

FINANCIAL PLANNING RESEARCH JOURNAL

Journal of the
Financial Planning
Association
of Australia

Characteristics of trust in personal financial
planning

Michelle Cull and Terry Sloan

Can stakeholders be satisfied with
accountants' education to act as advisors to
self-managed superannuation funds?

Brett Freudenberg and Dale Boccabella

Averting poverty and government budgetary
pressure through releasing home equity:
A safe and informed solution for baby
boomer homeowners

*Dianne Johnson, Mark Brimble and
Andrew Worthington*

The equity risk premium in Australia
(1900–2014)

*Robert J Bianchi, Michael E Drew and
Adam N Walk*

Aims and objectives

With an ever more complex financial system, an increasing emphasis on self-funded retirement for Australians, the increasing size of Australia's managed funds pool, and persistent evidence of financial illiteracy, the importance of financial planning is clear. The financial planning profession however, lacks an academic platform for discourse on the issues of individual personal financial planning and wealth management that can debate issues of practice and policy, and bring rigor, independence and evidence to the discussion. Currently there are no journals that fit into this niche providing a forum for dissemination of research in the specific area of personal finance and investments in the Australian context.

The context of personal finance and investments for Australia is different from the rest of the developed economies because of the presence of mandatory superannuation, a large managed funds pool and a strong social security system. Because of these factors international journals in the area of personal finance and/or investments may not suit an Australian audience. In addition, the rapid developments in regulatory and professional standards within the context of personal finance suggests there should be some interest in, and need for, independent, peer reviewed research in this area.

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Financial planning is on the journey to becoming a true profession, thanks to significant reform being put in place by both the Government and regulator. Alongside these changes, the Financial Planning Association (FPA) as Australia's leading professional body has made a commitment to strengthen relationships with the academic community, particularly around increasing education requirements and the development of more rigorous qualifications in financial planning.

This work was pushed forward with the formation of the Financial Planning Education Council

(FPEC) and the Financial Planning Academic Forum (FPAF). Both of these groups have worked to develop the national framework for higher education programs in financial planning in a collaborative, cross- institutional fashion. This resulted in the establishment of a Grants scheme in 2014, to facilitate the funding of academic research being offered to Education Institutions who have post graduate and undergraduate courses accredited by FPEC.

The grants scheme will be continued in 2016 and below are the key dates for the selection process.

Step	Activity	Timing
1	Call for submissions and website update. (FPA website initially)	8 July 2016
2	Submission of EOIs.	27 July 2016
3	GSC evaluates EOIs and invites full submissions.	29 July 2016
4	Full submissions due.	2 October 2016
5	GSC evaluates full submissions and awards grants. Funding agreements put in place.	November 2016

The 2016 Grants scheme brochure has been circulated to all of the FPE accredited providers.

We look forward to receiving applications for this valuable grants scheme.

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From the editors

We are pleased to present the second issue of the Financial Planning Research Journal, the journal of the Financial Planning Association of Australia. This issue of the journal comes at a time of heightened political debate – due to election campaigning and the somewhat controversial measures in the May 2016 Commonwealth budget in relation to superannuation and taxation changes. Furthermore, the push for more productive relationships to be formed between the higher education sector and industry in relation to the governments innovation agenda continues, both in terms of teaching and learning (work integrated learning and access to talent) and research (relevance, accessibility and commercialisation of outcomes). On the later point FPRJ makes a timely contribution as it is the product of sustained cooperation and collaboration between the Financial Planning Association of Australia and the academic community through the Financial Planning Education Council and the Financial Planning Academics Forum in particular. The production of this issue is testament to the outcomes that can be achieved through such collaboration.

We once again thank the Financial Planning Association of Australia and Griffith University for providing a platform for the dissemination and debate of research in this area. The first edition of the journal was well received and we hope to build on this with this and future editions of the FPRJ, and in doing so foster lively, evidence-based debate in the discipline.

This issue contains four articles on a range of topics from retirement poverty, to adviser education, the advice relationship and measuring risk in the equity markets. The papers offer a range of insights into issues currently being debated in the corridors of Canberra as well as practitioner offices around the country. Thus, we trust readers will find the papers relevant and useful when engaging in these debates.

The first article in this issue by Michelle Cull and Terry Sloan provides an empirical investigation of the client-adviser relationship focussing on elements of trust that support this relationship. A range of factors are shown to be important including specific behavioural and technical items, thus giving some guidance to practitioners in relation to skills and other factors that can build trusting relationships with clients.

The second article in this issue is by Brett Freudenberg and Dale Boccabella and focuses on the degree to which undergraduate accounting programs prepare accountants for SMSF advice. Given the upcoming legislative changes, this is a timely contribution to both the entry level and ongoing professional education debate. The paper finds that further reform is needed in the education space to support accountants moving into this advice area.

The next article is by Dianne Johnson, Mark Brimble and Andrew Worthington and examines retirement poverty. The paper highlights the needs of many retirees (in particular non-homeowner and single retirees) for income support. Picking up on the evolution of home equity release strategies and products, the paper argues for home equity to become part of the retirement income landscape and outlines further options for this to occur. This is another timely contribution to the literature as government explores changes to policy in superannuation and other retirement measures.

The final paper in this issue is by Robert Bianchi, Michael Drew and Adam Walk. It examines the Australian equity risk premium over the past century. With measurement of investment risk a key issue given the ongoing uncertainty in global political, economic and environmental contexts, this paper also makes a timely contribution to the literature and debate, offering long run historical evidence of how equity markets have performed and perhaps can be expected to perform in the future.

Finally we would like to thank the FPRJ production team for their efforts in getting the issue completed. Without the efforts of Xi Yang Li, Joy Lin, Sian Jones and Laura Phoenix, FPRJ simply wouldn't be produced.

We hope you enjoy the second issue of the Financial Planning Research Journal.

Dr Rakesh Gupta and Professor Mark Brimble

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CHARACTERISTICS OF TRUST IN PERSONAL FINANCIAL PLANNING*

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ABSTRACT

This Australian study utilises quantitative and qualitative research planning. Affective characteristics of trust were found to be essential to the client-adviser relationship. Increased legislation and specific behavioural and technical competencies of advisers were also found to build consumer trust in financial advice. The study's results provide guidance to financial advisers with regards to the skills and factors that build and maintain trust with clients. This may lead some advisers to engage in additional training or education programs to improve specific skills, or to reconsider the way they interact with clients.

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*This paper is developed from Michelle Cull's PhD thesis on "The Role of Trust in Personal Financial Planning" (University of Western Sydney, 2015)

Introduction

There have been significant changes and developments in the financial planning landscape over the past decade. The Global Financial Crisis (GFC) along with the collapse of prominent financial product and services providers has led to a loss of public trust in the financial planning industry. These events provided a turning point, prompting the industry to move from being a “transactional, investment and product focused industry, to one offering principally strategic advice and services” (Hoyle, 2010, p.1). While legislative reform through the Future of Financial Advice (FOFA) legislation (Commonwealth of Australia, 2009) has been introduced in response to these events, the latest events surrounding the life insurance arm of the financial planning industry, along with their being widely reported in the media (Ferguson, Christodoulou and Toft, 2016; McConnell, 2016; Robertson, 2016), have raised further trust issues. This has been accompanied by societal pressure for a cultural overhaul of the industry.

Professional financial planning advice has been linked to consumer well-being (Irving, Gallery, Gallery and Newton, 2011), including improved health (Joo and Garman, 1998) and better retirement planning (Peters et al, 2007) as clients realise their financial and life goals. Consequently, financial advisers play a significant role in assisting a large number of Australians to plan for their future well-being, investing large amounts of consumer savings for retirement and assisting them to achieve their life goals. Trust in the financial advice process ultimately impacts on public confidence in Australian capital markets and participation in the economy which assists in meeting broader economic and social objectives.

With so much attention directed towards trust in the financial planning industry it is pertinent that trust in the client-adviser relationship be subject to further investigation and academic debate. The characteristics of trust have been developed from an empirical study utilising both quantitative and qualitative research methods, and provide a foundation for future trust studies in personal financial planning. This paper contributes to research in this area by identifying seven primary characteristics of trust that were found to be essential to the client-adviser relationship in personal financial planning. It also highlights the importance of affective characteristics of trust to this relationship. In addition, the findings provide a practical contribution to assist financial advisers as they seek to establish, build and maintain trust with their clients.

Literature review

Trust has been described as multidimensional (Rotter 1967, Chun and Campbell 1974, Lewicki, McAllister and Bies 1998, Kirchmajer and Patterson 2003, Svennson 2004) and has been studied by a number of experts across a range of disciplines including sociology, social psychology, marketing and management. Due to the complex nature of trust, there have been a range of definitions employed, as identified in Table 1 (Cull, 2015, p. 300).

Table 1

Literature source	Trust construct or definition
Rotter 1967, p.651; Rotter 1980, p.1	'A generalised expectancy held by an individual that the word, promise, oral or written statement of another individual or group can be relied on.'
Wrightsmen and Baker, 1969, p.299	'The extent to which people are seen as moral, honest, or reliable'.
Johnson-George and Swap, 1982, p.1306	The element of risk involved when one must decide whether becoming vulnerable or dependent is worth the possibility of a shared positive outcome, despite a careful assessment of the other person's intentions, capabilities, and motives.
Barber 1983, p.164-165	Trust is a set of 'socially learned and socially confirmed expectations that people have of each other, of the organisations and institutions in which they live, and of the natural and moral social orders that set the fundamental understandings for their lives'.
Lewis and Weigert 1985, p.971	The 'undertaking of a risky course of action on the confident expectation that all persons involved in the action will act competently and dutifully'.
Rempel, Holmes and Zanna 1985, p.96	Trust is a construct with a number of elements: faith , dependability and predictability.
Schurr and Ozanne 1985, p.940	Belief that a party's word or promise is reliable and that a party will fulfill his or her obligation in an exchange relationship.
Zaltman and Moorman 1988, p.17	An interpersonal or inter-organisational state that reflects the extent to which parties can predict one another's behaviour; can depend on one another when it counts; and have faith that the other will continue to act in a responsive manner despite an uncertain future.

Literature source	Trust construct or definition
Anderson and Weitz 1989, p.312	Belief that needs will be met in the future by the actions of another party.
Anderson and Narus 1990, p.45	'the firm's belief that another company will perform actions that result in positive outcomes for the firm as well as not take unexpected actions that result in negative outcomes'.
Crosby, Evans and Cowles 1990, p.70	Confident belief that a salesperson can be relied upon to behave in a manner that will serve the long-term needs of the customer.
Moorman, Deshpande and Zaltman 1993, p.82	'willingness to rely on an exchange partner in whom one has confidence'
Morgan and Hunt 1994, p.23	'...confidence in an exchange partner's reliability and integrity.'
Fukuyama 1995, p.26	The expectation of 'regular, honest and cooperative behaviour based on commonly shared norms'.
Hosmer 1995, p.399	'the expectation of ethically justifiable behaviour- that is, morally correct decisions and actions based upon ethical principles of analysis'.
Mayer, Davis and Schoorman 1995, p.712	'the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party'
McAllister 1995, p.25	'the extent to which a person is confident in, and willing to act on the basis of, the words, actions and decisions of another.'
Robinson 1996, p.576	A person's 'expectations, assumptions, or beliefs about the likelihood that another's future actions will be beneficial, favourable, or at least not detrimental to one's interests'.
Christiansen and Devaney 1998, p.4	Frequent and honest communication plays a key role.
Zaheer, McEvily and Perrone, 1998, p.143	The expectation that an adviser can be relied upon to fulfill obligations (Anderson and Weitz 1989), behave in a predictable manner and act and negotiate fairly when the possibility of opportunism is present (Anderson and Narus 1990, Bromiley and Cummings 1995) .

Literature source	Trust construct or definition
Johnson & Grayson 1998	Multidimensionality of trust- cognitive and affective trust are separate dimensions of trust with unique antecedents and consequences for relationships.
Lewicki, McAllister and Bies 1998, p.439	'Confident positive expectations regarding another's conduct'.
Rousseau et al 1998, p.395	'Psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behaviour of another'.
Sharma and Patterson 1999, p.155	Implies personal vulnerability through reliance on, or confidence in, the financial adviser's competence and ability to satisfy the long-term interests of the client.
Johnson & Grayson in Swartz & Iacobucci (Eds) 2000, p.358 & p.365	Four levels (generalized, system, process-based, and personality-based) which vary in terms of relevance as the relationship progresses from exploration to commitment. Involves cognitive and affective indicators to provide a confident expectation that all involved will behave competently and dutifully.
Sirdeshmukh, Singh and Sabol 2002, p.17	The expectations held by trustor that the trustee is dependable and can be relied on to deliver promises made.
Albaum and Young 2003, p.255	Trust is 'an evolving affective state including both emotional and cognitive elements and emerges from the perceptions of competence and a positive, caring motivation in the relationship partner to be trusted, and functions to increase the propensity to manage risk in the relationship of parties' shared environment'.
Boyd 2003, p.398	Involves a belief in an agent's competence, predictability, integrity and benevolence.
Kirchmajer & Patterson 2003, p.4	A multi-dimensional construct involving credibility and benevolence. Based upon the ability of a financial planner to perform their role effectively, based upon their experience, expertise and task-specific competencies; with honesty and an intentional motive beneficial to the client.
Weisinger 2004, p.56	Based on communication.

Literature source	Trust construct or definition
Johnson & Grayson 2005, p.501	Knowledge and emotion driven action, with willingness to rely on a provider being based on reliable conduct and interactions.
Sharpe et al 2007, p.7	'the belief that the financial planner can be relied on to behave in such a manner that the long term interest of the client will be served (adapted from Crosby et al 1990, Sharma & Patterson, 1999)' .
Kohn 2008, p.17	'Trust is an expectation about another's actions, based on the understanding that the other has the capacity to create mental models of possible course of action, and to evaluate them within a framework that can incorporate interests besides the other's own.'
Wood, Boles, Johnston and Bellenger 2008, p.264	'An expectation by the buyer that the seller will engage in actions supporting the buyer's interests in that setting (Hardin 2002, Morgan and Hunt 1994).'
Miranda and Klement 2009, p.30	'... the belief that a person or organization will honour promises and act in ways that are expected of them'.
Guenzi and Georges 2010, pp.117-118	An affective response significantly driven by benevolence, competence and likeability/similarity; resulting in customer satisfaction, positive attitudes, intentions and behaviours.

Source: Cull (2015, p. 300)

Integrating the various trust constructs and definitions provided in Table 1 provides a basis for a definition of trust in the financial planning context. We define trust in financial planning as "the expectation that the adviser (trustee) can be relied on to act honestly, competently and in the best interests of the client (trustor) and thereby reduce the trustor's risk of loss" (Cull, 2015, p. 10).

As acknowledged in Table 1, Zajonc (1980) discusses the importance of both *affect* and *cognition* in the development of trust. Affect based trust relates to the 'feeling' dimension of trust such as emotional bonds, security and benevolence (Lewis and Weigert, 1985; Rempel, Holmes and Zanna, 1985; McAllister, 1995; Johnson and Grayson, 2005), while cognition based trust is related to the 'thinking' dimension of trust and is primarily concerned with competence, knowledge, reliability and dependability (Johnson-George and Swap, 1982; Rempel, Holmes and Zanna, 1985; McAllister, 1995; Rousseau *et al*, 1998, Johnson and Grayson, 2005). Empirical studies have tended to focus on cognitive based trust (possibly because it is easier to measure) and omit the affective dimension (Young, 2006). It has been suggested that this affective dimension is an important dimension of trust in the financial planning context (Kirchmajer and Patterson, 2003).

Evidence from Kirchmayer and Patterson (2003) indicates that 'social communication' (informal transfer of information, discussions of a social nature and two-way communication) is a major determinant of benevolence trust, a critical ingredient in developing the affective component of a client's intention to stay with their financial planner. This is because 'social communication' assures the client that their financial planner has a high level of goodwill towards them. In other words, that their financial planner's motives and intentions are friendly and they will act in an altruistic manner in their ongoing relationship. While the Kirchmayer and Patterson (2003) study demonstrated the importance of social communication in the affective dimension of trust, much existing research is based on service marketing models where communication is defined in terms of exchanging facts rather than specific communication skills or the qualitative aspects of the client-adviser relationship (Sharpe *et al*, 2007).

In financial planning, client trust has been found to be the most important factor for relationship quality (Hunt, Brimble and Freudenberg, 2011), and financial planners have a tendency to report the level of clients' trust in them as higher than that reported by their clients (Hunt *et al*, 2011; Cull, 2015). Many previous studies of trust in the context of financial planning are primarily related to relationship quality. Studies in Australia and the United States demonstrated that effective interpersonal communication skills (Christiansen and DeVaney, 1998; Sharma and Patterson 1999; Kirchmayer and Patterson, 2003; Sharpe *et al*, 2007) are fundamental to client trust.

Other empirical studies discuss the sales process and paradoxes of trust. For example, Oakes (1990) found that although sales depended on trust, 'the techniques required to form trust in personal sales nullify the conditions under which trust is possible'. In other words, it was found that high pressure 'selling' of a product led to greater distrust between the buyer and seller. Furthermore, Bejou *et al* (1998) found the degree to which clients trust their adviser to be positively influenced by the belief that the adviser is acting in the client's best interests (customer-oriented) and negatively influenced by the belief that the adviser is acting out of self-interest (sales-oriented). This was reinforced by David Hasib, head of accounting firm Chan and Naylor who stated "the quality and delivery of advice is more important than product flogging to achieve a sales target" and "advisers owe it to their customers to identify the most suitable products based on individual circumstances irrespective of commission" (Taylor, 2011, n.p.).

While a review of the literature has uncovered a number of studies of trust in a business or professional relationship, there have been few studies involving empirical research on trust in the professional client-planner relationship, and none which specifically identify the characteristics of trust in personal financial planning. This paper is the first to address this gap and as such provides a basis for future studies.

The for need and importance of examining trust at times of change/conflict and when uncertainty and risk are present, has been raised in the literature (Sharma and Patterson, 1999; Luhmann, 1988; Chen, Sparito and Belkin, 2011) where it has been suggested that “a potentially fruitful avenue of future research is the impact of dissatisfying events on the different dimensions of trust” (Johnson and Grayson, 2005). This paper addresses this area of concern as the data in the study were collected at a time of much economic uncertainty and risk, and at the time of the GFC – a dissatisfying event. As has been previously observed:

In the physical sciences, many phenomena are most salient when they are in the process of change...Therefore the most opportune time to examine trust may occur when stress or conflict has created a situation where confidence in the other is an issue (Rempel, Holmes and Zanna, 1985, p.111).

Methodology

Research Design

The research design utilised a social constructivist approach as an extension of the interpretive paradigm (Burrell & Morgan, 1979 Chua, 1986) with the ontological assumption that reality is socially constructed and continually changing and developing. As a result, the most suitable methodology was essentially qualitative in nature, asking the *how* and *why*. The research involved a combination of both quantitative and qualitative methods to answer the following research question:

RQ1: What characteristics of trust are evident in personal financial planning?

Five main research instruments, including two client questionnaires, a financial adviser questionnaire, semi-structured client interviews and semi-structured adviser interviews were utilised in these studies. A mixed-methods approach was seen to be appropriate for this research due to the underlying philosophical assumptions of the researchers, and the subjective nature of trust which is grounded in social psychology. For this study, interviews were able to provide a rich source of data, while the results from the questionnaires assisted in structuring the interview questions and provided internal validity checks (Denzin, 1978). In addition, multiple methods have been found to assist in overcoming the shortcomings of each method when used on their own (Neuman, 2006; Veal, 2005). The research also utilised triangulation of both method (quantitative and qualitative) and observers (clients and advisers).

