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Editorial

The S&P 500 is on pace for back-to-back years with total returns of more than 20%. The last time that happened? 1998-1999.

S&P 500: Total Returns (1928 - 2024 - As of 11/30/24)

Year	Return	Year	Return	Year	Return	Year	Return	Year	Return
1928	43.8%	1948	5.7%	1968	10.8%	1988	16.6%	2008	-37.0%
1929	-8.3%	1949	18.3%	1969	-8.2%	1989	31.7%	2009	26.5%
1930	-25.1%	**1950**	**30.8%**	1970	3.6%	1990	-3.1%	2010	15.1%
1931	-43.8%	**1951**	**23.7%**	1971	14.2%	1991	30.5%	2011	2.1%
1932	-8.6%	1952	18.2%	1972	18.8%	1992	7.6%	2012	16.0%
1933	50.0%	1953	-1.2%	1973	-14.3%	1993	10.1%	2013	32.4%
1934	-1.2%	**1954**	**52.6%**	1974	-25.9%	1994	1.3%	2014	13.7%
1935	**46.7%**	**1955**	**32.6%**	**1975**	**37.0%**	**1995**	**37.6%**	2015	1.4%
1936	**31.9%**	1956	7.4%	**1976**	**23.8%**	**1996**	**23.0%**	2016	12.0%
1937	-35.3%	1957	-10.5%	1977	-7.0%	**1997**	**33.4%**	2017	21.8%
1938	29.3%	1958	43.7%	1978	6.5%	**1998**	**28.6%**	2018	-4.4%
1939	-1.1%	1959	12.1%	1979	18.5%	**1999**	**21.0%**	2019	31.5%
1940	-10.7%	1960	0.3%	1980	31.7%	2000	-9.1%	2020	18.4%
1941	-12.8%	1961	26.6%	1981	-4.7%	2001	-11.9%	2021	28.7%
1942	19.2%	1962	-8.8%	**1982**	**20.4%**	2002	-22.1%	2022	-18.1%
1943	25.1%	1963	22.6%	**1983**	**22.3%**	2003	28.7%	**2023**	**26.3%**
1944	19.0%	1964	16.4%	1984	6.1%	2004	10.9%	**2024**	**28.1%**
1945	35.8%	1965	12.4%	1985	31.2%	2005	4.9%		
1946	-8.4%	1966	-10.0%	1986	18.5%	2006	15.8%		
1947	5.2%	1967	23.8%	1987	5.8%	2007	5.5%		

CREATIVE PLANNING @CharlieBilello

This statistic alone is intriguing, though doesn't tell a lot. After all, the S&P 500 had five successive years of +20% returns before the dot-com bubble burst in 2000.

The US market also did well prior to Covid, with three years of +18% returns in a row.

Good years aren't necessarily followed by bad years, and vice versa. The future isn't that easy to predict!

Longer-term charts often give us a fuller picture, and this one is a beauty.

CREATIVE PLANNING		Asset Class Total Returns Since 2011 (Data via YCharts as of 11/30/24)														@CharlieBilello	
ETF	Asset Class	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2011-24 Cumulative	2011-24 Annualized
N/A	Bitcoin ($BTC)	1473%	186%	5507%	-58%	35%	125%	1331%	-73%	95%	301%	66%	-65%	156%	**129%**	32260643%	149%
IWF	US Growth	2.3%	15.2%	33.1%	12.8%	5.5%	7.0%	30.0%	-1.7%	35.9%	38.3%	27.4%	-29.3%	42.6%	**31.9%**	713%	16.3%
GLD	Gold	9.6%	6.6%	-28.3%	-2.2%	-10.7%	8.0%	12.8%	-1.9%	17.9%	24.8%	-4.2%	-0.8%	12.7%	**28.5%**	77%	4.2%
SPY	US Large Caps	1.9%	16.0%	32.2%	13.5%	1.2%	12.0%	21.7%	-4.5%	31.2%	18.4%	28.7%	-18.2%	26.2%	**28.0%**	517%	14.0%
QQQ	US Nasdaq 100	3.4%	18.1%	36.6%	19.2%	9.5%	7.1%	32.7%	-0.1%	39.0%	48.6%	27.4%	-32.6%	54.9%	**25.0%**	961%	18.5%
IWD	US Value	0.1%	17.5%	32.1%	13.2%	-4.0%	17.3%	13.5%	-8.5%	26.1%	2.7%	25.0%	-7.7%	11.4%	**22.6%**	319%	10.8%
MDY	US Mid Caps	-2.1%	17.8%	33.1%	9.4%	-2.5%	20.5%	15.9%	-11.3%	25.8%	13.5%	24.5%	-13.3%	16.1%	**22.4%**	344%	11.3%
IWM	US Small Caps	-4.4%	16.7%	38.7%	5.0%	-4.5%	21.6%	14.6%	-11.1%	25.4%	20.0%	14.5%	-20.5%	16.8%	**21.6%**	274%	9.9%
CWB	Convertible Bonds	-7.7%	15.9%	20.5%	7.7%	-0.8%	10.6%	15.7%	-2.0%	22.4%	53.4%	2.2%	-20.8%	14.5%	**15.1%**	246%	9.3%
VNQ	US REITs	8.6%	17.6%	2.3%	30.4%	2.4%	8.6%	4.9%	-6.0%	28.9%	-4.7%	40.5%	-26.2%	11.8%	**14.4%**	204%	8.3%
PFF	Preferred Stocks	-2.0%	17.8%	-1.0%	14.1%	4.3%	1.3%	8.1%	-4.7%	15.9%	7.9%	7.2%	-18.2%	9.2%	**11.2%**	89%	4.7%
HYG	High Yield Bonds	6.8%	11.7%	5.8%	1.9%	-5.0%	13.4%	6.1%	-2.0%	14.1%	4.5%	3.8%	-11.0%	11.5%	**8.8%**	92%	4.8%
EEM	Emerging Market Stocks	-18.8%	19.1%	-3.7%	-3.9%	-16.2%	10.9%	37.3%	-15.3%	18.2%	17.0%	-3.6%	-20.6%	9.0%	**8.3%**	21%	1.4%
EMB	EM Bonds (USD)	7.7%	16.9%	-7.8%	6.1%	1.0%	9.3%	10.3%	-5.5%	15.5%	5.4%	-2.2%	-18.6%	10.6%	**7.9%**	64%	3.6%
EFA	EAFE Stocks	-12.2%	18.8%	21.4%	-6.2%	-1.0%	1.4%	25.1%	-13.8%	22.0%	7.6%	11.5%	-14.4%	18.4%	**6.7%**	103%	5.2%
BIL	US Cash	0.0%	0.0%	-0.1%	-0.1%	-0.1%	0.1%	0.7%	1.7%	2.2%	0.4%	-0.1%	1.4%	4.9%	**4.8%**	17%	1.1%
LQD	Investment Grade Bonds	9.7%	10.6%	-2.0%	8.2%	-1.3%	6.2%	7.1%	-3.8%	17.4%	11.0%	-1.8%	-17.9%	9.4%	**3.6%**	65%	3.7%
TIP	TIPS	13.3%	6.4%	-8.5%	3.6%	-1.8%	4.7%	2.9%	-1.4%	8.3%	10.8%	5.7%	-12.2%	3.8%	**3.4%**	43%	2.6%
BND	US Total Bond Market	7.7%	3.9%	-2.1%	5.8%	0.6%	2.5%	3.6%	-0.1%	8.8%	7.7%	-1.9%	-13.1%	5.7%	**3.1%**	35%	2.2%
DBC	Commodities	-2.6%	3.5%	-7.6%	-28.1%	-27.6%	18.6%	4.9%	-11.6%	11.8%	-7.8%	41.4%	19.3%	-6.2%	**0.5%**	-13%	-1.0%
TLT	Long Duration Treasuries	34.0%	2.6%	-13.4%	27.3%	-1.8%	1.2%	9.2%	-1.6%	14.1%	18.2%	-4.6%	-31.2%	2.8%	**-1.8%**	44%	2.7%
Highest Return		BTC	BTC	BTC	VNQ	BTC	BTC	BTC	BIL	BTC	BTC	BTC	DBC	BTC	BTC	BTC	BTC
Lowest Return		EEM	BIL	GLD	BTC	DBC	BIL	BIL	BTC	BIL	DBC	TLT	BTC	DBC	TLT	DBC	DBC
% of Asset Classes Positive		62%	95%	52%	71%	38%	100%	100%	5%	100%	90%	67%	10%	95%	95%	95%	95%

The chart shows it isn’t just US equities that have performed well. Every asset class is up, except long-duration US Treasuries. Bitcoin has again led the pack, rising 129% year-to-date. Gold has also been a big winner, increasing 29%, despite the strength of the US dollar.

Outside of this, US stocks have been the standout performer. Growth stocks have led the way, rising 32%, following by large caps up 28%, and the Nasdaq that’s 25% better off. US small and mid-caps lagged in the first half but have played catchup since.

And what about the asset classes that haven’t done as well? Stocks outside America fall into this category, whether it’s emerging markets or EAFE (Europe, Australasia, and the Far East).

Bonds have trailed most other assets for a fourth year in a row.

Commodities have also had a poor year, after an even worse 2023.

Now, let’s turn our attention to the far right column of the chart - it shows the annualised return of each asset class over the past 14 years.

Even on this basis, Bitcoin’s returns remain otherworldly.

US stocks also look healthy. Growth stocks have increased 16% per annum, large caps 14%, and the Nasdaq 19%.

Given that the S&P 500 has an annualized return of close to 10% over its history, you can see that the past 14 years have been an exceptional period for US equities. It’s also not hard to see that at some point, this performance could mean revert at some point. It’s probably part of the reason that Goldman Sachs has forecast the S&P 500 to have an annualized return of 3% over the next decade.

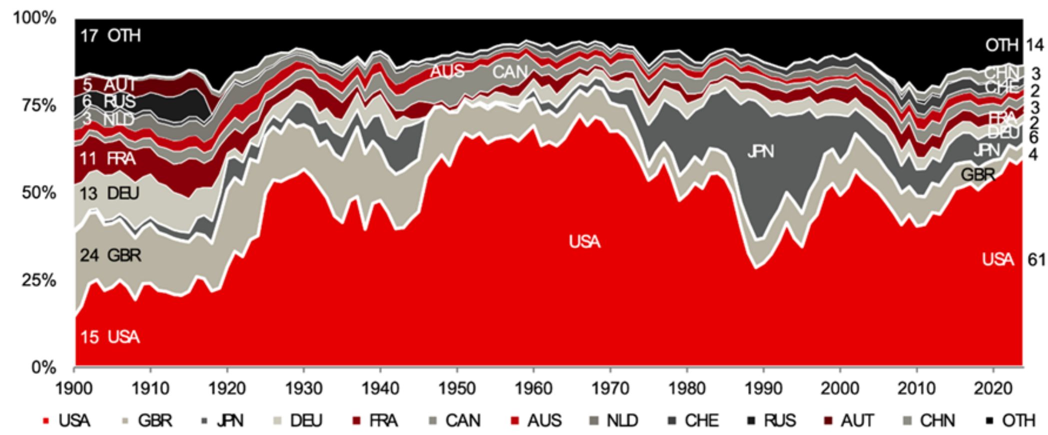
On the flip side, bonds and cash have had a terrible time of it over the past 14 years. And commodities are down from 2011 levels.

