



INSIDE THE 3RD BUCKET

A Generic Look at the Impact of Gearing

As outlined in the document *Using the BL&A 'Bucket Approach'* to investing, we believe that the most critical aspect of the investment is that of the 3rd bucket. In an era of flat cash and bond yields, there is going to be very little to distinguish the performance of the first and second buckets from fund to fund. Quite simply, in the first two buckets the dominance of cash and fixed interest investments limit the ability of any one investment manager to *significantly and consistently* outperform another.

This is not true however with regard to the 3rd bucket. By its very nature, the 3rd bucket has no exposure to defensive assets as it is 100% growth based. This allows each manager the opportunity to invest from an endless selection of shares, therefore producing different results. Importantly, it also provides the manager with the means of enhancing returns through additional strategies, such as gearing and tactical asset allocation. It is in the area of 3rd bucket investments that we see the greatest variation in returns. **Therefore, the selection of the investment itself should be guided by the choice of the 3rd bucket**, with the first two buckets merely 'going along for the ride'.

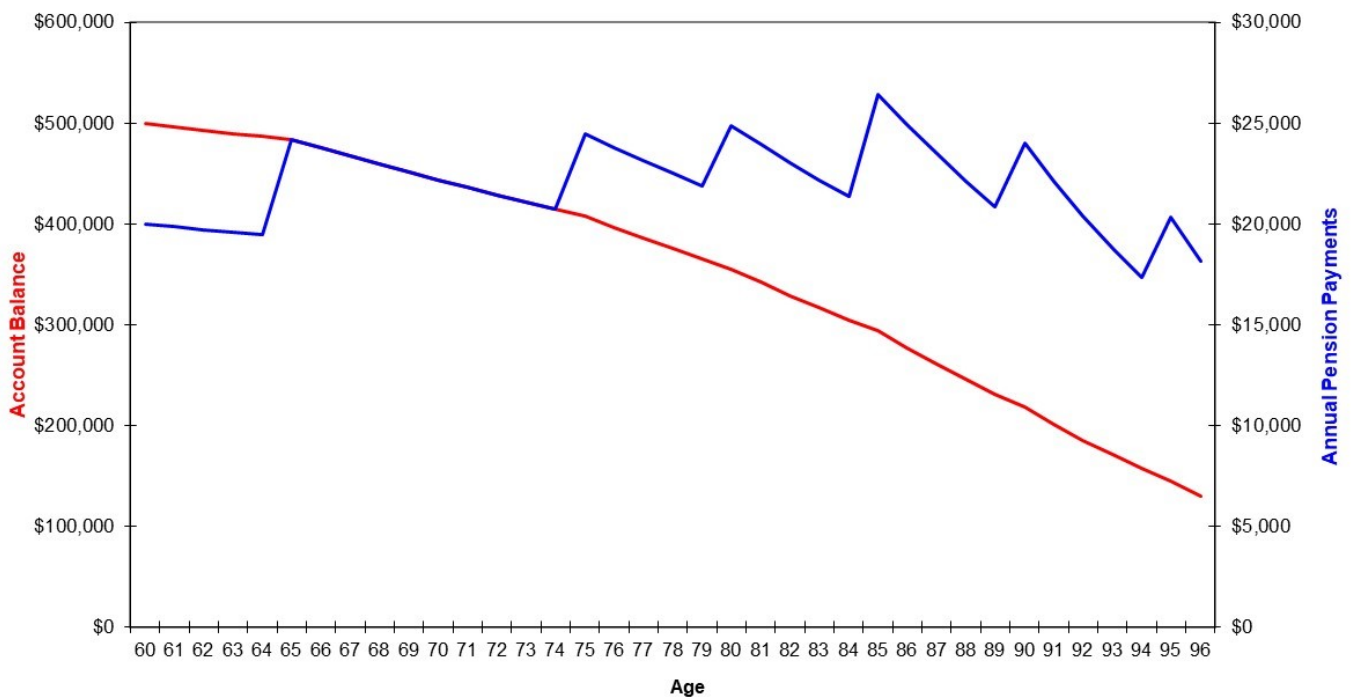
The significance of the 3rd bucket is best illustrated using the example of an allocated pension. A condition of using an allocated pension is that there is an annual withdrawal, in line with minimum amounts prescribed through legislation. These minimal withdrawal requirements are currently 4% for a 60 year old and 5% for a 70 year old. If the owner of the allocated pension wishes to keep the balance of the fund intact, then they must simply earn at least this amount in interest in the allocated pension each year, to replenish the minimum payments.

