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NAVIGATING THE RISKS OF RETIREMENT

BY JUSTINE MARQUET

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The world has undergone a transition in its financial climate, moving from low-rate, stable inflation conditions to a period of higher rates, a spiralling cost of living and rising uncertainty across financial markets.

Retirees need to navigate through the immediate market turbulence knowing a wrong move now might have long-term implications, impacting retirement plans for what could be decades. Given the prevalence of these risks, it's no surprise that funding their post-work lifestyle is a cause of stress for Australians close to retirement.

'Controllable' risks

There are several retirement risks that are often described as 'controllable', although that might not always be the case. Unforeseen circumstances can derail the best of plans, although personal insurance may provide a safety net for those forced to retire earlier than expected due to ill health or accident.

INSIDE

BEFORE YOU GET STARTED

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> Inflation risk is once again top of mind as Australia's cost of living rapidly increases. Higher inflation reduces the purchasing power of every dollar saved. It can exacerbate the fear of running out of money and increase loss aversion.

Controllable risks may include:

- The timing of retirement - although 43%[1] of Australians surveyed in 2021 were unexpectedly forced into early retirement due to ill health, accidents, carer responsibilities, job loss or business failure.
- The quantum of retirement savings available - while increasing contributions can mitigate the risk of insufficient savings, that's not always possible.
- The rate of withdrawal - the higher the rate of capital drawdown, the faster retirement savings will be consumed.

Uncontrollable risks

Uncontrollable risks are often interrelated and can result in retirees questioning how long their money will last or whether they can afford the lifestyle they want. These risks may have longer term ramifications: lower investment risk tolerance, increased uncertainty, a reduction in spending or unwanted lifestyle adjustments.

Will the savings last?

The biggest fear voiced by Australians prior to and during retirement is running out of money. This is known as longevity risk - or the risk of outliving retirement savings.

With the expectations of a longer life, how much can a retiree afford to draw down each year? For many, it's a dire choice: live more frugally today or risk running out of money.

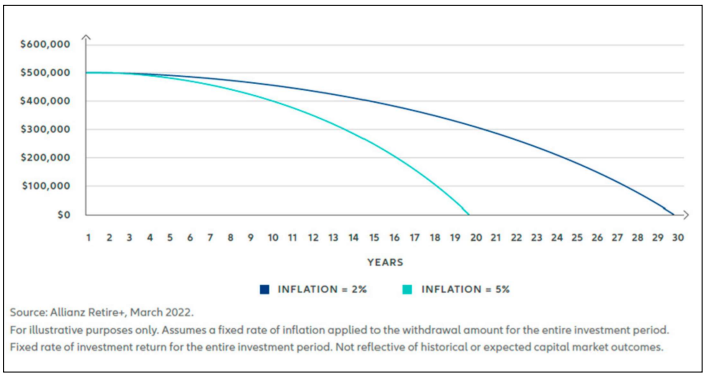
Inflation chips away at the value of savings

Inflation risk is once again top of mind as Australia's cost of living rapidly increases. Higher inflation reduces the purchasing power of every dollar saved. It can exacerbate the fear of running out of money and increase loss aversion.

The compounding impact of inflation over time can erode retirement savings as illustrated in Figure 1, which uses the example of a retiree with $500,000. An annual inflation rate of 5% would result in their savings running out 10 years sooner than if inflation stayed at 2%.

Concerns about inflation and rising costs are top of mind for many pre-retirees; for those already living on a fixed income, the figure is likely to be much greater.

Figure 1: The impact of inflation



Source: Allianz Retire+, March 2022.
For illustrative purposes only. Assumes a fixed rate of inflation applied to the withdrawal amount for the entire investment period. Fixed rate of investment return for the entire investment period. Not reflective of historical or expected capital market outcomes.

Market volatility erodes income producing assets

Financial market volatility is once again making headline news. The prevailing market conditions prior to and during retirement can affect the longevity of retirement capital and the level of income generated.

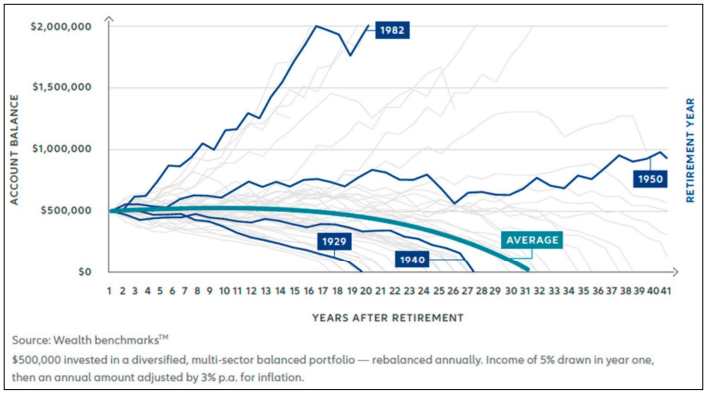
The timing, as well as the size, of a market downturn can have dramatic consequences. As modelled in Figure 2, the prevailing market conditions at the time of, and after, retirement can determine how long a retiree's capital could last when investing in a balanced portfolio. It was chance that dealt 1982's retirees buoyant markets, and chance that presented 1929's retirees with a crash and rapid capital depletion.

Because retirees usually can't align their retirement date with ideal market conditions, the decision (forced or not) to leave work can be a big gamble, particularly without the right mix of strategies and products. Unfortunately, chance can have a much greater impact on retirement outcomes than good planning.