Can US exceptionalism continue?

As a result if the strong US performance, international stock indices are now dominated by America.

This chart is from the start of 2024, and the US is now close to 65% of the world stock index. These levels were last seen in the late 1960s/early 1970s, when the US was at the peak of its powers versus the rest of the world.

Figure 3: The evolution of equity markets over time from end-1899 to start-2024

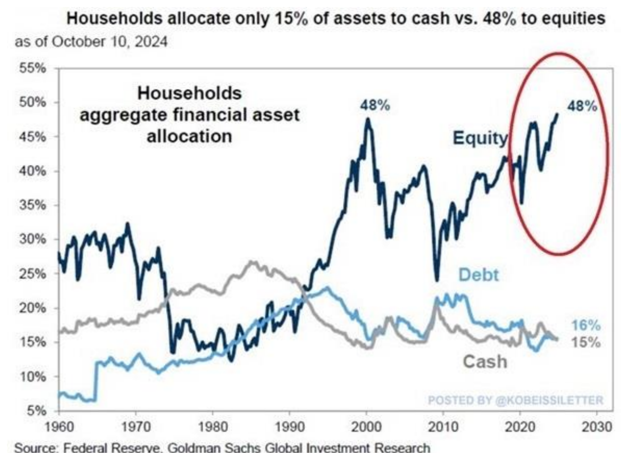


Sources: Elroy Dimson, Paul Marsh and Mike Staunton, DMS Database 2024 and FTSE Russell All-World Index Series weights (recent years). Not to be reproduced without express written permission from the authors.

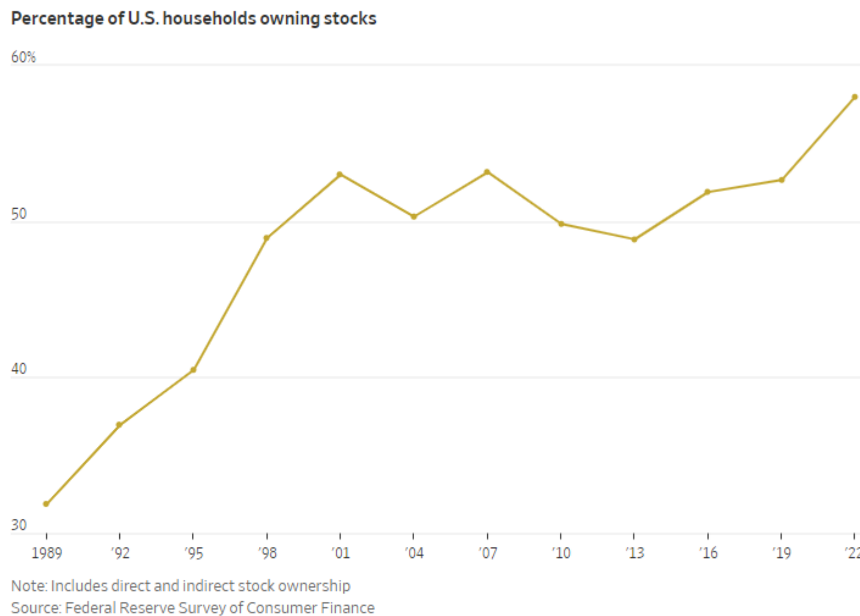
The US then had a precipitous drop until the late 1980s, before it's extraordinary run over the past 35 years.

Fund managers and individuals are very bullish on US prospects.

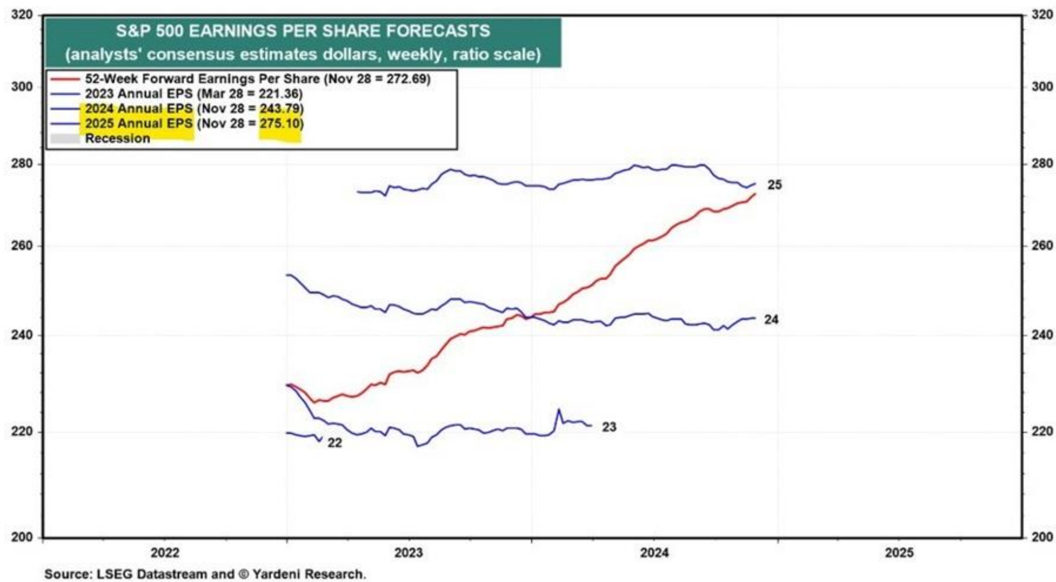
The rolling 12-month average of AAII's bull/bear sentiment spread of individual investors is at its highest level since 2005. US households have now allocated a record-equalling 48% of their assets to stocks.



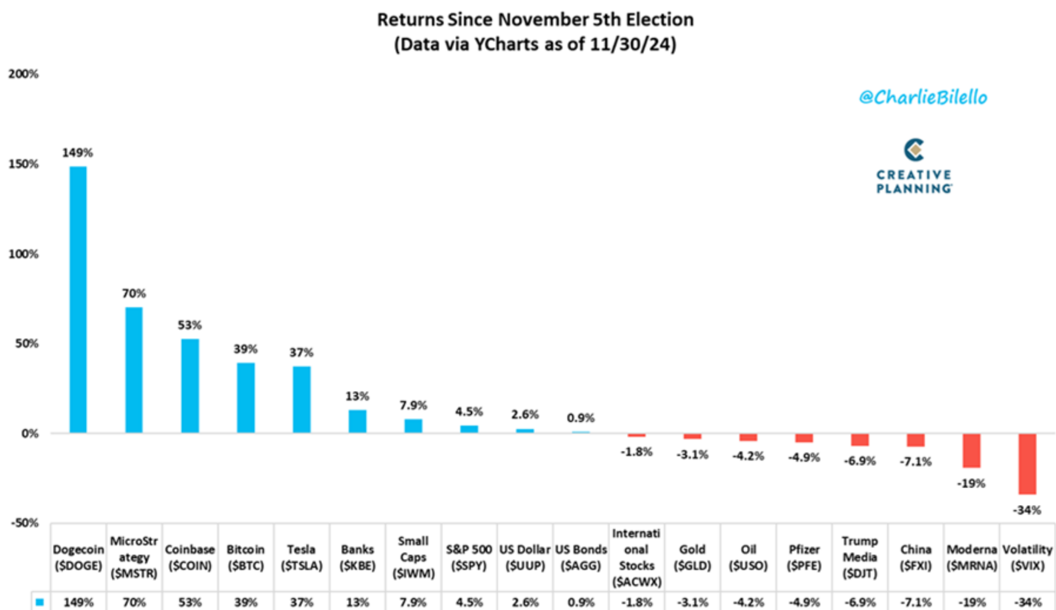
And the percentage of US households owning stocks has reached all-time highs.



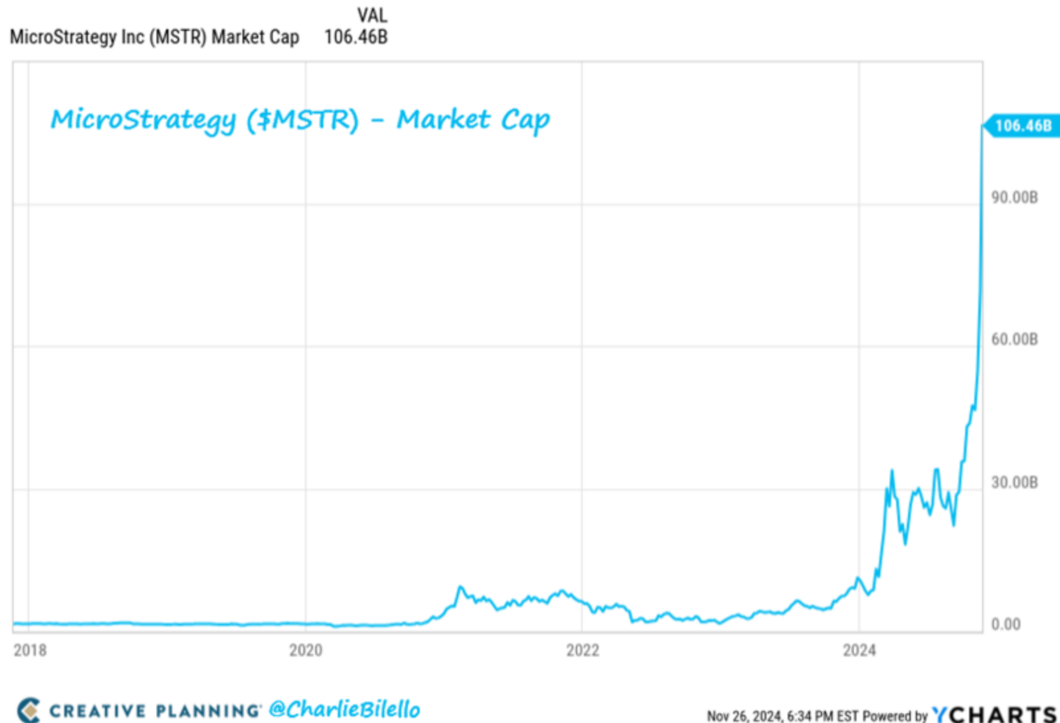
The optimism is reflected in US market valuations. The S&P 500 is trading at 22x earnings, compared to the median of 15.4x and average of 15.9x since 1990.



