ASX

Russell Investments

FULL REPORT // JULY 2017

# 2017 Long-term Investing Report

The 5 big threats to wealth creation for Australians

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# Executive summary

**The 2017 Russell Investments/ASX Long-term Investing Report shows how 5 major threats to long-term wealth creation could potentially play out for millions of Australians.**

Traditional investment approaches are unlikely to achieve the returns investors need to achieve their goals, as lower returns and the potential for increasingly volatile markets are predicted for core asset classes. So where and how can investors find optimum returns while mitigating risk?

All the signs point to a future where savvy investors will increasingly use diversified multi-asset strategies, designed to efficiently capture new sources of return opportunities, to help build their long-term wealth.

## 1. Rear-view mirror investing

Making investment decisions based on past performance is a high-risk strategy at the best of times, and we never recommend it. In the current climate, where the strength of investment fundamentals has weakened and new norms are being created[1], it is even more important that investors look beyond historical numbers and incorporate new investment insights. This is due to the dramatic global economic and political uncertainty that has and will change the drivers of success for future investment performance.

For example, chasing last year's winning asset class as a strategy has underperformed a traditional balanced fund by 1.2% p.a. over 10 years (excluding costs).[2] This is because a strategy that buys and sells to follow last year's winning asset class after it has outperformed assumes that past performance will continue year on year, which does not always eventuate. Furthermore, such a strategy incurs trading costs, which further drag down portfolio returns.

A better way to gain exposure to high-conviction investment opportunities is through timely implementation such as that offered by dynamically managed and agile real return strategies, that respond in real time to market changes.

## 2. Lack of portfolio diversification

As this Report shows, all asset classes are vulnerable to the vagaries of the market. Having a narrowly focused portfolio by putting all your eggs in one or two asset classes exposes investors to a lot of unnecessary downside risk.

A diversified multi-asset strategy invests in a wide range of asset classes so it cushions investors against dramatic year-on-year changes to returns should any particular asset class suffer large losses. These strategies can spread the risk even further by providing the option to diversify beyond traditional asset classes into alternative investments.

## 3. Reliance on residential property

Following residential property's star performance up to 2015, it again retained its place in 2016. However, we believe it carries significant stock-specific risk for people seeking stable, positive returns. While residential property overall has achieved strong positive returns over the last 10 and 20 years, it would be a mistake to blindly rely on the upward trend continuing across the board i.e. for the one or two properties an investor may have exposure to.

Median house prices rose less in 2016 than in 2015 and there was wide variation between regions, dwelling types and suburbs, with some areas declining. The only way to avoid the considerable downside risk of single-asset investing is true diversification across asset types.

## 4. Investing in over-priced traditional assets

Many global market commentators agree that the low-yield, highly dynamic environment we highlighted in last year's Report is likely to continue for core asset classes, especially shares and bonds. Our investment strategist group continues to forecast lower returns and higher volatility going forward as equity markets (especially in the U.S.) become more and more expensive, while markets may experience sharp sudden falls as unprecedented levels of political changes in numerous countries create fear and uncertainty.[3]

Similarly, according to well-respected market forecaster Jeremy Grantham of GMO, most equity markets are currently over-valued, resulting in low returns and increased risk. GMO forecasts an average annual decline of 3.8% for U.S. large-cap equities and 0.8% for U.S. bonds over the next seven years.[4] The potential benefits of greater diversification and active management become all the more meaningful the lower the expected market returns.

[1]Russell Investments 2017 Global Market Outlook: The New Abnormal https://russellinvestments.com/au/insights/market-insights/global-market-outlook
[2]Russell Investments: Value of diversification - https://russellinvestments.com/au/financial-advisers/investor-engagement-framework/client-servicing
[3]Russell Investments 2017 Global Market Outlook: The New Abnormal https://russellinvestments.com/au/insights/market-insights/global-market-outlook
[4]GMO 7-Year Asset Class Real Return Forecast, February 2017

5. Setting and forgetting

Instead of a 'set and forget' approach which relies on a steady-state, unchanging market environment, investors faced with volatile markets will require a nimble approach, shifting between asset classes and sub-asset classes in real time as market conditions change.

Dynamically-managed, real return funds can take advantage of emerging shorter-term investment opportunities and protect against draw downs while still positioning a portfolio to achieve longer-term return objectives.

# Data highlights

## Asset classes[5]

## 10 years

- Australian residential property was again the top performer, but with a slight drop on 2015.
- Equity markets posted double-digit returns for 2016 and many alternatives (high-yield debt, emerging market debt, listed infrastructure and property) performed strongly, but year-on-year 10-year returns fell compared to 2015.
- This is because 2006 was a stronger year than 2016 and the negative impact of the Global Financial Crisis moved closer to the beginning of the period.
- Only residential investment property (8.1% p.a.), global fixed income (7.4% p.a.) and Australian bonds (6.1% p.a.) exceeded a typical balanced fund target.
- Many growth assets disappointed, including Australian equities (4.3% p.a.) and hedged global equities (5.5% p.a.).
- Australian listed property continued its flat run from 2015 and was the worst performer at 0% p.a.

## 20 years

- Returns were much stronger than for 10 years, across multiple asset classes.
- All asset classes apart from cash (3.2% p.a.) outperformed a strategic balanced fund target.
- Although returns fell slightly when comparing 2016 to 2015, Australian residential investment property continued to be the top-performing asset class, returning 10.3% gross p.a.
- The return on Australian shares (8.5% p.a.) dipped slightly compared to 2015 (8.7% p.a.).
- Australian listed property and global listed property (unhedged) returned about the same at 7.7% p.a. and 7.6% p.a. respectively, but the latter was down on 2015's 20-year figure of 8.4% p.a.
- At 6.3% p.a., Australian bonds lagged hedged global bonds (7.5% p.a.) and hedged global shares (7.2% p.a.).
- Cash returned less in the 20 years to December 2016 than in 2015 (3.2% p.a. versus 3.4% p.a.).

## Traditional diversified funds

- For the 10 years to December 2016, the gross return for a balanced managed fund (70/30 growth assets/ defensive assets) was 5.4% p.a., for a conservative managed fund was 5.5% p.a. and for a growth managed fund was 5.0% p.a.
- The 2016 figures were down on 2015 for all three fund types, with the 10-year annual return for growth managed funds dropping by 0.8% p.a.
- All three were also below the typical balanced fund return target of 5.9% in 2016.