Survey question items were developed from a number of sources including the Birkett (1996) financial planning competencies, the behavioural skill research of Jackling and Sullivan (2007), trust literature (Rotter, 1980; Zajonc, 1980; Rempel *et al*, 1985; Lewis and Weigert, 1986; Crosby *et al*, 1990; Moorman *et al*, 1992; Mayer *et al* 1995, Christiansen and DeVaney, 1998; Rousseau *et al* 1998; Lin *et al* 2011; Stewart 2003; Schoorman *et al*, 2007; Kim *et al*, 2009; Fulmer and Gelfand, 2012) and the research project commissioned by CPA Australia on the impact of the Financial Services Reform Act (CPA Australia, 2005). For both clients and advisers, a five-point Likert scale was used to measure various behaviours of personal financial planners as well as responses to a range of statements about trust and financial planners. For clients, the survey also included questions about the usefulness and relevance of their statement of advice. All questionnaires included a 'free response' section to afford respondents the opportunity to provide additional information that they felt was relevant to the study.

The semi-structured, in-depth interviews were designed to address questions informed from both the survey results and the trust literature in order to provide a richer, more complex understanding of the characteristics of trust in personal financial planning. The questions were sequenced in a manner conducive to discussion in that where possible, questions would logically and naturally flow from the response to the previous question. The aim was to facilitate a relaxed discussion of the topic rather than asking questions one after another in a formal fully structured interview. Every effort was made to structure the interview in a way that would encourage the interviewee to participate and offer up any information or 'stories' that they felt assisted in answering the questions.

Data sample and collection

The data collection process commenced with a postal mail out of questionnaires to Australian residents over the age of 18 to a random sample of participants obtained from the Australian Address Reference File (AARF) using probability sampling and the Unaddressed Mail Service (UMS) using multi-stage sampling to subdivide the sample proportionately across residential postcode delivery points in each state. This captured a sample of Australian consumers who had accessed financial advice ('clients'), as well as those who had not accessed financial advice ('potential clients'). To capture a sample of financial advisers, questionnaires were mailed out to a systematic random sample of Australian Financial Service Licence (AFSL) holders and Authorised Representatives listed as providing financial advice on a current AFSL Representatives Report purchased from ASIC (Information Services Department). Subsequently, client and adviser interviews were conducted with willing respondents from the questionnaires, with these interviews being recorded and transcribed.

Participation in the research was entirely voluntary. In total, 207 consumer questionnaires (104 clients; 103 potential clients) were received along with 76 adviser questionnaires, and 8 client interviews and 9 adviser interviews recorded. Ages of clients ranged from 18 up to the 85-100 years age group, with every age bracket represented and representative of the Australian population (Australian Bureau of Statistics (ABS), 2010). Ages of advisers ranged from 27 to 84 years ($M = 49$). Although all major occupations were represented by the consumer sample, the response showed a higher incidence of 'professional' workers and lower incidence of 'labourers' when compared to the Australian population (ABS, 2014). A higher incidence of professional workers responding to the survey was expected as they have been shown to be more likely to seek financial advice and find the topic more relevant to their situation, while labourers are less likely to be interested in financial advice. Furthermore, Porter (2004) and Dillman (2007) acknowledge that non-responses are often from those who are less educated.

Data analysis

Demographic data and Likert scale responses from the questionnaires were coded and screened prior to quantitative analysis using IBM computer software known as Statistical Package for the Social Sciences (SPSS) for Windows (Version 22) to conduct descriptive and statistical tests such as frequency distribution, cross-tabulation, calculation of means, percentage distributions, chi square tests, t-tests and analysis of variances (ANOVA).

Qualitative analysis of the open-ended questionnaire responses and interview transcriptions employed through a four stage content analysis utilising Leximancer software to draw out the major themes. Stage 1 involved the manual flagging of themes with stage 2 mapping concepts and themes through Leximancer. This was followed by a manual confirmation of the Leximancer map in stage 3, and a manual interconnection of concepts and main themes in stage 4.

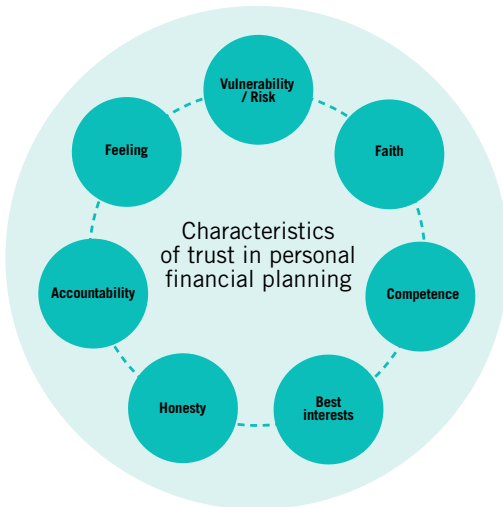
An overarching qualitative approach is taken in interpreting and discussing the results through triangulating the data obtained from the research groups using the various research instruments.

Results and discussion

Qualitative analysis of the open-ended comments in client questionnaires and client interviews provided an indication of the main characteristics of trust that are evident in personal financial planning. Results from client questionnaires that measured a range of trust characteristics using a five-point Likert scale supported the qualitative results.

There were seven main characteristics of trust found to be evident in personal financial planning: vulnerability/risk; feeling; honesty; faith; best interests; accountability, and competence. These results are now discussed, with an outline provided in Figure 1.

Figure 1: The seven characteristics of trust in personal financial planning



Source: Cull (2015, p.216)

1. Vulnerability/Risk

Results suggest that there must be an element of vulnerability or risk in order for trust to exist, whether it be a situation that a client finds themselves in (such as divorce or inheritance), or whether it be attributable to a lack of knowledge. The risk faced by clients is that the advice may not assist them to achieve their goals or worse still, may place the client in a worse position than they were prior to obtaining financial advice.

Clients identified with vulnerability and risk as key characteristics of trust, evidenced as follows:

I'm sure some people end up at a financial planner when they are very (*sic*) somewhat vulnerable or may have come into some money that was unexpected or gone through - I've helped a couple of people with divorces, and they were very vulnerable. [Interviewee 105]

Because I'm taking you at your word that my money's going to be safe where you're telling me to put it, and that's a big risk. [Interviewee 100]

I've got no expertise in this area at all and it just seems to be clouded in mystery of what you do... so I invested trust in them. [Interviewee 107]

This stuff makes me SO anxious because I don't know enough about the financial system...
[Client 450]

Made investments of my own in the end adviser received his money and I made nothing. I run at a loss. [Client 297]

While lack of knowledge has been referred to in the literature as a 'competence gap' (Brien, 1998; Lewis and Weigert, 1985; Miranda and Klement, 2009; Parsons, 1972), there is little empirical evidence in the literature (particularly from a client's perspective) to support the notion that the 'competence gap' is an inherent risk characteristic of trust. This study has provided the evidence that risk and vulnerability associated with the competence gap are characteristics of trust.

Furthermore, definitions of trust in the literature include references to both vulnerability and risk. For example, Mayer, Davis and Schoorman (1995, p.712), Rousseau *et al* (1998, p. 395) and Sharma and Patterson (1999, p. 155) recognise the psychological role of vulnerability in trusting relationships and Sheppard and Sherman (1998, p. 423), Lewis and Weigert (1985, p. 971) and Johnson-George and Swap (1982, p.1306) identify with trust as the undertaking a risky action. The results from the current study support previous theoretical studies and add to the body of literature by providing specific empirical examples of risky actions as described by clients in the personal financial planning environment.

2. Feeling

Trust in personal financial planning was found to have a large affective component – described as a 'feeling'. Although the literature acknowledges the affective component of trust (Zajonc, 1980; Johnson and Grayson, 1998; Johnson and Grayson in Swartz and Iacobucci (Eds), 2000, p. 358 and p. 365; Albaum and Young, 2003, p.255; Johnson and Grayson, 2005, p.501; Guenzi and Georges, 2010, pp. 117-118), many studies have focused on the cognitive characteristics of trust and fail to acknowledge the affective characteristics.

The research findings indicate that for trust to exist between a client and an adviser, cognitive characteristics of trust must be accompanied by the affective characteristic that clients simply describe as a 'feeling'. For example:

I think that you can usually tell by talking to a person and you get that **feeling** of trust or whether they're trying to push their own barrow or whether they're working in your best interests as well. Obviously he has to do what's best for him as well, but just that **feeling** that he wouldn't do anything dishonest. He's got his reputation to think of. And just talking to him generally, you get that **feeling**. [Interviewee 106]

Well, we always check our statements because we have moved money around a bit so, even though we trust him, we still check and I don't know, I guess – it's just a **feeling** we get that we do trust him and he's proven that we can trust him. [Interviewee 102]

While results from this study show trust in personal financial planning to have both cognitive and affective characteristics, the results indicate that the affective characteristics of trust in personal financial planning are perhaps more important to the presence of trust in a professional relationship, and may have more salience.

3. Honesty

When clients were asked to explain what trust meant to them, they often referred to honesty – honesty with financial information provided as well as honesty with fees and commissions earned by the adviser. Questionnaires showed on a five-point Likert scale that clients who trusted their advisers also regarded their advisers as honest (Mdn = 4). Also noteworthy was that advisers rated themselves higher than the rating given by their clients (Mdn = 5).

Results also showed that dissatisfying external events such as the GFC provide a real opportunity for an adviser to demonstrate their honesty. Rankings for honesty of advisers providing advice following the GFC were higher (M = 3.84, Mdn = 4) with clients finding that the sound advice provided to them by their adviser at the time of the GFC increased their trust in their adviser. Clients who reported their adviser to be dishonest had also ranked their adviser as untrustworthy and did not return to their adviser for subsequent advice after the GFC.

Clients in the research study found honesty to be an important characteristic of trust. The response from clients when asked to explain what trust meant to them was:

...the integrity of a person, their honesty, their fairness, their reliance, but most importantly, above all that, that they carry out that fiduciary duty, that that's what they're really there for. [Interviewee 105]

You're given the information to make a decision and that you feel that the information is true and correct. So that's what trust means to me. They know the industry that I don't know. They know the business and that if I take their advice and they're saying, 'here's the outcomes from that advice that they will be correct'. They will match. [Interviewee 107]

Open-ended comments from clients also indicated that honesty was a characteristic that clients were looking for in an adviser. For example:

They (clients) don't want 20 pages of a PDS – they want honesty and care. [Client 07]

Clients cited examples of honesty with regards to disclosure of remuneration, with the general expectation that honest advisers would declare their remuneration clearly upfront. Some examples follow below:

Paid advice is clean and reliable upfront. [Client 256]

He was upfront about it [receiving a commission]. If he had have gone oh, no, no, no, it's just because they're a really good company, dah, dah, dah, I possibly wouldn't have believed him. Because you know that they get commission from wherever they put their loans and stuff, so yeah, it was that sort of thing that increased my trust in him. [Interviewee 100]

As discussed above, honesty has been identified as an important characteristic of trust in personal financial planning. The results also provide empirical support to the literature where honesty has made an appearance in the definition of trust [for example, Rempel, Holmes and Zanna, 1985; Morgan and Hunt, 1994; Kirchmayer & Patterson, 2003; Svensson, 2004], and has provided new information in understanding the role of trust in personal financial planning where there currently exists a research gap. Furthermore, the findings have shown that in personal financial planning dissatisfying events provide a real opportunity for an adviser's honesty (or dishonesty) to be shown to clients. In addition, the findings provide support for legislation that bans commissions and increases transparency of fees by showing that it improves the perception that advisers are honest, and as a result increases client trust in financial advice.

4. Faith

Findings from the study show that faith is also an important characteristic of trust in personal financial planning as a client must have confidence, or faith that their financial adviser can be relied upon to provide the right advice. Dissatisfying events such as the GFC, or losing money on an investment, can lead a client to lose faith in their adviser if the client believes that the adviser cannot be relied upon to achieve an expected outcome. This, in turn leads to a lack of trust in the adviser.

Results from client questionnaires indicated that a client's faith in their adviser was higher when their adviser was reliable. This faith in their adviser was further supported by results from a five point Likert scale for the following statements regarding reliability and confidence respectively:

I can rely in my adviser to do the things he/she has promised to do (Mdn = 4).

When my adviser explains things that may seem rather unlikely, I am confident that he/she is telling the truth (Mdn = 3.5).

All clients who had engaged with an adviser since the GFC found their adviser to be reliable and were confident in their adviser, but this was not the case for some clients who had last engaged an adviser prior to the GFC. Further analysis of this data indicates that the clients who reported negative rankings for reliability and confidence had also ranked their adviser as untrustworthy. This assists in explaining why they had not returned to their adviser for subsequent advice post-GFC.

The interview results from clients describe faith as being characteristic of trust in personal financial planning, as evidenced by the following examples:

I guess trust, especially when it comes to money, means having **faith** that the person you're trusting with your money is going to do the right thing so that you don't lose any of that money that you've worked so hard for. [Interviewee 102]

I think you go in on somewhat blind **faith**, and I think therein lies the real problem with our financial planning industry at the moment, because it's so diverse. [Interviewee 105]

The results show faith to be a characteristic of trust in personal financial planning and while this adds to the body of literature on trust that includes terms such as confidence, reliability and belief in the definition of trust, the results also assist in understanding what trust in personal financial planning means to a client. This may be useful to financial advisers in building trusting relationships with their clients.

5. Best interests

Results from client interviews indicated that a client trusts their adviser when they perceive that the adviser acts in the client's best interests. This is supported by client responses to the question 'What elements build trust with a financial adviser?':

I want that financial adviser to act in the client's best interests and not just sell commissioned products. That's what the trust comes down to. [Interviewee 105]

Furthermore, results from client questionnaires indicated that where clients believed an adviser acted out of self-interest, they also reported them to be untrustworthy. For example, Client 24 consistently ranked their adviser to be untrustworthy and also included the following open-ended comment:

Sometimes feel that the investments recommended are also what is best for his company. [Client 24]

Clients who found advisers to be acting with self-interest rather than the client's best interests also 'strongly agreed' that their adviser was 'marketing oneself' (a ranked behaviour in the client questionnaire) and did not rank their adviser to be trustworthy, for example:

We find most financial advisers act with more self-interest in products offered and are rarely proactive in advising market trends. [Client 18]

Findings suggest that trust cannot exist in the client-adviser relationship unless the adviser is seen to put the client's best interests first. This provides the 'real-life' evidence to support the meta-analysis of literature conducted by Balliet and Van Lange (2013) that emphasized 'the importance of defining trust in terms of beliefs about others' benevolent motives' (p. 1102) in situations involving strong conflict of interest.

Furthermore, the results empirically support suggestions that the introduction of a Best Interests Duty (BID) as part of the federal government's FOFA reforms will improve trust in personal financial planning (Commonwealth of Australia, 2010).

6. Accountability

Accountability is found to be a characteristic of trust in personal financial planning and hence the role that regulatory and professional bodies play in maintaining trust in the financial planning environment. Clients acknowledged that they trusted their advisers because they understood that their advisers were accountable to their employer, regulatory authority or professional body. This accountability is described by clients as follows:

But I think it deepens your trust if you know it's part of a firm because then they're accountable to that firm. [Interviewee 102]

Also they were talking about bank tellers giving out financial advice or pushing products. Well I don't think that's appropriate. And I think that legislation should be put in place to protect people from that sort of pressure. [Interviewee 106]

Fukuyama (1995) and Johnson and Grayson in Swartz and Iacobucci (Eds) (2000) see accountability as being equally available to all firms operating in the same business environment. However, empirical results from clients in our study indicate that accountability, while a characteristic of trust, is not yet fully developed in personal financial planning in Australia. Furthermore, the findings suggest that clients would like to see greater protection through improved legislation and regulatory powers to deter advisers from pushing products or providing inappropriate advice by holding them accountable for poor advice.

Our findings support the implementation of an enhanced register of financial advisers (Commonwealth of Australia – The Treasury, 2014) as well as need for reform in fundamental areas as identified by the Financial Planning Association's General Manager Policy and Conduct as follows:

- “the role of ‘approved’ professional bodies in assisting ASIC to achieve consumer protection;
- the role of regulatory agencies in preventing the provision of unethical and misleading financial advice;
- compensation processes relating to unethical or misleading financial advice;
- the response and subsequent action by financial services providers and companies to misconduct in the industry” (De Gori, 2014, n.p.).

7. Competence

This study reveals that competence, as indicated by behavioural skills, technical skills and qualifications, is a vital characteristic of trust in personal financial planning.

Clients who trusted their financial adviser rated the behavioural competencies of their financial adviser more highly than those who did not trust their adviser. Furthermore, higher rankings of behavioural skills for advisers were associated with advisers who provided useful and relevant statements of advice (SOAs), providing further indication to clients that the adviser can be trusted.

Results from the *Leximancer* analysis showed qualifications as one of the most prominent themes raised by clients when discussing trust in the context of personal financial planning. Furthermore, clients who knew their adviser's qualifications also ranked both technical and behavioural skills of their adviser higher and advisers who held qualifications relevant to financial planning were trusted, while those with no relevant qualifications were not. Furthermore, all clients who found their Statements of Advice to be both useful and relevant ranked their advisers to have higher technical-based competence skills.

Open-ended comments from both clients and potential clients were mostly from respondents who reported that they did not trust financial advisers, as they felt that advisers did not have the necessary qualifications. For example:

Financial planners/advisers should be required by legislation to gain some recognised accreditation (similar to a CPA). [Client 203]

Financial advisers are generally not of the same quality and do not have the same level of qualifications as say doctors, lawyers, accountants. [Client 185]

Qualifications were a key ingredient for advisers who were trusted, as supported by the following:

So I probably wouldn't deal with him if he didn't have those qualifications. We knew that he had the Degree, etcetera, when we first met him. [Interviewee 106]

We wouldn't go to anybody who wasn't qualified. [Interviewee 102]

We've seen certificates up in his office and because we've known him for so long and he used to do our tax before he was our financial adviser, we trust him and we know that he's qualified. [Interviewee 102]

An array of literature on trust across different contexts and organisational settings cite the role of competence, expertise or ability in the production of trust. However unlike the theoretical approaches taken by numerous other authors [Barber (1983), Lewis and Weigert (1985), Mayer, Davis and Schoorman (1995), Rousseau *et al* (1998) and Johnson and Grayson in Swartz and Iacobucci (Eds) (2000)], the results in this study provide empirical evidence to validate claims that competence provides perceived positive intentions that contribute to trust.

The results from the study also elaborate on the literature on client commitment in personal financial planning that found interpersonal communication skills such as listening, caring, friendly and professional behaviour displayed by advisers to have a large effect on client commitment (Christiansen and DeVaney, 1998; Sharma and Patterson, 1999; Kirchmayer and Patterson, 2003; Sharpe *et al*, 2007) by identifying such behavioural skill competencies as characteristic of trust.

The study has implications for both practice and research. For practice, the study indicates can assist financial advisers should reconsider the way in which they interact and communicate with their clients. This may lead some to engage in additional training or education programs to improve skills that are found to build client trust. In addition, the findings urge policy makers to make regulatory reform that involves greater accountability for financial advisers.

