2018 Russell Investments/ASX
Long Term Investing Report

The journey matters as much as the destination

June 2018
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Executive summary

The Russell Investments/ASX Long-term Investing Report is typically used by investors to rank the best performing asset class for the last 10 and 20 years. For 2018, at face value, most readers would conclude Australian residential property is the clear winner for both time horizons to 31 December 2017. However, a closer look behind the headline numbers shows there’s a lot more variation year on year. Understanding these variations could benefit investors in their choice of investment strategy going forward and the likelihood of achieving their desired outcomes.

The “destination”: Headlines

The top line results from the 2018 Russell Investments/ASX Long-term Investing Report are:

Australian residential property outperformed all asset classes for the 10 and 20 years to 31 December 2017.

Compared to last year’s report, the results for the 10 years to 31 December 2017 were mixed compared to the 10 years to 31 December 2016 as shown in Figure 1.

› While residential property was still the winner, it returned 0.8% less than last year’s results. Similarly with Australian shares, showing a reduction of 0.5%.
› On the other hand, global shares (both hedged and unhedged) along with global listed property (unhedged) and Australian listed property fared better this year by 1.2%, 1.4% and 2.3% respectively.
› Overall, this led to slightly better results for the balanced and growth sample managed funds this year.
Figure 1 – Comparison with last year’s gross returns: 10 years to December 2017 vs December 2016

* Only the before-tax returns have been calculated.

Note: All returns gross of tax and costs. Past performance is not a reliable indicator of future performance.
Compared to last year’s report, the results for all asset classes (except Australian shares) for the 20 years to 31 December 2017 were weaker than the 20 years to 31 December 2016, contributing to lower returns across the sample managed funds overall, as shown in Figure 2. This reflects the lower returns from listed share, property and fixed income markets in 2017 compared to 1997.

Figure 2 – Comparison with last year’s gross returns: 20 years to December 2017 vs 2016

Note: All returns are gross of tax and costs. Past performance is not a reliable indicator of future performance.

Full details of the 10 and 20 year results to 31 December 2017, including the impact of tax and gearing, can be found in Appendix 1.
The “journey”: Details year on year

While the headlines are helpful in summarising the long term “start to end” results to a specific date, tracing through exactly how these results were achieved year on year reveals some interesting lessons which may present investors with opportunities to enhance risk/return outcomes going forward.

Figure 3. shows the best and weakest annual performance by calendar year for the last 20 years to 31 December 2017 on a gross of fees and taxes basis. It shows that the “winner” for each calendar year changed significantly year on year. For example, highlights include:

- **Australian residential property** took the top spot in 2001 and 2002, but also came last (below cash and Australian bonds) in 2004 and 2005. Moreover, last year, residential property underperformed global shares hedged by more than 10%.

- **Global (hedged and unhedged), Australian shares and Australian listed property** rankings fluctuated the most, taking both top and bottom spots year on year, reflecting the higher risks in these asset classes.

- **Global and Australian fixed income rankings** were less volatile, but still changed from year to year.

- The multi-asset portfolio (represented by the 70% sample growth fund) experienced the most consistent ranking, enjoying 19 out of 20 years of positive returns.
All returns are gross of tax and costs. Past performance is not a reliable indicator of future performance. See Appendix 2 for index data sources.
A bumpy ride: Predicting next year’s winner

Presented by these short and long term observations, it may seem logical to try to predict next year’s winning asset class and switch investment strategy every year (or more frequently). However, Russell Investments’ research and analysis shows investors generally tend to reduce their likelihood of achieving higher return outcomes by chasing last year’s winners or adopting other strategies based on their predictions. Some key observations from our research:

» If an Australian investor switched to follow the previous year’s winner each year, they would be 29% worse off compared to staying invested in a sample balanced fund return throughout the last 20 years to 31 December 2017.

» Based on our US analysis, the average equity investor’s inclination to chase past performance, would have underperformed the Russell 3000 Index by 1.8% annually in the 34 year period from 1984-2017.

