Getting it right in 2020: a checklist for the new year

SUE DAHN

The weeks ahead offer a decent time for a summer review of your investment portfolios — preferably with a clear head after all those holiday festivities. If you make the effort you can start the new year in good shape.

Here are the basic elements you could include in that review:

Review your risk tolerance

Another year has passed and you're now a year older and closer to retirement (or deeper into your retirement), your life circumstances may have changed in other ways and it may be that your tolerance to risk has changed. The financial markets have just delivered a record year of returns (20 per cent on the sharemarket). But as always there is plenty of uncertainty on the horizon for next year and there may be good reasons to reduce exposure to riskier assets. On the other hand, your wealth may have increased materially during the year, say by way of a significant realised asset or a bequest, and you may wish to increase your risk tolerance because you now can.

The key question: ask yourself "would I feel as bad or worse than I did last year if the market had a serious downwards correction now?"

Assess your asset allocation

If your risk tolerance has fallen, consider substituting risk in the sharemarket for some defensive alternatives. If your risk tolerance has increased, perhaps consider deploying excess cash into growth alternatives such as property, infrastructure and private equity. If you are an advised investor, schedule a discussion on this key topic with your adviser.

Rebalance portfolios

Portfolios inevitably drift through performance, dividend reinvestment, initial public offers, capital raisings, buybacks, takeovers, etc. Generate a report to establish how far away your actual allocation is from your original target allocation. If you don't have such a report, work it out manually. And make sure assets are correctly categorised. I am increasingly seeing credit investments characterised as defensive fixed interest, for example, when most credit assets are actually positively correlated to sharemarkets.

Concentration risk

Put simply, concentration risk is the "too many eggs in one basket" risk and can occur with asset classes, geographies, currencies, business sizes, business sectors, individual shares, funds and fund managers.

Most Australian investors are overexposed to Australian assets and the Australian currency, but so-called investor home bias is not necessarily a bad thing when it matches the location of future liabilities and currency of future cash flow needs.

In the same manner, review the diversification of business size and sector in the portfolio and consider whether it meets with your investment intentions.

For example, some equity investors can inadvertently hold way too much or way too little in small cap exposures — stick to the 80/20 rule. I've heard hilarious proclamations from investors — "Oh I am very diversified: I hold all four major banks!" Review any individual holdings over more than 5 per cent of your total portfolio and consider re-sizing. Review exposure to any active fund managers over 10 per cent of your portfolio. Review the most recent reports of fund managers — are you inadvertently doubling or tripling up on underlying holdings?

Review structures

The great enemies of the investor are unnecessary taxes and fees. Are your growth assets held in legal structures that enjoy the lowest available tax rates on realised capital gains? Are your income-generating assets held in legal structures that enjoy the lowest available tax rates on income?

If you are an investor who works closely with an adviser, this is a critical aspect of discussions, or you might wish to consult your accountant.

Similarly, are you in the lowest-cost version of any managed investment products — wholesale rather than retail, exchange traded fund rather than unitised managed fund? Do you know what you are paying? Also, are you getting value for money for any advisory, monitoring, management, administration and reporting fees paid to an adviser or advisory group?

Assess your liquidity

How much of your portfolio could be liquidated into cash in three days or seven days? Do any of your investments have gates or waiting periods to exit, or are completely locked up until a set termination date? You might do this to make sure your portfolios are liquid enough in the event of an emergency or need for funds.

Cash option

Yes, interest rates are historically low, but are you holding enough? Are you earning a reasonable (it's all relative!) interest rate on your cash holdings? A good idea at this time is to consider alternatives to traditional term deposits such as 12-month annuities.

Optimising super

It pays to periodically check that your super guarantee withholdings (if applicable) are getting through to your designated super accounts.

Now that another year has passed, also review whether you are in a position to turn on the most concessionally taxed "pension mode".

And for fortunate high-balance holders/high-income earners, you can work around the surcharges that come with exceeding your $25,000 annual concessional contributions by requesting that one or more of your employers are released from the requirement to pay your super guarantee.

Sounds like a lot of housekeeping, but trust me, it's worth the effort!

Sue Dahn is a partner at Pitcher Partners and was recently voted No 1 among Australia's top financial planners in The List: Australia's Top Financial Advisers

Why economists often get it wrong

Human nature does not always listen to the mathematics

ROGER MONTGOMERY

Economists have long been the butt of jokes: you know, they make sheep look like independent thinkers! Or the one about the economist shipwrecked on a deserted island with a chemist, a physicist and a single tin of canned beans.

Deliberating over how they might open the can in order to survive, the chemist suggests submerging it in saltwater so the tin might oxidise. The physicist suggests a device made from palm fronds that pitches stones at the can at just the right velocity to pierce its side. Then they turn to the economist … who contemplates the problem deeply, and then suggests they simply "assume the can is open".