The study contributes to the body of literature on understanding trust by providing empirical evidence, in the context of personal financial planning that demonstrates competence – both behavioural and technical – to be a characteristic of trust. To date, there have been no similar studies reported in the literature.

Limitations and future research

The generalisability of results may be limited by the relatively small sample size in the study. Future research on a larger sample size, and/or extending to countries outside Australia with similar economic and social objectives, would validate our findings.

As personal financial planning is still a relatively new profession, the current study provides a foundation for future studies on the characteristics of trust in personal financial planning, specifically the affective characteristics that were found to be essential to the client-adviser relationship. These characteristics of trust may also extend to other professional service relationships in a range of differing contexts.

Future research may also consider the educational and regulatory implications of the findings, such as how the characteristics of trust are incorporated into educational programs or the effectiveness of regulatory reform in improving accountability and trust of financial advisers.

Conclusion

In answering the research question, ‘what characteristics of trust are evident in personal financial planning?’ we found seven primary characteristics of trust evident in personal financial planning: vulnerability and risk, feeling, honesty, faith, best interests, accountability and competence. These seven characteristics of trust are essential to the client-adviser relationship in personal financial planning and can assist financial advisers to establish, build and maintain trust with clients. The study has emphasised the importance of the affective characteristics of trust in a professional relationship such as personal financial planning. To date, there have been no similar studies reported in the literature.

The characteristic of competence expands the literature on client commitment by emphasising the importance of interpersonal communication skills such as listening, caring and friendly and professional behaviour on client commitment. The research empirically demonstrates that competence - both behavioural and technical - is a characteristic of trust in personal financial planning.

The results further suggest that increased legislation and the behavioural and technical competency of advisers can build consumer trust in financial advice. Our findings lend support to the introduction of legislation that bans commissions and increases transparency of fees by showing it would improve perceptions of honesty, leading to increased trust.

Conflicts of interest and dissatisfying events can put client trust at risk where transparency and minimum educational qualifications are not properly regulated, with implications for policy makers, regulators and professional bodies and may also be true across a wide range of relationships and contexts.

The findings from this research can be used to inform curricula, policy and business practice. Professional development and educational programs for the financial planning profession can further develop the affective components of trust and build on the behavioural and technical competencies of advisers. This may be considered by the Finance Professionals' Education Council (FPEC) in fulfilling its obligations to raise the standard of financial planning education. Furthermore, by highlighting accountability and qualifications as important characteristics of trust in personal financial planning, this research provides guidance to policy makers in terms of educational and regulatory requirements imposed on the financial planning profession. The essence of trust is at the very heart of what regulatory bodies do as they 'promote confident and informed participation by investors and consumers in the financial system' (ASIC, 2015). Finally, the results can facilitate delivery of trusted financial advice, leading to greater confidence and participation in the economy, and meeting wider societal objectives by improving consumer well-being.

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CAN STAKEHOLDERS BE SATISFIED WITH ACCOUNTANTS' EDUCATION TO ACT AS ADVISORS TO SELF-MANAGED SUPERANNUATION FUNDS

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ABSTRACT

This article investigates to what extent accountants are taught about self-managed superannuation funds (SMSF) in their Australian undergraduate accounting degrees and subsequent professional education programs. The article reports a survey of 138 academics teaching into Australian undergraduate accounting degrees. The results indicate that during their undergraduate accounting degrees, students are likely to be taught little about SMSFs. In a curriculum audit of their subsequent professional studies through professional bodies there is also minimal coverage of SMSFs. The evidence presented in this paper supports reforms to increase the educational requirements for accountants to give specialist advice in this area.

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Introduction

With Australia's aging population and the push by government, the last thirty years has seen a dramatic increase of Australia's retirement savings, especially through superannuation. Currently there is \$1.8 trillion invested through Australia's superannuation system (Bambrick, 2014), with a significant proportion through self-managed superannuation funds (SMSFs). SMSFs experienced a staggering 40 per cent increase from 2008 to 2013 to approximately 530,000 in number, accounting for one-third of assets held in superannuation (Swift, 2014). This growth has raised concerns as to whether they are being recommended inappropriately, the adequacy of regulation and whether they are being used for other purposes (CPA Australia, 2009). Swift (2014) raises concerns as to whether accountants and other financial service providers have an adequate understanding of SMSFs. Indeed, accountants are seen as one of the 'gatekeepers' to ensure regulatory compliance (Power, 2013), and are one of the professions critical for day-to-day 'responsibility for ensuring professional management and compliance' (London, 2014). Other gatekeepers include: financial planners, SMSF auditors and financial product and service providers.

Given the growth of SMSFs in Australia, the evidence in this article supports reforms to increase the educational requirements of accountants to give specialist advice in this area, as their formal education in this area is scant. It should be noted that there is also criticism of financial planners (Freeman, 2014); however their educational requirements in this area are higher than accountants. It appears that the public shares this concern, as evidence suggests that one-third of SMSFs do not have a professional advisor due to a lack of confidence in advisors' expertise (Australian Securities and Investments Commission (ASIC), 2013, p. 19 citing Investment Trends (IT), 2012a, pp. 14 & 69).

Such concerns, in part, underlie reforms for a new licence regime commencing 1 July 2016 that will require accountants to obtain a formal licence to give advice about SMSFs (Explanatory Statement: Select Legislative Instrument (ES), 2013, para. [37]). It is estimated that up to 5,000 to 10,000 accountants will become licenced under the new licence regime (ES, 2013, para. [37]). Tyson-Chan (2013) asserts that to meet this new licencing standard accountants will have to 'upskill themselves' in the SMSF sector. Of the current 150,000 membership of the two major accounting bodies, CPA Australia (CPAA) and Chartered Accountants (Australia and New Zealand) (CAANZ), it is estimated that there are 7% of accountants currently advising or wanting to advise more extensively with SMSFs (CPAA & Institute of Chartered Accountants (ICA), 2012). However, by December 2015 only 84 limited Australian Financial Services (AFS) licences had been issued, and representing only a 34% acceptance rating of the total 249 applications received, with another 432 applications received by the ASIC from January 2016 to May 2016 (ASIC, 2016).

This article seeks to analyse whether the recent reforms about licensing and education of accountants is justified in terms of evidence about accountants' contraventions of existing regulations and their formal education concerning SMSFs. This analysis will use Porter's (1993) 'expectation-performance' framework, which was used recently by Anderson and Brown (2014) to assess whether regulatory reform is required for insolvency practitioners. Porter describes two types of 'expectation-performance' gap, being the reasonableness gap and the performance gap (Porter, 1993, p. 50). Adapting this for accountants in the area of SMSFs, the performance gap denotes 'differences between what the public reasonably expects of [accountants] and what [accountants] is perceived to actually achieve' in respect of SMSFs (Anderson and Brown, 2014, p. 187). This performance gap may be due to deficient performance or deficient standards. Deficient performance means 'differences between the expected standard of performance by the ... profession, as required by existing standards, and public's perception of that standard of performance'. Deficient standards mean 'differences between duties and obligations which can be reasonably expected and the professional regulatory requirements' (Anderson and Brown, 2014, p. 187). Whereas, the reasonableness gap refers to the 'differences between what the public expects of the [accounting] profession and what [accountants] can reasonably be expected to achieve' in respect of SMSFs.

It will be argued that there is evidence to suggest that accountants' formal education about SMSFs is extremely limited, especially at the undergraduate level. While there appears to be little evidence of accountants being negligent in their SMSF advice, given the growth of the sector (in terms of assets and importance), the government is justified to bring in formal licencing (education) requirements to require accountants to specialise in this area.

Section Two of this article will provide an analysis of the performance gap and focus on evidence of deficient performance and consider whether the current standards are adequate. Section Three will provide an outline of the evidence concerning the reasonableness gap in terms of public expectation and the reasonable expectation of accountants as generalists. From the analysis, Section Four will provide the overall observations and the conclusion for the article.

Performance gap

To consider if there is a performance gap, evidence of accountants' lack of understanding of SMSFs and breaches of current regulations; as well as deficient standards will be discussed.

Deficient performance

In determining whether there is a performance gap in accountants' role with SMSFs, it should be recognized that 23% of SMSFs do not have a main source of advice (advisor), the reason for which includes a lack of value added by advisors (33%), and a lack of confidence in advisors' expertise (33%) (ASIC, 2013, p. 19: citing IT, 2012a, pp. 14 and 69). However, it is not clear to what extent this is based on actual experiences of the SMSF member. For example, it appears that those with advisors reported the highest level of satisfaction with advice from accountants (in terms of investment and tax), followed by financial planners (ASIC, 2013, p. 19: citing IT, 2012a, p. 39).

There is anecdotal evidence of a perception of a 'general consumer lack of trust in the system' (Swift, 2014, p. 15: Quoting Bedding), and concerns about 'mis-selling of SMSFs by financial planners and accountants' to people without sufficient assets or investment knowledge (Swift, 2014, p. 15). It is difficult to find concrete evidence of a 'widespread compliance problem' (Durie, 2006, p. 3) by accountants, even though many have expressed concern. For example, Makeham has observed that he 'knows accountants ... who are delivering advice to people that is not anywhere near the level that it should be' (CPAA, 2014, p. 5 quoting Makeham). Furthermore, Dixon has stated that he has encountered new clients who have been given 'wrong and, in some cases, illegal advice from their accountants' in terms of SMSFs (Dixon, 2013).

To gauge the level of quality of SMSF advice, ASIC in 2012 undertook a review of the establishment of over 100 SMSFs, which were set up by 18 business advisors that were either accountants or financial planners (ASIC, 2013, p. 20). It was concluded that the majority of investors had received 'adequate quality advice', although there were areas for improvement and 'pockets of poor advice' (ASIC, 2013, p. 23). ASIC considered the 'exempt accountant advice' as part of this review and expressed concern that there was not strict compliance with it (ASIC, 2013, p. 23). For example, in a number of cases there was no record of the written statement that the advice was from a person not licenced to provide financial product advice and that the investor should consider taking advice from an Australian Financial Services ('AFS') licensee (ASIC, 2013, p. 26). Also, ASIC found that some accountants had recommended an investor change from an APRA-regulated fund to a SMSF, which falls clearly outside the restricted exemption (ASIC, 2013, p. 26).

Another measure of deficient performance can be ascertained through annual audits under the SMSF contravention report system, where only approximately 2% of SMSFs received a contravention report (ATO, 2013, p. 31). In 2013, 770 SMSFs had auditor contravention reports lodged containing 18,000 contraventions. However, it is not possible to determine what role accountants played in these contraventions, although the figures would suggest that overall the sector is very compliant. Nevertheless, there is concern about how robust the audit process is (Bambrick, 2013, p. 2). A study by Colmar Brunton interviewed a number of SMSF auditors, with many of them CPAs or affiliate members of the National Institute of Accountants (NIA) (Colmar Brunton, 2012, p. 71). They concluded that due to the competitive nature of the SMSF market the amount that could be charged for audit jobs was restricted and this meant that at most only three to four hours could be spent on a file (Colmar Brunton, 2012, p. 72). It could be questioned whether this time-frame is sufficient to ensure compliance.

This concern includes the level of 'independence' of auditors given that many auditors can also be the professional advisors to the funds in terms of preparing accounts, as well as doing audits for relatives or their own funds (Bambrick, 2013, p. 8). Also there is concern about the level of knowledge and experience of auditors, especially those undertaking only a few SMSF audits (Bambrick, 2013, p. 8).

A number of tribunal cases have highlighted some of the mistakes that accountants have made in terms of SMSFs. The case of *CBNP Superannuation Fund v FC of T* 2009 ATC 10-105 concerned the breach of the in-house asset rule and heard evidence that the taxpayer's previous accountant had given incorrect advice to "borrow money from the Fund with the intention of doing whatever was necessary to remedy the breach within the Fund as soon as possible" (para. [20]).

Of more concern is the case of *Trustee for the R Ali Superannuation Fund v FC of T* 2012 ATC 10-231 which involved breaches by an accountant's own SMSF through loans to family members. In this decision Senior Member O'Loughlin said "the breaches ... were implemented by an accountant who at least ought to have known that such arrangements constituted contraventions of the Act" (para. [68]).

Overall while there is anecdotal evidence of concerns about accountants' performance, there appears to be limited evidence about accountants' negligence in this area. However, could the performance gap be attributed to deficient standards?

Deficient standards

Below is a discussion about the current limited exemption for accountants providing SMSF advice work and the new licence regime commencing in 2016.

Current limited exemption

Currently, recognised accountants are exempted from holding an AFS licence, so that they can advise on the establishment, operation, structuring and valuation of a SMSF (Durie, 2006). Additionally, pursuant to this exemption accountants can provide advice on taxation issues of a SMSF (Regulation 7.1.29A(4)). There is some protection for accountants who provide financial product advice in the course of advising about the tax implications provided no benefit (such as fee or commission) is received as a result of the client purchasing a financial product, and for retail clients there is an appropriate written notification (Regulation 7.1.29).

This exemption is restricted and accountants need to be cautious as to whether they technically fall within it. Part of the confusion is that while an accountant could recommend a client to set-up an SMSF, they could not recommend a superannuation fund other than a SMSF (CPAA, 2014, p. 5). Also, while they can 'process' a rollover of funds into a SMSF or advise on operational issues, they can't 'recommend' a client rollover or switch into a SMSF or provide advice in relation to particular assets or investment strategies (CPAA, 2014, p. 5).

The current standard can be seen as deficient due to its ambiguity and how it could lead to incomplete advice. Westover of the CAANZ acknowledges that the exemption has “been quite a grey area” (Westover, 2014, p. 2). When looking at the reasons provided by the government for the new licence regime, it was couched in part in positive terms by indicating that licencing would enable accountants (once licenced) to be able to advise on a wider range of alternatives (Shorten, 2012). The biggest concern of the current standard appears to be that it can lead to incomplete advice (Cain, 2015, p. 62 quoting Twentyman). That is, accountants’ SMSF advice (and the necessary limitations that the exemption imposes on them) may be ‘lopsided’, as their advice cannot be comprehensive as they would not be allowed to discuss the merits of investment strategies of SMSFs compared to other financial products (ES, 2013, para. [9]).

Education was another area of concern, particularly as it relates to ‘consumer protection concerns’, as accountants are not required to maintain the “competence of employees and ensuring they are adequately trained” (ES, 2013, para. [7]). The licence reforms are stated to be necessary to achieve the goals of the *Financial Services Reform Act 2001* (Cth), particularly the advice coming from people “required to be familiar with, educated upon” about the area the advice concerns (ES, 2013, para. [7]). Westover argues that the success of SMSF compliance lies largely with the skills of professional advisors (Westover, 2014, para. [7]). The Cooper Review confirms Westover’s argument that education should focus on SMSF professional advisors who are required to attain and maintain a minimal level of SMSF competency (Cooper Review, 2010, p. 230).

Another concern was the disparity of licencing requirements between accountants and the other major sources of advice to set up SMSFs, namely, financial advisors who are required to have a licence with the requisite education requirements, whereas accountants do not (ES, 2013, para. [11]).

Also concerns were raised about whether accountants were revenue raising when recommending a client to set-up a SMSF. It was alleged that an accountant may “gain significant revenue” from the formation of a SMSF and the consequential professional services advice, such as audit and compliance work (ES, 2013, para. [10]).

Overall the limited accountants’ exemption could be perceived as a deficient standard.

New licence regime

In response to concerns about the limited exemption a new licence regime was implemented to commence July 2016 by the *Corporations Amendment Regulation 2013* (No. 3). The new licence regime will mean that accountants have three options: a limited AFS licence, full AFS licence or being an authorised representative under another entity’s AFS licence. The limited licence still allows accountants to give structuring advice with respect to SMSFs.

Also, there are transitional arrangements for recognised accountants who apply for an AFS Licence prior to 1 July 2016 and only provide 'advice'; they need not demonstrate the 'experience requirement' (Corporations Regulations 2001, regulation 7.6.01BA(2)). This restricted advice relates to: (a) advice to acquire (or not) or to dispose of a SMSF; (b) whether to establish a SMSF, advice about contributions or pensions from superannuation; and (c) class of product advice on superannuation, securities, simple managed investment schemes, general and life insurance products and basic deposit products (s 912A(4) *Corporations Act* 2001 (Cth)). Accountants seeking registration after 1 July 2016 will be required to meet the experience requirements to obtain a licence (ES, 2013, para. [25]).

It appears that this restricted licence was created to address concerns from accountants about costs involved in obtaining a full AFS licence in providing financial advice (ES, 2013, para. [16]).

An alternative for an accountant is to maintain a full AFS licence, or obtain a limited, strategic or full authority through an existing AFS licensee (Holman, 2014). Such an authority means that back office licensing, maintenance and operations regarding compliance, audits, responsible managers, policies and procedures is maintained by an existing AFS licence holder (Holman, 2014). However, Charlton emphasises if being a licensee it is important for accountants to provide "integrity and independent thinking" (Cain, 2015, p. 60 quoting Charlton). Overall these new standards provide for greater initial and ongoing education for accountants to advise about SMSFs. To what extent accountants already receive formal education about SMSFs is now considered.

Reasonableness Gap

To consider the reasonableness gap, the formal education of accountants will be detailed and then compared to the public expectations of them.

Reasonable expectations of accountants

To ascertain what accountants could reasonably be 'expected to achieve' given their formal qualifications a curriculum audit of Australian undergraduate accounting degrees and post-graduate education requirements was conducted.

Undergraduate coverage of SMSFs

Following Thompson's methodology (1998) a quantitative survey was conducted of Australian undergraduate accounting degrees in 2013 to elicit the time spent on teaching the various business structures (including SMSFs). While the general results of this survey are reported elsewhere (Freudenberg and Boccabella, 2014), this article will analyse the in-depth results relevant to SMSFs.

The survey explored the coverage of SMSFs in the various law courses likely to be taught within an accounting degree, as it would be expected that it would be these courses that would cover SMSFs. However, other accounting courses were also surveyed as well to explore if there was coverage in them. Questions explored the inclusion of SMSFs in course content, lectures, tutorials and assessment. A total of 154 Australian academics commenced the survey with 138 completing it entirely. One hundred and ten of these survey respondents were those teaching into 'business law courses' and 28 were respondents teaching into other 'accounting courses'. The sample is well distributed in terms of universities across Australia – with participants from 36 Australian institutions.

In terms of business law courses the survey specified the types of courses likely to be taught, as well as the option for participants noting an 'other business law course'. Through this it became evident that five business law courses were generally mandatory (note it is likely that within each accounting degree there is only three or four mandatory business law courses, but their names can vary).

Table 1 lists the five common mandatory courses, being:

- Introduction to Law/Foundations of Law ('Intro to Law');
- Introduction to Business Law ('Intro to Business Law');
- Law of Business Associations/Law of Commercial Associations ('Law of Associations');
- Company/Corporations Law – Introduction ('Company'); and
- Taxation Law – Introduction ('Tax').

Table 1: Business Law courses

Course name	Response count	Is it a 'mandatory' course	Your role with the course: Lecturer-in-Charge
Mandatory			
Intro to Law	25	92.3%	69.2%
Intro to Business Law	40	89.2%	64.9%
Law of Associations	22	81.8%	77.3%
Company	26	88.5%	57.7%
Tax	30	86.7%	90.0%
Elective			
Advanced Company	3	33.3%	67%
Advanced Tax	12	15.4%	92%
Other Business Law	18	15.8%	74%

This table details the various Business Law courses taught throughout Australian Universities, as well as whether the course is mandatory part of the degree for students, and whether the person doing the survey was the Lecturer-in-Charge of the course.

