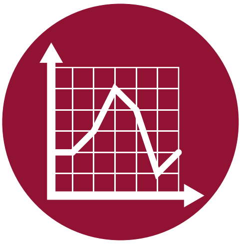

How to invest a lump sum

Some ideas to help people investing retirement funds, by a financial planner with lots of practical experience.

The "ideas" are:

- *Based on evidence*
- *Common sense*
- *As simple as possible but not too simple*
- *Provide a "strategic" basis*

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About this report....

I believe it is no exaggeration to say that many people who retired in the last few decades have got a raw deal, when it has come to investing their superannuation.

The focus of just about the entire industry, has been on how to ACCUMULATE retirement capital, with precious little attention given to how to invest it AFTER retirement. Then, after years of accumulating capital, you are faced with how to invest this sizeable lump sum, with big implications for your retirement lifestyle.

It falls to advisers to provide guidance and help in this task, and mostly they have done their best. However, we have been operating with one hand tied behind our backs - because the theories and models at our disposal have been designed with accumulators at the centre of things.

All these theories and models have their origins deep within the University and academic worlds, and they nearly all focus very much on investment performance over the long term. A recent study by the National Bureau of Economic Research in the United States, is titled The Rate of Return on Everything, 1870-2015. You could hardly accuse them of false modesty.

It is almost as if the search for "long term truths" is some sort of holy grail, which, when found, will unlock fundamental truths, of some sort. Furthermore, the chosen analytical tool is mathematics - often of mind boggling complexity.

All this is of limited use when applied to real-life retirement situations.

Firstly, the "long term" is never defined, and so its practical implications are forever clouded.

Secondly, when you retire, the dynamics become very different. Taking money out regularly, instead of putting it in regularly, changes the whole equation.

Thirdly, your time horizon inevitably changes. You need money now, as well as in a few months, and a few years. The "long term", however defined, is of only partial relevance.

As a result of this, I decided to have research undertaken, showing actual results, over different time periods, using real world figures. In other words;

Facts instead of theories

The results follow.

The whole purpose has been to look at history, which when combined with common sense and logic, can provide some useful lessons that we can draw from.

The data looks at 3 asset classes, Australian shares, Australian cash, and 10 year Government bonds. There are many other asset classes which may be added in time, but these 3 provide very useful insights.

I hope you find this useful.

John Cameron
February 2018

If numbers are sufficiently tortured, they will eventually confess to something.
Jonathon Pain,
economist

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The problems with current financial planning

I have been giving financial advice to retirees for over 30 years, and I have come to the realisation that IT IS TIME FOR A NEW APPROACH TO RETIREMENT INCOME, that is sourced from the likes of account based pensions, or general investments. Other sources such as annuities, can play a role, but they fall into a different category from this discussion.

From the research that forms the basis of this paper, it is clear that a different approach is required at different times, depending on the macroeconomic settings. For instance, a different approach is needed post GFC, compared with the 1990s, or earlier. There is no such thing as one solution which is best in all circumstances.

I am not the only one to point out current deficiencies. Jeremy Cooper, who is currently chair of Retirement Income, at Challenger, is one who has expressed such a view, noting that much of the current theory and advice is based on "Modern Portfolio Theory", which is ill suited to the trials and challenges of running a retirement portfolio.

In the long term –we are all dead.

John Maynard Keynes

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Just some of the problems are:

Most of the theory is far better suited to accumulators than retirees. Once you start drawing on your capital, the dynamics change completely.

- Modern Portfolio Theory assumes that all humans are rational, profit maximising computers, constantly searching for the best reward for a given level of risk, and with lots and lots of information (seriously). In recent years, behavioural economists have started shooting big holes in this, but the "models" live on.
- Modern Portfolio theorists speak wistfully about "in the long term", such and such will happen, but they never spell out what they mean by the "long term". John Maynard Keynes, the great 20th century economist, probably spelled it out best when he wrote, "In the long run, we are all dead".
- Time period is very important in retirement. You draw from your capital regularly, and don't have the luxury of building your capital with regular contributions, and waiting a long time for market disruptions to correct.
- The models have all been built by theoreticians and academics who have never sat in front of a client. They deal in large numbers of people, lots of averages and fancy statistical stuff, and never get down to the impact on individuals.

I could go on forever, but I think you get the drift.

So how should we go about this new approach?

As a minimum, it should cover 4 bases:

1. It should be based on evidence.
2. It should meet the test of common sense (something which theoretical approaches often fail).
3. It should be as simple as possible, but not overly simple.
4. It should be strategic. In other words, you should be able to build a plan and stick to it unless there are strong reasons to change.

