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This Week's Top Articles

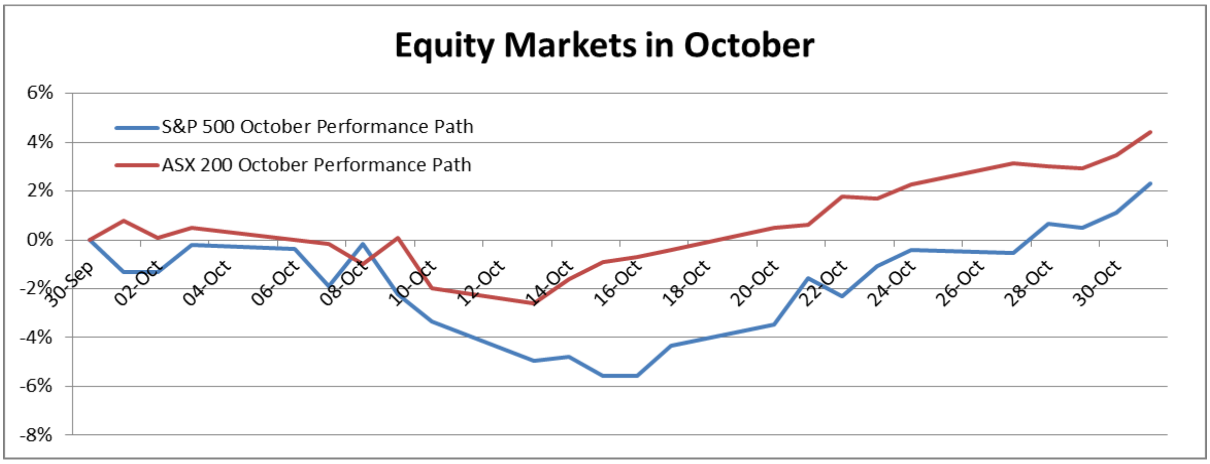
Reflections on markets in October 2014

David Bell

Looking at month-to-month outcomes, October 2014 could be filed away as another month of reasonably normal returns. However if you lived through it day-to-day, there was lots of volatility and events, including somewhat of a 'mini-panic'. Perhaps it's better to ignore the detail! However, markets are dynamic and learning opportunities should not be ignored. A recent business trip to the US gave me a chance to reflect, leaving as many questions as answers.

Reasons for the mini-panic were not new

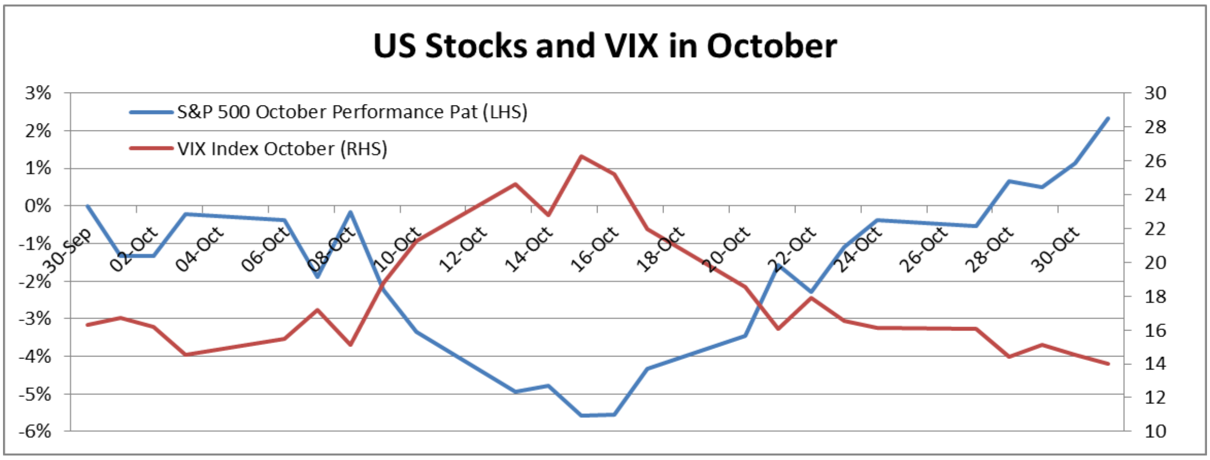
The performance path for October 2014 for US and Australian equities is presented below.



Source: Bloomberg

It looks like October was a non-event in Australia (falling only 2% by mid-month), but recall that Australian stocks were already close to 7% off their highs heading into October.

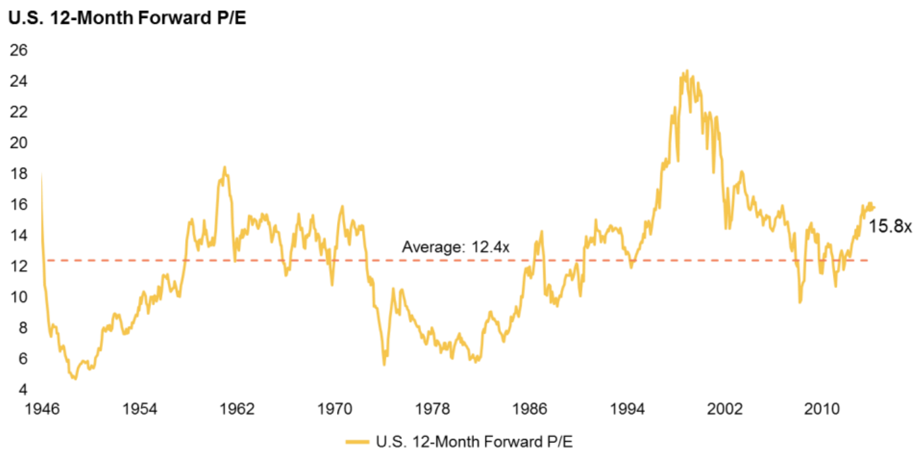
There were no real new reasons for the mini-panic during the first half of October. I title it a 'mini-panic' as the VIX index (a measure of implied market volatility, commonly known as the 'fear index') rose sharply before subsiding. The threat of Ebola, global security issues, strong USD, concerns of a European triple dip recession, further weakening in China, market over-valuation, inevitable rate rises in the US … the market was well aware of these issues. So what started the October mini-panic? When it comes to market triggers, we often don't know. It can be as simple as a couple of larger market participants selling down and this spooks others into action.



