieve the outcome. It includes hopeful statements such as:

"... the strategy should identify how trustees intend to assist their members to balance these objectives and whether the trustee's intended assistance is likely to increase or decrease the retirement incomes of their members."

Or this gem that reads as if from an undergraduate economics exam where the strategy is a strategic document (*sic*):

"In effect, the strategy is a strategic document developed by the trustee that:
1. *identifies and recognises the retirement income needs of the members of the fund; and*
2. *presents a plan to build the fund's capacity and capability to service those needs."*

There is even doubt about whether the Covenant is possible to implement under current regulations. Dr Pamela Hanrahan recently told a Conexus Institute webinar that trustees are limited in their ability to provide tailored advice for members, and the Covenant probably falls foul of the distinction between general and personal financial advice.

The Government's own policies on drawdowns are confusing. At the same time as they are advocating retirees spend their capital, they reduced the mandatory minimum amount required to be withdrawn from a pension account by 50%. Initially, this was due to the pandemic, but it was recently extended for another year after the market had strongly recovered.

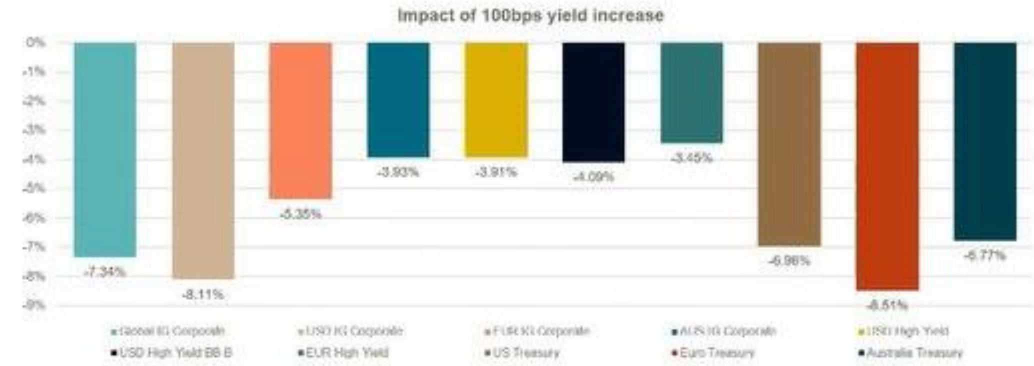
Not much merit in having a Retirement Income Review and now a Covenant arguing retirees should take money out when the Government then says leave it in.

As the Covenant paper gives trustees an obligation to develop retirement strategies without prescriptions, it will lead to a vast range of different outcomes, including some trustees who believe their current product range is fine.

Complicating matters, at a time when the risk-free bond rate is close to 1% and stockmarkets are at all-time highs and expensive by most standards, trustees cannot simply offer promises of attractive investment returns to satisfy retirement income needs.

Consider this chart, provided by First Sentier Investments, which shows the capital loss from a 1% rise in rates, on a range of bond indexes. Bonds are supposed to protect investor portfolios in times of distress. For example, in Australia, the government bond index has a duration of 6.8 years, meaning a 6.8% loss for a 1% rate rise. Trustees cannot rely on the past successes in the way a simple 60/40 portfolio delivered handsomely in a retirement.

Market	Global IG Corporate	USD IG Corporate	EUR IG Corporate	AUS IG Corporate	USD High Yield	USD High Yield BB-B	EUR High Yield	US Treasury	Euro Treasury	Australia Treasury
Index Name	Bloomberg Barclays Global Aggregate Corporate Index	Barclays Global Aggregate Corporate USD Index	Barclays Global Aggregate Corporate EUR Index	Bloomberg AusBond Credit 0+ Yr Index	ICE BofA US High Yield Index	ICE BofA BB-B US High Yield Index	ICE BofA Euro High Yield Index	Bloomberg Barclays US Treasury Index	Bloomberg Barclays Euro-Aggregate Treasury Index	Bloomberg AusBond Treasury 0+ Yr Index
Duration (yrs)	7.34	8.11	5.35	3.93	3.91	4.09	3.45	6.96	8.51	6.77



Source: Bloomberg, ICE as at 31 March 2021
Assume immediate and parallel shift across yield curve

Examples of retirement income products

In recent weeks (including this week), Firstlinks has published five articles with different solutions to the retirement income challenge, plus an earlier sixth article on lifetime annuities.

Let's quickly examine the six. Most of these are complicated structures and there is not space here for a full review.

1. Investment-linked lifetime annuities - https://www.firstlinks.com.au/manage-run-down-income-retirement

These products, such as offered by Optimum Pensions and QSuper, are a form of investment-linked annuity which invests in a balanced fund with growth exposure, supported by some longevity insurance. The aim is to bridge the gap between the usual account-based pensions and lifetime annuities with fixed payments. Each year's income varies based on the performance of the selected investment option, rather than as a specific dollar amount of income.

It is designed to give retirees confidence to invest in growth assets while drawing down their assets. Optimum Pensions buys longevity insurance from Hannover Re, while QSuper probably self-insures under a concept of 'group self-annuitisation' based on its large member base.

2. Magellan's FuturePay - https://www.firstlinks.com.au/magellans-new-fund-seeks-offer-income-added-support

Magellan's new product is an equity fund that pays a regular, inflation-linked income. It is protected by a Support Trust, initially seeded by Magellan with $50 million, paid in increments. There is also a committed a reserve facility equal to 2% of the fund, capped at $100 million to "provide additional support during poor market conditions". Payments into the Support Trust will flow from two key sources. First, when investors purchase units in the fund, a small amount of capital will be contributed from the fund to the trust. Second, in rising markets, where the portfolio is outperforming its inflation-adjusted index, FuturePay may reserve a portion of its outperformance by contributing capital to the Trust.

The assets in the FuturePay Support Trust do not form part of the assets of the fund. Investors who redeem units will receive the value of the investment portfolio but they leave behind their benefits in the reserve, which is why Magellan calls it a 'mutualisation' of the fund. The structure relies on strong markets in its early stages to build up the reserve and investors should consider they are in for the long haul.

3. Traditional balanced funds in an allocated pension - https://www.firstlinks.com.au/achieving-sufficient-income-retirement-portfolio

The account-based pension is the most common way Australians finance their retirement. The pension phase may differ in its asset allocation from the earlier accumulation stage, although with more people living 30 years or more in retirement, a switch to defensive investments paying negative real rates is less common. The pension works by the retiree withdrawing whatever is required for a chosen lifestyle (subject to mandated minimums) and hoping the outflows are covered by income.

This article by Martin Currie Australia is an example of the retirement solution without any specific protection included. Over the long term, stockmarkets generally rise and deliver an increasing dividend stream, supported in a balanced portfolio by more defensive assets to reduce volatility. By focussing on assets that generate a high and stable franked income stream through diversified sources, most retirement objectives can be met.

When I worked at CFS a decade ago, the main reason little work was done on a special 'retirement income product' was a belief that over time, a balanced account-based pension was a good solution. However, that was when the bond allocation could deliver closer to 8%. Some trustees of large super funds may argue the traditional approach is best for their members given the complexity and costs in other solutions.

4. Pooling among many members - https://www.firstlinks.com.au/protecting-retirement-savings-longevity-risk

A feature of life expectancy is that over half the people of a certain age will live longer than their expectations. However, pooling a large group of retirees of the same age will give a reliable distribution of ages at death. As the pool gets larger, the distribution of lifespans around the mean is more predictable.

The benefits of pooling can be passed on to retirees. Super funds can provide lifetime income products by pooling together retirees' capital through a product known as a group self-annuity (GSA). With enough members, they can reduce the uncertainty for individuals in the group.

Like a traditional defined benefit fund, super funds could hold reserves to support a pooled product, either permanently or until the pooled product reaches scale. The reserves can be used to smooth benefit payments and reduce the volatility for members.

5. Protected income products - https://www.firstlinks.com.au/two-factors-can-transform-retirement-investing

The Allianz Retire+ 'protected retirement product' is designed as part of a portfolio's defensive allocation. It is a long-term investment that discourages individuals from withdrawing their investment early as the value at early withdrawal is subject to market conditions.

As an example of current returns using a protection strategy with an investment of 50/50 in S&P/ASX 200 Total Return (3.50% cap) and MSCI World Net in AUD (3.20% cap) with a zero loss tolerance (before fees), a retiree could earn a maximum potential return of 2.55% pa if held for the full seven-year term.

6. Lifetime annuities - https://www.firstlinks.com.au/qa-long-term-annuities

The leading offers of the longstanding solution in the retirement space, lifetime annuities, are provided by Challenger and AIA Australia.

A lifetime annuity is a traditional product that will pay a guaranteed stream of income for life, with a potential option to pay a surviving spouse. This income is usually fixed or set to increase in line with inflation. The key feature of the annuity is the guarantee, backed by capital from a life insurance company. Innovations over the past decade have seen many features added to life annuities in Australia.

A typical example of a lifetime annuity is:

- $100,000 invested at age 64, life expectancy to 84, payment adjusted at CPI of 2.5%.
- At age 65, annual income $3,905, death benefit, $100,000. By the age of 74, income has risen to $4,877, death benefit still $100,000, but capital then starts to fall until it reaches zero at age 84.
- At age 84, income now $6,243, death benefit zero.
- At age 104, income $10,229.

In order to have more 'income' to live on, a retiree must draw on their capital later in life. In this example, after the age of 84, the income level is sustained until death but the capital has gone. Of course, this should be only part of the overall retirement solution as it does not have everything that a retiree might need, such as combining it with an ABP.

A wide range of retirement income solutions is coming

The vast majority of people no doubt think income and capital are different. If someone invests $100,000 and earns $2,500, this represents their 'income'. If they drawdown 'income' of $10,000 from an account (super or not) but their capital is now $92,500, few people will call this $10,000 of income.

Most members of large super funds will be confused by the product complexity of the coming retirement incomes products, and they may leave it for the fund to select a product for them. The major challenge will be communicating this complexity to the millions of members who are relatively disengaged and talk of longevity insurance will make it more difficult. There is no silver bullet.

And we all have to cope with a unique definition of 'income'.

Graham Hand is Managing Editor of Firstlinks.

How retirees might find a retirement solution in future

David Bell, Geoff Warren

Developing retirement solutions is the next big challenge facing the superannuation industry. And it is about to get serious. The Government is currently framing a Retirement Income Covenant (RIC), expected to come into operation on 1 July 2022. Treasury recently released a Position Paper that states the intent of the RIC is to:

"codify the requirements and obligations of superannuation trustees to improve the retirement outcomes for individuals".

The RIC will require trustees:

"to formulate, review regularly, and give effect to a retirement income strategy".

