Dream run leaves Challenger toppish

ROGER MONTGOMERY

With little value appearing across the sharemarket and non-income-producing assets such as two-digit licence plates or for that matter Basquiat paintings hitting all-time records, it's interesting to see one business hitting the ball out of the park in terms of performance.

Challenger Limited (CGF) appears to be enjoying a purple patch at present with a virtual monopoly on the annuities market in Australia, especially lifetime annuities. The shares were as low as $6.62 in early 2016 but today the shares have almost doubled to $13.07.

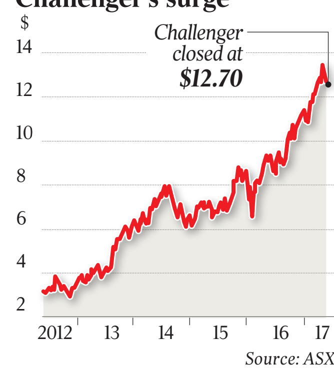
According to Towers Watson, Australia's superannuation system, which is already the fifth-largest global pension market, is growing at twice the rate of growth of the global pension market.

Challenger will benefit not only from the growth of the entire retirement savings pool, but also the growth in funds flowing from the accumulation phase to retirement (income) phase. This annual transfer of funds, within the $2 trillion of super savings, is estimated to amount to $58 billion in 2017. By 2030 — just 13 years away — the amount is estimated to reach $240bn annually, over four times larger. You'd be delighted with any investment you knew would be four times larger in 13 years.

Today, Challenger, led by chief executive Brian Benari, has more than $66.6bn in assets through two primary divisions — both marketed as providing "customers with financial security for retirement". Its funds management division comprises Fidante Partners, a house of boutique fund managers, and Challenger Investment Partners, which invests globally across real estate and fixed income on behalf of institutional investors, including Challenger Life Company.

The other primary division,

Challenger's surge



Source: ASX

Challenger Life, is Australia's largest provider of fixed term and lifetime annuities, guaranteeing the capital and regular income payments for over 60,000 investors.

Of the annuities sold in the first half of the 2017 financial year, 75 per cent were fixed term and 25 per cent were lifetime products designed to insure customers against longevity risk (living longer than expected and running out of savings). Challenger's lifetime sales accounted for 59 per cent of the growth in annuity sales in the first half of 2017.

Annuities monopoly

The establishment of credibility across the entire sales distribution network — including AMP and Colonial First State — research houses, consultants, super trustees and advisers, is not an insurmountable hurdle for a competitor, especially those with deeply connected relationships like the banks, but it would take considerable time to replicate.

As dealer groups and platforms, such Colonial in 2015 and AMP from late 2017 as well as Clearview Wealth and Suncorp, are signed up to distribute Challenger's products, other groups must join in order to avoid being competitively irrelevant.

Moreover the regulatory environment is backstopping Challenger with David Murray in his Financial System Inquiry recommending the mandating of annuities for a set percentage of an individual's superannuation.

Challenger makes its money by investing capital in assets, securing a rate of income return from those assets and then offering the income stream to customers who have purchased annuities. The perceived risks to the model are obviously twofold and both relate to investment margins.

First, there's the risk that payments on new liabilities — obligations to pay income to new annuity purchasers — exceed the returns available from assets available for purchase. Second is the risk that investment margins or spreads on the existing book of assets and liabilities are put under pressure from, for example, rising interest rates.

A remaining risk then, given that long duration assets are typically held to maturity, is credit risk or the risk of default. To that end, the quality of the assets purchased is critical to ensuring policyholders obligations can be met without the need for shareholders to contribute additional capital.

The first point to make is that the company's entire culture is built around the management of risk. Importantly, lifetime annuities, which are growing the fastest, offer a higher margin relative to term annuities, enabling Challenger to invest in longer-term assets which offer a higher yield. What's more, going through the GFC as well as the bust of the oil/fracking boom in late 2014 demonstrated Challenger's ability to invest wisely and without impact to policyholders or shareholders.