Moving on to the first base, what sort of evidence should we look for?

EVIDENCE

How about we look at history, to see how people's account balances would have fared over time, if they invested at a given point in time, and drew regularly from their account? It has long been my ambition to carry out this kind of analysis. It was just a matter of who would do it, as I did not have the resources and skill to do it myself.

Eventually, I appointed Michael Furey's business, Delta Research and Advisory, to do the work.

This choice had big tradeoffs. Michael is a highly qualified researcher with his own business. Importantly, his past includes a period as a Financial Planner. He knows what it is to sit across from clients, and hear their real-world concerns. When I started discussing the project with him, he quickly "got it". This was a big relief, and a sea change compared with the responses I got from others!

Furthermore, the basis of comparison would be ACCOUNT BALANCE, either over the course of a period, or at the end of a given period. This approach captures all events over the period, including booms, busts, recessions, wars, inflation, deflation……………… and so on.

Using account balance covers the third base. It is simple and easy to understand. It also encapsulates the whole aim of what we are doing. In the context of this study, the state of somebody's account balance is an indicator of how they are going in meeting their goals.

Importantly, what we are looking for is something that works (in terms of providing guidance for retirement portfolios) rather than some search for ultimate truth (which seems to be the goal of many academics).

When the evidence changes, I change my opinion. What do you do, sir?

John Maynard Keynes

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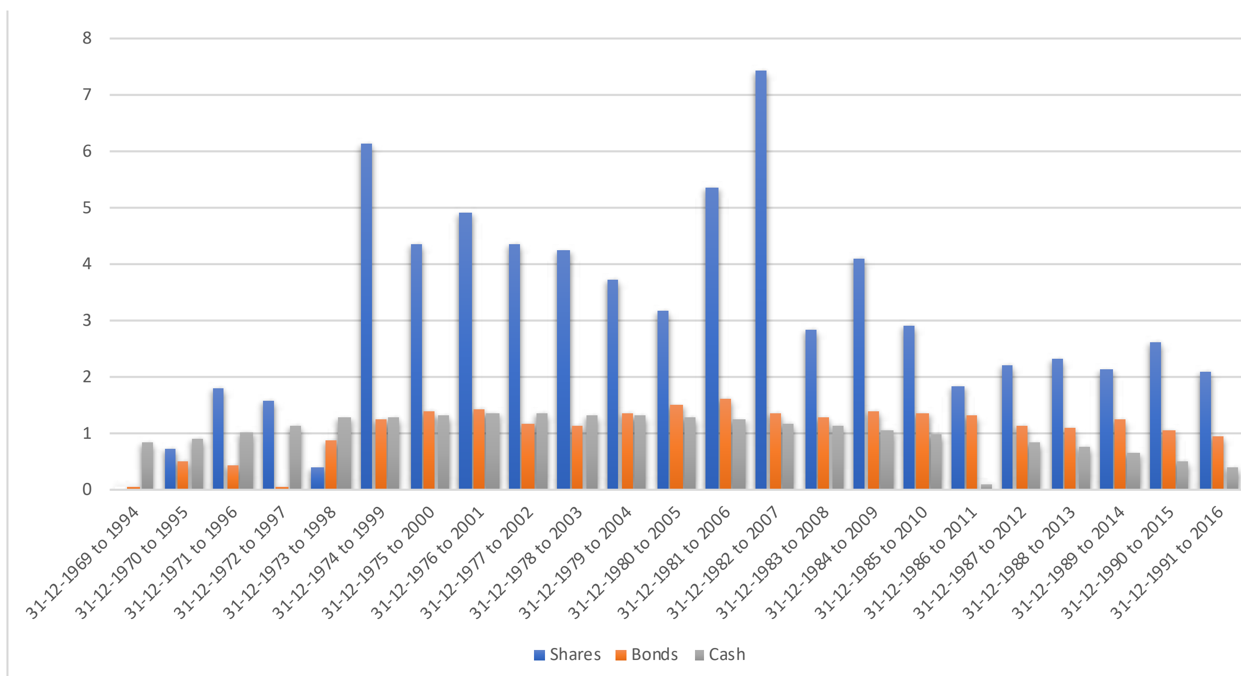
RESULTS

RESULTS

Time to get down to the nitty gritty, and look at some evidence. Sorry if the following has lots of numbers, and a few graphs, but that is the nature of evidence.