The impending codification will act as a catalyst for the major super funds to move from navel-gazing towards taking action over their retirement offerings. The focus of this article is how the framework might work for these funds. The RIC will also cover SMSF trustees who will need to consider whether their retirement strategy should be more formalised.

Principles for design, not a prescription

Rather than prescribing a retirement product, the RIC Position Paper focuses on the principles for *strategy design*. It discusses how funds might develop retirement strategies to balance the provision of income, management of risk (specifically investment and longevity risk), and flexible access to some funds.

We believe the RIC should also address *how retirement strategies are delivered*. Arguably matching retiring members with suitable retirement strategies is at least an equal, if not greater, challenge than designing those strategies in the first place.

The Government has intimated they want member choice to sit at the foundation of the retirement system. Indications are that they envisage individuals selecting a retirement strategy for themselves. This might occur through accessing information and decision support tools such as interactive financial calculators, which could be made available by their fund or other providers (perhaps ASIC MoneySmart).

Or it could occur under the guidance of financial advisers. Eventually, robo-advice might even play a role. Basically members would be expected to directly exercise choice over their retirement solution, including the products making up the strategies and their providers.

A purely choice-based architecture of this type would create some dissonance with the framework prior to retirement with which fund members are familiar. The figure below describes what the currently envisaged retirement framework might look like, and how it compares to the accumulation phase. A key point of distinction is that defaults play a central role in accumulation. Nearly 60% of pre-retirement assets of the major super funds are invested in MySuper defaults.

Indicated choice architecture for accumulation and retirement

	Accumulation	Retirement	Assistance
Within member's 'stapled' fund	1) MySuper default	1) Role of defaults?	
	2) Choice of investment option	2) Choice of retirement option	• Information • Guidance / tools • Advice offered by fund
External choice	3a) Choice of fund (inc. SMSFs) 3b) Choice of investment option	3) Choice from large range of retirement products	• Information • Guidance / tools • Advice by financial planners

Note: This diagram accounts for indicated changes under the RIC and stapling as introduced under Your Future, Your Super.

Capacity of members to select a retirement product

Thrusting members into an environment where they need to choose for themselves after they retire gives rise to a number of issues. An important concern is the willingness and capacity of members to engage with financial decisions. Research finds that most individuals have relatively low financial literacy. They can also be subject to various behavioural influences that may lead to sub-optimal decisions. This includes difficulties in processing information, anchoring on obvious choices, myopia and cognitive decline with age – just to name a few.

The difficulty of exercising choice in retirement is only compounded by the complexity of the problem. Managing finances in retirement requires deciding where to invest and how much to draw over a few decades, while accounting for other assets and income sources such as the age pension. Market returns are uncertain and people don't know how long they will live. The difficulty will only be further exacerbated by a likely proliferation of available retirement products, which the Government seems keen to encourage in order to spur innovation and create competitive tension.

The hurdles to effective self-choice might be overcome if people were willing to seek professional financial advice. Unfortunately, this is not likely to provide a solution for the masses. A full Statement of Advice reportedly costs $3,000 to $4,000, a price many retirees are not willing to pay. Further, the financial planning community is constrained in providing advice at scale. Personal advice is time-consuming, and adviser numbers have fallen sharply post the Royal Commission.

There is another way of matching retirees with suitable retirement solutions apart from relying on either financial advice or making a self-directed choice. Retiring members could also be given an option to request that their super fund selects a retirement solution on their behalf. We call this 'fund-guided choice'.

The selection could be framed as a recommended retirement solution that the member can decide to accept or not. Alternatively, the member might choose to ask their fund to assign them to a solution, followed by sign-off to confirm acceptance.

Some members will trust their fund to make a selection

We suspect that many retirees might welcome the opportunity to ask their fund to make a selection for them. Research indicates that a substantial portion of fund members are willing to trust their fund, and are content to accept options put in front of them due to a lack of confidence to decide for themselves. Fund-guided choice would be closer to what happens prior to retirement for those members who have willingly accepted the default.

Fund-guided choice could also introduce some useful nudges into the decision process that may improve member outcomes. Many retirees arguably limit the amount of value they extract from their retirement savings due to reluctance to draw down on savings to the extent affordable, minimal take-up of longevity insurance and investing too conservatively. Fund-guided choice could assist in addressing these issues through offering solutions to member that embed a suitable mix of higher drawdowns, longevity insurance and growth asset exposure.

The choice framework we suggest might operate through funds asking retiring members to choose one of the four options listed in the figure below. The election of option A or B invokes fund-guided choice, which might be followed by an invitation to furnish additional information to assist the fund to select a suitable solution. The menu of options might be supported by the provision of general and product information and various decision tools.

Choices that might be put to a retiring member by their fund

Please choose one of the following options:

A. Please assign me to a retirement solution
B. Recommend a retirement solution to me
C. I want to choose a retirement solution for myself
D. Please refer me to a financial planner

Note: A prior step would establish the balance that the member wishes to transfer into a retirement solution with their fund

The question arises as to what happens when members don't make a choice, perhaps because they are heavily disengaged. At a minimum, the fund might continue to attempt engagement. It might also be helpful for funds to have the scope to assign members to a retirement option under certain conditions, although this would run counter to a purely choice-based system.

Obligation to engage at retirement

The RIC offers an opportunity to establish a framework that caters for various types of retiree according to how they prefer to engage with choosing a retirement solution. This could be achieved through placing an obligation on fund trustees to engage with members at retirement to establish their preferred mode for choosing a suitable retirement solution and giving effect to their choice. These obligations might be included alongside those to develop retirement income strategies. Doing so should ensure that funds not only develop retirement solutions, but also that retirees can engage with the process in the way they feel most comfortable.

Dr Geoff Warren is an Associate Professor at the Australian National University's College of Business and Economics and sits on a number of advisory boards. David Bell is Executive Director of The Conexus Institute, a not-for-profit research institution focused on improving retirement outcomes for Australians. This article does not constitute financial advice. Further detail can be found in this opinion piece.

Dividend investors, your turn is coming

Max Cappetta

The upcoming reporting season will affirm how the global COVID-19 pandemic has impacted businesses and sectors in different ways. Aggregate dividend payments over the next 12 months will likely be back in line with that paid in calendar 2019 pre-COVID. However, the sources of these dividends will be different to previous years.

Dividend conservatism

The Australian equity market has now returned to its pre-February 2020 highs, at least in price terms. For the S&P/ASX200 Index, forward earnings estimates have returned to pre-COVID levels while share prices are, on average, 11% above pre-COVID highs.

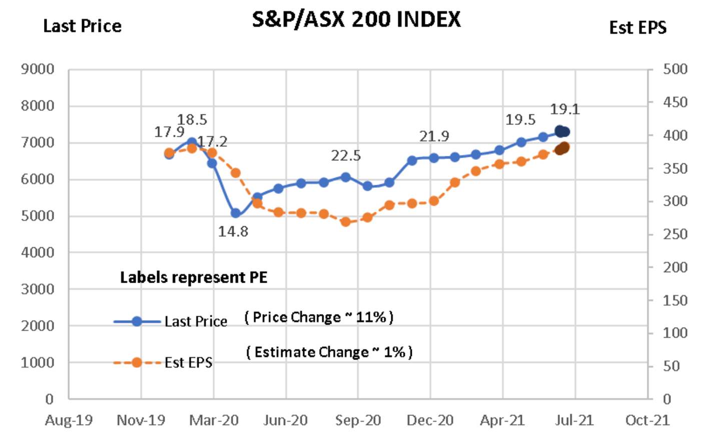
But while the unprecedented fiscal and monetary policy settings are reflected in share prices, corporates have so far been more conservative and held back on dividend payments.

This conservatism in payout ratios has been a double hit for self-funded retirees who have also seen interest payments on cash deposits cut at the same time.

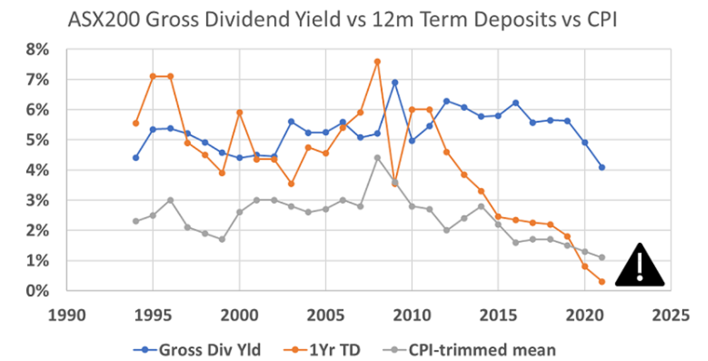
Inclusive of franking credits the ASX200 has delivered an attractive yield relative to term deposits over the long term and especially over the past decade. Driven by underlying economic growth, the resilience and rise in share prices is also a characteristic of dividend payments through time.

Furthermore, Australian corporates continue to favour higher payout ratios due to the Australia's policy of tax credits associated with company dividends.

This important policy pillar supports the retirement savings system and will enable appropriately constructed equity portfolios to play their part in an effective retirement income strategy. The Australian Government's 2021 Intergenerational Report is forecasting that over 40% of retirees will be self-funded by 2060, and less than 25% will be drawing a full government pension (versus 50% today).

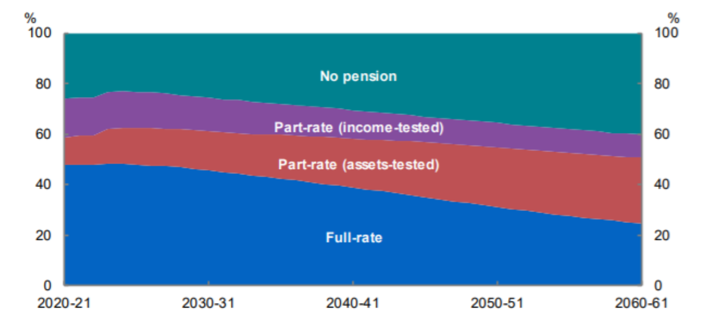


Source: Redpoint, Bloomberg



Source: Redpoint, Reserve Bank of Australia

Chart 7.4.1 Persons of Age Pension age or over, by pension category



Source: 2021 Intergenerational Report: Treasury, Australian Government

Dividends returning but slightly different to before

Australia's mining sector is set to be the star of the upcoming corporate reporting season in Australia. Record profits are expected from companies involved in iron ore mining thanks to record high prices. Companies such as Fortescue, Rio Tinto and Mineral Resources should deliver record dividends in the coming weeks.

Government financial support has ensured that retail spending has remained robust. Retailers such as JB Hi-Fi and Kogan have been beneficiaries and have rewarded investors with growing dividends. Supermarkets have also benefited from the 'stay-at-home' thematic, with Coles and Metcash paying a growing dividend stream over the past two years.

