Financially Speaking

Brought to you by your Financial Planner
North West Financial Services (QLD) Pty Ltd.

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Inside this edition

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Alternatives to low market returns

Financial markets today are very different to what they were in the 1980s and the 1990s. That era of steadily rising economic and income growth (sometimes referred to as "the great moderation") now seems so long ago.

Economic stagnation appears to have become entrenched in many developed countries, which is creating headwinds for equities, the traditional growth engine in investor portfolios.

So what investments, if any, can drive growth in portfolios when sharemarket returns are lacklustre and volatile?

Alternative Investments may hold the key to this question. A sub-set of Alternative Investments in particular known as 'hedge funds,' are gaining increasing recognition as a solution to the low-return conundrum as they seek to generate positive returns regardless of the general direction in equity markets.

Hedge funds have suffered in recent periods from the misperception that they are riskier than equities.

While it is true that choosing a good hedge fund strategy involves a broad assessment of risk, organisational and investment dimensions compared to more traditional forms of investment. An institutional quality hedge fund strategy can deliver very attractive returns with risk levels well below that of equities.

Most people think of alternatives as a single asset class or strategy. This is incorrect. Alternatives provide access to sophisticated investment strategies and types of investments that cross asset classes (as the sidebar explains), broaden diversification opportunities and potentially smooth portfolio returns.

Portfolio Comparison

Exactly how much of a portfolio should be allocated to alternative investments, and which of the various opportunities that are available should be included, are questions for experts. To gain some idea of what is possible, we compared the performance, over the last 12 years or so, of two portfolios.

One is a traditional portfolio (that is split 60/40 between equities and bonds). The other portfolio is split evenly between traditional equity investments, Traditional Bond Investments and a broad spread of Alternatives. The details, which relate to the period from April 2000 to March 2012, are shown below.

Both portfolios moved substantially in line with the S&P/ASX-200 Index. However, the portfolio which included Alternative Investments delivered higher returns with lower risk. Its Sharpe Ratio – a measure of the return earned for the risks taken – was much higher. In the worst year, the portfolio which included Alternative Investments lost 20% of its value, whereas the traditional 60/40 portfolio contracted by 28%.

In other words, alternative investments bring many advantages, provided that care (and professional advice) is taken when they are included in portfolios. They have the capacity to deliver stable returns in both strong and weak markets.

	Traditional 60/40 Portfolio	Portfolio With Alternatives
Return per annum	5.9%	6.9%
Risk	7.0%	5.0%
Sharpe Ratio (tells whether a portfolio's returns are due to good investment decisions or a result of excess risk)	0.1	0.3
Maximum Drawdown (measures an investment's high point to low point)	28.0%	20.0%
Correlation to S&P/ASX-200 Index	0.95	0.93

For illustrative purposes only. The 60/40 portfolio comprises a 40% allocation to income assets represented by an equal weight investment in the UBS Composite Index, the Barclays Global Aggregate Bond Index Hedged to $A, and the UBS Bank Bill Index. The 60% allocation to growth assets is represented by a 20% allocation to the MSCI World Ex Australia Hedged to $A, a 30% allocation to Australian Equities, a 5% allocation to the S&P/ASX300 REIT Index and a 5% allocation to the Dow Jones-UBS Commodity Index. The 60/40 portfolio plus Alternatives replaces 30% exposure to market betas (10% from bonds, funded equally between Australian and International bonds, and 20% from equities funded equally from Australian and International equities) with a 30% exposure to diversified hedge fund returns as represented by the DJ Multi Strategy HF index for the period April 2000 – Jul 2004 and a representative BlackRock diversified hedge fund strategy thereafter. Source: BlackRock, Datastream. Past performance is not a reliable indicator of future performance.

What are some of the Alternative Investment strategies that are available?

Some common examples of Alternative hedge fund strategies are as follows:

Long/Short Equity Strategies

- This involves a combination of 'long' and 'short' positions. Often 'short' positions – which increase in value if the price of the share involved falls – will account for a substantial part of the overall portfolio.

