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This Week's Top Articles

Super funds fail clients by not reporting retirement income

Bev Durston

Over the past 20 years, I have been managing a variety of government and industry superannuation and pension funds in Australia, Singapore and the UK. Returning to Australia last year after a seven year contract in the UK, I have noted some shortcomings in the way information about superannuation is reported to individuals.

The Australian superannuation system has an excellent reputation as one of the most successful for ensuring the majority of the workforce automatically makes some provision for their retirement. Many countries have subsequently adopted some of these features into their own systems including the UK which implemented its form of Defined Contribution (DC) pensions, known as 'Auto-Enrolment' in 2012.

The early adoption by Australia of a DC system more than 20 years ago was a masterstroke of strategic vision and demographic awareness. In implementing DC, it allowed the private sector, the Federal Government and the individual states and territories to largely eliminate any link of retirement incomes with workers' final salary defined benefits (DB). According to APRA, the DB-only component of the super industry was only $70 billion as at June 2013 – a mere 4% of the asset base.

But one of the unfortunate consequences of moving to a DC system is that superannuation has become detached from any link to an income that the individual can expect in retirement.

Losing the link to salary

The original idea of a 'final salary' or DB pension scheme was simple for an individual to understand: the level of income in retirement would be linked to the salary they were earning whilst contributing to the scheme. There were technicalities about contribution rates, which salary (final or career average) would be paid and how overtime and other variable uplifts would be treated, but the basic notion had clarity and was easy to communicate.

In Australia, only a limited number of employers ever offered DB income streams. The market here generally had a 'lump sum at retirement' model which I believe is far inferior to an income stream. Contrast this with the benefit in the UK where a worker who had contributed to their pension beyond 20 years could expect to receive roughly two-thirds of their salary by way of a pension income after retirement. This income would typically be indexed to the cost of living and would last for the entire life of the worker. Whilst the provision of income in retirement was the responsibility of the employer, the individual always had a guideline for the level of income in retirement.

Under the current DC system in Australia there is no link with the projected income that a worker can expect to receive in retirement. **All** of the risks of achieving an adequate retirement income have been successfully passed onto the worker. These risks include, but are not limited to:

- longevity risk - how long will the individual live and need the income
- adequacy risk - building an adequate pool of savings to cover the income needed
- investment risk - the investment strategy adopted for the rest of their life
- drawdown risk - how much to draw on the pool of savings once the individual retires
- inflation risk - how to keep pace with any rise in the cost of living in retirement
- healthcare risk - what health care needs the individual may have in retirement
- provision for after-death – how much to leave and how to manage this.

The responsibilities of the individual under a DC system are daunting.

The need to report projected income from superannuation

At present there is limited free advice available to individual workers to assist them with these DC risks. Some employers provide independent financial advice, and most super funds provide some level of free advice but this often focuses solely on their own funds. Most individuals are not equipped with the right information from their super funds to make the best informed decision.

Super funds should provide improved reporting to aid members to make decisions about retirement. Each individual receives an annual statement showing their current superannuation accumulation balance. What is missing is the projected retirement income (in real terms, adjusted for inflation) compared to their current salary. In the DC world, inflation risk rests with the employee, and they need to know the value of their savings in current dollars.

Behavioural finance concludes that people feel content with a much smaller accumulated total than they actually need. As soon as an accumulated balance gets close to a multiple of salary (say three times average salary at $150,000) or close to the cost of the average property in Australia (say ten times average salary at $500,000) then individuals 'feel' wealthy and no longer focus on saving more.

This is inappropriate because these sums will not provide - even for a worker on average salary – sufficient income in retirement to live at the same level of comfort as when they were earning their salary. The salary-linked reporting provides the right information, despite the fact that it may not be a pleasing message for most workers.

Sound assumptions are required to prevent this being used purely as a marketing exercise. Good practice would be to establish a set of assumptions (i.e. on asset growth rates, retirement age, inflation) for use by every super Fund across the industry so that the projected income number is comparable across funds. In the UK for example, the Pension Regulator sets the assumptions for these comparisons and each annual pension statement has to show an expected income per annum assuming growth rates of 3%, 5% and 7% of the assets until retirement.