This, however, ignores the impact of inflation. Given that an allocated pension may be expected to run for 30-40 years, it is important that the balance is allowed to grow to counter the inflationary effects over that time. Put simply, if all the earnings of the allocated pension are drawn down in income payments, then the balance of the allocated pension will diminish in real terms, at the rate of inflation, over its lifetime. Therefore, an allocated pension needs to earn sufficient interest to not only cover the minimum pension payments but to also cover the long term impact of inflation. This means that, with an annual inflation rate in the Reserve Bank's 2-3% range, the 4-5% pension payments become a 7-8% annual investment goal. More information regarding this can be found in the document titled *How much do I need in retirement?*

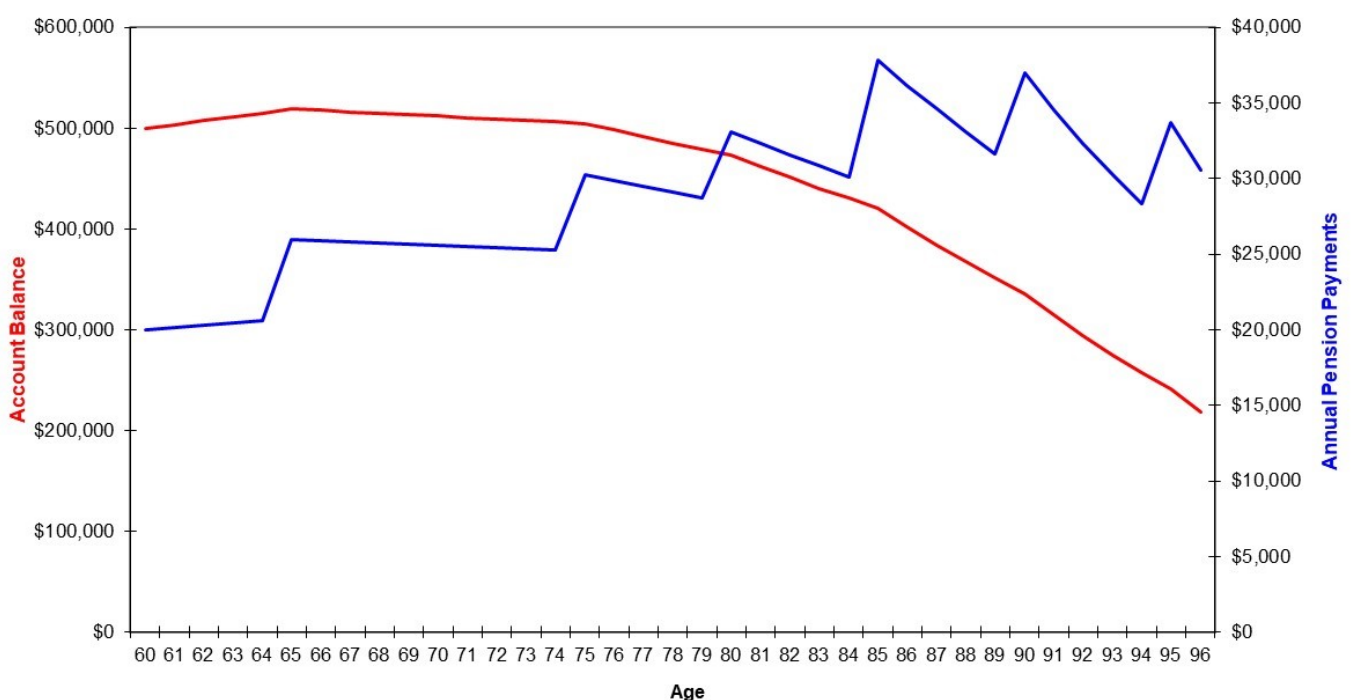
As explained in the document *Using the BL&A 'Bucket Approach' to investing*, the role of the first two buckets is to provide stability to the income payments in the short and medium term. Because these buckets have to cover short/medium term stability, they have to be invested conservatively and are not likely to earn the desire 7-8% outlined above. This means that the 3rd bucket has the job of producing sufficient returns to overcome the fact that the first two buckets will not, in the long term, achieve these returns. It is therefore true to say that the whole long term success of the investment depends upon the ability of the 3rd bucket to generate long term, above average results.

This is seen in graphs 1 and 2. Both show an allocated pension with a commencing balance of \$500,000 with the minimum income stream from age 60. The graphs show the balance of the allocated pension and subsequent income stream in real terms over the life of the pension.

Graph 1 Drawing the Minimum Pension
Earning 3.5% above inflation



Graph 2 Drawing the Minimum Pension
Earning 5% above inflation



In the first instance (graph 1) the allocated pension achieves an average rate of return of 3.5% above the inflation level. With the inflation of 2-3% per annum, this assumes that the allocated pension has annual earnings (after fees) of 5.5%-6.5% per annum.