The other non-mandatory (elective) business law courses (also listed in Table 1) tended to be:

- Company/Corporations Law – Advanced ('Advanced Company');
- Taxation Law – Advanced ('Advanced Tax'); and
- Other Business Law type course ('Other Business Law').

In terms of discussing SMSFs in lectures the results indicate that greater than 90% of mandatory business law courses and accounting courses, either did not cover or spent less than five minutes discussing them: Table 2. On average only 4.5% of mandatory business law courses and 7.2% of accounting courses spent between 30 minutes and five hours teaching SMSFs in lectures. None of these courses spent greater than five hours teaching SMSFs in lectures.

There was a greater chance of accounting students being exposed to SMSFs through elective business law courses, as on average 18.5% of these courses spent 30 minutes to five hours in lectures discussing them. The courses more likely to include SMSF coverage were the two tax courses (Tax and Advanced Tax.)

Table 4: Coverage of SMSFs in lectures

Course name	Total Not Covered or < 5 mins	5 mins to < 30 mins	30 mins to < 2 hours	> 2 hours
Intro to Law	90.90%	0%	9.00%	0%
Intro to Business Law	96.90%	0.0%	3.10%	0%
Law of Associations	95.00%	5.0%	0.00%	0%
Company	100.00%	0.0%	0.00%	0%
Tax	82.70%	6.9%	10.20%	0%
Average for mandatory courses	93.1%	2.4%	4.5%	0.0%
Advanced Company	100%	0%	0%	0%
Advanced Tax	33%	17%	50%	0%
Other Business Law	94%	0%	6%	0%
Average for elective courses	75.9%	5.6%	18.5%	0.0%
Accounting courses	92.8%	0.0%	7.2%	0.0%

This table details the percentage of courses in terms of time in lectures that the topic of SMSFs was covered for the various Business Law courses, as well as the Accounting courses surveyed.

In terms of what students were taught in these lectures for the mandatory business law courses there was an emphasis on (a) Distributions from fund; (b) Taxation of fund contributions, profits and distributions; and (c) Delay of access to funds: Table 3. For elective business law courses, there was a greater spread of emphasis, although taxation received the greatest attention. In comparison the accounting courses concentrated on (a) nature of and governing law; (b) formalities; and (c) liability issues (members/controllers).

Table 3: Coverage of SMSF topics in lectures

Topics covered	Topics not covered or < 5 mins			5 mins to < 30 mins			30 mins to < 1 hour			1 hour to < 2 hours			2 hours to < 5 hours			> 5 hours		
	M	E	A	M	E	A	M	E	A	M	E	A	M	E	A	M	E	A
Nature of and governing law	42	57	60	50	33	40	8	10	0	0	0	0	0	0	0	0	0	0
Formalities	50	48	80	42	43	20	8	10	0	0	0	0	0	0	0	0	0	0
Liability issues	42	48	80	58	43	20	0	10	0	0	0	0	0	0	0	0	0	0
Asset protection	33	57	80	67	33	20	0	10	0	0	0	0	0	0	0	0	0	0
Admission of new members	50	71	80	50	19	20	0	10	0	0	0	0	0	0	0	0	0	0
Distributions from fund	42	43	80	42	48	20	17	10	0	0	0	0	0	0	0	0	0	0
Cessation of fund	67	62	100	25	29	0	8	10	0	0	0	0	0	0	0	0	0	0
Taxation of fund contributions, profits and distributions	42	33	100	42	38	0	17	10	0	0	10	0	0	10	0	0	0	0
Delay of access to funds	50	33	100	42	57	0	8	10	0	0	0	0	0	0	0	0	0	0

M = Mandatory Law Courses, n = 12; E = Elective Law Courses, n = 21; A = Accounting Courses, n = 5. This table details the percentage of courses in terms of time in lectures that covered the various sub-topic about SMSFs.

In terms of whether accounting students have a further opportunity to workshop the issues surrounding SMSFs in tutorials, greater than 90% of mandatory business law courses and accounting courses either did not cover SMSFs in tutorials or spent less than 5 minutes: Table 4. Only approximately 4% of these courses spent substantial tutorial time (30 minutes to 2 hours) on SMSFs. Again the elective business law courses (especially Advanced Tax) had a greater focus on SMSFs in tutorials, with approximately 41% spending greater than 30 minutes discussing them.

Table 4: Coverage of SMSFs in tutorials

Course name	Total Not Covered or < 5 mins	5 mins to < 30 mins	30 mins to < 2 hours	> 2 hours
Intro to Law	90.91%	5%	5%	0%
Intro to Business Law	93.75%	0%	6%	0%
Law of Associations	100%	0%	0%	0%
Company	100%	0%	0%	0%
Tax	82.14%	11%	7%	0%
Average for mandatory courses	93.4%	3.1%	3.6%	0.0%
Advanced Company	100%	0%	0%	0%
Advanced Tax	50%	8%	33%	8%
Other Business Law	100%	0%	0%	0%
Average for elective courses	83.3%	2.8%	11.1%	2.8%
Accounting courses	93%	4%	4%	0%

This table details the percentage of courses in terms of time in tutorials that the topic of SMSFs was covered for the various Business Law courses, as well as the Accounting courses surveyed.

Considering whether accounting students were assessed on their SMSF knowledge, it becomes apparent that this largely does not occur. 100% of accounting courses surveyed, and 96% of the mandatory business law courses had no or less than 5% of assessment directed towards SMSFs: Table 5. The only elective business law course with substantial assessment towards SMSFs was Advanced Tax with an average of 17% of courses having 5% to 20% of assessment directed towards SMSFs, and 8% of courses with greater than 20%.

Table 5: Coverage of SMSFs in assessment structure

Course name	0% to < 5 %	5% to < 20%	>20%
Intro to Law	91%	5%	5%
Intro to Business Law	97%	3%	0%
Law of Associations	100%	0%	0%
Company	100%	0%	0%
Tax	93%	4%	4%
Average for mandatory courses	96%	2%	2%
Advanced Company	100%	0%	0%
Advanced Tax	75%	17%	8%
Other Business Law	100%	0%	0%
Average for elective courses	92%	6%	3%
Accounting courses	100%	0%	0%

This table details the percentage of courses in terms of weighting of assessment that the topic of SMSFs was assessed for the various Business Law courses, as well as the Accounting courses surveyed.

Overall this data demonstrates that Australian accounting students have minimal, if any, exposure to SMSFs in their undergraduate degrees. This is especially the situation if they do not do the elective 'Advanced Tax'. However, this perceived deficiency may be addressed in later post-graduate education especially that provided by the leading accounting professional bodies.

Professional bodies

To ascertain whether accountants are likely to be exposed to SMSFs during their post-graduate studies a review of the education courses required for professional membership of the two major professional accounting bodies was undertaken (CPAA and CAANZ).

Pursuant to the CPA Program there are four compulsory subjects, two electives and a practical component that is required. The compulsory subjects are ethics & governance, financial reporting, strategic management accounting and global strategy and leadership (CPAA, 2014b). Also, the two courses 'advanced taxation' and 'advanced audit and assurance' are compulsory if taxation law and auditing are not completed at the undergraduate level (which may be possible at some universities). Otherwise the electives include financial risk management and contemporary business issues. In all of these courses, including the advanced taxation course, there is no coverage of superannuation, let alone SMSFs. This would suggest that the expectation of what a member of CPAA could achieve in terms of SMSFs is low given their likely limited exposure to SMSFs throughout their formal undergraduate and post-graduate studies.

In terms of the CAANZ Program it has five courses: audit and assurance, financial accounting and reporting, management accounting and applied finance, taxation and a capstone course. For the CAANZ tax module there is one unit devoted to superannuation which focuses on Australia's superannuation system broadly, with only a brief mention of SMSFs. Indeed, in 22 pages of the superannuation unit the term 'SMSF' is only mentioned eight times. Out of the 27 hours of teaching provided for the CAANZ tax module four hours are allocated to the taxation of superannuation funds. Consequently, the expectation of CAANZ members in terms of SMSFs should be greater than that for CPAA members given they are likely to have more exposure to SMSFs. It should also be remembered that a member of CAANZ is required to have completed a taxation course within their undergraduate degree, whereas for CPAA, this is optional.

It appears for accountants to advise on SMSFs that this is a specialised area and accountants would need further study whether through attending seminars or stand-alone courses. Implicitly the professional accounting bodies have acknowledged that their members' knowledge and understanding of SMSFs may be lacking. Since the Cooper Review into the superannuation system there has been an increase in training efforts, especially since the licence reforms were legislated. For example, the CAANZ stated that since the review they have "made significant contributions" ... "through provision of training events including major SMSF conferences, publications, manuals, tools, checklists and formal guidance" (CAANZ, 2014, p. 18). While this is good progress, it does bring into question the adequacy of training and materials prior to the licencing changing. Also, CAANZ notes that it has recently brought in a 'CA SMSF specialisation' which includes mandatory education, assessment and experience requirements (CAANZ, 2014, p. 18). Similarly, CPAA has recently brought in a SMSF specialisation (CPAA, 2015). It appears that the government reforms have caused the professional bodies to increase activity in this area. For example CPAA provides a SMSF Learning Manual (Twin Pack) which is equivalent to 24 hours continuing professional development (CPD), covering Understanding SMSFs and SMSF strategies. More recently CPAA introduced a SMSF Specialisation with the first intake occurring in 2015 (CPAA, 2015).

Also, CPAA organised a one day SMSF conference and expo in 2015. CAANZ has a number of online and in-person workshops held for members in terms of SMSFs, including SMSF and property development, bankruptcy and SMSFs and advanced pensions.

Public expectations

To illustrate what is the likely public expectation from accountants, data about the role that accountants play in advising, establishing and providing on-going compliance work for SMSFs will be canvassed.

The public appears to expect accountants' assistance with SMSFs. Indeed, accounting professional bodies acknowledge that structuring advice in terms of setting up SMSFs is part of their "traditional accounting activities" (CPAA & ICA, 2012, p. 1). This role of accountants is implicit in that many small and medium sized business owners see having a SMSF as part of "running their next business" and are used to "dealing with an accountant" (Swift, 2014, p. 15: Quoting Robert Jackson, Director, Deloitte). Part of this is due to accountants being cognitive of the client's business, taxation and financial position (Durie, 2006).

When professional advice is sought the data demonstrates that accountants clearly have a major role, as nearly 50% of SMSFs were established by them (ASIC, 2013, p. 16: citing IT, 2012b, p. 13). Also accountants appear to be instrumental with instigating the establishment of SMSFs, as a reason for setting one up is due to advice from an accountant (32%) and then a financial planner (18%) (ASIC, 2013, p. 16: citing IT, 2012b, p. 14).

The public expectation of accountants' role in this area is also in terms of ongoing advice, as 32% of SMSFs indicate that their main source of advice is from accountants, followed by financial planner/advisers (19%), stock brokers (9%) and specialist superannuation consultants (6%) (ASIC, 2013, pp. 18-19: citing IT, 2012a, p. 33). Also, 99% of the 2012 SMSF annual returns were lodged by tax agents or accountants (ATO, 2013, p. 10). Case law re-enforces the role that accountants play. For example, in the case *CBNP Superannuation Fund v FC of T* 2009 ATC 10-105 the SMSF under review for breach of the in-house asset rules was not represented by a lawyer but instead their current accountant.

Conclusion

While there is only limited evidence of breaches and contraventions by accountants with SMSFs, there are overall concerns with their ability to adequately advise in this area. Given there is data demonstrating accountants' role with SMSFs, it is argued that there is an expectation gap as the public expects that accountants generally should be able to advise about their retirement savings, including SMSFs. However, the evidence suggests that Australian accountants' formal education about SMSFs is limited and therefore there appears to be a gap between the public's expectations of accountants without subsequent specialised training in this area. This is supported by evidence from Tran-Nam and Karlinsky (2008) which suggests that Australian small business advisors are struggling with Australia's retirement system as their survey found that 'retirement planning' (which would include SMSFs) was the third most complex area for advisors. Freudenberg et al. (2012 p. 697) has argued that this can be due in part to the low educational training of small business advisors in this area.

Also a 'performance gap' exists, as there appears to be deficient standards as there are "differences between duties and obligations which can be reasonably expected and the professional regulatory requirements (such as statute law, case law and professional standards)" (Anderson and Brown, 2014, p. 187). Of particular concern is that the current exemption could cause incomplete or 'lopsided' advice which could be as adverse as negligent advice.

The government's move to improve regulation and licencing in this area will assist to reduce the expectation-performance gap. Until recently, professional bodies have lobbied against regulatory change, with the CAANZ (2014) noting that "additional regulation of SMSF accountants and administrators is not warranted" and that they considered professional bodies are "best placed to achieve increased competencies without further regulation". However, the government has clearly seen a need for there to be regulatory reform to provide a catalyst for change in this area. It does appear the implementation of the new licence regime has finally caused the professional bodies to be more active in this area with increases in SMSF training and the introduction of specialisations.

The alternative is that it is not reasonable to expect accountants to advise in the SMSF area, given their other areas of expertise and educational background; and thus allow other professionals, such as financial advisors, to provide the expertise in this area. Without significant changes to accountants' education in the area of SMSFs, it is hard to oppose calls that accountants should remove themselves from advising in the SMSF sector.

The new licencing regime will address (in some way) the reasonableness gap in terms of what the public expects accountants can reasonably be expected to achieve in regard to SMSF advice, as it is a specialised area that normally accountants do not have substantial training in. It could be argued that the current undergraduate and post-graduate curriculum should be revised for accountants to include greater coverage of SMSFs. Given the role of the Advanced Tax course in covering SMSFs, it may be that this course should become a mandatory course compared to an elective course. Given that the professional accreditation requirements are a larger driver of the structure of accounting degrees (Freudenberg and Boccabella, 2014, p. 204), may be the professional bodies need to add the requirement for SMSFs to be taught. Alternatively, accounting students should consider doing a double major with Financial Planning, as the accreditation requirements of the Financial Planning Education Council provides greater coverage of superannuation and SMSFs (Financial Planning Education Council, 2012). Also, this is an opportunity for tertiary education institutions to provide courses to past accounting graduates about SMSFs if they are looking to upskill and improve their knowledge in this area.

Perhaps put too strongly, Holman re-enforces why accountants need to move in this area, as he argues that if accountants don't get a limited or full AFS licence, then "they will cease to exist in any meaningful way beyond the next five to seven years" (Holman, 2014, p. 2). This sentiment is supported by Charlton, as he warns "not being licensed will see a shrinking of the frontier regarding areas where accountants can advise without a licence" (Cain, 2015, p. 62 quoting Charlton). This is partly due to the fact that many clients will have SMSFs and these clients will expect that they can discuss their SMSFs with their accountants, and this will be an expectation that needs to be met (Holman, 2014).

Without adequate training and licencing of advisors in terms of SMSFs, Australia is at risk of jeopardising the progress made to date. With the exponential growth of the SMSF sector forecasted, it is critical that stakeholders are confident that professionals involved in the sector are adequately equipped. To this extent the new licencing regime and its educational requirements are important regulatory reforms.

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AVERTING POVERTY AND GOVERNMENT BUDGETARY PRESSURE THROUGH RELEASING HOME EQUITY: A SAFE AND INFORMED SOLUTION FOR BABY BOOMER HOMEOWNERS

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ABSTRACT

Homeowner baby boomers have relatively high levels of wealth in their homes and relatively low levels of superannuation. At the same time, non-homeowner baby boomers, especially lone retirees, appear to be in increasing need of income support such as that provided by the Age Pension. Both of these groups will need income support mechanisms during their retirement. In this context, policy momentum has been building in Australia for the inclusion of home equity in the retirement income mix. To address that need, this paper outlines a generation-targeted solution for supplementing baby boomer retiree income through efficiently drawing on housing equity. The proposed new product – Home Equity Accounts – differs from existing related products by being government-backed, securitised and incorporating financial planning.

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Introduction

In a time of increased awareness of the need to self-fund as much retirement consumption as possible, the incidence of poverty among older Australians continues to increase in the context of Australia's three pillar income system of the Age Pension, superannuation and other savings. Many older Australians will face significant income shortages in retirement, particularly retired renters (ACOSS 2014). However, even if a retiree owns their home outright, the financial considerations of remaining at home in later retirement are also becoming complex with income pressure from longer life expectancies and greater individual responsibility for financing health and aged care. Consequently, this paper details the financial wellbeing of older homeowners and renters and illustrates the current and potential role of housing equity in Australian retirement portfolio composition. This study contributes to a case for novel financial product development for Australian retiree income supplementation that is suited to Australian retirees with substantial housing wealth.

The objectives of the paper are threefold. First, to illustrate that Australia needs a generation-targeted solution, in addition to the Age Pension and superannuation, to supplement retiree incomes for baby boomers, and that drawing on home equity is a necessary component of that solution. Second, this paper aims to review existing products in the home equity release market and highlight the opportunities for further product innovation. Third, this paper will provide a framework for a new solution in this practitioner and policy space that would potentially deliver social and economic benefits. In answering the first objective, this paper explores current retirement income sources particularly the unsustainable demand on the Age Pension and the lack of superannuation for emerging retirees. Also in relation to the first objective, we explore the theory and context of homeownership in Australia for baby boomer retirees (conventionally those born 1946–1965) along with Generation X (born 1966–1976) and Generation Y (or Millennials) (born 1977–1986), including recent policy directions regarding retirement income. We detail the scope and market penetration of existing home equity release products as a means of addressing the second objective, particularly by highlighting a potential gap in the home equity withdrawal market. The solution we propose in meeting the third objective draws on evidence of retiree preferences in home equity withdrawal products, retiree wealth portfolios, recent market developments, and analysis of equity withdrawal scenarios.

In building a case for new housing equity withdrawal products, we consider the high levels of homeownership prevailing among older Australians and the extent to which Australian retirees are decumulating their housing equity, including the current mechanisms for doing so. We suggest that new retiree income product offerings linked to home equity could leverage from existing and emerging products that better fit retiree needs and risk profiles, and that through integration with better financial planning, can help drive generational reform in home equity decumulation. We consider suitable parameters for potential products and pathways to home equity decumulation in retirement for baby boomers, including a policy sunset clause to emphasise the generation-targeted nature of the proposed retiree income solution. To do so, we use data from the Household, Income, and Labour Dynamics in Australia (HILDA) survey to examine the income and asset holdings of older Australians and the levels of financial stress among retirees. The important distinguishing feature of the HILDA survey is that it has interviewed substantially the same households (9,835) and individuals (25,391) every year since 2001¹, thereby allowing researchers to see how their social, economic, and financial circumstances have changed over time (Wilkins 2015). The HILDA survey is population weighted to be representative of the Australian population and includes detailed data on some three thousand retirees (aged 65 years and over). The variables we analyse include family and lifecycle dynamics, age, homeownership, household debt, wealth, savings behaviour, consumption, and economic and subjective wellbeing in retirement. The analysis in this paper examines the extent and sources of current financial strain for retirees and potential solutions based on the composition of their wealth and the age pension policy challenges.

