Speaker 1: Hello, and welcome to the CPA Australia podcast, your weekly source of business, leadership, and public practice accounting information.

Murray White: Well, welcome to CPA Australia and Pitcher Partners podcast series for not-for-profit sector. In this five-part series we discuss some of the key issues for those working in the not-for-profit space, covering a different topic with each podcast. Today's topic is the fourth in the series, moving beyond cash, increasing returns without taking unnecessary risks. My name is Murray White and I'll be hosting today's podcast.

Murray White: A little bit about me. My accounting career began in 1972 and since then I've gained considerable experience in wealth management and retirement consulting. I was appointed chairman of CPA Australia's Superannuation Centre of Excellence, a position which I held for nine years. And I've represented the industry at national government level, helping develop and implement superannuation policy and legislation. I've also had the pleasure of appearing before the Australian Senate select committee on superannuation and been an expert witness representing the accounting profession.

Murray White: I've been fortunate enough to be rewarded for leadership in 2000, when I received the Henry Fox award. It's presented to public accountants for outstanding service to public practice. In 2004, I also won the President's Award and the Charles Holmes Medal. With me today to talk to about moving beyond cash, is our presenter Andrew Gillon.

Murray White: Andrew is a director/senior advisor in the investment advisory practice of Pitcher Partners. He joined the firm in 2015, after gaining over 15 years experience in investment and finance, mostly with Deutsche Bank where he acted as a portfolio manager in the Multi-Asset Group. Andrew is responsible for providing strategic and technical asset allocation, portfolio construction, together with investment advisory and management services to private clients, business owners, family groups, not-for-profit organisation, and institutional clients. Andrew is a former panel member of the Financial Ombudsman Service security section and sits on the investment committee of a not-for-profit organisation.

Murray White: Welcome, Andrew. Now firstly, what is cash? And as an investment, what are the key characteristics?

Andrew Gillion: Thanks, Murray. And it's great to be here. Firstly, the most important aspect of cash is that cash is still king. And I think that's really important in the context of not-for-profits, because, well, not-for-profits approach the treatment of cash in different ways. One of those ways, and what we're discussing here today, is that cash can be considered either a short-, medium-, or long-term asset or investment. Secondly, we'll be discussing whether it is a secure investment. In Australia, we would consider cash to be possibly the most secure investment. However, recent events in the last 10 years, even, globally, it may not been as secure in the bank as it once was.

Andrew Gillion: Thirdly, cash, from our point of view, should be considered part of any strategic asset allocation for a not-for-profit. But the flip side to that, of course, is that some not-for-profits may consider capital preservation, which the height of capital preservation would be cash. So these are all discussions that most not-for-profits will have around an investment in cash.

Murray White: Most people understand what cash is. It's the folding dollar bills. What impacts on that value?

Andrew Gillion: Look, thank you for the question. The interesting thing about folding cash ... and it's no longer anymore. You tap it, don't you? But the most important thing with cash is, and the impact on the value of cash in anyone's back pocket, is the rate of inflation. If the rate of inflation is higher than the one dollar, the $1 coin in your pocket, and rising, then all of a sudden your actual value of cash is going backwards. And the key drivers of that underlying value of a dollar, or cash, are short-term interest rates or long-term interest rates. And significantly, sovereign risk. And I mentioned that earlier, that sovereign risk is a really key driver of the value of any dollar, globally. But, obviously, underlying inflation is where you preserve the value, or the real value, of that cash. People tend to forget that you might put your spare dollar in the bank. And sometimes, recent history would suggest that, and Europe's a great example of this, is that the value of your cash is actually going backwards, where we had negative rates in Europe. And it was an EU directive that the banks were not allowed to actually pass those costs on to the underlying depositor. Therefore, they actually were retaining the value of their cash, if they held it outside of the bank. Namely, under the mattress.

