

Super funds and two years in a row of negative returns

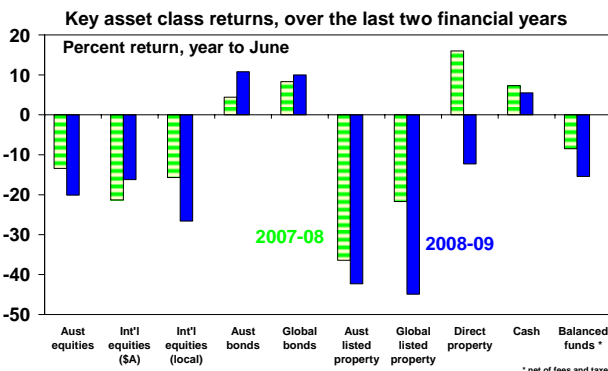


Key points

- The slump in investment markets has seen super funds post negative returns for a second financial year.
- While very disconcerting, periodic negative returns from growth assets are normal and are the price we have to pay for the higher long term returns they provide. Reacting to the current turmoil by moving to cash will lock in losses and only lead to lower long term returns.
- Fortunately, there are signs of improvement. Share and credit markets led the way down and they are now leading on the way up as the global financial crisis is abating and leading economic indicators are pointing to an economic recovery ahead.

Introduction

The key driver of returns for an investment portfolio is the asset classes in which it's invested. The most common diversified superannuation funds have 70 per cent of their funds invested in growth assets (mostly shares and property). The logic is that over the long term, growth assets provide higher returns. Of course this is not necessarily so in the short term and unfortunately over the last year most assets, except cash and government bonds, have had significant negative returns. Even unlisted assets such as directly held commercial property, infrastructure and private equity have come under pressure. As a result super funds have had a second financial year of losses.



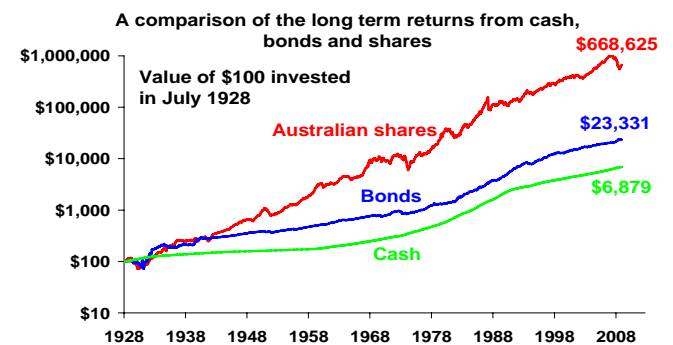
Source: Thomson Financial, Intech, AMP Capital Investors

After such a bad run the temptation is to think that cash is a better bet. However, there are several points to note.

Despite volatility, shares have higher long term returns

The first thing to note is that while shares provide a far more volatile ride than say cash or bonds they provide much higher returns over the long term. This is evident in the next chart which compares the cumulative pre tax return from \$100 invested in 1928 into each of Australian

cash, government bonds and equities. The chart starts in 1928 as I don't have monthly returns for cash before then. Note that it's also a log scale otherwise the lines go exponentially up pretty quickly and look silly.



Source: Global Financial Data, AMP Capital Investors

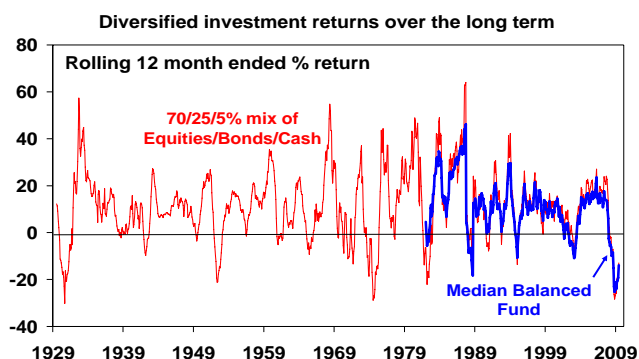
Over the whole period cash provides a relatively steady ride but only returns an average 5.4% pa such that \$100 invested in 1928 would have grown to \$6,879 today. Australian government bonds are a bit more volatile and provide a slightly higher average return of 7% pa taking the \$100 to \$23,331 today. By contrast Australian shares provide a rougher ride, but the benefit is that thanks to an average return of 11.5% pa, the \$100 invested in 1928 would have grown to \$668,625 today.

The point is that with shares we have to take the bad (periodic negative returns) with the good (higher long term average returns). Over the last century shares have had numerous setbacks (1930s crash, the near 60% plunge in the 1970s, the 1987 crash, etc), but the market has always recovered to resume its rising trend.

Periodic negative returns in super funds are not nice but are normal

Secondly, periodic negative returns from a diversified mix of assets are normal. Traditional diversified investment portfolios that underpin most superannuation funds aim to reduce the volatility associated with shares and other growth assets by having some exposure to cash and bonds. But despite this **the historical record indicates that traditional diversified portfolios (cash, bonds, property and equities) have negative returns every six years or so.** The next chart shows returns for balanced growth super funds from the Mercer Investment Consulting survey since 1982. Since balanced super funds only came into existence thirty years ago, the chart also shows a simulated balanced fund. This is constructed on the basis of 70 per cent in Australian equities, 25 per cent in

Australian bonds and five per cent in cash. The chart excludes exposure to global assets and property as we do not have a long term monthly return series for these. In any case, going by the last 27 years it's doubtful that it would change the pattern of returns dramatically.



