Black Swan Event
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It is just about impossible to predict future investment returns over time horizons that have meaning to retirees.

Over very long terms, of several decades, it may be possible but over periods of a decade or two, when needing to live off your capital, the impact of one or two prolonged downturns can be disastrous.

Conversely, a prolonged period of good returns (like from the late '80s until 2007) can produce undreamt of riches.

The Australian Financial Review recently published a letter I wrote on this subject (4 May 2016, page 39). It is reproduced here.

Future returns impossible to predict

Brian Toohey touches on a critical point for retirees concerning future investment returns ("Low yields to undermine Morrison", May 2).

Having been involved in retirement planning for a long time, I was disillusioned with the standard methods used to project retirees' account balances. Using a purpose-built model, I set out to test how people's account balances had fared over 25 years (for different periods), after taking an income starting at 5 per cent of their account balance and increased each year by inflation. The first period started in 1969.

The main conclusion is how vastly different the results are.

Some people ran out of money after 15 years, while others saw their capital increase, in real terms, by almost 10 times.

There were three distinct economic phases during the period. From WW2 to the early 1970s, there was a highly regulated global financial system with low inflation, low interest rates and good growth. From the early 1970s until 2007 we had deregulation, high interest rates, high inflation and massive credit growth. It all came to an end in 2007. Welcome to phase three.

The main conclusion is that it is impossible to predict future returns very far out.

Things can change in fundamental ways, very quickly, and it is important to stay flexible, adjust to fundamental changes, and don't buy into sweeping statements such as, "shares always outperform". It all depends.

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BUDGET 2016 — DETAILS AND COMMENTARY INSIDE

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BUDGET 2016

The 2016 Budget contained some important changes to superannuation.

Some come into effect on budget night, whereas for others, the important date is 1 July, 2017.

The main changes are outlined here, grouped by their date of effect.

Introduction of $500,000 contribution cap

Effective date: 3 May 2016

The Government has announced that it will introduce a lifetime cap of $500,000 on the amount of non-concessional contributions that can be made into superannuation.

This limit will look back to count non-concessional contributions made on or after 1 July 2007 (from which time the ATO has reliable contribution records).

If a person has already exceeded the $500,000 lifetime cap, they will not be penalised for any existing excess amount above $500,000. However, they will be penalised if they make any further non-concessional contributions.

The lifetime non-concessional contribution cap will replace the existing annual caps, which allow non-concessional contributions of up to $180,000 per year (or $540,000 every three years for individuals under age 65).

Comment

This greatly simplifies the whole issue of non-concessional contributions. However, it is a significant reduction in the amount of non-concessional contributions that can be made over your lifetime. It will have a big impact on those people who were planning to boost their superannuation in the last decade or so before retirement by making big non-concessional contributions.

Work test removed for those aged 65 to 74

Effective date: 1 July 2017

The Government has announced that it will remove the current restrictions on individuals aged 65 to 74 from making superannuation contributions, with effect from 1 July 2017.

There are currently minimum work requirements for Australians aged 65 to 74 who want to make voluntary (after-tax) superannuation contributions. To be eligible to make voluntary contributions to superannuation, individuals aged 65 to 74 must have worked for at least 40 hours over 30 consecutive days in the financial year the contributions are made. In addition, spouses aged 70 or more cannot receive spouse contributions, under current arrangements.

As part of this budget measure, the contribution acceptance rules will be amended to:

- Remove the requirement that an individual aged 65 to 74 must meet a work test before making voluntary or non-concessional contributions to superannuation
- Allow individuals to make contributions to a spouse aged under 75 without the need for the spouse to meet a work test

This measure will simplify the contribution acceptance rules, as the same rules will apply to all individuals aged up to 75 from 1 July 2017. It will also allow older Australians to increase their retirement savings, as they will no longer have to satisfy any minimum work requirements before making voluntary contributions to superannuation.

Comment

This is a welcome and common sense change. However, it would have been improved by bringing the implementation date forward to 3rd May 2016, to coincide with the changes to the lifetime cap, mentioned above.

Concessional cap changes

Effective date: 1 July 2017

There are two major proposed changes:

- A reduction in the concessional cap to $25,000
- For those with account balances of less than $500,000, an ability to make catch-up concessional contributions

Reduction in the concessional cap

From 1 July 2017, the concessional cap will be reduced to $25,000 for all individuals regardless of their age.

Catch-up contributions

From 1 July 2017, individuals who do not fully utilise their concessional contributions cap from the 2017/18 financial year onwards will be able to make catch-up concessional contributions. This ability will be limited to those with superannuation balances of less than $500,000 and the unused portion of the cap can only be carried forward for a maximum of five years.