Relative Value Strategies

- These seek to exploit apparent pricing/ valuation anomalies between particular securities. Typically, the manager will take a 'long' position in the security which appears to be undervalued and a 'short' position in the security which appears to be overvalued.

Event Driven Strategies

- These involve an assessment by the manager of how company-specific events, mergers, bankruptcies, restructurings etc. are likely to evolve.

Global Macro Strategies

- These involve an assessment by the manager of the likely evolution of contemporary developments in global economies and financial markets.

Managed Futures Funds

- These typically use algorithmic and technical models that focus on the trends exhibited by futures and other very liquid securities. These include most Commodities funds.

Multi Strategy Funds

- These use a number of the strategies noted above. As they are diversified across a wide range of different management styles and asset classes, they aim to deliver consistent returns with low levels of volatility.

Funds of Hedge Funds (FOHF)

- These often invest in 30-70 different underlying alternative strategies. What sets them apart from multi-strategy funds is that each of the underlying alternative strategies is typically handled by a different manager.

Source: BlackRock Investment Management (Australia) Limited, August 2012

The danger of overconfidence in your own ability

Of the psychological biases investors are prone to, overconfidence is perhaps the most damaging because faith in their judgements usually exceeds their accuracy.

Many surveys reveal that most people rate themselves "above average" when it comes to positive traits, such as driving ability, employment prospects or life expectancy. Such overconfidence is something investors must guard against. That's not easy because overconfidence in yourself is fuelled by related psychological biases, namely optimism; the illusion of knowledge and the distortion of hindsight. Most of us view the world as more benign than it is. We underestimate the likelihood of falling ill, for instance, yet overestimate the probability of good events happening to us, which explains lottery ticket sales.

Illusion of Knowledge

Our optimistic nature is augmented by other factors that boost our confidence. The *illusion of knowledge* is our tendency to believe that the accuracy of our forecasts increases with more information. This is not a given; information is not the same as insight. Today, investors are bombarded with information that encourages some to make frequent changes to their portfolios. However, studies suggest that these investors are guilty of overtrading, virtually guaranteeing mediocre returns after transaction costs. One explanation for overtrading is that investors feel motivated to master the environment. This is the *illusion of control*, the tendency to overestimate our ability to influence trajectories over which we have little control.

Hindsight Distortions

On top of all this, *hindsight* distortions can feed confidence levels. By extrapolating recent experience into the future, we are often guilty of making confident predictions that are regularly proved wrong.

Overconfidence becomes especially problematic in bull markets – whether in shares or bonds – and during periods of sustained stability; when confidence takes hold that the prevailing conditions will last. Yet our collective overconfidence in ourselves sows the seeds of our subsequent downfall. Economist Hyman Minsky is famous for observing that stability begets instability. His *Financial Instability hypothesis* suggests that people tend to take greater risks in periods of sustained stability.

Overconfidence in our own ability is most conspicuous in share markets just before a slump, but it can equally apply to others assets whose valuations may not properly reflect the risks.

Diversification

There is much to be said for considering the contrarian view and taking a range of outcomes into account. It's a large part of why investors should have a diversified portfolio of risky and defensive assets. For diversification is a sleep-at-night solution to the problems stemming from overconfidence in ourselves and hindsight distortions.

Source: Fidelity Worldwide Investment, July 2012

The things you can control

We all crave control. Whether it is our careers, personal lives or our investments, a sense of control is important to our overall feeling of confidence.

So it is no surprise that a sense of control is a strong driver for why so many Australians are establishing their own Self-Managed Super Fund (SMSF).

This month the Vanguard/Investment Trends April 2012 SMSF Investor report on Self-Managed Super Fund investors was released and with it insights into attitudes and behaviours of SMSF investors after what has been a challenging year for investment markets. (Investment Trends surveys more than 2000 SMSF investors in their annual survey.)