It is very useful for a 40 year old Australian who still has time to save more for retirement to be told that their projected income will be only 15% of their current salary adjusted for inflation. They have time to take corrective action, if financially possible.

Given that contributions are related to salary it seems strange that the accumulation pot size is given so much importance. The objective of the DC saving scheme is to produce an **income in retirement** for individual workers. A sceptic might suggest that super funds do not want to tell their members this vital piece of information lest they receive poor member feedback, or worse, cause members to switch to another fund. This can be addressed by using agreed industry-wide assumptions which are sanctioned by the regulator, APRA. But not giving this vital piece of information as early on as possible is letting the clients down.

Link to the employer's remuneration policy

Another hidden corollary of the current compulsory DC system is that employers have now 'switched off' from using pensions as a positive tool in their remuneration policy. Before compulsory superannuation, quality employers would use higher superannuation benefits as a method of enticing quality employees to work for them and to retain the loyalty of their existing staff.

Nowadays in Australia the opposite might be true – that superannuation might actually become a negative for remuneration policy. Since it is compulsory, superannuation is not considered a variable component of remuneration policy. And the requirement for incremental increases in superannuation contributions over time may actually 'backfire' on employees. A worker may feel they lose out because a potential wage increase may instead be allocated towards a mandated super payment. In this way real wage cuts are likely as superannuation contributions gradually increase.

Summary

The Australian super system has set the standard for governments to reduce their reliance on social security pension provision. But the individual worker has assumed significant responsibilities for the total management of their income from retirement to grave. Most individuals are relatively unaided and without the necessary reporting tools to correctly interpret data and make decisions. I find it startling that even today, most super funds do not report to their members a projected income in retirement.

Bev Durston has over 25 years' experience of implementing investment solutions for pension funds, sovereign wealth funds and fund managers. She recently relocated to Sydney and founded an advisory business for institutional clients, Edgehaven Pty Ltd. Bev has a first class Banking and International Finance degree from CASS in London, and a Masters of Applied Finance from Macquarie University.

Beware Division 293 tax on superannuation contributions

Monica Rule

Normally when I write articles, I try to minimise the technical jargon. However, this article is about the new tax on superannuation contributions, commonly referred to as the 'Division 293 tax', and I encourage you to use the same terminology.

At a recent meeting of SMSF professionals, there were many reports that clients were complaining about this law after receiving a 'surprise' tax assessment from the Australian Taxation Office (ATO) requesting payment due in 21 days. Before I explain all the nuts and bolts of this law, let me explain its purpose.

What is a Division 293 tax?

Division 293 tax is an additional 15% tax imposed on relevant concessionally taxed superannuation contributions (referred to as low tax contributions) made to superannuation funds (including SMSFs) by individuals whose income exceeds $300,000.

It has been easy to forget this law. It was originally announced in the 2012 Federal Budget as a "Reduction of the higher tax concession for contributions of very high income earners" and at the time wasn't actually referred to as the 'Division 293 tax'. The law did not pass until 28 June 2013 and while the commencement date was backdated to 1 July 2012, assessments only started being issued from January 2014.

The purpose of the law

The average income earner's marginal income tax rate is 32.5% (excluding the Medicare Levy). Superannuation contributions made for the benefit of the individual are taxed at 15%, effectively giving them a 17.5% tax concession. By contrast, very high income earners pay 45% tax on income over $180,000, effectively giving them a 30% tax concession. Division 293 tax applies an additional 15% tax to certain concessional contributions effectively diluting the 30% concession to 15%, in line with the concessions received by average income earners.