Source: Bloomberg

Overvalued equity markets but interest rates are so low

On many measures equity markets are overvalued. In the US in particular, profit margins are at abnormally high levels, so any reversion to this component makes US companies appear even more overvalued. The chart below is one of many valuations of the US equity market.

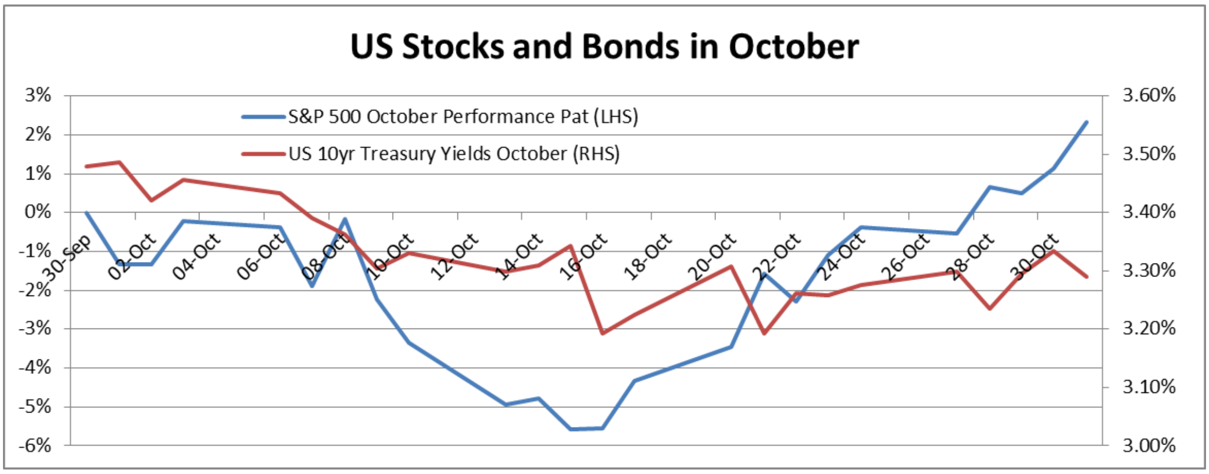


Source: Morgan Stanley Investment Management Global Multi-Asset Team analysis.

When valuations are stretched it feels like minor falls can turn into major market corrections. But while interest rates remain at extraordinarily low levels, it is difficult for equities to fall significantly as investors are reluctant to accept the alternative of zero return guaranteed. October proved the same when sharemarket falls in the first half of the month were accompanied by falls in bond yields (suggesting lower interest rates for longer) which attracted investors back to equities. These are uncomfortable times for asset allocators who focus on fundamentals.

Bonds provided diversification during the mini-panic

Like many market observers I constantly worry that at some point bond yields will sell-off and this will cause a sell-off in equities at the same time. This structural break in the historical correlation between equities and bonds would create a difficult environment for investors (such an event has occurred in the past). Traditional diversification will have failed. However October proved not to be this case: equities fell and bond yields rallied and so the status quo was preserved. I can rationalise this: while short term interest rates are very low in the US, bond yields are a fair bit higher (so the yield curve is reasonably steep). This leaves room for bond yields to rally reflecting a market view, not that interest rates will fall, but that interest rates will be lower for longer. The rationalisation in my mind is that the risk of traditional diversification failing is more nuanced: while the yield curve is steep, and if the negative catalyst is an economic growth concern, then the traditional relationship (diversification) between equities and bond yields may well still continue. If the curve is more flat or the catalyst is rising interest rates then the traditional relationship will be challenged.



Source: Bloomberg

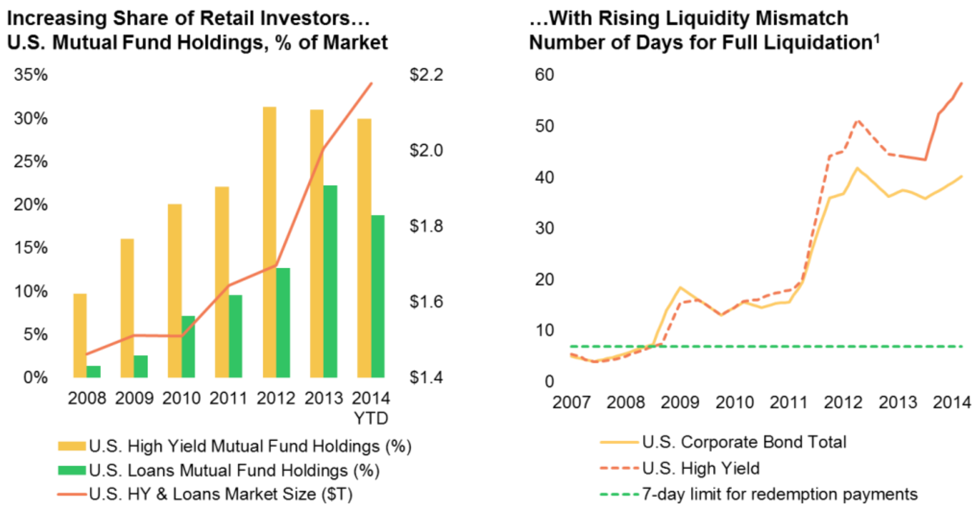
Hedge funds struggled but don't write them off

Hedge funds struggled in October. There were some idiosyncratic events (two large trades common to many managers experienced adverse events – AbbVie's takeover of Shire and a ruling on Fannie Mae/Freddie Mac preference shares) were just an unfortunate coincidence with October's events. But months like October (a mini-panic and then a strong recovery) are difficult for hedge fund managers because many cut risk in response to market falls and rises in volatility. So hedge funds locked in some of their mid-month losses whereas traditional long-only equity fund managers recovered all of their losses. That said I wouldn't write off hedge funds. Such an approach to risk management has the potential to protect them in an extremely difficult environment.

Market structure has changed: watch your liquidity

The structure of the market (the mixture of market participants) constantly changes. It is an area which requires ongoing monitoring. One of the big themes has been the reduction in bank proprietary capital. Deprived of capital banks now carry less inventory. This means that when you go to transact in a security like a high yield bond, the bank is less likely to exchange with you directly (on their own balance sheet) and more likely to be an arranger of a sale by finding another interested counterparty. This can negatively affect liquidity.