This compares to graph 2 which shows an allocated pension which earns 5% above the inflation level. Again, with inflation in the 2-3% Reserve Bank range, this requires annual average earnings of approximately 7-8%.

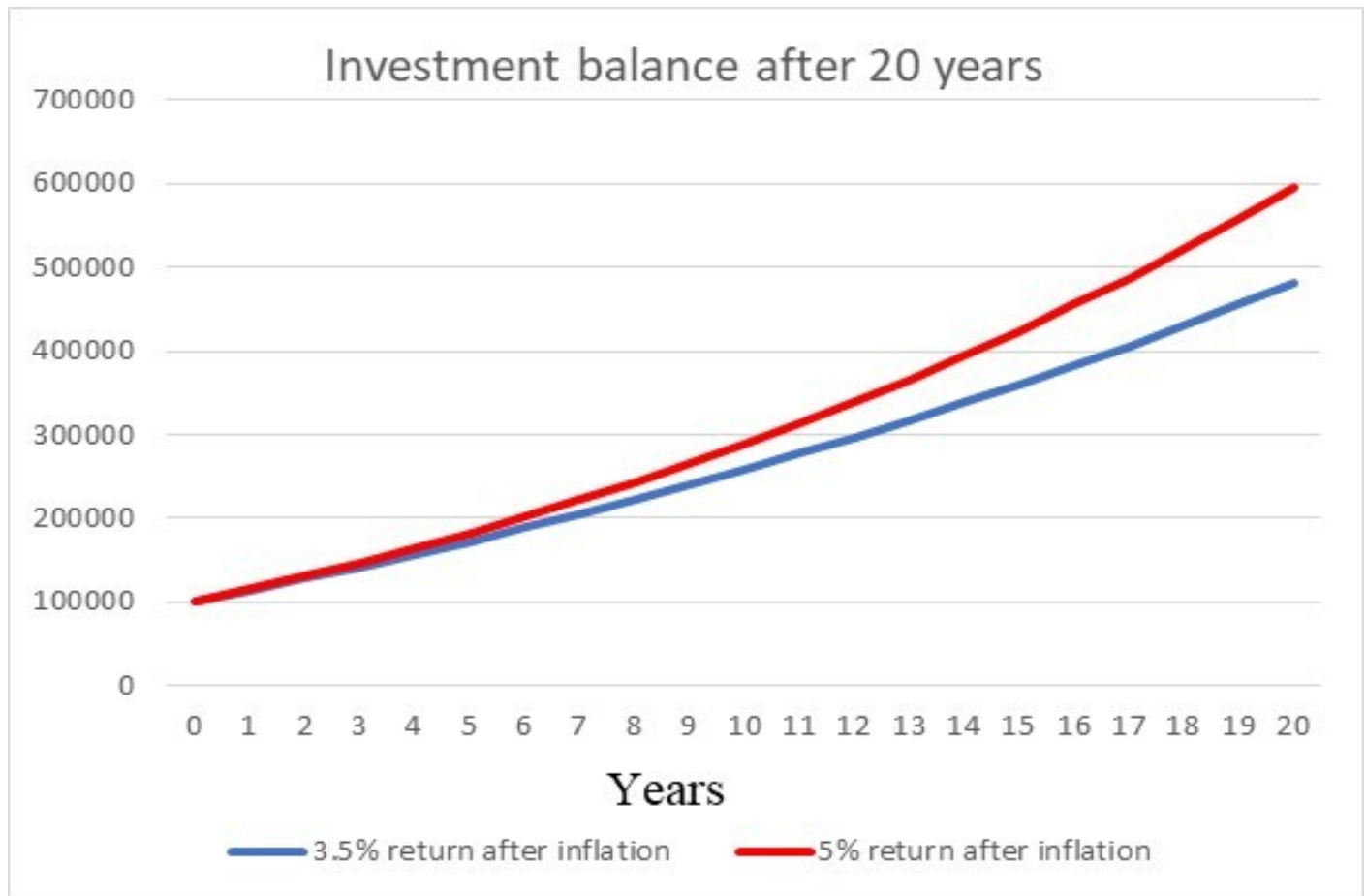
As seen in graph 1, the balance of the allocated pension (as measured by the red line and the left hand scale), in real terms, starts to decline immediately. The income stream increases (as measured by the blue line and the right hand scale), and then falls away. If the individual was looking to commute (withdraw) the balance of the allocated pension to (say) cover age care costs in their eighties, the balance will have diminished in actual and real terms.