## Residential property

- Residential property was the  top-performing asset class in 2016 and, on average, for the last 10 and 20 years.
- However, the 10-year and 20-year gross returns were slightly lower compared to 2015.
- Nationally, median house prices rose by 7.5% but units only rose by 4.8% and half the capital cities recorded negative or no growth.
- Price changes in 2016 varied considerably across Australia between states, within states, between different dwelling types and within capital cities.
- Median house prices for Sydney increased by nearly 12.0% over the year but by only 0.7% for units in middle Sydney.
- In South Australia, Adelaide's median house price increased by 3.4% in 2016 but in the Riverland region they fell by nearly 15.0%.

[5]The typical return target for a balanced fund in 2016 was CPI+3.5% (5.9%). This has been reduced from the target of CPI+4% in previous years due to lower expectations of future returns.

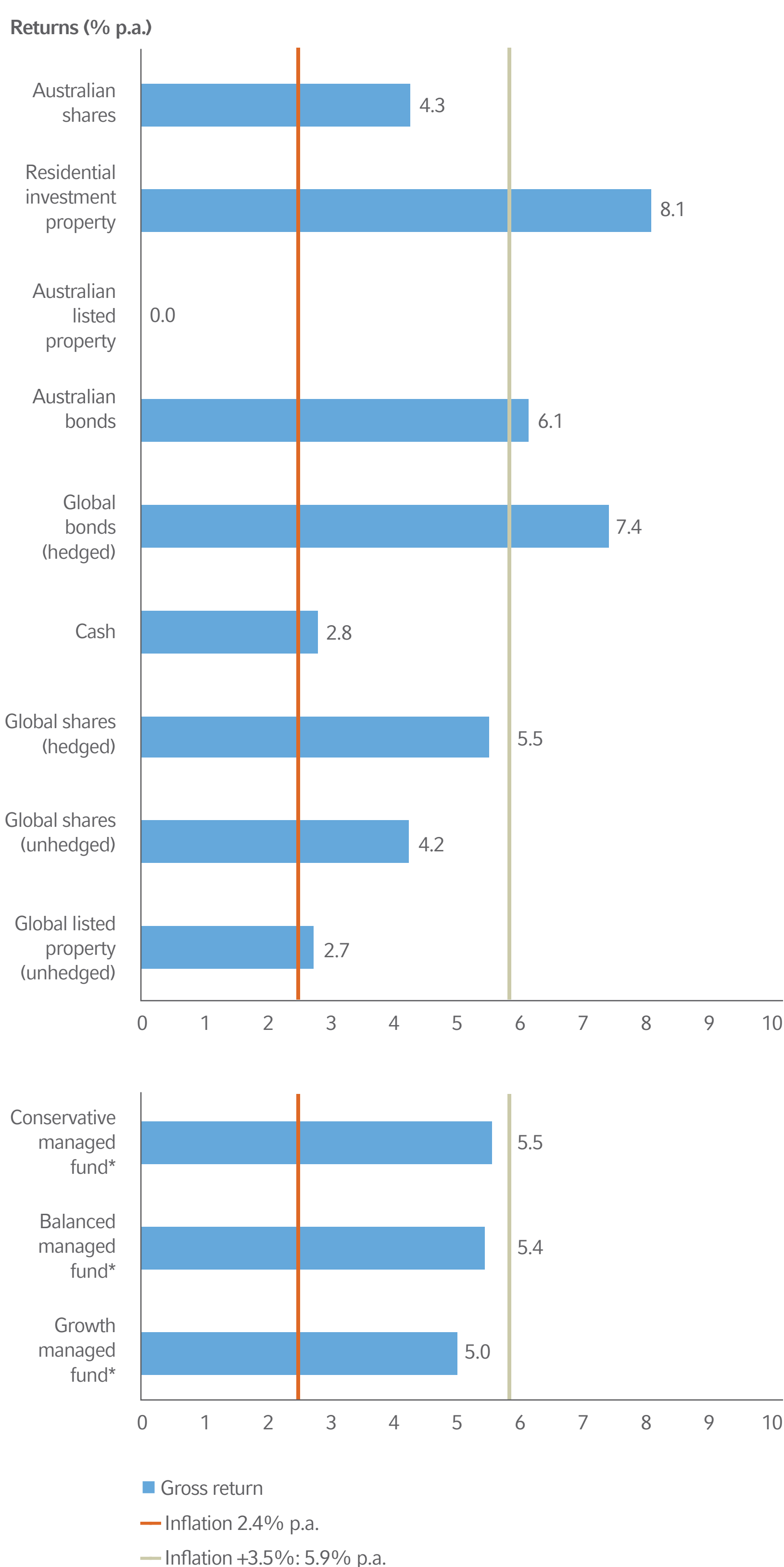
## Comparison across asset classes on a before-tax basis: 10 years

- Australian residential investment property was the strongest performing asset, producing 8.1% p.a. on a before-tax, after-fees basis.
- This was followed by global bonds (hedged), at 7.4% p.a. and Australian bonds returning 6.1% p.a.
- Australian shares fell further away from the top 4 performing asset classes, returning 4.3% p.a.
- Australian listed property continued to achieve a below-inflation return over the 10 years to 31 December 2016, returning 0.0% while inflation was 2.4% p.a.
- Cash returns averaged 2.8% p.a. for the 10-year period.

## Comparison across managed funds on a before-tax basis: 10 years

- Managed funds - The sample conservative managed fund returned 5.5% p.a., followed by the sample balanced managed fund returning 5.4% p.a., and the sample growth managed fund returned 5.0% p.a.