For example, there has been a massive inflow of capital into high yield bond funds and ETF's by retail investors, as shown in the first graph below, presumably chasing the higher yields on offer. The underlying funds offer daily liquidity. So the potential availability of liquidity is lower and the potential demand for liquidity is higher. This doesn't sound appealing to me. Redemption expenses could be higher and there is an increased potential for larger market events. However October didn't test this change in market structure: because high yield bonds are fixed rate and interest rates rallied, high yield bonds performed reasonably and outflows were not substantial. In my assessment a good risk manager would mark their high yield exposure as less liquid and having a larger negative skew to its return distribution.



Source: EPFR; IMF; Bloomberg LP; Morgan Stanley Investment Management Global Multi-Asset Team analysis.

Markets like October provide useful lessons

While October 2014 market behaviour proved to be a mini-panic which was quickly recovered, it created useful insights. Thinking through the issues, working out the appropriate balance between return and risk, and watching for emerging risks and regime changes are what makes the job of a portfolio manager so fascinating.

David Bell is Chief Investment Officer at AUSCOAL Super. This article is for general educational purposes and is not personal financial advice.

Sustainability of the super system in a time of disruption

Pauline Vamos

Pauline Vamos is Chief Executive Officer of The Association of Superannuation Funds of Australia (ASFA). This is an extract from her keynote speech at the ASFA Conference on 13 November 2014.

It could be said that the super system is always facing disruption. We know that as the system grows and as average account balances increase, tax concessions also grow, putting pressure on governments to take a look at super as a source of revenue, or as a potential source of tax savings.

We also know that as the demographics of the community shift and their expectations of a 'comfortable retirement' continue to grow, the system will be constantly reviewed, scrutinised and changed. While this will no doubt pose its challenges, in my view super is at the core of both the community and the government's ability to respond to a rapidly changing environment.

Yesterday we heard thoughts on how the industry should 'step up'; on how the system should be designed in the future; and on how we should respond to our technology-savvy, device-driven members.

These thoughts and messages will continue to be a theme throughout the Conference, as it is our aim to turn your focus to how we can 'step up' as an industry, how your organisation can 'step up' and how you can 'step up' personally. These three tasks have one universal element – they all involve leadership.

In this session, I will focus on how the industry can 'step up' and officially launch a new, significant paper that we hope will ensure the sustainability of the system in a time of disruption.

A plea to come together

But let's talk about 'us' first. The industry needs to come together, not so much so that various sectors can compromise, but instead to meet with a common mindset - one where, as an industry, we collectively put ourselves in the shoes of our members and those of the broader community.

I'm sure most of you will be thinking that your first priority is always to the members of your fund. It's true that your primary obligation should be to your members. But in my mind you cannot and will not meet your obligations to the members of your fund unless you also think about how well the system is delivered to the general community via the collective industry.

On some things we must work together for the collective as well as the individual good.

So what do I mean by that? I like to think of the system as a bit like a road network. As industry participants, we are all delivering the same system, albeit through our different respective vehicles.

The system can be viewed as the road on which we drive these vehicles. Without it, the vehicles would have little purpose for existence, so while we are all in a fiercely competitive race, we also have a responsibility to build and maintain the roads, abide by the same road signs and ensure that the community is safe and secure as they navigate its turns.

As a compulsory industry, it is also our collective responsibility to make sure that they get to their desired destination, no matter what vehicle they choose to go in.

While some of the road building and signage is the responsibility of governments and regulators, many of its elements are our responsibility. True leadership means we both recognise and deliver on that responsibility. We are responsible for the brand of industry and for the effectiveness of the system delivery and there are many parts that can only be delivered collectively.

This means we need to make a greater effort to agree on those issues where, in order for us to deliver to our individual members, we must take a collaborative and cooperative approach.

Sometimes we do need to put short term competition aside to focus on **enhancing governance, efficiency, transparency and accountability** for fund members, and improve the community's experience with superannuation.

The more we do this, the more our voice will have credibility when we advocate for good policy.

Standards of **governance** encompass the system as well as individual funds. Governance of the system is a shared responsibility – the brand and reputation of your organisation is closely linked to the brand and reputation of the industry.

We must focus on what governance structures including regulatory structures we need for the future as we move to income streams and the world continues to increase in complexity.

ASFA's position on fund governance is clear: conflicts of interest that limit a trustee's ability to meet its fiduciary obligations must be removed and there must be enough flexibility in the appointment process, and board structures, to ensure the right people, with the right skills, experience and knowledge, are guiding the fund towards the best outcomes for its members.

We have conflicts in all sectors. Let's not be blind to them. Let's address them.

Focus on transparency and accountability

Transparency and accountability are huge topics. Within these, I believe there are three things we need to focus on:

The **first is fee disclosure**. I know there are many issues and many legitimate reasons why there have been a number of different interpretations when it comes to the requirement to disclose fees. However, you only need to read through the pages of the FSI interim report to know that fees will continue to be a big issue for super.

The community wants better clarity around what they are paying for, and also to have the ability to compare fees from fund to fund. Therefore we need a plan to fix the issues surrounding fee disclosure, and we need to do this as a matter of urgency, before the media debate over fees overtakes sound policy thinking in this area.

The **second is improving the way we measure risk**, and communicate risk to fund members. The current version of the Standard Risk Measure has its critics and there are real concerns about using it as a disclosure tool. But consumers and regulators are looking for ways to better understand risk, so let's adjust the measure so it meets both prudential and consumer needs.

The **third area is a new one for us. How do we actually measure and disclose the value of an income** stream. If I retire with a lump sum, how do I make the choice as to which income stream is going to suit me best in terms of cost, return, longevity and level of guarantee? We cannot expect the income stream product market to be opened up if we do not tackle this issue. It's important for the industry to step up and put forward a practical design to Treasury and regulators.

Pauline Vamos is Chief Executive Officer of The Association of Superannuation Funds of Australia (ASFA). This is an extract from her keynote speech at the 2014 ASFA Conference. The full speech is linked here.

The saga of FoFA (so far)

Harry Chemay

In the aftermath of the Global Financial Crisis, many Australian investors suffered losses as a result, either in part or substantially, of financial advice that was subsequently found to have been deficient. In many instances these deficiencies were exacerbated by conflicts between the giving of the advice and the nature of the remuneration received by the adviser.