The following bar chart shows the account balance, in real terms, after drawing an income for 25 years. The income starts at 5% of the initial account balance and rises each year by the amount of inflation.

The end account balances after 25 years, with varying start dates, are seen in this bar chart.



Source: Models developed by Delta Research and Advisory Pty Ltd

The model is built on the basis of investing all of the assets in one asset class at the beginning, and then drawing from there. There is no rebalancing. Money is taken from the income (dividends, franking credits in the case of Australian shares, and interest in the case of bonds and cash) produced by that asset class, to pay drawings. Assets are sold to fund drawings if the income is insufficient, and there is no cash left. Thus, income and growth are treated separately. This is an important departure from traditional analysis, which lumps income and growth together to come up with one number, called "total return"

Just to be clear, all available funds are invested in either cash, bonds or Australian shares. There is no mixing of asset classes. Hence, the graph serves as a comparison between the three asset classes.

Data is based on:

Shares: MSCI Australia. Assumed franking of 70%.

Cash: 90 day Bank Bill rate

Bonds: 10 year Australian Government bonds held until maturity.

A CLOSER LOOK

Let's look a bit closer. There are 23 periods:

- Shares are the top performer in 21 periods.
- Cash is the top performer in 2 periods
- Bonds do not top any period.
- Cash beats bonds in 8 periods

The first thing that jumps out how dominant shares have been in most periods.

However, there is no asset class which comes out on top in all periods. It depends on markets, and the results differ markedly.

Somebody who retired in December, 1969, and had all their money in shares would have seen all their money gone after 15 years.

Somebody who invested at the end of 1982, and had all their money in shares, would have received an indexed income, and still had an account balance after 25 years that was 7.5 times bigger than they started with – in real terms.

It's almost as if "when you retire is more important than how much you retire with". Pity we don't have much say in the "when".

Also, some of these results are seriously at odds with the conventional wisdom that is often spruiked by fund managers and theoreticians.

These include:

✘ "Shares are the best longterm asset class"

Well, not in this case. People who invested in 1969, with all of their money in shares, would have seen their account balance fall to zero after 15 years. Also, those investing in 1970, saw shares outpaced by cash – which is meant to be the worst longterm performer.

✘ "Bonds beat cash over the longterm"

Once again, not true. People who invested in 1969 or 1972, just made it to 25 years. At that time the account balance was staring at empty.

Cash beat bonds in most periods between 1969 and 1978. It wasn't until we got into the 1980s that the conventional ranking of shares, followed by bonds, followed by cash became the norm.

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SOME DISASTER EVENTS

Timing can be very important, and it is just possible that the above 25 year analysis, all based on the same start date (31/12) of the respective year, misses something. We all know instances where people who retired just before the GFC, were crunched.

By contrast, those who invested just after the GFC, have fared much better, so long as they invested a good portion in shares.

Unfortunately, many people – for understandable reasons – were not game enough to do so.

So, let's look at some disaster events, to see the impact.

We look at the results from investing just before the disaster (worst time), with investing just after the disaster (best time).

The initial investment in each case is $1,000,000.

Disaster 1: The GFC

INVESTING JUST BEFORE THE GFC versus JUST AFTER THE GFC

We get the following account balances after 8 years:

	Aussie Shares	Cash	Bonds
Start 31/01/2007 (before)	$791,000	$770,000	$876,000
Start 31/01/2009 (after)	$1,456,000	$702,000	$772,000

Looking deeper - GFC

- Those who invested just before the GFC would have done best in bonds. However, bond rates were markedly higher then, than now, and when the time comes for the investments to mature and be reinvested, rates will be much lower.
- For those who invested after the GFC, shares have been the best performer.
- For as long as interest rates (cash and bonds) stay low, shares almost certainly will be the best performer, and the gap between them and the others will grow.
- In the case of those who invested at the height of the market, just prior to the GFC, shares will almost certainly overtake bonds in the next couple of years.

The main lesson from this – you need to have a good exposure to a diversified portfolio of dividend paying Australian shares in order to generate the cashflow to pay you, so long as current conditions last.

Also, if there are fundamental changes, you should be prepared to change your portfolio.