The extra 1.5% makes a considerable difference in the shape of the graph. The balance of the allocated

pension continues to hold its value in real terms until the individual is in their early eighties.

The annual income stream continues to increase into the eighties, providing the individual the opportunity of greater income or re-investing surplus income elsewhere.

This is also true in the accumulation phase; whether this be in a superannuation or a non-superannuation investment.



This is seen in graph 3 which shows the balance of an investment fund over a twenty year period. The assumptions that are made in the graph are as follows:

- That the investment starts with \$100,000;
- In the first year an additional \$10,000 is contributed to the investment;
- In the second and subsequent years, the \$10,000 annual contribution is increased in line with the inflation rate;
- The investment has two possible returns, the first being 3.5% above the inflation level (as measured by the blue line), while the second is 5% above inflation (as measured by the red line);
- The investment runs for twenty years; and

- It is assumed all income is reinvested but does not account for tax on the reinvested income distributions (which would be payable at an individual's marginal tax rate).

Clearly, the amount of earnings an allocated pension/managed investment/superannuation fund receives over its lifetime has a huge impact on what is left over at the end of the day. Regardless of whether the balance will be used to purchase a car, cover aged care costs or passed on to beneficiaries through an estate, the investment needs to earn a good rate of return in order to maximise these options. **At BL&A we see a clear correlation between this higher rate of earnings and the selection of the 3rd bucket.**

As stated in the *Using the BL&A 'Bucket approach' to investing* document, the 3rd bucket should be 100% share based. Notwithstanding this, there are different schools of thought as to how to achieve out-performance in this area of 100% shares.

STRATEGY ONE

Tactical asset allocation

Tactical asset allocation is a strategy used by some fund managers, attempting to “pick the market”. Quite simply, a manager may believe that the share market is overvalued and about to fall, so they sell all their shares and sit in cash. In theory, when the market corrects they purchase the shares back at the lower price.

At BL&A we have little regard for this theory. There is no quantitative evidence that any fund manager gets this call correct often enough to be a credible form of investment. The real risk with this strategy is that the manager makes the call, sells the assets, only to see the market continue to rise in value. This places the manager under the additional pressure of having to continue to sit on the sidelines waiting for the correction, or having to purchase the shares back at a higher price.

STRATEGY TWO

Buying the “best shares”

Every investment manager in the share market starts off with a clean sheet of paper, and then needs to work out which shares they will purchase. Some do this through a “top down” approach, where they firstly consider which sectors of the share market (e.g., telecommunications, banking, retail etc.) will be profitable, and then select stocks within those sectors. Other managers work on a “bottom up” approach, doing research on every available share, and selecting the shares that they believe have the greatest scope for profitability, regardless of the sector that they are in.

Additionally, different managers have different styles. A traditional value manager is likely to turn over 130% of their portfolio in a twelve month period. True value managers have no loyalty for any share that is, by their definition, overpriced. If a share exceeds its “value range”, the manager will sell it, and purchase it back when it comes into that value range again, either through a fall in its value or an increase in the company’s profitability or earnings.

This contrasts to a growth manager who may only turn over 20-30% of their portfolio in a year. This type of manager will hold onto a stock which exceeds its “value range” if they believe that the company still has growth prospects.

At BL&A we are strong believers in the theory of regression to the mean. This theory basically states that no one style or manager will be able to outrun the pack forever. At some stage, the style of investing will produce below average returns as markets change, and different shares increase or decrease in value. Over the years when the market performs strongly, growth managers generally perform better than value managers; however, in the tough bear markets the value managers are generally the better performers.

One key point about active management (buying the best shares) is that it brings its own administrative cost with it. As can be read below, one option available in the 3rd bucket is an index fund. In an index fund there is no research to select the “best stocks” as the fund merely replicates the broader index that it invests in. An Australian share index fund will typically comprise the same 200 shares that comprise the ASX 200, with their weighting in the fund mirroring their respective weighting in the ASX 200. In other words, if BHP makes up (say) 12% of the value of the ASX 200, an Australian share index fund will have 12% of its portfolio in BHP shares. An active manager may have 15% in BHP (if they are bullish about it), or none.

As a result, an index fund is considerably cheaper to manage than an active fund, as they do not undertake the same degree of research on “what stocks” to have in the portfolio.

An active fund must therefore outperform the index by an amount that covers these higher administration costs.

Having said that, there is more than one way to structure an index fund and this is discussed in the document providing specific 3rd bucket option recommendations for your allocated pension/ managed investment/accumulation fund.