As a result of a number of high profile collapses, including Storm Financial and Opes Prime, the Labor Government launched an inquiry into laws governing the provision of financial advice. The findings of the Ripoll Inquiry, delivered in November 2009, formed the core of the then-Government's legislative response, released in April 2010 under the moniker *Future of Financial Advice* (FoFA). The FoFA changes became law in June 2012, applying on a voluntary basis from 1 July 2012. Compliance with FoFA became mandatory effective 1 July 2013.

What is all the fuss about?

Whilst FoFA encompassed a variety of changes, the most contentious reforms related to:

1. The introduction of a statutory client best interest duty

Prior to FoFA advisers had to ensure compliance with a set of *suitability rules* when giving advice. FoFA introduced a statutory requirement to 'act in the best interest of the client in relation to the advice'. Compliance with this duty could be demonstrated via a seven step statutory process known as the *safe harbour* provisions.

2. A ban on conflicted remuneration

FoFA introduced a ban on all forms of conflicted remuneration, being any payment that could influence the product recommended, or advice given, to a client. The ban applied to commissions and precluded both the payment and receipt of conflicted remuneration (with a few exceptions including for insurance advice) between product manufacturer and advice provider.

3. Enhanced ongoing client engagement and fee disclosure requirements

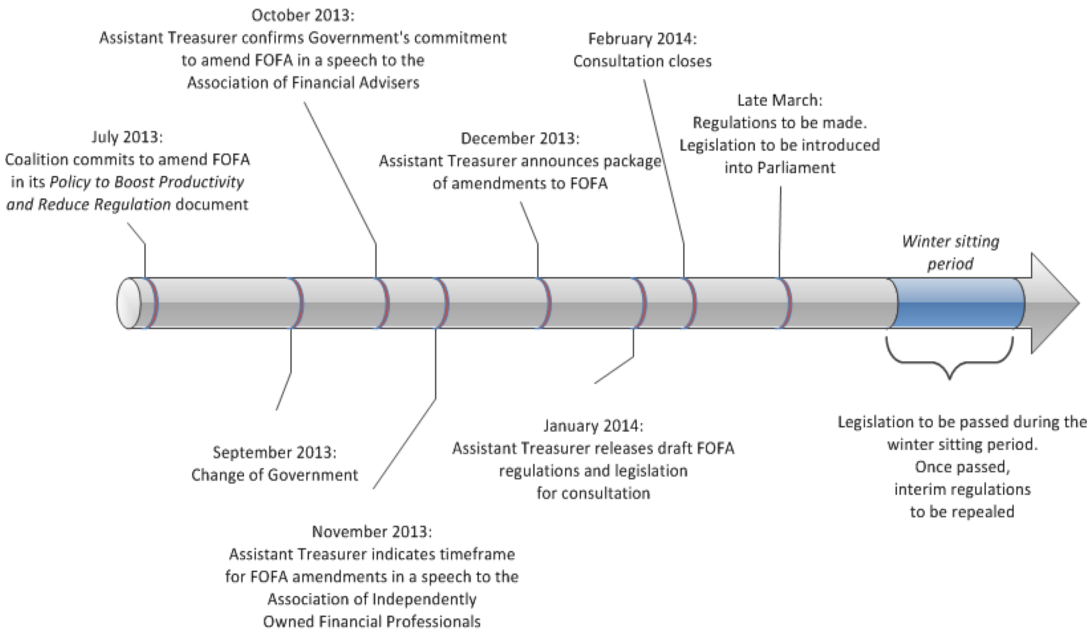
These changes were designed to empower clients and encourage fee transparency. For clients first engaged after 1 July 2013, advisers would need to receive permission every two years, via an *Opt-In* statement, to continue the provision of ongoing advice. In addition, advisers would need to provide an annual *Fee Disclosure Statement (FDS)* to all ongoing clients (irrespective of when first engaged), with the FDS providing details of services rendered and amounts charged over a preceding 12 month period.

An orphan soon after birth

FoFA had not long been in full effect when the September 2013 federal election resulted in a change to a Liberal Government. In December 2013, the new government announced a package of measures to amend FoFA, citing a desire to "reduce compliance costs for small business, financial advisors and consumers who access financial services". The package of changes included:

- the removal of the Opt-In requirement
- restricting the FDS requirement to clients first engaged after 1 July 2013
- watering-down the best interest duty (via the removal of a 'catch-all' provision)
- exempting general advice (advice given without detailed knowledge of a person's financial needs, objectives and circumstances) from the ban on conflicted remuneration.

A schematic of the FoFA amendment timeline, as expected by the Liberal Government, appears below:



Source: Revised Explanatory Memorandum, Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014

The *Corporations Amendment (Streamlining of Future of Financial Advice) Bill 2014* was introduced into the House of Representatives in mid-March 2014 and was met, as expected, with vociferous opposition from members of the former government. To expedite matters the government, in late June 2014, pushed its FoFA amendments through via regulation.

This regulation applied with effect from 1 July 2014, and so allowed advice to be provided under the amended FoFA obligations from that date. It was meant as an interim measure until such time as the amending Bill became law. A *fait accompli*, one would have thought.

Senate disallows FoFA

Entering the Senate for a second time in early September 2014, the FoFA Bill faced almost immediate delay in an economics committee. Press coverage was openly critical of the softening of both the best interest duty and the conflicted remuneration provisions. Taken together these amendments appeared to favour the large banks, as both creator and distributor of financial product via branches and bank-owned financial planning businesses.

Through October and into November 2014, the FoFA Bill was subject to much negotiation, including the establishment of a National Register of Financial Advisers. Just when it looked likely to pass into law, on 19 November 2014 a motion to disallow the *Corporation Amendment (Streamlining Future of Financial Advice) Regulation 2014* was put forward by the opposition and garnering the support of Senators, both independent and from other parties, was upheld.

The disallowance means that the FoFA amendments are effectively nullified, with the FoFA laws as at 1 July 2013 applying forthwith. With the potential for enormous disruption in the advice industry, ASIC has stated that it will take a "practical and measured approach to administering the law" and will "work with Australian financial services licensees, taking a facilitative approach until 1 July 2015".

Ultimately then, the government could not shake the perception that its FoFA changes would have benefited the 'big end of town' at the expense of consumer protection. Coinciding press coverage of poor advice practices at two of the largest banks in the country, and of losses suffered in agribusiness schemes promoted by advisers, only served to reinforce this disquiet.

Towards a day when the 'Fo' in FoFA is redundant

FoFA has already changed the advice industry. In 2011 ASIC found that on average only 10% of total revenue generated by the 20 largest planning businesses was paid directly by the client. By 2013 this figure stood at 36%, with two groups receiving over 90% of revenue directly from clients.