Healthcare has also delivered on dividends with plasma giant CSL, protective-wear specialists, Ansell, and equipment manufacturer Fisher and Paykel Health all growing their dividends (albeit this growth has not translated to share price growth for CSL, which currently trades at 20% below its pre-COVID highs).

The IT sector has been a standout winner in the past year driven by the fall in interest rates and the perceived stability in their revenues regardless of whether workers are in the office or at home. Global logistics software specialists Wisetech is on track in 2021 to almost double the 2020 dividend. Similarly, global security specialists

Codan has grown dividends by 50% in 2021 versus 2019 levels. Both companies pay fully franked dividends, albeit they are a low yield. This highlights that income-focused investors need to ensure their income generation also provides some exposure to earnings and dividend growth and not simply focus on high yield alone. Wisetech remains slightly below its pre-COVID highs while Codan trades at $17, more than double its pre-COVID high of $8.

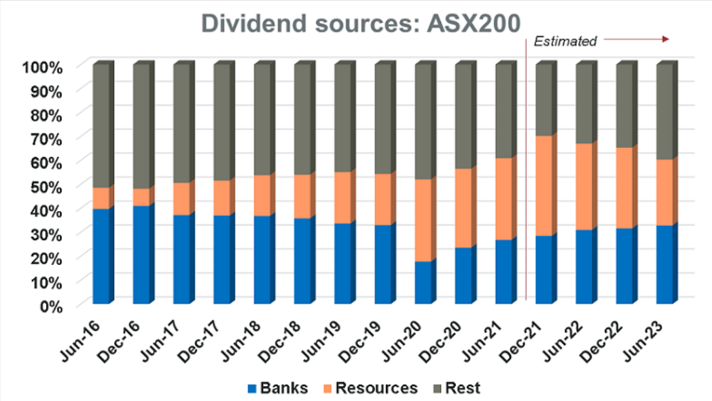
For the banking sector, Australia's banking regulator, the Australian Prudential Regulation Authority, dropped restrictions that banks limit dividends to 50% of profits in mid-December. This enabled an increased dividend from all four of Australia's largest banks in the first half of this year. CBA is likely to further increase its dividend in August after being more cautious in February, with the remaining three seeing economic conditions improve in early 2021 before paying increased dividends in May. The rollout of product innovations and divestments in the sector could be a catalyst for earnings growth moving forward.

On the other side of the ledger, COVID-19 has been devastating for industries such as tourism and travel. After promising signs through the start of 2021, new lockdowns mean it is unlikely that operating conditions will improve soon but investors need to be aware of the potential for mergers and acquisitions as conditions improve.

Just like driving: look forward, not back

Being distracted by a high historic yield can be detrimental to investment outcomes. High yields can often hide low growth, business stress or a failure to properly reinvest to support future growth.

Research indicates that a focus on historical yield has consistently underperformed the ASX200, and by taking a forward-looking approach to dividend yields, opportunities can be found.



Source: Redpoint, ASX, IHSMarkIt

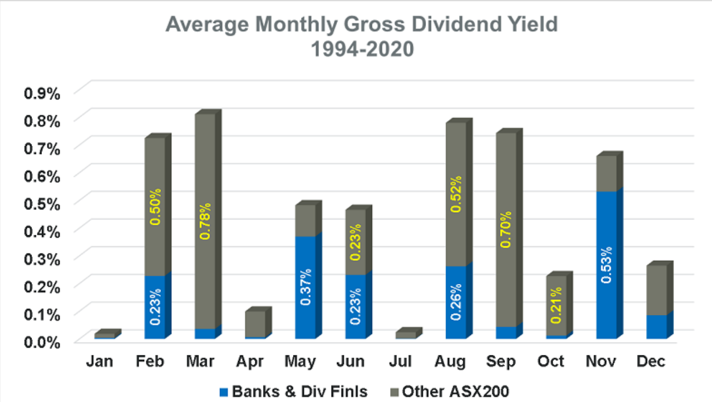
Don't focus only on high yields

The market goes through phases where dividends and companies that pay dividends are in demand, and other periods when they are not. The past 15 months are a brutal reminder of investor appetite for growth and risk versus cashflow and dividends.

Some income-focused strategies commence with defining an investible universe based on higher dividend yielding stocks. Some strategies start with a specific income style and then seek to identify the highest yielding stocks within that sub-group. This can be rewarding at times when dividend-paying companies are in greater demand but can be harmful to overall returns at other times.

Being constrained to invest in just a subset of the market can also lead to less consistent dividend capture if particular sectors of the market are impacted by a change in business conditions while others are not. This is where risk management and a diversity of stock selection views can deliver an investment edge versus a singular focus on high yield alone.

Different companies pay dividends at different times during the year. There is an opportunity for a dynamic approach to trade across these different times to capture an overall above-average income yield while retaining exposure to higher growth stocks. Of course, investors need to abide by holding period rules to ensure they not only capture the cash dividend but also any tax credits attached.



Source: Redpoint, ASX

Capturing a consistent dividend yield from equities cannot be a set and forget endeavour. Building a portfolio from last year's best-yielding stocks has delivered above average dividend income but has consistently underperformed the index overall.

The goal for most income-seeking equity investors should be to earn a consistent and above average yield on their capital, including an appreciation of the calendar and industry profit cycles can assist with this goal. While the last year has been one of the most challenging in history, it has also highlighted the opportunities for a more dynamic perspective into how investors should seek to capture income from equities.

Max Cappetta is Chief Executive Officer and Senior Portfolio Manager at Redpoint Investment Management, a specialist investment manager partner of GSFM, a sponsor of Firstlinks. This information is of a general nature only and is not financial product advice. Opinions constitute our judgement at the time of issue and are subject to change, and do not consider the circumstances of any investor.

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Four tips to catch the next 10-bagger in early-stage growth

Andrew Mitchell

If investors cast their eyes back over the last two decades, it's obvious the stock market's massive winners and 10-baggers – the likes of Amazon, Google and Afterpay – have always looked overvalued and un-investable based on conventional valuation methods. Many investors wielding traditional valuation tools shunned these stocks and missed out on staggering returns.

When investors value established companies, it is a relatively straightforward exercise guided by market capitalisation and earnings multiples, as well as some subjective elements. But it is much more difficult to value early-stage growth companies. Investors often lack these foundations and are forced to follow a process that looks quite different.

Small cap equity investors, particularly, must frequently value less mature companies with short revenue histories, zero profit, and that require significant external capital for growth. Without years of financial data to rely on, early-stage companies and their investors must employ more creative ways to substitute these inputs.

We are in a period of unprecedented innovation and disruption globally. Exciting new companies are emerging every day. If investors can better understand how to value young, fast-growing companies, they will be much better placed to identify the next 10-bagger.

When DCF doesn't work

For investors to grasp the challenges in valuing early-stage growth companies, they must first understand the mechanics of Discounted Cash Flow (DCF), a valuation method that all analysts are taught.

A DCF financial model projects the expected cash flows of a business into the future. Those future cash flows are then brought back to a value today by applying a discount rate to adjust for the level of risk and uncertainty faced in achieving those cash flows.

The DCF methodology is relatively easy to implement when investors value mature business that have years of consistent earnings and stable margins. But it is much harder to value a business using DCF when its earnings streams are less predictable, such as in an early-stage, fast-growing company. This can lead to potentially extreme mispricing of equities over time, as the likes of Amazon, Google and Afterpay all appeared overvalued but recorded spectacular growth.

Useless metrics

As with DCF, many of the stock standard valuation metrics such as P/E (price/earnings) or PEG (price/earnings to growth) can be completely useless when analysing immature companies. Their P/E or PEG ratios can look astronomical, and change wildly, because their current earnings may only be a tiny sliver of their potential earnings when they mature. To achieve scale, these companies are often heavily reinvesting in themselves with high R&D costs. Revenues may grow rapidly, but it could take years to deliver profits.

Why is Afterpay's 'value' so high?

A classic example is Afterpay. "How can it be valued so high when it doesn't make a profit?" they ask. By 'valued' we assume they mean its market capitalisation.

Our answer is simple: Afterpay's valuation, such as its P/E, is so high because it is deliberately keeping the 'E' low to non-existent by reinvesting for future growth. Given Afterpay's superior offering, and the massive size of its potential markets, we would prefer that the company reinvest and realise that potential, rather than spit out profit today.

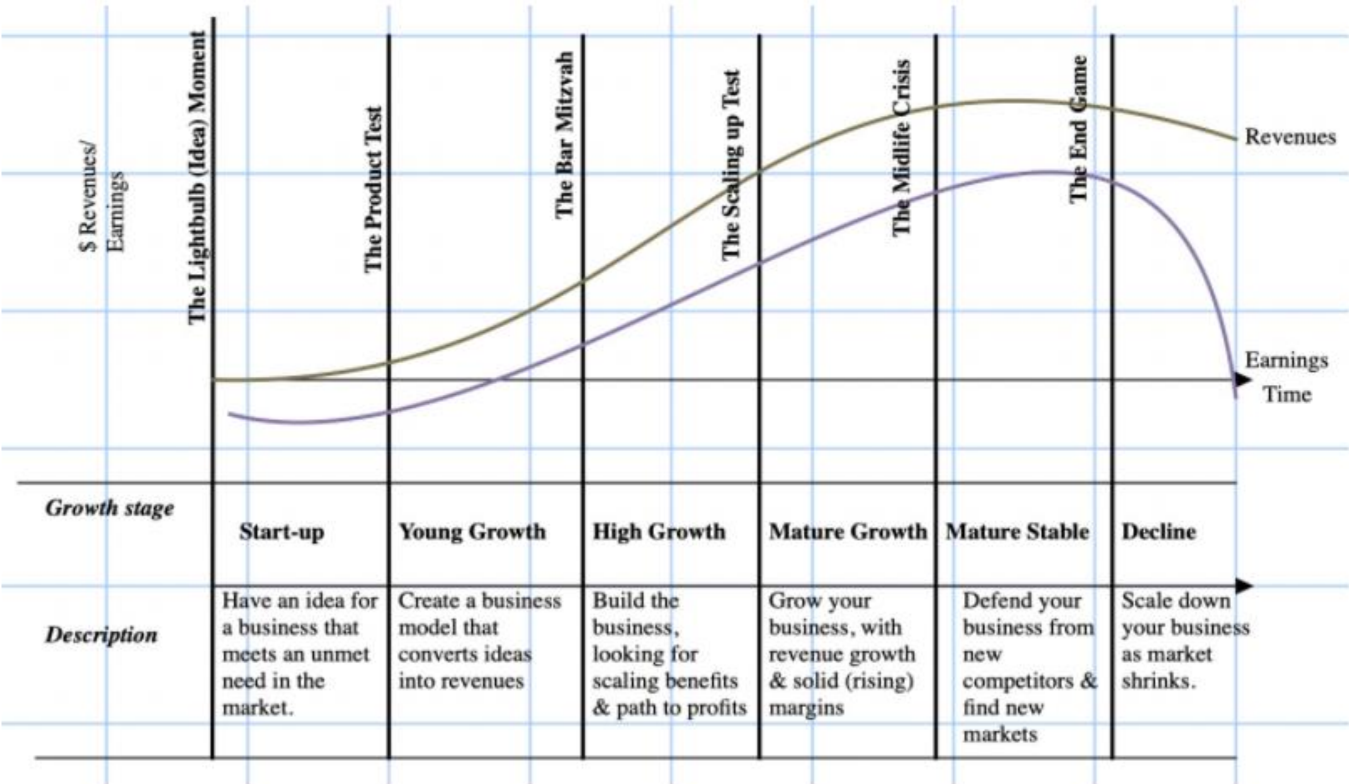
At the risk of oversimplifying, you can have revenue growth or you can have profits now, but you can't have both.