**Exhibit 1** Gross returns for 10 years to December 2016

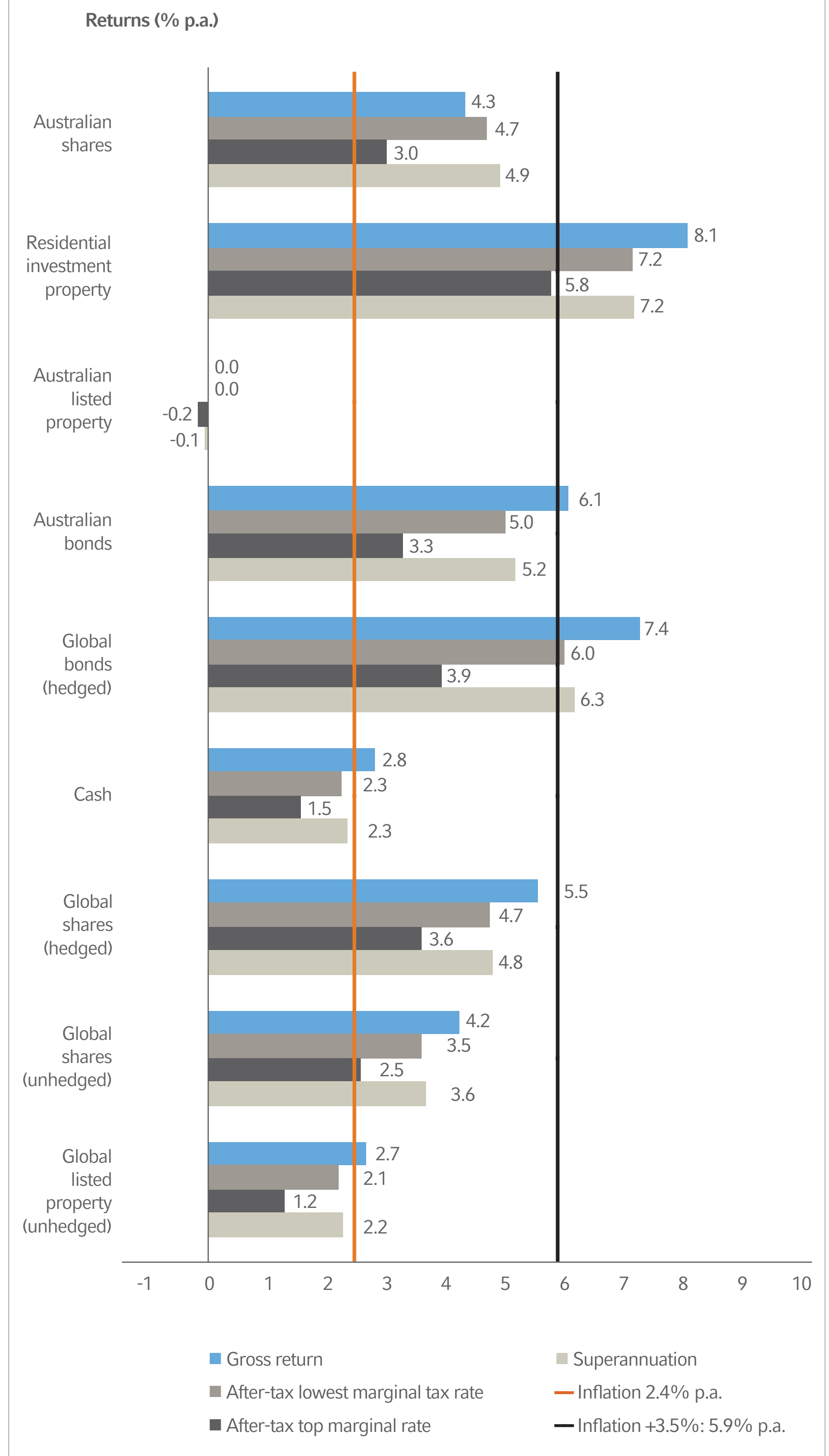



* Only before-tax returns have been calculated.
See Appendix for details on how these sample funds are defined.

**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

## Comparison across asset classes taking into account tax: 10 years

- Returns changed significantly when tax was factored into the analysis.
- Franking credits added to the returns for Australian shares, while tax deductible expenses from Australian residential investment property lowered taxes paid.
- The impact of tax on global assets was noticeably larger than the impact of tax on Australian assets.