The final question, however, for investors relates to value and whether there is any in the share price. With the share price trading at 2.7 times price to book, it appears the market appreciates the monopoly characteristics, widening economic moat and the growth runway of Challenger.

To me, it's an excellent business run by extraordinary people. And while there appears to be little risk of operational disappointment, the market's valuation is full, therefore requiring some positive surprises from the company, to generate better than market returns.

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

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What if you live a lot longer than you expected?

More people are faced with a long retirement that will require a considerable deal of planning

WILL HAMILTON

Everyone is living longer. In fact, this extended longevity is driving great and continuous change in the Australian way of life. This includes how we think about work, lifestyle and retirement — key factors that affect fundamental decision-making about retirement and how to both organise and fund it.

Rapid change and innovation, together with improved health outcomes that inform longevity, make tax, investment and superannuation planning more complex than ever.

When do "middle age" and "old age" now begin — and end? You might be surprised to find that recent research suggests old age now starts at 74. And it can last another nine years beyond that.

In other words, turning 50 is a kind of midpoint and where once it might have been considered a trigger to consider a nursing home, now it's more a "second half of life" wake-up call for work and investment to secure a comfortable and practical lifestyle.

The startling differences to how we think about later life are affecting every financial decision an investor makes. That plan might now involve looking "out" to a lifespan of 100-plus years.

James Vaupel, of the Max Planck Institute for Demographic Research in Germany, expressed this concept of longevity very clearly when he wrote: "In countries doing well, life expectancy has been increasing by 2.5 years per decade, three months per year, six hours per day."

It is important to keep in mind this quote does not come from a marginal figure. Vaupel and his team work for one of the world's leading science institutes: the Max Planck centre is a celebrated non-profit network of science research institutes that go back to 1911.

Closer to home, the Australian Institute of Health and Welfare puts this into perspective by noting that in Australia a boy born from 2013 to 2015 can expect to live to 80.4 and a girl could be expected to live to 84.5, compared with 47.2 and 50.8 years for boys and girls born from 1881 to 1890.