Income and contributions included in the $300,000 threshold

An individual will be liable to pay Division 293 tax if the sum of their income plus their low tax contributions exceeds $300,000. The ATO will use the following information from income tax returns:

- taxable income *(assessable income less deductions)*
- total reportable fringe benefits amounts
- net financial investment loss
- net rental property loss
- amounts on which family trust distribution tax has been paid
- superannuation lump sum taxed elements with a zero tax rate *(because it falls within the low rate cap amount).*

These elements are added together (except the superannuation lump sum amount, which is subtracted) to give the income amount.

To calculate an individual's low tax contributions, the ATO will use the following information:

- employer contributed amounts
- other family and friend contributions
- assessable foreign fund amounts
- assessable amounts transferred from reserves
- notional employer contributions, known as defined benefit contributions, when the fund is a defined benefit superannuation fund.

The above contributions are concessionally taxed within a superannuation fund. For Division 293 tax purposes they are known as low tax contributed amounts, and are equal to the low tax contributed amount *minus* excess concessional contributions. Therefore, low tax contributions do not include non-concessional contributions and concessional contributions that are subject to excess concessional contributions tax.

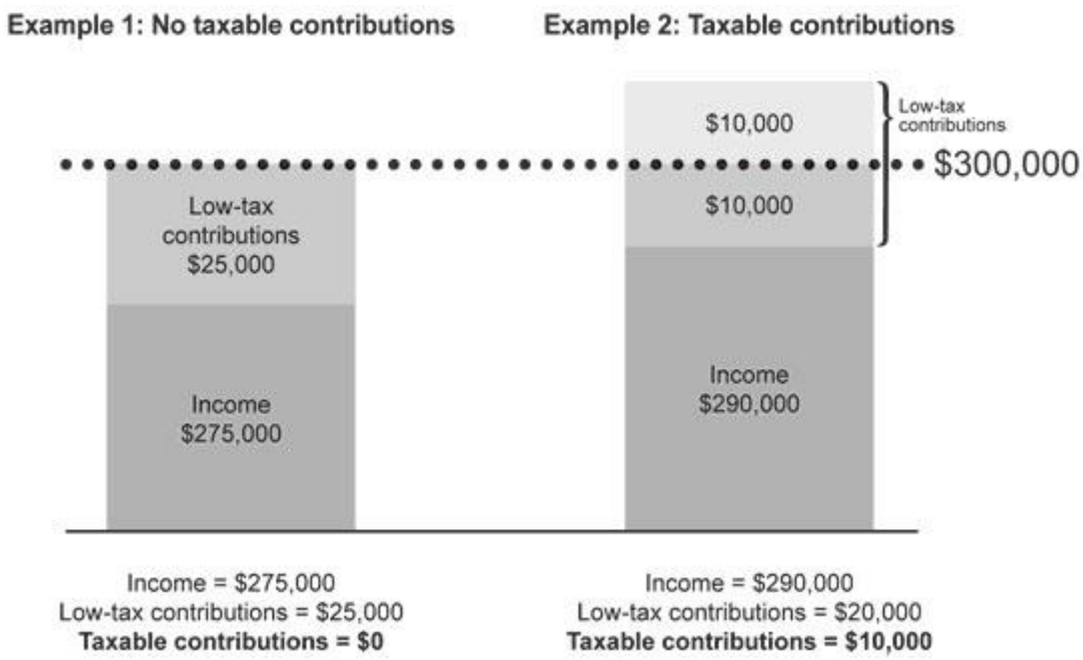
Division 293 tax of 15% will be charged on an individual's concessional contributions above the $300,000 threshold (up to the concessional contribution caps). There are special rules for members of defined benefit superannuation funds, constitutionally protected state higher level office holders, certain Commonwealth justices and temporary residents who departed Australia.

Division 293 tax calculation and assessment

To calculate the Division 293 tax liability, the ATO will:

1. Add the individual's income and low tax contributions.
2. Compare the amount from step 1 to the $300,000 threshold to identify any excess above the threshold.
3. Compare the low tax contribution amount and the amount from step 2. Take the lesser of the two amounts, which then become the taxable contributions.
4. Apply a 15% tax rate to the taxable contributions.