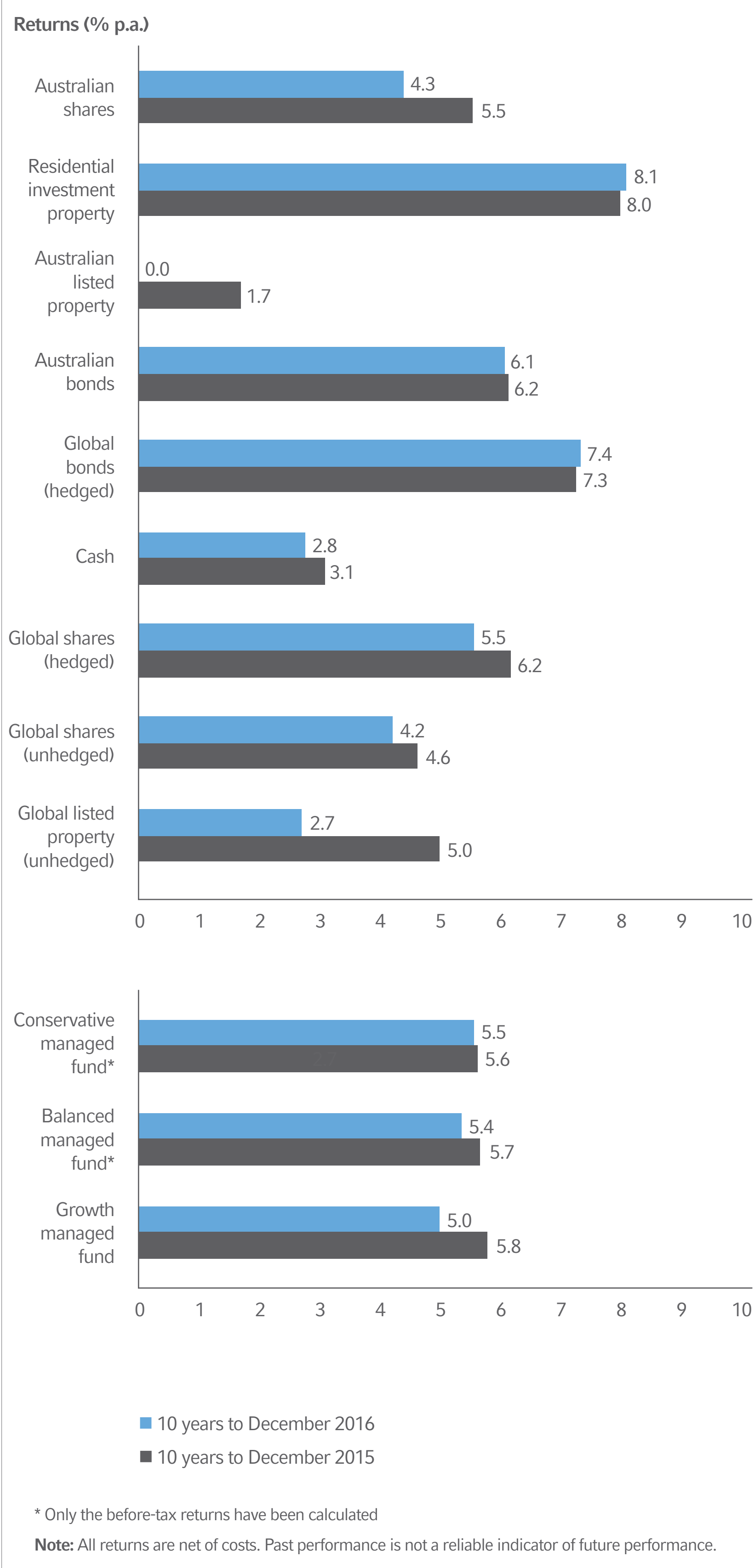



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

## Comparison with last year's gross returns: 10 years

- Comparing the 10-year results to 31 December 2015 and 31 December 2016 on a gross basis, Australian residential investment property continues to take first place, while with Global bonds (hedged) retained second place again.
- Australian bonds continued to outperform Australian shares. Australian listed property retained its ranking from last year as the worst performing asset class, returning 0.0% p.a. over the 10 years to 31 December 2016, compared to 1.7% p.a. to 31 December 2015.
- Global listed property (unhedged) fell positions significantly, returning 2.7% p.a. over the 10-year period to 31 December 2016, compared to 5.0% p.a. over the 10-year period to 31 December 2015.

**Exhibit 3** 10 years to December 2016 vs December 2015



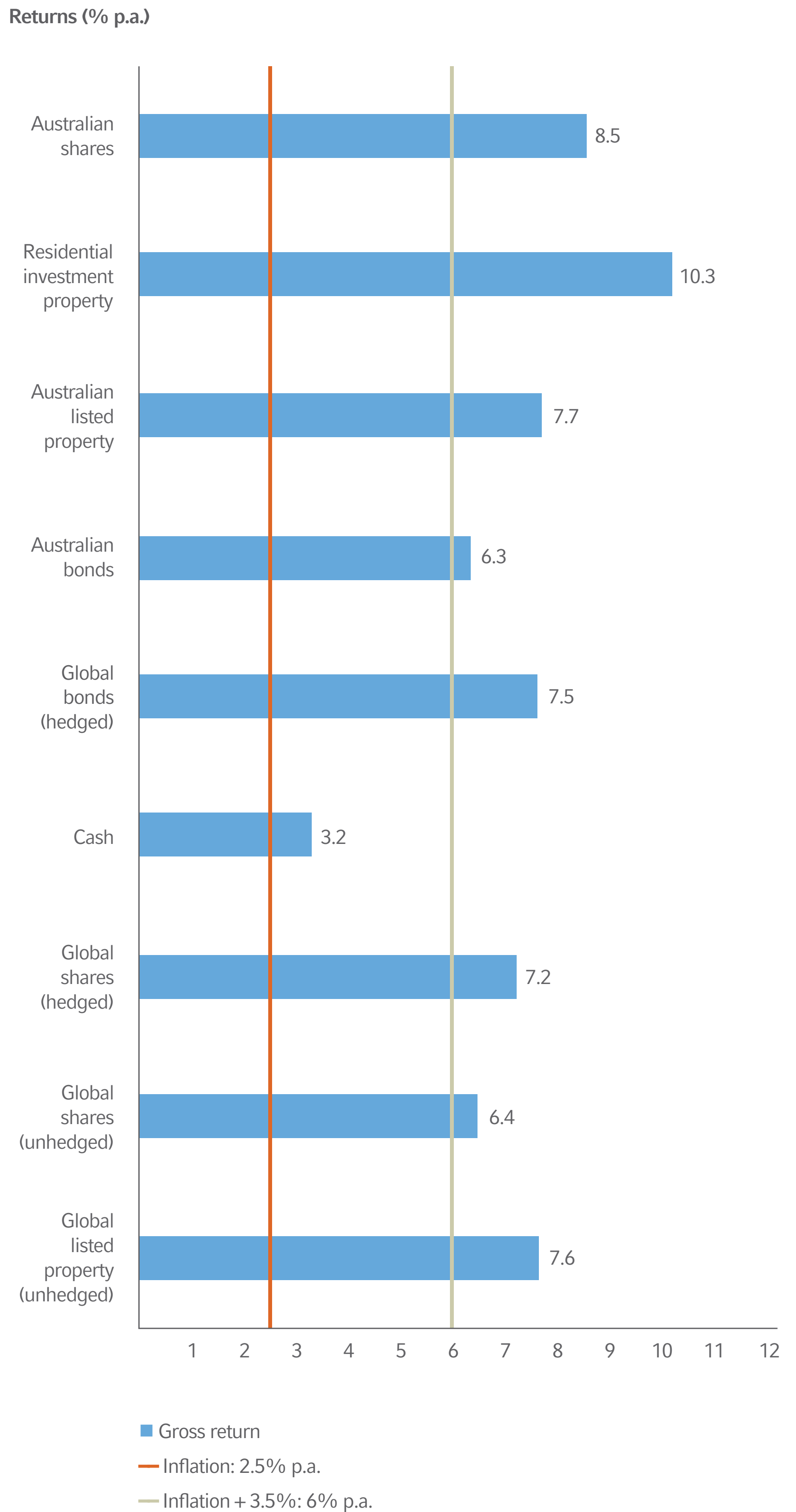

* Only the before-tax returns have been calculated

**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

## Comparison across asset classes on a before-tax basis: 20 years

- Australian shares and Australian residential investment property continued to be the top 2 performing asset classes, with Australian shares returning 8.5% p.a. and Australian residential investment property returning 10.3% p.a.
- Australian listed property was third and returned 7.7% p.a.
- Global listed property (unhedged) followed, returning 7.6% p.a.
- Global bonds performed well, returning 7.5% p.a. Its domestic counterpart, Australian bonds, returned 6.3% p.a. both slightly lower returns compared to last year.
- Cash returned 3.2% p.a.
- All asset classes beat inflation, which stood at 2.5% p.a. over the 20-year period.

