WEALTH

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“Investors must stop chasing yield and start searching for growing income.”
ROGER MONTGOMERY, THE MONTGOMERY FUND

Don’t change super asset allocation in haste

PAULINE VAMOS

The just completed September quarter recorded the worst outcome for stockmarket returns in four years. It is natural for people to be thinking about the impact of this for their superannuation balance and on what to do. Research into the behaviour of superannuation fund members during the GFC and the impact of changing investment options gives a clear indication of what not to do.

The most important thing for people to do is to not panic and not change their asset allocation in superannuation without seeking advice first.

Superannuation is a long-term savings and investment vehicle with a time horizon of 40 years or more for many people. Over this time there will be many quarters of poor or negative returns as markets correct with periods of both significant declines and recoveries.

Australian superannuation is weighted to equities, but with good reason. The long-time horizon of the investment, Australians’ long life spans and the need to maximise returns mean the allocation to shares is appropriate given that equities outperform other asset classes over the longer term. A typical balanced superannuation fund includes asset allocations of 20 per cent in Australian shares and 27 per cent in international shares so the recent decline in the value of listed shares has a substantial direct impact.

However, the average balanced fund also includes investments in assets that are not affected directly by the share market. On average, a balanced fund will have 18 per cent in domestic and international bonds, 10 per cent in property and 9 per cent in cash.

The asset allocations in these funds are carefully chosen by the trustees of superannuation funds to maximise returns over an individual’s life and is designed to take into account large swings in the market during that time and average life expectancy.

Since the global financial crisis, the average balanced superannuation fund has delivered an after-tax return to members of 9.5 per cent per annum. Even over the past 10 years, which includes the dip and recovery in markets from the GFC, returns have averaged 6.4 per cent a year. So it makes sense for a member of a superannuation fund to maintain a long view of their investment and look at five and 10-year rates of return.

It is also important to remember that owning equities is not just about capital appreciation. Equities continue to pay dividends despite their fall in share price. For those in the retirement phase of superannuation, this income stream with associated franking credits is valuable during any period in which asset prices are lower. While the current market correction is not a repeat of the global financial crisis, research on the behaviour of superannuation fund members during that period shows the risks to individuals of hasty decisions taken without seeking advice.

The GFC provided the largest negative impact on superannuation assets since contributions were made compulsory in 1992. Research by Paul Gerrans from the University of Western Australia into behaviour of superannuation fund members during the GFC gives an important insight into this behaviour and how it can affect long-term retirement incomes.

The research shows that there was an increase in people changing the asset choice in their superannuation fund during the GFC. Over a three-year period that included the GFC around 5-6 per cent of people made a change. There was an increase in switching both in the most volatile month and the month of the market’s lowest point. While it was a minority of members who made that decision, it is nonetheless significant for those individuals.

> The most important thing to do is to not panic and not change their asset allocation in super without seeking advice first

Of greatest concern is that most members who changed their asset choice during the GFC reduced their exposure to equities just as the market bottomed. This led to a double hit of crystallising the GFC declines and missing out on the subsequent market improvement. Ultimately this action reduces the retirement incomes of this group.

This research is just as valid for SMSF owners as it is for those in the larger superannuation funds. Perhaps even more so — since SMSF owners are more likely to be actively engaged in managing their portfolio.

For the large bulk of people who default into a fund through MySuper, the trustees of the superannuation funds are working hard to ensure the best outcomes for fund members. However, choice of asset allocation within superannuation is an important part of the system.

Individuals have the right to make the asset allocation they want to — after all it is their money. The only concern comes when people make a choice without being fully informed. While some will have the requisite knowledge and experience to make that choice, most of us do not. Making a change right now may be tempting, but the best thing to do is to hold tight or if you do want to change, seek advice.

Pauline Vamos is chief executive of ASFA, the Association of Superannuation Funds of Australia.

Higher payout ratios can leave your income static

ROGER MONTGOMERY

For the last few years, investors have made out handsomely by simply buying large-cap stocks with high yields like banks and Telstra.

Low-yielding term deposits have plunged retirees into what can only be described as an income recession and their cries have been heard by company boards, who have acquiesced to their demands for more income from shares by raising their company payout ratios.

This will prove to be the great undoing for many retirees’ investment portfolios because the corollary of high payout ratios is low growth, and what retirees will need in a few years is not a high yield but growing income.

The maths is pretty simple.

If a company with $10 of equity earns a 20 per cent return on equity every year and pays out 100 per cent, its equity doesn’t grow (assuming no more debt or fresh capital is raised).

