logical financial management

# Logical Thoughts

## WHEN A PAIR IS NOT A PAIR... BUT A LEMON

A topic that is rarely discussed and certainly not well understood by the broader market is industry funds and their strategic asset allocation mismatch. Given the ramp up in advertising in recent years by Industry Super Australia, retail investors are increasingly (and rightfully so) comparing performance to that of industry super options. However, due to limited information and lack of transparency, this comparison is not always straightforward, and I think it's important to shed some light on a complex topic and provide you with the knowledge to appropriately 'compare the pair'.

### What is strategic asset allocation and why is it important?

Strategic asset allocation is the long-term mix of assets (shares, bonds, property, infrastructure, cash and "alternative" assets) as well as the allocation between growth and defensive assets that suit your specific risk profile (e.g. balanced or growth etc.) and investment time horizon (minimum 5 years for a balanced investor). This combination of assets is estimated to provide a level of competitive returns over the long term that matches your tolerance for risk in your portfolio. *You invest in a mix of assets based on your tolerance for risk.*

Asset allocation is one of the most important decisions facing an investor, as it is a key driver of the portfolio's long-term return. An inappropriate asset allocation can either result in your portfolio failing to achieve your long-term investment goals or subjecting you to *unnecessary levels of stress about the riskiness of your investments.*

As we will discuss, a number of Industry Super Funds invest in a mix of assets but not necessarily based on the member's tolerance for risk and as a result this may lead to a higher level of investment risk and may lead them to unnecessary levels of stress about the riskiness of the member's retirement savings.

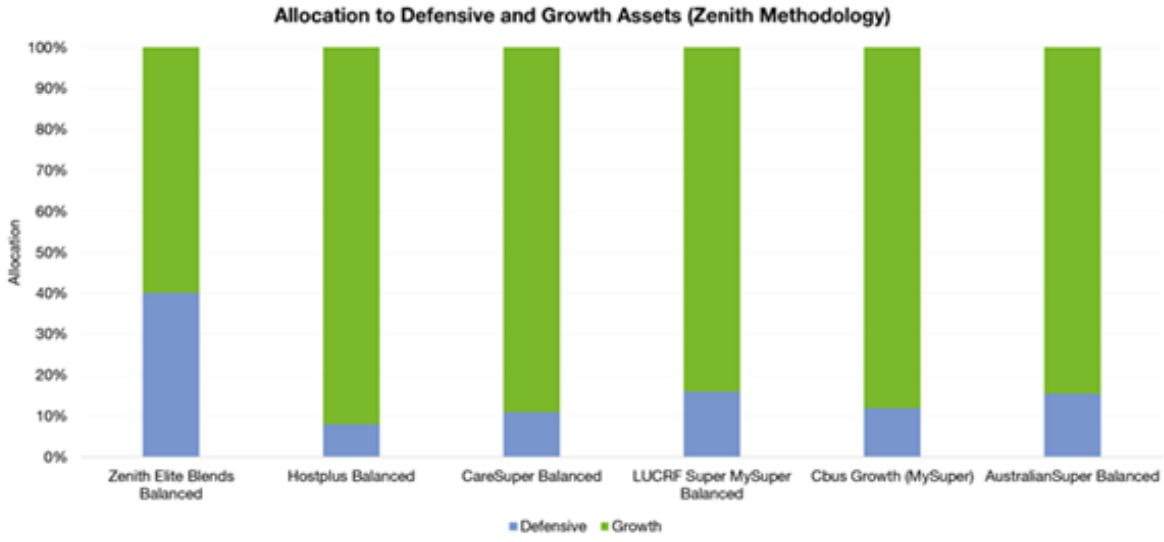
## Can you compare the Pair?

Lonsec Research advocates for a 60%/40% split in terms of growth and defensive assets and is generally an industry standard for a balanced portfolio. At a very basic level, growth assets are riskier investments, such as equities, property, infrastructure and certain alternatives. Defensive assets typically include traditional fixed interest, credit and cash. However, without an industry standard as to what constitutes a growth or defensive asset, differences in categorisation of assets leads to portfolios with the same branding (e.g. Balanced) having divergent levels of embedded risk.