Their Australian business is highly profitable but they are using that excess cash flow to grow and take market share in new geographies, meaning they have little to no profit at a group level. The moment they stop reinvesting for growth to prioritise generating profits, at least in the short to medium term, this would likely represent to us a signal for exiting the business.

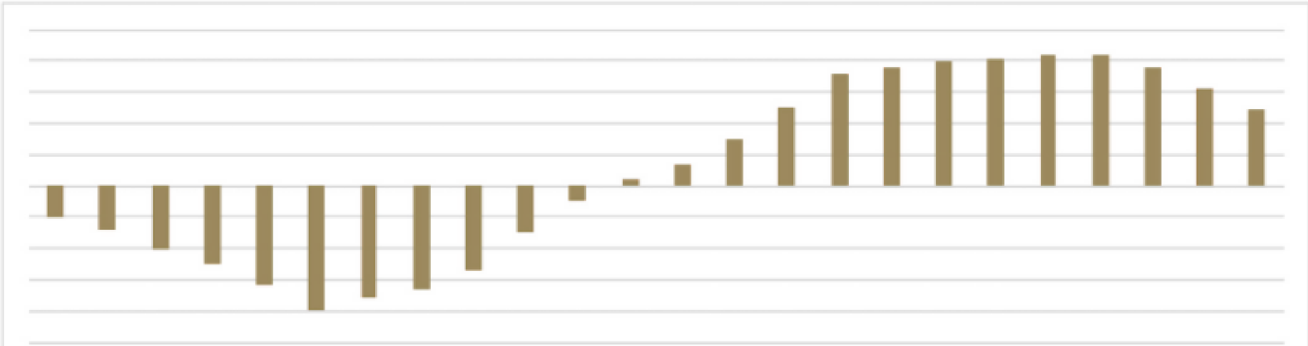
The corporate lifecycle

The stylised example below paints a typical picture of a corporate's lifecycle. Many early-stage growth companies simply don't have free cash flows that are used to value the worth of a share. So, investors must make assumptions about what these will look like in the future.

Corporate Life and Death – a stylised lifecycle



Growth stage	Stage 1 Start-up	Stage 2 Young Growth	Stage 3: High Growth	Stage 4 Mature Growth	Stage 5 Mature Stable	Stage 6 Decline
Operating Profits	Large operating losses	Operating losses narrow	Operating profits turn positive	Operating profits grow quickly	Operating profits level off	Operating profits decline
Reinvestment	Very high	High	Remain large, but scale down as percent of firm	Decrease	Scale down further	Divestment
Free Cash Flow to Firm	Negative	Negative	Cross over to positive territory	Positive & growing	Positive & stable	Positive & dropping



Source: Aswath Damodaran

Turning to qualitative factors

But how do you make those assumptions?

To evaluate young, high-growth companies, analysts must dive into the underlying business, and judge how long it will take to mature. They will need to refer less to financial ratios and income statements, and more to qualitative factors such as:

- Recurring revenue
- Scalability
- Competitive advantage
- Size of addressable market
- Best-in-class leadership
- Organisational culture
- Track-record of success
- Ability to create new revenue streams

Few of these traits can be meaningfully reflected in spreadsheets.

For legendary investors, such as Peter Lynch, Warren Buffett and Howard Marks, it is the quality of a company's growth that determines its value, not revenue or even earnings growth per se. When they analyse the broad range of factors outlined above, they can make informed judgements on which businesses are most likely to be long-term successes.

Focusing on four factors

The study of early-stage companies should focus heavily on four key factors:

1. Identifying assets

Usually, the first thing to consider when formulating a valuation for an early-stage company is the balance sheet. List the company's assets which could include proprietary software, products, cash flow, patents, customers/users or partnerships. Although investors may not be able to precisely determine (outside cash flows) the true market value of most of these assets, this list provides a helpful guide through comparing valuations of other, similarly young businesses.

2. Defining revenue Key Progress Indicators

For many young companies, revenue is initially market validation of their product or service. Sales typically aren't enough to sustain the company's growth and allow it to capture its potential market share. Therefore, in addition to (or in place of) revenue, we look to identify the key progress indicators (KPIs) that will help justify the company's valuation. Some common KPIs include user growth rate (monthly or weekly), customer success rate, referral rate, and daily usage statistics. This exercise can require creativity, especially in the start-up/tech space.

3. Reinvestment assumptions

Value-creating growth only happens when a firm generates a return on capital greater than its cost of capital on its investments. So a key element in determining the quality of growth is assessing how much the firm reinvests to generate its growth. For young companies, reinvestment assumptions are particularly critical, given they allow investors to better estimate future growth in revenues and operating margins.

4. Changing circumstances

Circumstances can move or change quickly for early-stage companies. When a young company achieves significant milestones, such as successfully launching a new product or securing a critical strategic partnership, it can reduce the risk of the business, which in turn can have a big impact on its value. Significant underperformance can also result when competitive or regulatory forces move against a company.

Landing the next 10-bagger

At Ophir, we believe that the market should reward the businesses with the greatest long-term potential premium valuations.

If you avoid early stage growth businesses simply because they have high valuation multiples compared to the market (such as P/Es), you will often miss the most exciting businesses and the next '10-bagger'.

That doesn't mean you should ignore valuation measures, and they are a core part of our process. You can still overpay for high-growth companies.

But when you analyse high-growth early-stage companies, you need to accept that the long-term potential of a business ultimately matters more than its valuation at any given time.

Andrew Mitchell is Director and Senior Portfolio Manager at [Ophir Asset Management](), a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. Read more articles and papers from Ophir [here]().

Investing in Japan: ready for an Olympic revival?

Claire Gallagher

You're a long-distance runner, on the starting line at the Tokyo Olympics. The games were delayed, the stands are empty, but you cannot let this distract you. The past is behind and you must focus on the opportunity in front of you. Winning is a mix of skill and luck and you want to give yourself the best chance of succeeding. A poor start can cost you the race

Now apply that thinking to investing where how much you pay – the start of your race – will have an impact on your overall success. Overpay, and there is a risk of being disappointed if the future is not as bright as you expect. Underpay and even if the future is only middling, you'll probably still do ok. High valuations are a handicap on future returns and paying too high a price can put you too far behind the starting line.

Competing for returns is even harder today because valuations across many asset classes are high. Even 'boring' assets like bonds and cash seem risky due to low yields and the fear of inflation. This is forcing many investors into more speculative assets which, in turn, pushes their valuations to new extremes.

Time to look again at Japan

With the world now focused on the Tokyo Olympics, we thought it might be interesting to see how and what value investing looks like in Japan.

You may be skeptical. The Japanese stock market has left many investors desolate over the past 30 years. Japan experienced a massive asset bubble in 1990 and, at its peak, Japan shares made up 44% of the MSCI World Index (it's less than 7% now). That bubble exploded spectacularly and since 1990 the Japanese market has returned 6% (yes, just 6%) versus 743% for the MSCI World (both in JPY).

But that's the past. Looking at the opportunity in front, Japan appears cheap versus its history and against other major markets.

Of course, things are often cheap for a reason and there is no doubt Japan has its fair share of negatives. These include a reputation of poor capital allocation and corporate governance. Versus other regions, Japanese stocks tend to be less profitable and so the valuation discount is justified.

But there are signs of improvement. Rather than amassing excess cash on their balance sheets or splurging on poor acquisitions, many Japanese companies are focusing more on shareholder returns and increasing dividend payout ratios and buybacks. This leads to more income for shareholders.

Also, across the major stock markets, Japan is the most geared to global growth and an economic recovery. This may not seem like a big negative right now given the large amounts of fiscal and monetary stimuli being pumped into economies by major governments and central banks in response to the pandemic. But taking a macro bet on a global rebound can feel speculative.

However, even if Japan continues to lag global markets, history suggests that a contrarian-value approach within Japan may still do well. Contrarian investing does not necessarily mean that you go against the market at every opportunity. Rather, contrarian investors focus on the facts and figures and make up their own minds about an investment. They run their own race.

Is Japan a market for value investors?

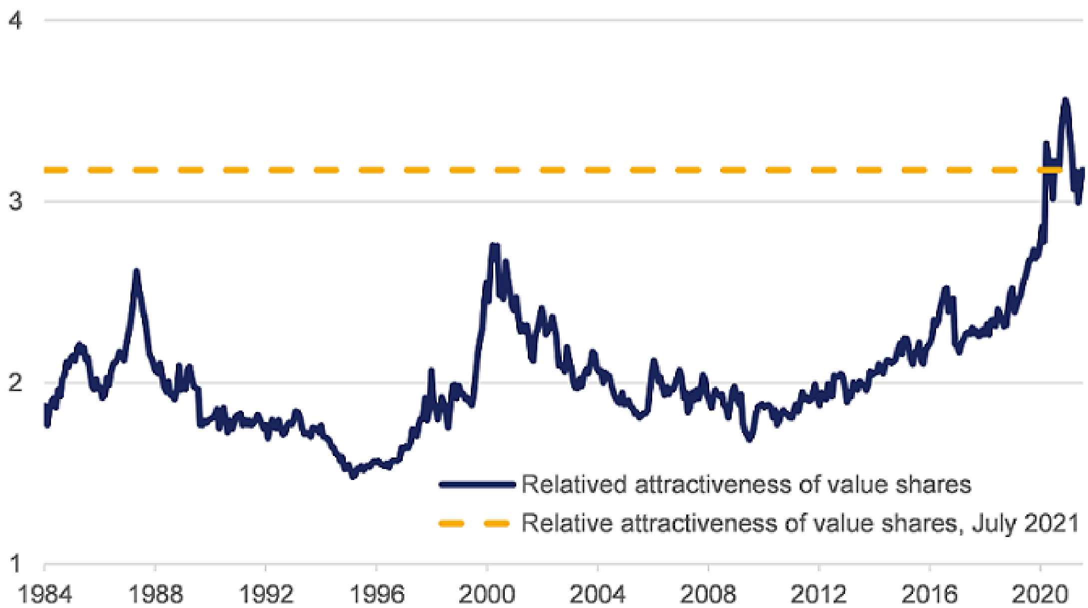
Historically, Japan has been a great market for value investors. Since 1975, value has outperformed growth by 4.1% p.a. in the country, far exceeding the 0.9% per annum relative return of value globally.