Comment

This change indicates a very narrow mindset on the part of policy makers. It takes no account of the following:

- Many people planning to retire in the next few years have not had the benefit of full superannuation throughout their working lives (compulsory superannuation started in 1992 and contributions were initially only 3%), and were hoping to top it up in the last few years of working (which also corresponds with their period of maximum savings capacity).
- For most people, the ability to contribute to superannuation fluctuates considerably as they go through various life phases, typically being low in the early years of home purchase (and high mortgage commitment) and young children, and increasing over the decades as these commitments reduce.
- It seems to imply an outdated view of work life, in which somebody has a steady job with steady superannuation, throughout their working life (as may happen in the public service). However, this is not the world many people live in, especially those who swap jobs and take time off for further education or to raise children.

Restrictions eased on tax deductions for personal contributions

Effective date: 1 July 2017

The Government will allow all individuals under age 75 to claim an income tax deduction for personal contributions from 1 July 2017, up to the concessional cap ($25,000).

This effectively allows everyone up to age 75, regardless of their employment circumstances, to make concessional contributions up to the concessional cap. Individuals who are partially self-employed and partially wage and salary earners, and individuals whose employers do not offer salary sacrifice arrangements are expected to benefit most from these changed arrangements.

This is a significant change as it removes the complexity and inequity that currently exists under the "10% rules" – i.e. under the current rules, a personal deduction is only available where less than 10% of the person's income is derived from eligible employment activities.

Members of certain prescribed funds will not be entitled to deduct contributions to those schemes. Prescribed funds will include all untaxed funds, all Commonwealth defined benefit schemes, and any State, Territory or corporate defined benefit schemes that choose not to prescribe.

Comment

A welcome and sensible change.

Low income superannuation tax offset (LISTO)

Effective date: 1 July 2017

From 1 July 2017, the Government intends to introduce a Low Income Superannuation Tax Offset (LISTO) to reduce the tax on superannuation contributions for low income earners.

The LISTO will apply to low income earners with adjusted taxable income up to $37,000 p.a. who have had a concessional contribution made on their behalf.

The LISTO will provide a tax offset to the low income earner's superannuation fund, based on the tax paid on concessional contributions made on behalf of low income earners, up to a maximum of $500. The ATO will determine a person's eligibility for the LISTO and advise their superannuation fund annually. The fund will contribute the LISTO to the member's account.

The LISTO will replace the current Low Income Superannuation Contribution (LISC) when it ends on 30 June 2017, to effectively reduce the tax rate on superannuation contributions to zero for low earners.

Comment

A welcome and sensible change.

Low income spouse tax offset increase

Effect date: 1 July 2017

The Government intends to increase access to the low income spouse tax offset from 1 July 2017 by raising the income threshold for the low income spouse from $10,800 to $37,000 p.a.

The low income spouse tax offset provides up to $540 per annum for the contributing spouse. The offset will continue to be set at 18% of the amount of eligible contributions. The offset will be gradually reduced for income above $37,000 and will completely phase out at income about $40,000.

This Budget measure is aimed at improving the superannuation balances of low income spouses (whether married or de facto).

As a result of the significant increases to the current eligibility threshold announced by the Government (over three times the current amount), this measure is likely to open up the tax offset to more spouses on lower incomes and boost their retirement savings, particularly those of women.

Comment

This measure will encourage partners to make contributions to their low income spouse's superannuation by extending the eligibility for individuals to claim a tax offset for these contributions.

Introduction of $1.6 million transfer balance cap

Effective date: 1 July 2017

This measure proposes that from 1 July 2017, the maximum amount of superannuation that an individual can transfer from the accumulation phase into the retirement phase (i.e. to start an income stream) will be $1.6 million.

Where an individual accumulates amounts in excess of $1.6 million, they will be able to maintain this excess amount in the accumulation phase, where earnings will be taxed at the concessional rate of 15%.

If an amount above $1.6 million is transferred into the pension phase, penalty tax (similar to that applied to excess non-concessional contributions) will apply.

Importantly, members already in the retirement phase with balances above $1.6 million will need to reduce their balance to $1.6 million by 1 July 2017. Excess balances may be rolled back into the accumulation phase or removed from the superannuation system as a lump sum payment.

The cap will be indexed in $100,000 increments, in line with the consumer price index.

Defined benefit members also impacted

There will be commensurate measures to capture defined benefit schemes through changes to the tax arrangements for defined pension amounts over $100,000 from 1 July 2017.

Comment

This is perhaps the most contentious of the changes. People with balances over $1.6 million will have to make changes to their arrangements, and these could be complex and costly in some instances. There is, however, a certain consistency with other Government decisions, relating to the age pension and the assets test. When they announced the new assets test rules that come into effect from 1st January, 2017, they chose not to grandfather existing pensioners, but to make all pensioners subject to the new test – which is more generous to people with smaller assets, but more restrictive to people nearer the upper threshold.