**Exhibit 4** Gross returns for 20 Years to December 2016

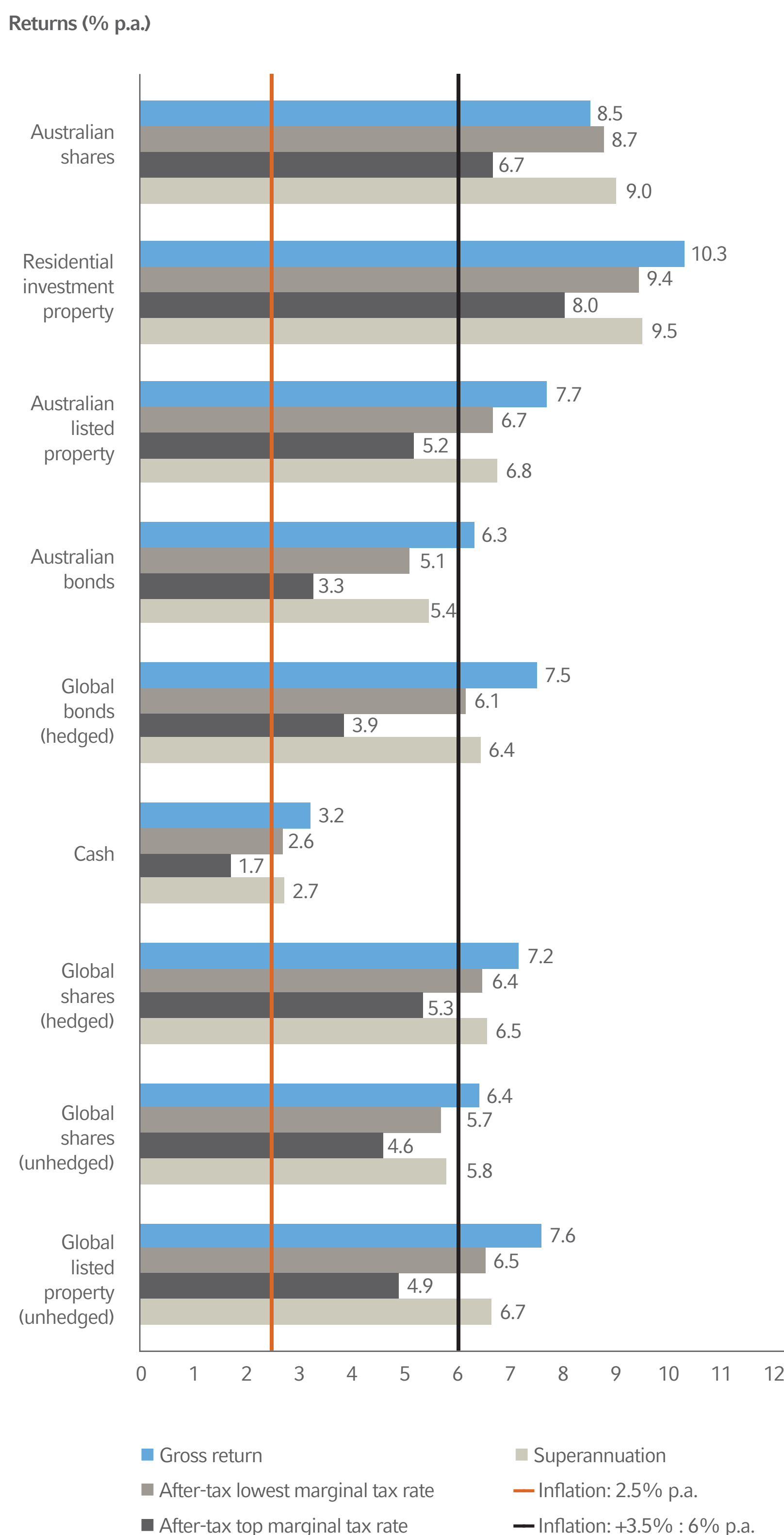



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

## Comparison across asset classes taking into account tax: 20 years

- Those investors in the highest marginal tax rate category saw more significant changes in return.
- For investors in super and the lowest marginal tax category, tax reduced returns for all asset classes aside from Australian shares.
- In Australian shares, investing in a superannuation vehicle added an extra 0.5% p.a. compared to gross returns. For investors on the lowest marginal tax rate, after-tax returns were 0.2% p.a. higher, while investors on the highest marginal tax rate saw returns reduced by 1.8% p.a. after tax.
- As expected, the impact of tax is more heavily felt on Australian bonds and cash as they are treated as income and are not offered any tax concessions.
- Investing in cash and paying the highest marginal tax rate led to a return of 1.7% p.a., making it the only asset class and investment structure that failed to keep up with the 2.5% inflation rate for the period.