Today, the opportunity for value-driven investors is compelling. The following chart shows the price-to-book valuation of the cheaper (value) half of the market versus the more expensive (growth) half of the market. When the dark line is low, cheap stocks are only slightly cheaper than the expensive stocks. When the line is high, cheap stocks are really cheap and attractive relative to the expensive stocks. This type of spread analysis is the mainstay for value-driven investors and they get very excited when spreads are wide.

During these extremes, taking a contrarian stance and leaning into value stocks has led to higher returns.

The recent bounce in value has brought spreads in a little but they are still very wide.

Valuation spreads in Japan are extraordinarily wide



Source: Orbis, Refinitiv. Statistics are compiled from an internal research database and are subject to subsequent revision due to changes in methodology or data cleaning. Value (growth) shares are those in the cheapest (richest) half to the market on a price-to-book basis. Relative attractiveness is based on the ratio of the relevant market segments.

Mitsubishi Corp is a good example of the sort of company you can find in Japan. Mitsubishi was first established as a shipping company over 150 years ago, and then evolved into a *trading company*. Trading companies (of which there are currently five) were tasked with securing the natural resources that Japan lacks. Today Mitsubishi is a diversified conglomerate with approximately 40% of its profits from natural resources and the rest from a diversified mix of cyclical and defensive businesses - food, autos, power generation etc. The company has grown its dividend steadily since 2013 and currently yields around 4.4%.

For long-term value investors, the real reason for liking Mitsubishi is (again) valuation. Despite being just as profitable as the average Japanese company, it trades at a discount mainly because investors are put off by the complicated and cyclical nature of its business. In 2020, Warren Buffett announced that Berkshire Hathaway had bought a 5% stake in Japan's five largest trading companies, including Mitsubishi.

Can Japan help with diversification?

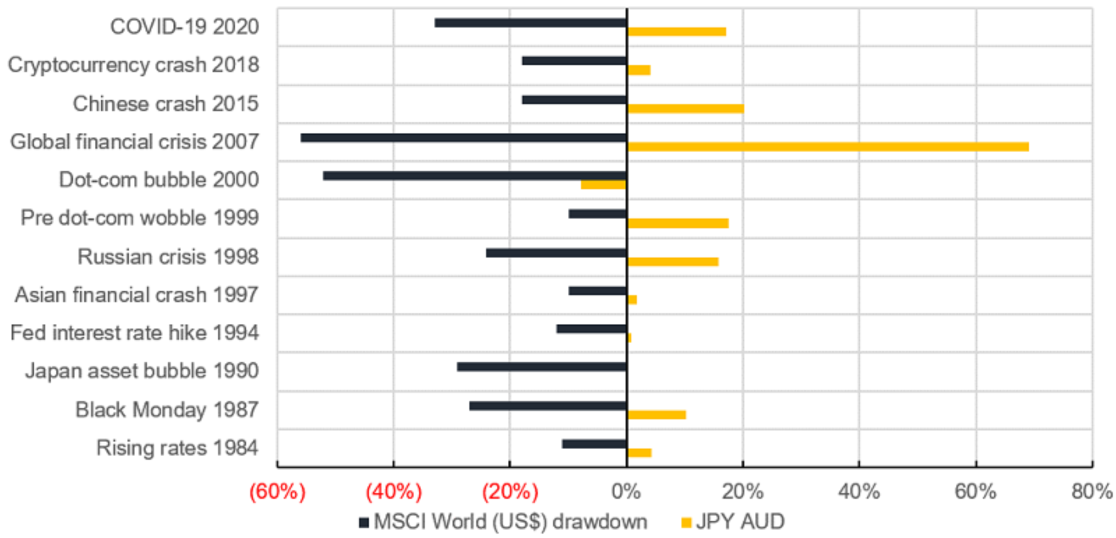
In addition to the low valuation opportunity, adding Japanese stocks to an international portfolio also has the potential to provide increased downside protection in the event of a market crash and it helps spread your bets.

Safe haven yen. When you invest in Japanese stocks and leave the currency unhedged, you gain exposure to the Japanese yen. The yen is countercyclical and can act as a haven when equity markets go down. This is the opposite of the pro-cyclical 'risk-on' Aussie dollar (AUD).

The COVID-19 market crash in early 2020 illustrated this cushion effect. During the crash, the MSCI World index fell 33% (in USD) while the JPY strengthened by 17% against the AUD.

Since the AUD floated in 1983, the JPY has strengthened against the AUD in 10 of the 12 largest stock market declines. The two exceptions were the bursting of the overvalued Japanese stock market bubble in 1990 and the bursting of the dot-com bubble - a period when the AUD had become extremely cheap (it was less than 50 cents vs the USD at the time).

Japanese yen acts as a safe haven during equity market crashes



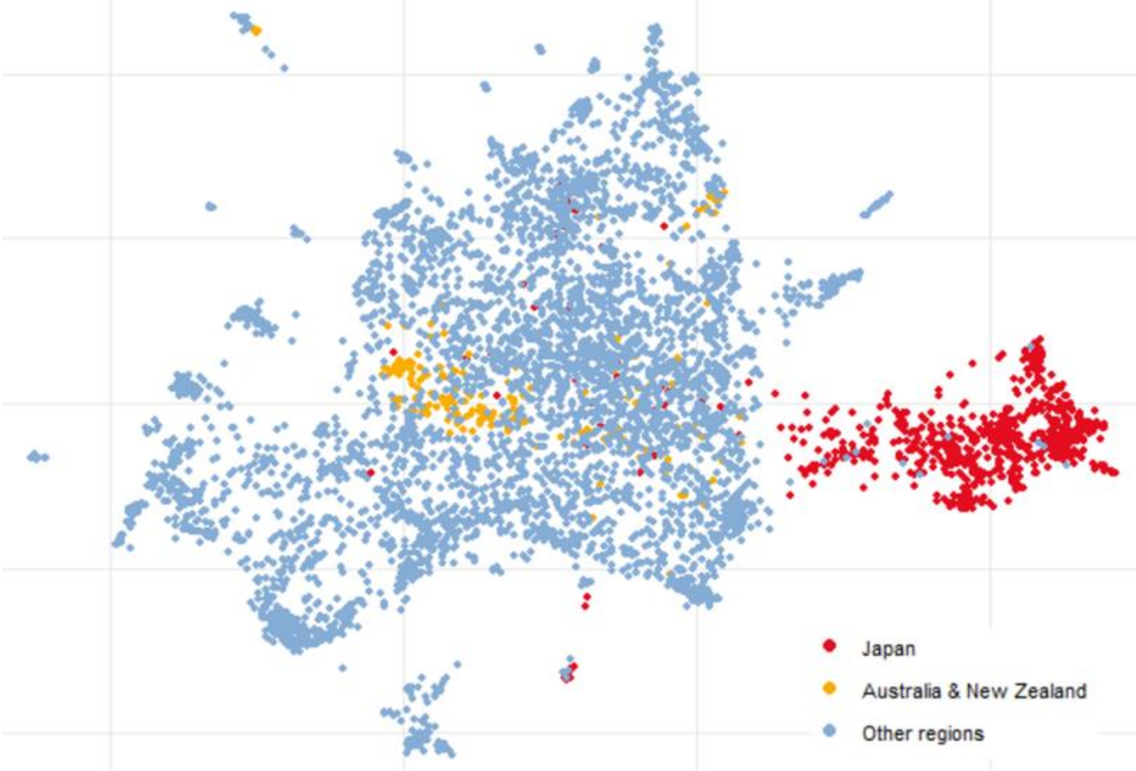
Source: Orbis, Refinitiv. Charts shows drawdowns of MSCI World (USD) greater than 10% since the Australian dollar was floated in 1983. During each equity drawdown, change in spot exchange rate of JPY AUD is measured. A positive change in JPY AUD indicates strengthening of JPY versus AUD.

Diversification. Japanese stocks tend to behave differently to their international peers and when included in a global portfolio, have the potential to add diversification. Consider the following visualisation technique from machine learning to form a sort of *correlation constellation*. This correlation constellation captures how big global stocks (approximately 5000 stocks represented by dots) move in relation to each other.

Without getting bogged down in the math (of the dots), it doesn't matter where a stock (dot) is located in the constellation. What matters is a stock's distance from other stocks, i.e. who is in its neighbourhood. If two stocks are close neighbours, they behave similarly, i.e. similar bets. If they are far apart their prices have moved differently, differentiated bets. All else equal, if you invest in two stocks that are far apart, you are better diversified (spreading your risk) than investing in two that are close together (concentrating your risk).

Japanese stocks (red dots) are tightly clustered, almost like an island. Contrast that with the Australian and New Zealand stocks, which are packed in with those from other regions and so offer less diversification.

Correlation constellation – Japanese stocks behave differently to their global peers



Source: Refinitiv. Global large cap equity market depiction using Uniform Manifold Approximation and Projection (UMAP) of 3-year weekly local equity returns. Global large cap approximated as current constituents of the FTSE World and MSCI Emerging market indices.

As the Olympic Games progresses, all eyes are on Japan. For athletes, it represents the culmination of disciplined and patient training. The road to the starting line has been uneven and uncomfortable. But that's the past. Looking at the opportunity ahead, they will put their best foot forward. Will you?

Claire Gallagher is an Investment Specialist at Orbis Investments, a sponsor of Firstlinks. This report contains general advice or information only and not personal financial or investment advice. It does not take into account the specific investment objectives, financial situation or individual needs of any particular person.

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Five lessons for bond investors from the Virgin collapse

Matthew Macreadie

Virgin Australia was an Australian-based full-service airline providing both domestic and international operations. In the Australian domestic market, Virgin held the number two market share, with Qantas its main competitor. Prior to COVID-19, Virgin had an issuer rating of B+ and B2 by S&P and Moody's respectively. Ratings are ranked from highest credit quality of AAA down to CCC and D for default.

Virgin was ground to a halt by the first wave of COVID-19. The airline requested financial support from the Australian Government and its shareholders, all to no avail. Then Virgin announced it would enter voluntary administration in April 2020. In August 2020, Virgin's new owner, Bain Capital, confirmed that unsecured creditors - including bondholders – would receive between nine and 13 cents of the par value of their bonds.

Virgin traded under the code VAH before delisting.