With the FoFA amendments blocked, will the additional compliance burden result in costs to the advice industry of an additional $190 million a year, as estimated in the Bill's explanatory memorandum? Even if this were the case, for an industry generating some $4 billion in annual revenue it would represent a small margin contraction. Whilst not insignificant, it might be the price required to address the trust deficit if the financial advice industry is to genuinely become a profession.

Where to from here? As the former Chair of the Financial Planning Association, Matthew Rowe, told the 2014 FPA Conference last week, that when discussing legislative changes with politicians, "… we need to be able to do that through the lens of what's in the public's best interests". That's where, so far, the battle has been lost.

Harry Chemay is a Certified Investment Management Analyst (CIMA®) who consults across both retail and institutional superannuation, focusing on post-retirement outcomes. He has previously practised as a specialist SMSF advisor, and as an investment consultant to APRA-regulated superannuation funds.

FoFA is not in anyone's best interests now

Noel Whittaker

In 2006 Westpoint, a mortgage trust offering returns of 12% per annum, went belly up leaving their investors with nothing. In 2008 Opes Prime collapsed, resulting in further losses, followed a few months later by the demise of Townsville-based Storm Financial which caused thousands of Australians to lose their life savings. Subsequent investigations revealed that Storm had been charging entry fees of up to 10%, and that Westpoint had been paying a 10% commission to advisers who recommended them.

Naturally, disasters of this scale made headlines, and gave vested interests the opportunity to bag the financial advice industry in general. The paradox is that the actions of these three companies were far removed from the operations of the average financial adviser.

Westpoint was a mortgage trust that got caught in the development business, Opes Prime was a margin lender with shonky documentation, and Storm had a one-size-fits-all model which resulted in many of their clients being over-geared.

The desire to 'do something'

Be that as it may, the cries for somebody to 'do something' resulted in the Ripoll Inquiry, which was charged with the responsibility of recommending reforms to the financial system so these disasters could never happen again.

The final report was released in November 2009, and its recommendations were introduced to parliament by the Labor Government, with the title FoFA - Future of Financial Advice. Despite the best intentions of the members of the Ripoll Committee, who are good people, FoFA has been a disaster. It has created layer upon layer of red tape, yet has done little to protect the investor.

The cost of implementing FoFA, which will ultimately be borne by the consumer, was estimated in 2009 at $700 million, with annual costs of $375 million. Given the raft of paperwork since, it's fair to say that FoFA has cost well over a billion dollars.

Following representations from the financial planning industry, and as part of their programme of eliminating red tape, the current Coalition Government attempted to wind back part of the FoFA 'reforms'. The changes appeared to be on track until the last minute when Senators Lambie and Muir took us back to square one.

It is ironic that the complaints from the Timbercorp investor who had lost money were the catalyst for the change of heart, yet it has been reported that, in that specific case, the intermediary had been an accountant, not a financial adviser.

Ill-informed views

Given the adversarial nature of politics and the argy-bargy between industry funds and other players in financial services, we have been subjected to an unprecedented amount of ill-informed hysteria.

Opt-in is a classic example. The original FoFA rules contained an opt-in provision which required financial advisers to contact their clients at least once every two years for clients to confirm in writing that they wished to stay with their present arrangements, and were happy to continue to pay asset-based fees.

The requirement is pointless. Clients are already provided with details of fees in the original Statement of Advice, as well as in their annual fee disclosure statements AND in their regular product statements. Furthermore, they are not locked-in, as they could be with a telephone or pay TV contract. They are free to opt-out at any stage without penalty.

National Seniors have been running a scare campaign claiming that their members will be seriously disadvantaged if the government scraps the opt-in rules. National Seniors would be better off using their precious resources on an education campaign.

Are they trying to say their members are so naïve that they don't talk to their financial planner at least once every two years, and they're not capable of reading a simple statement of fees being charged?

Australia is sinking under a weight of unnecessary and onerous compliance. Almost weekly, I receive large documents from people such as my accountant, insurance agent, bank and stockbroker providing information which I don't need, and will never read, because it's now the law. There is still a feeling among bureaucrats that the only way to protect a consumer is to require bigger and bigger amounts of paperwork in the interests of 'disclosure'. The practical effect is a load of unnecessary work on the good guys who have to churn it out, and even more confusion for the consumer who is handed reams of paperwork they are most unlikely to read.

The overreach of 'best interests duty'

A major stumbling block is the requirement that the financial adviser must act in the 'best interests' of their clients. This would seem to be stating the obvious because one could reasonably expect that your lawyer, doctor, dentist and every other person you dealt with would have an obligation to act in your best interests. My legal friends tell me this is not the case. People who contract with you have a duty of care and if they fail on this duty of care, an action can be taken for negligence.

The introduction of the new term of 'best interests' opens a new area of law. The regulations require that an adviser act in the best interests of clients, provide appropriate advice, warn the client if the advice is based on incomplete or inaccurate information, and prioritise the client's interests.

In an attempt to get around the problems with the definition of best interests, there is provision for an adviser to put themselves into a 'safe harbour'. To be protected by 'safe harbour' rules, the adviser must:

1. Identify the objectives, financial situation and needs of the client
2. Identify the subject matter of the advice sought
3. Identify the objectives, financial situation and needs of the client that would reasonably be considered relevant
4. Make reasonable enquiries if it is apparent that the information provided by the client is incomplete or inaccurate
5. Assess whether they have the expertise to provide the advice sought. If not decline to give advice
6. Conduct a reasonable investigation into the financial products that might achieve the client's objective
7. Base all judgements on the client's relevant circumstances.

Now here's the rub! As well as all the foregoing, there is a final 'catch-all' point, that the adviser is also required to take "any other step that … would reasonably be regarded as being in the best interests of the client." (Corporations Act 2001, Section 961B (g)). Yes, we are back to square one.

To help in clarifying my own thinking, I spent an hour with a senior legal figure to discuss FoFA in depth. Raising an eyebrow he chuckled, "This is so vague I could drive a cart through it."

He also opined out that it encouraged advisers to think in terms of tick-the-box - in other words, to focus on and spend time box-ticking in lieu of ethics.

FoFA was well-intentioned, but the grim reality is that it now costs a financial advisory firm at least $2500 to open a file and prepare a Statement of Advice for potential clients. This means that the lowest paid in the community, those who need advice the most, have been priced out of the market.