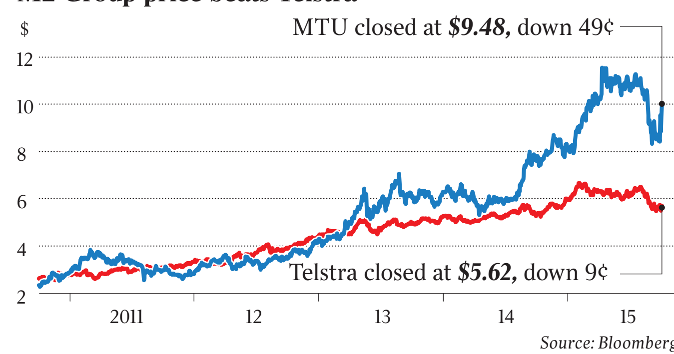
If the equity doesn’t grow and the return on equity remains constant, the earnings don’t grow either.

If the earnings don’t grow, the dividends cannot.

If we make the assumption that the shares always trade on a price/earnings ratio of, say, 10 times next year’s earnings, then we can buy the shares in year one for $20.00, receive $2 of dividends each year and sell the shares at some future date for $20.00. Our internal rate of return will be 10 per cent, which is precisely equal to the dividend yield at the time of purchase.

AAP

M2 Group CEO Geoff Horth and James Spenceley, CEO and founder of Vocus



But that’s all. Unless they speculate that the P/E ratio might rise, their best return is the dividend yield.

Retirees who appear to have been smart buying stocks with yields a little higher than term deposits will soon find their income fixed by the high payout ratio, and the purchasing power of their income eroded by inflation. If the above company paid none of the earnings as a dividend, all of the earnings would be retained and the equity, the earnings and the share price would all rise by 20 per cent per annum — equivalent to the return on equity of the company — and yielding a return that was double that of the first investor.

The impact of this cannot be overstated.

In 2005 you could have invested $100,000 in the shares of Telstra — a company that was paying more than 100 per cent of its earnings as a dividend — at $4.69, paying a dividend of 28c for a yield of just less than 6 per cent or income of $5900.

As an alternative, you could have also invested in the shares of another telco called M2 Telecommunications — a company that was retaining a meaningful proportion of its profits and compounding them at an attractive rate of return on incremental equity.

M2 was trading at about 30c and was paying a dividend of about 1.25c, which corresponded to a yield of just 3.90 per cent.

Any dividend hungry investor would have gone for the Telstra shares.

Fast forward to 2015 — 10 years later — and the $100,000 invested in Telstra has grown to about $135,000 and the $6000 of income in 2005 has grown to about $6400.

Compare this to M2, where the $100,000 has grown to more than $3 million and the $3900 of income on your $100,000 investment has grown to $93,750.

Chasing the dream of higher income is a good thing but it cannot be achieved by focusing on high-yielding stocks in companies whose payout ratios are high.

Unless these companies raise fresh capital, lower the dividend or borrow money, earnings won’t grow nearly as quickly as a company that can retain profits and compound them at a satisfactory rate of return on equity.

Investors must stop chasing yield and start searching for growing income.

Roger Montgomery is founder and chief investment officer of The Montgomery Fund.

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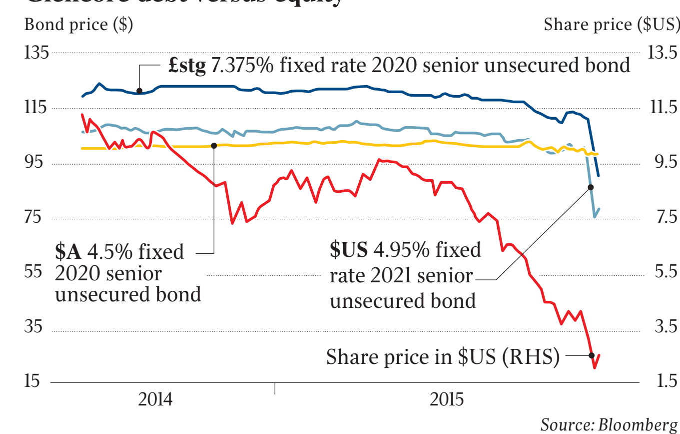
Bonds less prone to hits if Glencore endgame plays out

LIZ MORAN

Global sharemarkets have had a tumultuous quarter. Miners have been hit hard and face low growth scenarios for long periods and greatly reduced commodity prices. Some analysts are questioning valuations and ultimate survival if commodity prices stay low, with Glencore one company under the spotlight.

