

12 February 2016

General Manager  
Law Design Practice  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: [taxlawdesign@treasury.gov.au](mailto:taxlawdesign@treasury.gov.au)

Dear Sir/Madam

## **RUSSELL INVESTMENTS SUBMISSION – EXPOSURE DRAFT OF AMENDMENTS TO THE PRIVATE ANCILLARY FUND GUIDELINES 2009 AND THE PUBLIC ANCILLARY FUND GUIDELINES 2011**

Thank you for the opportunity to provide feedback on the proposed amendments to the Private Ancillary Fund (PrAF) Guidelines 2009 and the Public Ancillary Fund (PuAF) Guidelines 2011.

### **Focus of this submission – Changes to the Minimum Annual Distribution**

Russell Investments (Russell) is a global asset manager and one of only a few firms that offer actively managed, multi-asset portfolios and services that include advice, investments and implementation. Russell has developed a unique set of integrated capabilities, including: portfolio design, capital markets insights, manager research, factor exposure management and implementation services.

Russell has more than \$330 billion in assets under management (as of 30 September 2015) and works with over 2,500 institutional clients, independent distribution partners and individual investors globally. Russell is the largest manager of institutional outsourced assets globally<sup>1</sup>. As a consultant to some of the largest pools of capital in the world, Russell has \$3.2 trillion in assets under advice (as of June 2014). Russell has four decades of experience researching and selecting investment managers and meets annually with more than 3,500 managers around the world.

As a leading investment manager and consultant, one of our areas of expertise is advising clients on their investment objectives. As the Minimum Annual Distribution (MAD) requirement is a key input into the investment objectives for PrAFs and PuAFs our submission focuses on the proposed changes to the minimum annual distribution requirements as set out in Item 7 of Schedules 1 and 2 of the Exposure Draft.

In summary, we support the stated intention to reduce the MAD rate. We believe MAD rates of 4% and 5% for PuAFs and PrAFs respectively are unsustainably high, based on our current expectation of low future investment returns over an extended period. We expect that the proposed method of determining the MAD rate in the Exposure Draft will achieve a lower MAD rate in the current low interest rate environment. The proposed method will also provide greater flexibility for PuAFs and PrAFs in determining the amount that they can distribute. However, if we confine ourselves only to the problem of unsustainably high MAD rates, a simple solution is to reduce the rate to 3% for both PuAFs and PrAFs.

The details of our analysis which supports the reduction of the MAD for both PuAFs and PrAFs are set out below.

### **Typical investment objectives for Public and Private Ancillary Funds**

We advise our clients that investment objectives are the cornerstone of any successful investment strategy. Their development plays a key role of providing stakeholders with a genuine and tested indication of what can be expected from investment returns. To this end, the investment objectives

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<sup>1</sup> For the fourth year in a row, Russell was reported as the largest manager of institutional outsourced assets based on the AUM from its fully discretionary clients. In 2015's, CIO's 'Outsourced Chief Investment Officer Survey' included 49 firms.

should, amongst other things, be realistic and achievable. We would generally consider an investment objective as being achievable if it is expected to be achieved with a probability that is at least above 50%.

PrAFs and PuAFs generally aim to maintain the value of their corpus in real terms to maintain the purchasing power of the corpus i.e. at least grow with inflation. This means that investment objectives are typically expressed as an after fees and expenses return (net return) above the change in the Consumer Price Index (CPI, which is the widely accepted measure of inflation). Given the current MAD rate of 4% for PuAFs, it is common for PuAFs to articulate their investment objectives as 'to achieve returns in excess of CPI + 4% net of fees and expenses' (or CPI + 5% for PrAFs).

### **Investment return expectations**

Our support of the reduction in the MAD for both PuAFs and PrAFs is grounded in our expectations of future low investment returns over the long term (at least over the 10 years from now). Our long term return expectations stem from our capital markets research, which is in part informed by current interest rates.

We note that interest rates in Australia, as measured by the 10 year Commonwealth Government Bond yield, have almost halved since the turn of the century from 5.6% as at 30 June 2001 to 3.0% as at 30 June 2015. The general fall in interest rates over past decades, to the current low interest rate environment, have led to the realisation of substantial capital gains, significant falls in income yields and lower future return expectations across all asset classes.