The SMSF market continues to grow – both in numbers of funds (now 468,000 in March this year) and assets – up 3% to $416 billion, according to the Australian Prudential Regulation Authority (APRA) market data.

When asked what the driver for setting up their own super fund was, 77% of investors cited control and lower costs as the primary reasons.

Almost 60% of investors wanted more control of their investments. But what does that mean?

When Investment Trends drills down into the specific drivers one of the key themes that emerges is that a sense of control comes from being able to select specific shares to invest in. Other common messages focus on the poor performance from their existing super fund and the belief that they can make better decisions than super fund managers.

This has manifested itself dramatically in the growth in direct shares and cash in SMSF portfolios and a corresponding fall in the use of managed funds since 2007.

At a recent seminar an investor perhaps summed it up best – "fund managers have been losing my money, I can do that myself".

This is an intriguing aspect of investor behaviour – if the investor continues to lose money will he/she really feel better about it because they were in control? A sense of control can be comforting but also dangerous if it manifests itself as overconfidence.

Do individual investors truly believe they can outsmart well-qualified professionals who spend all day, every day managing portfolios for a living?

The disenchantment with super fund managers is hardly surprising given that the median growth super fund has delivered 7.2% over the three years to the end of May but is slightly negative at -0.4% over five years according to the Chant West Multi-Manager performance survey.

The critical question here is what investors expect from their fund managers.

It is hardly surprising that investors expect professional fund managers to deliver higher than average market returns because a huge amount of marketing and advertising effort goes into promoting high returns, short-term trading and the professional expertise that you are paying for when you invest with a professional fund manager.

The industry's dirty little secret is that the majority of fund managers do not outperform their respective market indices after costs are deducted over the long term.

Morningstar provides market return data and if you look at wholesale Australian equity fund managers and wholesale Australian fixed interest managers over the past 10 years only 18 per cent of Australian equity managers and 12 per cent of Australian fixed interest managers succeeded in beating the index return (refer to figure 2).

So it is perhaps not surprising that investors are feeling short changed – and motivated to take more control. But let us look at what investors can control and what they cannot. Apart from the desire to invest more directly in shares, the Investment Trends research also heard from investors that the fees being charged by super funds and the desire to save money on fees were strong influences.

Past performance is just that – a historical score. And future performance will be delivered more by markets than managers so it makes good sense for investors of all types to keep the costs of investing in those markets as low as possible. In investing you get what you don't pay for.

As an SMSF investor you can directly control how much you pay in fees – be it to your fund manager, auditor administrator or financial adviser. That is real control.

Source: Vanguard Investments Australia Ltd.