Earnings on transition to retirement (TTR) pensions subject to tax

Effective date: 1 July 2017

Clients with Transition to Retirement Income Streams (TTRs) currently enjoy the benefit of the earnings within their TTR being subject to a zero rate of tax. From 1 July 2017, the Government plans to remove the tax exemption on earnings of assets supporting TTRs. It will also remove a rule that allows individuals to treat certain superannuation income stream payments as lump sums for tax purposes.

Comment

This will greatly reduce the attractiveness of transition to retirement strategies, especially for people with larger balances.

Is the financial advice you are getting truly tailored for you, or are you being averaged?

Financial planners are required to provide clients with advice that is in their best interests, given their circumstances and appetite for risk.

Unfortunately, many of the big, institutionally owned advisor groups have adopted a formula based approach to providing advice, which runs something like this:

> They first have you complete a risk profile questionnaire. This is a series of questions intended to work out what your risk tolerance is and put you in a 'box'. Depending on your age, you will then be allocated to another box, which has a pre-set asset allocation and a pre-set lot of investments.

The whole process is heavily averaged. The risk profiling is based on averages from a large sample of the population. The asset allocation is based on many decades of average volatility and average returns for different asset classes.

The whole process of averaging permeates just about every aspect of portfolio theory. It may or may not be suitable for that, but it is almost certainly not suitable for individual advice. One of the problems is that most portfolio theory is built for groups that manage huge amounts of money, invested for long periods, for the benefit of thousands of people of differing ages. Hardly the same as individual advice.

Also, and importantly, things which are built for average people often end up being unsuitable for everybody.

Continued...

Todd Rose, in the book *The End of Average*, tells the case of the US Air Force, and the 'average cockpit'. After World War II, the US Air Force built cockpits that fitted the average pilot, based on a whole lot of averages, such as average height, average torso length, average leg length, average arm length and so on.

The problem was, most pilots were not average in at least some dimensions, and in some cases in most dimensions – and a lot of accidents and near misses were the result. For example, a pilot with short arms might not be able to reach a vital switch at a critical point of some manoeuvre and disaster could happen.

So the US Air Force went back to basics and redesigned cockpits so they were adjustable and could be adjusted by each pilot to fit their own profile.

Rose give other examples, such as brain research, where things have been designed to fit an average, only to end up fitting nobody.

If you seek financial advice, beware of solutions that come out of a box. After all, something maybe true in general, but false in particular.

In simpler terms, *one size does not fit all*.

Forecasters—rabbits, foxes or hedgehogs?

It's that time of the year when forecasters are thick on the ground. It's like they're breeding like rabbits. But, however they breed, are they more like foxes or hedgehogs?

Hedgehogs are driven by one big defining idea. Their style is well suited to 10-second grabs.

Foxes, on the other hand, are into the detail. They look at lots of small facts. However, they don't come across well in the media and their style can quickly bore the pants off just about anybody.

Little wonder that most of the forecasters who have been bombarding us lately are hedgehogs.

Tetlock and Gardner, in their recent book, *Superforecasting: the art and science of prediction*, have tested the accuracy of forecasters.

Their conclusion: nobody is very good at forecasting, but foxes are much better than hedgehogs.

Over the last couple of months, there has been a deluge of forecasters making dire predictions about the future of the share market. The gloomy forecasts have happened despite there being no new data and generally OK economic conditions.

A deeper contributing factor is that nobody knows for certain what is the real value of shares (or real estate). It all depends on forecasts. As the great economist John Maynard Keynes said, such decisions (about values) are based very much on second-guessing what other people think the value should be. He likened it to beauty pageants, then popular in British newspapers, in which people had to guess who other readers thought was the most attractive entrant. The winners were those who correctly guessed what the majority of readers would guess.

Recently, experimental economists have replicated the beauty pageant in games – not using actual beauty pageants but using the same logic of guessing what everybody should guess with a given set of facts. There is a definite answer. But nobody gets it.

As Yogi Berra said: "Forecasting is very hard, especially when it's about the future."

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Is it time to reconsider what we mean by 'risk'?

Traditionally, investments such as government bonds have been considered 'safe', whereas shares are considered 'risky'.

So pervasive has this been that, in the jargon of financial markets, when somebody talks about 'taking on more risk', what they are really saying is that they are selling bonds and buying shares (or using cash to buy shares). Conversely, if they are selling shares and moving to bonds or cash, they are 'reducing risk'.