We believe that it is pointless trying to time a jump between different styles and managers. With the vision of hindsight we can always know the best managers over a period of time, however this is impossible to predict in advance. Jumping between managers on the suspicion that one is about to do better than the other is somewhat akin to swapping aisles at the supermarket checkout when your line stops moving. As everyone knows, as soon as you leave your line the new line stops moving and your old line starts again.

Our rejection of this strategy is quite a significant plank of our philosophy. We do not advocate investments that concentrate on a specific sub category of shares (e.g., those funds which only invest in small cap shares,

banking sector shares, or shares from a specific country or region). This type of strategy requires a very high level of ongoing speculation, such as, is it the right time to leave a Japanese based share fund and go to a European based one?

The BL&A investment strategy involves portfolios that are diversified and predominantly blue chip. We achieve this through the use of multi-fund managers, index funds or by combining a number of managers who have different styles. This is also discussed in the document providing specific 3rd bucket option recommendations for your allocated pension/ managed investment/accumulation fund.

STRATEGY THREE

Using internal gearing

The concept of gearing is not new. Typically, an investor purchasing an investment property will need to borrow some, or all of the cost of the property, which means that the property is geared. By borrowing money, the amount of the investment is increased, potentially increasing returns over the long term.

Through gearing, the investment performance of the internally geared fund, relative to the interest rate paid on the borrowing, is magnified (whether this is positive or negative). The advantage of this type of fund is that the institution is borrowing, not the investor. This ensures there is no further liability for the investor, unlike a margin lending arrangement. Additionally, the institution is able to achieve competitive borrowing

rates.

To illustrate, assume the fund has received \$10 million from investors and borrows \$10 million (representing a 50% gearing ratio) at an interest rate of 5.5%, bringing the total amount available for investment to \$20 million. Assume also that the total investment return (net of fees or expenses) of the fund in a particular year was 10%.

This means the net return of the fund would be:

- Investment earnings
- (\$20 million @ 10%) \$2.0 million
- Less interest on borrowings
- (\$10 million @ 5.5%) \$0.55 million
- Net return \$1.45 million

This equates to a 14.5% return, compared to the 10% return that investors would have received if the fund had not borrowed. The table below provides an example of the expected returns to the investor (assuming a 5.5% interest rate on borrowings in the geared funds) which are dependent on the earnings of the fund.

This table shows the relationship between gains and losses in internally geared funds, based on the gearing ratio within the funds. Where a fund matches every \$1 of investors' funds with \$1 of borrowed funds, they are said to have a 50% gearing ratio. This is because half the money in the fund is borrowed. If a fund borrows \$1 for every \$1.86 of investor's funds, the gearing ratio is 35%. If a fund borrows \$1 for every \$3 of investors'

Investment return (net of expenses) of a non-geared fund	Return to Investors			
	10% gearing	25% gearing	35% gearing	50% gearing
30%	32.7%	38.1%	43.1%	54.5%
25%	27.1%	31.5%	35.4%	44.5%
20%	21.6%	24.8%	27.7%	34.5%
15%	16%	18.1%	20.1%	24.5%
10%	10.5%	11.5%	12.4%	14.5%
5%	4.9%	4.8%	4.7%	4.5%
0%	-0.6%	-1.8%	-2.9%	-5.5%
-5%	-6.1%	-8.5%	-10.6%	-15.5%
-10%	-11.7%	-15.1%	-18.3%	-25.5%
-15%	-17.2%	-21.8%	-26%	-35.5%
-20%	-22.8%	-28.4%	-33.7%	-45.5%
-25%	-28.3%	-35.1%	-41.3%	-55.5%
-30%	-33.9%	-41.8%	-49.0%	-65.5%
-35%	-39.4%	-48.4%	-56.7%	-75.5%
-40%	-45%	-55.1%	-64.4%	-85.5%
-45%	-50.6%	-61.8%	-72.1%	-95.5%
-50%	-56.1%	-68.4%	-79.8%	-100%

While internally geared funds have a set gearing ratio (or a gearing ratio range), you can adjust your level of gearing simply by using a combination of internally geared funds and non-gearred funds for the 3rd bucket.

One factor which also contributes to the success of the geared share fund strategy is the cost of borrowing. Clearly the lower the borrowing costs, the lower the amount that the borrowed shares have to earn to cover their costs.

The extent of the magnification of the investment gains or losses depends on the level of gearing and the difference between the interest rate on the borrowing and the investment returns. Critical to this concept is that this strategy is only used for 3rd bucket investments, which by definition are long term investments.

In years of strong rising share markets, the more gearing the better. This is clearly evidenced by the table on the previous page and shows why funds with a gearing ratio of 50% have been able to achieve large double digit returns when share markets are positive. However, it was these highly geared funds which suffered the biggest losses in the decline of 2008.