The following graphic, taken from the ATO's website, illustrates how the calculation works. In example 2, the amount of Division 293 tax payable would be $1,500 ($10,000 x 15%).



The Division 293 tax notice of assessment will state the total earnings for tax purposes, the taxable contributions and the amount of Division 293 tax that is due and payable by a set date which is generally 21 days after the ATO's notice of assessment was issued.

Individuals are responsible for paying their Division 293 tax. The following payment options are available:

- pay the assessed tax out of their own monies
- pay the assessed tax and then seek to reimbursement from their fund, or
- pass on the notice of assessment to their fund using a release authority to have their fund pay the tax on their behalf.

Using a release authority

Individuals can send a release authority to their superannuation fund or SMSF to have the money released. They can choose to have the entire amount or a partial amount released from one fund, or partial amounts released from a number of funds. To do the latter, photocopies can be made and presented to each superannuation fund, as long as there is an original signature on each photocopy and the total amount noted for release does not exceed the amount of the Division 293 tax. Released amounts can be paid to either the individual or directly to the ATO.

General Interest Charge (GIC)

Regardless of how one chooses to pay the tax, if the whole amount is not paid by the due date (21 days after the notice is issued), a general interest charge will start to accrue.

The ATO acknowledges that where a release authority is used, there may be timing issues as superannuation funds are allowed 30 days to process authorities. In these circumstances, the ATO will take this into account when considering applications for remission of GIC accrued during the superannuation fund's processing period.

Monica Rule worked for the ATO for 28 years and is a specialist SMSF adviser. Monica is running SMSF seminars at the Perth Convention and Exhibition Centre on 7 May 2014.

Pension eligibility age – the devil is in the detail

David Bell

Continuing my review of possible areas of pension reform I explore the potential for the pension eligibility age to be increased. The mainstream press reports that an increase in the pension eligibility age to 70 is likely. The obvious desires of such a policy are to increase workforce participation levels amongst the elderly and reduce government spending on the age pension. The real sting in such a policy would be if it were accompanied by an increase in the preservation age for accessing superannuation. Once again complexity reigns. I try to present a balanced argument of the reasons for and against an increase in the eligibility age.

See Cuffelinks for my previous articles on indexing and income test tapering.

Reasons to increase the eligibility age

The most obvious argument for increasing the pension eligibility age is fiscal sustainability. Such a change would partially redress the increasing dependency rate. By increasing the pension eligibility age people are encouraged to work for longer. This view is most strongly worded by the Productivity Commission's 2013 paper *An Ageing Australia: Preparing for the Future* where it states that older Australians *"are characteristically neither infirm nor inept"*. The modelling suggests that through to 2060 increasing the pension eligibility age would save about $150 billion in today's terms. Interestingly, the Productivity Commission is silent on superannuation preservation age.

The Harmer Review points to productivity benefits noting that longer periods in employment would contribute to higher national levels of production while providing employers with greater access to an experienced workforce.

Harmer makes a perhaps somewhat optimistic argument that increasing the pension eligibility age would actually result in higher standards of living. The logic is that older people will earn a higher income for longer, save more and not draw down on superannuation thereby having more to spend in retirement. There is a major assumption here that these people choose and can find work. This type of argument is purely an economic one which puts no value on leisure time, caring duties etc.

It is in the Henry Tax Review that reference emerges to aligning (gradually) the superannuation preservation age with an increased pension eligibility age. Henry notes a somewhat surprising statistic that approximately one third of superannuation savings are being drawn down before age 65 years. In Henry's words:

"*Allowing these savings to finance early retirement detracts from the sustainability of the system in two ways — by increasing the length of retirement and reducing the amount of savings available to fund retirement. Only compulsory savings that are carried through to retirement take pressure off pension expenditures, through the pension means test. Arrangements that encourage shorter working lives also reduce participation rates and place a greater tax burden on those who work."*

In short, Henry suggests that increasing the pension eligibility age is only a partial solution which has its own fiscal and social issues (the wealthy are more likely to be able to self-fund retirement from superannuation while others cannot). If the aims of any policy change are to increase participation amongst elderly and reduce age pension expenditure then a solution which combines an increase in both the pension eligibility age and the superannuation preservation age is more likely to succeed.

