Managing risk in volatile markets

Glenn Rushton discusses how a market-neutral approach can help SMSFs overcome the risk and volatility inherent in the current investing landscape.

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Share market volatility and geopolitical uncertainty are making it harder than ever for SMSF trustees to select investments that can generate meaningful returns without adopting uncomfortably high risk.

This was the message from an *Australian Financial Review* article in August, citing a study that found SMSF trustees have scaled back their return expectations to just 2.8 per cent, down from 6.6 per cent the year before. The same study found bearish trustees were increasingly turning to managed funds or increasing their cash holdings to circumvent persistent market volatility.

This comes as no surprise to anyone keeping up to date with global political and economic events, including the impact of the Brexit vote, rising United States interest rates and the US presidential poll.

Global volatility

Britain's shock 23 June vote to leave the European Union hit global markets, which were already precariously positioned as the world held its breath watching how China managed its slowdown.

As Westminster begins its long exit from the continent, this uncertainty is likely to persist, and it will potentially become exacerbated by the November US elections and political tensions in Europe, Russia, Brazil and the Middle East.

If these political conditions are a nightmare for SMSF investors, the economic climate does not appear much better. Zero and negative interest rates in Europe and Japan are crippling cash and bond returns, while those in Britain and the US remain below inflation. Even emerging markets are not safe from economic problems, with many amassing potentially unsustainable levels of corporate debt.

Both the Organisation for Economic Co-operation and Development (OECD) and International Monetary Fund (IMF) have predicted the global economy will continue its subpar performance this year and next, with advanced economies slowing and emerging economies struggling to pick up speed.

The Paris-based OECD expects the world economy to expand by 2.9 per cent this year and 3.2 per cent in 2017, both well below the long-run average of around 3.75 per cent, while the IMF tips global growth of just 3.1 per cent this year and 3.4 per cent in 2017.

While Australia has posted a record 25 straight years of economic expansion, the IMF expects a relatively slow 2.9 per cent expansion this year, dropping to 2.7 per cent in 2017. The Washington-based organisation also expects Australia's inflation rate to remain weak, with consumer prices forecast to rise by just 1.3 per cent in 2016 and 2.1 per cent next year, well within the Reserve Bank of Australia's (RBA) 2 per cent to 3 per cent target range, with the IMF warning of the risks of deflation.

Local impacts

The significance of these events for Australian SMSF investors cannot be understated. The Australian economy and share market have long suffered when uncertainty, sluggish growth and other issues have plagued significant overseas economies, particularly those that are also major trading partners.

It is a double-edged sword because SMSF investors, who typically display investment bias towards local equities, have also suffered an underperforming share market for more than a decade, according to *The Sydney Morning Herald*.

"CommSec data reveals that Australia [has] underperformed most global markets regardless of the state of the global economies," a recent article said.

"At the height of the global financial crisis in 2008 it ranked 33, despite being one of the few developed nations to escape a recession. Not even a mining boom in 2010, 2011 and 2012 pulled Australia into the top 10."

Given the high risk, low returns and

underperformance of the local bourse, SMSF investors would usually turn to traditionally low-risk asset classes, such as cash, bonds and property. Unfortunately, record low interest rates have pulverised cash and sovereign bond yields, and sent property prices rocketing upwards.

Property analyst BIS Shrapnel predicts the Australian property bubble is about to burst, with real price falls between 1 per cent and 12 per cent predicted across the capital cities by the end of 2018/19. Similar to the share market, current valuations are detached from the fundamentals, due to the generous monetary policy of the RBA.

However, slowing population growth and reduced investor demand as the Basel III global banking restrictions are enforced could result in property prices suffering a painful demise, with the Perth market alone expected to see a 23 per cent drop in real prices in 2019 compared with 2007.

The OECD has even commented on this possibility, saying Australia risks a "dramatic and destabilising" end to the property boom, while global financial services giant UBS has ranked Sydney as the third most risky property market in the world.

> The avoidance of risk is particularly pertinent for SMSF trustees, even more so for those already at retirement age and dependent upon drawings from their super to provide for basic living expenses.

When concerns over risk, returns and growth disqualify traditional investment strategies, which typically represent a mix between cash, shares, bonds and property, SMSF trustees need to begin considering alternative investment approaches that have been used by some of the world's leading investors for decades.

The Yale approach

What SMSF trustees, or any investors for that matter, need to consider is how to build the most efficient portfolio possible. An efficient portfolio is one that achieves the maximum expected return for an acceptable level of risk, or achieves the minimum level of risk while yielding the expected returns.