**Exhibit 5** Before and after-tax returns over 20 years to 31 December 2016

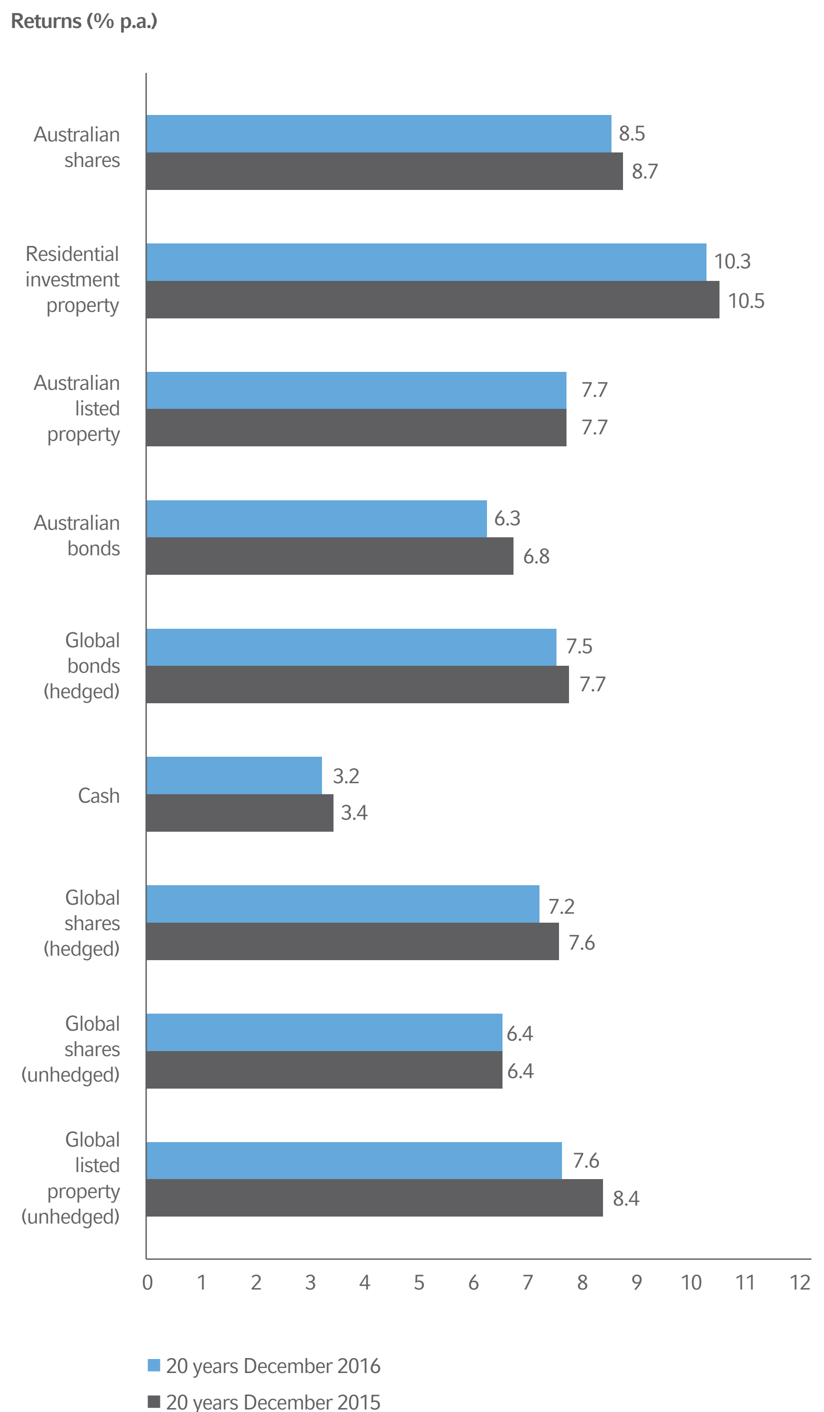



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance. See Appendix for details of marginal tax rates.

## Comparison with last year's gross returns: 20 years

- Although returns fell slightly when comparing the 20-year period, Australian residential investment property continued to be the top performing asset class, returning 10.3% p.a. compared to 10.5% p.a.
- Again this year we saw a slight dip, however, Australian shares remained in second place, returning 8.5% p.a. compared to 8.7% p.a.
- Australian listed property was in third position, returning 7.7% p.a. Its global counterpart, global listed property (unhedged), followed returning 7.6% p.a. compared to 8.4% p.a. to 31 December 2015.
- Australian bonds, at 6.3% p.a. fell behind Global bonds (hedged) which returned 7.5% p.a. and Global shares (hedged) returned 7.2% p.a.
- Cash returned 3.2% p.a. compared to 3.4% p.a. to 31 December 2015.

**Exhibit 6** 20 years to December 2016 vs December 2015

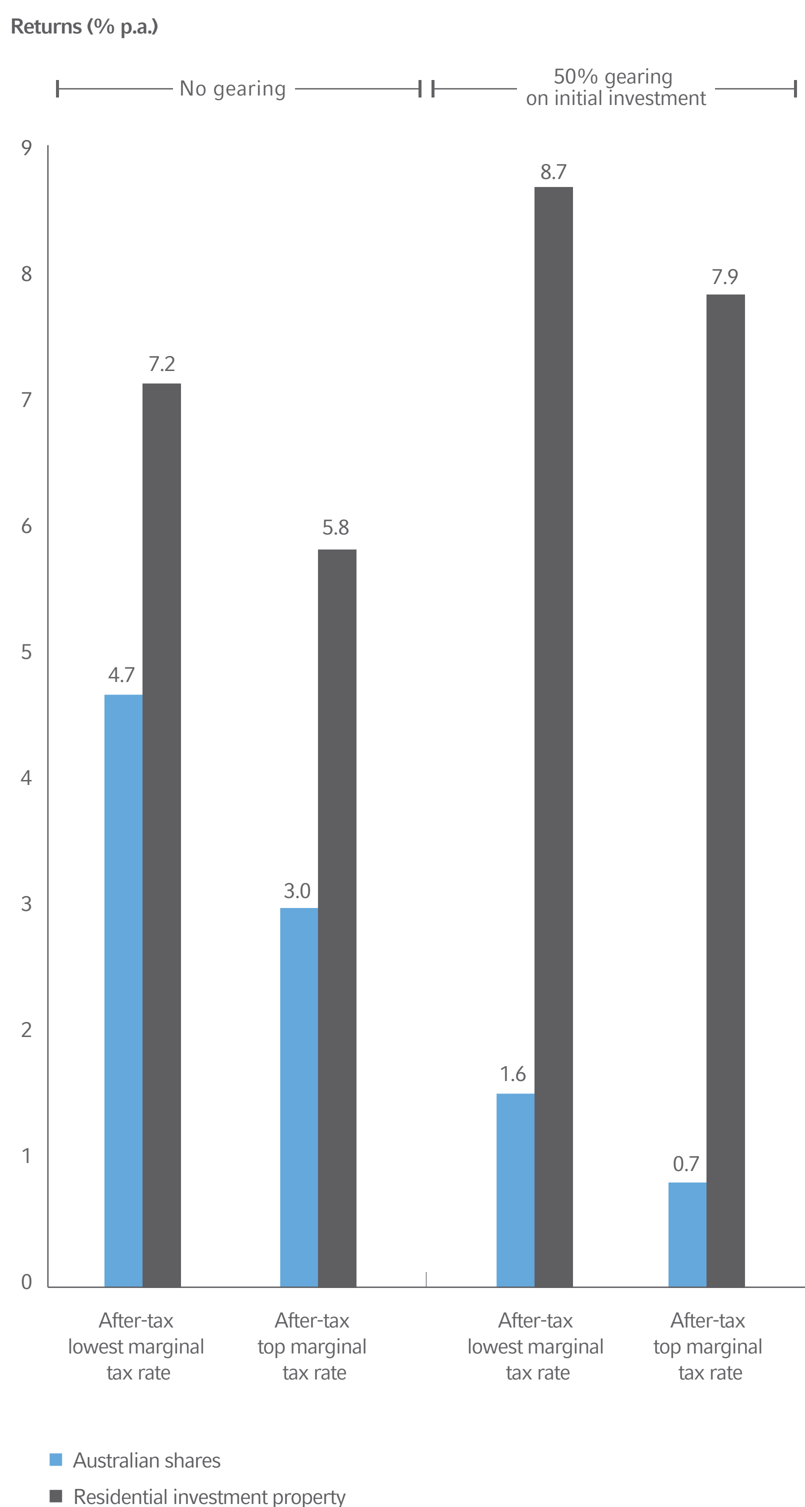



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

## Comparison with and without gearing: 10 years

- Gearing did not enhance returns for Australian shares for investors at the highest and lowest marginal tax rates. This was due to the net returns being unable to match the cost of borrowing.
- Investors with residential investment property saw an uplift in returns by holding a 50% geared portfolio, as property returns exceeded the estimated cost of borrowing.
- Total returns on residential property for both groups of investors (highest and lowest marginal tax rates) were higher after gearing compared to investors who owned the full initial outlay (no gearing).
- Australian residential investment property outperformed Australian shares for the lowest and highest marginal tax rates with and without gearing.