Reasons to leave the eligibility age unchanged

While the arguments for increasing the pension eligibility age are primarily economic, the arguments against are more social.

A commonly cited argument is the inability of elderly people to be active workforce participants. The Henry Review is cognisant of this noting that:

"*A number of studies find that health expectancies (the number of years spent in good health) have increased at a slower rate than life expectancy, indicating that the increase in the period that the average person could be expected to participate in the workforce would have grown at a slower rate than the growth in life expectancy*."

However a fair argument can be made that increasing the retirement age to 70 is still appropriate – indeed we are playing catch up with large increases in life expectancy compared to a pension eligibility age which, aside from an increase to 67 by 2020 (announced in 2010), had remained stagnant at 65 for 100 years!

There are nationwide social issues with employing the elderly. Sometimes there appears an expectation that people will retire, or at least scale back their hours, prior to retirement age. Some express a view that older workers are keeping jobs from the young.

There are also more nuanced social and structural issues regarding employment. For instance workers in hazardous and arduous industries may find themselves becoming unsuitable for those roles. Another issue will be dealing with workers whose cognitive abilities are in decline (cognitive abilities tend to decline from age 65). Employers may need to develop more workplace flexibility to accommodate the elderly and there are concerns around the ability of the elderly to successfully retrain.

Finally it needs to be acknowledged that many retired people continue to work and contribute, often through volunteer work or through caring for their parents or their grandchildren. Sometimes it is difficult for economists (and politicians) to place a value on these contributions.

So what did all the Reviews have to say?

The Harmer Pension Review was supportive of an increase in the pension eligibility age by between 2 to 4 years by 2050 (noting the pension eligibility age was 65 at the time of the Review). Harmer suggested that it may be appropriate to match the superannuation preservation age to the pension eligibility age but left further analysis on this issue to the Henry Tax Review (which was being undertaken in parallel). Harmer also outlined the need for Government attention to be directed to the training and retraining needs of older workers.

The Henry Review formalised the recommendation of aligning the superannuation preservation age with the pension eligibility age, but over a lengthy period of time (the two would align at 67 in 2024 and an additional review of the issue in 2020 to see if further age increases are required). The Henry Review highlighted the need for any changes to be implemented slowly as people may begin developing a retirement plan quite early in life.

The Productivity Commission focused primarily on increasing the pension eligibility age.

Summary

It is likely that the pension eligibility age will increase at some point in the near future, but it is the details that matter. For instance:

- Will the superannuation preservation age be aligned with the pension eligibility age? If yes then these changes will affect a much larger part of the population
- Over what timeframe will the changes be implemented? Hopefully a decent length (more than ten years) to allow people to adapt their retirement plans accordingly
- Will the Government commit expenditure to programmes that assist and champion the role of older people in the workplace?

It is easy to get caught up in the emotions of a single headline such as 'Pension eligibility age to become 70'. It is the full details of any changes which will determine if it is good policy or not.

David Bell's independent advisory business is St Davids Rd Advisory. In July 2014, David will cease consulting and become the Chief Investment Officer at AUSCOAL Super. He is also working towards a PhD at University of NSW.

Status, longevity and the age pension

Bruce Gregor

Policy makers seem to overlook the fact that people of higher socio-economic status have longer life times. Unfortunately, there is little data from Australia to study this effect. It requires greater study considering the impact on financial planning for the high socio-economic client and the topical issue of increasing the age pension entitlement age.

Until 2005, the UK Office of Statistics published separate mortality tables every five years for six different occupational classifications. This is the best public mortality data set available at a national level related to socio-economic status. The classifications range from Class 1 ('Professional') to Class V ('Unskilled'). The difference in average life expectancy from age 65 for these two classifications was 4.2 years for males and 4.3 years for females in the 2005 data. Since the first data in 1976, life expectancy increased more for higher status than for lower status.

