# Superannuation Portfolio

By Michael Kemp

Remember those superannuation ads on TV?

*Compare the pair*

- *Same age*
- *Same income*
- *Same super contribution*

*yet there could be a lifetime of difference in their final retirement payout*

Great stuff - we'd all rather be sipping Moet than sparkling white after clocking off from our final shift.

The ads demonstrated how hefty management fees savage our superannuation nest eggs. That's true. But the way those final payout figures were nailed down to the very last dollar – even Nostradamus couldn't have pulled that one off. The rapid-fire voice-over at the end of the ads suggested the figures could be a bit rubbery. That was an understatement, one this article will expand a bit further.

And we'll also consider that other big driver of portfolio performance - asset allocation.

**Brinson, Hood & Beebower**

Most articles on asset allocation mention the 1986 Brinson, Hood and Beebower study. After looking at the returns of ninety-one US pension funds they concluded the holy grail of portfolio construction had little to do with stock picking. They concluded returns were driven by two main things - the asset classes within the portfolio and the proportion of each held. Which means: those analysts who beat themselves up trying to find the next big stock are probably wasting their time. Plenty of me-too studies have come to the same conclusion.

**Rules of Asset Allocation**

Studies measuring the past performance of each asset class – cash, fixed interest, shares and property - have their place. But these studies should come with a warning. Don't rely on them. It's the future which determines investment outcomes. And the future is uncertain.

We manage uncertainty by coming up with rules. Here's one – The Birthday Rule. Invest your age in bonds. So when you get the Queen's (or King's) telegram, you should be 100 percent invested in fixed interest.

Other asset allocation principles include constant weighting allocation, tactical asset allocation, dynamic asset allocation, insured asset allocation, integrated asset allocation and the most popular one of all – "I've got absolutely no idea what all that means so I'll get someone else to invest for me!"

 

**What Really Matters?**

The self-managed super industry is booming. There are now over 750,000 Australians managing their own super – an increase of 50 percent in the past 5 years. Over the next several years more and more of these squirrel funds will be morphing into drawdown mode. It's estimated that by 2021 forty percent of funds will be paying pensions. If you're one of the 750,000 who manage your own pile of loot there are some very important things to consider.

Firstly think about what you are trying to achieve. It's not always about maximizing returns.

Take for example the Gen X and Gen Y's. They're today's accumulators. They're looking for growth. Which means their portfolios should be weighted towards shares. With time on their side they can afford to ride out a stock market crash or two. Their aim is to maximize their retirement lump sum.

But those who are close to retirement, or have already retired, look upon their portfolio with a different set of eyes. They want to sleep well at night. To do that they need a regular cash flow that won't run out in their lifetime. Think inflation-protected annuities, fixed interest, and rock solid low-geared REITs holding properties with long-term leases in place. A proportion of shares can be there as well. But think solid business models, proven cash flows and a long history of positive earnings. Leave the junior miners and tech start-ups to the other guys.

**Interpreting Studies on Asset Returns**

Investors are forever peering into the future. Trying to work out how much their portfolio will be worth one day. They apply an expected rate of return to an estimated rate of savings. The expected rate of return used is usually based on the past performance of the asset class in question. But never forget, whether the rate relates to cash, bonds, property or shares, it's simply an historical average. And you can never bank on either – history or averages.

Which means you can't be sure how much your portfolio will be worth in the future. Doesn't that make things difficult? How can you make plans?

Simple! Change the way you work out the figures. For starters don't rely on historical averages.

Statisticians and savvy investors don't think one outcome. They think possible outcomes. To do that they use something called the standard deviation. It's a measure of dispersion or spread. The higher it is the less trust you can place in the average figure. It's like the guy who had his head in an oven and his feet in an ice bucket. His average body temperature was fine. But the standard deviation was off the dial.

Let's use returns on shares as an example. Over the very long term shares, have delivered an average annual return of about 10 percent. That includes inflation and dividends. But that doesn't mean every share investor is going to get a 10 percent return. The chances are it will be more or less – maybe a lot more or less. But by how much? The following figures, delivered at a 2011 AIA Conference by Jeremy Cooper, Chairman of Retirement Income at Challenger Limited, paint the picture.

Consider an investor who, in 1999, tries to work out what his broad-based equity portfolio would be worth in 5 years' time. He needs a rate of return to work out how much his money will grow. For that he uses the average annual return for the All Ordinaries Accumulation Index over the previous 20 years. He reckons a 20-year average should be a reliable enough indicator. That figure was 16.6 percent.

He calculates the All Ordinaries Accumulation Index to be just over 31,000 in 5 years' time. Which means his $300,000 equity portfolio should be worth nearly $650,000. But things didn't turn out that way. The reality is 5 years down the track the Accumulation Index came in at the much lower figure of 22,690. Which meant his $650,000 expectation became a $470,000 reality.

The mistake he made was he should never have considered it all as a done deal. In 1999, rather than thinking in terms of just one figure for the rate of return – the twenty year historical average - he should have thought in terms of a range of possible returns. Then he could have come up with a range of possible outcomes.

By using a range there's less chance he would have been surprised down the track. Whilst the 9.46% annual return he actually did achieve was well short of 16.6%, it was well within the realm of possibility.

I know what some of you are thinking by now. Stock markets don't always conform to statistical measures. Nassim Taleb's *Black Swans*, fat tails and all that stuff. You realists have a point (and I've been known to argue the case myself). But if you start thinking in terms of possible rather than certain outcomes you'll be streets ahead of those who don't. And thinking in terms of statistical confidence intervals, rather than single averages, is a good way to start getting your mind around the problem.

Oh – I nearly forgot. For those mathematicians out there: the standard deviation of that average 16.6 percent 20-year return was 24.5 percent. Happy calculating!

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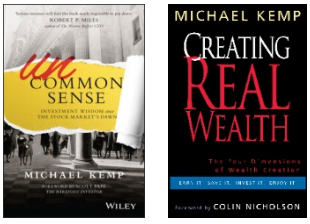


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*Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.*