This is an important historical observation to make. We would typically expect to see investment returns that are materially higher than the long term historical averages during extended periods of high and declining interest rates. As we have seen in the past 30 years. Conversely, we would expect to observe investment returns that are materially lower than the long term historical averages over an extended period of very low and rising interest rates. As we expect to see in the forthcoming years.

Our current (2015) long term gross return expectations (before fees and expenses) for the asset classes that PuAFs/PrAFs typically invest in are set out in the Attachment to this letter.

In the paragraphs below we use our current capital markets insights to consider how the returns for the portfolios of PuAFs/PrAFs are affected by these low return expectations in the context of their investment objectives. To highlight the historical context, we contrast these expectations with what we would have expected in 2001.

### **Are the investment objectives of Public and Private Ancillary Funds realistic/achievable?**

In the table below we show the results of our modelling of the expected long term returns of a balanced portfolio (approximately 70% invested in shares and property) that a PuAF/PrAF would commonly invest in.

We chose to model a balanced portfolio because in our experience it has a risk profile that is consistent with the risk appetite of a typical tax exempt investor such as a PuAF/PrAF. We do not believe that it is the purpose of the suggested amendments to change the risk appetite of these investors. The modelling assumes fees and expenses are deducted from investment returns at an annual rate of 1%. Other assumptions, such as expected returns, volatility and asset allocation, are set out in the Attachment to this letter.

We have shown results based on both our 2001 and 2015 (current) long term return expectations. The 2001 results provide historical context and illustrate how our long term return expectations have changed in response to the changing interest rate environment since the turn of the century.

Expected returns are shown before and after inflation. Two measures of risk are provided; volatility, and the probability of a negative return. Importantly for our argument, the table below includes a measure of the probability that the balanced portfolio will achieve different investment objective levels (CPI +2%, CPI + 3%, CPI + 4% and CPI + 5%).

**Table 1. Results of modelling analysis**

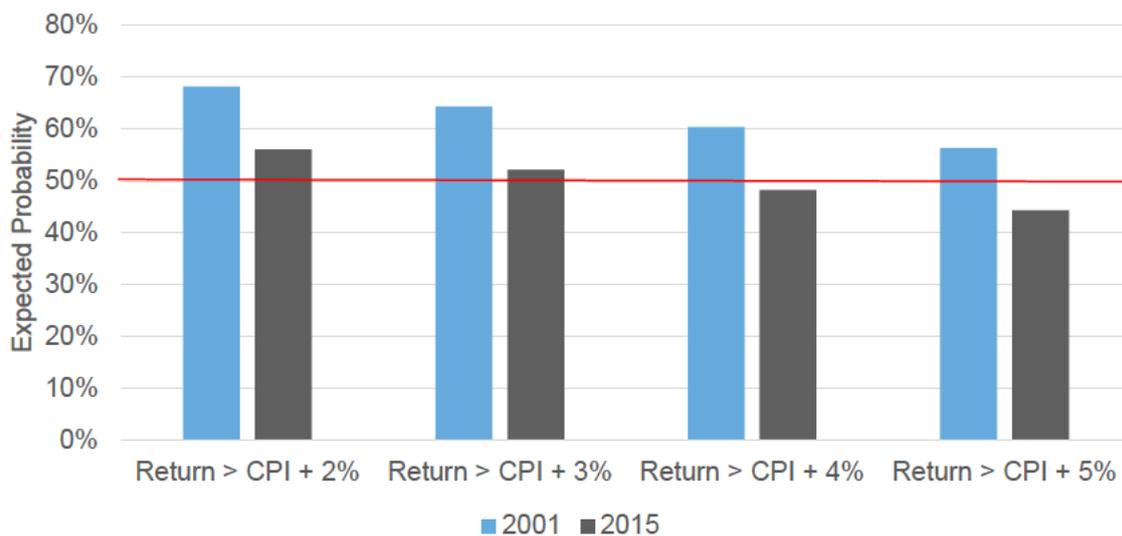
	2001 Assumptions	2015 Assumptions
Expected net <sup>1</sup> nominal return (i.e. not inflation adjusted) per annum	9.4%	6.1%
Expected net <sup>1</sup> real return (i.e. inflation adjusted) per annum	6.5%	3.5%
Expected nominal volatility	10.8%	11.0%
Probability of a negative return in any one year	16%	27%
<b>Probability net return is greater than:</b>		
CPI + 2%	68%	56%
CPI + 3%	64%	52%
CPI + 4%	60%	48%
CPI + 5%	56%	44%