Andrew Gillion: So the key there was to get investment back into Europe. In Australia, of course, mostly our rate of cash or our interest rate associated with cash will come from the RBA's overnight cash rate, which currently sits at 1.5% and is really just an interest rate between banks on any given night, essentially. But the important thing there is that over time that rate of cash, that 1.5%, doesn't exceed, is actually higher, or in this case, lower, than inflation. So inflation's around 2%. The overnight rate of cash is 1.5. Therefore, technically, you should be slightly better investing cash. But that isn't always the case. Particularly, a couple of years ago when our inflation rate was about 1.5%. And when you have very little wages growth in this country, all of a sudden, you can see yourself ... or the investor in cash can see themselves going backwards.

Murray White: I don't think anyone would argue that we're in unprecedented, uncertain times. The current macro geopolitical events, the Trump effect for example. What type of returns do you think we can expect in these uncertain markets?

Andrew Gillion: Market events, macro events, and geopolitical events are in themselves inherently different events. And therefore, the return or the expected rate of return on cash, under any particular situation, will be different. I think the best way to look at, say, cash in a market event, is that there should be ... normally, for example, if you had a market correction, like a stock market crash, then that

may be a precursor to something like a recession. It may be that asset prices have moved higher and are unsustainable, therefore the market's come back and pulls back. And normally that would be under a situation where you've got rising interest rates as well. And in that situation then, all of a sudden, your underlying $1 that you have, has done particularly well in risk assets previously, but all of a sudden you've got a period of time where other asset classes are underperforming cash.

Andrew Gillion: So all of a sudden, that is just a pure investment decision. Sometimes it's a very short, or what we'd call a V-shaped recovery, in that instance. And a short allocation or movement into a cash investment can be opportunistic and work in your favour. The other side would be something like a GFC, where that was much more of a systemic risk issue. Well, it turned out to be a much more systemic issue than I think people realised at the time. And you put aside the Lehman Brothers and a few other financial participants shocks, I suppose the biggest impact to cash, during that period, was when the likes of Ireland put deposit guarantees, and actually therefore, in many ways, forced countries like Australia to do the same. In fact, we still have deposit guarantees in this country.

Andrew Gillion: And so therefore, that's where you ... in the old days, and I use that term loosely, but where we used to have, even here ... maybe we might be able to, Murray, remember with those run on cash at the state banks or whatever they were, 30 years ago. They happen. And they did happen in Greece. So the value of cash is really important. And from a systemic point of view, that leads directly into a geopolitical or sovereign risk that I mentioned before.

Murray White: These unknown unknowns can really happen. When there was the run on the state bank ... when I was a kid, I used to take my State Bank savings book to school, and they'd stamp it, and they'd put probably 2 cents, or 2 pennies, in it, at that stage. So it was really the emotional effect of the knock on ... well, not so much the economic effect. There was knock on of the emotion of the State Bank of Victoria goes belly up. It had to be saved by the Commonwealth Bank. And just to top it off, the State Bank of South Australia fell over at the same time. It really gets to these unknown unknowns. And what seems to happen in these situations, is that they're never on the front page of the Fin Review, you get unintended consequences. So when they took those bank guarantees and put them on, it caused a lot of the credit co-ops and credit unions to get into real strife, particularly in the regional areas in Australia. So on the one hand, they were putting in those guarantees, and on the other hand, they were causing people to lose their money because they were in second-tier type financial institutions.

Andrew Gillion: But we're seeing that now as well. Because now we're seeing a lot of the building societies are now gaining banking licences and they're actually becoming banks, because of the guarantee. And so we've seen a lot more of these smaller banks turn up. But I think from unknown unknowns, I think, when we pull this back into that not-for-profit discussion and about how so many of

these not-for-profits are essentially endowment funds, they are there for the long, long term, you can't just park cash and expect it will be there forever and a day. I mean, I think we are in a much, much better position than we ever have been. And to Costello's credit, he did put that macroprudential APRA coverage in it, over the top of the system. But it's like, even like a share, you say, "Oh, you must talk to a stock broker," and they say, "Oh, just put that one in the bottom drawer." Well, it's not real. And I think cash, even for with a 30, 40, 50 perpetuity endowment, they do need to think about cash. And it's something that they need to look at the environment around them and say, what are the market, macro, systemic, geopolitical risks associated with that. Now, we would say it's extremely low. But 1% is still a risk. And people forget that.