As can be seen from this table, if the current financial year posted a year of -30% returns in the share market, the geared share funds with a 50% gearing ratio would see around 65% removed from the value of the fund. The damage would not be as great to an internally geared share fund with a 35%, 25%, or 10% gearing ratio, with losses restricted to around 49%, 41% and 34% respectively. On the other hand, if the financial year posted double digit positive share market returns, highly leveraged funds would certainly be the place to be.

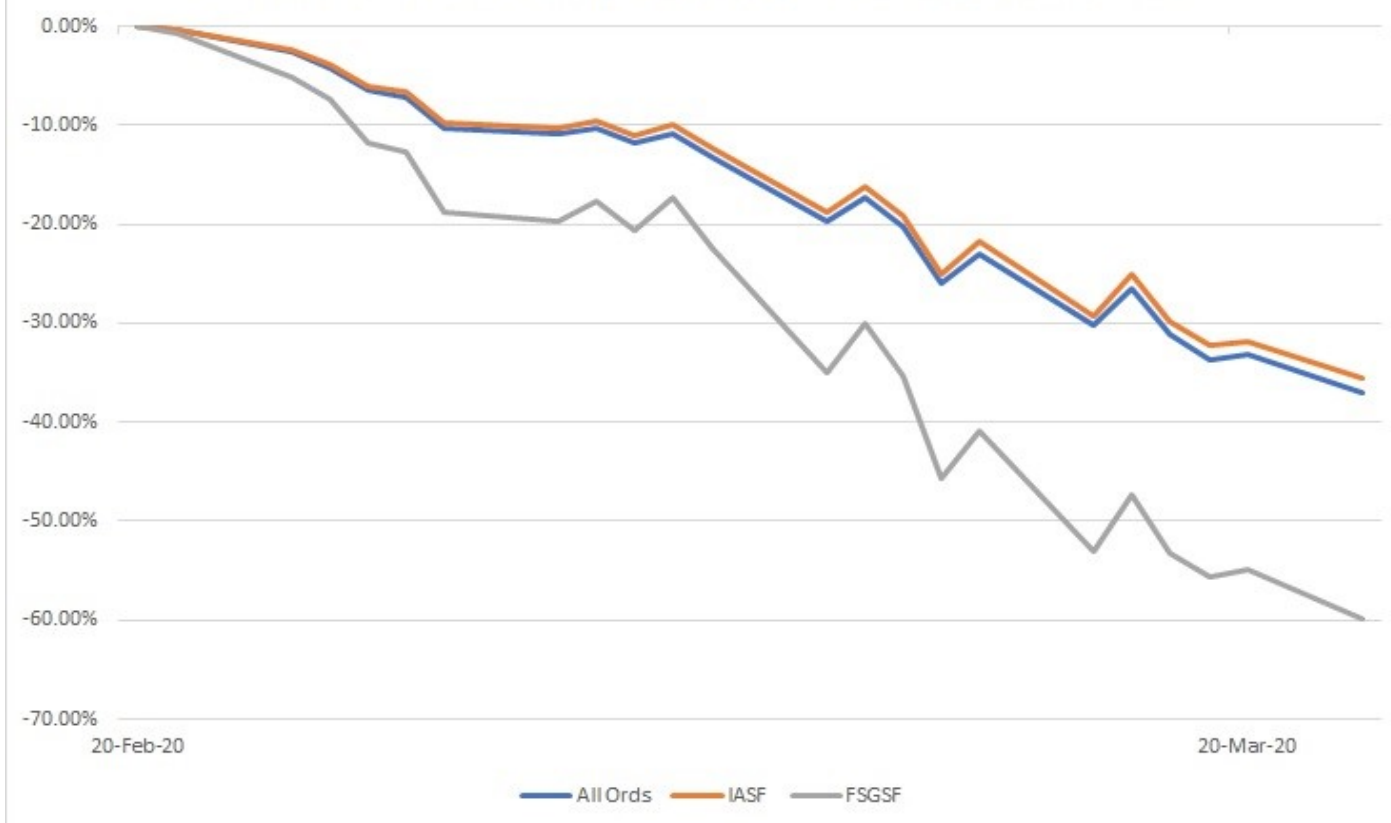
This raises a very important consideration – how likely is the investor to lose their funds?

If we continue to work from this table, in making these comments, we must also assume that the performance of the underlying fund (if an active fund), matches the performance of the broader index itself.