A significant capital loss requires a significant gain to get back to the same point. As illustrated in Figure 3, there is a nonlinear relationship between gains and losses; as the loss grows, the gain required to recoup the loss escalates.

> The market conditions that prevail in the years just before and after a person retires can make an enormous difference to how long their funds last. Those crucial years are often called 'the retirement risk zone'; a period when retirees are most vulnerable to market volatility.

Figure 2: Impact of retirement year on future returns



Source: Wealth benchmarks™
$500,000 invested in a diversified, multi-sector balanced portfolio — rebalanced annually. Income of 5% drawn in year one, then an annual amount adjusted by 3% p.a. for inflation.

Figure 3: The math of recovery from portfolio loss

Percentage loss	Gain needed to restore loss
10%	11.1%
20%	25.0%
30%	42.9%
50%	100%

Source: Craig Israelsen, Ph.D.

A fall in market value can exacerbate longevity risk and increase loss aversion. While clients in the accumulation phase generally have the advantage of time to recover losses, retirees in the decumulation or pension phase generally don't have this opportunity.

Timing risk impacts the longevity of retirement savings

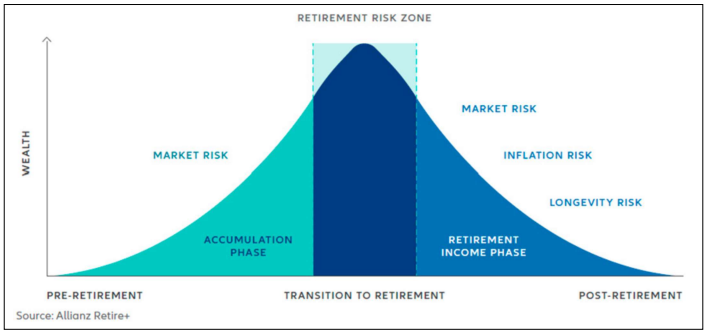
The market conditions that prevail in the years just before and after a person retires can make an enormous difference to how long their funds last. Those crucial years are often called 'the retirement risk zone'; a period when retirees are most vulnerable to market volatility.

If someone is fortunate enough to retire in a period of upbeat markets, then their income drawdowns will be fully or partially offset by investment returns.

However, if the 'retirement risk zone' (see Figure 4) coincides with a period of negative returns, retirees may start eating into their savings at an accelerated rate, potentially emptying the nest egg[2]. Market shocks during the vulnerable period will leave Australian retirees with less time to recover, while falling asset prices and drawdowns for income can magnify the scale of capital losses.

Ultimately, any losses will diminish the total value of the remaining assets.

Figure 4: Timing risk zone



Source: Allianz Retire+

Loss aversion can negatively influence retirement decision making

Loss aversion, sometimes called behavioural risk, can impact how a retiree invests, how much income they draw - and can even impact their lifestyle. A range of behavioural studies have illustrated that the pain of a loss is exacerbated in retirement, and that there are other traits and biases that can impede people from making reasonable decisions about their retirement savings.

These biases might stem from others' experiences, the fear of outliving their savings or the fear of losing capital. Investment Trends[3] identified three retirement fears pertinent in the current environment.

Expect to outlive their super	47%
Concerned about medical costs	43%
Concerned about inflation & rising costs	42%

Loss aversion is a major factor influencing investor behaviour, particularly in retirement when it's difficult to recoup losses. Understanding the biases and fears that can negatively impact decision making is an essential part of retirement planning.

Navigating retirement risks

Successfully navigating the (somewhat) controllable and non-controllable risks facing retirees and pre-retirees is challenging but not unachievable. Certainly, a more comprehensive set of considerations and features need to be incorporated into this cohort's future income and estate plans to effectively address retirement risks. This is likely to include guaranteed lifetime income, market-linked returns and downside protection, as well the flexibility to make withdrawals and to have appropriate beneficiaries receive any death benefits.

Retirement income strategies will benefit from a layered and diversified approach that includes not only a super account-based pension with the usual mix of assets and perhaps an investment property, but also more innovative income solutions that help manage the unique risks of retirement and provide for longevity without sacrificing financial flexibility.

Justine Marquet is Head of Technical Services at Allianz Retire+, a sponsor of Firstlinks. This article is for general information only and does not take into account your objectives, financial situation or needs. For personal financial advice please speak to your financial adviser.

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Image by Gerd Altmann from Pixabay

A Random Walk Down Wall Street by Burton G. Malkiel

BY WEALTH ADVISER

"A Random Walk Down Wall Street" by Burton G. Malkiel is a seminal work in the field of investing that has profoundly influenced both academic thought and practical investment strategies. The book popularises the idea that stock prices are largely unpredictable, advocating for a passive investment approach as the most reliable strategy for individual investors. Through this Q&A, we'll explore key concepts from the book, including the efficient-market hypothesis, modern portfolio theory, and the benefits of asset allocation and dollar-cost averaging. Each question delves into Malkiel's insights, offering practical guidance for investors looking to navigate the complexities of financial markets.

Question 1: What is the efficient-market hypothesis (EMH) and how does it relate to stock pricing?

The efficient-market hypothesis (EMH) posits that financial markets are "informationally efficient," meaning that stock prices fully reflect all available information. This implies that it's impossible to consistently outperform the market through stock selection or market timing. According to the EMH, stock prices adjust rapidly to new information, making it difficult for investors to exploit pricing discrepancies. The theory suggests that the current stock price is the best estimate of a company's true value, given all publicly available information.