Murray White: Yeah. It's a trade off between being recklessly conservative and being reckless. And it's a fine line. And it really takes some judgement and prudential controls to make sure that you have got your governance systems in place, that they're appropriate with the current market conditions.

Andrew Gillion: Because it's just as important for a not-for-profit to recognise if the value, or the real value, of their investment in cash is going backwards. That is, potentially, just as damaging. And it's very important that they're conscious of that anyway.

Murray White: Andrew, what have the long-term, short-term returns been in Australia, on cash?

Andrew Gillion: Well, they have been better than most places on the planet for the last, or at least for a developed market AAA credit rating country on earth, over the last 10 years. So over 10 years, cash has broadly returned 3.2, 3.3 percent. 5 years too. And as you can imagine, it's come right down. Obviously, 1 year at about 1.8, because obviously the cash rate is at 1.5. And so that means that you are ahead of the cash rate. And I think it's really important that, even at, let's call it 2% over the last, say, three years, .5 on 1.5 is essentially a 25% out-performance of the cash rate. And thereabouts, inflation somewhere between one. So you're slightly ahead, but on a relative basis, you are quite a fair way ahead, in some respects. So I don't mean to say that 1.8% is small. But versus 1.5% on a relative basis, it's pretty good. However, I think when it comes to returns on cash, when you compare it to Europe, as I said, short-term cash rates negative, US, 0, Japan, I mean, Japan's been 0 for, what, 10 years, maybe even more. So the value of real assets have gone backwards in most developed countries, but they haven't here. And cash is still, essentially, on a developed market AAA rated basis, a high-returning interest rate country.

Murray White: Yeah. And I guess that is the investment challenge, with rates being so low. If you look at the late 80s, when interest rates got to 17, 18 percent, 27% on bank card, life was easy. Put the money in the bank and get 17% return. What's the problem? But today it's a real challenge. So if you want to improve those returns above that cash rate, because, in reality, you're not going to get rich quick getting 1.83% return on your money a year, what considerations do you think you should have?

Andrew Gillion: In the not-for-profit context ... and I do stress that it's not always just related to not-for-profits. The average household budget needs to consider these things as well. As you suggested, you could put your own money in the bank at 17% back in the 80s. But look, you've still got to come back to the very basics of, what is your expected or preferred risk and return objective, versus the most, well, considered secure investment in cash. And that'll vary. Some people are inherently risk averse and some people aren't. Some people like taking risk. And also, in this environment, we've seen this happening a little bit, over the last five years, volatility in this market has reduced quite a lot. However, in, I suppose ... we won't say it's since Trump, because it's actually not really. It was when interest rates started moving up, probably about six months before Trump got in, that volatility's also started moving.

Andrew Gillion: And, of course, cash isn't volatile like other asset classes. So, basically, we would expect, you've got to look at your, I suppose, your attitude to volatility. Can you sleep at night, comfortably, knowing that you're actually stepping outside of cash, or any investment out of cash. And increasing, what we're talking about, nowadays, other things to consider outside of returns of cash, are things that asset class correlations. I suppose it's a discussion that we've been increasingly having in this low interest rate environment, where can we go get a return above cash that doesn't necessarily act in the same way as shares, bonds, or cash, or property. That's something that we're looking a lot more at. So, on the whole, we're constantly looking and talking to our not-for-profit clients, around what is their real attitude to risk, and how comfortable are they stepping away from cash.

Murray White: I guess the next issue is the risk-return trade off. There are alternatives to cash. But, inherently, they come with volatility and risk.

Andrew Gillion: Absolutely right. Once you step outside of cash, you are entering a investment world, where you must ... at least in Australia's case, maybe not in Ireland in the last 10 years, but in the Australian case or the US, you are stepping into a more risky environment, regardless of where you think you're going. It doesn't matter whether you're stepping into US treasuries or German bonds. It doesn't matter whether you're stepping into enhanced credit products, which are basically just an active manager who's running a book of term deposits or other things that are taking different duration and the like. So the moment you do step outside of that cash or bank, you are inherently entering a world of volatility.