» Investors often exhibit some common behavioural biases which have negative implications for their portfolios. Examples of these are summarised below.

Full details of each bias and the counterproductive investment strategies they can lead to, can be found in Russell Investments’ “How to avoid common behavioural biases and their detrimental impact on investor portfolios”, June 2018.
The smoother journey: Staying invested in diversified portfolios

A strategy that diversifies across multiple asset classes and relies on different types of return drivers\(^1\) is expected to provide investors with a smoother journey year on year, while increasing the likelihood of achieving their longer term goals. While certain risk/return patterns are expected for higher risk assets versus lower risk assets (e.g. shares to outperform bonds and cash) over the longer term, these may not always hold true in shorter investment time horizons and at entry/exit timings during particular points in the market cycle\(^1\). Specifically, it is important to manage sequencing risk - the order and timing of investment returns year on year (or more frequently). This is especially poignant for investors with less flexibility or more uncertainty about when they need to liquidate their investments (such as those close to retirement).

Investors selecting between diversified portfolio options should consider the following observations:

» Do It Yourself (DIY) versus dynamically managed multi-asset portfolios:
  » **DIY portfolios** tend to be more domestically oriented and exposed to less liquid assets\(^5\).
  » **Dynamically managed multi-asset portfolios** tend to be more globally diversified, across a range of different investment strategies and return sources. They tend to more quickly implement changes to asset allocations as a response to significant market and geo-political events due to the level of capital markets and implementation resources available\(^5\).

» Risk profile versus real return target funds:
  » **Target risk profile funds.** The investor’s appetite for investment risk determines the level of risk assets in the funds, e.g. select from lower risk conservative funds (e.g. 30% allocation to risk assets) or higher risk balanced or growth funds (70% allocation to risk assets) depending on the level of risk and time horizon the investor is able to tolerate.
  » **Target real return funds.** These tend to be more dynamic in asset allocation changes as market conditions evolve and are focused more on achieving absolute returns above inflation, with a focus on managing downside risk.

**HOW COMFORTABLE IS YOUR INVESTMENT JOURNEY? WHAT DO YOU CONSIDER SUCCESSFUL INVESTING?**

Yes, it’s about long-term results. But, at Russell Investments, we believe it’s more than that. Managing the year to year (month-to-month and more frequent) fluctuations in asset values is equally important. Whether it’s a bumpy or smooth ride in the short term can impact the ability of your investment strategy to achieve your desired outcomes. So, as well as noting the long term asset class winners, it’s just as important to recognise the potential behavioural biases when you try to predict next year’s leaders. We believe one of the best ways to overcome these and the detrimental impact on your portfolios is to stay invested in diversified multi-asset portfolios according to your risk and return objectives.

The journey matters as much as the destination. Where are you today on your investment journey?

For more information, visit russellinvestments.com/au/solutions/multi-asset-funds
Appendix 1

For the 10 years on a gross of fees and tax basis, residential property was the top performing asset class, followed by global shares (hedged) and global fixed income (hedged), while Australian listed property, cash and Australian shares were the bottom three asset classes, as shown in Figure 4.

Figure 4 – Comparison across asset classes on a before-tax basis: 10 years to December 2017

* Only before-tax returns have been calculated. See Appendix 2 for details on how these sample funds are defined.

Note: All returns are net of gross of tax and costs costs. Past performance is not a reliable indicator of future performance.
For the 20 years on a gross of fees and tax basis, residential property was the top performing asset class, followed by Australian shares, global shares (hedged) and global listed property (unhedged), while cash, global shares (unhedged) and Australian fixed income were the bottom three asset classes, as shown in Figure 5.

Figure 5 – Comparison across asset classes on a before-tax basis: 20 years to December 2017

Note: All returns are gross of tax and costs. Past performance is not a reliable indicator of future performance.
The rankings for each asset class change slightly on a net of tax and costs basis, but the overall picture is similar, as shown in Figure 6 and Figure 7 for the 10 and 20 years respectively.