Now, it seems, the jargon is moving mainstream. I recently saw a retiree being interviewed on television. In order to make ends meet, he said he was taking on more risk with his investments.

How suitable is this system of risk classification in the current environment?

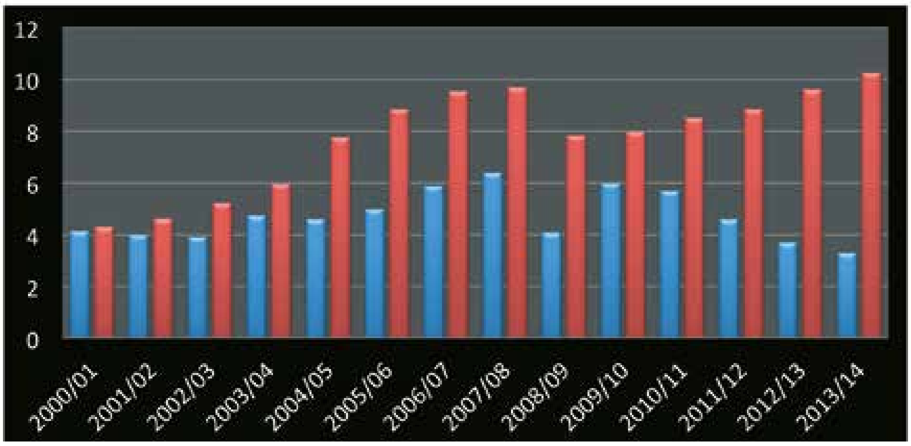
I argue that it is not suitable at all, and it is time to reassess what is risky, and what is not. Consider the following:

- Most of the research into the performance of bonds and shares has occurred in conditions very different from what we now have. Interest rates now are at record lows and in some countries even negative (which theory said was impossible).
- The relative 'riskiness' is based on one measure only – the volatility of total returns (growth and income) of bonds and shares.
- Volatility consists of both decreases *and* increases in returns. This is a method favoured by academia but I have yet to meet anybody in the real world who regards them as the same.
- However, when we break the returns down into their two components (income and growth), we see that income from shares is far less volatile than income from bonds, when taken across the whole market.
- With interest rates so low, there is a substantial risk of big capital losses from bonds if rates rise.
- Over the longer term, there has been a strong historical trend for income from shares to rise (across the whole market), whereas interest rates are all over the place, rising in some years and falling in others.
- Also over the longer term, there has been a well established tendency for the value of shares to rise. Not so for bonds and cash.
- If somebody is drawing 5% (the minimum allowable between ages 65 and 74) from their account-based pension, then their balance is certain to fall if the money is in 'safe' term deposits. With rates of around 3.25% (on a good day), that equates to a shortfall of 1.75% pa even before we talk about other expenses. In this case, you are sure to see your account balance going backwards. That looks pretty risky to me.

In a recent newsletter, I tracked the position of two amounts invested in 2001. Both amounts were $100,000. One was invested in 12-month term deposits, with the capital reinvested each year and the interest used for living expenses.

The other $100,000 was invested in a portfolio of shares and the income was spent each year. This graph shows the result. The red lines (dividends) won hands down.

Term Deposits vs Dividends



The Principal of Black Swan Event Financial Planning is John Cameron, who is one of the most experienced Financial Planners in the country.

"In our day to day activities," John says, "we help people meet their financial goals by using a range of financial products, most of which are also available to other financial planners.

However, our long industry experience and extensive industry knowledge enables us to apply additional insights to product selection, implementation and strategy.

"Our relationship with clients is ongoing over the short, medium and long term. We continue to look over their shoulders as life stages, markets, legislation, needs and circumstances change and provide appropriate advice and solutions (provided they want ongoing service).

"We will always 'tell it like we see it'. We won't claim to always get it right, but we will always give our honest opinion. What you see is what you get."

John Cameron, B.Econ; B.Com; Grad Dip Bus; MBA, Post Grad Dip Economics; CFP

Richard Gordon, Master of Business (Finance and Economics) DFP

Introducing Black Swan Event Financial Planning Investor and Adviser Richard Gordon.

"I have travelled the world applying my expertise in finance and learning as much as I could.

"Over the past 13 years, I've had tremendous and unique opportunities, which have allowed me to develop my passion for finance into a deep understanding of the ways that industries, economies and financial markets interrelate. I have also learned just how quickly things can change – and how important it is for plans to fit the circumstances.

With a wealth of international experience, technical knowledge and education, I made the decision to become a financial adviser in 2014.

I wanted to be working more closely with people and apply my skills in a more meaningful way.

In John Cameron, I've been very fortunate to find an associate who shares my values, my lifelong interest in finance and economics, and my firm belief that personalised and educated financial advice is the only kind worth giving."

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