This level of subjectivity when classifying assets has a material impact on the growth/defensive split of portfolios and total returns. In the chart below, Zenith Investment Partners has broken down assets based on their definition of growth and defensive assets and compared their 60%/40% balance portfolio with five industry super funds.

The aim was to demonstrate that in some cases you cannot 'compare the pair' and an industry fund balanced strategy is often in fact a growth or even a high growth strategy. This dispersion in asset allocation makes it challenging for investors to compare the absolute performance of Industry super funds to that of portfolios with the same risk profile name, such as a "balanced" fund.

An example of this asset allocation is the AustralianSuper Balanced pre-mixed portfolio that has a 15% allocation to income assets and an 85% allocation to growth assets based on Zenith's asset class definitions. This is a far cry from a 60%/40% Balanced portfolio and more aligned to a Growth or even High Growth risk profile. You should not be surprised to find out that this strategy returned 20.4% for the year to the end 30th June 2021 and was one of the top-performing "balanced funds" in the marketplace.




## Total Return and Risk - Diversified Options

The total return of the different diversified benchmark options below highlights that any exposure to defensive assets dramatically reduced a portfolio's total return in the 2021 financial year. The Balanced strategy outperformed the Conservative strategy by just over 10%, Growth by more than 15% and the Aggressive by 20%. There is little surprise that Australian Super's "balanced" strategy with 85% exposure to growth assets was able to generate a total return of 20.4% and beat the balanced benchmark (60% growth assets/40% defensive assets) by 6.31%.

| Returns (as at 30th June 2021) | Conservative (%) | Balanced (%) | Growth (%) | Aggressive/High Growth (%) |
|---|---|---|---|---|
| 1 year | 4.05 | 14.09 | 19.49 | 24.69 |
| 3 years (pa) | 4.47 | 7.99 | 9.49 | 11.19 |
| 5 years (pa) | 4.03 | 7.78 | 9.46 | 11.59 |
| 10 years (pa) | 5.35 | 8.35 | 9.76 | 11.33 |

*Conservative Fund: M'star Aust Conservative Index TR AUD, Balanced Fund: M'star Aust Balanced Index TR AUD, Growth Fund: M'star Aust Growth Index TR AUD, Aggressive Fund: M'star Aust Aggressive Index TR AUD.*

The greater exposure the investor has to growth assets the higher level of risk, including the risk of capital loss and more ups and downs in returns particularly over the short term. As a general rule, the higher the potential return from an investment, the greater is the investment risk and the probability of experiencing capital losses. It would seem with some industry funds the name of the investment option is not reflective of the underlying asset allocation, and therefore the risk level is not equivalent for all investment options with the same name.

The table below highlights that as you increase your exposure to growth assets the level of risk in your portfolio should increase, remembering you cannot diversify all the risk away in

your portfolio. For example, the variability (68% of the time) in returns for a growth index fund over three years is 10.74% compared to a balanced index fund of 8.06% and a conservative index fund of 3.44%. Investing in some industry funds may result in a higher level of investment risk and unpredictability of returns or the chance that returns will be different (higher or lower) than expected.

| Volatility (standard deviation) (as at 30th June 2021) | Conservative (%) | Balanced (%) | Growth (%) | Aggressive (%) |
|---|---|---|---|---|
| 1 year | 3.16 | 5.82 | 7.44 | 8.80 |
| 3 years (pa) | 3.44 | 8.06 | 10.74 | 12.82 |
| 5 years (pa) | 2.90 | 6.61 | 8.79 | 10.55 |

*Conservative Fund: M'star Aust Conservative Index TR AUD, Balanced Fund: M'star Aust Balanced Index TR AUD, Growth Fund: M'star Aust Growth Index TR AUD, Aggressive Fund: M'star Aust Aggressive Index TR AUD.*

## Performance numbers are not transparent

As per industry super fund standards, performance results are disclosed after tax which will account for tax payable and a franking credit rebate. Conversely, many diversified portfolios available in personal or retail funds will not disclose performance results net of tax. Unlike industry super funds, these options can be invested in several capacities (e.g. individual, company, trust, etc.) all of which are taxed differently. Therefore, it is not feasible to accurately disclose after-tax returns. Similarly for portfolios held via investment administration platforms (such as Panorama, Hub24, Netwealth etc) franking credits are not included in performance numbers. This is an additional layer of complexity that makes performance comparisons even more cumbersome.