**Figure 6 – Comparison across asset classes taking into account tax and costs: 10 years to December 2017**

Note: Past performance is not a reliable indicator of future performance.
Appendix 1

Figure 7 – Comparison across asset classes taking into account tax and costs: 20 years to December 2017

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Gross return</th>
<th>AfterTax Lowest Marginal Tax Rate</th>
<th>AfterTax Top Marginal Rate</th>
<th>Super</th>
<th>CPI</th>
<th>CPI+3.5% : 6% p.a.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aust Shares</td>
<td>8.8%</td>
<td>8.8%</td>
<td>7.2%</td>
<td>6.7%</td>
<td>6.1%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Residential Investment</td>
<td>9.0%</td>
<td>8.9%</td>
<td>7.2%</td>
<td>7.6%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Property</td>
<td>9.0%</td>
<td>8.9%</td>
<td>7.2%</td>
<td>7.6%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Aust Listed Property</td>
<td>7.0%</td>
<td>7.0%</td>
<td>6.1%</td>
<td>7.0%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Aust Fixed Income</td>
<td>6.6%</td>
<td>6.6%</td>
<td>6.1%</td>
<td>6.1%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Global Fixed Income (hedged)</td>
<td>6.2%</td>
<td>6.2%</td>
<td>5.8%</td>
<td>6.1%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Cash</td>
<td>6.4%</td>
<td>6.4%</td>
<td>6.1%</td>
<td>6.2%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Global Shares (Hedged)</td>
<td>6.4%</td>
<td>6.4%</td>
<td>6.1%</td>
<td>6.2%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Global Shares (Unhedged)</td>
<td>6.4%</td>
<td>6.4%</td>
<td>6.1%</td>
<td>6.2%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
<tr>
<td>Global Listed Property (unhedged)</td>
<td>6.5%</td>
<td>6.5%</td>
<td>6.1%</td>
<td>6.2%</td>
<td>6.2%</td>
<td>6.3%</td>
</tr>
</tbody>
</table>

Note: Past performance is not a reliable indicator of future performance.
Similarly, the gearing analysis shows Australian residential property outperforming Australian shares, with 50% leverage enlarging the differentials for both the lowest and highest marginal tax rates. For the 10 years to 31 December 2017, gearing caused the levered returns from Australian shares to become negative for both tax rates due to the weak returns from Australian shares for the last decade, as shown in Figure 8.

**Figure 8 – Comparison with and without gearing: 10 years to December 2017**

![Graph showing returns with and without gearing](image)

**Note:** All returns are net of costs. Past performance is not a reliable indicator of future performance.
For the 20 years to 31 December 2017, levered returns from Australian shares remained positive, as shown in Figure 9.

**Figure 9 – Comparison with and without gearing: 20 years to December 2017**

*Note:* All returns are net of costs. Past performance is not a reliable indicator of future performance.
Appendix 2

This analysis has been conducted on the following basis

**Investment comparison**
- All investment returns are determined after taking into account expenses relating to the acquisition, management and disposal of the asset. **Gross returns** are calculated before tax but after costs. **Net returns** allow for the taxation treatment of each investment over the period of the analysis. This aims to represent a realistic method of comparing the different asset classes for an investor.
- **Compound returns** are calculated over a 10-year period from 1 January 2008 to 31 December 2017 and over a 20-year period from 1 January 1998 to 31 December 2017. The returns are equivalent to the per annum compound returns that investors would have received for an investment in the particular asset class if they invested in an equivalent portfolio over the two periods.

**Income tax**
- The lowest and highest marginal tax rates are currently 19% and 45% respectively, as quoted on the Australian Taxation Office website. These rates have varied slightly over the 10 and 20 years due to changes in taxation policy. These variations have been taken into account in the calculation of after-tax returns.
- The calculation of after-tax returns is also inclusive of the 2% Medicare levy, which brings the applied lowest and highest marginal tax rates to 21% and 47% respectively.