Positive sentiment towards the US market has spilled over into signs of frothiness. Bitcoin and related entities have rocketed since Trump's election, as has other stocks favoured by speculators, like Tesla.



The stock, MicroStrategy, is a case in point. Its primary business is essentially buying Bitcoin, and at its recent peak, it had a market capitalization of more than US100 billion. What's interesting is that at this valuation, it was almost 3x higher than the value of its Bitcoin holdings. And the MicroStrategy's 7-year return of 3,420% exceeds even that of Nvidia.



There are other signs of excess. Recently, China-born cryptocurrency entrepreneur, Justin Sun, made headlines when he paid $US6.2 million for a conceptual art piece called Comedian, which consists of a banana attached to a white wall with duct tape. A few days later, he ate the banana at a press conference in Hong Kong!

Looking elsewhere for ideas

If the US market is looking toppy, where else can investors put their money? Stocks outside of America may be worth considering. Japan looks appetising given it has many world-class companies with inexpensive valuations and corporate reform that's still playing out. India also boasts many great companies though it's looking expensive right now and could be considered on dips.

Unfortunately, much of the ASX appears overvalued too. The rise in bank shares has been incredible and detached from fundamentals. On the other hand, many commodity stocks have been left for dead and that's where value may lay. Oil majors like Woodside (ASX:WPL) and Santos (ASX:STO) appear cheap at these levels.

In addition, there may be value in best-in-class businesses that are being dragged down by sector-wide issues. For instance, the stand-off between hospitals and health insurers over hospital funding is weighing on the share prices of companies in this space. That potentially offers an opportunity in companies with great track records like Medibank Private (ASX:MPL).

Finally, people often ask about bonds after their recent underperformance. For me, bond cycles tend to be drawn out over 30-40 years, and we are year four into this current bear market. If history is any guide, bonds may have rallies, but they're best sold rather than bought. I prefer putting money into fixed-term deposits, which are offering attractive real returns with yields well above the rate of inflation.

Super funds have been battered in the press of late. My article this week adds (inadvertently) to the pile-on. I suggest that while the performance of the largest super funds has been admirable, they've become so big that it will make it difficult for them to outperform their benchmarks in future. It's something that isn't widely discussed but should be.

James Gruber

Also in this week's edition...

The world and Australia's retirement landscape have changed a lot since 2020, and **Kaye Fallick** thinks that if the Retirement Income Covenant is to achieve its goals, a wider spread of responsibility and a rethink across all five pillars of retirement planning are needed.

To give you an idea of how much you will need to live on in retirement, the Association of Superannuation Funds Australia provides the ASFA Retirement Standard. **Pascele Helyar-Morey** says that the standard doesn't reflect reality, especially for women. She says more needs to be done to address the growing gap in superannuation balances between men and women.

Investors have cheered Donald Trump's focus on deregulation and for the federal government to play a smaller role in the economy and financial markets. **Robert Almeida** from **MFS** says that investors may not have fully thought through the implications of this policy. He says it will impact business profitability, which could dampen the market's enthusiasm.

The market share of ETFs and index trackers keeps rising and with it concerns about reduced market efficiency. **Joachim Klement** says some of these concerns are valid, though he doubts we've seen 'peak ETF' and there doesn't seem to much that active managers can do about it.

Any discussion on annuities needs to address the credit risk associated with relying on the solvency of a single insurer. **David Orford** and colleagues offer a helpful guide on the regulation of annuities and the best ways to assess solvency risk.

Can a crime invalidate a will? A lot depends on the nature of the crime, says **Nick McColl**.

Lastly, in this week's whitepaper, **RQI Investors** – part of **First Sentier** – takes a deep dive into profitability and why it's a useful measure for investors and might be persistent through time.

Is the Retirement Income Covenant really the right answer?

Kaye Fallick

In July 2020, Michael Callaghan, Deborah Ralston and Carolyn Kay presented the final report of the *Retirement Income Review*. In brief, this government-initiated review found that Australia's retirement income system was working for most retirees and that, with a few tweaks and more concentration on certain vulnerable groups, it was fit for purpose.

But the Review also found that the move from the accumulation phase to decumulation was 'underdone', and that it was up to the trustees to ensure that their super funds would more pro-actively guide members towards more secure retirement funding outcomes.

Enter the Retirement Income Covenant (RIC), which was enacted in legislation taking effect on 1 July 2022. Since then, regulators ASIC and APRA have issued a series of negative report cards on the progress of this requirement, accompanied by much hand wringing about the funds' commitment to the Covenant.

But there have been no real consequences, which begs the question how patient the regulators will be with the slow delivery of this reform. How long should it take? How much latitude will the funds continue to be given? Why so much carrot and so little stick?

This leads one to question the whole point of the RIC and ask if it was a *good* idea, poorly executed or just a *poor* idea with little chance of success, regardless of how it was executed.

Or maybe something else entirely.

A lot has changed in the two and a half years since the RIC became law. Such changes include:

- Continued growth in the combined funds under management for the superannuation sector. This was $3.3 trillion in June 2022 – it is now $4 trillion, growing at nearly 10% per annum according to APRA.
- The rate at which Australians are retiring has increased, largely due to the spike in population represented by baby boomers in their 60s. Estimates vary, but at least 700 people are retiring on a daily basis.
- There is a rapidly shrinking pool of financial advisers to cover the needs of those entering retirement. Adviser numbers are down to about 15,000 nationally compared to a peak of 26,000. The ratio of advisers to retirees in cities is low, but it's even worse in the regional towns and rural areas.
- Economic shocks such as those experienced during the pandemic have undermined confidence in long term returns on retirement savings.
- Ongoing economic volatility, evidenced by increased cost of living and higher interest rates further reduce retirement planning confidence.

- A sharp increase in the proportion of Australians carrying a mortgage into retirement means that more than 50% of those aged 55-59 are doing so.

There is also an entirely different sentiment toward industry super funds, which hold the lion's share of the nation's retirement savings.

When mandatory super was introduced in 1992, industry funds were the poor cousins to the more glamorous, strongly marketed retail funds, many owned by major banks. But over time poor performance by retail funds means that the lower fee, better performing industry funds have gained strength and membership.

More recently, industry funds have attracted so many assets that they have needed to head offshore to find suitable scale investment opportunities. The union origins of industry funds have tended to invite ongoing scrutiny of trustees, board makeup and marketing funds by conservative politicians. The slow processing by CBUS of death benefit claims has now resulted in Federal court proceedings by ASIC - and perhaps a class action.

It's clear that the industry funds are no longer the darlings of the sector that they were in 2022. This is likely to further exacerbate a general lack of confidence in retirement planning.

Another less easily recognised change, but arguably one with far higher consequences, is the significant growth in the complexity of retirement funding, which relies on not one, two or three, but now five pillars:

- the Age Pension,
- superannuation,
- private investments,
- work income and
- home equity.

Some retirees will be restricted to only one or two, others three or four, while some will utilise all five pillars. But here's the challenge: each pillar interacts with each of the others, and changing a setting on one pillar changes your options with another. Consider the following example of using some super to pay off your mortgage.

In one move you've changed your super balance, so your expected drawdowns will be lower and longer-term earnings will compound at a lower rate. You've also potentially improved your Age Pension entitlements because funds have moved to a means-tested asset to a non-means tested asset, namely your home. And you have increased the value of your home, thus changing the potential equity access opportunities.

Phew! If it feels like a game of snakes and ladders, that's because it is. How does the average Australian cope with the complexity of these diverse but interconnected rules? Most don't.

Retirement income literacy is not sufficiently entrenched to enable a majority of them to tackle the intricacies of retirement income planning. A recent survey finding revealed that fewer than 50% of retirees understood what preservation age was. Given it is when (subject to meeting certain conditions) one can access super, this basic lack of knowledge is a poor start to the necessary further financial decision-making.

What does this all mean for the RIC?

The legislative requirement for funds to take responsibility for guiding and supporting 'retirees to have the confidence to spend their hard-earned savings, while enabling choice and competition' is a huge ask. One which raises some important questions:

- Super funds are being asked to do the heavy lifting – all of it, basically, on behalf of the four other pillars of retirement income. Why?
- Despite the RIC being a legislated requirement since 2022, the funds' response to date seems to be to devote time, money and resources into developing or white labelling products (typically lifetime income streams) as opposed (with the exception of one or two larger funds) to creating a customer journey with the intention to educate, inform and support. Is this evidence that they prefer a financially rewarding strategy over one that helps members?
- Is there a fundamental conflict of interests inherent in the RIC? Do super funds really want most of their members to withdraw more money, earlier and more regularly, than they have been? Or would they prefer to have a higher level of funds under management?

If an RIC isn't the solution, then what is?

It appears to be both unfair and unproductive to expect the funds alone to solve the problem of retiree engagement, timely decumulation and productive management of their savings and resources.

Part of the responsibility for this program is that of the Federal Government. Yet successive governments have abdicated this responsibility for decades. A few dollars now being thrown at the Moneysmart website to supplement its retirement section is hardly going to help solve such a huge problem. So what will?

Let's go back to the five pillars of retirement funding. What if each pillar 'owned' a share of the responsibility, and therefore the actions needed to support the transition from work to retirement. Here's how it might work:

1. The Age Pension is the foundation of most Australian retirements – about 65% of retirees from age 67 and about 80% of retirees in their 80s. This pillar needs to be better explained and serviced by the provider, the Federal Government. This could include information on how pension payments combine with super to form a higher income stream and public education programs, targeted to different ages and retirement stages, sharing specific explainers about options, actions and outcomes are needed. An expansion of Centrelink's Financial Information Service (FIS) would also help, particularly in rural and regional areas – a regular nationwide roadshow would also reach those in need.

2. Superannuation will mature from its current status as a 'top up' to the Age Pension and become a main income stream in a decade or two. The education and information about transitioning from accumulation to decumulation should rightly be offered by all funds. But they don't need to reinvent the wheel – nationally approved templates could be used by all super funds (including SMSFs) for this purpose, saving time and resources and avoiding multiple compliance checks.

3. Private savings and investments are not 'owned' by any one group. Here there is a role for the entity which sets many of the rules – the ATO. Additionally it is incumbent upon individuals to step up and educate themselves on this form of retirement income, with perhaps a minor role for the ASX and other investment institutions.

4. Work income in retirement is becoming more prevalent. Education about transitioning to retirement could be provided by HR departments, with Centrelink needing to do a better job of explaining Work Bonus credit rules. Workplaces could do a far better job of ensuring that departing employees are aware of the fundamentals of retirement income.

5. Home equity can be accessed by using the government's Home Equity Access Scheme (HEAS) or a reverse mortgage. Both the Federal Government and private mortgage providers need to explain these schemes in plain English (and other languages) so retirees can consider this 'under the radar' fifth pillar.