Disaster 2: The '87 crash

IINVESTING JUST BEFORE THE '87 CRASH, versus JUST AFTER THE '87 CRASH

Comparing the results over 10 years and 25 years, and starting with $1,000,000 we get:

10 years	**Aussie Shares**	**Cash**	**Bonds**
Start 31/08/1987 (before)	$831,000	$1,170,000	$1,440,000
Start 31/01/1988 (after)	$1,740,000	$1,160,000	$1,300,000
25 years			
Start 31/08/1987 (before)	$1,024,000	$843,000	$1,087,000
Start 31/01/1988 (after)	$2,470,000	$819,000	$1,162,000

Looking deeper – '87 crash

- This example shows the importance of time. Over ten years, those who invested before the crash would have done best in bonds, and worst in shares. Over 25 years the difference between shares and bonds is small.
- Unsurprisingly, those who invested in shares just after the crash, did best over both periods.

You may be amused – or find it instructive – to know that Sir Isaac Newton, discoverer of gravity, astronomer, inventor of calculus and all round genius, made this comment after losing his fortune in the South Sea Bubble.

I can calculate the motion of heavenly bodies, but not the madness of people.
Sir Isaac Newton

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HOW COME?

Let us go back to the 25 year bar chart on page 7.

The 25 year bar chart shows some interesting patterns.

- Those who invested in the early 1970s showed very different results from those who invested from the mid '70s until the mid '80s.
- From the mid '80s onwards, there is yet another pattern.

How is this so?

It is possible to identify four periods since World War 2, when the Global Financial System showed distinctly different characteristics.

The first period

The first was from World War 2 until 1972. During this period the International Financial System was heavily regulated. Interest rates were tightly controlled, banks were highly regulated (even in terms of their lending policies), exchange rates between different countries were fixed, and the flow of money between countries was highly controlled.

This was called the Bretton Woods era, named after the conference venue where it was hammered out just prior to the end of the War. It provided financial stability for many years.

However, the Bretton Woods era ended in 1972, after coming under pressure for several years, when America abandoned the gold standard. This was not a planned event, and the repercussions went on for years. Thus began...

The second period

The financial system was gradually deregulated. Exchange rates were freed, interest rates were deregulated, and banks were freed. There was a rapid expansion in lending, and some major recessions. During this period, interest rates and inflation were stubbornly high. Based on Reserve Bank data, cash rates peaked at close to 20% in 1974 and the 10 year bond rate reached 16.5% in 1982. I am sure many readers remember with horror the mortgage rates of the late 80s. During this period, inflation spent most of the time well into double digits, and peaked at close to 18%.

The third period

The third period, started in the late 1980s, when inflation finally cracked. Interest rates fell for many years, as did inflation. The result was an increase in the rate of deregulation, a massive increase in global debt and an ongoing boom in asset prices (shares and real estate).

The fourth period

The fourth period is what we are in now, post GFC. The rapid expansion of lending came crashing down in 2007/08, and a much worse situation was only prevented by Governments and central banks stepping in to save the banking system, dropping interest rates to record lows, and undertaking stimulating expenditure.

And the lesson is: there is no "best" strategy, in all situations. It depends on the financial settings of the time. Your plans should take this into account and you should review your portfolio if there are fundamental changes.

Shares do very well relative to cash and bonds in all but two periods (1969 and 1973). In those kind of extreme circumstances, shares can tank more than the others – but this is blessedly rare.

In 1948 the West German economy was heavily regulated. Minister of the Economy Ludwig Erhard made sweeping deregulation. He was carpeted by General Clay, in charge of the American military occupation. Clay said, "Herr Erhard, my adviser tells me what you have done is a terrible mistake. What do you say to that?" Erhard replied:

Herr General, pay no attention to them. My advisers tell me the same thing.

Ludwig Erhard

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WHERE WE ARE NOW

The situation we now find ourselves in is, in many ways the opposite of the 1970s and 1980s – low inflation (deflation in some places), lowest interest rates on record, and slow (but positive) growth. This environment heavily favours investment in shares (I am not talking about particular shares, but about the market overall – as an asset class).

This is particularly the case in Australia, where the sharemarket pays high dividends, and the dividends come with valuable tax benefits. On top of the dividends there has been growth as well.

Hence, at least for the foreseeable future shares must play a central role in any retirement portfolio. However, bear in mind that this will all change sometime.

Just when, or what the change will look like, only time will tell. When it does happen, reassess your portfolio.

THE MAIN TAKEAWAYS

Pay close attention to current financial conditions and heed "market signals". There is no formula which applies all the time. The returns and the risks stack up differently, at different times.

If there are fundamental changes in markets, prepare to re-weight your portfolio. It is important that these are "fundamental" changes, and not just "market noise".

