AustSafe Super An Industry SuperFund

Two years of losses not so super

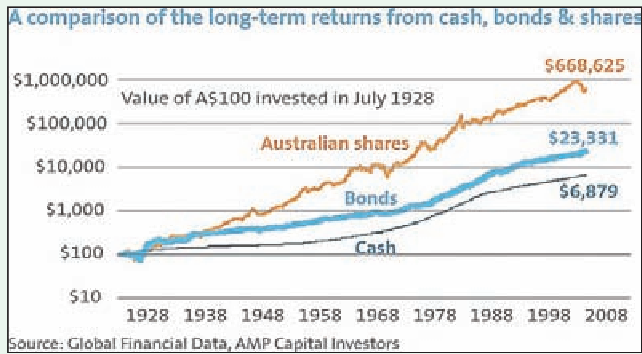

Figure 2: Diversified investment returns over the long term.

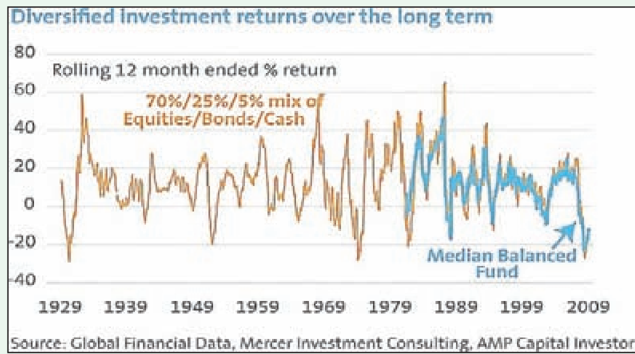

Figure 3: Comparison of constant strategy versus switching to cash after bad times.

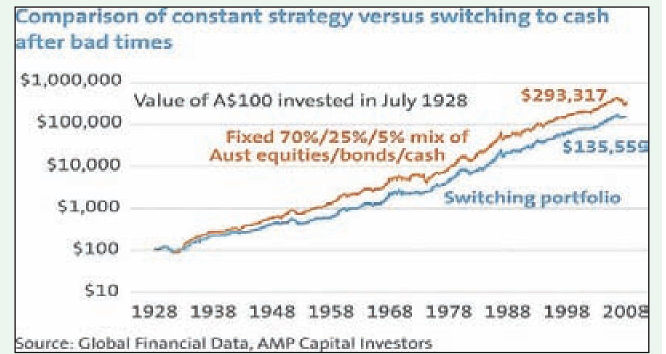

Figure 4: Key asset class returns over the past two financial years.

THE key driver of returns for an investment portfolio is the asset classes in which it is invested. The most common diversified superannuation funds are 70pc invested in growth assets (mostly shares and property). The logic is that over the long term, growth assets provide higher returns. This is not necessarily the case in the short term, and over the last year most assets, except cash and government bonds, have had significant negative returns. As a result superannuation funds have had a second financial year of losses.

Key asset returns

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 (Figure 4). Firstly, while shares provide a far more volatile ride than 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 A$100 invested in 1928 into each of Australian cash, government bonds and equities. The chart starts in 1928, as we do not have monthly returns for cash before then. Note that it also uses a logarithmic scale.

Cash, bonds, shares

Over the period (Figure 1), cash provides a relatively steady ride but only returns an average 5.4pc per annum (pa). So A$100 invested in 1928 would have grown to A$6879 today. Australian government bonds are a bit more volatile and provide a slightly higher average return of 7pc pa, taking the A$100 to A$23,331 today. By contrast, Australian shares provide a rougher ride, but due to an average return of 11.5pc pa, the A$100 invested in 1928 would have grown to A$668,625 today.
With shares we have to take the bad (periodic negative returns) with the