And if there is one Age Pension reform worth pondering – one suggested by financial experts such as David Knox at Mercer and Greg Jericho from The Australia Institute - it's a serious consideration of whether the income test should just be removed.

This could reduce Age Pension complexity while encouraging more older workers to remain healthily engaged in the workplace. Tax would be paid on extra work income, thus ameliorating some of the costs.

Not all of these ideas will work, but what they might achieve is two things.

First, they would share the load of providing support for retirees across the five main pillars of retirement income in a much more equitable way. It is not just the job of the super funds.

Second, spreading the huge responsibility outlined above could result in quicker and more efficient progress towards the RIC's original goal: to help Australians face their retirement journeys with a far higher degree of retirement income literacy and confidence.

Kaye Fallick is Founder of STAYINGconnected website and SuperConnected enews. She has been a commentator on retirement income and ageing demographics since 1999. This article is general information and does not consider the circumstances of any person.

Are mega super funds' returns set to fall?

James Gruber

Our superannuation system receives almost universal praise, and rightly so. It's served us well.

Yet, growing pains within the system are becoming apparent. For instance, there's been rising pressure on funds to better meet the retirement needs of Australians.

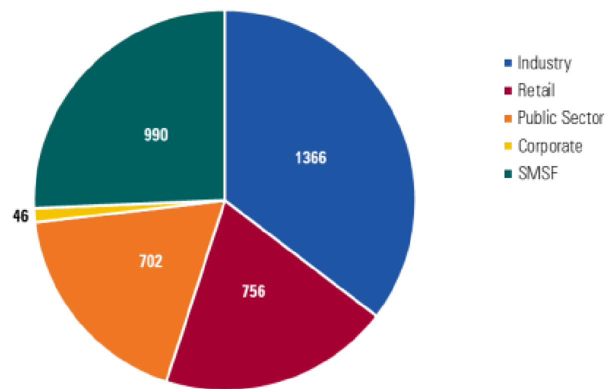
I'm going to suggest that pressure may come from another source in the not-to-distant future: from mega super funds struggling to outperform their benchmarks.

Why do I say this? Because the mega funds are becoming so big that their size will almost inevitably impact their performance.

If I'm right, it'll make it even more important to find the right fund for you.

Supersize me

A recent Morningstar report highlighted the successes of our superannuation system. Sector assets have soared from $150 billion in 1992 to more than $4 trillion today, and some forecast that number to rise to $9 trillion by 2040. The super sector is among the five largest pension pools in the world. That's quite the feat given Australia's population is outside the top 50 countries globally.



Source: APRA. Data as of June 30, 2024.

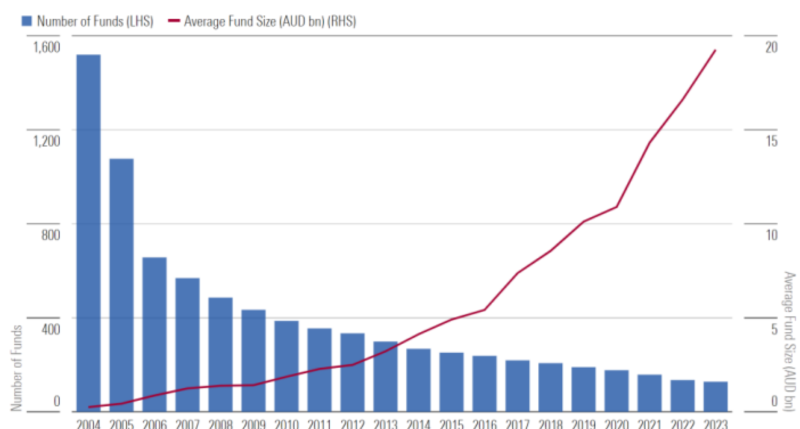
Super assets dwarf those of almost any sector in Australia, barring residential property. They're 40% larger that Australia's GDP. And they account for about 80% of local managed fund assets.

There are more than 60 licensees with a combined $2.7 trillion in assets—around 70% of sector assets— managing the super of over 90% of the population with superannuation balances.

The rise of mega funds

Normally, with the growth in assets that super has seen, you'd expect more competition and a greater number of players entering the sector. But that hasn't been the case.

In fact, the number of APRA-regulated funds has fallen by 93% over the past 20 years. Consequently, the average fund size has rocketed from $250 million in 2004 to $19 billion now.



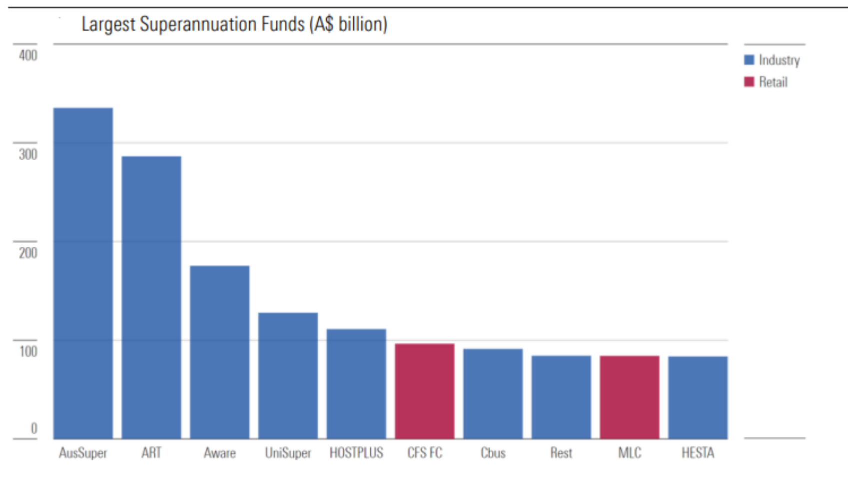
Source: APRA. Data as of June 30, 2023.

APRA has encouraged consolidation in the sector. It's labelled funds with less than $30 billion in assets as "uncompetitive'.

That's led to a spate of mergers, both large and small. The larger ones include First State Super and VicSuper forming Aware Super in 2020, and Sunsuper and QSuper

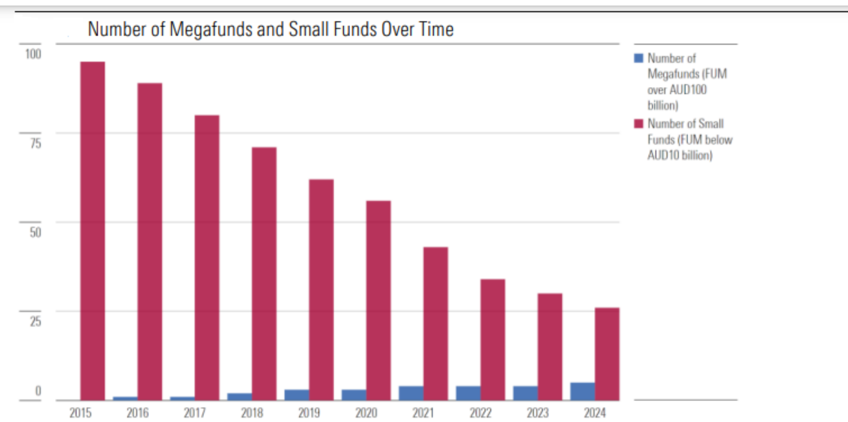
teaming up to create the Australian Retirement Trust in 2022.

And it's led to the rise of five so-called mega funds: Australian Super, ART, Aware Super, UniSuper, and Hostplus. Three others, in HESTA, Rest, and Cbus may join this club soon.

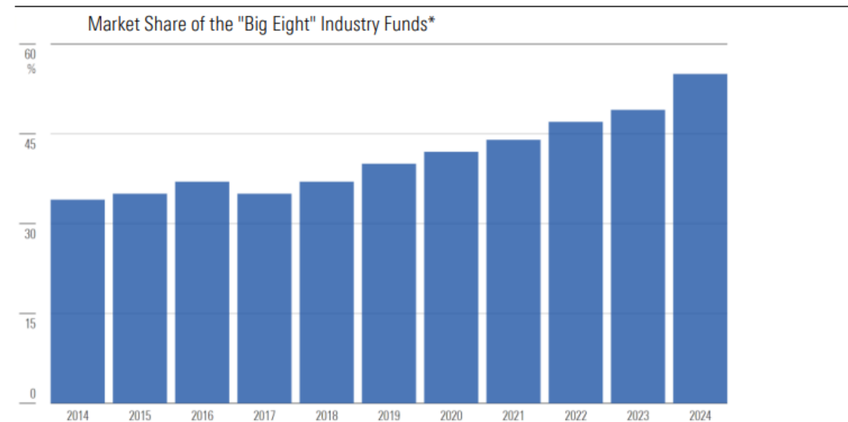


Source: APRA. Data as of March 31, 2024.

These eight funds control more than 50% of super assets. The largest of them, AustralianSuper and ART, hold about 25% of the sector's assets.



Source: APRA. Data as of June 30, 2023.



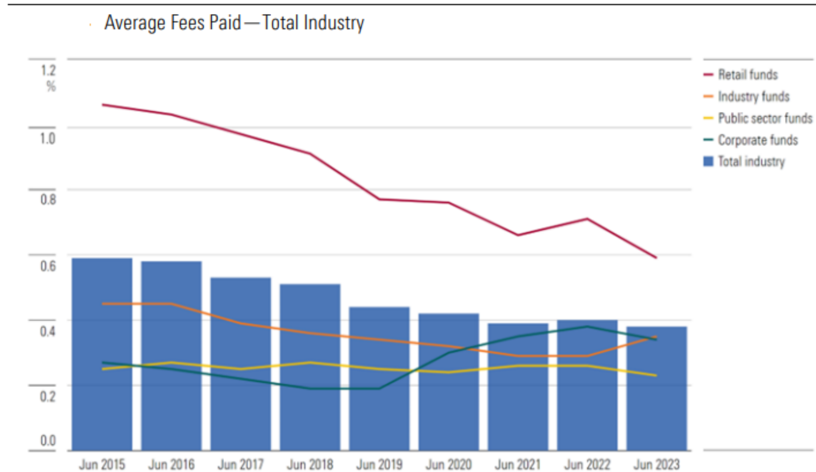
Source: APRA. Data as of March 31, 2024.

* 2021 and earlier combines QSuper and Sunsuper (ART), and 2019 and earlier combines First State Super and VicSuper (Aware). Both were combined through a "merger of equals" rather than an absorption of a large fund by a small fund.

Benefits of scale

As Geoff Warren and Scott Lawrence have pointed out in a previous Firstlinks article, size brings two key advantages. First, it lowers the cost per member, aka economics of scale. Mega funds can reduce costs by managing assets in-house, negotiating lower fees for external investment managers for larger mandates, and by spreading administration costs over a larger customer base.

Morningstar says that the percentage of fees paid (incorporating administrative, investment, and insurance costs) across the industry has fallen by more than 20 basis points, from 0.59% to 0.37%, since 2015.



