CAUGHT IN THE HEADLIGHTS? - SUPER IDEAS FOR MANAGING VOLATILITY

COLIN LEWIS
Senior Manager, Strategic Advice
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One of the things that happens when investment markets are volatile is that investors' emotions go to war with their logic.

Intellectually, super investors know they're investing for the long term, so short-term volatility may be a good time to add to super as the assets may be cheaper. Unless retirement is imminent, investors may have years – maybe even decades - for the market to move back in their favour.

Yet as the work of some great behavioural psychologists[1] remind us, our inbuilt emotional biases are more powerful than logic. Volatility leads to anxiety and so it's easy for investors to rationalise the need to 'wait and see'. Some say they're waiting for the bottom of the market. Others rationalise the need to wait until 'confidence' returns before they invest. Ironically, even when markets recover, many of these same investors say they'll wait for the market to fall again before buying bargains.

All these investment attitudes can create 'investor paralysis' which can lead to long term financial disappointment. The delay in investing means investors are unable to participate in the benefits of recovering markets.

Albert Einstein is purported to have said that compound interest is man's greatest invention. Whether or not he said it, there is no doubting the incredible growth potential of an investment where you earn "interest on your interest" over a long period of time.

DOING SOMETHING TO MANAGE VOLATILITY

Those psychologists mentioned above will also tell us that it's not enough to understand how emotions affect your investing. We need to find ways to manage past those emotions – and so achieve our long-term goals. One powerful way to do that is 'dollar cost averaging' – making regular deposits into an investment at regular intervals over a period of time.

Dollar cost averaging overcomes 'investor paralysis' by giving investors the opportunity to build exposure to growth assets in a disciplined way.

The good news is that dollar cost averaging is how most salary earners and executives invest in super anyway – via the regular super contributions their employers are required to make out of their salary (the Superannuation Guarantee). Similarly, most salary sacrifice contributions – the additional contributions many of us make in an effort to boost our long-term super savings - are made via regular contributions.

That's why it's important investors don't lose faith in this approach and reduce their contributions when markets are weak because in many ways that's when dollar cost averaging does its best work.

DOLLAR COST AVERAGING – HOW IT WORKS

Indeed the essence of dollar cost averaging is that when you commit to investing a regular fixed amount into an investment which varies in price (such as shares or managed fund units) you purchase more when the price is low and less when the price is higher. Over time this can reduce the overall costs of your investment – and therefore increase the potential for gain.

So while dollar cost averaging is not a guarantee of higher returns - or a substitute for lump sum investments when you have the available capital - it **is** a powerful strategy for investors who would otherwise be reluctant to stick to a long-term investment plan in the face of volatility.

ACTUALLY, YOUR SUPER IS NOT "GOING DOWN"

During periods of market instability, investors can be particularly concerned that superannuation may no longer be their best option and may stop or reduce their voluntary deposits into super.

It must be remembered that a super fund is an **investment vehicl**e, not an asset class. Regardless of whether you invest via a super fund or outside super, it's what you invest in – cash, shares, property etc. - that determine whether your wealth goes up or down. Super does not lose money!

Investing for retirement via a super fund can be a highly effective way to invest because there are significant tax benefits. Earnings are taxed at a maximum of 15% rather than at your marginal rate (which can be as high as 49%). In addition, super has other strategic benefits – for example, it can be used to cost effectively hold insurance. The downside is that your money is generally locked away until your retirement.

WHEN MARKETS FALL - ARE YOU BETTER OFF IN SUPER THAN OUT?

As mentioned above, while markets are depressed, topping up your super may be a useful way to buy quality investments at a lower cost. The tax benefits of super and the risk-management, cost-cutting benefits of dollar cost averaging mean the case for sticking with a disciplined contributions strategy is actually more compelling in a market downturn.

Looked at another way, super can reduce the impact of market losses because the tax benefits have already insulated you from a bigger "loss" ie – the tax man taking a big portion of your money). Let's look at an example.

- Marion earns $150,000 a year and is on a tax rate of 39 percent (including

Medicare levy).

- By making pre-tax salary sacrifice contributions Marion puts 85 cents of each dollar to work in super as opposed to only 61 cents had she paid tax and invested outside super.
- As the illustration below shows, the tax benefits of super make it harder for Marion to “lose” money when the market is falling. Indeed the money she saves in tax means her superannuation investments must drop 28% before she is worse off from sticking with her super strategy.

Investment $1000

	SUPER		OUTSIDE SUPER				
TAX RATE	15%	30%[1]	21%	34.5%	39%	49%	49%[1]
NET INVESTMENT	$850	$700	$790	$655	$610	$510	$510
EXPOSURE TO EQUITY MARKETS			**SUPER INVESTMENT MUST FALL (%) TO BE WORSE-OFF**				
100%			7	23	28	40	27
70%			10	33	40	57	39
60%			12	38	47	67	45

Notes:

[1]Additional 15% contributions tax for high income earners withdrawn from fund

Tax rate outside super includes 2% Medicare levy and 2% Temporary Budget Repair Levy where applicable

That’s just one more reason to stick with your long-term super strategy even when markets appear to be moving against you. If you want more information on the benefits of a disciplined approach to your super why not talk to a Perpetual adviser?

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[1] See Daniel Kahneman’s *Thinking Fast and Slow*