COMMON SENSE

What common sense guidelines can we draw from all of this? I offer the following:

- There is no universal answer to the question as to how to construct a retirement portfolio. Market conditions vary greatly, and it is important to be in tune with market realities of the time. In the 1970s and '80s, this would imply a large exposure to cash and fixed interest investments. Since the GFC, the emphasis should be in shares.
- It is important to take a strategic approach. This involves working out where you want to get to, and then implementing the investment mix to achieve those aims. While there have been big changes in Financial Market dynamics since World War 2 (the four periods), each period has run for many years. That is, big changes are not frequent. It is important to not react to every bit of news that comes along. There is lots of "chatter" in the markets, and most of it has very little true informational value.
- Risk is always present, and don't forget this. No matter how much we think we know, there will always be much more we don't know. It is a matter of MANAGING the risk, and this inevitably involves making tradeoffs, mainly in the form of diversification. The main diversification involves spreading money across different asset classes.
- Black Swan Events happen. A Black Swan Event is a special kind of risk – an event that is totally unforeseen. They can be either good, or bad, but the focus is usually on the bad ones. They can also be either personal (such as loved one suddenly needing expensive medical care), or global (the GFC), or anything else you can think of.
- We are all human, with human emotions (this will come as news to some Modern Portfolio Theory junkies), and we sometimes make emotional decisions. I know hardened investment professionals who panicked and sold out of the market at the very bottom in 2008 (it is easy to classify this as panic in hindsight, but we have to make decisions in real time, without the benefit of hindsight).
- Time matters. When markets dive, one of the familiar refrains of the modern portfolio tribe is, "hang in there, it will bounce back in the long run." Problem is, "the long run" is never quantified. Sometimes it is the best advice, but in retirement you have to be very careful – you don't have the luxury of "forever".
- Following on from the above, "this time may be different". The phrase, "this time is different", is often heard during the late stages of a rising market, and is frequently a signal that the market is topping out, and a crash is just around the corner. The moral is that times are just the same, not different at all. If something is overpriced, don't expect it to stay overpriced forever and the same rules of valuation apply – not different ones. However, when it comes to retirement, times may indeed be different. This was the experience of people retiring in the late 1960s and early 1970s. They ran into a "perfect storm" of rapidly rising inflation, skyrocketing interest rates, recession and rapidly falling sharemarkets (which then stayed down for a long time). In order to fund their lifestyles, those invested in shares saw their drawings increasing rapidly (to keep up with inflation), while they were having to sell more shares at reduced prices. In these times, cash was indeed king – due to high interest rates.
- When markets fall, "how long" they stay down, is just as important as "how far" they fall. A market that drops sharply, then quickly recovers, will have little impact.
- Individual risk profiles matter – a lot.

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SOME INSIGHTS

It behoves me to provide some thoughts on how retirement portfolios can be constructed in the current environment.

The layered portfolio

A good approach is to build the portfolio in layers.

The **bottom layer** is made up of low risk interest bearing investments such as cash, term deposits and variable rate instruments.

These investments produce income, but at a fairly low rate. Importantly, this layer provides a buffer that can be accessed in case of emergency. Importantly, it gives you options as to where to draw money from in an emergency in the light of market conditions at the time.

For example, if you need money when the sharemarket is in the doldrums, you might take it from the buffer and thus avoid selling shares at depressed prices. Conversely, if sharemarkets have boomed, you might sell some of your shares to fund the drawings. In other words, the bottom layer is your main risk management tool.

The **second layer** is made up of Australian shares that pay good dividends. These may be either directly owned or owned via managed funds that specialise in producing high dividend payments. Diversification is essential. In addition to dividends, there is the likelihood of additional cashflow coming from tax credits, due to the imputation system.

In current conditions, a total income of 6% to 8% should be achievable from this source, plus some growth. This layer produces most of the income for the portfolio. It is interesting to note that dividends (taken across the whole market, not from a small number of companies) provide a less volatile income source than most fixed interest sources. Just think what has happened to term deposit rates over the last several years.

The **third layer** is made up of growth investments, being Australian and international shares. This layer has the highest potential return, but it can be volatile.