Source: [Market Index]

In Australia, the most recent previous collapse was Ansett in 2001. The company went into liquidation with no cash at bank and Ansett Global Rewards frequent flyer points were worthless. Unlike Ansett, Virgin's Velocity Frequent Flyer business was a separate entity and did not enter voluntary administration. Thus, the points were not worthless.

Lessons learned

1. Credit ratings do not always accurately predict default risk

Historically, Australian default statistics are much lower than global comparisons, partly due to our high-grade credit market. Per S&P's latest annual global corporate default study, the B+ rating of Virgin implied a less than a 2% and 10% chance that Virgin would be downgraded to default over the next one and three years. The ratings of B+ and B2 were not downgraded until March 2020, after which the price of Virgin bonds had already fallen significantly. Consequently, the rating agencies may have underestimated the actual default risk once implications from COVID-19 on air travel were present in late 2019.

2. Debt structure matters just as much as the probability of a default

When assessing an expected loss on a bond, investors need to consider the probability of default as well as 'loss given default' (LGD). Investors can have different loss outcomes depending on whether their bonds are secured or not.

The debt structure of Virgin consisted of secured bank loans (secured by aircraft leases), unsecured loans, unsecured bonds (issued in AUD and USD), finance leases, letters of credit, and bank guarantees.

In this instance, priority creditors and employees were looked after first, thus diluting the overall recovery for bondholders to between nine and 13 cents in the $1.

3. Having a strong balance sheet can shield against low probability, high consequence events

Virgin went into COVID-19 with a weaker balance sheet and liquidity than Qantas, which made it financially more vulnerable. Once the airline was grounded, it was burning cash given its high operating leverage.

Unlike Qantas, Virgin had minimal cash on balance sheet and did not have the capacity to raise equity from its investor base, including foreign airlines who were themselves in trouble. Furthermore, unencumbered assets are generally only valuable when there is capacity to fly.

4. Cyclical credits can be incorrectly priced if based on forward-looking earnings

Virgin had consistently reported losses over the five fiscal years up until 2019. In October 2019, management provided commentary that earnings were expected to rebound over the next 12-24 months through productivity and cost base initiatives.

Using forward-looking earnings, Virgin had a stronger credit rating than the issuer rating of B+ and B2 implied by S&P and Moody's respectively. In 2019, Virgin issued an ASX-listed 8% coupon 5-year AUD bond which fully priced this incremental improvement in credit fundamentals.

5. Relying on government support for an investment decision is fundamentally flawed

Many investors thought the Australian Government would come to the rescue and bail Virgin out. Hanging investment decisions on external support from a third-party can often end in tears.

What is more important for investors is to look for businesses that can absorb and withstand external shocks and are critical pieces of the economy. For investors, differentiating between essential and non-essential industries has become a key facet in this COVID-19 world.

Takeaways on the high-yield bond market

In this volatile environment, it pays to do the research and diversify a portfolio. A high-yield allocation remains valid for investors needing income, but watch for red flags. Over the past 10 years, the broader US high-yield asset class has delivered an annualised return of 7% against an equivalent investment-grade return of 4%. In addition, US high-yield has delivered a 15% return over the past year. This is based on data from the Bloomberg Barclays US corporate high-yield index as at 30 June 2021.

We expect the Australian high-yield market to continue to grow and inevitably there will be both good and bad high-yield credits due to a variety of reasons:

- debt structure
- strength of balance sheets
- industry in which the company operates
- covenants
- whether the management is skilled and even trustworthy.

As an investor, a key priority is the management of idiosyncratic risk and ensuring an appropriate return on all risks.

Benefits of diversification

Owning a mixture of high-yield and investment-grade bonds in a diversified portfolio is critical to withstanding unforeseen exogeneous events. In a risk off environment, high-yield bonds have historically had a higher correlation to equity returns than their investment-grade bond counterparts offering less protection.

Furthermore, a large number of bonds in the portfolio can also help lower risk and stabilise returns, thus offsetting any loss of value that occurs from a loss on a catastrophic holding.

In the past, this portfolio diversification has been more difficult for some retail or non-professional investors, with most fixed income securities classified as 'wholesale only'. However, it is possible now for more investors to access over-the-counter (OTC) wholesale fixed income securities which can enable greater diversification.

Let's use Virgin as an example to illustrate this point:

- Imagine an investor had an equally-weighted bond portfolio of five names, including a Virgin bond six months prior to the collapse at close to par. If the recovery on the Virgin bonds ended up at 10 cents in the $1, the investor would have lost 18% of their capital (that is, 20% of the portfolio was in Virgin and only 2% was recovered).

- In the current environment, achieving a return of 18% on the remaining bonds in the portfolio to offset this loss would be almost impossible.

- On the flip side, imagine an investor owned an equally-weighted bond portfolio of 20 names. In this instance, let's assume they bought Virgin six months prior to the collapse, also at par. If the recovery on the Virgin bonds ended up being 10 cents, they would have lost 4.5% of their capital.

- While 4.5% is still a heavy loss, there is a good chance this loss would have been covered by income on the remaining bonds in the portfolio.

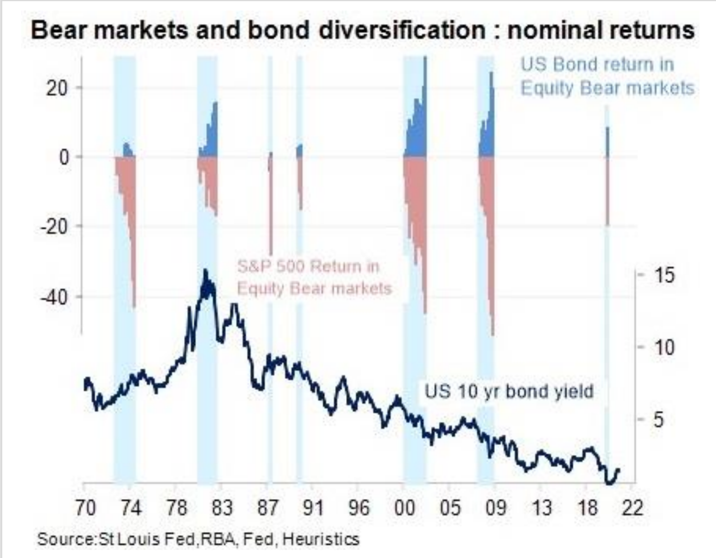
Matthew Macreadie is a BondIncome Credit Strategist at Cashwerkz, a sponsor of Firstlinks. This article is general information and does not consider the circumstances of any investor. Please consider financial advice for your personal circumstances. For more articles and papers from BondIncome, please click here.

The 60:40 portfolio ... if no longer appropriate, then what is?

Damien Hennessy

Investors have been treated for the past two decades to a period of extremely strong returns. This has been driven by a massive structural decline in inflation and interest rates, set against the backdrop of reasonable economic growth, a global savings glut and supportive policy settings. There have been setbacks along the way, including the sharp downturns in the early 2000s, in 2008-09 and in 2020, but they have been met with increasingly aggressive monetary policy easing.

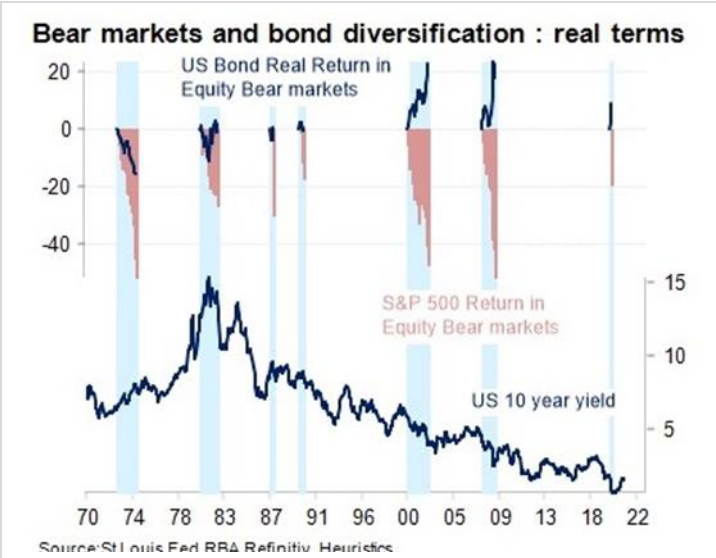
Most policy makers now wish to see higher wages, higher inflation, lower unemployment, and eventually more 'normal' interest rate levels. This pivot towards both arms of policy working in tandem is designed to not only reflate economies but spread the benefits more widely than experienced over the years of reliance on monetary policy alone.



The 60:40 portfolio has easily met its objectives

The traditional balanced portfolio (60% growth, 40% defensive) has performed strongly in the predominately disinflationary regime of the past two decades, generating returns of 7.9% a year over the past 10 years and 6.9% over the past 20 years.

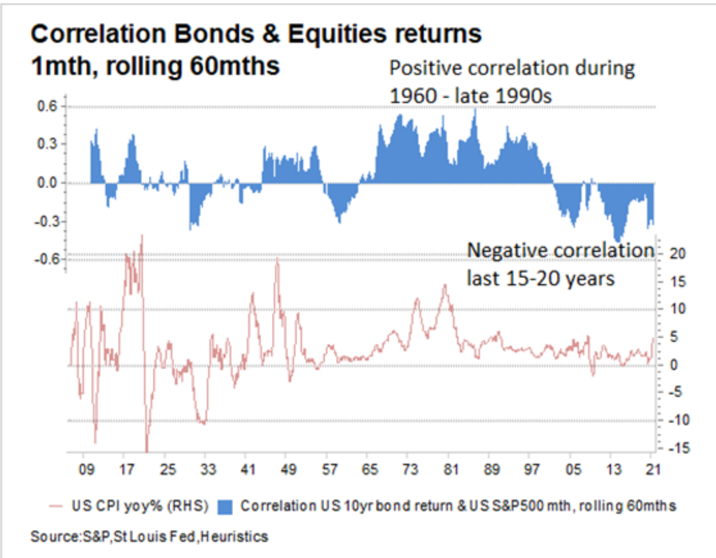
With inflation averaging just 2% over 10 years and 2.5% over 20 years, the traditional portfolio has easily achieved its return objective with relatively low volatility.



When equity market drawdowns have occurred, bonds have generally provided the diversification expected through a combination of yield and capital growth associated with declining yields on long duration securities. Even in the COVID-19 equity market downturn in 2020, bonds provided some gains to help cover initial equity losses.

Inflationary periods are different

But in earlier, more inflationary periods, this was not always the case. As the following chart shows, in inflationary periods, despite high yields to begin with, bond returns in real terms failed to offset equity market declines, and in some cases, compounded the problem.