**Capital gains**
- Generally, assets acquired on or after 20 September 1985 are subject to the capital gains tax provisions. For 10- and 20-year returns, capital gains tax is calculated on the initial investment and any subsequent reinvestment of income. Cash is not subject to capital gains tax, as all gains are taxed as income and subject to marginal rates. For ease of calculation, and in the absence of Australian bonds coupon and capital data, the report assumes returns from Australian bonds are treated as income.
- Assets acquired prior to 21 September 1999 and held for longer than 12 months can be assessed for capital gains tax in one of two ways. Private investors can choose to pay capital gains tax (at their marginal tax rate) on 100% of the capital gain (with indexation of the tax cost) or 50% of the capital gain (with no indexation). In this report, we have presented sector returns based on the calculation method that provides the higher after-tax returns. The discounted capital gain method (as opposed to indexation) has provided the higher after-tax returns in all cases.

**Capital losses**
- **Capital losses** may be carried forward indefinitely and offset against other capital gains in future periods. We have assumed that the investor has other investments – either today or in the future – that have produced or will produce capital gains against which capital losses may be offset.

**Imputation credits**
- Since July 2000, low-tax rate investors with imputation credits remaining after offsetting all tax have been able to claim back the excess as a refund from the Australian Taxation Office. Prior to this, the excess could only be offset against income tax from other sources. We have assumed that, before July 2000, the investor had other sources of income against which to offset this excess.

**Gearing**
- After-tax returns with **gearing** have also been calculated for Australian shares and residential investment property over the 10-year period from 1 January 2008 to 31 December 2017, and over the 20-year period from 1 January 1998 to 31 December 2017. Half of the initial investment is assumed to be borrowed, and gearing arrangements are assumed to involve interest-only loans (that is, periodic payments do not include any repayment of principal). In addition, allowance is made for the deductibility of interest costs.
- **Borrowing costs** are based on data from the Reserve Bank of Australia (RBA) bulletin. The borrowing costs for residential investment property are based on the standard variable rate for housing loans. The borrowing costs for Australian shares are based on the margin loans rate.

**Superannuation**
- The investment earnings of a complying superannuation fund or retirement savings account have been taxed at a rate of 15% as of 1 July 1988. Prior to this, there was no tax on superannuation earnings. The capital gains
tax discount for superannuation funds is one-third of the capital gains included in a superannuation fund’s assessable income. The tax that a superannuation fund pays on its assessable income (earnings and taxable contributions) can be reduced by using imputation credits.

\[ \text{The investor is over the age of 60 when assets are redeemed, so no tax is payable on a superannuation lump sum or income stream benefit payments.} \]

### Investment measures

- **The residential property** measure is a population-weighted average return calculated across major capital cities. Increases in value are based on median house prices obtained from the Real Estate Institute of Australia. Data from the Australian Bureau of Statistics is used to make adjustments for capital improvements. Net rental income allows for vacancy rates, maintenance expenses, management fees, government charges, land tax and insurance. Acquisition and disposal costs include conveyancing, stamp duty and agents’ fees.

- **The cash** measure is based on the Bloomberg AusBond Bank Bill Index.

- **The Australian shares** measure is based on investment in listed shares, with price movements and dividend reinvestment consistent with the S&P/ASX All Ordinaries Accumulation Index. Allowance is made for brokerage and stamp duty (where applicable) on acquisition and disposal. Stamp duty ceased to apply from 1 July 2001 for transfers of marketable securities quoted on the Australian Securities Exchange. Dividend franking is taken into account in determining the impact of tax on dividends.

- **The Australian bonds** measure is based on investment in Australian Government and corporate bonds. Returns are derived from the Bloomberg Australian Bond Composite 0+ Yr index. For ease of calculation, and in the absence of available data, price movements and coupon payments are both deemed to be taxed as income.