In relation to existing retiree home equity release products, we discuss the very limited market penetration outlined in this paper in terms of the product features preferred by retirees for home equity withdrawal. This helps illustrate the lack of products meeting retiree expectations. We propose a safer supported mechanism, namely, Home Equity Accounts (HEAs), which enables retirees to relieve financial stress and meet their health and aged care needs by efficiently and safely decumulating housing equity for increased cash flow. Importantly, the proposed solution has financial planning embedded as a core component of implementing the HEA product. We conjecture that HEAs could support healthy ageing and assist baby boomers to live well, while simultaneously reducing the pressure on public pensions. Thus, we set a challenge to engage more Australians in the emerging conversation regarding age pension asset tests, and to question and reset the biases that many Australians hold about housing and retirement income.

¹ Note: In 2011, there was a 'top-up' sample of 2,153 households and 5,451 persons to counter sample attrition.

The remainder of the paper is structured as follows. Section 2 outlines the breadth, depth and value of homeownership in Australia across several generations, and the context of retiree income in Australia. In Section 3 we explore the existing theoretical basis for retiree home equity withdrawal, including potential weaknesses in retiree home equity withdrawal theory. Section 4 outlines the currently available Australian retiree home equity withdrawal products, underscoring the nascent state of home equity withdrawal in Australian retirement, culminating in a proposed solution for retiree home equity withdrawal in Australia, that is, HEAs. Finally, Section 5 models several retiree home equity withdrawal/income supplementation scenarios and elaborates on the critical role of financial planning in operationalising HEAs, followed by suggested areas of further research.

Building the case for home equity withdrawal products

Context of homeownership, retiree wealth and retirement income in Australia

Numerous publications have detailed the ageing of Australia's population (ABS 2012a; Johnson et al. 2015; Ong et al. 2013). However, unlike this existing literature, we aim to link data on the ageing population and their income in retirement, with homeownership status, and the superannuation and housing wealth components of Australian retirees.

In terms of existing retirees, Australia currently has over three million people aged over 65 years (ABS 2012a) with 50 per cent receiving the full age pension and 30 per cent receiving a part pension, collectively accounting for the 80 per cent of all retirees receiving at least some age pension (Rothman 2012). In terms of the wealth of Australians overall, Table 1 shows that in 2015 housing equity remains the primary source of wealth at \$5.9 trillion (ABS 2015b), compared to just \$2 trillion in superannuation (APRA 2015).

However, these aggregates mask differences in the form of the wealth by generation. When we calculate the estimates and projections for the different generations at or approaching retirement, the significance of housing wealth for baby boomers becomes more apparent. Baby boomers hold most of their wealth in home equity and the release of home equity for income represents huge potential in helping baby boomers cross the retirement income chasm. Hence, further analysis of differences in generational asset holdings warrants analysis that is more detailed and is the subject of the following section.

There are no universal definitions of generations. However, the ABS has defined the 'baby boomer' generation as those born between 1946 and 1965, while 'Generation X' and 'Generation Y' are those born between 1966 and 1976, and 1977 and 1986, respectively. In 2006, the size of the baby boomer cohort in Australia was 5.47 million while Gen X and Y combined were another 5.49 million (ABS 2006). With the bulk of the baby boomers turning 65 between 2011 and 2029, we now examine the major asset holdings of home equity and superannuation for baby boomers compared with Gen X and Y over the same period.

Starting first with homeownership and home equity, the baby boomer generation has generally high levels of homeownership. Baby boomers in 2011 had an overall homeownership rate of approximately 78 per cent (ABS 2012b, 2013e) and as shown in Table 1, have approximate total home equity valued at \$1.39 trillion compared to only \$540 billion for existing retirees (those aged over 65 years) in 2011. Further, it is notable that the housing equity of existing retirees has continued to grow markedly with retiree home equity growing to over \$830 billion in 2014, a growth rate well above the approximate 10 per cent increase in the number of retirees, underlining the scale of growth in home equity. Looking ahead to 2031, when all baby boomers will be aged more than 65 years, the projected value of home equity is expected to be \$2.48 trillion for baby boomers alone (see Table 1).

In contrast, if we consider superannuation wealth for the various age cohorts in Australia, in 2013–14, the median baby boomer superannuation balance was approximately \$59,000 (including zero balances), (\$93,000 for males and \$36,000 for females). In comparison, the mean balance (also including zero balances) was approximately \$164,000 (\$215,000 for males and \$114,000 for females) (Clare 2015), clearly demonstrating the positive skewness (a long thin tail extending to the right) of the distribution of superannuation account balances. In comparison, Gen X had a median superannuation balance of approximately \$35,000 (including zero balances) (\$47,500 for males and \$26,000 for females). The mean balances for Gen X, including all zero balances, was approximately \$59,000 (\$74,000 for males and \$45,000 for females) (Clare 2015).

Overall, the data in Table 1 shows that over the longer term, the value of home equity will remain more than superannuation holdings as a whole, but is more skewed for baby boomer home equity holdings than for their superannuation. In contrast, by 2033, both Gen X and Gen Y will hold more superannuation than home equity.

Table 1: Superannuation and housing value and equity*

Time period and age profile	Superannuation	Housing wealth	Size of cohort
2011 Retirees 65+	\$267 billion [#]	\$540 billion ¹ (equity*)	3.1 million ^a
2011 Baby boomers (ages 45-64)	\$780 billion ^{##}	\$1.39 trillion ²	5.5 million ^b
2014 Retirees 65+	\$454 billion [^]	\$830 billion ³ (equity*)	3.44 million ^c
2015 All ages	\$2 trillion ⁺	\$5.9 trillion ⁴	23.5 million ^c
2029-2033 Gen X and Gen Y (will be aged between 47-64)	\$4 trillion ^{&} (in 2029)	\$1.5 trillion ⁵	5.49 million ^b
2033 Baby boomers + migration (will all be aged over 65 by 2033)	\$836 billion ^{&}	\$2.48 trillion ⁶	6.1 million ^d
2033 All ages	\$7.6 trillion ⁺⁺	Est. \$10 trillion ⁷	33 million ^d

*The term 'equity' is used here to specifically refer to non-mortgaged housing value.

[#]Author's own calculations approximated by taking proportion of superannuation assets held by Australians over 65 in 2009-10 (20.4%) (Clare 2011) against total superannuation assets in 2011 of \$1.31 trillion (APRA 2012)

^{##} Author's own calculations approximated by taking proportion of superannuation assets held by Australians aged 45-64 in 2009-10 (59.6%) (Clare 2011) against total superannuation assets in 2011 of \$1.31 trillion (APRA 2012)

[^]ASFA (2015)

⁺ APRA (2015)

[&] Deloitte (2015)

⁺⁺Deloitte (2015) \$7.6 trillion in future nominal dollars

¹ Authors' calculations based on 3.1 million Australians aged over 65 (ABS 2012b), with 56% sharing a household with a spouse (ABS 2012b) resulting in approximately 2.2 million households, 83% of which (1.8 million) are owner occupied (ABS 2013d) by the conservative median house price of \$300,000 (HILDA 2011 Median home value of those aged 65+) = \$540 billion in retiree housing equity.

2 Authors' calculations based on 5.5 million Australians aged 45- 64 (ABS 2012b), with 49% sharing a household with a spouse (ABS 2012b) resulting in approximately 3.96 million households, 78 per cent of which (3.0888 million) are owner occupied (ABS 2012d) by the conservative 2011 'median' house price of \$450,000 (HILDA 2011 Median home value of those aged 45-64) = \$1.39 trillion in retiree housing equity.

3 Authors' calculations based on 3.44 million Australians aged over 65 in 2014 (ABS 2012b), with 56% cent sharing a household with a spouse (ABS 2012b) resulting in approximately 2.66 million households, 78% of which (2.08 million) are owner occupied (ABS 2012d) by the conservative median house price of \$400,000 (HILDA 2011 all those aged 62+ who would then be 65+ in 2014) = \$832 billion in retiree housing equity.

4 ABS 2015b

5 Conservative estimate only. Author's own calculations based on 49% of Gen X and Gen Y living with a spouse (ABS 2012b, 2013e) (49% of 5.49 million = 2.7 million) by 53% homeownership (ABS 2012b, 2013e) = approx. 1.5 million households by the median home value for ages 25-45 of \$400,000 (HILDA 2011) = \$600 billion (plus 0.5% per annum for growth each year in homeownership rate, including shared households) indexed at 2.5% for inflation, plus 2.5%pa in value growth over the time period 2015-2033 = \$1.5 trillion (ignoring intergenerational transfer).

6 Conservative estimate only. Author's own calculations of \$1.39 trillion (2011 baby boomer home equity estimate) indexed at a rate of 2.5% to account for 5% home value increase and 2.5% inflation = \$2.28 trillion plus 0.6 million new migrants with home equity \$210 billion = \$2.48 trillion.

7 Conservative estimate only. Author's own calculations (excludes new homes) as calculated by \$5.9 trillion in home value as at 2015 indexed by 2.5% per annum, compounded monthly until 2033 = \$10.2 trillion.

a ABS 2013a

b ABS 2006

c ABS 2015c

d ABS 2013c 6.1 million includes migration, 33 million approximate (Series A assumptions)

Gen X and Y (including those aged under 35 years who were heads of households) had a homeownership rate of 53 per cent in 2010 (ABS 2012b, 2013e) with an approximate aggregate home value of \$600 billion², albeit with most being owned but mortgaged. However, the projected value of superannuation in 2029 for Gen X and Y is approximately \$4 trillion compared to the baby boomer superannuation total in 2033 of \$836 billion (see Table 1). That is, in terms of potential sources of retirement income, Gen X and Y will be relatively better able to draw on their superannuation.

The relatively high rate of homeownership and lower levels of superannuation for baby boomers already suggests a way forward, but the baby boomers are not uniform and there are sizable segments that are not homeowners and in fact face the real risk of poverty. As shown in Table 2, for households with a person aged 65 years and over, approximately 11 per cent are renters, rising to 17.6 per cent of lone-person households (ABS, 2012b)

2 Conservative estimate only. Author calculations based on 49% of Gen X and Gen Y living with a spouse (ABS 2012b, 2013e) (49% of 5.49 million = 2.7 million) by 53% homeownership (ABS 2012b, 2013e) = approx. 1.5 million households by the median home value for ages 25-45 years of \$400,000 (HILDA 2011) = \$600 billion housing value.

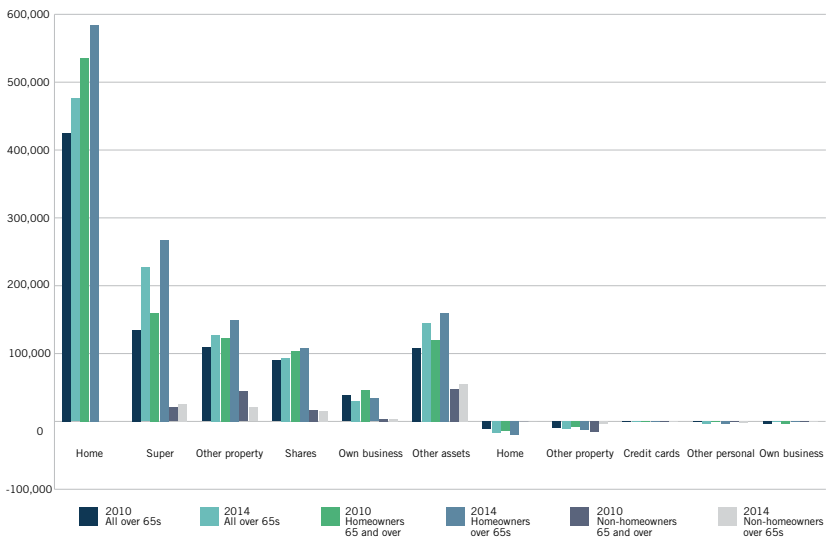
Table 2: Living arrangements for Australians aged over 65 by household composition, 2009-10

Household composition	Estimated number of households	Homeowner %	Renter %	Other living arrangement %
Lone person	742.0	75.9	17.6	6.5
Couple only	741.6	91.4	5.8	2.8
All households	1,767.5	84.6	11.1	4.3

Source: ABS 2012b

The divide between homeowners and non-homeowners is even starker in terms of the differences in wealth as depicted in Figure 1. The mean value of the home alone for homeowners aged over 65 years is almost five times more than that of all non-homeowner assets combined.³

Figure 1: Mean asset and debt components for those aged 65 years and over, by homeownership status, 2010 and 2014



Source: Authors' own calculations. HILDA 2010: (N=1624 (all); 1294 (homeowners); 256 (non-homeowners)) 2014: (N= 3112 (all); 2543 (homeowners); 444 (non-homeowners))

3 2014 HILDA mean home value for +65 years homeowners is \$584,131 compared with all assets of +65 year non-homeowners of \$120,208, a wealth ratio of 4.85:1

Not only is there a disparity between homeowners and non-homeowners in terms of the components of wealth, but also in terms of the income in retirement. Table 3 shows the gross income bands of all retirees, with 44.5 per cent overall having a gross income under \$30,000, and then when disaggregated by homeownership status, with only 39.1 per cent of homeowners having an income less than \$30,000 compared to 64.3 per cent of non-homeowners.

Table 3: Gross income bands for fully retired Australians by homeowner status, 2011

	All households cumulative per cent n=2,477	Homeowner households cumulative per cent n= 1,957	Non-homeowner households cumulative per cent n= 442
Negative or \$0	.2	.2	.5
\$1-\$9,999	.8	.6	2.0
\$10,000-\$19,999	17.8	13.9	33.0
\$20,000- \$29,999	44.5	39.1	64.3
\$30,000-\$39,999	60.5	56.4	75.8
\$40,000-\$49,999	72.1	69.4	82.4
\$50,000-\$59,999	79.3	77.5	86.0
\$60,000-\$79,999	87.6	86.5	91.6
\$80,000-\$99,999	91.8	90.6	95.7
\$100,000 and over	100	100	100

Source: Authors' own calculations from HILDA wave 11.

Additionally, 54 per cent of those aged 65 years and over agreed or strongly agreed that they have had to adjust to a major decline in their income since retiring (see Table 4).

Table 4: Percentage of retirees (aged +65 years) reporting having to adjust to a major decline in income since retiring, 2011

Level of Agreement with the statement “I have had to adjust to a big drop in my income since retiring”.	Per cent (n=1,089)
Strongly disagree	4.2
Disagree	27.4
Neither agree nor disagree	14.4
Agree	40.6
Strongly agree	13.4

Source: Authors’ own calculations from HILDA wave 11.

We have seen that relative to Gen X and Y, homeowner baby boomers have a relatively high level of wealth held in their homes and relatively low levels of superannuation. Conversely, non-homeowner baby boomers, especially lone retirees, face increased risk of income poverty. The risk of poverty for non-homeowners indicates the urgent need for pension reform. The 65 years and over age cohort already faces a risk of poverty of at least 35 per cent (ACOSS 2014). Asset poor retirees will then need to have the age pension, as their income safety net, safeguarded. Even so, additional mechanisms for retiree income support is needed for both homeowner and non-homeowner baby boomers. The following section explores the theory and policy context regarding income in retirement and the current treatment of assets, including the primary home.

Theory and policy context of retirement income

Analysis of wealth accumulation and decumulation is traditionally grounded in the lifecycle theory of consumption, which hypothesises that households will engage in lifecycle consumption smoothing (Modigliani et al. 1954; Hurd 1990; Davies et al. 2000) and Markowitz’s classic portfolio selection theory (1952, 2005), which suggests that investors select assets based on the mean and variance of portfolio returns. Traditional theories, however, may be inappropriate or need to be adapted due to the substantial structural inefficiencies present in the Australian home market, especially for older citizens and retirees. The drivers of these market disruptions are the nature of the home, the role of asset tests in determining the degree of pension eligibility, and the extent of demographic change.

The family home does not readily fit into typical strategic asset allocation given the nature of housing compared with other asset classes (Worthington 2009). The relevant characteristics include the substantial and indivisible asset size of the home, which often renders the home as a caveat or exception to analyses of strategic asset allocation, and the intangible social characteristics of the home (Easthope 2004), such as providing shelter, a sense of belonging, security and special significance for intergenerational households. Both the lifecycle theory of consumption and modern portfolio theory need to better accommodate the changing social context of retirement, longer life expectancies and housing as a major portfolio component for Australia's baby boomer generation.

Discussion

In terms of retiree income and strategic asset allocation, the analysis so far has shown that superannuation and the Age Pension alone will not provide affordable, nor adequate, retirement income for baby boomers. In addition, policy intervention has skewed portfolio selection toward housing equity, particularly because of the exemption of the primary residence from the assets and income test applied to age pension eligibility. As early as 1912, the then prime minister, Andrew Fisher, proposed that exempting the family home would help aged persons remain independent of their relatives, thereby allowing them to contribute more to national prosperity (PC 2015). At the time, only about 4 per cent of Australians were aged over 65 years, whereas by 2010, the proportion of Australia's population aged over 65 years had risen to 13.5 per cent and is expected to increase further under alternative scenarios to between 21 and 23 per cent by 2041 (ABS 2011).

Similarly, there has been other social and demographic change in Australia. For example, the overall life expectancy of Australians increased from 55–59 years in 1912 to 80–84 years in 2016, notwithstanding the substantial gap in life expectancy for Indigenous Australians of 69.1 for males and 73.7 for females in 2010–12 (ABS 2013a, 2013b, 2015a). In addition, the nature of work and ageing has changed dramatically as has the population's expectations of retirement (Karpf 2014).

The policy issues that have sought to address these forces have led to a consensus building in the academic literature and policy reports that a sustainable system of home equity withdrawal in retirement can be a potential source of retirement income. Numerous government and other reports have already proposed reforms to the principal residence exemption, including the Harmer Pension Review (Harmer 2009), the Henry Review (Henry et al. 2009), the Grattan Report (Daley et al. 2013), the Productivity Commission (2011, 2013, 2015); Rice-Warner (2015), and the National Commission of Audit (NCA) (2014a, 2014b). As an example, the NCA suggested "...a proportion of the value of the primary home should be included in the means test, such as the value over a relatively high threshold. One suggested means test would capture the value above \$500,000 for single pensioners and \$750,000 combined for coupled pensioners" (NCA 2014b, Recommendation 13).

Even with a cautious approach to intervening in the design of home equity products, a strong case has been made by the National Commission of Audit (NCA 2014a) and the Henry Review (Henry et al. 2009, 2010) to incorporate a threshold value of the primary home in the pension assets test. Importantly, the primary home would still receive concessional treatment relative to other assets, but would pave the way for some pension savings by considering housing wealth more equitably.

Although implementing such a means test could be politically troublesome, a possible way forward would be to link any such changes with a mechanism for tapping into home equity that is already widely accepted by many retirees and their advocates. The following sections note some of the characteristics of current products available and suggest some policy parameters and product characteristics that could make them more useful and successful.

This paper to now has examined the dynamics of maintaining a decent fiscal standard of living in retirement in Australia and has established that with Australia's ageing population and budgetary pressures, that there is a looming baby boomer cashflow crisis once the 5.5 million baby boomers join the current three million retirees in retirement.

The literature established that even though there is ample evidence that government budgets will be pushed to breaking point over the coming decades, that there is not sufficient research to support adequate policy reform. Consequently, to assist in closing the research gap, the following section will delve into the existing home equity withdrawal products in Australia, and in the context of recent policy work highlighted earlier, will propose a potential solution to meet the looming retiree cashflow crisis.

Current home equity withdrawal products

Australia's reverse mortgage market totalled \$3.66 billion at the end of 2014 (Deloitte 2015), up marginally from \$3.3 billion at 31 December 2011 with 42,410 reverse mortgages (SEQUAL 2016). However, this represents only a tiny fraction (0.44%) of the over \$830 billion of non-mortgaged housing equity of Australian retirees in 2014, as calculated earlier.