And while all this has been going on the property spruikers, the real villains in the 'advice' space, are left free to carry on their rapacious trade. Apparently, regulating the property market stays in the too hard basket.

Noel Whittaker is the author of Making Money Made Simple and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. His website is www.noelwhittaker.com.au*.*

The great myth of the '1 in 100 year' event

Craig Swanger

How many times have you heard lately that a '1 in 100 year' event has occurred? Weather and financial market events in particular seem to have occurred far more often in recent times, typically with grave consequences for people's quality of life.

The Global Financial Crisis was described many ways, 'a five standard deviation event', 'a black swan event', 'once in a generation'. But putting odds on this type of event is misleading. It suggests that these are predictable events, which they are not, or that they will not occur for another 100 years. That's why for all the time finance professionals spend talking about risk, 99% of them failed to forecast the GFC. Too much of the industry looks in the rear vision mirror to assess risks, such as 'based on the last 100 years of data, the chances of that event happening are 1 in 100'. They define this rear vision probability-based approach as 'risk'.

But what if past performance is not indicative of future performance? What if the world has fundamentally changed, for example due to climate change, or more leverage being applied by parts of the finance sector? What if the world's population in the future is much older than the population in the past therefore making past data irrelevant?

Looking backwards to define risks is missing a major part of the current and future risk equation. The other part of the risk equation is 'uncertainty'.

What is the difference between risk and uncertainty?

Risk is typically defined as the chances of something happening in the future given what we know about the past. Uncertainty is the reality that some outcomes aren't predictable just by looking at the past.

Frank Knight, a relatively unknown economist from the 1920s, described the difference very elegantly. He was the first economist to break ranks and suggest that assuming certainty was foolish, and that there were two distinct concepts of 'risk' and 'uncertainty'. His assertion was illustrated by imagining an urn containing marbles, 40% of which are red and 60% are not red. If you draw one marble from the urn, you don't know what colour the marble will be, but you know that there is a 40% risk that it will be red.

The non-red marbles are yellow and black. You don't know how many there are of each. So when you are about to draw a marble from the urn, if you were asked what the risk is that it will be black, you have no way of really assessing the probability. It's not 40% or 60%, it is unknowable. That unknowable is what Frank Knight characterised as uncertainty. And there is a big difference between risk and uncertainty.

Uncertainty is the most important consideration in investing

Uncertainty must be considered in planning retirement in particular. Once retired, there is typically little chance of being able to earn back any capital lost. Similarly, there is no chance of stopping your spending while you wait for markets to rebound. You either need to have enough certain income, or you will be forced to sell assets during the storm, which is never a good outcome. Uncertainty, more than risk, poses a significant question for investors: "If no-one can predict the future with any certainty, what can I do to ensure I survive the storm?"

Many investors decide the best way to survive is to simply invest in term deposits and other cash investments. In fact, the average SMSF in Australia today has around 27% of its assets in cash. If we look at 'risks', i.e. looking backward, this seems like a safe strategy. Inflation has been between 2 and 3% for nearly a generation and doesn't appear to be going anywhere any time soon. But what if inflation did spike like it did in the 1970s? How would your retirement funds survive then?

"The asset class that most investors consider the 'safest' – cash – is actually extremely risky." – Warren Buffett

Obviously Buffett has used 'extremely risky' for effect. Cash isn't extremely risky. But it's not risk free either, and the risk is inflation. It is not anticipated inflation (2-3% pa), it is the unanticipated inflation that is damaging. What is hard is thinking about how inflation could possibly jump to say 5% or more when it has been so benign for so long.

Investors in 1970 probably felt exactly the same. At that stage, they had seen 18 years of inflation averaging 2-3%. But retirees in 1970 would see 76% of their savings eroded by inflation over the following 13 years (their life expectancy at that time). Economists in 1970 were saying there was a 'minor risk of inflation'. But uncertainty was about to impact retirees like never before.

Inflation risk and inflation uncertainty

Most economists aren't predicting a jump in inflation now either, and nor are we. Our expectation is that inflation can be contained in the 2-3% range, with some risk on the upside if the fall in the AUD pushes up import prices. We can point to that risk because in the past a falling AUD has led to inflation pressures, such as due to rising petrol prices.

But there is a new uncertainty at play at the moment, quantitative easing. Will global inflation spike as a result of the cheap credit that central banks in the US and EU are providing? Five years or more of pumping cheap credit into financial institutions and the economy is unprecedented. Just like predicting the chances of pulling a yellow marble out of the urn, we don't have any data to use to predict what impact this will have on inflation in the next 10 years. This is 'unknowable' because there is not much more than academic theories to guide us.

That unknowable risk is what Frank Knight characterised as uncertainty. Given that it is unknowable, all you can do is to consider whether you want to include investments in your portfolio that rise in value and/or increase income if inflation does suddenly jump. Gold, oil, farmland, infrastructure and inflation-linked bonds are historically amongst the best inflation hedges (i.e. investments that will go up in value if inflation rises). Australian investors have plenty of options for investing in these assets with many on the ASX, but also through the unlisted bond market. We've listed a few examples below:

Bond	Offer	Retail
Sydney Airport 20Nov20 CIB	CPI+3.02%	Yes
Sydney Airport 20Nov30 CIB	CPI+3.86%	Yes
JEM Southbank 28Jun35 IAB	CPI+3.12%	Yes
MPC Funding 31Dec33 IAB	CPI+2.97%	No
Civic Nexus 15Sep32 IAB	CPI+2.80%	Yes

Yields and prices are indicative only and there is no guarantee as to their accuracy.

Craig Swanger is Head of Markets at FIIG Securities. To learn more Corporate Bonds click here. This article is for general education purposes only and is not personal financial advice.