Question 2: How does modern portfolio theory suggest investors can reduce risk?

Modern portfolio theory, developed by Harry Markowitz, proposes that investors can reduce risk through diversification. By combining assets with different risk profiles and correlations, investors can create portfolios that offer the best possible expected return for a given level of risk. The theory emphasises that it's not just about selecting individual high-performing stocks, but about creating a balanced portfolio where the risks of different assets offset each other. This approach can lead to a portfolio with lower overall risk than the sum of its individual components.

Question 3: What are the key principles of asset allocation according to the text?

The text outlines several key principles of asset allocation. First, risk and reward are related - higher potential returns generally come with higher risk. Second, the risk of investing depends on the length of time investments are held, with longer holding periods generally reducing risk. Third, dollar-cost averaging can help reduce risk when investing in stocks and bonds. Fourth, rebalancing can potentially reduce risk and increase returns. Lastly, investors must distinguish between their attitude toward risk and their capacity for risk, which depends on their overall financial situation.

Question 4: How does dollar-cost averaging work and what are its potential benefits?

Dollar-cost averaging is an investment strategy where an investor regularly invests a fixed amount of money into a particular investment or portfolio, regardless of the asset's price. This approach can help reduce the impact of market volatility on the overall purchase. When prices are high, the fixed amount buys fewer shares, and when prices are low, it buys more shares. Over time, this can result in a lower average cost per share compared to trying to time the market. The potential benefits include reducing the risk of investing a large amount at the wrong time and providing a disciplined approach to investing.

Question 5: What is the "4 percent solution" for retirement withdrawals?

The "4 percent solution" is a strategy for managing retirement savings withdrawals. It suggests that retirees should withdraw no more than 4 percent of their nest egg annually to ensure their money lasts throughout retirement. This approach is designed to balance the need for current income with the need to preserve capital for future years. The 4 percent rule is based on historical market returns and inflation rates, and it aims to provide a sustainable withdrawal rate that allows the retiree's portfolio to potentially last for 30 years or more, even through market downturns.

Question 6: How do closed-end funds differ from open-end mutual funds?

Closed-end funds differ from open-end mutual funds in several key ways. Unlike open-end funds, closed-end funds issue a fixed number of shares after the initial offering and do not issue or redeem shares on demand. Instead, shares are bought and sold on the open market like stocks. The price of closed-end fund shares is determined by supply and demand, which can lead to them trading at a premium or discount to their net asset value (NAV). This characteristic can create opportunities for investors to potentially buy assets at a discount, although such opportunities have become less common for U.S. domestic funds in recent years.

Question 7: What are exchange-traded funds (ETFs) and how do they compare to mutual funds?

Exchange-traded funds (ETFs) are investment funds traded on stock exchanges, much like stocks. They typically track an index, sector, commodity, or other asset, but can be bought and sold throughout the day like a regular stock. ETFs often have lower expense ratios compared to mutual funds and can be more tax-efficient due to their structure. Unlike mutual funds, which are priced once a day, ETFs are priced and traded continuously during market hours. However, ETFs may incur brokerage fees and bid-ask spreads, which can impact returns, especially for frequent traders or those investing small amounts regularly.

Question 8: What is the difference between fundamental and technical analysis in stock selection?

Fundamental analysis involves evaluating a company's financial health, competitive position, and growth prospects to determine its intrinsic value. This approach looks at factors such as earnings, dividends, assets, and industry conditions. Technical analysis, on the other hand, focuses on studying past price movements and trading volumes to predict future price trends. Technical analysts use charts and statistical indicators, believing that price patterns tend to repeat themselves. The text suggests that while both methods are widely used, neither has consistently outperformed a simple buy-and-hold strategy in a well-diversified portfolio over the long term.

Question 9: How does behavioral finance challenge the efficient-market hypothesis?

Behavioral finance challenges the efficient-market hypothesis by highlighting the impact of psychological factors on investor decision-making and market prices. It argues that investors are not always rational and that markets can be driven by emotions such as fear, greed, and herd mentality. Behavioral finance identifies various cognitive biases that lead investors to make suboptimal decisions, such as overconfidence, loss aversion, and the tendency to extrapolate recent trends into the future. These biases can create market inefficiencies and asset price bubbles, contradicting the EMH's assumption of rational investors and efficient markets.

Question 10: What are some common cognitive biases that affect investor behavior?

The text discusses several common cognitive biases affecting investor behavior. Overconfidence leads investors to overestimate their ability to pick winning stocks or time