## Final Comments

Clients need to be aware that it is not easy to 'compare the pair' due to limited information, lack of transparency and different reporting requirements of performance numbers. You need to be aware that the name of an industry super fund risk profile is often not indicative of the level of embedded risk. In most cases, industry super funds allocate a much higher exposure to growth assets and therefore their absolute performance is not comparable to portfolios with the same risk profile name.

Whilst we hold some Industry Funds in very high regard and have many clients who are members of such funds, it is important to understand that "comparing the pair" takes further research and skill with a focus on the **risk adjusted return** – that is, how much investment risk am I taking to achieve this return?

Interestingly, the vast majority of industry fund members are young people with low balances, who care little about a savings mechanism they cannot access until age 60…or maybe later. As such, the default for most members is the "Balanced Option" whereas they

should actually be invested in growth or aggressive portfolios…maybe the trustees of these huge funds are one step in front and have worked this out?

For those pre-retirement and in retirement, this can and has caused problems.

For those of us who prefer a more personalised and bespoke approach, we at Logical can construct portfolios in line with one's risk tolerance and create strategies containing multiple asset classes and quality, best of breed investments that over the long-term investment horizon, increases the likelihood of meeting one's overall target objectives (which is often retirement planning, encompassing longevity planning and finally estate planning). These issues may vary from preservation of capital at all costs, growing portfolio capital, or tax planning to generating a certain level of regular investment income…etc, etc.

This investment approach has shown to best achieve our clients' objectives over the years without having to reclassify unlisted assets as defensive assets and promote a balanced risk profile that is in fact a growth or high growth/aggressive profile.

## HOW COMFY IS COMFORTABLE?

The Association of Superannuation Funds of Australia (ASFA) provides annual budget figures to give Australians an idea of how much they will need to spend in retirement to fund a 'comfortable' retirement. According to their paper, the costs to support a comfortable lifestyle, and the lump sum needed at retirement to support it are as follows:

| | Single | Couple |
|---|---|---|
| Budget per year | $44,818 | $63,352 |
| Lump sum required | $640,000 | $545,000 |

*Source: ASFA Retirement Standard – June 2021, Australian Superannuation Funds of Australia*

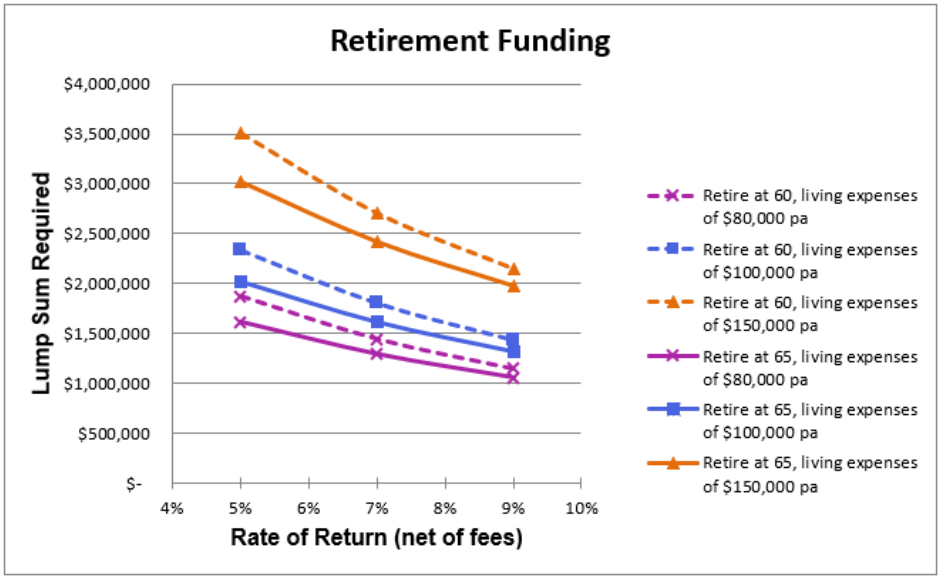
The figures assume that the retiree(s) own their own home, are relatively healthy, and will be eligible for some age pension. The budget includes essential household costs as well as allowances for:

