Creating a financial magic pudding

The importance of long-term growth over short-term returns.

Summary: It was the stock market that enabled most balanced super funds to produce the 10 per cent-plus super return generated for 2016-17. A financial advisor can't be responsible for this, but they should be the go-to professional for creating a long-term investment strategy that goes well beyond annual returns.

Key take-out: Investing is nothing to do with chasing last year's returns. It's about having a long-term strategy based around your risk profile and needs, and a good financial planner should be the central point in achieving those objectives.

Right now, a superannuation fund member with an account balance of $500,000 12 months ago is likely to be wearing a $50,000-plus smile.

But, contrary to what their marketing machines working at full steam would have you believe, the retirement savings arms of the banks and super fund behemoths were not responsible for the 10 per cent-plus per annum super returns generated in 2016-17.

It was in fact the stock market which enabled most balanced super funds to produce, on average, a 10 per cent per annum return on investment in the last financial year.

What gets lost in all the hyperbole, misleading information and self-congratulation is that superannuation funds and banks are just mechanisms to manage investments on behalf of their clients and members. In reality, these mechanisms are no more sophisticated than a deposit account.

Financial advisers have a different role – and it was not this role that generated that 10 per cent per annum growth last financial year, either.

What your financial advisor really does

The only certainties in investment are fees and tax, and the more of these you pay the less market returns you get to keep.

So, if your financial planner looks you in the eye and claims "I got you 10 per cent" they should also be prepared to say "I lost you 10 per cent" when the market turns!

Financial advisers make their contribution by understanding the investment risk profiles of their clients, and identifying well managed and cost-effective investment vehicles so those clients get to keep as much as possible of the best returns over the long term.

They are required to keep abreast of relevant legislation and the most competitive product and administration platforms in the marketplace. They should provide strategies designed to maximise financial outcomes for their clients. A good financial planner will also work closely with their client's lawyers and accountants to ensure the best structures are in place for their circumstances.

Financial advisers are responsible for keeping a client's life insurance costs competitive, as well as being an advocate for insurance claims and ensuring that appropriate estate planning is in place. They 'value add' by helping their clients and families navigate the taxation/superannuation/social security interface.

The market returns what the market returns

Readers of my columns will be aware that I am a passionate advocate for achieving lower fees. If a bank or a super fund wants to honestly claim to have influenced returns, they do this by negotiating lower fees – but we are talking about half a per cent or so, not 10 per cent.

There have been a lot of positive headlines about the ASX performance and the returns that super funds will get from the last financial year. While a good result, it is still less than 1 per cent higher than the last 30 years' average annual return of 9.3 per cent.

My philosophy? The market returns what the market returns.

While the long-term average return of 9.3 per cent per annum was exceeded slightly in the last financial year, I see the sensible approach in encouraging people to set their expectations and cost of living at around 5 per cent per annum. This is insurance against financial heartbreak. There will always be gyrations in the stock market – they should not be feared, but anticipated, and seen as an opportunity.

Getting good financial advice will keep you from getting caught up in the adrenaline rush of a booming market. At times of market stress, it will help contain the herd panic, which traditionally leads to bailing into cash.

Invest, but don't punt

Getting lucky by choosing some market sectors or individual stocks which do well for a period can have a dramatic impact on returns, especially because you often get unlucky when they fall. That is why it has long been said that the stock market is a very effective tool for transferring wealth from the impatient to the patient.

This all feeds very well into the active versus passive funds management debate. After more than 25 years in the industry, you will find me standing firmly in the passive camp with Warren Buffett – the man who advises his family to 'buy the market' with their inheritance rather than speculate. Indeed, passive management has proven by far the safer option, outperforming stock picking over the last decade and beyond.

'Buying the market' will effectively insure against the big losses, by foregoing some of the biggest wins that only come with taking big punts. In taking this approach, investors are applying what I believe to be the number one rule for investing: diversify your portfolio.

Not just for investment markets

The average annual return of 9.3 per cent over the last 30 years reinforces that rule, and applies to tax structures and investment income strategies too. It is the core reason members of public sector super schemes should not keep all their eggs in the defined benefit pension basket.

Yet many competent people still go 'all in' and lock themselves into a 100 per cent lifetime pension.

The rationale? To achieve a return of around 5 per cent per annum on their potential lump sum super 'pool'. In other words, if it is a $1 million pool, they will receive $50,000 per annum often (but not always) tax-free for life, and usually (but not always) indexed.

A guaranteed $50,000 each year in retirement sounds good. It is approximately the equivalent of earning employment income of $70,000, as it is often (but not always) tax, Medicare and NDIS free. Expenses are generally lower at the retirement stage of life, so the attraction can be seen in the short term.

Even with some indexation, however, the real purchasing power of a defined benefit pension is diminished over time. For example, I don't see my gas and electricity going up by a mere 2 per cent per annum.

Conversely, those defined benefit super fund members who cashed out part of their defined benefit pension would see the basic value of their investment increase well over CPI – and they can choose how much they draw down from their tax-free/tax-exempt

account-based pensions. On average, they will have created a 'financial magic pudding', where they draw down on the fund and it increases by more than that, plus inflation.

That is the market at work.

Theo Marinis