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Addicts abound in investment

By Theo Marinis

- Investment exposed 100% to one stock is fundamentally flawed
- Dopamine overrides logic for the vulnerable
- Wall Street and other indices (and asset classes) are fundamentally different

Over the course of a career, I've marvelled at how many investors are prepared to commit to schemes which can be shut down at the whim of a government minister.

These investors are likely to be the same people who have held time share apartments on the Gold Coast for the last two decades waiting for them to boom like the agent said they would…or have 50 acres of trees just waiting to be harvested when the tax treatment changes, again!

That said, much has recently been written post the Shorten announcement of the ALP's plan to eliminate the refund of excess dividend imputation credits (apparently at the moment, to all BUT age pensioners!).

There are so many 'ifs' around this story that it doesn't really warrant the air-time it has already been given, but what it does point to is one of the flaws the Howard government created in taxation policy, and the vulnerability of investors who have become addicted to the 'dopamine hit' provided by tax driven investments.

Perhaps I'm more than a bit old fashioned, but the old principle applies here: 'If it sounds too good to be true… then it probably is'.

Like any drug of dependence, dopamine (the naturally occurring 'feel good' hit when we do something we think is particularly clever) will ultimately end in a downward spiral.

An example of the impact of this dependency was played out for me some time ago, in the form of an approach by a potential client seeking to maximise Transition to Retirement opportunities (not an uncommon request) as he and his partner moved from accumulation to draw-down phase.

My brief was to provide 'technical/strategic only' advice. The client, a professional his early 60s, had specifically requested not to receive investment advice on an SMSF portfolio valued at $2m, invested 100% in Telstra shares. The investment allocation rationale was based solely on Telstra's high dividend payment track record and accompanying dividend imputation credits.

The scope of the terms of my engagement expressly excluded the provision of investment advice; this did not mean, however, that my professional obligations to flag the risks associated with not addressing related advice areas (in this case, an appropriate investment strategy) could be similarly 'scoped' out.

The risks – primarily the serious lack of diversity in the portfolio and the fact that it was not in line with the clients' identified investment risk profile – formed the subject of some lengthy discussions, as well as part of my formal written advice.

But the estimated income yield delivered by the transition to retirement strategy (including the ***full*** refund of Telstra's imputation credits) was the hook. Warnings highlighting the serious risks involved in not diversifying the portfolio were happily dismissed.

A few years later, due to some circumstantial changes, I was again approached by the same individual to provide additional technical strategy advice. By this time the portfolio had been 'diversified'; the Telstra holdings had been diluted to just a quarter of the portfolio – fortunately before the corporation had lost 40% in capitalisation. The proceeds from the sell down had been applied to buy shareholdings in the big four Australian banks, plus one of the smaller ones… with investment allocation continuing to be driven by the 'siren song' of dividend policies and imputation credits.

The portfolio now held six stocks, representing 94% of the SMSF investment exposure, held entirely in the local market.

Concerns regarding the risks associated with exposure to a handful of stocks in a single market, the portfolio's vulnerability to the ebb and flow of global capital (notwithstanding the fact that a retirement income strategy based on 94% growth and 6% defensive asset exposure was not a rational or recommended approach) were raised.

An offer of investment strategy advice was again deemed unnecessary, on the basis of what I could only conclude to be the same dividend driven 'dopamine hit' overriding logic.

In the expectation that this case will be dismissed by some as a 'one off, extreme example' broader evidence of the impact of chasing imputation credit refunds can be found in the aftermath of the GFC.

To use an expression by Warren Buffett, many pension funds (both SMSF and non SMSF) "were caught naked when the tide went out". For a number of years, due to severely impaired dividend payments, the prescribed ABP pensions could not be paid from income without selling shares at a significant loss.

The reason? An overexposure in 'pension phase' super funds to Australian shares, and an addiction to their associated imputation credits (not to mention a home equity bias – another cognitive distortion) following the sudden and synchronised 50%+ fall in world share markets in 2008/09. The resulting post GFC fall in profits also saw large falls in dividends.

As a result, for a number of financial years, that famous duo, Howard and Costello were forced to halve the prescribed minimum percentage payments for account based pensions. It could be said that this rule change was necessitated in the wake of the distortion caused by their previous imputation credit policies – a distortion which continues!

Diversify and avoid having to go cold turkey

Post GFC, NONE our clients were forced to live off 50% the normal ABP minimum amounts, which meant that their retirement incomes were not compromised. There were two reasons why this was the case:

Their investment portfolios were all fully diversified, with adequate cash and fixed interest buffers to ride out the storm; they also had 50% of their share exposure overseas, as a volatility reduction strategy.

During the GFC, when ALL share markets fell around 50% or more, the $A fell more than 50%. This meant losses on overseas share market investments were more than made up for on the exchange rate movement on their overseas investments. This strategy worked exactly as it was designed to do.

Sticking to investing ONLY in shares at home – without having some global exposure – for example, the US market – is a major flaw in any investment portfolio.

There are some massive structural differences and investment exposure in the two indices which provide the astute investor the opportunity for significant capital gains in the US, and robust dividends in Australia. Similarly, Asia offers enormous potential.

Instead of treating your investments like a punt at the track, always follow the first three rules of Investment: diversify, diversify and diversify!

That means diversifying within all asset classes and across all asset classes and doing it with low cost index funds. In the long term, you will always get a better and less volatile outcome and a happier retirement!

If you think you might be a dopamine addict, act quickly. Go and see your broker or financial adviser and take the 12-step plan… to diversification.

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