Figure 1 - Main reasons for setting up an SMSF

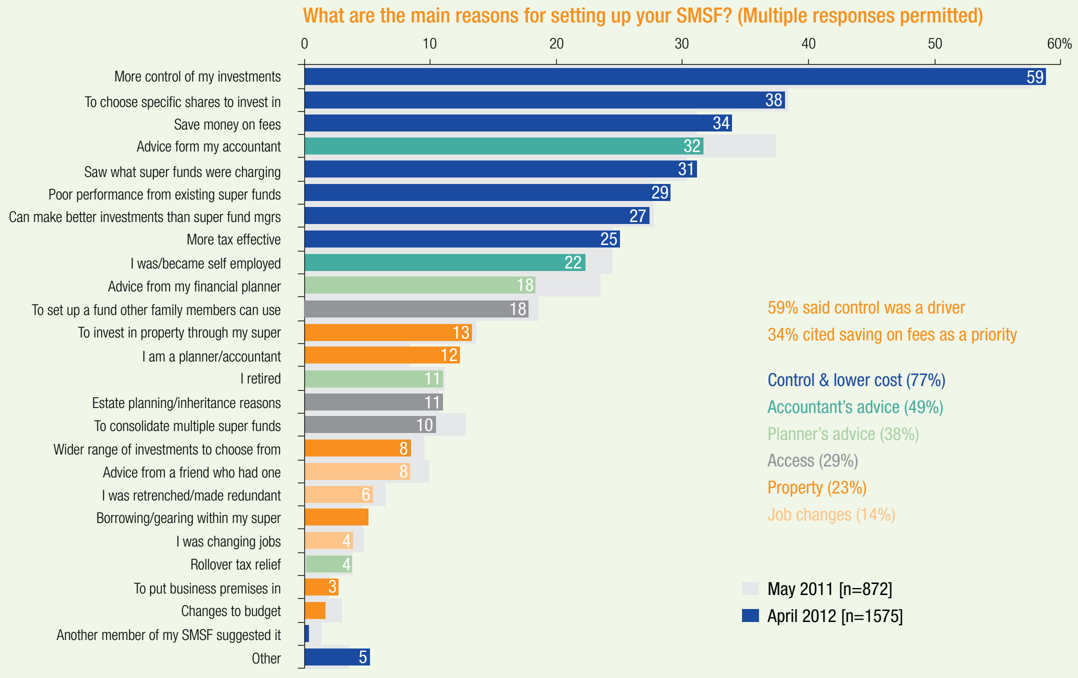

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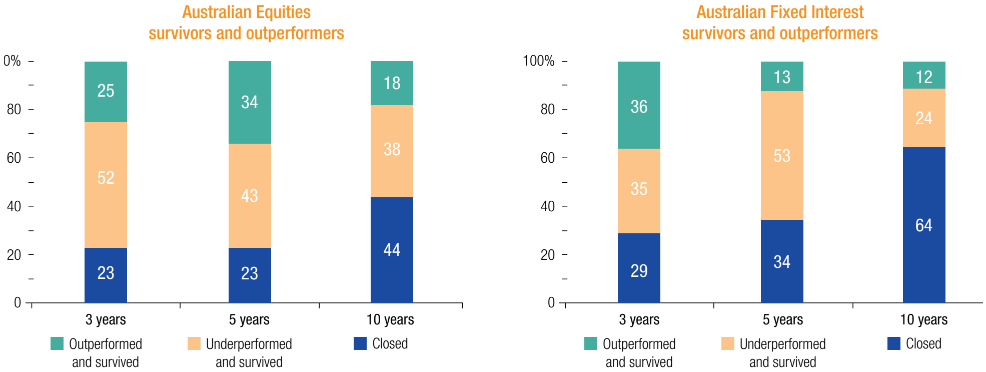
Figure 2 - Survivorship and outperformance



Notes:

a. Three-year figures are for the period Dec/2008 – Dec2011; 5 year figures are for the period Dec/2006 – Dec/2011 and 10 year figures are for the period Dec/2001 – Dec2011.

b. Sample size for Australian equity was 682 funds for three years, 576 funds for five years and 323 funds for ten years; while for Australian fixed interest was 97 funds for three years, 96 funds for five years and 98 funds for ten years.

Sources: Vanguard Investments Australia Ltd. analysis, based on data from Morningstar, Inc.

Self Managed Superannuation Funds and Estate Planning

Flexibility available to members in managing their superannuation money is one reason people establish their own Self Managed Super Fund (SMSF). That flexibility involves many activities of the fund, from the investment of the available money, to the payment of pensions.

Effectively planning for the distribution of their benefits when they die is another very important consideration for people. SMSFs can provide a much broader range of estate planning options for members than are available in other superannuation funds.

Whilst a Will is a significant part of the estate planning process, it is not the only part - a Will generally has no direct bearing on the superannuation benefits of a member.

Many people operate under misconceptions when it comes to understanding how their superannuation is managed when they die. That includes assuming that their superannuation benefits will automatically pass to their estate.

Without specific directions, the trustee of the superannuation fund is required to decide who is to receive a deceased member's superannuation, considering a range of potential beneficiaries.

SMSF Trust Deeds

Although SMSF trustees are generally family members who can be counted on to make the correct decision, there are unfortunately legal cases which have occurred because 'unpopular' decisions have left family members without benefits.