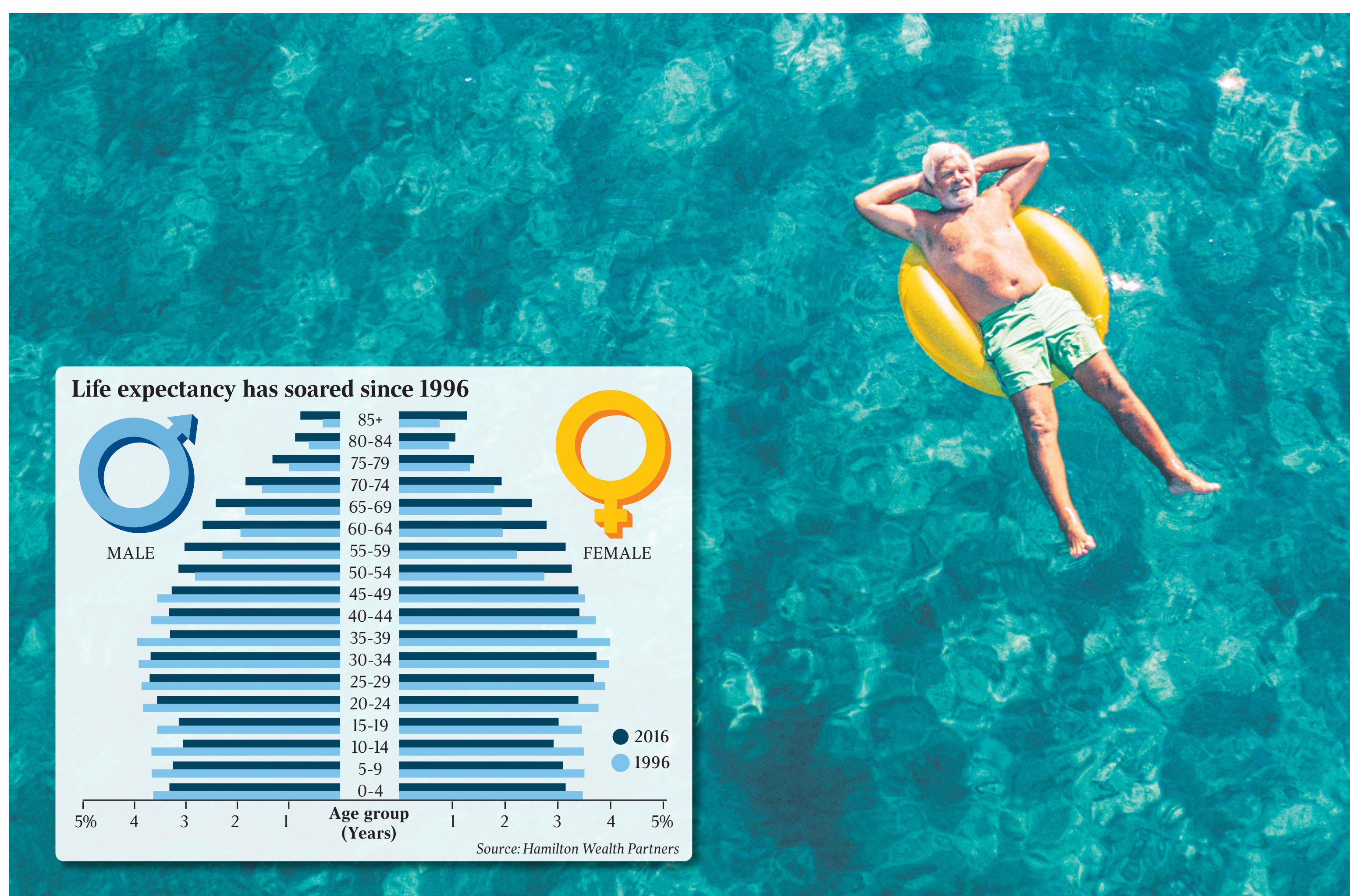
It is amazing to think that my own children, who were both born in the 1990s, could live through three centuries.

But there is every reason to believe this is the case. The Australian Bureau of Statistics points out that in the year ending June 30, 2016, the number of people aged 85 years and over increased 15,100 (3.2 per cent) to reach 484,600.

What's more, with 168 hours in a week, if you live to 70, that is 611,000 hours in a lifetime.

But let's extrapolate to an extreme; if you extend longevity to 100 years, that is 873,000 hours in a lifetime.

In potentially living an additional 262,000 hours, the pressure has come on to governments as to how to finance this longer life.



Source: Hamilton Wealth Partners

Looking well ahead

In practical terms, the population is ageing and the working population (taxpayers) is decreasing.

Not surprisingly, both the official retirement age and pension eligibility age are being kicked upwards. This has serious implications for planning for prosperity as well as staying in work and being gainfully occupied.

We now have a pension age of 65 but it is inching higher under a plan unleashed by then treasurer Wayne Swan. From July, the pension age moves from 65 to 65-and-six-months, with incremental increases until we reach a retirement age of 67 in 2024 and then 70 by 2035.

Given federal government changes of recent years, the older traditional pension model may not work, and here's why:

Beyond the PAYG society: We have been brought up in a Pay-as-You-Go society where taxes have paid for retirees.

As the population ages and the proportion of the population as retirees rises, the balance tips and the working population decreases. The challenge is and will be how government can sustain this on an affordability basis — and what the roll-on outcomes are for individuals?

Increased pension age: We have yet to see if the ambitious lifting of the pension age becomes a reality — and if it does, it will change a variety of estimates and projections across the markets.