- Some leisure and recreational activities
- Eating out from time to time
- Private health insurance at the top rate
- Occasional economy overseas holidays
- Domestic holidays

For detailed budget breakdowns and assumptions, go to: ASFA Retirement Standard Budgets

### What if your idea of comfortable is not the same as the average Australian in the ASFA survey? What if you know it's unlikely you will be eligible for any Age Pension?

The following graph and table give an idea of how much a person may need to have accumulated at retirement to support higher living costs of $80,000pa, $100,000pa and $150,000pa, assuming different rates of return of 5%pa, 7%pa and 9%pa and either retiring at age 60 or 65.



| Retiring at age 60 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Living Costs | $80,000 | | | $100,000 | | | $150,000 | | |
| Return | 5% | 7% | 9% | 5% | 7% | 9% | 5% | 7% | 9% |
| Lump sum Required | $1.87 m | $1.44 m | $1.15 m | $2.34 m | $1.80 m | $1.43 m | $3.51 m | $2.71 m | $2.15 m |
| **Retiring at age 65** | | | | | | | | | |
| Living Costs | $80,000 | | | $100,000 | | | $150,000 | | |
| Return | 5% | 7% | 9% | 5% | 7% | 9% | 5% | 7% | 9% |
| Lump sum Required | $1.61 m | $1.29 m | $1.06 m | $2.01 m | $1.61 m | $1.32 m | $3.02 m | $2.42 m | $1.98 m |

Given there is no Age Pension or tax taken into the calculations, for each level of living expenses, the lump sum required is the same for both singles and couples.

Please note the following important assumptions:

*Estimates should be viewed as purely indicative only, as they are based on many assumptions and cannot be guaranteed.*

- Living expenses shown are in today's dollars and indexed each year by inflation.
- All funds are depleted at age 89, which is the average Australian life expectancy.
- No allowance has been made for any Age Pension.
- No allowance for tax has been made (i.e. 100% of the money is invested in a superannuation-based pension, which under current legislation provides tax-free income for people over age 60).
- Rates of return are net of fees.
- Inflation of 3.5% pa.

As you can see, a person's rate of return (as determined by their asset allocation or risk profile), and retirement age significantly affect the quantum of the lump sum needed to fund retirement living expenses.

Most people need to make additional contributions to their super to achieve balances in the ranges set out in the graph. Given the caps on contributions under current legislation, careful planning needs to be done well in advance of retirement to achieve the above lump sum requirements.

Logical can assist in providing personalised modelling to determine the best way to grow your retirement savings to ensure you have sufficient assets to fund your retirement lifestyle…however comfy you want it.

## WHY CONSISTENCY WINS THE RACE

Watch Magellan Chairman and Chief Investment Officer, Hamish Douglass' recent investor briefing in which he outlines why real returns could be lower in the coming decade and why he believes this calls for a portfolio that focuses on lower-risk, high quality global businesses that compound returns over time. (Viewing time: 49 mins).

Hamish also does a deep dive into two of the big holdings in his portfolio – Microsoft and Netflix. Well worth watching!

**Gavin Shepherd**
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Gavin has been an investment specialist for more than 20 years and is the head of Investment Research at Logical.

Gavin's qualifications include a Masters of Applied Finance (Macquarie University), Bachelor of Agricultural Economic (Sydney University), Graduate Diploma of Applied Finance and Investment (Finsia) and he is currently studying a Master of Financial Planning at the University of New South Wales.

**Kate Cramsie**
Certified Financial Planner

Kate has been in the industry for over 20 years and is a senior adviser at Logical.

She holds a Bachelor of Business (University of Technology, Sydney), Diploma of Financial Planning (Deakin University) and is a Certified Financial Planner.

# Looking for Financial Advice?

In an ever increasingly complex financial and legislative world, our mission is to provide you with clear, concise and tailored strategic advice.

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