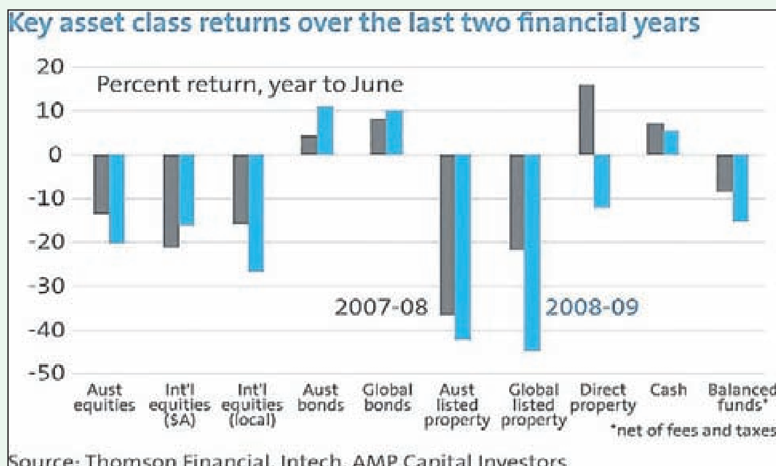

Figure 1: A comparison of the long-term returns from cash, bonds & shares

good (higher long-term average returns). Over the last century, shares have had numerous setbacks (1930s crash, the near-60pc 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 asset mix are normal. Traditional diversified investment portfolios aim to reduce volatility associated with shares and other growth assets by having some exposure to cash and bonds. But the historical record indicates traditional diversified portfolios have negative returns every six years or so. The next chart shows returns for balanced growth super funds from a Mercer Investment Consulting survey since 1982. As balanced funds only came into existence 30 years ago, the chart also shows a simulated balanced fund. This is constructed on the basis of 70pc Australian equities, 25pc Australian bonds and 5pc cash. The chart excludes global assets and property as we do not have a long-term monthly return series for these.

History as a guide

From the chart (Figure 2), it's clear that while the losses over the past 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 and recessions were a key factor in most of these episodes. The only way to avoid negative returns entirely would be to invest solely in cash, but this would result in much lower returns over the long term.

Mean reversion

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

Stay the course

Fourthly, given the danger of getting locked into prevailing sentiment, the best approach for most investors is adopting an appropriate long-term strategy and sticking to it. After the losses of the last two financial years the temptation is to switch to conservative or cash. The problem is this locks in the loss and invariably results in lower long-term returns. Our chart (figure 4) shows the cumulative return of two portfolios from July 1928:

- One is a fixed balanced mix of 70pc Australian equities, 25pc bonds and 5pc cash;
- The other portfolio starts off with the allocation above but moves 100pc into cash after any negative financial year and does not 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 called 'switching portfolio'. The switching strategy does produce better short-term results when there are two consecutive financial years of negative returns from the fixed balanced mix (see Figure 3). However, over the long run, it produces an average return of 9.3pc pa versus 10.4pc pa for the balanced fund. On a A$100 investment in 1928 the switching portfolio would have grown to A$135,559 by June 2009 compared to A$293,317 for the fixed balanced mix. As noted earlier, over the same period A$100 invested in cash would have grown to A$6879 and A$100 invested in bonds would have grown to A$23,331. It's clear. Over the long term, cash and government bonds will generate much lower returns than diversified assets and switching to cash after a bad patch is not the best strategy.

Signs of recovery

Finally, there are good reasons to expect better returns ahead. Admittedly, 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. 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.
The past two years have been disappointing for investors. However, history tells us that bouts of negative returns from growth assets, and hence super funds, are to be expected. Switching to cash may seem temptingbut this only locks in losses and results in much lower long-term returns. The good news is that super returns have started to improve over the last quarter, reflecting the improving financial markets. With global financial conditions on the mend and signs of an economic recovery appearing, a further improvement is likely. *– Dr Shane Oliver, Head of Investment Strategy and Chief Economist, AMP Capital Investors.*

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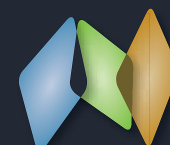

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