Too complex superannuation: At the same time as government limits its entitlement to the Age Pension, self-funded retirees with their savings in superannuation are restricted in the form of tax treatment when they meet conditions of release to start a pension from their own superannuation savings.

One poor outcome is a reduction in the incentive to fund retirement through superannuation, not just by the introduction of more complexity and change but also a $1.6 million assets cap.

Better health but with greater challenges: Improvements in health outcomes and greater demand for lifestyle improvements will be coupled with the challenges of ageing involving the balance between body and mind.

Both research and management of later life conditions such as dementia will need to be funded either by government or the individual.

Many investors are focusing on short-term planning looking to July 1. I am also seeing an rise in demand for planning that considers the challenges and opportunities of longevity.

More broadly, investors should look at their short-term SMSF and investment strategies and consider the bigger questions around how to fund a potential 100-year life span. That may mean dealing with tough issues around what kind of retirement lifestyle an individual may have planned for — and what is possible and practical for the second half of their lives.

You must ensure the longevity factor is considered and that the evolving changes are factored in to secure independent future wealth.

Will Hamilton is managing partner of Hamilton Wealth Management, a Melbourne-based independent wealth manager.

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My husband and I are saving to buy our first home. Can you please explain how the proposed First Home Super Saver Scheme announced in the 2017 federal budget will work and what we need to do to take advantage of the incentive?

From July 1, 2018, first-home buyers will be able to access their superannuation to withdraw voluntary contributions made to their superannuation fund from July 1, 2017, including associated deemed earnings, to buy their first home.

Under this initiative, up to $15,000 per year and $30,000 in total can be contributed to superannuation per person. Both members of a couple are eligible to take advantage of this measure to buy their first home. Effectively a couple can make a combined contribution of up to $30,000 per year and $60,000 in total.

The contributions will be included in the applicable superannuation contribution caps. The concessional contribution cap which includes employer contributions or personal deductible contributions will be $25,000 and the non-concessional contribution cap (personal after-tax contributions) will be $100,000 per financial year effective July 1, 2017. Voluntary concessional contributions will be taxed at 15 per cent when made to the fund. Non-concessional contributions can be made tax free.

Investment earnings available for withdrawal will be calculated at a deemed rate of return. The deemed rate of return will be the 90-day bank bill rate plus 3 per cent. Based on the current 90-day bank bill rate of about 1.74 per cent, the deemed rate of return would be 4.74 per cent.

Concessional contributions and earnings that are withdrawn to buy a property will be taxed at the individual's marginal tax rate less a 30 per cent tax offset. When non-concessional contributions are withdrawn, they will not be taxed, however the earnings are anticipated to be taxed at the individual's marginal tax rate less the 30 per cent tax offset.

The First Home Super Saver Scheme will be administered by the ATO. The ATO will determine the amount of contributions that can be released as a deposit and will instruct the superannuation funds to make the withdrawal payment. The ATO will administer the compliance to ensure the funds are used to buy a first home.

As the initiative caps out at a limit of $60,000 per couple, it should be used as part of an overall strategy of saving for a home deposit.

If you plan to buy a home in the next three years, you would want to start the strategy as soon as possible. As the pre-tax contributions will be limited to the concessional contribution cap of $25,000 which includes employer contributions, if you earn $120,000, then you already would receive at least $11,400 in superannuation guarantee contributions a year so you would therefore be limited to $13,600 a year of voluntary concessional contributions towards your first home deposit.

The First Home Super Saver Scheme is only a proposal and needs the passage of legislation before being implemented. My understanding of how the initiative will operate is limited to what information has been published to date. There are some aspects requiring further clarity; for example what happens if the value of the super fund actually falls or the rate of return is less than the deeming rate? In either of those instances, how much can be withdrawn? What happens to eligibility if one member of a couple has previously bought a home? What are the consequences of breaching the rules? Stay tuned for further detail once the legislation is released.

Visit the Wealth section at www.theaustralian.com.au to send your questions to Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.

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