**Exhibit 7** Investment returns for 10 years to December 2016

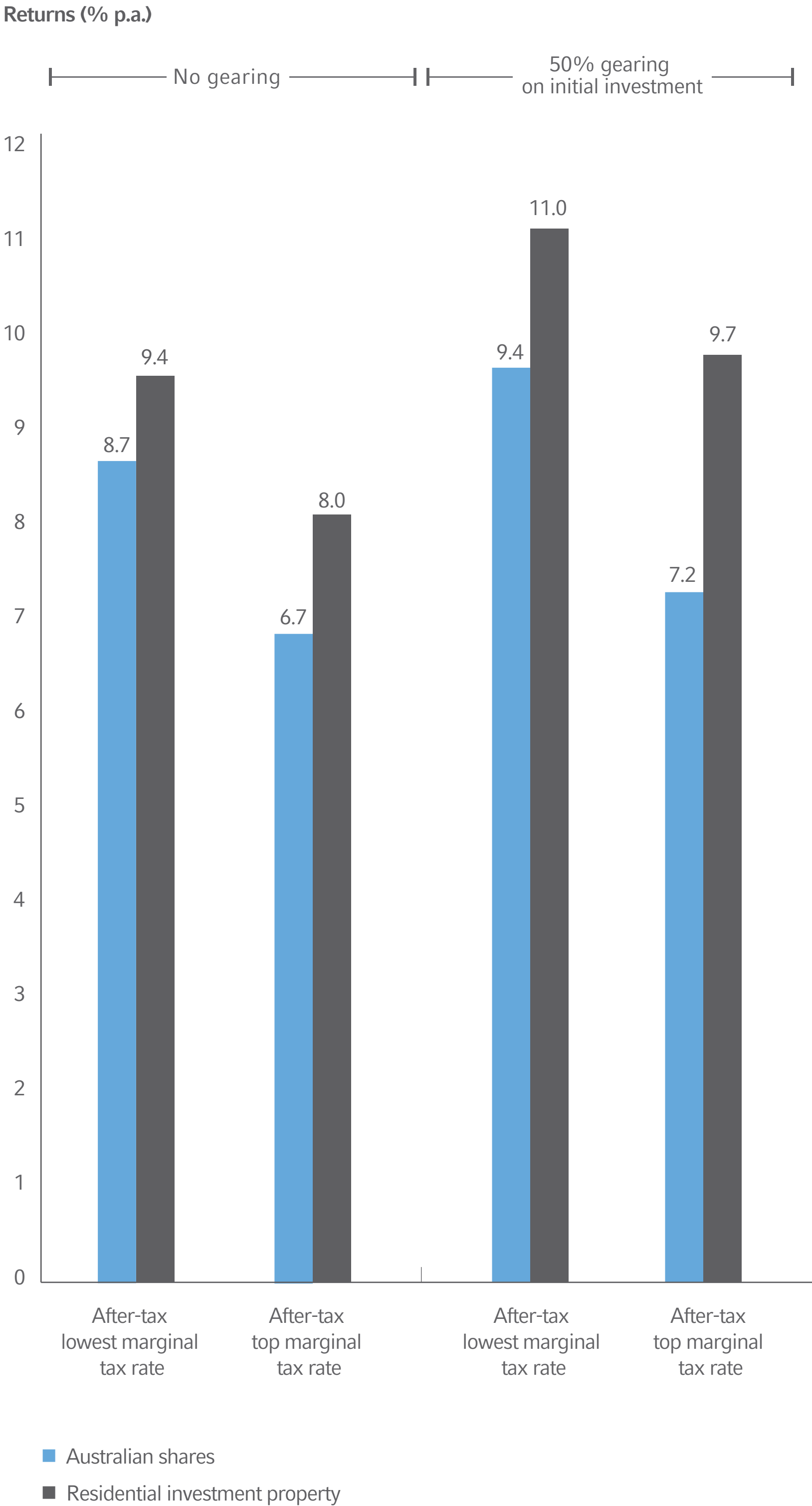



**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

## Comparison with and without gearing: 20 years

- Over the 20-year period, Australian shares and residential investment property for both groups of investors (highest and lowest marginal tax rates) saw enhanced performance, as returns over the longer time period exceeded the relation costs of borrowing.
- Australian residential investment property outperformed Australian shares for both the lowest and highest marginal tax rates with and without gearing.

**Exhibit 8** Investment returns for 20 years to December 2016




**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.

# Appendix

This analysis has been conducted on the following basis

## Investment comparison

- All investment returns are determined after taking into account expenses relating to the acquisition, management and disposal of the asset. **Gross returns** are calculated before tax but after costs. **Net returns** allow for the taxation treatment of each investment over the period of the analysis. This aims to represent a realistic method of comparing the different asset classes for an investor.
- **Compound returns** are calculated over a 10-year period from 1 January 2007 to 31 December 2016 and over a 20-year period from 1 January 1997 to 31 December 2016. The returns are equivalent to the per annum compound returns that investors would have received for an investment in the particular asset class if they invested in an equivalent portfolio over the two periods.

## Income tax

- The lowest and highest marginal tax rates are currently 19% and 45% respectively, as quoted on the Australian Taxation Office website. These rates have varied slightly over the 10 and 20 years due to changes in taxation policy. These variations have been taken into account in the calculation of after-tax returns.
- The calculation of after-tax returns is also inclusive of the 2% Medicare levy, which brings the applied lowest and highest marginal tax rates to 21% and 47% respectively.