Table notes:

1. After fees and expenses of 1.0%.

The chart below illustrates the probability of the expected net return exceeding the different investment objective levels modelled.

**Chart 1. Probability of net return achieving investment objectives**



We make the following key observations regarding the results of our modelling:

- When we undertook this sort of analysis in 2001:
  - We would have expected, based on our long term return expectations at that time, the balanced portfolio to realise an average nominal (not inflation adjusted) net (after fees and expenses) return of 9.4% per annum, which is equivalent to an expected long term real (inflation adjusted) net return of 6.5% per annum.
  - We would also have expected a balanced portfolio to have a probability of around 16% of suffering a negative return in any one year period. This implies we would see a negative return a little less than one year in six.

- The balanced portfolio had a greater than 50% chance of achieving the CPI+4% or 5% investment objective.
- In contrast, based on our 2015 long term return expectations:
  - We expect the same balanced portfolio to realise an average nominal net return of only 6.1% per annum, which is equivalent to an expected long term real net return of 3.5% per annum.
  - The probability of a negative return has nearly doubled to around 27%. That implies that we should now expect a negative annual return more often than once in every four.
  - The investment objective would need to be reduced to CPI + 3% or less in order to be considered realistically achievable.

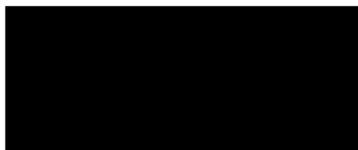
We trust that this comparison has highlighted the very different expected future return environment that trustees face, which makes it important for the MAD rate to be reduced. In such circumstances, we believe it would be difficult for a trustee of a PuAF/PrAF with a balanced investment portfolio to accept an investment objective that is greater than CPI + 3%.

We believe that the results of our analysis, as outlined above, support our submission to reduce the MAD rate to 3% for both PuAFs and PrAFs. We note that although a MAD rate of 3% is higher than the proposed MAD rate (determined as the average of the Reserve Bank of Australia's target cash rate over the previous financial year, which was 2.4% for the financial year ending 30 June 2015), it is a simple alternative to achieve the stated intention of the Exposure Draft to reduce the MAD rate.

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Please do not hesitate to contact me on [REDACTED] if you wish to discuss any aspect of this letter.

Yours Faithfully



Glenn Smith  
Director, Investment Consulting  
Russell Investments

**ATTACHMENT**

The table below shows both the 2001 and 2015 (current) long term gross return (before fees and expenses) and volatility expectations for the asset classes that PuAFs and PrAFs typically invest in. A comparison of these sets of long term return expectations shows the significant reduction in gross return expectations (before fees and expenses) between 2001 and 2015.

**Table 2. Long Term Expectations**

Asset Class	Long Term Expectations			
	Gross <sup>1</sup> Return		Volatility	
	2001	2015	2001	2015
Australian Equities	12.2%	8.8%	20.0%	19.0%
International Equities (H)	10.9%	6.8%	18.9%	18.9%
International Equities (UH)	11.2%	8.7%	19.8%	17.0%
Property	9.3%	6.4%	14.2%	20.2%
Fixed Income	7.4%	4.1%	4.9%	3.8%
Cash	5.5%	3.1%	3.0%	3.7%

Table notes:

1. Before fees and expenses.

The asset allocations used to model the balanced portfolio is shown in the table below.

**Table 3. Balanced portfolio asset allocations**

Asset Class	Asset Allocation
Australian Equities	28.0%
International Equities (H)	13.5%
International Equities (UH)	13.5%
Property	6.0%
Fixed Income	27.0%
Cash	5.0%
<b>Total</b>	<b>100.0%</b>