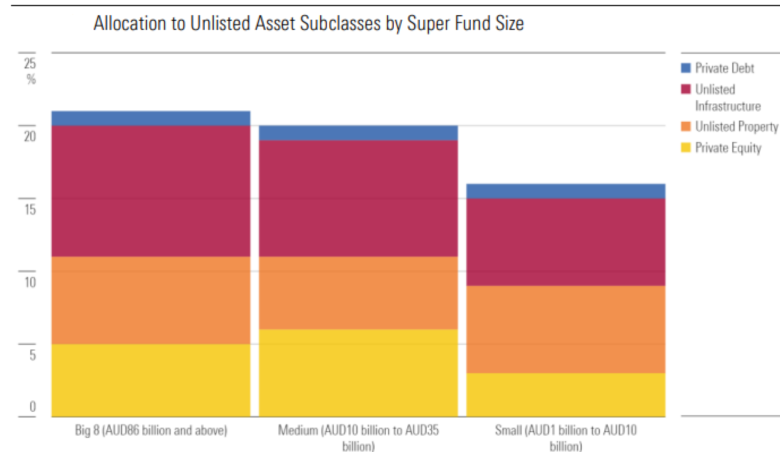
Source: APRA. Data as of June 30, 2023.

The second advantage of size is on the investment side. Scale allows mega funds to invest in larger assets that smaller funds can't touch. The funds have been investors in infrastructure projects, for instance. And they've also ramped up investments in other private assets over the past decade.

Size limitations

Size also brings disadvantages. It inevitably makes the funds more complex and bureaucratic. We're already seeing some evidence of this with their attempts to cater to the growing retirement needs of their members.

The second disadvantage is that size limits where mega funds can invest. Consider that AustralianSuper is aiming to increase assets from $341 billion to $500 billion by 2028. Investing that amount of money on a daily, monthly, and yearly basis will be challenging to say the least.



Source: APRA. Data as of March 31, 2024.

The size factor may partly explain why the funds have moved so aggressively into international and private assets. A number of the funds have said that the moves are due to these assets offering more opportunities and greater returns. However, I think there's also been an element of 'force' at play. Australian assets, including equities, have become too small for many of these funds and that's forced them to look elsewhere for returns.

Studies show size reduces returns

The investment disadvantages of size haven't received the attention they should. That's largely explained by the impressive historical performance of the super funds.

I suggest that outperformance from the mega funds will become more difficult going forwards.

Why do I say this? First, because numerous academic studies have concluded that size impacts the performance of funds.

A 2015 paper by Lubos Pastor and colleagues for the Journal of Financial Economics found that as the size of the active mutual fund industry increases, a fund's ability to outperform passive benchmarks decreases.

A 2018 study by Ping McLemore detailed how fund mergers resulted in deteriorating performance of the acquiring funds, and liquidity played an important role in the negative relationship between size and performance.

A 2020 paper by Pastor and colleagues studied tradeoffs among active managers and found "diseconomies of scale" among these managers.

There is other evidence of scale impacting performance. Look no further than one of the world's greatest ever investors, Warren Buffett. His company, Berkshire Hathaway has returned 19.8% since 1965, compared to the 10.2% of the S&P 500. That outperformance of almost 10% is superb, yet deceptive.

As Ashley Owen has pointed out, most of the outperformance came from 1965-1990, and it's been downhill since. Berkshire outperformed the index by 27% per annum (p.a.) in the 1960s, 16% p.a. in the 1970s, and 21% p.a. in the 1980s. However, it has only performed roughly in line with the index since 2002.

What explains the steep fall in Buffett's outperformance? It's likely to be less about skill and more about size. Consider that Buffett is currently sitting on a cash pile of about US$325 billion, which is larger than the market capitalisations of 477 of the 500 companies in the S&P 500. He's having a harder and harder time investing the enormous cash that Berkshire is generating.

Pick your fund wisely

This is not to say that all mega funds will suffer. The main point is that the funds have enjoyed the fruits of scale up to now, as have their members. Yet, the downsides of scale are just starting to show, and are likely to become more apparent in future. Some funds will handle these challenges, while others won't.

Monitoring fund performance, portfolio composition, and risks will become even more critical for superannuants.

James Gruber is Editor at Firstlinks.

Australia's shameful super gap

Pascele Helyar-Moray

I have presented to thousands of women on superannuation. I always ask my audience to raise their hands if they know how much money they will need to retire on. Usual response? Crickets. Honestly. I can only recall one presentation where a few hands in the room went up – and that was in Canberra, where the majority of the audience was government employees, so it wasn't surprising.

To give you an idea of how much you will need to live on in retirement, the Association of Superannuation Funds Australia (ASFA) provides the ASFA Retirement Standard, where it outlines annual and weekly budget figures for different standards of living – 'modest' and 'comfortable' – and based on whether you're single or part of a couple.

ASFA updates their budget guidelines every quarter, factoring in inflation and a host of other inputs. For reference, at the time of writing the maximum Age Pension is $1116.30 per fortnight for a single person, including all available supplements. This works out to around $29,024 per annum, which is really a small supplement rather than anything that can be relied upon.

ASFA defines a 'modest' retirement lifestyle as one that is 'considered better than the Age Pension, but still only allows for the basics' – such as basic health insurance and infrequent exercise, leisure and social activities with family and friends. For the March 2024 quarter, the budget for this lifestyle worked out to be $32,915 per year for a single person aged 64 to 84.

'Comfortable' is defined as allowing 'an older, healthy retiree to be involved in a broad range of leisure and recreational activities and to have a good standard of living through the purchase of such things as; household goods, private health insurance, a reasonable car, good clothes, a range of electronic equipment, and domestic and occasionally international holiday travel'. For the March 2024 quarter, this lifestyle tallies to $51,630 per annum for a single person aged 64 to 84.

The following tableS provides a snapshot of ASFA's living standards.

ASFA Retirement Standard, March 2024

	Couple		Single	
Expenditure items	Comfortable lifestyle	Modest lifestyle	Comfortable lifestyle	Modest lifestyle
Building and contents insurance	$44.34	$44.25	$41.82	$34.82
Council rates	$44.53	$40.67	$44.53	$38.32
Water charges	$26.50	$26.50	$22.81	$22.81
Home improvements	$7.96	$0.00	$7.96	$0.00
Repairs and maintenance	$23.86	$23.86	$23.86	$23.86
Total housing	**$147.18**	**$135.28**	**$140.98**	**$119.81**
Electricity and gas	**$62.83**	**$53.71**	**$50.66**	**$39.99**
Food – groceries and other fresh food	**$248.64**	**$205.13**	**$143.05**	**$110.64**
Bundle of home phone, broadband, mobile	**$29.70**	**$20.55**	**$22.82**	**$18.25**
Household cleaning and other supplies	$30.84	$18.43	$23.64	$18.43
Cosmetic and personal care items	$7.61	$7.29	$5.44	$5.21
Barber or hairdressing	$27.68	$12.25	$18.03	$7.35
Media, including digital	$9.58	$2.80	$9.35	$2.80
Computer, printer and software	$5.07	$2.85	$5.07	$2.85
Household appliances, air conditioners, smart phone	$17.97	$2.94	$16.59	$2.94
Miscellaneous	$7.75	$0.00	$7.75	$0.00
Total household goods and services	**$106.50**	**$46.56**	**$85.87**	**$39.58**
Clothing and footwear	**$52.04**	**$39.76**	**$27.95**	**$20.92**
Car transport and running costs	$189.49	$111.82	$177.31	$107.43
Public transport	$5.59	$5.59	$2.79	$2.79
Total transport	**$195.08**	**$117.40**	**$180.11**	**$110.23**
Health insurance	$93.52	$35.74	$46.75	$17.87
Chemist	$50.36	$25.18	$28.99	$14.49
Co-payment and out of pocket	$66.63	$49.28	$36.97	$24.65
Vitamins and other over the counter medicines	$6.26	$0.00	$3.12	$0.00
Total health services	**$216.77**	**$110.20**	**$115.84**	**$57.01**
Membership clubs	$6.76	$4.50	$4.53	$3.37
TV, DVD	$1.21	$0.46	$1.21	$0.46
Streaming services (Stan/Netflix or like)	$12.30	$3.30	$12.30	$3.30
Alcohol consumed or equivalent spent with charity or church	$46.27	$26.16	$22.17	$17.35
Lunches and dinners out	$97.29	$50.96	$69.49	$30.11
Cinema, plays, sport and day trips	$11.27	$13.51	$6.76	$6.76
Domestic vacations	$90.45	$63.20	$59.42	$40.06
Overseas vacations	$34.93	$0.00	$22.05	$0.00
Take away food, snacks	$32.79	$17.10	$23.87	$12.72
Total leisure	**$333.27**	**$179.20**	**$221.80**	**$114.13**
Total weekly expenditure	**$1,392.01**	**$907.80**	**$989.07**	**$630.55**
Total annual expenditure	**$72,663.00**	**$47,387.00**	**$51,630.00**	**$32,915.00**

Numbers are weekly, except where otherwise specified. Totals may not exactly equal the sum of components due to rounding of price adjustments.
Reproduced with kind permission from ASFA.

To check the most recent ASFA Retirement Standard, go to superannuation.asn.au/resources/retirement-standard/

While I appreciate the good folk at ASFA are trying to strike a balance between catering for the average Aussie and not terrifying the daylights out of us, more than a few generous assumptions are baked in here:

- These prices are not reflective of pricing in any metro area – unusual, given that 87% of us live in metro areas, according to Statista. As a Sydneysider, the estimates around hair services, cinemas, snacks and dining out caused me great amusement.
- Chemist costs – something I would deem 'essential', particularly at retirement age – do not scale in the way shown in ASFA's figures, simply based on whether you're part of a couple or not. Similarly, water, electricity and gas costs don't quite work the way they're laid out either.
- Co-payment and out-of-pocket costs for health services – again, at this age and stage of your life, your biggest spend is likely to be on your medical bills – also look to be very low.

Among all these medium-sized flaws, this budget also contains a huge problem, an issue of which very few people – even those who work in the super industry – are aware.

Run your eye down the line items again. What do you see? Or rather, what do you not see? Well spotted. You do not see a line item for mortgage and rent payments.

That's correct – the ASFA figures assume that you own your property outright by the time you reach retirement. This may have been a fair assumption to have made in 2004, when the ASFA Retirement Standard was created, however, we need to consider how the economic and property environments have iterated 20 years on.

These changes include the following:

- Mortgage and rent payments can comprise up to 44% and 31% of income respectively, according to the Real Estate Institute Australia Housing Affordability Report March 2023.
- The average Australian first home buyer is now aged 36, according to realestate.com.au – and will only become older, given property prices outstrip wage growth by a factor of 10.
- Around 2.9 million people, or 31% of all households, were rent-payers in 2019–20, up from 28% over the last 15 years, according to the Australian Institute for Housing and Welfare (AIHW).