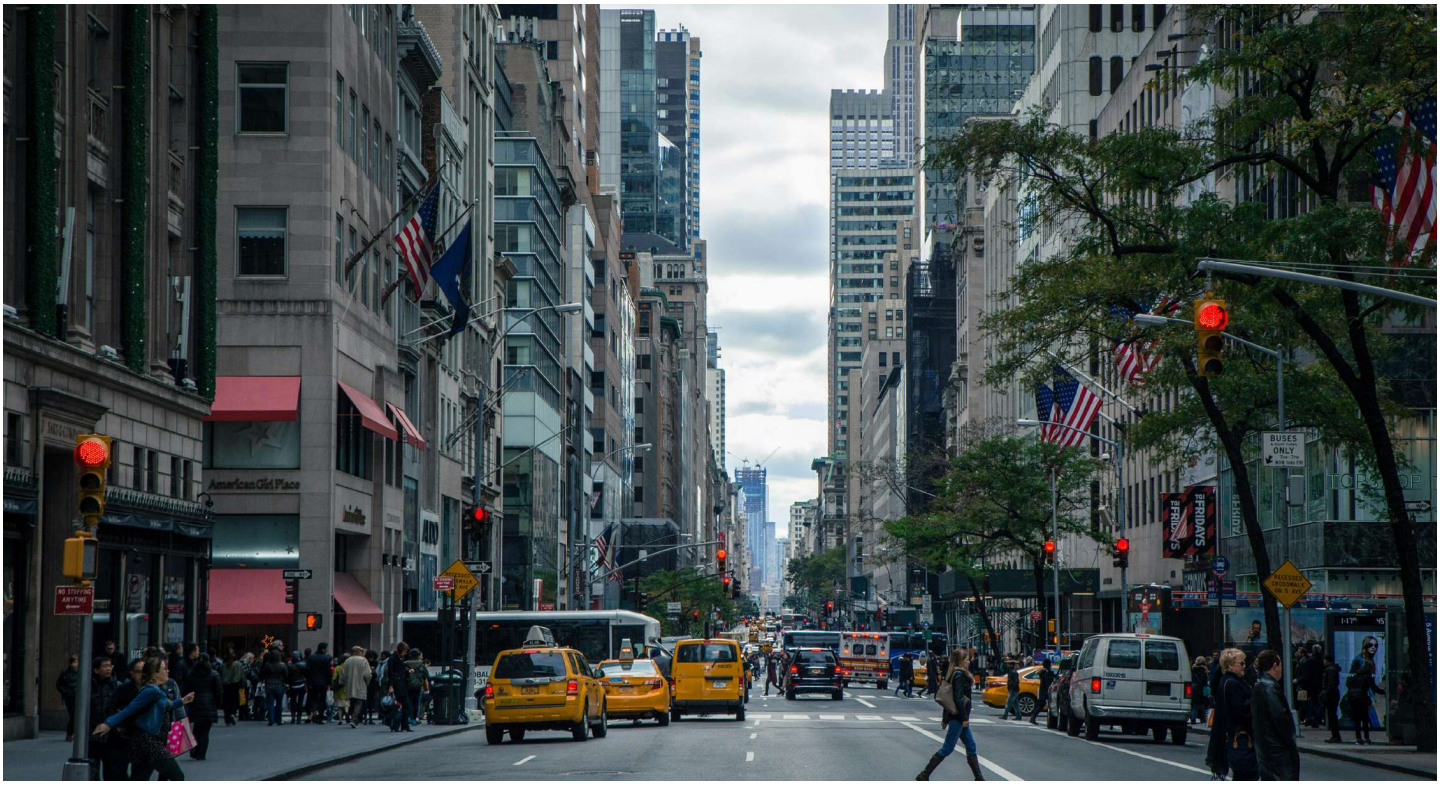


Photo by Nout Gons of Pexels

the market. Loss aversion causes investors to feel the pain of losses more acutely than the pleasure of equivalent gains, often leading to suboptimal decision-making. Herding behavior prompts investors to follow the crowd, potentially creating or exacerbating market bubbles. Confirmation bias leads investors to seek out information that confirms their existing beliefs while ignoring contradictory evidence. Recency bias causes investors to give too much weight to recent events in their decision-making process, potentially overlooking long-term trends or historical patterns.

Question 11: What is the random walk theory and how does it relate to stock market predictions?

The random walk theory suggests that stock price movements are unpredictable and follow a random pattern. This theory posits that future price movements are independent of past price changes, making it impossible to consistently predict short-term price movements. The theory supports the idea that technical analysis, which attempts to forecast future prices based on past patterns, is ineffective. Instead, it aligns with the efficient-market hypothesis, suggesting that prices quickly incorporate all available information, making it difficult for investors to gain an edge through analysis of historical price data.

Question 12: How do dividends and earnings growth contribute to long-term stock returns?

Dividends and earnings growth are key components of long-term stock returns. The text explains that total stock returns can be broken down into three parts: initial dividend yield, earnings growth rate, and changes in valuation (price-to-earnings ratio). Over the long term, a stock's return is primarily driven by its dividend yield and the growth rate of its earnings. As companies grow their earnings, they can increase dividend payments, reinvest in the business, or both. This growth in earnings and dividends contributes significantly to the overall return investors receive over time, especially when compounded over many years.

Question 13: What is the importance of international diversification in a portfolio?

International diversification is crucial for reducing overall portfolio risk and potentially enhancing returns. By investing in markets outside one's home country, investors can spread risk across different economic and political environments. The text emphasises that different countries' markets often do not move in perfect tandem, providing diversification benefits. For example, when one market is underperforming, another may be doing well. The author specifically recommends including emerging markets in a diversified portfolio, noting their potential for higher growth and their ability to offset risks in developed markets.

Question 14: How do bonds differ from stocks in terms of risk and return?

Bonds and stocks differ significantly in their risk and return profiles. Bonds typically offer lower potential returns but also lower risk compared to stocks. They provide regular

interest payments and return of principal at maturity, making them more predictable than stocks. However, bonds are subject to interest rate risk (prices fall when rates rise) and credit risk (risk of default). Stocks, on the other hand, offer potential for higher returns through capital appreciation and dividends but come with higher volatility and risk of loss. The text suggests that a mix of both asset classes can help balance a portfolio's risk and return characteristics.