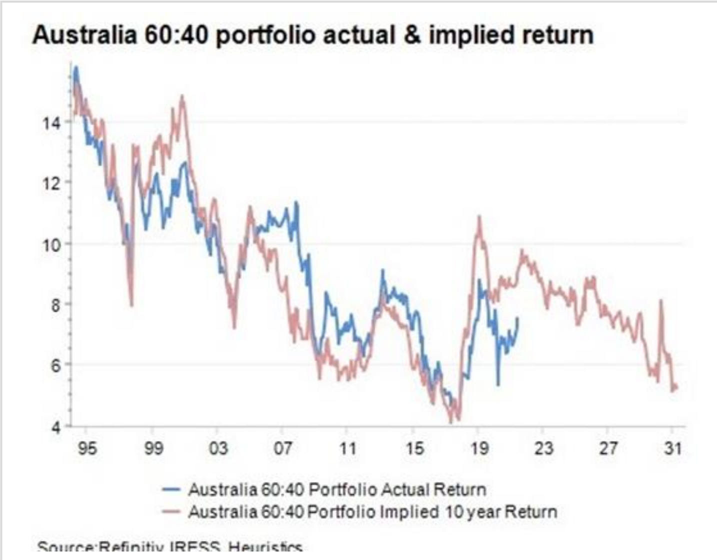
In future, we may not be able to depend on bonds for diversification benefits if the negative correlation between bond and equity returns reverts to a positive correlation in an environment of rising inflation but with low, perhaps even suppressed, nominal yields.

What to expect in the future

It's obvious that the income attribute of bonds has diminished significantly. While bonds would still likely produce solid capital growth in a deflationary regime, helping to offset equity declines, their ability to provide a dampener on volatility is likely to be found wanting in a rising inflation environment.

Even in an environment of low growth, low inflation and extremely accommodative policy bonds now rely almost totally on further capital gains (declining yields) to produce an offset to equity weakness.

If we assume that the 10-year forward returns for a 60:40 portfolio reflect a return to mean valuations and earnings for equities, and that the current 10-year yield is a good approximation of bond returns for the next 10 years, then a simple 60:40 portfolio in Australia might be projected to return around 4% in nominal terms over the next 10 years.



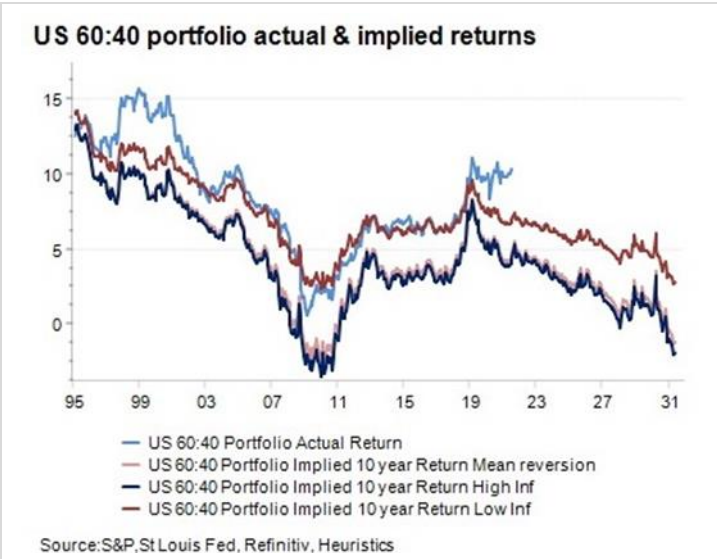
With inflation back to the target of 2.5%, that would generate real returns of **1.5% a year**, significantly below most 'CPI plus' objectives and recent history.

Rather than assume the naive mean reversion scenario, it would be useful to reflect on what might happen in different inflation regimes.

In the chart below we show for the US, that the 10-year return outlook varies considerably depending on the inflation regime.

In a simple mean reversion scenario, returns for a US 60:40 portfolio might be expected to be zero over the next 10 years.

Under a higher inflation scenario, we might expect a significant de-rating of equities. The average Shiller PE in high inflation regimes has been around 16 times, dragging total returns lower to an estimated -2% a year over the 10 years in nominal terms and -5.5% in real terms.



On the other hand, a continued low inflation regime (with more moderate mean reversion) would see returns closer to 3% a year (or 1-2% in real terms).

What are the solutions?

Bonds still have a role to play, particularly in the event of a major equity market drawdown related to a deflationary event or regime. As we saw earlier, a high inflation regime is typically not good for bonds and equities. The equity bear markets since 2000 have all occurred within a deflationary backdrop.

Here are five possible scenarios:

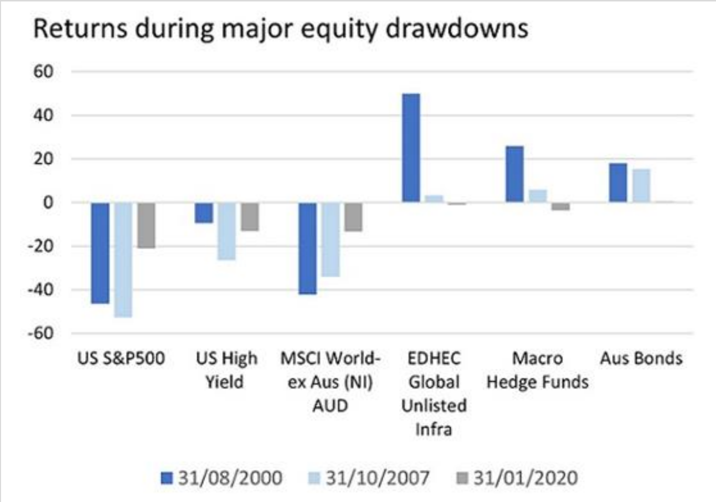
1. Seeking yield and defensive attributes in asset classes such as unlisted infrastructure and direct property is one approach but introduces a level of illiquidity and exposure to a rise in real yields from current extreme lows.

2. Certain hedge fund strategies have provided solid performance in equity drawdowns since 2000 but limited data from the higher inflation periods and the dispersion of performance across managers in this space creates another set of challenges.

3. Higher yield in credit is a feature of the current investment environment but credit has a relatively high correlation to equities and spreads are already hovering near record lows. Some credit markets also have considerable duration risk.

4. Buying defensive characteristics in quality equity exposures, high dividend or defensive sectors can also play a role although equity beta is still high, and these sectors also carry an exposure to rising bond yields.

5. Offshore currency exposure for an Australian investor has provided portfolio diversification benefits during equity drawdowns with unhedged global equities providing similar performance to that of high yield during equity bear markets over the past two decades.



The chart (right) shows the performance of a range of these assets during the last three major equity market drawdowns.

Investors want the best of all worlds

Investors desire income, growth, downside protection and inflation protection although often in different doses. Projected income returns are now very low, growth exposures come with a heavy price tag, while downside protection and inflation protection are generally expensive, sometimes illiquid, and difficult to access.

Rather than think in terms of an arbitrary 60% growth and 40% defensive portfolio, investors need to think in terms of the growth/defensive continuum and building a robust portfolio for a range of different environments. Defensive assets are often characterised as such based on having lower volatility but perhaps investors should be more concerned about the ability of an asset to provide downside protection in different scenarios.

Bonds provide downside protection in deflationary environments but not in periods of inflation. Inflation-linked bonds, gold and commodities are more volatile, but may provide a defense against inflation. Protection strategies, gold and bonds may be useful in a deflationary environment. Infrastructure and property assets offer modestly defensive characteristics in disinflationary scenarios but perhaps not so in economic downturns or rising inflation and interest rate phases. Some growth assets have relatively more defensive characteristics than others if they carry a certain factor, sector or regional exposure.

For Australian investors, unhedged global equities can provide some downside protection. By understanding an asset's attributes in different circumstances rather than merely focusing on volatility and arbitrary definitions of growth and defensive assets, investors will be better placed to build truly balanced portfolios for the more challenging investment environment ahead.

Damien Hennessy is Head of Asset Allocation at [Heuristic Investment Systems](), a subsidiary of Zenith Investment Partners. This article is general information and does not considr the circumstances of any investor.

Two factors that can transform retirement investing

Caitriona Wortley

The rally in Australian shares in 2021 and forecasts of rising house and other asset prices suggest good times are back for investors. That might be true for growth investors seeking capital gains, but for income investors who live off their portfolio's yield, times have never been tougher.

Many conservative Australian investors face the biggest problem ever seen in markets, with record-low interest rates punishing savers and distorting asset valuations. Nobody is more affected by low rates than retirees.

Declining income for retirees

In dollar terms, a pre-GFC retiree with $1.25 million in term deposits could generate around $103,000 of risk-free annual income without touching their capital, based on a term deposit rate of 8.25%. Today, the same retiree can generate only $3,125 of income from that investment, based on a term deposit rate of around 0.25%.

Worse, a retired couple today would need around $25 million invested in cash to fund a comfortable standard of living at the current average term deposit rate of around 0.25% based on the the Association of Australian Superannuation Funds (ASFA) Retirement Standard of $62,828 for a retired couple who want a 'comfortable lifestyle'. Retirees who invested the bulk of their savings in cash and term deposits in the past decade could have suffered immense financial damage (in real terms). Sadly, many retirees have adapted to lower returns by downgrading their living standards.

Our industry should not accept this. Nobody wants retirees investing most of their savings in cash and term deposits because they are fearful of either losing or running out of their money.

Two changes required

I believe two behavioural shifts could improve retirement investing and enhance living standards for many older Australians.

The **first** is financial advice. Our industry must encourage more retirees to seek financial advice much earlier in their investing journey. We know that Australians who have financial advice are in a significantly better position than those who go it alone, yet only about one in five people who planned to retire last year was likely to pay for financial advice, according to the Financial Planning Association. This means about 351,000 Australians (of approximately 438,000 who planned to retire) will not pay for financial advice (Retirement and Retirement Intentions, Australia. Australian Bureau of Statistics, 2018-19).

The result? Too many unadvised retirees will park the bulk of their savings in cash and term deposits and earn a negative return (after inflation). Some retirees will automatically roll over term deposits year after year, even though cash returns are falling. Or worse, make major asset-allocation shifts after a market shock – such as moving entirely to cash after the GFC – and never returning to markets because they fear sharemarket volatility.

The **second** change relates to how advisers build the defensive component of portfolios in retirement. In a low rate environment, with an aging population, the traditional 60/40 model of portfolio allocation is on life support.

Consider a portfolio with 60% in growth assets and 40% in defensive assets. The current, very low returns from defensive assets means that 40% of the portfolio is simply not earning enough return. If a retiree is then drawing down on a pension of 4, 5, 6 or 7% p.a., they could be going backwards. In this scenario, there is a strong argument to introduce more growth assets.

But with growth assets comes greater volatility. According to Callan Associates research, for investors to earn a 7.5% return 30 years ago, they could have done so with no exposure to growth assets and a standard deviation of 3.1%. In 2019, to earn that same return, the exposure to growth is set at 96% with the standard deviation skyrocketing to 18%.