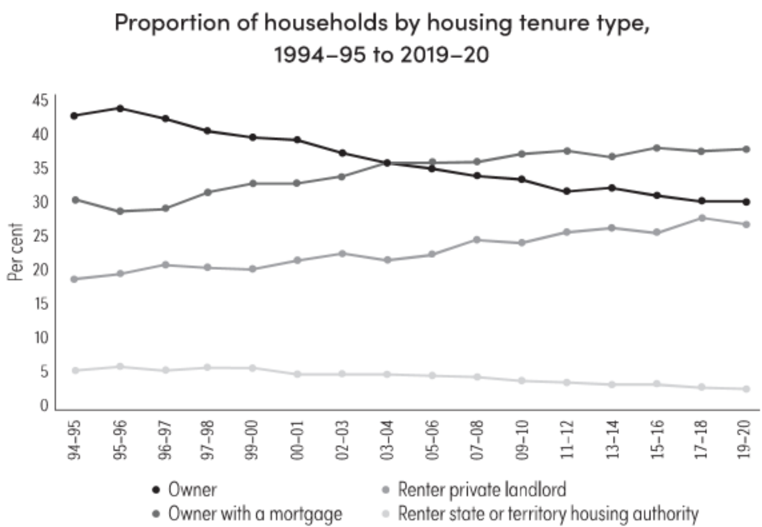
It's worrying that the super industry standard does not include mortgage or rent in its retirement budget calculations. The standard is relied on for member guidance by the super funds' retirement planning websites such as Super Guru and Moneysmart.

Another factor at the time of writing is that record numbers of retirees are accessing their super to pay down their mortgage. ABS statistics show that the rate of outright home ownership by those in the 55 to 64 age bracket was 40% for 2021, having dropped from 65.1% in 2001.

Meanwhile the number in that age group with a mortgage had more than doubled, increasing from 15.5 to 35.9% in the same 20-year period. These trends are best represented by the following figure, sourced from AIHW. Also note the trend shown in the figure for private renters.

This group has increased substantially, reflecting those who have been priced out of the property market. Without their own properties, these people will definitely be paying rent in their retirement.

Bottom line – when calculating how much you'll need to live on in retirement, don't forget to factor in some element of mortgage or rent payment.



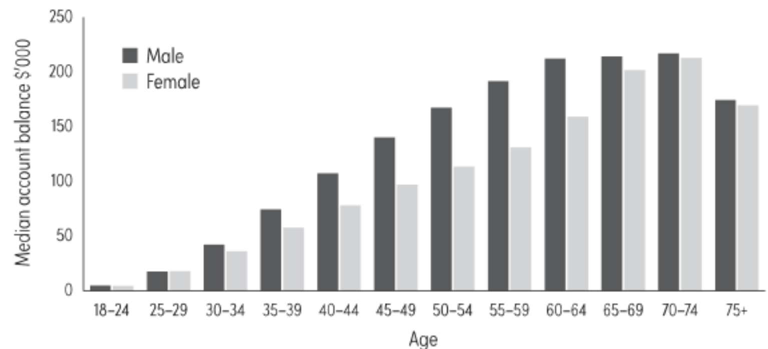
Source: Australian Institute of Health and Welfare.

How much will you need for retirement?

The average Australian woman lives to be 85.3 – so if she retires at 68, she will have almost 20 years of living expenses she will need to fund. The multiplication of these two numbers ($32,915 times 20) is over $650,000 – and that's without indexing for inflation.

When articulating these calculations, a glacial chill fills the room. I look at my audience to discover that most of them have a look of terror on their faces. The remainder are fighting back tears – with no other emotion in between.

You see, these women are also calculating the gap: the gap between $650,000 and what their current super balance is – which, if you're a 40- to 44-year-old woman, is likely to be around $107,000 according to 2021 ASFA data of super balances by age and gender.



Effectively, I have just spelled out to them that they need to grow their super balance by a factor of more than 3.5 over the course of the next decade or so. I may as well have told them to fly to the moon.

Australia's shameful super gap

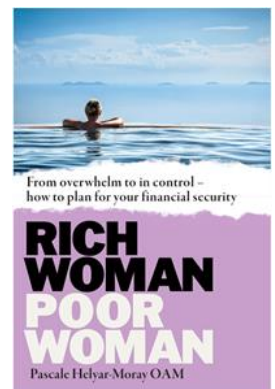
The super gap is reflected in the median super balance for men and women shown in the following figure, based on 'Taxation statistics 2020–21', available via the Australian Tax Office website (ato.gov.au). You can see how the data diverges between men and women as early as their post-graduate earnings; the gap then increases as women hit their 30s – typically the child-bearing years.

Even more stark are the following figures: the 2016 Senate Inquiry into Women's Economic Security in Retirement found one in three women were retiring in Australia with no super at all. ABS figures from 2022–23 aren't much better, with only 21.4% of women reporting superannuation as their main source of income in retirement, compared to 33.2% of men, and a further 18.4% of women reporting no personal income, compared to 4.4% of men.

The reason for these statistics is, quite simply, the gender super gap. Now, is it just me or do you find these statistics incredible? How is it that in a country as rich as ours, we treat 51% of the population this way? How have we built a retirement system in this country worth $3.5 trillion – trillion – yet we 'forgot' about half the population along the way?

Pascale Helyar-Moray OAM is the founder of Grow My Money, a platform where members can shop with scores of major Australian brands and receive a cashback into their superannuation account.

For a full guide to overhauling your super and wealth as a woman in modern-day Australia, read Pascale Helyar-Moray's new book Rich Woman, Poor Woman*, published by Major Street Publishing. The publisher is offering Firstlinks members a 25% discount off the purchase of Rich Woman Poor Woman from the Major Street website. Just key in **MORNINGSTAR25** at the checkout and your discount will be applied.*



How will stocks fare with a smaller US government?

Robert M. Almeida

With the best post-election day performance for the S&P 500 in decades and a continued bid for stocks in the days after, investors are enthusiastic about the policies that may be put forth during a second Trump term.

Investors have particularly welcomed Trump's focus on deregulation and for the federal government to play a smaller role in the economy and financial markets.

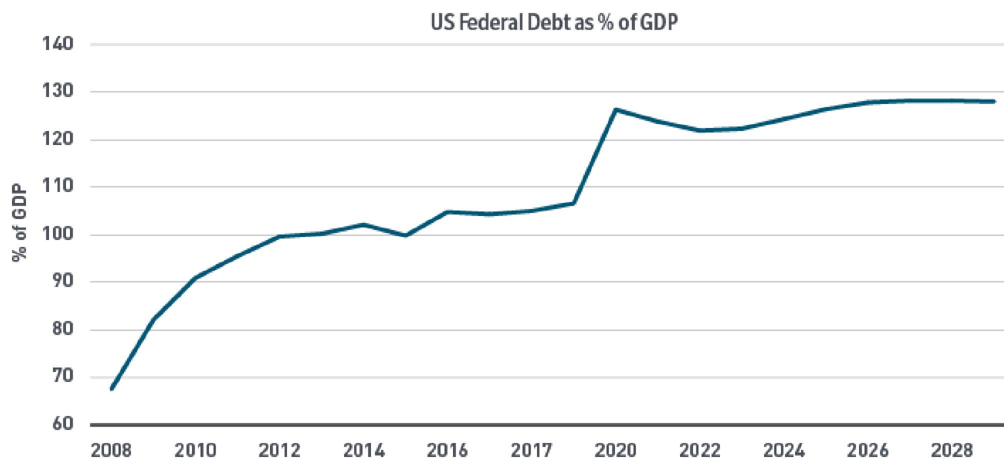
The government has been a very large player

The purpose of capitalism is the allocation of societal resources by the private markets. Instead of bureaucrats, capitalist systems prefer to allow the 'wisdom of crowds' to determine what projects should be funded and where capital should be pulled from to drive societal growth.

How much has government been involved in this process? Since the global financial crisis (GFC) of 2008, the answer is a lot.

Exhibit 1 charts the ratio of US government debt to GDP, which has grown from 68% before the financial crisis to an astonishing almost 130% today.

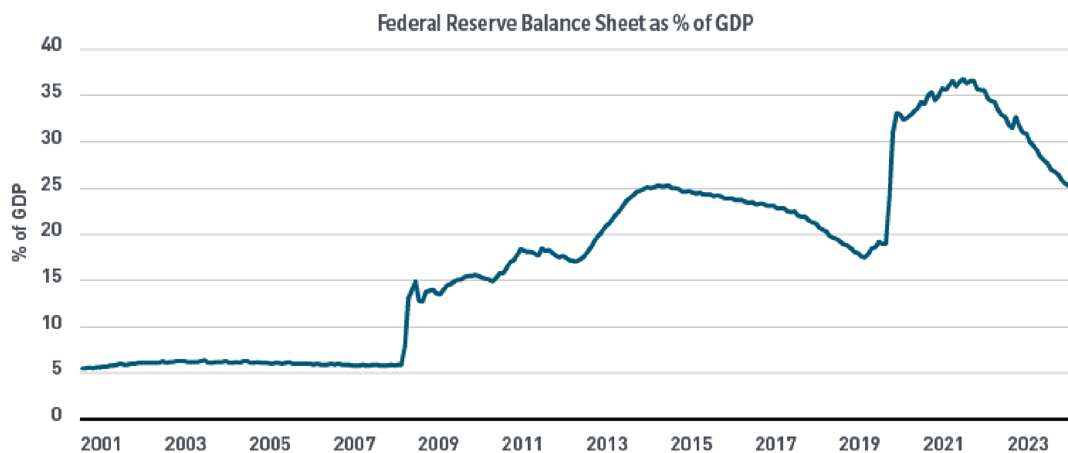
Exhibit 1: US government debt-to-GDP ratio has exploded



Source: Bloomberg. Annual data from 31 December 2008 to 31 December 2023. Data from 2024 to 2029 are estimates.

Exhibit 2 captures the growth of the size of the US Federal Reserve's balance sheet as a percentage of the economy since the turn of the century. From its average of 5% pre-GFC, it has ballooned to 25% today. Twenty-five cents out of every dollar of GDP is held by the US central bank. Said another way, the supply of money has exploded.