Where an individual has no gearing, then the market must cease to exist (i.e., fall 100%), before the investor is left with no funds. Where an investor chooses to not use geared funds, we would be using index funds as the basis of their 3rd bucket. This means that they effectively have a portfolio within their fund which matches the broader index itself. As an example, an Australian index fund would effectively hold every stock in the ASX 200 (including BHP, the major banks, Woolworths, etc. etc.). For this fund to have no value, the index itself must have no value, which means the share price of all of these companies must fall to \$0. There will always be corporate failures in the broader share market (ABC Learning, One.Tel etc.), however it is highly unlikely that the top 200 Australian companies would all fail at the same time. Following on this logic, it is true to say that where an investor chooses a strategy which has no gearing; their investment will always be worth something. Its value will however fluctuate, in line with the value of the share prices which make up the broader index.

The higher the level of gearing, the greater the possibility that an investor will lose their funds in a rapid market fall. As can be seen from the table on page 5, a rapid fall of 50% in the value of the share market could see someone, in a fund with a 50% gearing ratio, left with nothing. In a fund with a lower level of gearing (say 25%), it would require a rapid fall of around 75% in the market to lose all capital.

In understanding your investments, it is important to look at how they behave in both rising and falling markets. At this point, it may be useful to look at some “real life” examples.

Graph 4 Period of poor share market performance

**Period of negative share market performance:
20 February 2020 – 23 March 2020**

Graph 4 shows the performance of the Australian All Ordinaries Index and different 3rd bucket Australian share options for the period 20 February 2020 to 23 March 2020. This period is marked by a significant drop in the share market because of the pandemic.

Returns in this period are shown in the table below:

A further explanation of the table is seen below:

	Value at 20 Feb 2020	Value at 23 Mar 2020	Percentage Decrease
ASX(Blue line)	7255	44564	-37.09%
CFS IASF (orange line)	4.8680	3.1354	-35.59%
FS GSF(grey	10.9378	4.3983	-59.79%

– ASX (blue line) refers to the closing balance of the Australian All Ordinaries Index. This is the broadest measure of the daily movement and value of the Australian share market and is the commonly quoted index on the nightly news.

- CFS IASF (orange line) is the daily unit price for the Colonial Index Australian Share Fund. We could pretty much pick any index fund (whether it be from Colonial or anyone else) as all index funds basically provide the same return. This is because they are set up to replicate the weighting of the broader Australian share market. For example, as discussed earlier, if BHP makes up 12% of the ASX, the index fund will have 12% of BHP shares. Importantly, index funds do not utilise internal gearing. As such, we use them as the benchmark for what all other non-gearred bucket funds are likely to return.
- FS GSF (grey line) shows the daily unit price of the First Sentier Geared Share Fund. This fund invests only in Australian shares and as the name suggests, incorporates internal gearing.

Having explained this, it is now appropriate to look at our selected timeframe. As can be seen in Graph 4 and the indices opposite, this period saw decreases in the Australian share markets.