According to Callan, retirees are about five times more loss averse than the average investor. To increase returns in this environment, investors may be taking bets on the defensive side of the portfolio, increasing duration, credit risk or other risks within portfolios. But in many cases, this makes the assets more akin to growth and subject to significant volatility.

The question then becomes: "*How can the 40% in defensive work harder to deliver greater returns without excessive risk?*"

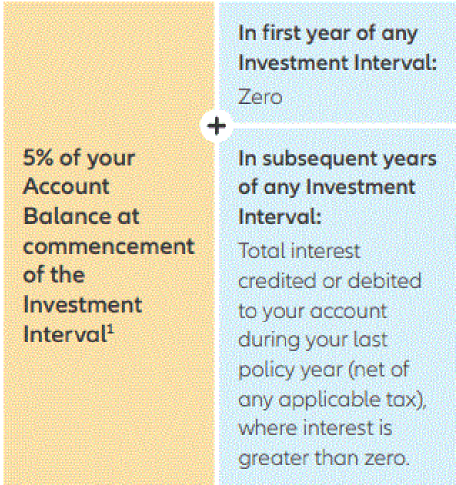
The need for a protected retirement product

Protected retirement products are not just for growth allocations in portfolios. Increasingly, advisers are using such products as a sleeve in a portfolio's defensive allocation. Of course, that is only part of the answer in a low-rate environment. Protection strategies are not risk free and can involve long-term products that discourage individuals from withdrawing their investment early.

For example, by using a protection strategy with a 0% floor (that is, zero loss tolerance), a retiree could earn a maximum potential return of 2.55% p.a. with a maximum downside of -0.8% p.a. (the fee on the structure) in the defensive allocation.

(This example is based on a Allianz Retire+ Future Safe seven-year investment interval, 0% floor, 50/50 investment into S&P/ASX 200 Total Return (3.50% cap) and MSCI World Net in AUD (3.20% cap) indexed at June 2021. Net of 0.80% pa fee.*)

The product is designed to be held for the full term although it enables investors access to income (liquidity), either through regular or ad hoc withdrawals, up to a free withdrawal amount. The free withdrawal amount is 5% of the initial investment from year 2, the total credited or debited to the account during the previous policy year (net of any applicable tax), where interest is greater than zero, as shown in the diagram below.



1. Account Balance at commencement of the Investment Interval is your initial investment less any applicable taxes, stamp duty and upfront adviser service fee for the initial Investment Interval; and Account Balance at the start of each subsequent Investment Interval.

Withdrawals above the free withdrawal amount are permitted but are subject to a market value adjustment.

Research consistently shows retirees want better returns than those currently on offer but they have limited appetite to dial up their risk exposure in order to achieve it. Most of all, retirees want to sleep easy at night, knowing their savings won't run out when they need it most. That requires an element of certainty and protection, but financial advisers have had few such tools available to provide this. Previous protection products were too costly, complex or required too much upside to be given away.

Change is coming. A potential extra 1-2% return each year on portfolios compounds over time.

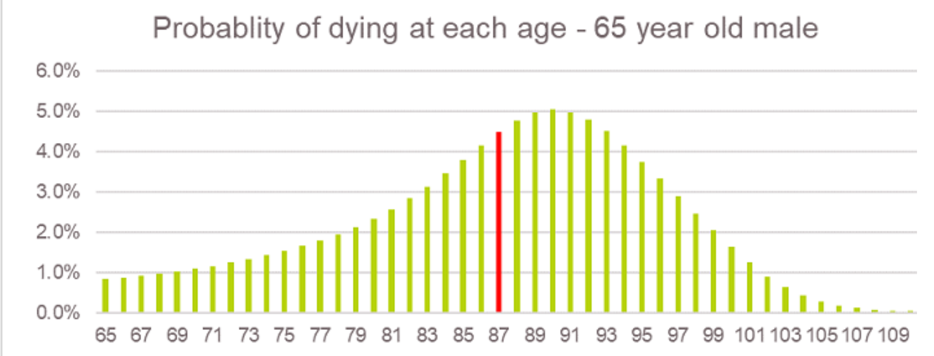
Caitriona Wortley is Head of Distribution at Allianz Retire+. This material is for general information purposes only. It is not comprehensive or intended to give financial product advice and does not take into account your objectives, financial situation or needs.

**This example uses past-performance data, which is not a reliable indicator of future performance and is no guarantee of future returns. The returns on the Future Safe product issued by Allianz Australia Life Insurance Limited ABN 27 076 033 782, AFSL 296559 (Allianz Retire+) which are used in this example are subject to a number of variables including investor elections, market performance and other external factors, and may differ from this example. Investors should consider the Product Disclosure Statement (PDS) which is available on (www.allianzretireplus.com.au).*

Protect retirement savings from longevity risk by pooling

Doug McBirnie

A feature of life expectancy is that over half the people of a certain age will live longer than their life expectancy. Retirees using these widely published figures as a reference point when planning how to spend their savings, are more likely than not to run out. The chart below shows how likely someone retiring today is to pass away at each age into the future.



Source: Australian Life Tables (ALT) 2015-17 with 25-year improvements.

More prudent retirees who plan for their savings to last longer than life expectancy can reduce the risk of outliving their savings, but this comes at the expense of a more frugal retirement.

In the example above, a 65-year-old male has less than a 1 in 10 chance of living past age 97. However, if the retiree spread out his spending so that his savings lasted to age 97, the annual retirement income from his savings might be around 20% lower than if he'd planned for life expectancy (assuming savings are spent over the planning horizon and a 3% p.a. real net investment return). It is this uncertainty that makes planning how to spend your retirement savings so difficult.

There is a growing acceptance from super funds that current account-based retirement products, where members bear all the risks (including longevity risk) lead to poor outcomes for many members. With prompts from the government, forward-looking funds are considering retirement products that pay members an income for life.

Benefits of pooling

Pooling a group of retirees of the same age will tend to have a more reliable distribution of ages at death. As the pool gets larger, the distribution of lifespans around the mean is more predictable.

The benefits of pooling can be passed on to retirees in a number of ways. Super funds can provide lifetime income products by pooling together retirees' capital through a product known as a group self-annuity (GSA). With enough members, they can reduce the uncertainty for individual in the group.

How many members make a pool?

To understand whether a pooled product is viable for a particular super fund, it is necessary to know what size of pool is needed to reduce the longevity risk for members.

The benefit payments made to members in a GSA are determined based on assumptions about how long members will live. Benefit payments are then adjusted to the extent that the actual experience of members differs from those assumptions.

To take a simplified example, consider a GSA with 500 male members, all 70 years old. It can be expected that 493 would survive to the following year, and the projected payment in the following year is based on this playing out.

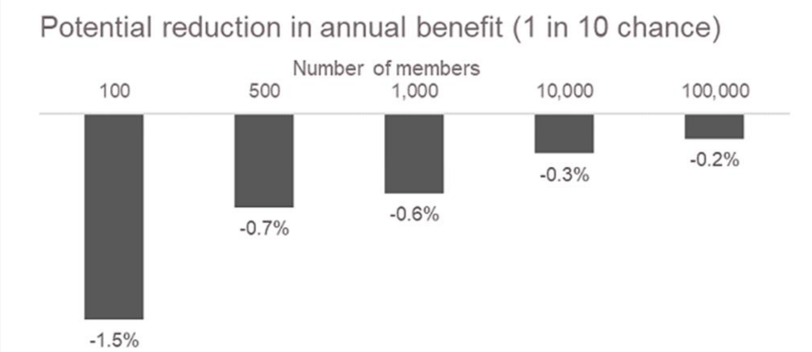
If fewer members pass away, then the benefit payments going forward are reduced, as benefits are being paid to more members than assumed. The greater the deviation from the assumed number of survivors, the larger the adjustment that is needed to members' benefits.

This is why the size of the pool is important. The larger the pool of members, the less likely it is that assumptions will be deviated from, as a proportion of the total membership. Adjustments to members' benefits due to mortality experience are therefore likely to be smaller for larger pools of members.

The chart below shows the impact on members' benefits when fewer members than assumed die in a particular year.

It considers a hypothetical GSA where benefit payments are adjusted each year in line with experience and looks at the reduction the payments members receive year-on-year as a result of mortality experience differing from the assumptions. It assumes all other experience, such as investment returns, is in line with what was assumed when payments were set.

For example, for the GSA product with 500 members, there is around a 1 in 10 chance that the actual number of survivors is 496 rather than 493. With more survivors the annual payment for each member would need to be reduced



Source: Challenger analysis. Assumes a pool of 70-year-old male members, with fixed annual benefit payments, no death or withdrawal benefit and a net investment return of 5.0% p.a. Mortality rates in line with ALT 2015-17 with 25-year improvements. The number of survivors for a given probability is rounded to the nearest whole number of lives.

by 0.7% in the following year. In smaller pools, it only takes a few more survivors in a given year to drive a material change in benefits for all members.

Consistent with other research, this suggests that a pool of at least 10,000 members would be preferable to reduce the risk of a member's payments falling significantly from one year to the next due to mortality experience.

Of course, members of super funds aren't all the same age when they retire, and their health and longevity traits will vary widely too. This heterogeneity can lead to greater volatility in payments.

For super funds that are confident of reaching the scale needed to operate a pooled retirement product, a second issue is the time needed to get there. If mortality experience is passed on continuously (e.g. in annual benefit indexation) to members, then it is likely they will experience volatile benefit payments in the first few years of the product's life.

Reserving as an alternative approach

Rather than letting members bear all the volatility of benefit payments that can result from a pool that is too small, super funds can look at other ways to manage that risk.

Like a traditional defined benefit fund, super funds could hold reserves to support a pooled product, either permanently or until the pooled product reaches scale. The reserves can be used to smooth benefit payments and reduce the volatility for members.

Equity for other classes of members requires that reserves are established from part of the pooled product members' initial contributed capital. This will necessarily reduce the benefit payments members receive, at least initially. The reserves will need to be managed which can add costs. Added complexity can reduce the transparency to members, making communicating with them more difficult.

It is also possible for super funds to insure longevity risk to provide greater certainty for members. In a longevity swap, a counterparty takes on this risk for the fund, for a cost, to remove members' exposure to longevity risk.

An alternative to a pooled product is for super funds to offer a holistic retirement product that includes an account-based pension and a lifetime income stream, which offers both flexibility and longevity risk protection for members.

Conclusion

Pooled retirement products can significantly reduce or remove personal (idiosyncratic) longevity risk, providing better outcomes for members than current account-based products. However, to be effective, pooled products need sufficient scale and it can take time to get there.

Doug McBirnie is a General Manager and Senior Actuary at Accurium. This article contains general information only and is not intended to be financial product advice. No warranty is given on the information provided and Accurium is not liable for any loss arising from the use of this information.