Andrew Gillion: That said, when you look at something like US treasuries, 10 year treasuries, which is where, basically, all global evaluations are based off, and the risk associated with a AA+, rather than AAA, nowadays, US government, you're not really taking on ... data would suggest you are taking on more risk. But markets would probably argue that you're really not stepping that far away from what is essentially a risk-free asset. However, the data tells you it is more risky than cash. It's just as simple as that. It's just a fact. So we would advocate that allocations, as we said before, that a strategic asset allocation to cash is essential. And they're stepping outside of that, therefore you can go into slightly

higher returns with slightly higher volatility and slightly higher risk into government bonds. Australian government bonds, generally global government bonds, mostly US maybe. Look, even Nestle had negative interest rates on its debt at the height of the GFC. So Nestle was perceived to be more secure than the US government.

Andrew Gillion: So these things are all generally baked into an investment decision. And they're definitely decisions that all not-for-profits should have, because they can, in certain circumstances, provide ... They do provide income. And they can, in certain circumstances, provide capital appreciation. But you need to weigh up the pros and cons of that capital appreciation or loss, over any given period.

Murray White: That's the risk, isn't it? In a rising interest rate environment, you have a capital loss on the bond that can make the differential on the interest rate look hardly a good bet at the time.

Andrew Gillion: Absolutely. And I think people sort of ... It's really important to point out that ... I don't even know the stat, and I'd love to refer to the appropriate website, but I think you need to remember that global bond markets are, what, 10, 15, 20, 30 times bigger than equity markets, if not more. So they are a key driver of where cash rates, where global interest rates, will be going. And, really, sometimes, risk assets like equities are bystanders. And, really, that pure cash and US treasuries are the drivers of underlying value in assets.

Murray White: I guess, some of the credit funds, the real trick is to dig down and see what the underlying substantiation of the asset is. History tells us that some of the mezzanine financing and some of the Ponzi-type arrangements are out there globally, that no one sort of knew much around till they blew up. So it really is the secret, isn't it, to get to the bottom of the underlying asset, just make sure the quality's there.

Andrew Gillion: And I think, we always stress, at Pitchers, that a lot of the not-for-profit investment committees and their investment policy documents may often stipulate that they must be investment grade. That's often written into their schedule of investment policy or their approved investments. Sometimes, though, there is a need for a discussion with the not-for-profit, that just because something is not investment grade, doesn't mean it's not seeing your debt in a really well-run business. It just means that they haven't gone out to get a credit rating from S&P. So you can have some fantastic businesses in Australia, and seen your debt associated with covenants, or whatever it is, on the underlying asset, and they can't invest in them. And that's often a discussion in advisory panels or investment committees, because there is a wealth of investment opportunities that are not so much ... they're not secure. But they're very highly rated investments that will give you better returns in cash.

Murray White: Yeah. I guess, in the debt space, if you're looking for some of the second-tier debt, it's really a risk assessment to see what the volatility is in the marketplace, and how that's being priced relative to the books that you're buying. Because

sometimes there's a bit of a capital gain that can be picked up there. Is that right?

Andrew Gillion: Absolutely right. Yeah. Absolutely. And digging down into the actual underlying investments and assets is absolutely essential. And the advisors or research teams will do that. I mean, in our case we're fortunate enough to have that. But, yes, digging down is often not that hard. And often they will give you that information.

Murray White: Yeah. Sometimes during the cycle there can be some real opportunities.

Andrew Gillion: There certainly can. Absolutely. And, again, you can build into this whole ... the Royal Commission or we can build in other macroprudential and regulatory issues that are going on here, that create periods of mispricing, and the banks can't go into this area because of the regulatory or perceived regulatory constraints. And therefore, other types of financial institutions pick up that slack. And, as you suggested, there's some real quality in there, and mispricing, and there are opportunities. And these are things that we do try to communicate to clients and-

Murray White: Just in terms of that mispricing, sometimes there's opportunities around duration, that the various sectors are priced in quite strange ways. You can actually have a very solid investment at a different duration with a higher market.