Rather than hoping that greed will not influence decisions, the wise course of action is to plan the distribution of the superannuation benefits, and put in place valid instructions for trustees to follow.

The first step is to make sure the SMSF Trust Deed is up to date. Older deeds do not provide the same flexibility as do recent trust deeds, because of the innovations which are constantly being introduced.

A well drafted trust deed will permit SMSF members to put in place quite specific directions about how their superannuation is to pass on their death.

The SMSF trustee must follow those directions, if the trust deed is valid.

The instructions can actually be included in the SMSF trust deed - this is called a Death Benefit Rule, which means there is no doubt as to the wishes of the member.

One of the most popular directions is an Automatic Pension Reversion. That instruction relates to a pension a member is receiving from their fund, and nominates that the payment of the pension will continue on their death, to another person - generally the spouse or a child.

Binding Death Benefit Nomination

The other most widely used direction is called a Binding Death Benefit Nomination. As mentioned, superannuation death benefits do not automatically pass to the estate of the deceased member. Through a Binding Death Benefit Nomination, a member can direct the trustee to pay benefits:

- as a lump sum to their estate; or
- to nominated individuals, as a lump sum or, possibly, as a pension.

Binding Death Benefit Nominations remove the decision from the remaining trustees. If those trustees are the type who will make the correct decision, there is nothing lost. If they could be influenced by other interests, a Binding Death Benefit Nomination will overcome that influence, and direct the benefits as intended.

Good SMSF trust deeds will permit detailed Binding Death Benefit Nominations which provide for eventualities such as the earlier death of an intended beneficiary and gifting of specific investments to beneficiaries.

Death Benefit Guardian

To safeguard the Binding Death Benefit Nomination failing - because it was invalid or missing, the appointment of a Death Benefit Guardian, an individual who provides a degree of oversight when the trustee is paying death benefits, is important. The role of a Death Benefit Guardian - generally a trusted friend or relative, or a professional adviser - is not to act as trustee but to ensure benefit payments are made as intended. The Death Benefit Guardian would only be involved if the:

- Automatic Pension Reversion; or
- Death Benefit Rule; or
- Binding Death Benefit Nomination; were not in place or not valid.

Enduring Power of Attorney

Enduring Powers of Attorney can also fill a very important role. An Enduring Power of Attorney ceases on the death of the individual, the 'donor', so it may seem odd for it to be considered part of the estate planning process. But as estate planning also involves maximising the assets to pass to intended beneficiaries, including Enduring Powers of Attorney does start to make sense.

A person appointed under an Enduring Power of Attorney is able to act as the trustee of the donor's SMSF, in their place, if unable to manage the SMSF themselves (i.e. are sick or suffer an accident). That could allow the SMSF to continue without incurring unnecessary taxes on closure of the fund.

Source: Topdocs Pty Ltd.

How to find a real income solution

With four successive interest rate cuts since November 2011, an increasing number of Australians could be forgiven for rethinking the role of term deposits in a low interest rate world.

In the peak of the global financial crisis the one-year term deposit rate reached as high as 8.25% - not a bad investment considering the Federal Government guarantee on bank deposits in an environment where fear was blanketing financial markets. However, since mid-2008 term deposit rates have almost halved and these days you will be hard pressed to find a one-year deposit rate above 4.4%. Investors that could once rely on term deposits for a healthy income are now faced with a choice of sticking with the same low returning asset or pursuing other higher return investment strategies.

While the term deposit has the appeal of reliable principal and interest, the hidden risk in a low interest-rate world is that living costs and inflation work together to gradually erode the real return you receive. In the 15 years to December 2011, living costs for retirees increased by 3.4% per annum which is even higher than the annual inflation rate of 2.9%. Furthermore, it is estimated that aged pensioners will need to additionally draw down on their capital by up to 8% per year to maintain living standards. When you consider term deposit returns from this perspective, it may be right to question their suitability as a long term investment strategy.

