In search of risk-adjusted super returns

Super fund losses can be an unfortunate trigger for members to switch to more conservative options, such as cash, at the wrong time. **AFR**

by **Sally Patten**

Equity market volatility has fallen dramatically over the past few years. Sometimes it may not feel like it, but earlier this month the Vix – or the Chicago Board Options Exchange Volatility Index, often referred to as the "fear" index – hit its lowest level for three years.

But some experts reckon that could all be about to change, as investors come to the realisation that US President Donald Trump may not be able to deliver on his policy agenda. The US economy may be improving and corporate earnings are strong, but the "Trump trade" could be on the wane.

"The markets were in need of a growth story. Markets welcomed the new growth paradigm and immediately priced it in. Now they are adjusting to the fact that reform takes time, political capital takes time to build and trade relations are a complex problem. We'll definitely see more volatility. We are adjusting back to normal volatility," Andrew Lill, chief investment officer, Asia Pacific, Morningstar Investment Management told *The Australian Financial Review* last week.
What might this mean for superannuation funds, where equities account for 90 per cent of the risk of a typical balanced portfolio, even though only 50 per cent or 60 per cent of the portfolio is invested in shares? Indeed, what might it mean for individual investors, whose effective exposure to equities might be even higher?

If stockmarkets take a turn for the worse, presumably super fund members would be hit with lower returns, or they might even see their retirement savings accounts go backwards. Unfortunately, losses can be a trigger for members to switch to more conservative options, such as cash, at the wrong time.

QSuper might argue that a wholesale re-thinking of super fund asset mixes is required to reduce the influence of equities on portfolios. A shift towards focusing on risk-adjusted returns can result in quite different portfolios, but without necessarily sacrificing returns – or indeed perhaps enhancing them.

When QSuper shifted its investment goal, removing any hint of a peer objective, after the global financial crisis, it lowered the proportion of equities in the balanced fund to 35 per cent from 60 per cent. The proportion of the portfolio exposed to infrastructure assets trebled to 15 per cent. In the meantime fixed income holdings rose to 20 per cent, mainly due to an increase in so-called long duration bonds. These long-term bonds are a useful diversification tool because they are negatively correlated to equities, while carrying equity-style risk. If central banks are forced to cut interest rates in response to a financial shock, the bonds will rise in value.

Damian Lillicrap, head of investment strategy at QSuper, says the revised asset mix has more than halved the balanced portfolio's sensitivity to equity prices. If there were a 50 per cent collapse in share prices today, the value of the fund would fall by 10 per cent, rather than the 25 per cent loss it would have suffered in the early 2000s. Equities are still the dominant risk but that dominance is less, at about 60 per cent of the portfolio, Lillicrap says. At the same time, the cumulative return since 2010-11 has surpassed that of the average balanced vehicle.

Other factors may have helped returns. They may be less influential, but another useful lesson. Only a quarter of QSuper's equities portfolio – or 7.5 per cent of the whole fund – is invested in the Australian sharemarket, mainly because the investment team is wary of the level of concentration in the local market. And since 2009, QSuper's equity exposure has been index-based, although thanks to the use of so-called smart beta strategies, much of the fund's shareholdings do not resemble stock indices.

But back to asset allocation and investment objectives. There are lots of different theories around portfolio construction, but funds that insist on benchmarking themselves, even implicitly, against peers without paying sufficient attention to their risk profiles are doing members a disservice. If it is possible to achieve the same level of return with lower risk, what member would say 'no' to that?

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