Question 15: What are TIPS (Treasury Inflation-Protected Securities) and how do they work?

Treasury Inflation-Protected Securities (TIPS) are government bonds designed to protect investors from inflation. The principal value of TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When TIPS mature, investors receive either the adjusted principal or the original principal, whichever is greater. Interest payments are made twice a year and are calculated based on the adjusted principal. This structure ensures that both the principal and interest payments maintain their purchasing power over time, making TIPS an effective hedge against inflation risk. However, the text notes that TIPS can have unfavorable tax implications when held in taxable accounts.

Question 16: How does rebalancing a portfolio potentially reduce risk and increase returns?

Rebalancing involves periodically adjusting a portfolio back to its target asset allocation. This process can potentially reduce risk by maintaining the desired risk level of the portfolio. When certain assets perform well, they may become overweighted in the portfolio, potentially increasing overall risk. By selling some of the outperforming assets and buying underperforming ones, rebalancing helps maintain the intended risk profile. Additionally, rebalancing can potentially increase returns by systematically selling high and buying low. The text provides an example where a regularly rebalanced portfolio outperformed a non-rebalanced portfolio over a 14-year period, demonstrating both lower volatility and higher returns.

Question 17: What is the life-cycle approach to investing and how does it work?

The life-cycle approach to investing suggests that asset allocation should change as an investor ages. Younger investors, with longer time horizons and higher risk tolerance, can afford to have a larger portion of their portfolio in higher-risk, higher-return assets like stocks. As investors age and approach retirement, they should gradually shift towards more conservative investments like bonds to reduce portfolio volatility. The text provides specific asset allocation recommendations for different age groups, ranging from an aggressive portfolio for those in their twenties to a more conservative mix for those in their late sixties and beyond. This approach aims to balance the need for growth with the increasing importance of capital preservation as retirement approaches.

Question 18: How do index funds compare to actively managed funds in terms of performance?

The text strongly advocates for index funds over actively managed funds, citing numerous studies showing that index funds generally outperform actively managed funds over the long term. This outperformance is largely attributed to lower fees and lower turnover in index funds. Active managers, despite their efforts, rarely beat the market consistently after accounting for fees and expenses. The author notes that the few examples of consistent outperformance are likely due to chance rather than skill. Moreover, past performance of actively managed funds is not a reliable predictor of future results, making it difficult for investors to select winning funds in advance.

Question 19: What are the potential advantages and disadvantages of annuities for retirees?

Annuities offer retirees a guaranteed income stream for life, which can provide peace of mind and protection against outliving one's savings. They can be particularly beneficial for risk-averse individuals concerned about market volatility. However, annuities also have potential drawbacks. They typically offer lower returns compared to a diversified investment portfolio, especially in low-interest-rate environments. Annuities are often inflexible, making it difficult to adjust income or access principal if circumstances change. They can be complex and costly, with high fees and commissions. The text suggests that while partial annuitisation can be beneficial for some retirees, it's important to carefully consider the trade-offs before committing to an annuity.

Question 20: How do tax considerations affect investment strategies?

Tax considerations play a crucial role in investment strategies. The text emphasises the importance of tax-efficient investing, particularly for high-income individuals. Strategies like holding investments in tax-advantaged accounts (e.g., 401(k)s, IRAs), using tax-exempt municipal bonds, and considering tax-managed funds can help minimise tax liabilities. The order in which assets are withdrawn in retirement can also impact overall tax burden. For taxable accounts, the text recommends considering the tax implications of frequent trading and suggests a buy-and-hold strategy to defer capital gains taxes. It also discusses the potential benefits of Roth IRAs and 529 college savings plans for tax-efficient wealth accumulation and transfer.

Question 21: What is the importance of keeping investment costs low?

Keeping investment costs low is crucial for long-term investment success. The text emphasises that expenses, such as management fees and trading costs, directly reduce returns. Even small differences in fees can compound over time to significantly impact overall portfolio value. Index funds are highlighted as a cost-effective option due to their low expense ratios and minimal trading costs. The author also warns against high-cost investment products like some annuities and actively managed funds. By focusing on low-cost options, investors can retain more of their returns, potentially leading to substantially higher wealth accumulation over time.

Question 22: How can investors protect themselves against inflation risk?

To protect against inflation risk, the text suggests several strategies. Treasury Inflation-Protected Securities (TIPS) are recommended as they adjust principal and interest payments based on inflation rates. Investing in stocks is also suggested as a long-term inflation hedge, as companies can often raise prices to keep pace with inflation. Real estate investments, including Real Estate Investment Trusts (REITs), are another recommended option. For retirees, considering inflation-adjusted annuities can help maintain purchasing power. Diversification across asset classes and geographies is also emphasised as a way to mitigate inflation risk, as different assets may respond differently to inflationary pressures.

Question 23: What role do real estate investments play in a diversified portfolio?

Real estate investments are recommended as an important component of a diversified portfolio. The text suggests that real estate can provide both potential for capital appreciation and steady income through rent or dividends from REITs. Real estate often has low correlation with stocks and bonds, enhancing portfolio diversification. The author recommends that individuals consider owning their own homes and also invest in commercial real estate through REITs. REITs are highlighted as a way for individual investors to access a diversified portfolio of commercial properties without the complexities of direct property ownership.

Question 24: How do small-cap stocks compare to large-cap stocks in terms of risk and return?