Currency hedging for international equity portfolios

Scott Hamilton

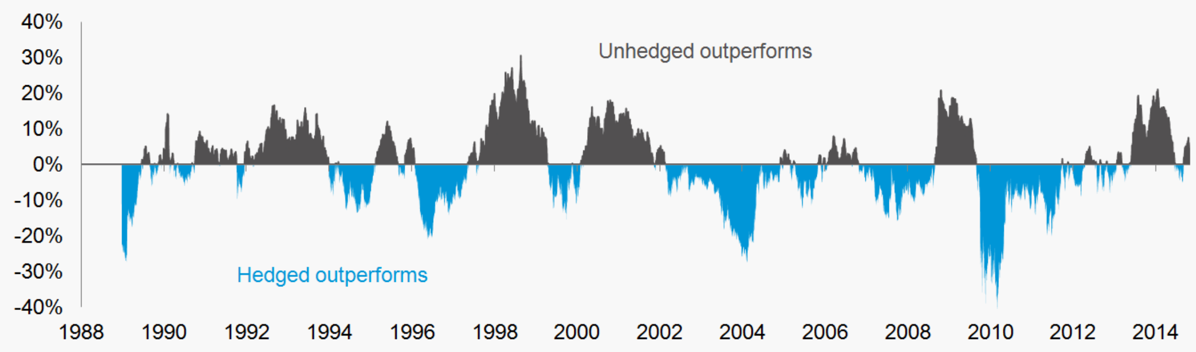
With recent volatility in the value of the Australian dollar (AUD), investor attention is again drawn to the topic of currency hedging. This article looks at the impact of currency on international equity investments for an Australian investor and explores some of the factors that influence the decision to hedge currency exposure.

The impact of currency risk

Currency risk is typically a significant proportion of the total risk of an unhedged international equity portfolio which can have a large impact on returns. For example, over the 12 months to February 2009, unhedged investors were about 20% better off than their hedged counterparts, while over the 12 months to March 2010 they were about 40% worse off (Chart 1).

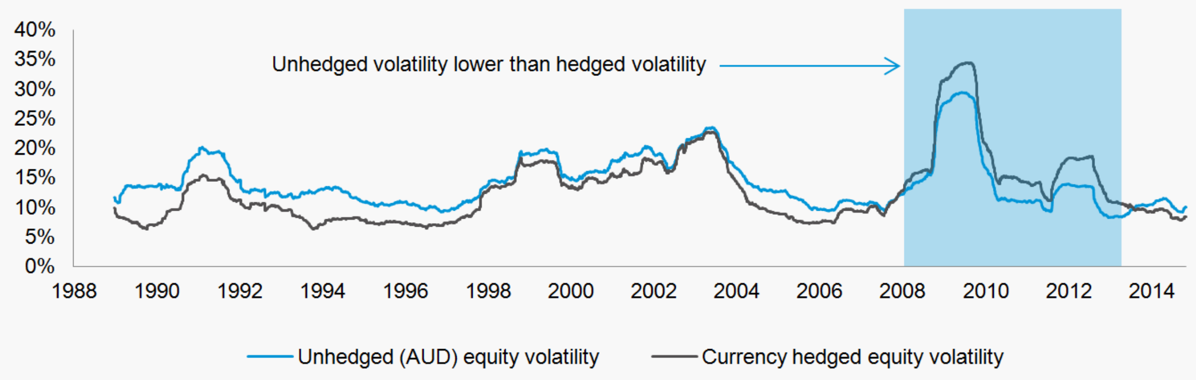
Over the long term, the difference between hedged and unhedged returns is less dramatic because currencies have a tendency to fluctuate around a long-term average. However, hedged investors have been better off by an average of 1.2% per annum (ignoring hedging and carry costs) over the 26 years since 1988. The hedged portfolio has had the added benefit of lower volatility (on average) than the unhedged (14.0% vs 14.8%).

Chart 1: Rolling 12mth difference between hedged and unhedged MSCI All Country World Index (ACWI)



Source: MSCI, Factset, Realindex, as at October 2014

Chart 2: Rolling 12mth volatility of MSCI ACWI (hedged and unhedged)



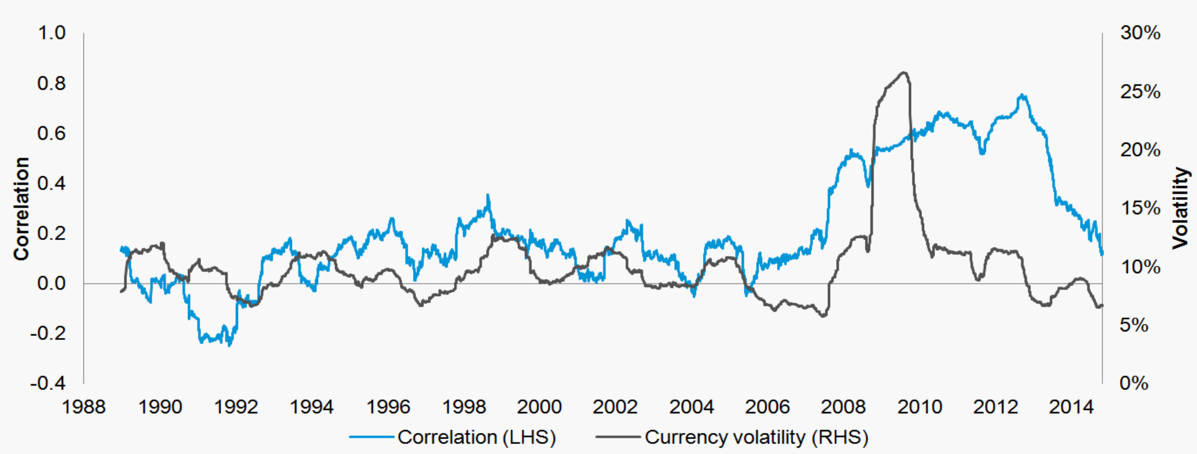
Source: MSCI, Factset, Realindex, as at October 2014

The relationship between currency and equity returns

In the aftermath of the GFC, the volatility of a currency-hedged All Country World Index (ACWI) portfolio rose above that of an AUD unhedged ACWI portfolio; an unusual situation that persisted until mid-2013 (Chart 2). In other words, it became more 'risky' for an investor to hedge their AUD currency exposure than to not hedge during this period. This somewhat counter-intuitive phenomenon was the result of a significant increase in correlation between the AUD currency basket and international equity returns (as shown in Chart 3). During this period the currency exposure of an AUD ACWI equity portfolio became a diversifying position. From a 'total risk' perspective it was hard to justify hedging currency risk during this period because it increased overall risk. However correlations have now returned to more normal levels and hedged volatility has again dropped below unhedged on a trailing 12 month measure.

This event clearly illustrates that relationships between financial assets are not guaranteed to remain stable and any assumptions that are made as part of the investment process need to be monitored.