How can income investors stay ahead of the ever rising living cost curve without exposing themselves to volatile sharemarkets or highly-geared investment products?

One approach is to invest in funds that can grow their income stream, rather than having their income at the mercy of bank decisions. That way, as inflation increases the cost of living, the investor gets a higher income return with less chance of needing to put in more money or withdraw some of their principal or even worse cutting back on living standards.

Australian shares are one option and they do have the ability to increase income over time with higher company dividends. However, for many conservative investors the risk of capital loss is simply too far a leap.

Real Assets

Another solution with less volatility risk can be found in the real asset space. Real assets are the tangible building blocks of the economy that most of us use every day and include listed property trusts, utilities and infrastructure. While many of us may be aware of listed property trust assets such as shopping centres and office buildings, utilities and infrastructure may be less familiar. Specific examples include tollways, airports, power grids and gas pipelines. The key benefit of investing in real assets is that they can provide a highly reliable income stream and they can generally increase their revenues over time. In fact, many have in-built contracts that allow for increases in cash flows to match inflation. For example, Melbourne's Transurban which owns CityLink is a real asset that has been able to increase its traffic tolls every year to match inflation. This is good news if you are an investor in this real asset wanting to protect your future income from inflation.

While there is no industry benchmark to measure the performance of real assets in the same way the S&P/ASX Index measures the sharemarket, an alternative is to measure the performance of a fund investing in the real asset sector. On the risk side, in comparison to term deposits, listed real assets may have some ups and downs in their capital. However this volatility is expected to be significantly less than the wider sharemarket.

Real assets may be one option to consider if you are seeking higher income than term deposits without significantly higher risk. Even if you are a risk averse investor, the hidden risk of not being able to pay for future living costs – which is more likely with term deposits – may provide a compelling reason to discuss new income solutions with your financial adviser.

Source: Legg Mason, August 2012

Does parity mean party time?

That depends which side of the coin you are on... literally!

Our relationship with the US dollar has been quite turbulent since decimalisation in 1966.

In May 1974, our dollar reached an all time high of $1.4875 against the US dollar (USD), eventually dipping to an all time low of $0.489 in March 2001.

Before the collapse of Lehman Brothers and the onset of the Global Financial Crisis in September 2008 we came close, but it wasn't until 15 October 2010 at 11.28pm, that the Australian dollar (AUD) reached parity with the USD for the first time in 28 years.

Since then the dollar has been bouncing above and below the parity line. While economists spend a lot of time speculating what the AUD will do, many opportunists watch the dollar to book overseas holidays and shop online. But the issue of parity is a double edged sword.

What does it mean for our economy?

The rise in the value of the Australian dollar reflects a strong domestic economy, high commodity prices and relatively high interest rates.

The high Australian dollar means our export industries become less competitive. For example, education is one of Australia's largest export industries and international enrolments make up a large portion of Australian universities' revenue. Since their product is priced in Australian dollars, it's now significantly more expensive for international clients.

Many of our manufacturing export sectors, of course, experience the same issue.

For commodities it is a slightly different story as the goods are priced in the global market in US dollars. In this way, it's not that the goods become more expensive, our resource and commodity exporters simply receive fewer Australian dollars per unit of sales. This has a negative impact on profitability since most of their costs are priced in Australian dollars and don't fall in line with their reduced Australian dollar earnings.

To compound matters, the high Australian dollar makes it cheaper to buy products from countries whose currencies are falling (such as the UK, US and China). This affects domestic companies that compete with those imports.

What does it mean for your investments?

What this all means for your investments is complicated. Not only do you have to consider the economic impacts here at home, you also need to consider currency impacts on your international investments.