Glencore is the world’s largest commodity trader and has significant worldwide assets, with several major ones in Australia. Domestically, it is the nation’s largest coal producer through its subsidiary Glencore Xstrata.

The company disappointed the market in August when it missed earnings estimates, reporting a half-year net loss of $US817 million. Early last month, in an effort to counter negativity, it announced plans to reduce its $US29.6 billion ($42.1bn) net debt by a third. But the market savaged the company and its US shares, trading at $US8.35 as at June 30, are now 70 per cent lower at $US2.42. Market capitalisation is well below net debt and as of September 30 was $US16bn.



The bonds have held up much better, although declining significantly in the past week. A five-year US dollar bond issued in April trading at $US98.41 as at June 30 is now trading at $US78.75 (a 20 per cent decline) with an implied yield to maturity of 8.63 per cent a year.

Analysing what happens when the outlook for companies deteriorates can be insightful when considering future investment opportunities.

Glencore operates in a cyclical commodity business, where investors can expect fluctuations in the value of their investments. Like with any company, the bonds will be less volatile than the firm’s shares as they are a legal obligation where interest and the initial loan amount must be paid. So bondholders will be protected at the expense of shareholders, as companies have no legal obligation in relation to shares to pay any dividends or return capital.

The company has tried to placate the market and instil confidence by announcing a plan to reduce debt by a third to around $20bn by next year. The measures include: raising $US2.5bn in equity; suspending dividend payments; reducing working capital; selling assets (it’s rumoured Glencore’s “jewels in the crown” Latin American copper mines may be considered); cutting industrial capital expenditure; and reducing long- term loans

The focus for management is ensuring the company survives. Practically all the measures above are supportive of the bonds, to the detriment of the shares. While management will be concerned at the significant fall in the share price, it will not see the company fail.

Jamie Peterson, an analyst at Goldman Sachs, said: “The credit default swap market is pricing a roughly 50-50 survival probability for the company over the next five years. My feeling is that it won’t take that long for this story to play out. Glencore has $US14bn of debt coming due next year; the key date is the massive $US8.45bn unsecured revolving credit facility that comes due at the end of May.”

Should the worst scenario play out, most probably shareholders will be wiped out completely. Bond holders will probably recoup some of their investment.

Elizabeth Moran is director of education and research at FIIG Fixed Income Specialists. www.fiig.com.au

I have a super account with MLC and have been surprised to find that it is imposing a fee on me to fund its operational risk financial reserve. Is this legal? Why is it charging me to fund the reserve instead of rearranging its investments to fund the reserve?

On December 16, 2010, the federal government announced the Stronger Super package of reforms in response to the recommendations of the Super System Review. As part of these reforms, it announced that the capital requirements for superannuation fund trustees should be replaced with a risk-based system applying to all funds regulated by the Australian Prudential Regulation Authority for holding capital reserves against “operational risk” (Prudential Standard SPS 114).

An “operational risk” is the risk of loss to a member of a fund as a result of inadequate or failed internal process, people, systems or risk management from the superannuation entity.

Think of it like an insurance policy for a member of a super fund protecting the members from the wrongful actions of the fund. From July 1, 2013,

> What are your options? Grit your teeth and pay it or shop around to find another fund that doesn’t charge the member to protect them from ... operational risks

superannuation funds were obligated to build this reserve within their fund. The target level of the reserve is determined by the trustees of the fund and approved by APRA. Trustees had three years from July 1, 2013, to comply with this new requirement.

In MLC’s case, it has determined that it will hold 0.25 per cent of total assets under management in reserve to satisfy its obligations by July 1 next year. To fund this, it has imposed a levy on all superannuation fund members of 0.1 per cent of your fund balance for the 2014-15 financial year and the 2015-16 financial year.

It subsequently will reserve the right to charge you additional amounts to top up the fund if it deems it necessary from time to time. Meaning, if it has to dip into the fund to compensate members of the fund, the members may need to pay more to replenish the fund.

Is it legal? Yes. Are you happy about it? Most likely not. What are your options? Grit your teeth and pay it or shop around to find another super fund that doesn’t charge the member to protect them from the fund’s operational risks.

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Date / Time	Guest	Conversation topic
Wednesday 7 October 10.30am	**CEO - Frank Wilson** TFS Corporation Ltd	Find out why investors are excited about sandalwood!
Thursday 8 October 10:30am	**CEO - Warren Ebert** Sentinel Property Group	Find out how Sentinel Property Group became one of Australia’s leading commercial property investment firms.
Tuesday 13 October 10:00am	**CEO - Richard Haire** Webster Limited	Learn why agribusiness Webster Limited is positioned well for growth over the next 5 years.

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