The text indicates that small-cap stocks have historically provided higher returns than large-cap stocks, but with higher volatility and risk. Over an 80-year period, small-cap stocks produced an average annual return of about 11%, compared to 9.8% for large-cap stocks. However, small-cap stocks are generally more volatile and can experience sharper declines during market downturns. The author suggests that including some allocation to small-cap stocks can potentially enhance overall portfolio returns, but warns that they should be considered as part of a diversified portfolio due to their higher risk profile.

Question 25: What are some key rules for successful stock selection according to the text?

The text provides several key rules for stock selection, while emphasising that beating the market consistently is extremely difficult. These rules include: 1) Focus on stocks of companies that can sustain above-average earnings growth for at least five years. 2) Never pay more for a stock than can be justified by a reasonable estimate of future earnings. 3) Look for stocks with stories of anticipated growth that can capture investor imagination. 4) Trade as little as possible to minimise costs and taxes. The author also stresses the importance of diversification and suggests that for most investors, a strategy of buying and holding a diversified portfolio of low-cost index funds is likely to produce the best results over the long term.

Super and growth assets as long-term investments

KEY POINTS

- While growth assets like shares go through bouts of short-term underperformance versus bonds and cash, they provide superior long-term returns. So, it makes sense that superannuation has a high exposure to them.
- The best approach is to simply recognise that occasional sharp falls in share markets and hence super funds are normal and that investing in both is a long-term investment.

BY DR SHANE OLIVER

Republished from amp.com.au

Introduction

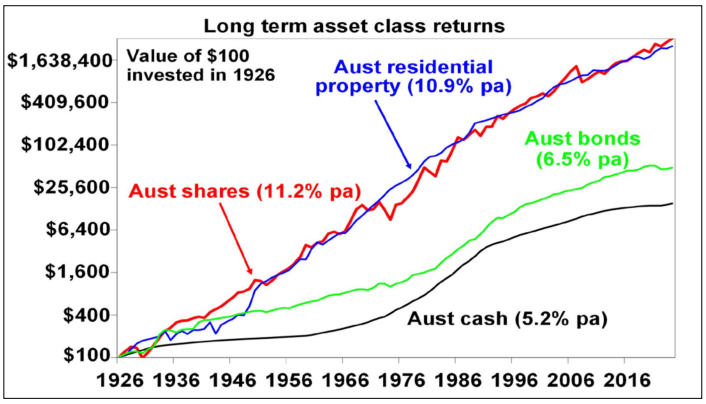
"Aussie share market loses $100bn in bloodbath"

Two weeks ago, there were lots of headlines like that after share markets fell sharply in response to US recession fears. But such headlines are nothing new. After such falls, the usual questions are: What caused the fall? What's the outlook? And what does it mean for superannuation? The correct answer to the latter should be something like: "Nothing really, as super is a long-term investment and share market volatility is normal". But that can seem like marketing spin. However, the reality is that - except for those who are into trading - shares and superannuation really are long-term investments. Here's why.

Super funds, shares & the power of compound interest

Superannuation seeks to provide maximum risk-adjusted funds, within reason, for use in retirement. So typical super funds have a bias towards shares and other growth assets, and some exposure to defensive assets like bonds and cash in order to avoid excessive short-term volatility. This approach seeks to take advantage of the power of compound interest. The next chart shows the value of a $100 investment in Australian cash, bonds, shares and residential property from 1926 assuming any interest, dividends and rents are

reinvested on the way, and their annual returns. As return series for commercial property and infrastructure only go back a few decades I have used residential property as a proxy.



Source: ASX, Bloomberg, RBA, REIA, AMP

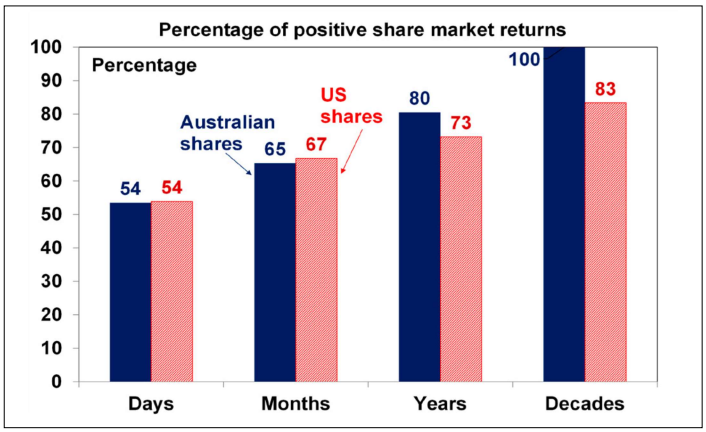
Because shares and property provide higher returns over long periods the value of an investment in them compounds to a much higher amount over time. So, it makes sense to have a decent exposure to them. The higher return from shares and other growth assets reflects compensation for their greater risk (seen in volatility & illiquidity) versus cash & bonds.

But investors don't have 100 years?