Creating an efficient portfolio that generates double-digit returns at a palatable degree of risk, even in times of economic uncertainty and market volatility, requires an alternative approach, such as that used by the Yale University endowment fund.

One of the largest endowment funds in the world, worth more than US$23 billion, it generated a return of 13.9 per cent a year in the two decades between 1994 and 2014, while investments in global shares produced returns of just 7.59 per cent a year in the same period.

What was Yale's secret to success? It invested 80 per cent of its portfolio in alternative assets, including market-neutral funds and private equity. Not only did this strategy produce far superior returns to global shares, but it did so with less volatility, as measured by the standard deviation of

Continued on next page

Continued from previous page

annual returns.

Yale's chief investment officer and the architect behind the model, David Swensen, has hailed the market-neutral strategy, also known as absolute return, for its proven efficacy.

"Well-managed absolute return portfolios provide a high-return, low-risk source of diversification," Swensen says.

"Absolute-return investing appeals to investors who believe that providing funds to superior managers operating with few constraints will lead to impressive investment results, regardless of the upswings and downswings of traditional marketable securities."

This strategy, now universally known as the Yale Endowment Model, has been widely adopted by other major endowment funds and institutional investors, and its market-neutral approach can be adopted by Australian SMSF investors.

Going market neutral

Market-neutral funds neutralise risk by using two sub-portfolios: one that takes a long position, while the other takes a short approach, with each holding about the same dollar value in assets.

The long position involves investing in a stock, bond, currency or other asset with the expectation its value will increase. Conversely, the short position uses the borrowing of an asset from a broker, and then selling it, with the expectation it will decrease in value and can then be bought back at a cheaper price and returned to the broker for a profit.

By holding roughly equal values in both long and short positions, a market-neutral fund can enable SMSF trustees and other investors to target positive returns in both rising and falling markets, while insulating investors from market risk.

Having an investment that has the ability to perform equally well in a rising or falling market provides much needed downside protection since it removes the risk of relying too heavily on rising asset prices and being overweight the good times.

As well as being market neutral, the Rushton Global Market Neutral Fund and the Rushton Conservative Global Market Neutral Fund are also currency neutral. As the security for the exposure is held in Australian dollars, and the Rushton funds hold around equal amounts of long and short positions in each currency, the funds have very little net currency exposure, which means they achieve the benefits of international diversification – without the currency risk.

The funds are currently diversified across multiple investment themes and about 400 large, liquid positions across several countries, with plans to expand to many more countries and around 1000 positions in the near future. There is also a self-imposed 1.5 per cent limit on maximum position size to minimise individual company risk.

The funds' focus is on capital preservation, since the highly diversified, market-neutral approach reduces volatility and also improves risk-adjusted returns. This is important as investors should not take any more risk than is necessary to achieve their investment objectives – and they should be well compensated for the risk they do take.

Rushton has as an 'all-weather' investment strategy, since investing is a marathon, not a sprint, and with retirees now expecting around 30 years in retirement, a sound investment strategy must be able to navigate a wide range of economic conditions.

An SMSF solution

The avoidance of risk is particularly pertinent for SMSF trustees, even more so for those already at retirement age and dependent upon drawings from their super to provide for basic living expenses.

A category of risk not yet touched on in this article is sequencing risk, which could be considered as the Murphy's Law of investment returns, and poses the question: what happens if you get the worst possible return at the worst possible time? The most notable recent example of this was those who were about to retire, or had just retired, at the onset of the global financial crisis in late 2007.

The threat of sequencing risk increases as SMSF trustees approach retirement, and while all investments could be held in cash, this negates the possibility for portfolio growth, particularly with current low interest rates, which also rules out the other traditional safe haven of sovereign bonds.

Having an investment that has the ability to perform equally well in a rising or falling market provides much needed downside protection since it removes the risk of relying too heavily on rising asset prices and being overweight the good times.

So instead, the best strategy is to scale back exposure to risk from around the age of 50 onwards, making a market-neutral approach ideal for those in this age bracket as it has the ability to generate a healthy return over the medium to long term with lower volatility than a long-only share investment.

As Yale and countless other institutional investors have shown in recent decades, share market volatility does not mean investors have to compromise returns and risk exposure, and with the rising popularity of these alternative investments among SMSF trustees, many Australian investors are joining the trend.

As Australia's SMSF sector looks towards 2017, it is apparent there is little sign of market and economic risks diminishing, or a sudden upturn in official interest rates or bond yields. Adopting alternative investments as part of a diversified and conservative portfolio could prove crucial in helping SMSFs successfully navigate this uncertain investment environment.