Exhibit 2: So has the Fed's balance sheet

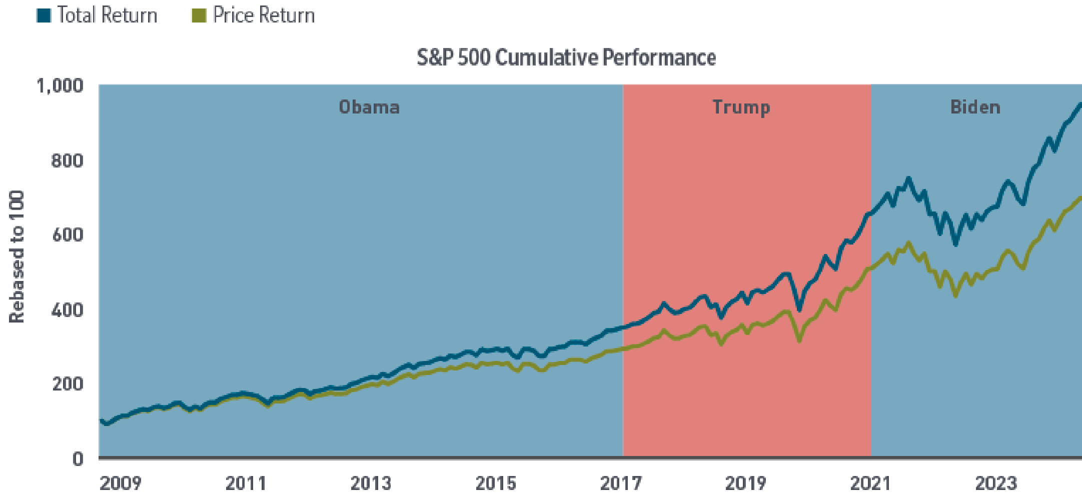


Source: Bloomberg. Monthly data from 31 January 2001 to 30 September 2024.

Finally, COVID stimulus policies, from the CARES Act to the American Rescue Plan, resulted in over US$5 trillion being fed into the US economy, culminating in a fiscal deficit rivaling only wartime periods.

For those surprised that the US avoided recession in the last year or two, the explanation is simple: The economic soft landing the US is experiencing was purchased at great cost.

How did stocks fare during this period of exponential government growth? Starting at the beginning of the Obama administration to the end of October 2024, the S&P 500 returned 839% for an annualized return of around 15%.[1] Whether under President Obama, Trump or Biden, stocks greatly exceeded normal historical return and risk profiles.



Source: Bloomberg. Daily data from 16 January 2009 to 31 October 2024.

Via monetary and fiscal policies, the US government's involvement in the private sector effectively allowed for the privatization of wealth in good times and for the socialization of losses in bad ones.

This has reduced the ability of the private sector to efficiently price risk and allocate capital and resources under both Democratic and Republican administrations. So where might we go from here, with deregulation ahead, but also tariffs?

The look ahead

While most (certainly me) welcome less regulation and intervention by policymakers, investors need to consider our starting point today. The exhibit below, which is the cyclically adjusted price-to-earnings ratio for US equities over the last 100 years, may help.

Source: FactSet, Robert Shiller, Yale University Department of Economics. Monthly data from 31 January 1928 to 31 October 2024. US Shiller CAPE ratio is the price to earnings ratio based on average inflation-adjusted earnings from previous 10 years.

While prices today aren't as high as they were during the 1990s internet bubble, given the historical return of risk assets, we shouldn't be too surprised to see that they compare to the levels of the late 1920s. However, I'm not suggesting a redux of October 1929, or another Great Depression, as there are too many differences between the periods.

While valuation is one similarity, valuation alone can be a dangerous investment signal. Importantly, investors need to consider the pathway of future earnings, the denominator in the chart above, and the prime determinant of the prices investors will pay. Which brings me to one other similarity to the late 1920s: tariffs.

In 1929, investors began to discount the Republican Congress's plans to tariff over 25,000 goods entering the US. This mattered to investors because, while tariffs make US goods more attractive to domestic buyers, they drive up costs for US producers sourcing goods outside the country as well as consumers. While there were other catalysts heading into October 1929, the prospects of the Smoot-Hawley tariffs were a factor that changed both how investors thought about future profits and what they were willing to pay.

To be fair, long before the 2024 election, input costs had risen as capital and labor costs jumped. But companies were largely able to offset those pressures by passing on higher prices to customers and cutting spending in non-mission critical areas. What has changed is consumers have begun substituting goods and services where necessary, driving prices and inflation down, and lowering corporate spending in unnecessary areas. With the low-hanging fruit already plucked, profit margin protecting maneuvers will be harder to achieve in the future, bringing forward a new paradigm with far greater return dispersion in benchmarks.

In conclusion, less government involvement in the economy and markets is long overdue and welcome. But I think investors need to consider what a reduced government role may mean for the profitability of projects and businesses that are unable to offset rising cost pressures. As a result, I think Trump 2.0, specifically smaller government, may upend the performance dominance of passive investing.

Endnotes

[1] Source: Bloomberg, S&P 500. Cumulative and annualized return calculated using monthly data from 31 January 2009 to 31 October 2024. Returns are gross and in USD.

Robert M. Almeida is a Global Investment Strategist and Portfolio Manager at MFS Investment Management. This article is for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. It has been prepared without taking into account any personal objectives, financial situation or needs of any specific person. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This article is issued in Australia by MFS International Australia Pty Ltd (ABN 68 607 579 537, AFSL 485343), a sponsor of Firstlinks.

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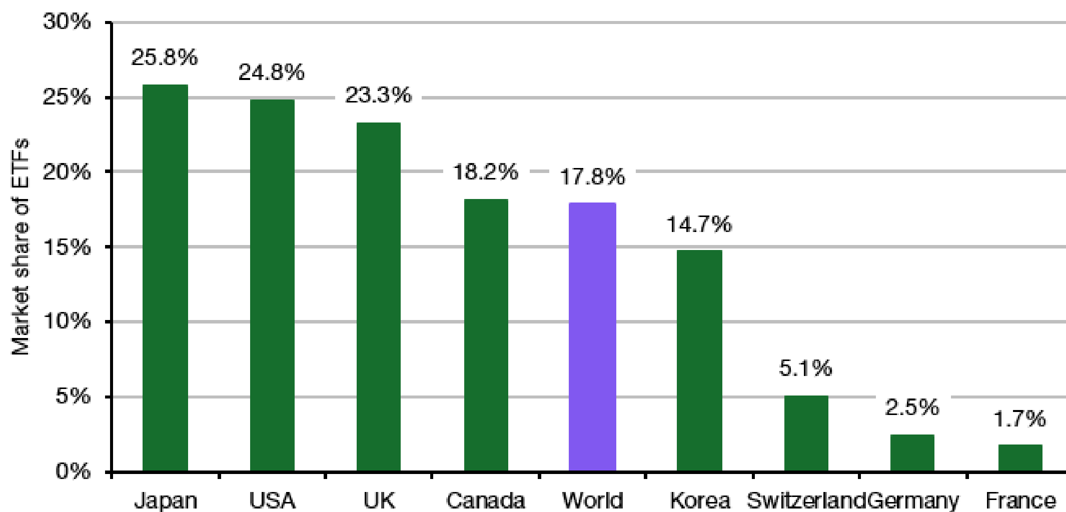
Where is peak ETF?

Joachim Klement

The market share of ETFs and index trackers keeps rising and with it concerns about reduced market efficiency. In theory, if everyone would simply track an index, new information would no longer be reflected in share prices, and it would become highly profitable to be active and short stocks with negative news flow while buying stocks with positive news flow. This theoretical argument shows that there should be an equilibrium between index funds and active investors or that markets stop working. But where that equilibrium is, is anyone's guess.

If we look at the latest figures from the Investment Company Institute about ETF market share in different countries (note this is across stocks, bonds, real estate, and commodities, so the numbers are lower than equity markets alone) we can see that in Anglo-Saxon countries, ETFs and index trackers typically have a much higher share than in continental Europe. Japan and South Korea seem to follow more the US and UK example, which is why we should consider Germany, France, or Switzerland outliers (there is a future post in that statistic somewhere).

Market share of ETFs across all major asset classes



Source: ICI, The Investment Association

The question is whether the market share of 15-25% reached by index trackers today is the peak. I doubt it and I expect index trackers to continue to gain share for many years to come.

But there are also increasing signs that with the rising share of index trackers, markets are becoming less efficient, particularly in the large-cap space.

Theresa Hambacher reviewed the last 20 years of research on index funds to see if index funds really reduce market efficiency and if active managers can drive markets back toward efficiency if too many investors switch to index trackers.

Her literature review concludes that the majority of studies show that the rise of index investing creates an 'index inclusion effect'. Historically, this index inclusion effect meant a price jump in stocks that are newly included in an index and a drop for stocks that are excluded. But this price impact has declined significantly and all but disappeared in the US.

Nowadays, the index inclusion effect is more related to other metrics, most notably an increase in liquidity in stocks in an index. With this increase in liquidity also comes an increase in investor attention and a somewhat higher valuation. The increase in investor attention leads to higher institutional ownership, higher analyst coverage, and increased media coverage. But it also has other, more material effects. Most notably, increased liquidity and higher valuations reduce the cost of capital for both debt and equity capital and thus give index constituents an advantage over smaller stocks that are not part of the index.

On the other hand, there is ample evidence that market efficiency and price discovery decline if index funds capture a larger share of the market. This should in principle give an opening for active managers, who on average increase price efficiency and take advantage of market mispricing.

The reality, however, is more complex. Market efficiency is driven by a whole lot of factors, not just the share of index funds. This means that if active funds capture market inefficiencies and make markets more efficient, this does not drive investors away from index funds. Instead, markets may adjust in such a way as to become more efficient without reducing the market share of index funds. Plus, market efficiency is not the only driver of index fund market share. Hence, active funds may outperform index funds and improve market efficiency but get no reward in the form of higher market share. Instead, index fund investors may simply free-ride on the work of active fund managers.

These two effects are not new. They have been known for some time. But taken together they imply that the market share for index trackers may well increase past the optimal level and stay there for many, many years. And there seems very little if anything that active managers can do to reverse that. Hence, we do not know where peak ETF is, and while active managers provide a valuable service in making markets more efficient, they are not necessarily rewarded for it by capturing a larger share of investor assets.

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Solvency risk with lifetime annuity providers

David Orford and team

Awareness is building in relation to the benefits and importance of lifetime income products (annuities) in Australia to address the needs of some retirees. In 2014 the Financial System Inquiry noted that "Managing longevity risk through effective pooling … could significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement, while still allowing them to retain some flexibility to meet unexpected expenses."[1] This finding has been echoed repeatedly in other government reviews and consultations.

As a result, SIS Reg 1.06A was added in 2017 to encourage product innovation. In 2019 Age Pension incentives were put in place to encourage the uptake of lifetime income products and we've seen an expanding number of new products emerging.

In the Retirement Incomes Review final report, the panel assumed retirees will allocate some of their superannuation to longevity products. We then saw the introduction of the Retirement Income Covenant which made it clear that super funds must help their members with these topics.