It might seem immediately obvious to all of us, but it has taken a scientist to finally admit that economists still have a lot to learn.

In a new perspective piece published by Ole Peters from the London Mathematical Laboratory at the Santa Fe Institute in peer reviewed journal Nature Physics, people's real-world behaviour often "deviates starkly" from what standard economic theory would recommend.

What? Really?

According to the ergodicity problem in economics, economists have been making a repeated mistake in their assumption about human behaviour and it has infected economic models that seek to explain everything from trading bitcoin and gambling, to insurance and switching jobs.

Individual economic decisions can fundamentally be reduced to a bet, or a gamble, aiming to maximise an individual's wealth over time. How individuals make sense of those is the subject of the paper.

Peters uses the example of a simple gamble, a coin toss, to explain the way economists tackle individual decision-making. In economics, a "gamble" refers to any decision we make from "choosing the kindergarten for your child [to] deciding on matters of taxation". Because the future is an unknown, we never quite know the consequences in advance, and economically this is often expressed as a random wealth change.

> It might seem obvious to all of us, but it has taken a scientist to finally admit that economists still have a lot to learn

Looking at each decision or gamble discretely, there's a set of pairs of possible wealth changes and corresponding probabilities. In Peters' gambling example, he models the following situation: toss a coin, and for heads you win 50 per cent of your current wealth, for tails you lose 40 per cent."

Thanks to the famous exchange of letters between Pascal and Fermet in 1654, which established the expectation value as a key object in the theory of randomness, economists assume rational people will always take the bet because, according to classical economic theory, rational individuals would consider all possible outcomes and then take the average (ergodicity).

If there is a 50 per cent chance of heads adding 50 per cent to your wealth and a 50 per cent chance of tails losing 40 per cent of your wealth, the formula produces a positive mathematical expectancy of 5 per cent. And according to classical economic theory, rational people will always play such a game.

But would people gamble on a repeated coin toss where a heads would increase their net worth by 50 per cent but a tails would decrease it by 40 per cent? Peters asks: "Would you accept the gamble and risk losing at the toss of a coin 40 per cent of your house, car and life savings?"

The failure of the expected wealth model to describe actual human behaviour is known as the St Petersburg paradox. Indeed, by 1713, it was clear that there's more than expected wealth changes to financial decisions under uncertainty. Somebody still hasn't told the economists!

In 1738, Daniel Bernoulli concluded that when people decide whether to take part in a gamble, they don't consider the expected changes in wealth, but the expected changes in the usefulness of wealth. Importantly, Bernoulli proposed that the usefulness, or utility, of an extra dollar is roughly inversely proportional to how many dollars you already have.

So the more dollars you already have, the less likely you are to gamble it away. We see this among wealthy clients who care less about making the last few per cent return in a bull run and more about not losing 20, 30 or 40 per cent in a bear market. It's why we prefer to hold cash than invest in our 50th best idea.

I recall a very wealthy individual telling me once, "I just want to go up with everyone else, and not down with everyone else." Music to Bernoulli's ears! But Peters says utility theory doesn't posit a way to deal with time. Time is dealt with quite separately, namely through the process known to investors as discounting.

Peters suggests that the classical "solution" lacks a fundamental understanding of the individual's unique trajectory over time.

Instead of averaging wealth across multiple parallel possibilities, Peters advocates an approach that models how an individual's wealth evolves along a single path through time. His simple demonstration involves randomly multiplying the player's total wealth, in a sequence, by either 150 per cent or 60 per cent depending on the coin toss. The player must accept the gain or loss of each round, and take it with them to the next. As the play time increases, Peters' model reveals an array of individual trajectories and, while they all follow unique paths, they all eventually plummet downward. You may end up with 5 per cent, but no investor is hanging around to see it.

It makes perfect sense: losing 40 per cent of your wealth at some point is inevitable if you're gambling on coin tosses and the result will be painful. In other words, the approach reveals a spread of exponential losses where the classical conception would show a single exponential gain.

If a fund manager offered a regular 5 per cent per annum (economic theory) but delivered 50 per cent gains followed by 40 per cent losses (real life), you'd have ASIC involved. Ask your local economist to consider that.

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

www.montinvest.com

First-home buyers save with scheme to replace mortgage insurance

STUART WEMYSS

Housing affordability has been a hot topic for many decades. The truth is that property has always seemed expensive, particularly for first-home buyers as their financial positions tend to be relatively weak.

Governments have tried numerous ways to ease the affordability challenge with grants, concessions and incentives. A criticism of first-home owners grants is that they artificially distort property values. We observed this in 2008 and 2009, when vendors factored in the higher FHOG receipt when they set their selling price. So, essentially, when the Rudd government doubled the grant, property prices increased commensurately, so it did nothing to make property more affordable.