- **The Australian listed property** measure is based on the returns implied by the S&P/ASX 300 Property Trust (Accumulation) Index. Acquisition and disposal costs, such as brokerage and stamp duty (where applicable), have been factored into the return calculations. Assumptions have been made with respect to the tax treatment of listed property income, including the component of tax-free income (abolished in July 2002) and tax-deferred income.

- **The global shares (unhedged)** measure is based on investment in listed shares with price movements and dividend reinvestment consistent with the Russell Global Large Cap Index (unhedged) in Australian dollars from 1997, onwards and the MSCI World ex-Australia Gross Dividends Accumulation Index (unhedged) in Australian dollars prior to 1997. Allowance is made for brokerage on acquisition and disposal. Withholding taxes are used to offset Australian taxes in the year the dividends are received.

- **The global listed property** measure is based on dividend reinvestment consistent with the FTSE EPRA/NAREIT Developed Index in Australian dollars (unhedged). Allowance is made for brokerage on acquisition and disposal. Withholding taxes are used to offset Australian taxes in the year the dividends are received.

- **The conservative managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 25%–35% growth assets. Growth assets include Australian shares, overseas shares (hedged and unhedged) and property. After-tax returns are not calculated due to lack of data on distributions.

- **The balanced managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 65%–75% growth assets. After-tax returns are not calculated due to lack of data on distributions.

- **The growth managed fund** measure is based on investment in an indexed managed fund with an asset allocation consistent with the industry average for funds that have between 75%–85% growth assets. After-tax returns are not calculated due to lack of data on distributions.

- **The global bonds** measure is based on investment in investment grade global fixed income. Returns are derived from the Bloomberg Barclays Global Aggregate Bond Index. For ease of calculation, and in the absence of available data, price movements and coupon payments are both deemed to be taxed as income.
End Notes

1 Case study is for illustrative purposes only and are not indicative of actual performance over the quoted period. Sources for the asset classes and sample balanced portfolio are as follows: Australian shares: ASX All Ordinaries Accumulation Index. Australian bonds: Bloomberg Australian Bond Composite => Yr Index. International shares: Russell Investments Global Large Cap Index (MSCI World Net Dividend Reinvested Accumulation Index in AUD prior to 1997) and International shares hedged: Russell Investments Global Large Cap index – AUD Hedged (MSCI World ex Australia Net Dividend Index (hedged) from Jan-98 to Feb-99, Russell Developed Large Cap AUD Hedged (Net) from Mar-99 to Dec-06). International bonds hedged: Barclays Capital Global Aggregate SA Hedged (formerly Lehmann Bros Global Aggregate Index $A Hedged). Prior to 2002, Salomon Smith Barney World Government Bond Index $A Hedged. A-REITs: S&P/ASX 300 A-REIT Index (ASX Property Trust Accumulation Index prior to 31 March 2000). The sample balanced portfolio is hypothetical only and is calculated by a weighted average of the asset class index returns. Case study performance calculations are based on geometric averages.

2 "Average" US equity investor is based on general cash-flow trends as measured by the Investment Company Institute (ICI) compared to the market’s overall performance. US mutual fund data was used as robust global or Australian historical data is not currently available. Source: BNY Mellon Analytical Services, IIFIC, Russell Investments. Based on annualised returns from January 1, 1984 to December 31, 2017. Return was calculated by deriving the internal rate of return (IRR) based on IICI (Investment Company Institute) monthly mutual fund net new cash flow data which was compared to the rate of return if invested in the Russell 3000 Index and held without alteration from January 1, 1984 to December 31, 2017. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. For more details, see Russell Investments’ “Why do I need financial advice?” March 2018.

3 Low correlations with traditional shares and fixed income assets.

4 For example, when investors invest or withdraw from assets at market peak/trough extremes which represent the point of maximum risk/opportunity respectively. For more details, see Russell Investments’ “Cycle of market emotions” 2018.

5 For more details, see Russell Investments’ “A tale of two investors” June 2018.