Australia now has 15 organisations that provide a lifetime income option for retirees. 'Lifetime' options are designed to pay income for the full lifespan of each individual customer – in contrast to account-based pensions that can run out.

The question about solvency risk of lifetime income product providers is therefore timely given these products run for a lifetime - perhaps 30 to 40 years into the future. A lot can happen to an issuer e.g. life insurer or super fund, in that time.

(Technically, 'annuities' can only be provided by life insurers, while 'pensions' can only be provided by superannuation funds. They are effectively the same product but provided by different types of providers, and superannuation funds don't have the capital required to provide guarantees themselves. This article mainly deals with annuities being provided by life insurers.)

Background – Regulation of annuities

All lifetime income providers in Australia are regulated and supervised under the Australian Prudential Regulation Authority (APRA) prudential framework which involves extensive monitoring and reporting. This covers life insurers that offer lifetime annuities and superannuation funds that offer lifetime income products to their members. APRA is a very inquisitive, active and incisive regulator and no life insurer has failed since the Life Insurance Act was established in 1945. In relation to lifetime annuities, no life insurer has defaulted on an annuity payment.

Insurance companies are subject to the Life Insurance Act. Each year, an annual financial condition report and quarterly returns must be produced by the Company's appointed actuary in addition to audits by independent firms. APRA is tasked with directing the entities which it supervises, including all lifetime income providers, to take actions to ensure they are able to meet their obligations both now and into the future. Providers must hold sufficient capital backing to demonstrate that they could meet a '1 in 200 year' adverse market event. Basically, if we were to experience the worst market conditions that a 200-year time period might be expected to deliver then lifetime income products are expected to be OK.

All life companies hold significantly more than the regulatory minimum capital and usually have the ability to raise more capital. This capital and retained earnings is held separately from the Statutory Funds or Benefit Funds, which themselves will usually contain sufficient reserves to meet those Funds' obligations over time. This means the assets supporting lifetime income streams are legally independent, quarantined and protected from any adverse trading conditions of the provider. In the event of an adverse event affecting the provider, the Statutory Funds and their reserves remain able to be dealt with separately as required by the Life Insurance Act 1995 and APRA.

Some life insurers also set up reinsurance arrangements where a reinsurer takes on some of the longevity risk too. Reinsurance transfers some (or all) of the mortality risk away from the provider– so less capital is required by that provider. Reinsurers are often global companies that aggregate capital and insurance business on a world-wide basis – so are not subject to just one market or country and thus have a great spread of risks and less volatility of performance than a national insurer. Reinsurers are subject to regulation in their country of origin as well as the countries in which they operate. However, reinsurers are also subject to failure.

When insurers have looked like they may experience difficulty in the past, APRA has worked with them to restore solvency, which can include asking shareholders to inject more capital or asking them to appoint another insurer to take on the business in their Statutory Funds.

Assessing the solvency risk of a particular provider

Things to look at when assessing the solvency risk of a particular lifetime income product provider include:

- Benefit design of the product – in particular what is guaranteed and what risk is passed on to customers or the reinsurer. See the next section.
- Who provides the guarantees.
  - With self-insured pools such as a Group Self Annuitisation (GSA) scheme or lifetime products managed by some superannuation funds, there is no guarantor – meaning that any problems directly impact the assets (and thus solvency) supporting the product. If the product experienced problems i.e. lighter mortality experience than forecast, it may result in a reduction in income payments to customers, rather than losing all their money.
  - In other cases the provider e.g. a local insurer, may work closely with another insurer or reinsurer which provides the whole or some of the guarantees.
- The ratio of (a) the assets available to (b) the present value of future annuity payments to customers (the 'liabilities').
- If there is a concern, what has APRA said about that product provider?

The calibre of management is crucial, but hard to assess. That's why APRA visits product providers regularly and asks telling questions. It is also why APRA requires life insurers to hold operational capital separate to the assets of the product — to protect the investors against poor operational management.

What could cause problems for lifetime income products?

The key risks for lifetime income providers are when the cost of providing the promises made to customers are different to the assumptions that were made when customers purchased the products. This can include:

1. Investment returns not being sufficient to support guaranteed income levels.

Some insurers that provide investment guarantees may experience problems with an asset-liability mis-matching risk, which arises where some of the assets held in the Statutory annuity fund mature but get re-invested at a lower rate than initially assumed. Similarly, the terms on which investments are sold are important e.g. have interest rates risen since the investment was purchased resulting in a loss?

The asset-liability mis-matching risk does not apply to investment-linked lifetime annuities as the actual investment performance is passed on to customers (in a similar way to other superannuation products e.g. via unit prices). Pure investment-linked annuities have an exact matching between assets and liabilities when it comes to investment performance – as the retiree bears the investment risk as they do before retirement and after retirement with Account Based Pensions or ABPs or personal investments.

2. Benefits paid to customers being higher than anticipated.

There are several examples where this may occur:

- With inflation linked annuities. If inflation is higher than expected, then this might be a strain on the assets supporting the product unless they correspondingly increase in value.
- If customers live longer than expected. This means the total income payments to customers will be more than anticipated – which puts a strain on the Statutory or other Fund supporting the product.

Note that lifetime income products that pass on good and bad investment performance to the customers do not provide any investment performance guarantees. This further reduces the chance of provider failure.

Life insurers have to allow in advance for future reductions in mortality rates i.e. increases in life expectancy over time. Longevity improvements are a global trend that is expected to continue into the future due to medical developments and lifestyle improvements. Some financial planning software doesn't allow for this trend. As a result, projections from that software may make it seem cheaper to use an account-based pension

than to purchase a lifetime annuity – if the software doesn't properly account for how long a client's retirement income needs to last.

If an annuity provider were to make insufficient allowance for improvements in life expectancy, then a future transfer of assets into the Statutory Fund might be required to maintain solvency. Alternatively, annuity providers can reinsure this risk with global reinsurers.

3. Administration costs being higher than expected.

In other countries, even if an annuity provider experiences financial difficulties, customers are more likely to see a reduction in their annuity income rather than losing their money.

Quality of the management

The quality and risk tolerance of the provider's executive team is also an important factor, as is the ability to raise shareholders' capital, if ever required.

Investment managers see this as a very important requirement before they invest in an entity. The management team of an annuity provider need to be experts in the type of risks they have undertaken and the products they have issued. Investors can check the academic qualifications and business experience of the management team.

It's also important for insurance companies to have a solid risk culture, including the Chief Risk Officer and the CEO. If difficulties do arise for any reason they should be identified quickly so that the organisation can rapidly design and implement action plans to mitigate them in a timely manner.

Conclusion

Modern retirement income products involve long timeframes – potentially several decades into the future. For retirees who wish to pass some or all of these risks to a third party, like an insurer, the good news is that APRA does an excellent job in regulating those providers which underwrite annuities and were applicable, their reinsurers. APRA has a strong track record in requiring providers to take relevant actions in order to meet their long-term obligations.

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[1] Note that pooling is a form of insurance. With a pool, investors pool assets together and agree rules on how those assets get used to fund their collective needs. With insurance, an insurance company manages the assets and the insurer guarantees what benefits will be payable to customers.

David Orford is the Founder and Managing Director of Optimum Pensions. Optimum Pensions was launched in late 2017 with the objective of providing innovative sustainable retirement income solutions. This article is general information and does not consider the circumstances of any investor.

Can a crime invalidate a will?

Nick McColl

Can committing a crime or having criminal record impact a will or other elements of the estate planning process?

A criminal record, in particular the nature of a crime, can impact whether or not a person benefits under a will or remains in the position as an executor, trustee or testamentary guardian under a will.

A criminal record doesn't automatically prevent a person from benefitting under a will or being appointed as an executor, trustee or testamentary guardian. But it is most certainly a factor that should be taken into account when advising a client how a beneficiary should inherit under a will, and who they should appoint in these roles.

If an heir has killed or injured the will maker

In estate administration, one key legal principle is the forfeiture rule, which prevents a beneficiary who has killed or injured the testator, or the will maker, from inheriting any part of their estate.

This rule is based on the idea that no one should profit from their wrongdoing, particularly in cases involving violence against the testator. If a beneficiary is found guilty of intentionally causing the death or serious injury of the testator, then they are legally barred from receiving any inheritance under their will.

A person who has unlawfully killed another is also unable to obtain a grant of probate or letters of administration and, if a grant has already been made, then it will be revoked.

For example, in *Re Edwards* [2014] VSC 392 the forfeiture rule was applied in a case of defensive homicide and upheld on appeal. Even though there had been a history of domestic violence and the will maker's murder was committed in self-defence, it was held that the rule applied to all cases of murder and manslaughter without exception.

In the case of a person procuring the making of a will by fraud

Generally, fraud is the only crime which may affect the validity of the whole or part of a will.

Where fraud is alleged, it must be shown that another person deceived or misled the testator in such a way as to materially impact the making of the whole or part of a will in a certain way.

This includes wilfully false statements or the suppression of key facts by another person, intended either to gain benefits under a will for themselves or to prevent benefits being received by a person who would ordinarily expect to benefit under a will.

Where a beneficiary is a convicted criminal

Generally, a beneficiary who is a convicted criminal is entitled to inherit under a will, provided that their crime is not directly related to the testator's death. However, this can potentially impact the way in which a beneficiary in this position should benefit under a will.

For example, a protective trust may be more suitable than leaving a direct benefit to a beneficiary in this position, particularly where they may misuse the funds left to them.

That being said, a testator has the freedom to disinherit or limit an inheritance to any beneficiary, including a convicted criminal, if they choose.

For example, consider the case of a client who wants to leave their entire estate to their only son, who is a convicted drug dealer, but they want to support them.

While it would not be illegal for the son to inherit the estate outright, a client may be concerned with how the funds would be used. For this reason, the client may opt to include a protective trust under the will managed by a professional trustee.

The terms of the protective trust would allow for the son's financial needs to be met with the safety of a professional trustee managing his inheritance, minimising the risk of misuse.

Another benefit is that an immediate family member of the son would not be acting as trustee, a role which necessitates the making of difficult decisions in the best interests of a beneficiary. This often gives rise to situations of conflict, potentially impacting family relationships.

When an appointed trustee, executor or testamentary guardian has a criminal record

A person with a criminal record can be appointed as an executor or trustee under a will. However, where the crime was an offense involving dishonesty, it can constitute grounds for their passing over as executor or removal as trustee by the Court.

If a person who has committed a crime is appointed as testamentary guardian, which is someone who assumes parental responsibility in the event that both parents have died, the Federal Circuit and Family Court of Australia may intervene and appoint another person as guardian or even put the child into foster care.

Nick McColl is Legal Counsel at Equity Trustees. This article is for general information only. It does not take into account the investment objectives, financial situation or particular needs of any particular person. Before making an investment decision, you need to consider (with or without the assistance of an adviser) whether this information is appropriate to your needs, objectives and circumstances.

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