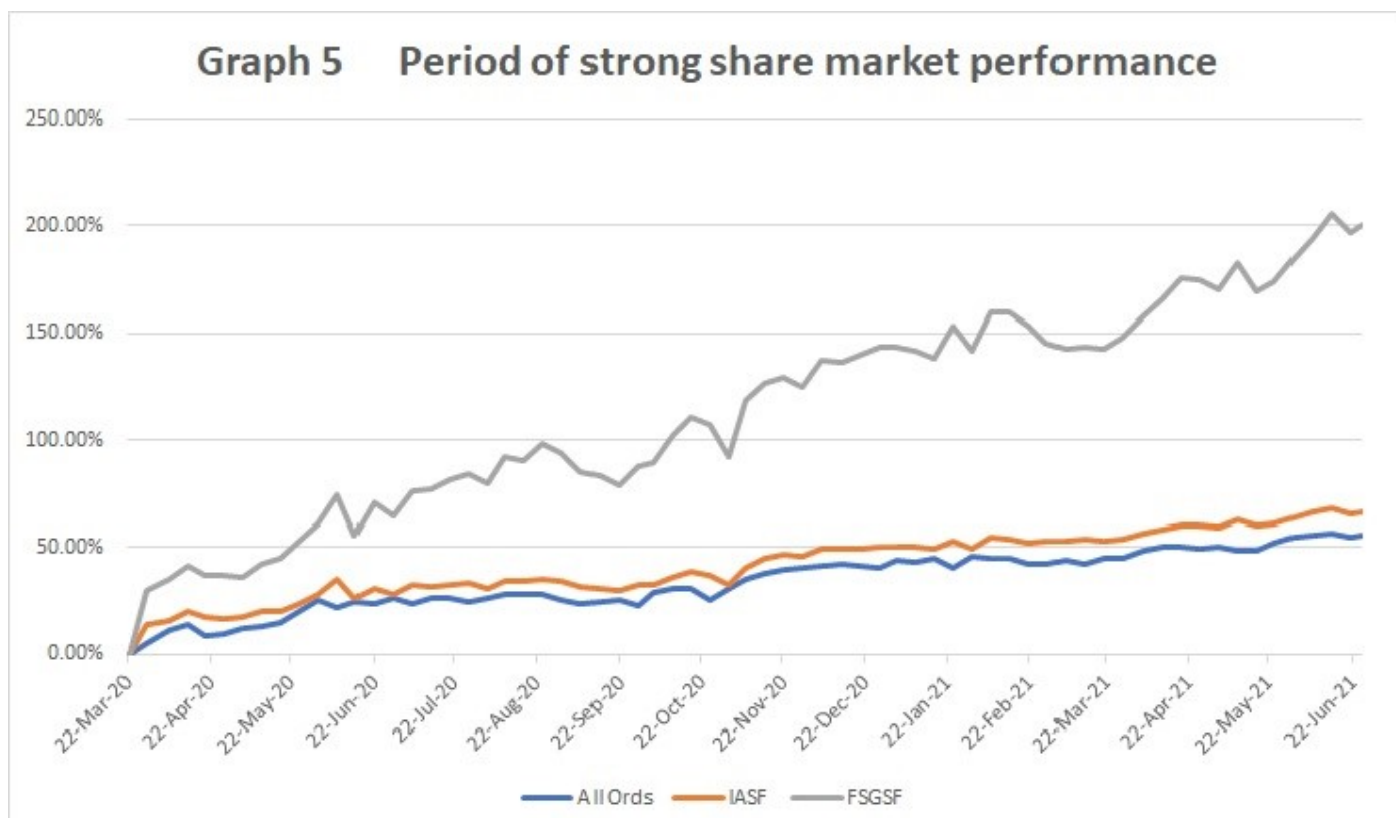
Over this period the ASX decreased by some 37.09%; the IASF (which is a typical 3rd bucket fund which does not gear), decreased by 35.59%, pretty much in line with the fall in the market. The First Sentier geared fund decreased by 59.79% - much greater than the fall in the ASX.

As explained above, the First Sentier fund has a gearing ratio of around 50%. This means that for every \$1 of your money invested, it borrows every \$1 of your money invested, it borrows another \$1. This gives you two dollars of shares rather than one, therefore, when the market falls 37.09%, it is logical that a 'two for one' share fund would fall by approximately double that amount.

What happens, though, when the market surges?

Period of strong share market performance: 23 March 2020 – 25 June 2021

Graph 5 shows the performance of the Australian All Ordinaries Index and different 3rd bucket Australian share options for the period 23 March 2020 to 25 June 2021. This period is marked by a significant rise in the share market.



Returns in this period are shown in the table below:

Over this period the ASX increased by about 55.48% and the IASF increased by 66.07%. The First Sentier geared fund however, increased by 200.25% which clearly shows the benefits of gearing in a rising market.

	Value at 23 Mar 2020	Value at 25 Jun 2021	Percentage Increase
ASX(Blue line)	4874	7579	55.48%
CFS IASF (orange line)	3.1354	5.2070	66.07%
CFS GSF (grey line)	4.3983	13.2060	200.25%

In the 'bad' first period, the internally geared funds accentuated the bad performance of the share market and the positive performance in the share market, in the second period, was accentuated by the internally geared fund.

With the belief that markets increase in the long term, the value of gearing can be appreciated.

Summary

It is important to remember these figures are net of taxes and fees. Therefore, if you share our belief that over the long term (eight years plus) markets will rise, it should also be obvious that the selection of internally geared funds remains very logical.

This is not to say that these funds do not require tweaking every now and then. Our document titled *Investing through BL&A* discusses the provision of these services to those who choose to invest through

It also goes without saying that it is imperative that enough funds are left in the 1st and 2nd buckets, to enable the 3rd bucket the opportunity of being a long term investment, and not have to be drawn down on earlier. There will be gains and losses along the way, but the long term gains should compensate for the volatility.

INTERNATIONAL SHARES

Geared share funds are not restricted to Australian shares; they also apply to international shares where the same general principles apply. In these funds, however, it is not always as easy to see the effects of the internal gearing as other factors (such as movement in the Australian dollar, level of currency hedging within the fund, etc.) can skew these results.

Companion documents:

Using the BL&A 'Bucket approach' to investing

How much do I need in retirement?

Investing through BL&A

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