The lack of uptake on current products such as reverse mortgages from banks could stem from a range of issues, including uncompetitive interest rates, fees and charges, or simply from the reluctance from retirees to access their housing equity (Bridge et al. 2010). When attempting to identify the parameters that are a minimum requirement for retirees when considering home equity release, of those retirees already using a reverse mortgage, some of the key factors they considered included: access to information and advice, no negative equity guarantee (NNEG), the competitiveness of interest rates, valuation estimates (i.e. loan to value ratios, LVRs), ongoing fees and charges, their relationship with the broker/lender, and the reputation of the lender (Bridge et al. 2010). Recent product developments in this market suggest the industry is trialling a range of options.

For example, Bendigo Bank’s ‘Homesafe Wealth Release’ is available in Victoria and NSW and allows a retiree to sell a share of the future sale value of their home in exchange for a lump-sum cash amount (Bendigo Bank 2016). In addition to the range of banks that offer reverse mortgages, home reversion schemes and reverse annuity mortgages, there have been a few new products emerging onto the Australian home equity-release market in recent years. One such product is Property Options for Pensioners and Investors (or POPI), which allows an older homeowner to grant an investor the right to purchase the home in the future at an agreed price today, in exchange for an income stream (POPI 2016). Another product is DomaCom, which provides fractionalised investment in housing, effectively a regulated managed investment scheme.

What perhaps differentiates DomaCom is that its regulated products require customers to go through a financial planner, thereby permitting its inclusion in a licensee’s Approved Product Listing. DomaCom has recently applied to have a seniors-specific product for home equity release approved by the Australian Securities and Investments Commission (ASIC), which may even better meet the risk profile and needs of retirees than current reverse mortgages (DomaCom 2016).

What we do know is that the level of financial risk Australians are prepared to take on becomes increasingly less as they age (see Table 5). In evidence, the proportion of the age cohort not willing to take any financial risks increases to 52.1 per cent for those aged 65 years and over and 62.1 per cent for households [with one or more residents] aged 75 years and over. Seemingly, despite this, around 10 per cent of these same residents report that they never have any spare cash.

Table 5: Financial risk Australian homeowners are prepared to take by age, 2011

	All ages (n=8,335) Per cent	Baby boomers (age 47-64) (n=2,787) Per cent	65 and over (n=1,598) Per cent	75 and over (n=628) Per cent
Takes substantial risks expecting substantial returns	1.4	1.1	.6	.3
Takes above-average risks expecting above-average returns	6.1	6.2	2.4	1.1
Takes average financial risks expecting average returns	38.5	43.2	34.7	27.2
Not willing to take financial risks	41.4	37.5	52.1	62.1
Never has any spare cash	12.6	11.9	10.3	9.2
Total	100.0	100.0	100.0	100.0

Source: Authors’ own calculations from HILDA wave 11.

The majority of older homeowners having a more conservative approach to financial risk may be a critical hurdle for the uptake of home equity-release products in Australia. In this context, there is growing evidence that older Australians are becoming more amenable to considering a debt-free home equity product if it has a government guarantee (Harper 2011). However, the parameters of any product given government backing would need to show some tight properties and would benefit from clarity of purpose, such as a focus on enabling the supplementation of retiree income to a modest level and to smooth expenses related to health shocks for retirees.

So far, this paper has examined the financial position of current retirees, to provide an overview of overall net wealth at retirement, including a comparison between homeowners and non-homeowners. In addition, the results have detailed the proportion of the retired household's portfolio that is in housing equity and other asset classes, the income of retirees and financial stress in retirement. This data has established that not only is there evidence that retirees hold substantial assets in housing, but also that both homeowners and non-homeowners could have an improvement in lifestyle if some home equity of asset-rich retirees was withdrawn to supplement their retirement income. However, this paper has also detailed evidence that retirees have not utilised current home equity withdrawal products to the extent expected, which may be due to the current product parameters not being sufficiently suited to the needs and expectations of retirees. New product offerings may better fit the needs and risk profiles of Australian retirees by being government-backed, which would help support new retirement income channels through home equity release. In addition, this paper has found that the other preferences of retirees for home equity release could be better met with products that have competitive interest rates, stronger communication and integrated support. We outline a potential product solution below.

A proposed solution – Home Equity Accounts (HEAs)

We propose a HEA as a government-subsidised, low-interest loan that retired homeowners can use to draw on their home equity for income and consumption. The proposed HEA loan would be government-backed to ensure retirees know the government supports the system, and to attract investors which would make the HEA system more viable. The government backing would need to guarantee returns for investors (albeit at low rates) as well as assure homeowners that their homes will have a no negative equity guarantee, which is inherent in the strict LVR parameters of the loan. The proposed HEA process would also ensure that retirees have been given qualified, affordable financial advice prior to undertaking a HEA loan. The loan could support healthier ageing by modestly supplementing income on a fortnightly or monthly basis, or providing lump sums for home modifications related to health needs. The homeowners would still have complete control over their home, with the loan solely drawing on a portion of the equity.

The security for the HEA loan is a portion of the retiree's home equity; however, the financing of the loan would ultimately be from investors who purchase units in the pool of retiree home equity included in the HEA system, for a modest return. In the early stages, the government may need to provide seed funding to establish the system, and subsidise the low interest rate, which would presumably be justifiable given the potential for billions of dollars in annual age pension savings (Cowan et al. 2015). Such support would also send a strong message to retirees that their home is a source of retirement income. Nevertheless, in the longer term, investors purchasing exchange-traded units or bonds formed by securitising the home equity would fund the loans.

Retirees benefit from a HEA product by being able to access low-cost, low-risk, modest income supplementation and support for health consumption. If used modestly, they would still be able to bequest the bulk of their home equity in most cases, even with changes in housing market prices, as the scenarios in the next section demonstrate. Ultimately, the retiree is able to fund healthier ageing and stay in their own home. Linking with a financial planner in a low cost way may also contribute to better financial outcomes in areas other than home equity withdrawal.

Government and taxpayers benefit from being able to safeguard the age pension as a sustainable safety net with a fairer assets test, as well as manage increasing imposts on government budgets, such as health care for a population who are living longer. Furthermore, the current urgent need for a HEA system and the government guarantee required to ensure its uptake, could have sunset clauses built-in in the order of 30 to 40 years to underscore the generation-targeted nature of the retiree income solution. For investors, the HEA units or bonds would have low risk by being government-based, albeit with a low return, and would add more choice in the fixed asset classes as well as opening up the large home equity market for investors.

The loan could alternatively link to suitable emerging products that meet criteria such as supporting a modest income in retirement, supported by trusted financial advice, being flexible, low cost, low risk, scalable and most importantly, government-backed/guaranteed. Such a product could have strict eligibility conditions for a government guarantee such as set loan to value ratio (LVR) level, fee schedule, requirements for eligibility regarding pension eligibility or aged care needs, an agreed process for valuation of properties and review, through to limits on other indebtedness (Cowan et al. 2015).

The risks inherent in the HEA product and related exchange traded products are different but also related in the proposed solution in this paper. Relatively strict parameters for a HEA loan would help safeguard the viability of HEAs as well as reduce the risk to government who are safeguarding both homeowners and investors by offering a government guarantee. Risk is also partly addressed through mechanisms such as securitisation of the home equity that is being lent back as income. By being securitised through exchange-traded bonds, a wider range of investors is able to fund the loans, albeit with modest returns.

For the most part, current comparable products such as reverse mortgages are not the best in terms of efficiency and matching to retiree risk profiles (PC 2015). Instead, the proposed HEA product could be a solution, and will depart from existing products by being government-backed, securitised, and by incorporating financial planning services. Even merely introducing the term 'Home Equity Account' could favourably challenge perceptions regarding the place of the primary home in supplementing retirement income. Rather than seeing any change to the pension assets test as a punishment or disincentive to purchase a home, rethinking of the family home as a 'Home Equity Account' in retirement that could be drawn on to supplement a modest retirement income may be a more useful framing. The following section works through and stress tests several examples of what a product might look like in order to be attractive to financially conservative retirees and to a government guarantor, with the section thereafter discussing the role of financial advice in this new paradigm.

One component of the conversation regarding the use of home equity for retirement income supplementation is to allay the fear that a retiree's home is going to rapidly decline in value by the time they die. Tables 6 and 7 detail examples of home equity withdrawal, with scenario one being for a house valued at AU\$950,000 and scenario two being for a house valued at AU\$350,000. In each of these examples, if modest income was drawn from home equity over a 25-year period, the loan to value ratio (LVR) will remain at between 10 and 45 per cent, even across a range of interest rates.

Modelling HEAs

Scenario 1: In this example, the retiree's home value is \$950,000 at the start of the loan. The retiree is borrowing a \$1,000 lump sum as well as income of \$1,115 per month. This income amount is being used to show the effect of having to replace the pension income lost if housing assets over the value of \$500,000 were deemed to be providing income at a rate of 1.75 per cent for the first \$48,600 and 3.25 per cent for the remainder (these are the Australian Department of Human Services' deeming rates for financial assets when assessing pension eligibility as at 1 July 2015). The model adjusts for 2.5 per cent per annum inflation (adjusted six-monthly). The model has home values increasing at 3.5 per cent per annum (adjusted monthly), no repayments, and ignoring fees. A term of 25 years has been shown simply to cover a longer than average life expectancy for baby boomers, which is 74.85 years for males and 78.35 years for females as at 2012 (ABS 2013a).

Table 6: Reverse mortgage calculation* for starting home value of \$950,000, various interest rates, 25-year term

Loan interest rate (Compounded monthly)	4% p.a.	5.25% p.a.	6.25% p.a.
Home value at the start of month, Year 1	\$949,000	\$949,000	\$949,000
Monthly income drawn (Yr 1 to Yr 25)	\$1,115 rising to \$2,024 by Yr 25	\$1,115 rising to \$2,024 by Yr 25	\$1,115 rising to \$2,024 by Yr 25
Home value at the end of month, Year 25	\$2,273,635	\$2,273,635	\$2,273,635
Size of loan, compounded at end of Year 25	\$746,331	\$884,934	\$1,019,781
Remaining home equity after 25 years with monthly withdrawals	\$1,527,305	\$1,388,701	\$1,253,854
Loan to Value Ratio (LVR)	33%	39%	45%

Source: Authors' own calculations

*AU\$1,000 lump sum as well as income of \$1,115 per month inflation 2.5% pa (adjusted six monthly), over 25 years, home value increasing 3.5% pa (adjusted monthly).

In both examples in Tables 6 and 7, the difference in loan value ratio (LVR) and final equity are shown across three different interest rates (4%, 5.25%, 6.25%) over a 25-year term, demonstrating that a more competitive interest rate presents a much more compelling outcome for the retiree in terms of home loan value over the longer term.

The model in Table 6, for example, shows that over a 25-year term, at 4 per cent the value of the home still exceeds \$1.5 million, even with monthly income drawings, compared to \$1.25 million at a 6.25 per cent interest rate.

Scenario 2: The second scenario models an outcome for retirees with a home value of \$350,000 who would be eligible for a full pension (even with the introduction of deeming for home values over \$500,000), but who may still require some income supplementation. Table 7 shows that a modest release of home equity to supplement retirement income of \$200 per month plus an initial \$1,000 lump sum, still leaves the homeowner with a relatively low LVR over the long term, even at the higher interest rate. However, the lower interest rate would undoubtedly make a more compelling case for the retiree to undertake home equity withdrawal.

Table 7: Reverse mortgage calculation* for starting home value of \$350,000, various interest rates

Loan interest rate (Compounded monthly)	4% p.a.	5.25% p.a.	6.25% p.a.
Home value at the start of month, Year 1	\$349,000	\$349,000	\$349,000
Monthly income drawn (Yr 1 to Yr 25)	\$200 rising to \$363 by Yr 25	\$200 rising to \$363 by Yr 25	\$200 rising to \$363 by Yr 25
Home value at the end of month, Year 25	\$836,142	\$836,142	\$836,142
Size of loan, compounded at end of Year 25	\$133,871	\$158,733	\$182,920
Remaining home equity after 25 years with monthly withdrawals	\$702,271	\$677,409	\$653,222
Loan to Value Ratio (LVR)	16%	19%	22%

Source: Authors' own calculations

*AU\$1,000 lump sum as well as income of \$200 per month inflation 2.5% pa (adjusted six monthly), over 25 years, home value increasing 3.5% pa (adjusted monthly).

In terms of the risk of a decline in home property values, if the same modelling was done as in scenario one and two, but with a negative growth in home equity, of say, -3.5 per cent per annum for a starting home value of \$950,000 at an interest rate of 4 per cent, it would take until May of the 20th year of the loan before the home equity was completely exhausted. This would be May in the 19th year at an interest rate of 5.25 per cent and August in the 18th year for an interest rate of 6.25 per cent. For a starting home value of \$350,000, (drawing only \$200 per month), negative growth in home equity of -3.5 per cent per annum would still leave home equity at the end of a 25-year period of \$11,428 at an interest rate of 4 per cent. It would then take until March of the 25th year at an interest rate of 5.25 per cent and February of the 24th year at an interest rate of 6.25 per cent before the home equity was completely gone. This would be an unprecedented indeed implausible decline in long-run residential property values in Australia and is not included as a realistic risk plan, but rather to demonstrate the long-term potential of home equity withdrawal, even under this rather unlikely scenario. More realistically, short-term declines in home value may occur, but over the long term, if home equity withdrawal remained at a modest level, based on historical home value cycles in Australia, the home equity of the average Australian baby boomer could withstand a term of at least 25 years, as well as stay within reasonable LVR limits (<25% at age 65 and <45% at age 85).

In the context of financially conservative retiree homeowners and the need for appropriately knowledgeable individuals to enact the selection criteria required for a government guarantee, there is a substantial role in this system for financial planners. Similarly, the presence of financial planners will also be an assurance for retirees to ensure they make informed decisions regarding home equity withdrawal in retirement. We discuss the use of a financial planner in utilising a government guaranteed HEA in the following section.

The role of financial planning in the new retiree income paradigm

New ways of owning and investing in housing as an individual and a community, for both retirees and other generations, will require planning and support for people who have not traditionally opted for financial planning. Underscoring the critical role of financial planning is the evidence that cognitive impairment and the early onset of dementia may be affecting the financial planning decisions of older Australians (Teale 2015). To reduce the risk that financial decisions are rushed or prompted by crises when the person is most vulnerable, a new model for retiree income planning may be needed to circumvent the reluctance of older Australians to undertake planning for their possible future ill health and end of life needs (PC 2015).

A recent survey of retirees found that approximately one-third of older Australians are uncomfortable with their own financial planning for retirement (PC 2015). Data from HILDA also shows that 29.4 per cent of retirees who get financial planning agree or strongly agree that they wish they had started to plan for retirement earlier (see Table 8). These results underscore the potential positive impact of financial planning for retirees and the benefits of a nudge from government to engage in financial planning even if for a HEA process only.

Table 8: Percentage of retirees (age +65 years) report wishing they had started to plan for retirement earlier, 2011

Level of Agreement with the statement “I wish I had started to plan for retirement earlier”.	Per cent (n=1,085)
Strongly disagree	7.2
Disagree	40.7
Neither agree nor disagree	22.7
Agree	22.3
Strongly agree	7.1

Source: Authors’ own calculations from HILDA wave 11.

Efficiently and safely drawing on home equity for income in retirement also opens another dimension of strategy for financial planners and investment managers when planning and managing retirement income for clients. Strategy for generating retirement income in the short-term may have hitherto focussed on a narrow range of fixed-interest products, which have provided returns lower than inflation since the global financial crisis in 2008. Consequently, some financial planners may have opted for securities that have provided better returns, but in so doing, the client may be exposed to greater risk for short-term income than is ideal, particularly in a low interest rate environment. Utilising home equity for short-term income could provide a strategy alternative to moving up the equity ladder at the wrong stage in the investment cycle if fixed interest assets are not providing adequate returns. The use of housing equity to smooth income in times of stock market volatility may also help support the increased longevity of superannuation savings. Rather than seeing home equity as a final resort once all other sources of income are exhausted, home equity could then be part of a planned strategic asset allocation that is decumulated at the most appropriate time during the market cycle.

Conclusion

The retirement context in Australia displays a high risk of income poverty and financial stress for retirees, combined with increasing pressure on government budgets. This paper first established that Australia's 5.5 million baby boomers who are progressively moving into retirement need a generation-targeted solution to supplement their retirement incomes, and that housing wealth is the linchpin of that solution. Second, the paper detailed evidence that existing home equity release products have not established the market traction needed to meet the needs of retiree income supplementation. In analysing potential market failures for retiree home equity release, the preferences of retirees for home equity product parameters have been explored to assess potential solutions.

Third, we have suggested a safer, supported mechanism that enables retirees to relieve financial stress and meet their health and aged care needs by efficiently and safely decumulating their housing equity for increased cash flow. The solution proposed in this paper – Home Equity Accounts (HEAs) – differs from existing products by being potentially government-backed, securitised and in providing higher-quality planning for those retirees with lower net worth than those who typically engage a financial planner.

Overall, this paper has illustrated the current and potential role of housing equity in Australian retirement portfolio composition and contributed to a case for new financial product development for Australian retiree income supplementation. The solution is for all retirees: for homeowners, who are part-pensioners, and for those who are full-pensioners and living under financial stress. Perhaps even more critically, enabling HEAs for homeowner retirees will support the income of retiree renters, because it will shore up the ever-decreasing pool of government funding for those 11 per cent of all retiree households, and particularly the 17.6 per cent of sole person retiree households, who are renters and have very few assets at all.

The current urgent need for retiree income supplementation is not necessarily ongoing; it is a mechanism that can assist baby boomers to live well, while simultaneously reducing the pressure on pensions. Toward the end of the baby boomer cohort lifecycle, superannuation levels will begin to dramatically increase and the need for HEAs may well begin to diminish. Built-in sunset clauses for the HEA government guarantee would help underscore the generation-targeted nature of the retiree income solution.

The results of this study have important implications for social policy and financial products designed to increase the financial wellbeing of retirees. Over the next 15 to 20 years, a HEA system could potentially save hundreds of billions in age pension payments and still leave considerable home equity for baby boomer retirees to bequest from the approximate \$2.48 trillion home equity in 2033. In addition, this paper commented on the theoretical base for asset holdings and decumulation over the lifecycle and identified the theories in need of extension to reflect a new paradigm of ageing, work, and retirement, which will be an area of further research.

In terms of other related future research, we are of the opinion that recent policy reports have not gone far enough to push the market for home equity release. There is more scope to establish a targeted transition plan toward increased use of home equity for retirement income in Australia. The three million current retirees and 5.5 million baby boomers need to be drawn into a conversation on the future of retirement income planning and the emerging place of home equity withdrawal in retirement when testing portfolio scenarios for retirees.

In addition to the right product, there needs to be recognition of the will to stay in place for current retirees and a need to trust any new product offered regarding their housing equity. Ideally, any new product would be supported by trusted financial advice. With the right, well-priced product, these new scenarios could be the light at the end of the tunnel for some retirees. In the context of new financial products that draw on housing equity and match the risk profile and needs of Australian retirees, the potential positive impact of quality financial planning, could completely change the financial stability of retirees and, in turn, government finances.