There are a range of possible explanations. Unskilled occupations may have involved greater risk and lead to health problems in later life. Professionals may have developed better diet and health care habits that extend into later life. However there are deeper dimensions and career experiences within occupations.

Someone who has studied these deeper dimensions is Sir Michael Marmot. Originally from Australia where he graduated in medicine in 1968, he became an international expert in longitudinal studies of health and longevity. His book, '*Status Syndrome'*, published in 2004, is a comprehensive coverage of his work in a field that might be labelled psychosocial effects on health and longevity. My conclusions from Marmot's work are that whilst health status and income are significant determinants of longevity, differences in longevity in later life are also due to the level of autonomy and engagement people have enjoyed in their careers.

A first implication of these conclusions is that financial planners lucky enough to capture clients with these fortunate career attributes as well as financial self sufficiency, need to factor in a substantially longer life time (and future improvement) than population averages.

A second implication relates to how age pension policy is being managed. In current public debate it is an easy logic to argue something like "since the age pension started in 1909, average life expectancy has increased by 25 years so we need to keep updating the age pension entitlement age". Average life expectancy is a neat tool for this argument; however it ignores the dimensions around this average of people with different status.

For example, women now in their 50's and 60's who through child rearing and divorce may have had little opportunity to enjoy autonomous and engaging careers may have little in the way of superannuation and financial assets. Waiting until age 67 or 70 for the age pension, with limited employment opportunities and below subsistence unemployment benefits, is not a satisfactory situation. Similar arguments could be applied to manual workers who physically struggle to continue occupations past age 60.

A better approach to age pension reform than just increasing the eligibility age for all would be to apply a more sophisticated status and financial means test from say age 60. This could be blended proportionately with a different status and means test applying fully from say age 80. Full pension rates might be different in the age 60 and 80 formulae. This approach could accommodate full inclusion of home value and (non-annuitised) superannuation assets with greater public acceptance. Let's stop treating people as if they're all the same when they reach age 70.

Editor's Note: For additional material on this subject from the Wall Street Journal, 18 April 2014, see 'The Richer You Are, the Older You'll Get.'

Bruce Gregor is an actuary and demographic researcher at Financial Demographics and established the website www.findem.com.au.

Caveat Emptor: Lifetime annuities versus indexed bonds

A question from Kevin:

Given the Government's emphasis on promoting self-funded retirees and the likelihood of the pension getting harder to obtain in the future, it would seem prudent to plan on having our minimum (survival) needs covered by income that will not fluctuate with market waves, but will also adjust with inflation to provide continued long-term buying power.

I'm aware that Lifetime Annuities is one such vehicle, but actuaries are amongst the best mathematicians I know, so presumably the average person to take out a Lifetime Annuity will pay a premium for these products (only a very few will live longer than expected by the insurer) however what we get in return is peace of mind. However are there other ways to get the same peace of mind?

One alternate is Treasury Indexed Bonds, these are fairly easily traded now via the Australian Stock Exchange, presumably carry even less risk than Lifetime Annuities and have the added bonus of preserving your initial capital.

Would it be possible to do a comparison of the benefits/drawbacks of Lifetime Annuities vs Treasury Indexed Bonds from the perspective of providing a guaranteed income indexed for inflation over a 20-30 year period?

We asked Jeremy Cooper from Challenger to respond on lifetime annuities, and Elizabeth Moran from FIIG Securities to explain indexed bonds.

Response from Jeremy Cooper, Chairman, Retirement Income, Challenger

Kevin, in the space available, we are going to assume that a retiree needs a certain level of income, and is not solely focussed on expected investment returns. This secondary purpose can be served by the other (growth) assets in the portfolio.

As you note, a retiree should have minimum income needs covered by a cash flow (adjusted for inflation) that does not fluctuate with market gyrations. The age pension provides such a cash flow for life, but it's not enough. Most Australians have a minimum income need higher than the age pension, but will not have enough wealth to secure every dollar of income they will want in retirement in this way.