## Capital gains

- Generally, assets acquired on or after 20 September 1985 are subject to the capital gains tax provisions. For 10- and 20-year returns, capital gains tax is calculated on the initial investment and any subsequent reinvestment of income. Cash is not subject to capital gains tax, as all gains are taxed as income and subject to marginal rates. For ease of calculation, and in the absence of Australian bonds coupon and capital data, the report assumes returns from Australian bonds are treated as income.
- Assets acquired prior to 21 September 1999 and held for longer than 12 months can be assessed for capital gains tax in one of two ways. Private investors can choose to pay capital gains tax (at their marginal tax rate) on 100% of the capital gain (with indexation of the tax cost) or 50% of the capital gain (with no indexation). In this report, we have presented sector returns based on the calculation method that provides the higher after-tax returns. The discounted capital gain method (as opposed to indexation) has provided the higher after-tax returns in all cases.

## Capital losses

- **Capital losses** may be carried forward indefinitely and offset against other **capital gains** in future periods. We have assumed that the investor has other investments – either today or in the future – that have produced or will produce capital gains against which capital losses may be offset.

## Imputation credits

- Since July 2000, low-tax rate investors with imputation credits remaining after offsetting all tax have been able to claim back the excess as a refund from the Australian Taxation Office. Prior to this, the excess could only be offset against income tax from other sources. We have assumed that, before July 2000, the investor had other sources of income against which to offset this excess.

## Effective tax rates

- This study shows that tax (and its differing effect on capital gains and income) makes a significant difference to the end return for an investor. Overall, for the 20-year period to 31 December 2016, the effective tax rates for top marginal tax payers were:

| | 20 yrs* |
|---|---|
| Australian shares | 21% |
| Australian listed property | 31% |
| Residential investment property | 23% |
| Global shares | 28% |
| Global shares (hedged) | 25% |
| Global listed property | 33% |
| Australian bonds and cash | 48% |
| Global bonds | 48% |

* To 31 December 2016.

## Gearing

- After-tax returns with **gearing** have also been calculated for Australian shares and residential investment property over the 10-year period from 1 January 2007 to 31 December 2016, and over the 20-year period from 1 January 1997 to 31 December 2016. Half of the initial investment is assumed to be borrowed, and gearing arrangements are assumed to involve interest-only loans (that is, periodic payments do not include any repayment of principal). In addition, allowance is made for the deductibility of interest costs.
- **Borrowing costs** are based on data from the Reserve Bank of Australia (RBA) bulletin. The borrowing costs for residential investment property are based on the standard variable rate for housing loans. The borrowing costs for Australian shares are based on the margin loans rate.

## Superannuation

- The investment earnings of a complying superannuation fund or retirement savings account have been taxed at a rate of 15% as of 1 July 1988. Prior to this, there was no tax on superannuation earnings. The capital gains tax discount for superannuation funds is one-third of the capital gains included in a superannuation fund's assessable income. The tax that a superannuation fund pays on its assessable income (earnings and taxable contributions) can be reduced by using imputation credits.
- In the superannuation example, it is assumed the investor is over the age of 60 when assets are redeemed, so no tax is payable on a superannuation lump sum or income stream benefit payments.

## Investment measures

- The **residential property** measure is a population-weighted average return calculated across major capital cities. Increases in value are based on median house prices obtained from the Real Estate Institute of Australia. Data from the Australian Bureau of Statistics is used to make adjustments for capital improvements. Net rental income allows for vacancy rates, maintenance expenses, management fees, government charges, land tax and insurance. Acquisition and disposal costs include conveyancing, stamp duty and agents' fees.
- The **cash** measure assumes an investment of $50,000 in cash management bank accounts, based on an average of the five largest banks' rates sourced from the RBA.
- The **Australian shares** measure is based on investment in listed shares, with price movements and dividend reinvestment consistent with the S&P/ASX All Ordinaries Accumulation Index. Allowance is made for brokerage and stamp duty (where applicable) on acquisition and disposal. Stamp duty ceased to apply from 1 July 2001 for transfers of marketable securities quoted on the Australian Securities Exchange. Dividend franking is taken into account in determining the impact of tax on dividends.

- The **Australian bonds** measure is based on investment in Australian Government and corporate bonds. Returns are derived from the Bloomberg Australian Bond Composite 0+ Yr index. For ease of calculation, and in the absence of available data, price movements and coupon payments are both deemed to be taxed as income.
- The **Australian listed property** measure is based on the returns implied by the S&P/ASX 200 Property Trust (Accumulation) Index. Acquisition and disposal costs, such as brokerage and stamp duty (where applicable), have been factored into the return calculations. Assumptions have been made with respect to the tax treatment of listed property income, including the component of tax-free income (abolished in July 2002) and tax-deferred income.
- The **global shares (unhedged)** measure is based on investment in listed shares with price movements and dividend reinvestment consistent with the Russell Developed Large Cap Index (unhedged) in Australian dollars from 1997, onwards and the MSCI World ex-Australia Gross Dividends Accumulation Index (unhedged) in Australian dollars prior to 1997. Allowance is made for brokerage on acquisition and disposal. Withholding taxes are used to offset Australian taxes in the year the dividends are received.
- The **global shares (hedged)** measure is based on investment in listed shares with price movements and dividend reinvestment consistent with the Russell Developed Large Cap Index (hedged) in Australian dollars from 2000 onwards, and the MSCI World ex-Australia Gross Dividends Accumulation Index (hedged) in Australian dollars prior to 2000. Allowance is made for brokerage on acquisition and disposal. Withholding taxes are used to offset Australian taxes in the year the dividends are received.
- The **global listed property** measure is based on dividend reinvestment consistent with the FTSE EPRA/NAREIT Developed Index in Australian dollars (unhedged). Allowance is made for brokerage on acquisition and disposal. Withholding taxes are used to offset Australian taxes in the year the dividends are received.
- The **conservative managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 25%–35% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal, and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated, due to lack of data on distributions.
- The **balanced managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 65%–75% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal, and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to lack of data on distributions.
- The **growth managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 75%–85% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. Allowance is made for buy/sell spreads on acquisition and disposal, and annual investment management fees equivalent to that of a retail indexed manager. After-tax returns are not calculated due to lack of data on distributions.
- The **global bonds** measure is based on investment in investment grade global fixed income. Returns are derived from the Bloomberg Barclays Global Aggregate Bond Index. For ease of calculation, and in the absence of available data, price movements and coupon payments are both deemed to be taxed as income.

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Russell Investments/ASX Long-term Investing Report

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