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THE EQUITY RISK PREMIUM IN AUSTRALIA (1900–2014)

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ABSTRACT

The equity risk premium (ERP) remains one of the most hotly contested ideas in finance. The disagreement, in practical and theoretical terms, centres on how best to measure the risk of an investment, how to convert this risk measure into an expected return that compensates the investor for holding that risk, and its degree of predictability. This paper provides Australian evidence for the period 1900 through 2014.

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Introduction

Perhaps one of the few things we can agree on in modern finance is the idea that the greater the investment risk, the greater the expected reward required to compensate for risk. We could say that the expected return on any investment can be written as the sum of the risk-free rate and a risk premium to compensate for that risk.¹

And, alas, this is where the niceties end.

The equity risk premium remains one of the most hotly contested ideas in finance. The disagreement, in practical (and theoretical) terms, centres on how best to measure the risk of an investment, how to convert this risk measure into an expected return that compensates the investor for holding that risk, and its *degree of predictability*. A central number in this debate is the premium that investors demand for investing in the ‘average risk’ equity investment, that is, the *equity risk premium* (ERP) (Damodaran, 2015).

So why is this a debate that generates so much heat, but little light?

Let’s look at the last 20 years of capital market history. For Australian investors, we have witnessed the Asian Financial Crisis (1997); the dotcom crash in 2000; the September 11 attacks (2001), Bali bombings (2002) and Second Iraq War (2003); to the Global Financial Crisis including the US subprime crisis (2007) and collapse of Lehman Brothers (2008); and more recently, sovereign debt concerns around the world, including the most recent focus on Greece (2015) and China (2015). This timeframe can be described as unsettled at best, and chaotic at worst.

The lived experience of investors over these two decades has resulted in serious contemplation on the matter of the ERP, more specifically, what might be a reasonable expectation of the premium investors expect to earn above the risk-free rate? Such rumination is not limited to Australia. Hammond and Leibowitz (2011) note that globally there has been, “renewed *uncertainty* about what may be the most important measure in all of finance – namely, the equity risk premium” (p.1).

Let’s consider the most basic expression of the ERP (Hammond and Leibowitz, 2011).

$$ERP = E(r_e) - E(r_f) \tag{1}$$

where:

$E(r_e)$ = Expected return for equities; and

$E(r_f)$ = Expected return for the risk-free rate.

Investors are also interested in the inflation-adjusted or ERP(i) (or real ERP) which can take the form:

$$ERP(i) = (E(r_e) - E(i)) - ((E(r_f) - E(i))) \tag{2}$$

¹ For a contemporary survey of the literature, see Hammond and Leibowitz (2011) and Damodaran (2015).

We can also visualise how investors can consider the total return to equities as a long-run equilibrium concept, made up of various premiums. This approach, shown in Figure 1, is known as the 'build-up' method of Ibbotson and Siegel (1988)².

Figure 1: Components of the expected return for stocks, bonds and bills

Stocks

Equity risk premium	Bonds	
Bond horizon premium	Bond horizon premium	Bills
Real risk-free rate	Real risk-free rate	Real risk-free rate
Inflation	Inflation	Inflation

Source: Ibbotson (2011), Ibbotson and Siegel (1988). Note that the first three terms (inflation, real risk-free rate and bond horizon premium) are typically combined into the long-term yield of a riskless bond because this yield is directly observable in the marketplace (Ibbotson, 2011).

In short, we can think of the ERP as the future compensation (or premium) to an investor for owning a risky portfolio of stocks rather than the risk-free asset. And therein lies the rub. From a theory perspective, there is an investable market portfolio (M) consisting of every asset (which is infinitely divisible). Moreover, there is a risk-free asset that is genuinely free of any risks. However, in the real world, investors cannot simply invest in M as suggested in the textbooks; we have to select proxies for each of these theoretical inputs in order to estimate the ERP^{3,4}. We also know that interest rates are not constant⁵. These are some of the practical challenges investors face when formulating their views on the ERP.

2 It is important to note that Figure 1 says nothing about the respective time horizon required for investors to garner these premia. We will consider differing investment time horizons and the ERP later in the study.

3 One could argue that this line of argument is akin to the Roll (1977) critique.

4 When estimating, say the ERP in the U.S., the proxy for the universe of stocks is generally the S&P500 (or a similar broad index). It is also important to note that such exchange traded indices do not include other forms of equity (such as private equity, housing equity or human capital). Likewise in Australia, the proxy for the portfolio of stocks is the All Ordinaries Accumulation Index or the S&P/ASX 300 Index.

5 The proxy for the risk-free asset is generally the U.S. Government 30- or 90-day Treasury Bill or 10-year Treasury Bond. In reality, these zero-risk proxies are not genuinely 'risk-free' as investors remain exposed to factors including inflation risk, liquidity risk and the possibility of government default. In terms of the risk-free asset, the Australian Commonwealth Government Treasury Note can be used as a proxy, an Australian Government Treasury Bond, Bank Accepted Bills or the Bloomberg AusBond Bank Bill Index which is an index comprised of bank bill securities.

In this study, we will report historical estimates of the ERP over the last century. The great advantage of the historical method is that it provides evidence about the behaviour of the premium through time. The downside? Siegel and Thaler (1997) note that “one view is that history has just been kind to stock markets. According to this view, we have just experienced 200 years of good luck (p. 198).”⁶

The Historical Perspective

In many financial applications, historical data are used, rightly or wrongly, as an anchor for future expectations. In this section we consider the historical method for estimating the ERP. By doing this, we can observe both the general level of, and variation in, the ERP through time.

In considering historical data, we recommend the reader proceed with caution because any analysis inevitably ends up being backward looking (Damodaran, 2015). If we are to accept that the historical ERP in Australia, for example, is helpful in forming future expectations, we are implicitly making a number of assumptions about the future economic trajectory of the Australian economy. Historical data show us that the economic outcomes may vary widely. For example, in the year 1900, Canada and Argentina had very similar levels of wealth as measured by GDP per capita (\$2,911 and \$2,756 respectively, measured in 1990 US dollars) (World Economics Ltd, 2015)⁷. Fast forward to 2008 and we see that the relative wealth of these nations has diverged dramatically with Canada having an estimated \$25,267 per capita versus Argentina with \$10,955 per capita. The point we make at the outset is that the future realised ERP is in part a function of real economics (i.e. companies making profits by selling things), and real economic outcomes are by no means assured.⁸

6 For historical perspectives on the ERP, see Fisher and Lorie (1964, 1968, 1977), Ibbotson and Sinquefeld (1976), Dimson, Marsh and Staunton (2003) and Siegel, (2005, 2007). For Australian perspectives, see Brailsford, Handley and Maheswaran (2012). While the evidence to date suggests that a long-term investment in a well-diversified portfolio of stocks typically provides investors with a premium (or compensation) for holding additional risk, this premium can, in some instances, take very (very) long periods of time to materialise (see Section 4).

7 Technically the GDP per capita data cited herein is measured in the Geary-Khamis dollar (GK\$), which is also commonly known as the international dollar. It is a hypothetical unit of currency that has the same purchasing power parity that the US dollar had domestically at a given point in time, in this case in 1990.

8 This example might also act as a salutary reminder to policy-makers of the importance of their task, and the risks of policy errors.

Global returns

To examine the historical ERP, we use the well-known and widely-cited Dimson, Marsh and Staunton (DMS) (2002, 2015) database, covering 19 countries (and three regions: world, world ex-US, and Europe), all with index series covering the period 1900 through 2014^{9,10}. To get a sense of the global ERP experience over the sample period, we first look at comparative numbers across the 19 countries and three regions in Table 1, which reports the real returns for equities in all countries and regions in local currency terms. The data show that investing in equities across all countries delivers an equity risk premium over the long-term. The results also reveal that the Australian sharemarket was the second best performing equities market in the world over the 115 year dataset earning 7.3% p.a., only marginally outperformed by South Africa with a real return of 7.4% p.a. Such an outstanding performance by Australian stocks is well worth remembering looking into the future. The question arises: what are the chances of reproducing such stellar performance over the next 115 years? We leave such a question for future work.

A second interesting observation about the results in Table 1 is that equity risk in Australia has been relatively modest compared to other nations, with Australian stocks exhibiting the third lowest standard deviation of returns of all nations listed (recall that these are in local currency terms)¹¹. It is also noteworthy that for a number of economies (and the three regions) the year of the GFC, 2008, is the worst recorded calendar year for inflation-adjusted equity performance out of the 115-year history examined.

9 As noted by Dimson, Marsh and Staunton (2011), the database contains annual returns on stocks, bonds, bills, inflation, and currencies for 19 countries from 1900 to 2014. The countries comprise two North American nations (Canada and the USA), eight euro-currency area states (Belgium, Finland, France, Germany, Ireland, Italy, the Netherlands, and Spain), five European markets that are outside the euro area (Denmark, Norway, Sweden, Switzerland, and the UK), three Asia-Pacific countries (Australia, Japan, and New Zealand), and one African market (South Africa). These countries covered 98 per cent of the global stock market in 1900, and 91 per cent of its market capitalisation by the start of 2015.

10 Details about the data, the sources, and the index construction methods are presented in Dimson, Marsh, and Staunton (2008, 2011 and 2015).

11 Despite its widespread use, it is arguable whether standard deviation is the most appropriate measure of investment risk particularly when considering questions relating to long term investing (see, for example, Bianchi et al., 2014).

Table 1: Real (inflation-adjusted) equity returns in all countries, 1900-2014 (local currency returns)

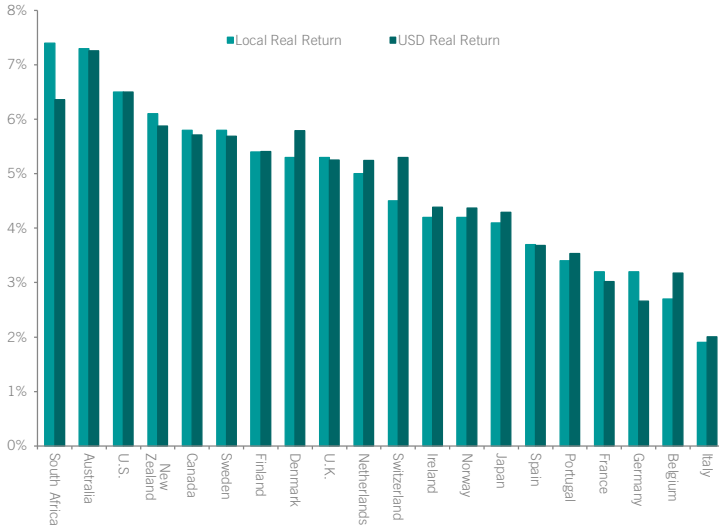
Country / Region	Geometric Mean (%)	Arithmetic Mean (%)	Standard Deviation (%)	Standard Error (%)	Minimum Return (%)	Year of Minimum	Maximum Return (%)	Year of Maximum
Australia	7.3	8.9	18.0	1.7	-42.5	2008	51.5	1983
Belgium	2.7	5.4	23.8	2.2	-48.9	2008	105.1	1919
Canada	5.8	7.1	17.0	1.6	-33.8	2008	55.2	1933
Denmark	5.3	7.2	20.8	1.9	-49.2	2008	107.8	1983
Finland	5.4	9.3	30.1	2.8	-60.8	1918	161.7	1999
France	3.2	5.7	23.2	2.2	-41.5	2008	66.1	1954
Germany	3.2	8.2	31.9	3.0	-90.8	1948	154.6	1949
Ireland	4.2	6.8	23.0	2.1	-65.4	2008	68.4	1977
Italy	1.9	5.9	28.7	2.7	-72.9	1945	120.7	1946
Japan	4.1	8.8	29.7	2.8	-85.5	1946	121.1	1952
Netherlands	5.0	7.1	21.5	2.0	-50.4	2008	101.6	1940
New Zealand	6.1	7.8	19.5	1.8	-54.7	1987	105.3	1983
Norway	4.2	7.2	27.0	2.5	-53.6	2008	166.9	1979
South Africa	7.4	9.5	22.2	2.1	-52.2	1920	102.9	1933
Spain	3.7	5.9	22.0	2.1	-43.3	1977	99.4	1986
Sweden	5.8	8.0	21.3	2.0	-42.5	1918	67.5	1999
Switzerland	4.5	6.3	19.6	1.8	-37.8	1974	59.4	1922
United Kingdom	5.3	7.1	19.7	1.8	-57.1	1974	96.7	1975
United States	6.5	8.5	20.1	1.9	-37.6	1931	56.3	1933
Europe	4.3	6.2	19.9	1.9	-47.5	2008	75.7	1933
World (ex-US)	4.4	6.2	19.1	1.8	-44.2	2008	80.5	1933
World	5.2	6.6	17.4	1.6	-41.0	2008	68.2	1933

Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Note: The statistics for Germany exclude the hyperinflammatory period of 1922-23

Figure 2 reports the inflation-adjusted performance of equities across all countries in both local currency and US dollar terms. Interestingly, Australian stocks are ranked second in the world based on local currency returns, but first in US dollar terms. It is also noteworthy that there are five English-speaking nations (Australia, Canada, New Zealand, UK and the US) who report returns in the upper half of the sample of countries. Overall, the evidence suggests that real equity returns have been strong and positive for most countries over the long-term regardless of their measurement basis.

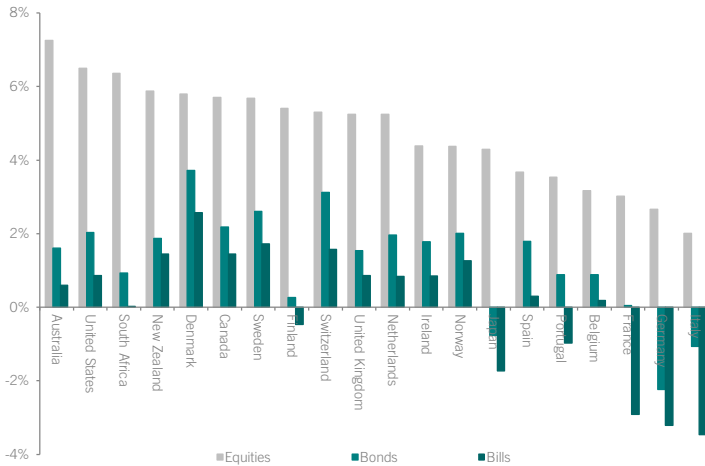
Figure 2: Real Annualised Equity Returns in Local Currency and US Dollars, 1900-2014



Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Figure 3 compares the long-term inflation-adjusted performance of stocks, bonds and bills in US dollar terms across countries. As we have already mentioned, Australian equities were the highest performing asset class across all countries in US dollar terms. At the other end of the spectrum, Italian equities report the lowest real return on stocks with a long-term real geometric rate of return of 2.0% p.a., demonstrating that equity returns can vary widely between countries over the same span of time. The real returns from bonds are positive for all countries with the exception of Japan, Germany and Italy. Bills earn a return greater than inflation for all countries except in Finland, Japan, Portugal, France, Germany and Italy. Overall, we can conclude that owning stocks and bonds in most countries delivered a return higher than the inflation rate over the long-term.

Figure 3: Real Annualised Returns on Equities, Bonds and Bills, All Countries, 1900-2014 (in US Dollars)



Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Let us now look at global ERPs, and then drill down on the Australian experience. To cater for different preferences, in Tables 2 and 3 we report the summary statistics for the equity risk premium calculated against both bills (Table 2) and bonds (Table 3) for each country in local currency terms. These results confirm that the equity risk premium has provided a strong and positive return over the long-term; however, this reward was associated with high levels of variability in returns (measured using standard deviation of returns). Furthermore, investors seeking the ERP must experience potential large annual losses as evidenced by the worst annual returns columns, which show losses in the range of -34% to -67% in a single calendar year.

While covering different periods and using different data, the estimated historical ERPs for Australia of 6.6% (and 5.6%) over bills (and bonds) are of the same order of magnitude as that found in Brailsford et al. (2012) who found ERPs of 6.5% and 6.1%, respectively (for data covering 1883-2010). Furthermore, our estimate of the ERP versus bonds for the US of 4.4% is, due to more recent returns, understandably lower than the 5.7% found by Arnott and Bernstein (2002) based on 75 years of data.

Table 2: Worldwide Equity Risk Premium Relative to Bills, 1900-2014 (local currency returns)

Country / Region	Geometric Mean (%)	Arithmetic Mean (%)	Standard Deviation (%)	Standard Error (%)	Minimum Return (%)	Year of Minimum	Maximum Return (%)	Year of Maximum
Australia	6.6	8.1	17.5	1.6	-44.4	2008	49.2	1983
Belgium	3.0	5.4	23.9	2.2	-49.7	2008	125.0	1940
Canada	4.2	5.6	16.9	1.6	-34.7	2008	49.1	1933
Denmark	3.2	5.0	20.5	1.9	-50.3	2008	95.3	1983
Finland	5.9	9.5	29.9	2.8	-53.3	2008	159.2	1999
France	6.1	8.7	24.2	2.3	-43.1	2008	85.7	1941
Germany	5.9	9.9	31.5	2.9	-44.7	2008	131.4	1949
Ireland	3.5	5.8	21.3	2.0	-66.3	2008	72.0	1977
Italy	5.7	9.5	31.6	2.9	-48.6	2008	150.3	1946
Japan	6.1	9.3	27.7	2.6	-48.3	1920	108.6	1952
Netherlands	4.4	6.5	22.5	2.1	-51.4	2008	126.7	1940
New Zealand	4.4	5.9	18.1	1.7	-58.3	1987	97.3	1983
Norway	3.1	5.9	26.1	2.4	-55.0	2008	157.1	1979
South Africa	6.3	8.4	21.7	2.0	-33.9	1920	106.2	1933
Spain	3.4	5.5	21.6	2.0	-39.3	2008	98.1	1986
Sweden	3.9	5.9	20.5	1.9	-40.8	2008	64.6	1999
Switzerland	3.7	5.3	18.7	1.7	-37.0	1974	54.8	1985
United Kingdom	4.4	6.1	19.7	1.8	-54.6	1974	121.8	1975
United States	5.6	7.5	19.6	1.8	-44.1	1931	56.6	1933
Europe	3.4	5.2	19.3	1.8	-48.3	2008	76.0	1933
World (ex-US)	3.6	5.2	18.6	1.7	-45.1	2008	80.9	1933
World	4.3	5.7	17.0	1.6	-41.9	2008	68.6	1933

Note: The statistics for Germany exclude the hyperinflammatory period of 1922-23

Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Table 3: Worldwide Equity Risk Premium Relative to Bonds, 1900-2014 (local currency returns)

Country / Region	Geometric Mean (%)	Arithmetic Mean (%)	Standard Deviation (%)	Standard Error (%)	Minimum Return (%)	Year of Minimum	Maximum Return (%)	Year of Maximum
Australia	5.6	7.5	1.9	20.0	-53.4	2008	66.3	1980
Belgium	2.3	4.4	2.0	21.1	-53.8	2008	80.1	1940
Canada	3.5	5.1	1.7	18.2	-40.7	2008	48.6	1950
Denmark	2.0	3.6	1.7	17.9	-54.3	2008	74.9	1972
Finland	5.1	8.7	2.8	30.1	-55.4	2008	173.1	1999
France	3.0	5.3	2.1	22.8	-49.2	2008	84.3	1946
Germany	4.9	8.4	2.7	28.6	-51.5	2008	116.6	1949
Ireland	2.6	4.5	1.8	19.6	-66.9	2008	83.2	1972
Italy	3.1	6.5	2.7	29.5	-48.1	2008	152.2	1946
Japan	5.1	9.1	3.0	32.6	-45.2	2008	193.0	1948
Netherlands	3.2	5.6	2.1	22.3	-56.4	2008	107.6	1940
New Zealand	3.9	5.5	1.7	17.9	-59.7	1987	72.7	1983
Norway	2.3	5.3	2.6	27.7	-57.8	2008	192.1	1979
South Africa	5.4	7.1	1.8	19.6	-36.1	2008	70.9	1979
Spain	1.9	3.9	1.9	20.7	-43.7	2008	69.1	1986
Sweden	3.0	5.3	2.0	21.5	-49.5	2008	84.3	1999
Switzerland	2.1	3.6	1.6	17.5	-41.3	2008	51.9	1985
United Kingdom	3.7	5.0	1.6	17.3	-38.4	2008	80.8	1975
United States	4.4	6.5	1.9	20.7	-50.1	2008	57.2	1933
Europe	3.1	4.4	1.5	16.1	-48.2	2008	53.6	1923
World (ex-US)	2.8	3.9	1.4	14.7	-48.1	2008	35.8	1999
World	3.2	4.5	1.4	15.5	-48.2	2008	37.5	1958

Note: The statistics for Germany exclude the hyperinflammatory period of 1922-23

Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Overall, analysis of the historical ERP across the countries in the sample suggests that it is strong and positive over the long-term (that is, over the last century). Whilst owning shares provides investors with a return premium (the ERP), investors must also be willing to accept high levels of return volatility and occasional very large capital losses over the course of a year (or even longer time horizons). A question that must be considered is whether stocks are a suitable investment for all investors? For example, do some investors – e.g. *retirees who are regularly consuming part of their capital* – have the capacity to take the risks of investing in stocks even if the ERP appears, at face value (using long *historical* datasets), attractive?