Andrew Gillion: Yeah. Sure. Of course. I mean, duration is one of the key drivers of any sort of pricing in the debt market or interest rate market. So we would argue that you've probably ... you'd have short-duration most investments at the moment, because you're probably not getting paid, at the long end, enough to hold five, six, seven year debt. However, as I said, if you've got an extremely well-run business that is issuing paper or debt for seven years, well, those opportunities can and do arise.

Murray White: A lot can happen in seven years.

Andrew Gillion: A lot can happen in seven years.

Murray White: How do you know when you're getting it right if you step away from cash?

Andrew Gillion: How do you know if you get it right? For starters, everything is on a risk-adjusted basis. So never ever do we advise not-for-profit investment committees to make decisions that is either against their intended risk or return profiles. But how do you know if you're getting it right? You know you're getting it right if you're achieving their underlying goals, you're achieving their risk metrics, you're achieving their underlying return objectives, and increasingly, you're not stepping outside of the risk profile in order to get it. And so that's where we would always argue that diversification is key. And understanding the

underlying ... as you alluded to before, about digging down into the underlying asset itself. I don't think you can make poor decisions if you have more information. So that's a benefit-

Murray White: Yeah. There's a real challenge. How do you know whether you're actually getting the balance between risk and return right? Whether you're accepting those lesser interest rates or whether you're being too aggressive in the market for a disproportional amount of risk, how do you know when you're right?

Andrew Gillion: Look, that's a really tough question to answer, because I think, as we know, markets will drive asset prices, they will drive the return outcomes. And sometimes, particularly when you step outside of cash, you just have to be patient. You have to make sure you are not overpaying for something that's going to penalise you in the future. And as we discussed earlier, is that interest rate sensitivities can actually have huge impacts on the underlying capital value of an investment. So how do you know if you're getting it right? You know you're getting it right when the not-for-profit is, over the cycle, three to five, seven years, they're achieving their long-term investment return objectives. They're actually achieving and not exceeding their maximum risk objectives. And these can be measured. And another key part of that is actually, obviously, diversification and increasing, in our case, looking for correlations.

Andrew Gillion: But, you're right, within those product suites that are outside of cash, which is normally a form of fixed interest, often it is just making sure that the analysis, the research, that is done, and deep dive into the underlying product, provides sufficient comfort that you're not. Because I don't think you can always guarantee, in this market, where I do believe that there is a pricing differential between retail and institutional. And for every, let's call it a hybrid security or a bond fund that you buy, there's a cost associated with buying that, if you're a mum and dad investor versus an insurance company that's got several billion dollars. So it's not always easy. You just got to make sure in the long-term you achieve your long-term return objectives.

Murray White: So in this low interest rate, highly destructed world markets, which are extremely volatile, is cash a good investment?

Andrew Gillion: Yes. In fact, we would say, at Pitcher Partners, right now, we're of the view that with volatility, that it is a keep the powder dry, it's an accumulate. There's no reason why you can't be accumulating the current reporting season and the dividends that come through, because we think that as volatility increases, and you've alluded to it, then there will be other opportunities to invest into other asset classes, outside of cash, probably over the next six months. Therefore, yeah, there's no ... In the short term, we're reasonably comfortable holding cash and accumulating cash in the current environment.

Murray White: Well, thank you, Andrew, for your expert insights. I'm sure we've all discovered much more about moving beyond cash, and the secret to increasing returns without taking unnecessary risk. Thank you to all our listeners for tuning into

CPA Australia Pitcher Partners broadcast series, on the not-for-profit sector. Please join us next time for a discussion on how to run an investment tender, another important topic for this sector.

Andrew Gillion: Thank you, Murray.

Speaker 1: Thank you for listening to the CPA Australia podcast. To download the transcript and to access the show notes for this episode, please visit www.cpaaustralia.com.au/podcast/86.