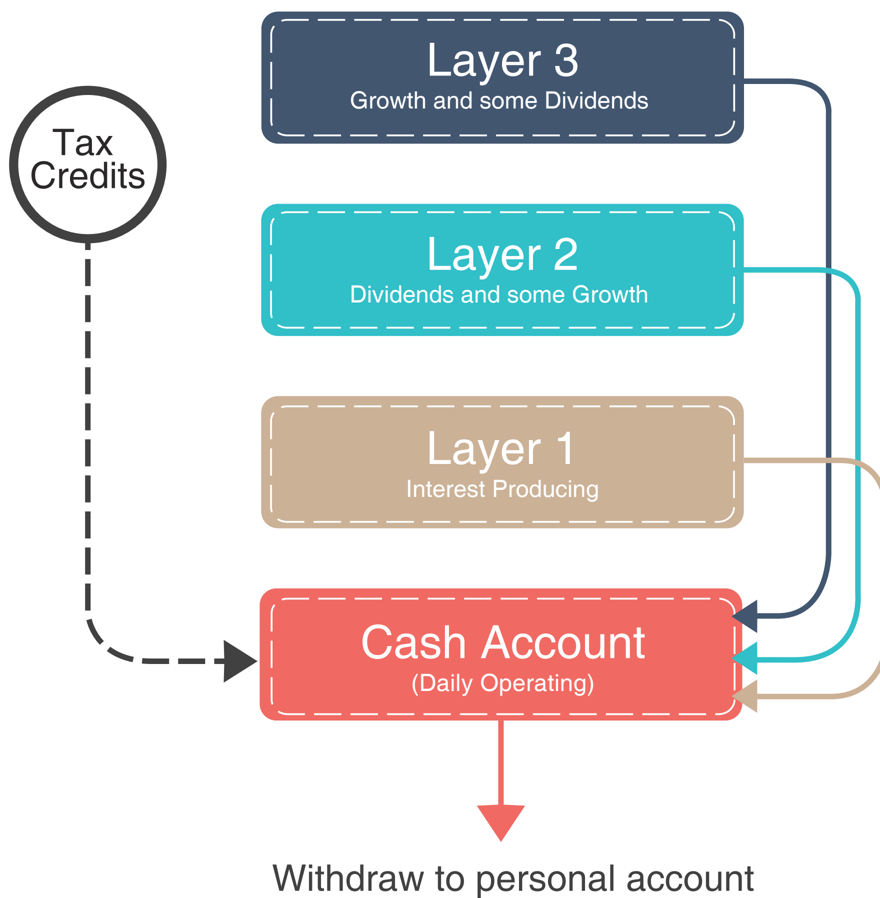
The **overall strategy** is for the three layers of the portfolio to produce income that is sufficient (or as close as possible) to fund regular drawings. Thus, you will not depend on growth to meet day to day living expenses, and the growth investments should have the time needed to produce the results hoped for.

To implement this 3 layer strategy, it is necessary to select funds that restrict their investments to one asset class, and combine these into an overall portfolio that meets your individual risk profile. This helps provide the transparency and flexibility necessary for ongoing review and alteration, as needed. In other words, selecting funds such as the ubiquitous "balanced" fund, will not work.

CASHFLOW

Cash flows from each of the investments, into the cash account, and living expenses are drawn from there.

If investments are sold, then proceeds go into the cash fund and proceeds can be drawn from there.



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RISK MANAGEMENT

The cashflow can be described as follows:

Risk is managed in two main ways:

1. By varying the exposure to each of the layers. Those who are very risk averse, will have a high exposure to layer 1, and lower exposures to layer 2, and, especially, layer 3. The less risk averse will have the opposite mix.
2. By regular reviews. Reviews ensure that the portfolio can be kept up with changes in your personal situation, or substantial changes in markets.

What goes up, must come down.

Sir Isaac Newton

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John Cameron is one of the best qualified, most experienced and respected financial planners in Australia.

He's well qualified academically, with degrees in both economics and commerce, an MBA and other post-graduate qualifications.

He's also supremely qualified by experience, with over 30 years hands-on experience creating effective investment strategies for people.

And he's the direct opposite of the fast-sales, pre-packaged product model that dominates the financial planning industry. He's interested in customised, personal plans, crafted for long term clients he has the time to know – and his clients include people of ordinary wealth, not just "high net worth individuals".

John Cameron is the Principal of Black Swan Event Financial Planning, in Perth.

Says John, "Thirty years in this business has taught me that no two clients are the same and there is no place for commoditised pre-packaged products. To maximise your returns, you need a strategy that takes into account all relevant issues and then customised to you. To maximise your returns, there needs to be recognition that things change and that frequent reviews of the strategy – to minimise the impact of black swan events – is essential."

His promise to clients is, "With us you won't see a new person every time: I'll stick with you. And I'll always 'tell it like I see it'. I won't claim to always get it right, but I will always give our honest opinion. What you see is what you get."

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