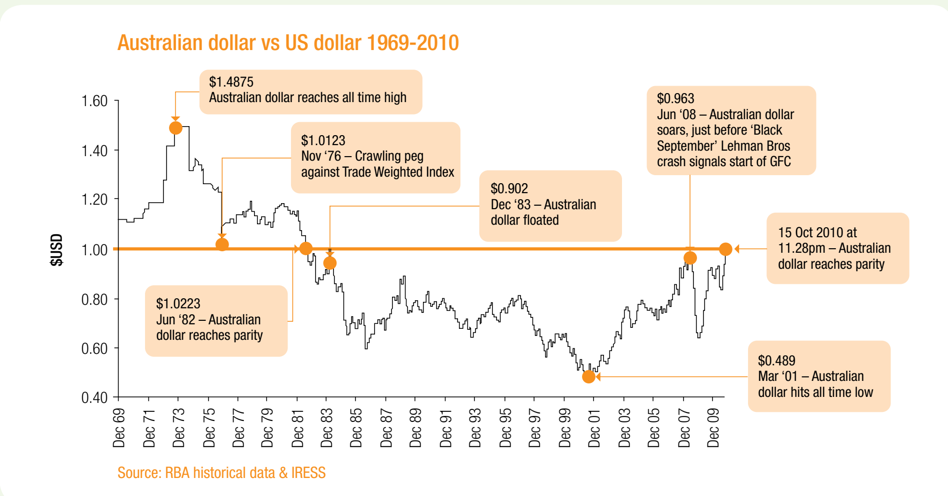
As the dollar rises, it has a negative impact on returns earned on international assets.

Conversely, if the dollar slides back, it will have a positive impact on returns earned on international assets. Further complicating matters is the fact that many international investment managers hedge their currency exposure so that currency fluctuations do not affect the capital value of the investments.

Currency hedging is designed to protect the value of the investment in Australian dollars from exchange rate fluctuations but it does have other implications which can affect the investments' ability to pay distributions.

As with all investment decisions, it's best to get the right guidance from your financial adviser. Your adviser can talk you through the effects of parity and how currency fluctuations affect your investments and then make recommendations that will suit your personal circumstances.

Source: IOOF Holdings Ltd. February 2012.



Protect Yourself from Investment Fraud

Cold-call investment fraud, perpetrated by offshore, organised crime groups, is becoming a growing threat and, to combat this problem, Federal and State authorities have called on us to help.

So, in order to protect yourself and your hard earned money, if you ever receive information about an investment opportunity, we recommend you always speak to your Financial Adviser before you make any investment decision.

Because remember, if it sounds too good to be true, it usually is.

What's the nature of the threat?

Criminals claiming to be investment brokers initially make telephone contact with victims. They build a rapport through regular telephone and email contact, and create a perception of legitimacy through:

- professional looking websites
- personal accounts for victims with login access
- regular reports about strong investment returns
- media releases, and
- in some cases, the delivery of professional looking documents via courier.

Victims are coaxed into electronically transferring significant amounts of money to overseas bank accounts.

As at June 2012, law enforcement had identified more than 2,600 Australians who had been defrauded of $113 million in recent years. While the average individual loss is $42,348, losses range from $35,000 to $4 million.

"Many of these investment scams are so professional and believable that it is hard to tell them apart from genuine investment opportunities." Australian Securities and Investments Commission (ASIC) Chairman Greg Medcraft.

Who is being targeted?

While anyone with savings to invest is at risk, victims are usually Australian males aged over 50 who have invested previously.

What is the Government doing?

The Australian Crime Commission Board has established a multi-agency task force to disrupt and prevent this form of organised fraud and to educate Australians about the threat it represents. The task force is working with key stakeholders in banking, financial advisory and superannuation industries to develop strategies to disrupt and prevent the crime.

How can you protect yourself?

- Always seek the advice of your Financial Adviser before making an investment.
- Alert family and friends to this fraud, especially anyone who may have savings to invest.
- Report suspected fraud to the Australian Securities and Investments Commission, via www.moneysmart.gov.au or 1300 300 630, or your local police. Any information that can be provided such as company name, location and contact details will assist with subsequent investigations and enquiries.
- Hang up on unsolicited telephone calls offering overseas investments.
- Visit www.moneysmart.gov.au or call 1300 300 630 for further information.

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