Chart 3: Correlation of AUD/international currency basket with international equity performance

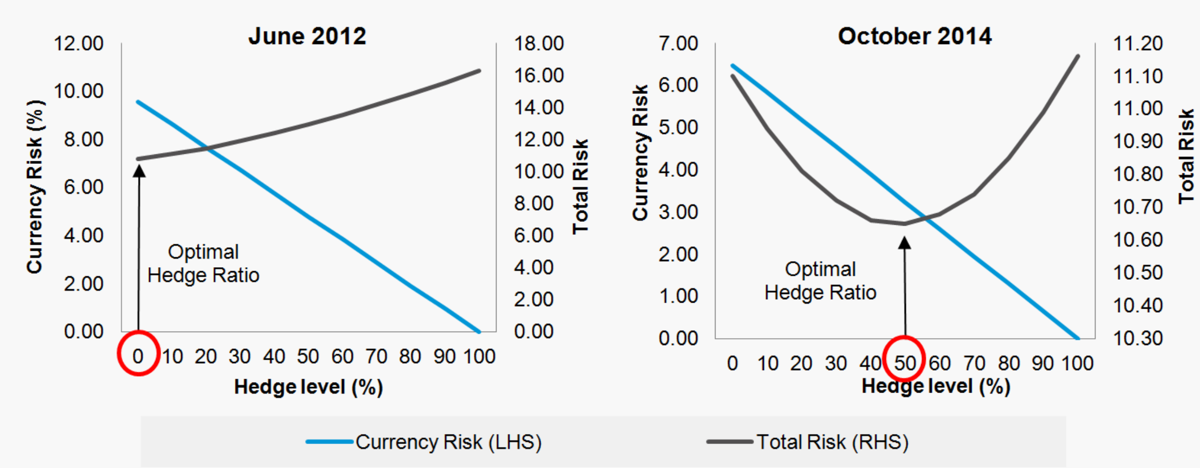


Source: MSCI, Factset, Realindex, as at October 2014

Optimal currency hedge ratios

To illustrate the impact of this correlation change we calculate the optimal currency hedge ratio for an investor trying to minimise the total volatility of their global equity portfolio by adjusting the currency hedge (Chart 4). The grey lines show the total risk of equity and currency combined, while the light blue line shows the currency risk in isolation. The optimal total-risk hedge level will be the lowest point on the grey line. We see that in June 2012 the optimal total-risk position was to leave AUD exposure completely unhedged, while the current optimal position is to be roughly 50% hedged. A hedge level of 50% implies that half of the total currency exposure is hedged. Of course if your objective is to eliminate as much currency risk as possible then the optimal choice is always to be fully hedged, regardless of total portfolio volatility.

Chart 4: Impact of currency correlation on combined equity and currency volatility

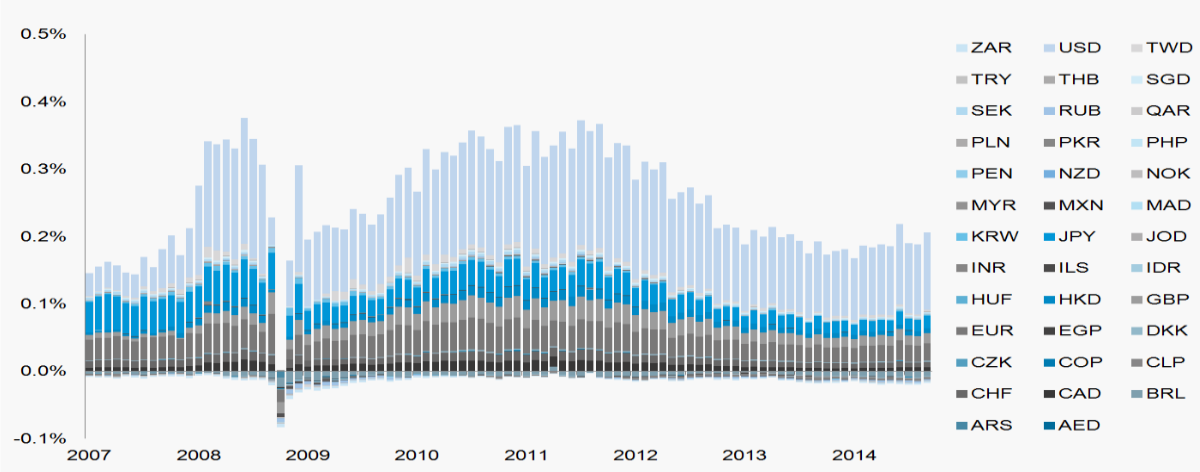


Source: MSCI, Factset, Realindex, as at October 2014

Hedging returns

Some investors may not be aware that there is a return associated with a currency hedge that is independent of currency and market movements. This return is the 'cost of carry' (or a 'return of carry') which reflects interest rate differential between the base currency and foreign currency exposures which are being hedged; it is priced into the currency 'forward points'. A currency hedge effectively earns the domestic interest rate and pays the foreign rate; for AUD investors this has historically provided a benefit, as illustrated in Chart 5. This benefit would reduce if, for example, US interest rates were to rise while AUD rates remain on hold. You will notice there is variability in the hedging return, which means that it is not 'risk free', however the variation in forward returns is typically much lower than the variation in the currency returns which are being hedged.

Chart 5: Monthly return from an international currency hedge to AUD



Source: MSCI, Factset, Realindex, as at October 2014

Why hedge currency exposure

So does it make sense to hedge currency exposure? There are several reasons investors might want to consider currency hedging, including:

1. Prior to 2008, hedging currency exposure reduced the total volatility of an AUD based international equity portfolio. Now that correlations have returned to more historically normal levels this may be the case again going forward (though of course this is not guaranteed).

2. If a view is held on the AUD, this can be reflected in the level of currency hedge. If there is no view on the currency then arguably it is unwise to take exposure to a source of risk from which you have no expectation of return and therefore we would argue that currency hedging should be considered in this scenario too.

3. Historically there has been a carry benefit to hedging the AUD due to the prevailing interest rates. As long as interest rates in Australia are higher than the weighted average rates of international markets, then this may remain the case.

Summary

If an investor holds a long term view on the AUD then it is sensible to implement a hedging strategy that reflects that view (be it hedged or unhedged), and stick to it. If no view is held on the currency, then there are still very valid reasons to consider hedging currency exposure. In either case, it is important to ensure that any performance benchmark is aligned with the strategic hedging decision, and that the risk and cost implications of this decision are fully considered.

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