Source: Global Financial Data, Mercer Investment Consulting, AMP Capital Investors

The simulated series tracks the median Balanced Fund return pretty well suggesting that it's a good proxy. It's clear from the chart that, while the losses over the last two years are extreme, they are comparable to experiences in the 1930s and 1970s, and more broadly it's clear that negative returns every few years are a normal cyclical phenomenon. Negative returns occurred in 1929-31 (Great Depression), 1938-39, 1941-42 (World War II), 1949, 1952, 1956, 1960-61, 1964-65, 1970-71, 1972-74 (oil crisis, stagflation, Watergate, etc), 1981-82, 1987-88 (share market crash), 1990, 1994 (bond crash) and 2001-03 (tech wreck, terrorist attacks). Equity market falls were a key factor in most of these episodes as were recessions. The only way to avoid negative returns entirely would be to invest solely in cash, but this will result in much lower returns over the long term.

Mean reversion

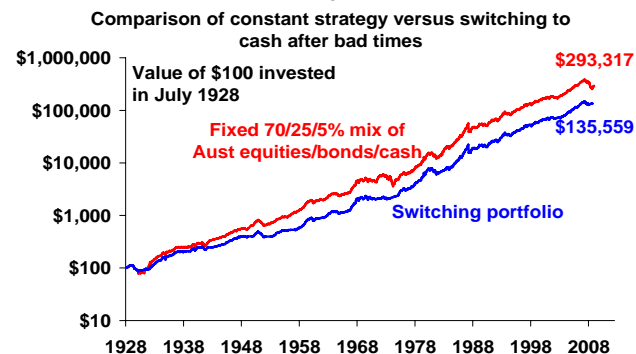
Thirdly, average returns from superannuation funds over the 25 years to 2007 were well above what might reasonably be considered to be sustainable. Over the period 1901 to 2007 the average return from a mix of 70% in equities and 30% in bonds and cash is 5.5% pa after inflation. By comparison the median real balanced growth superannuation fund return was more than 2% pa above this over the 1982 to 2007 period and between June 2003 and June 2007 real returns were more than double this. In other words, investment returns over the 1982-2007 period were well above what might be considered sustainable and the bad patch over the last couple of years in growth assets should be seen as a correction after many years of above average returns. For super funds it all means that a realistic long term real return expectation is inflation plus about 5% pa, not the double digit gains of the good times, but also not the negative returns of the bad times.

Stay the course

Fourthly, given the danger of getting locked into the prevailing sentiment of the times, the best approach for most investors is to adopt an appropriate long term investment strategy and stick to it. After the losses of the last two financial years the temptation is to switch to a more conservative strategy or cash. The problem though is this will just lock in the loss and will invariably result in lower long term returns. The following chart shows the cumulative return to two portfolios since July 1928:

- a fixed balanced mix of 70 per cent Australian equities, 25 per cent bonds and five per cent cash;

- a portfolio which starts off with the above but moves 100 per cent into cash after any negative financial year and doesn't move back until after the balanced portfolio has one financial year of positive returns (assuming an investor will require a year of positive returns to get confident again). We have assumed a two-month lag. This is called the "switching portfolio".



Source: Global Financial Data, AMP Capital Investors

The switching strategy does produce better short term results when there are two consecutive financial years of negative returns from the fixed balanced mix as in the early 1930s, mid 1970s, earlier this decade and, of course, over the last year. However, over the long run it produces an average return of 9.3% pa versus 10.4% pa for the balanced fund. On a \$100 investment in 1928 the switching portfolio would have grown to \$135,559 by June 2009 compared to \$293,317 for the constant balanced mix. As noted earlier, over the same period \$100 invested in cash would have grown to \$6,879 and \$100 invested in bonds would have grown to \$23,331. The conclusions are clear. Over the long term cash and government bonds will generate much lower returns than a diversified mix of assets and switching to cash after a bad patch is not the best strategy for maximising wealth over time.

Signs of recovery

Finally, there are good reasons to expect better returns ahead. To be sure, unlisted assets such as direct property are still catching up to the earlier fall in shares. However, shares and other financial assets have staged strong gains since March and this has been flowing into super fund returns which have just had their first positive quarter since the September quarter 2007. With increasing evidence of an approaching economic recovery the profit outlook is likely to improve, and this combined with the fact that shares are very attractive compared to low yielding cash and bonds, should help them recover further going forward.

Conclusion

The last two years have been very disappointing for investors. However, history tells us that bouts of negative returns from growth assets, and hence superannuation funds, are to be expected. While switching to cash may seem tempting, this will only lock in losses and result in much lower long term returns. The good news though is that superannuation returns have started to improve over the last few months reflecting the improvement in financial markets. With global financial conditions now on the mend and increasing signs of a looming economic recovery, a further improvement is looking likely.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital Investors

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