A further consideration that should be taken into account is that the ERPs reported herein are *estimates*. Again, we must stress that the ERP is not directly observable and is the outworking of two asset class returns. The academic literature suggests that there may be biases in historical ERPs – e.g. international survivorship bias, transaction costs, the extent to which investors correctly priced stocks given their risks, pension asset and taxes, and biases in historical bond returns (Siegel, 2005) – so the estimates reported herein should not be treated as guaranteed¹². In fact, a sobering aspect of conducting this research has been the frequent reminder of its heavy reliance on assumptions and estimates. It is also worth an investor considering how these biases have evolved over time and whether this evolution has had any impact on trends in the ERP over time.

Australian returns

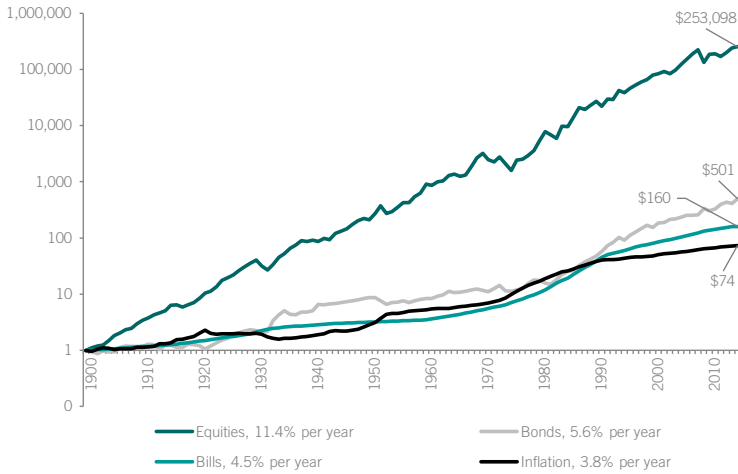
Having considered the global relative returns and two different ways of computing the ERP, we now look at the historical Australian experience in more detail. Panel A of Figure 4 plots the cumulative total nominal returns for Australian stocks, bonds, bank bills, and inflation from 1900 to 2014. As finance theory anticipates, stocks performed best with a \$1 investment growing to \$253,098 to the end of 2014. Australian stocks delivered a (geometric) mean return of 11.4% per year, more than double the return of Australian bonds which returned 5.6% p.a. Bills returned 4.5% per year which was marginally higher than the Australian rate of inflation which was reported at an annualised rate of 3.8% per year over the 115 year sample period.

To strip out the impact of the overall rise in prices over the period, Figure 4 Panel B reports the equivalent inflation-adjusted (or 'real') returns over the sample period. These results show that Australian equities earned 7.3% per year over and above the rate of inflation, which as we discussed earlier is relatively attractive versus the global peer group (see Figure 3). Australian bonds earned a real return of 1.7% per annum while bills marginally beat the Australian rate of inflation by only 0.7% p.a.

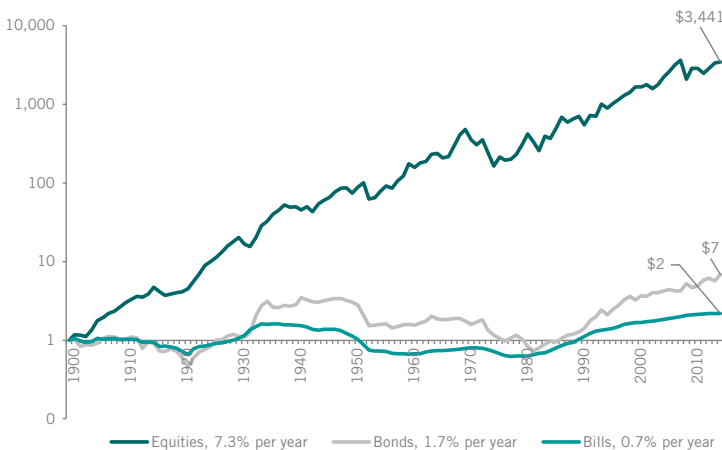
¹² In the Australian context, the actual return from equities for a given investor will depend to a large extent on their tax status. For a discussion on the level the potential impact of dividend imputation on the returns earned by Australian investors, see Bianchi, Drew and Walk (2015).

Figure 4: Cumulative Returns on Australian Equities, Bonds, Bills and Inflation, 1900-2014 (1900 = \$1; log scale)

Panel A: Nominal terms



Panel B: Real terms

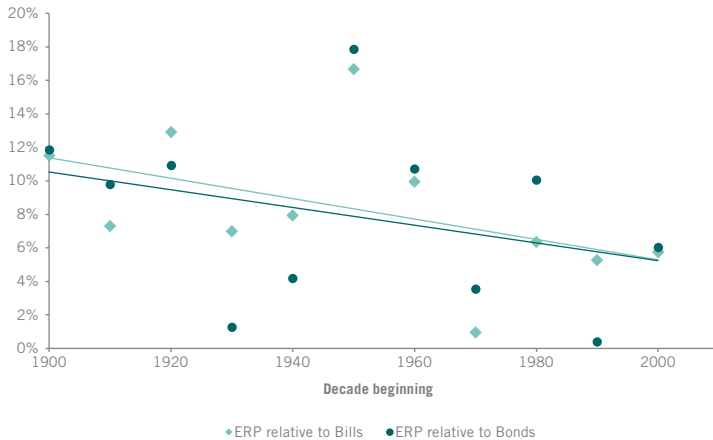


Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Now that we have looked at total nominal and real returns for our three asset classes (and inflation) let us look at the Australian ERP in detail.

Figure 5 illustrates the ERP (over bonds and bills) on a decade-by-decade basis, with linear trend lines for each series. The results show that the ERP is volatile (i.e. varies widely around the trend) and declining over time (i.e. a downward sloping trend line) causing us to ask: if this is the trend, what might the future hold?

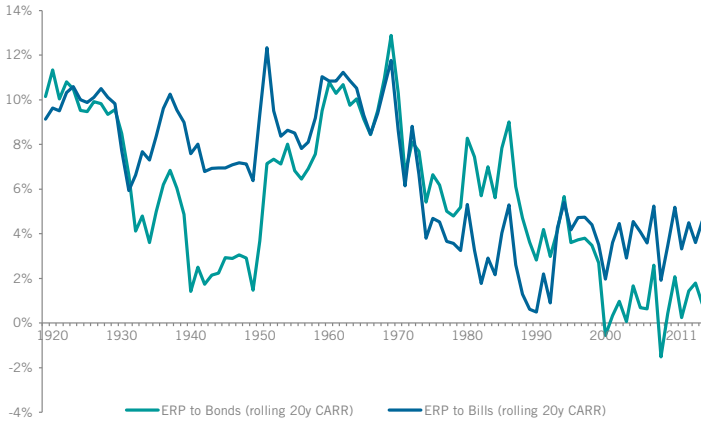
Figure 5: Realised Australian Equity Risk Premium – Average Annual Rate of Return, by decades (1900-2010)



Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

The trends of volatility in ERPs, and the overall downward shift in ERPs through time, are both confirmed in Figure 6 which shows rolling 20-year annualised ERPs for the entire dataset. Even with a 20-year investment horizon, we see that ERPs range from a maximum of around 13% p.a. to a minimum of around -2%. Looking at the data in this way also shows a more pronounced downward trend in ERPs, with the lowest ERPs being observed in the past 10-15 years. The exact nature of how these various factors have impacted (or otherwise) the ERP in Australia remains unknown; however, the data suggests the net effect has been negative through time. Whether or not this trend continues into the future is up for debate and is a potential area of future research.

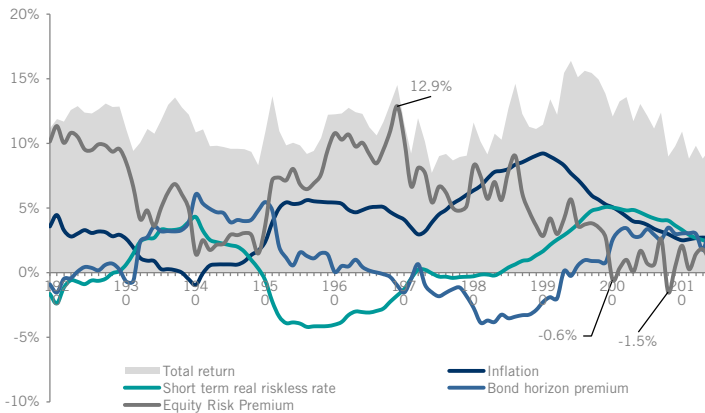
Figure 6: Rolling 20 year annualised ERPs, 1900-2014



Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Ibbotson and Siegel (1988) inform us of four (4) components that comprise total equity returns over the long-term. These components are: inflation; real riskless rate; bond horizon premium; and the equity risk premium. Figure 7 visualises how the rolling 20-year average of the four components of equity returns in Australia have varied through time.

Figure 7: Rolling 20 year components of annualised stock returns, 1900-2014



Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Figure 7 shows that each component of returns (the four line series) is relatively volatile with *all components being negative at some time* over the period shown (recall, we are showing 20 year averages). We also see further evidence of the downward trend in the ERP, especially since the 1960s. A 20-year time horizon is a long period for any investor. For instance, if an investor were 65 years of age, their life expectancy in Australia is around 85 years, which is roughly equivalent to a 20-year horizon. It has become conventional wisdom not to hold stock portfolios for short periods of time; the corollary is that stocks are usually the province of those with a long investment horizon.

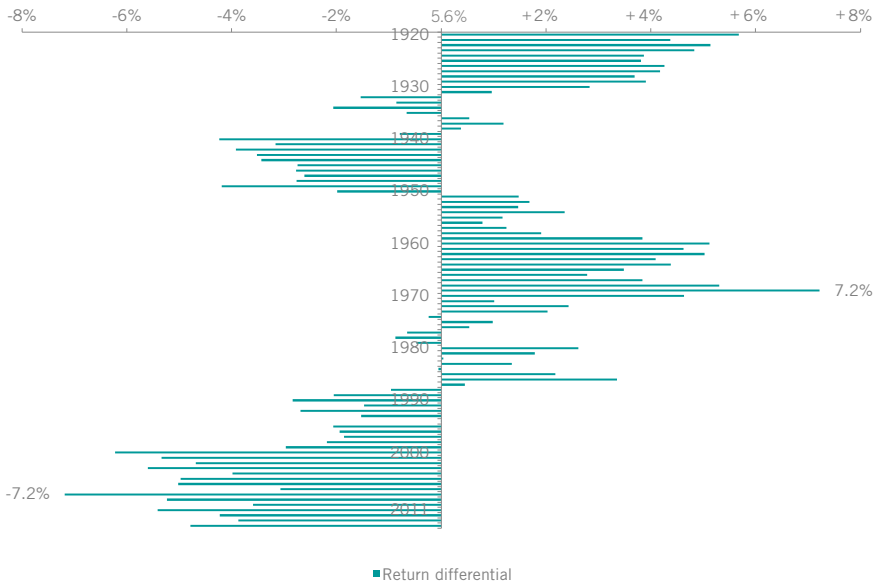
The historical evidence presented in Figure 7 underscores the risk that investors (even with a 20-year holding period) can experience a 'bad draw' (i.e. realised 'sequencing risk') when pursuing the ERP. In fact, two of these holdings periods delivered negative per annum ERPs when compared to bonds¹³.

Returning to the opening remarks in the introduction of the study, "*... the lived experience of investors over the past two decades has resulted in serious contemplation on the matter of the ERP, more specifically, what might be a reasonable expectation of the premium investors expect to earn above the risk-free rate?*" We would go a step further and argue that the unpredictability of the ERP over the most recent 20 years is not all that extraordinary when compared to the larger dataset examined herein. We will consider the implications for retirement investors later in the paper.

We now turn specifically to the risk (or variability) of the ERP over rolling 20-year periods. In Figure 8, we illustrate the variability of the 20-year ERP around its long term average of 5.6% p.a. We see that, in the face of wide variability through time, measures of central tendency (that is, the 20-year average annual ERP) provide little insight as to the potential 'ride' investors may experience. There are prolonged periods of time (for instance over the last quarter of a century in Australia) where the ERP has been below its long term average. Comparing Figures 7 and 8 we see that, in recent times, the story isn't only about equities. In fact, total equity returns have been sound, but bond returns have been relatively strong making the ERP (the difference between the two) appear narrower. Again, this underscores the idea that the ERP is not simply a function of the performance of the equities asset class.

¹³ See Basu and Drew (2009) and Basu, Doran and Drew (2012) for an analysis of sequencing risk in a pension finance context.

Figure 8: ERP to Bonds (20 year rolling CARR) around the historical mean of 5.6% p.a.

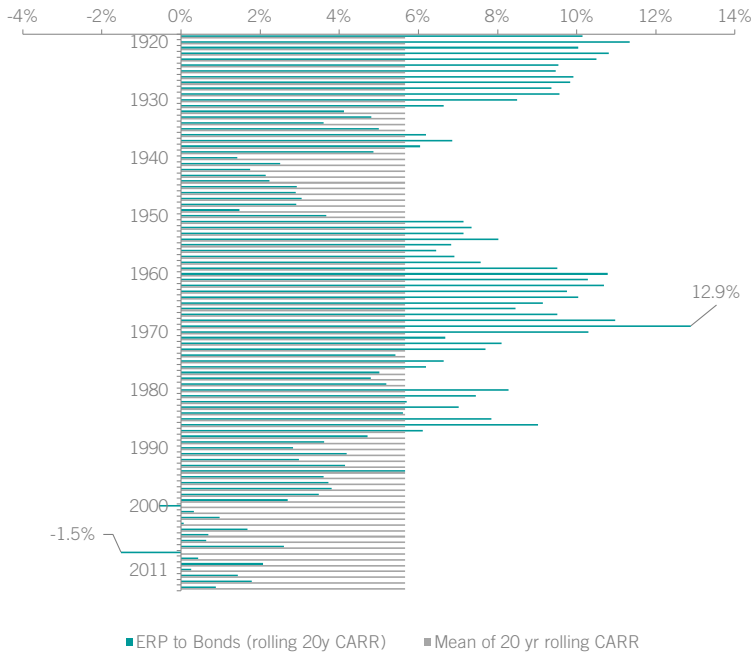


Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

We have also highlighted anecdotal evidence that suggest that investors take a set-and-forget approach to setting their forward looking expectations of the ERP. As the behavioural literature tell us, in the face of complexity and/or uncertainty, individuals tend to employ 'heuristics' (or rules-of-thumb) to simplify the decision making process. The evidence presented here underscores the complexity of the problem facing investors.

Figure 9 presents how many times over the last century the 20-year ERP has met and/or exceeded its long term average (i.e. how effective might the long term average be as a shortcut). The historical experience points to the idea that, using rolling 20-year windows, the ERP has ranged from a stellar 12.9% p.a. through to a dismal -1.5% p.a. In short, this is risk. We can illustrate that a prudent investor, even with a 20-year time horizon, faces an unpredictable and wide potential distribution of outcomes.

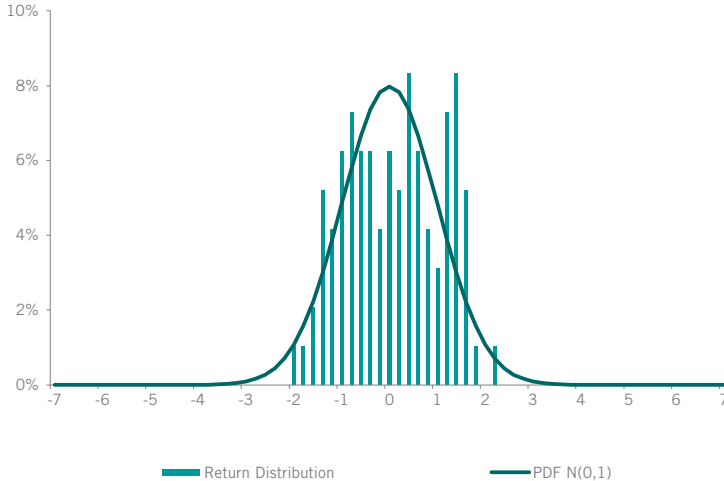
Figure 9: ERP to Bonds (20 year rolling CARR) versus the historical mean of 5.6% p.a.



Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

In the interests of completeness, we present a histogram of the distribution of rolling 20-year ERP outcomes (Figure 10). The distribution is striking in that it is platykurtic (a fancy way of describing a distribution that has a lower peak and 'thinner tails' than a normal distribution).

Figure 10: ERP to Bonds (20 year rolling CARR) – Full sample period



Source: Dimson, Marsh and Staunton (2015); Authors' own calculations

Concluding remarks

This study examined the returns and variability of the Australian and global ERP using the DMS dataset from 1900-2014. The findings reveal that Australian equities recorded one of the highest ERPs compared to sharemarkets of other countries. The Australian ERP exhibits a high degree of variability. Various time horizon analyses show that equity investors required very long investment horizons (of 20 years and more) to garner the historical ERP in Australia. This long time horizon that is required to capture the ERP is the challenge facing all equity investors (past, present and future).

With current Australian cash rates and government bond yields at record lows, it is difficult to foresee an expected ERP that is reflective of historical returns. Quite the contrary, yet, the prevailing question that cannot be answered is, what is the likely performance of the ERP in the future? Almost 20 years ago, Siegel and Thaler (1997) documented their future expectations of an ERP of 3 per cent p.a. in the U.S. for the next two decades. They very cleverly end their paper with the following note, “we are stressing long-term results and will not accept complaints for 20 years. Feel free to call us in 2017 (p. 199).” From an Australian perspective, our study illustrates the long-term performance of the ERP over many decades. The results suggest that investors may have to lower their long-term expectations of equity returns.

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