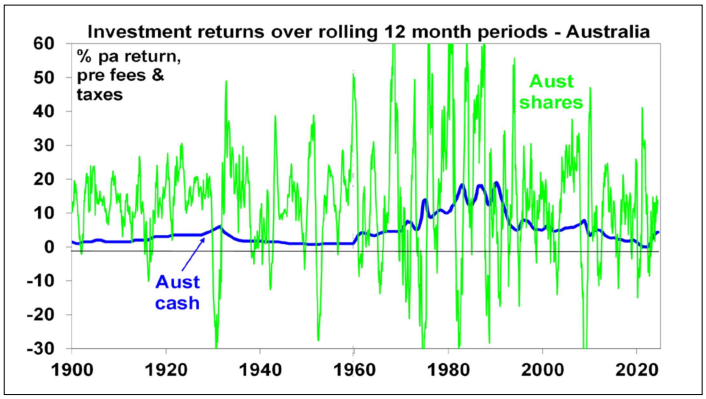
Of course, we don't have one hundred years to save for retirement. In fact, our natural tendency is to think very short term. And this is where the problem starts. On a day-to-day basis shares are down almost as much as they are up. See the next chart. So, day-to-day, it's pretty much a coin toss as to whether you will get good news or bad when you tune in for the nightly finance update. But if you just look monthly and allow for dividends, the historical experience tells us you will only get bad news around a third of the time. And if you only look each year, you will only get negative news 20% of the time for Australian shares and 27% of the time for US shares. And if you look just once a decade, positive returns have been seen 100% of the time for Australian shares and 82% for US shares. So, while it's hard given the bombardment of financial news these days it makes sense to look at your returns less because then are you more likely to get positive news and less likely to make rash decisions or end up adopting an investment strategy that it too cautious.

This can also be demonstrated in the following charts. On a rolling 12 month ended basis the returns from shares bounce around all over the place versus cash & bonds.

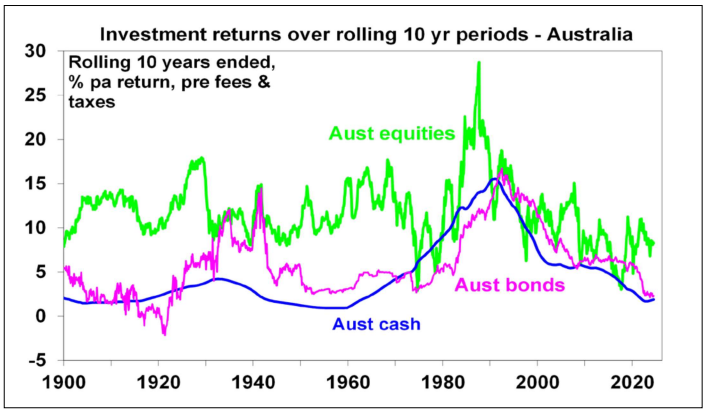
However, over rolling ten-year periods, shares have invariably done better, although there have been some periods where returns from bonds and cash have done better, albeit briefly.



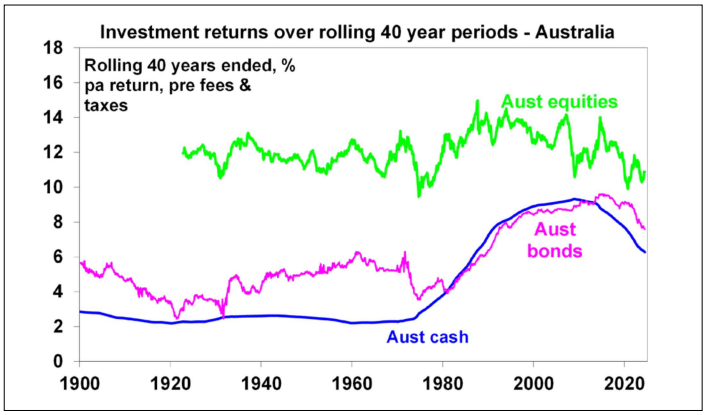
Daily & monthly data from 1995,yrs & decades from 1900. ASX, Bloomberg, AMP



Source: ASX, Bloomberg, RBA, AMP



Source: ASX, Bloomberg, RBA, AMP



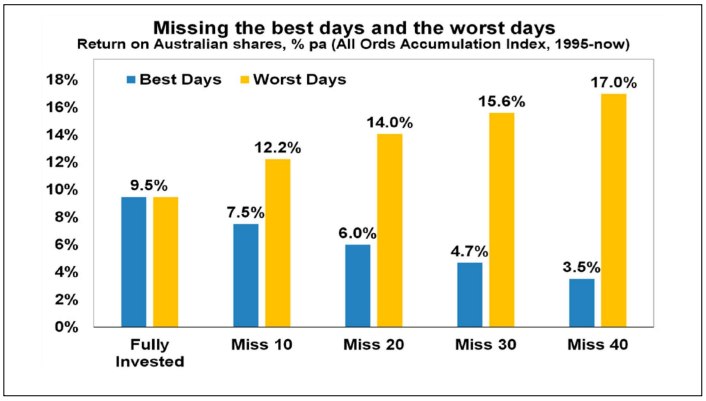
Source: ASX, Bloomberg, RBA, AMP

Pushing the horizon out to rolling 20-year periods, returns from shares have almost always done even better, although a surge in cash and bond returns after the very high interest rates of the late 1970s/1980s saw the gap narrow for a while. Over rolling 40-year periods - the working years of a typical person - shares have always done better.

This is consistent with the basic proposition that higher short-term volatility from shares (often around periods of falling profits & a risk that companies go bust) is rewarded over the long term with higher returns.

But why not try and time short-term market moves?