State governments have tried to ease the housing affordability challenge, too. Most states waive stamp duty for first-home buyers if the property's value is below a certain limit, which typically ranges from $400,000 to $650,000, depending on the state. This incentive can save a first-home buyer more than $30,000, so it's a very effective tool.

However, perhaps the biggest "hidden" cost of buying a first property is mortgage insurance. In the event that a borrower requests a loan that is more than 80 per cent of a property's value, the lender requires the loan to be insured by either QBE or Genworth (there are only two mortgage insurers in Australia).

The lender will arrange an insurance contract to cover its risk, not the borrower's. That is, the risk that the bank loses money if it has to sell the property, but the proceeds are not enough to repay the loan. The lender passes the insurance premium cost on to the borrower.

> To add insult to injury, most states charge stamp duty on the mortgage insurance premium

The problem is that mortgage insurance fees have skyrocketed in recent years.

In 2011, someone who borrowed $500,000 at a 90 per cent loan-to-value ratio would pay a mortgage insurance fee of about $7500. Today, that fee has increased to up to $14,000. That equates to an annual rate increase of more than 8 per cent. According to data from the Real Estate Institute of Australia, the median house price in Australia has only increased by 3.7 per cent over the same period. And the inflation rate has been even more benign at only 1.9 per cent. If these cost increases are not arrested, an increasing number of first-home buyers will be locked out of the market.

To add insult to injury, most states charge stamp duty on the mortgage insurance premium, adding up to 11 per cent onto the total cost (so, the cost increases from $14,000 to $15,500).

In an effort to make first homes more affordable, NSW and the ACT abolished stamp duty on mortgage insurance premiums in 2017. No other states have followed, however.

The federal government's new First Home Loan Deposit Scheme will provide some much-needed relief to the escalating cost of mortgage insurance. The scheme begins on January 1 but it will only be available to 10,000 borrowers a year. The government will offer lenders a guarantee in respect to eligible first-home borrowers that will replace the need for mortgage insurance. This scheme is only available to those who earn less than $125,000 a year (or $200,000 for couples) and who buy a property below the mandated threshold, which ranges between $250,000 and $700,000, depending on state and location.

Eligible borrowers can apply to participate in the scheme via a participating lender. NAB is the only lender appointed to date, but more are expected to be added.

Stamp duty and purchasing cost concessions do not artificially distort property prices as much as grants do, if at all. Giving someone a wad of money that they never had to work hard to accumulate is psychologically different to waiving a fee. A grant is a windfall gain whereas a fee waiver does not put you in a better position; it just helps you avoid being put in a worse position. A fee waiver is unlikely to change how judicious you are when contemplating how much to offer to buy a property.

Hopefully, the First Home Loan Deposit Scheme simulates much-needed competition in the mortgage insurance sector. Economists estimate there are 110,000 first-home buyers in Australia each year. Therefore, the First Home Loan Deposit Scheme in its current format will help less than 10 per cent of the market.

If the scheme is successful, perhaps the government should consider extending it and maybe also introducing a fee to participate to ease the burden on the public purse.

Stuart Wemyss is an independent financial adviser and author of Investopoly: the 8 Rules for Mastering the Game of Building Wealth.

swemyss@prosolution.com.au

Escape to Greenland

Win an amazing Arctic Luxury Expedition with PONANT

Win the trip of a lifetime to Greenland where you'll discover uninhabited volcanic islands, alpine landscapes and majestic fjords with someone you love. You'll be treated to 15 days of unforgettable sightseeing aboard PONANT's luxurious 264-passenger expedition ship *L'Austral.*

This bucket-list prize is valued at $40,000, including:

- Return International flights and port transfers.
- 2 nights accommodation in Paris.
- 14 night "Greenland of Great Explorers" PONANT expedition cruise.

Members, enter now at theaustralianplus.com.au/greenland

THE AUSTRALIAN plus

Entries open Sunday 1 December 2019 at 12:00am AEDT and close Tuesday 19 January 2020 11:59pm AEDT. Winner determined Tuesday 21 January 2020 at 4:00pm at News PTY Limited, 2 Holt St, Surry Hills, NSW, 2010. Winner's name published on www.theaustralianplus.com.au. Total prize pool valued at up to $40,000. Prize must be taken by 24 June 2020. A complete list of prize inclusions and full terms and conditions available at www.theaustralianplus.com.au. Photograph: © PONANT Studio PONANT: Nathalie Michel. NSW Permit No. LTPS/19/39506 ACT Permit No. ACT TP 19/04540 SA License NO. T19/564.