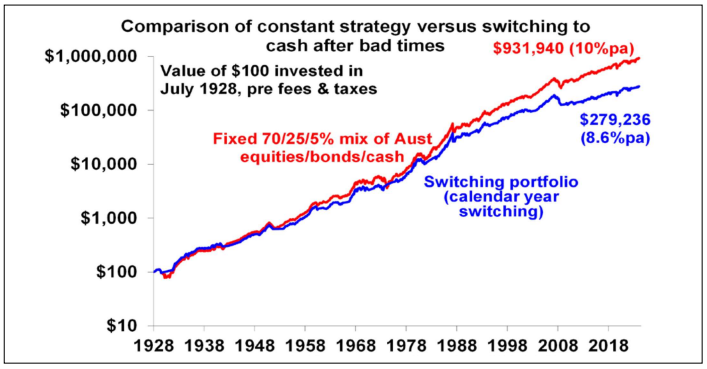
The temptation to do this is immense. With the benefit of hindsight many swings in markets like the tech boom and bust, the GFC and the plunge and rebound in shares around the COVID pandemic look inevitable and hence forecastable and so it's natural to think "why not give it a go?" by switching between cash and shares within your super to anticipate market moves. Fair enough. But without a tried and tested market timing process, trying to time the market is difficult. A good way to demonstrate this is with a comparison of returns if an investor is fully invested in shares versus missing out on the best (or worst) days. The next chart shows that if you were fully invested in Australian shares from January 1995, you would have returned 9.5% pa (with dividends but not allowing for franking credits, tax and fees). If by trying to time the market you avoided the 10 worst days (yellow bars), you would have boosted your return to 12.2% pa. And if you avoided the 40 worst days, it would have been boosted to 17% pa! But this is really hard, and many investors only get out after the bad returns have occurred, just in time to miss some of the best days. For example, if by trying to time the market you miss the 10 best days (blue bars), the return falls to 7.5% pa. If you miss the 40 best days, it drops to just 3.5% pa.



Source: Bloomberg, AMP

The following chart shows the difficulties of short-term timing in another way. It shows the cumulative return of two portfolios.

- A fixed balanced mix of 70 per cent Australian equities, 25 per cent bonds and five per cent cash;
- A "switching portfolio" which starts off with the above but moves 100 per cent into cash after any negative calendar year in the balanced portfolio & doesn't move back until after the balanced portfolio has a calendar year of positive returns. We have assumed a two-month lag.



Source: ASX, Bloomberg, RBA, AMP

Over the long run the switching portfolio produces an average return of 8.6% pa versus 10% pa for the balanced mix. From a $100 investment in 1928 the switching portfolio would have grown to $279,236, but the constant mix would have ended more than 3 times bigger at $931,940.

Key messages

First, while shares and growth assets have periods of short-term underperformance versus cash & bonds they provide superior long-term returns. So, it makes sense for super to have a high exposure to them.

Second, switching to cash after a bad patch is not the best strategy for maximising wealth over time. In fact, it can just lock in losses.

Third, the less you look at your investments the less you will be disappointed. This reduces the chance of selling at the wrong time.

The best approach is to recognise that super and shares are long-term investments and adopt a long-term strategy to suit your circumstances - in terms of your age, income, wealth and risk tolerance.

Finally, anything that cuts your super balance early on can cut your super at retirement a lot. Eg, a $20,000 withdrawal from super at age 30 - say for a dental expense - can cut your super at age 67 by around $74,000 (in today's dollars) due to the loss of compounding returns on that amount (using the assumptions in the ASIC MoneySmart Super calculator).

AMP Limited provides banking, super, retirement and advice services in Australia and New Zealand, supporting over one million customers and employing approximately 3,000 people.

Q&A: Ask a Question

Question 1

My friend told me his salary sacrifices into super as he wants to boost his retirement funds. Can I do this?

Yes, salary sacrifice is an arrangement where an employee agrees to contribute a portion of their gross salary in exchange for non-cash benefits provided by the employer. This typically involves directing the sacrificed amount towards things like additional super contributions. The main advantage is the potential for tax savings, as the sacrificed salary is deducted before income tax is calculated, reducing taxable income.

It is essential to understand the implications of salary sacrifice, such as ensuring super contribution caps aren't breached, or eligibility for certain benefits. Before salary sacrificing, the impact on take-home pay and any potential effect on future earnings or entitlements need to be considered. It's best to discuss this with your financial planner before making any decisions.

Question 2

The other day, I was looking at my dividend statements and I noticed that I got franking credits. What are franking credits?

A franking credit is a tax credit attached to your dividends paid by companies, reflecting the tax the company has already paid on its profits. When you receive your dividends, it can include a franking credit that represents the tax already levied on those profits. This credit allows you to offset your own tax liability by the amount of tax the company has paid.

For example, if a company pays a $100 dividend with a $30 franking credit, it means the company has already paid $30 in tax on that $100 profit. You would then include the $100 dividend in your taxable income but can use the $30 franking credit to reduce your tax bill, avoiding double taxation on the same income.

It is important that you speak with your financial adviser to better get a better understanding of how franking credits may affect your specific circumstances.

Question 3

I'm aware that if you invest in shares, you will have to declare your dividend income for tax. Is that still the case with investment bonds?

If you hold an investment bond for at least 10 years, you generally do not need to declare the income generated by the bond throughout the holding duration. This is because the earnings within the bond are taxed at 30% within the bond itself.

Before making any decision to invest in an investment bond, you should consult with your financial adviser who will help you make an informed decision based on your specific circumstances.

If you have a question that you would like to see answered in **Wealth Adviser**, please send it through to **centraladvice@wtfglimited.com.**

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