What are the advantages of using a lifetime annuity compared to Treasury Indexed Bonds (TIBs) to fill this gap?

A retiree's need for regular income lasts for their lifetime and won't abate when a TIB matures, requiring reinvestment. A lifetime annuity provides a layer of income, which can be paid monthly, quarterly or yearly, for life. While TIBs provide coupon payments quarterly, these cash flows are only for the term of the bond, with capital paid back at maturity. A lifetime annuity, in conjunction with the age pension, can provide the minimum income required for the life of a retiree.

It should be no surprise that to receive an equivalent level of income from a TIB which returns capital at term, you need a much greater amount of capital to begin with. While you might leave a greater bequest with this strategy, it is an inefficient use of capital and moreover, will reduce your age pension entitlements.

Consider a retired couple who would like $40,000 a year to spend. The current full age pension for a couple is $32,417 a year, so there is a relatively small gap to cover (ie $7,583 a year).

As at 23 April 2014, the September 2030 Treasury Indexed Bond was yielding a real 1.82%. At this rate, generating $7,583 a year would require over $400,000, meaning a full Age Pension would not be available. Generating $40,000 a year would require $2,197,802, a figure well beyond the means of the vast majority of households and one which completely excludes you from any age pension entitlement.

A lifetime annuity can deliver income to fill the gap at a lower cost than TIBs. Using the latest payment rates (as at 23 April 2014 and posted on the Challenger website) a 65-year-old male would need $174,724 to generate the required $7,583 (indexed to CPI) through a Challenger lifetime annuity; a 65-year-old female, $181,368. Splitting the cost of the annuity between the genders, the income could be generated with $178,046, which is less than the means test so the couple would receive a full age pension.

Because the lifetime annuity is cheaper than the TIB strategy, you will have more money to invest and leave your children, if leaving a bequest is an important goal. Research by National Seniors Australia among retirees indicates that a bequest is not a key issue for many people, due to awareness about greater longevity and the rising cost of living. Hence for many, an annuity’s ability to blend a capital return with an income payment makes it an attractive, controlled way to consume your capital – which, after all, is what we’re meant to do with our concessionally-taxed superannuation.

As Kevin notes, government bonds are the lowest risk (and lowest return) investment available. The risks with annuities are also very low. The life company providing the annuity is subject to prudential supervision by APRA under one of the toughest regulatory capital regimes in the world which requires shareholder capital to back the promises made to you.

Until 2011, a key disadvantage of the annuity would have been the ‘hit by a bus’ scenario. That is, premature death would have seen your premium go into the life company’s insured pool for the benefit of those living longer. However, recent product innovation has introduced 15 year guarantee periods in which you, or your estate, can access your capital.

In conclusion, when evaluating guaranteed retirement income options, you need to consider not only the comparable fixed returns but also your opening capital amount, your willingness to consume all or some of that capital, your desire to leave a bequest and interaction with the Centrelink asset and income tests. For many people who don’t have enough capital to live on returns alone, a modern lifetime annuity can be an attractive option.

Response from Elizabeth Moran, Director of Education & Fixed Income Research, FIIG Securities

Kevin’s question is an intelligent one. Few investors recognise the need to protect enough capital to ensure a minimum standard of living for a longer period of 20 to 30 years, yet longevity is increasing.

Lifetime annuities do provide long term protection, but generally provide low returns and payments cease on passing of the investor. If an investor lives for a very long time, well past statisticians’ estimates, lifetime annuities are an excellent investment. If however, an investor does not reach the mean lifespan estimate, the issuer of the annuity benefits to the detriment of the investors’ estate.

Inflation linked or indexed bonds are an excellent alternative. There are two main types of inflation linked bonds. The first is called a capital indexed bond where the capital you invest is linked to inflation and each quarter (assuming inflation is positive), the capital value of this bond increases, protecting the value or purchasing power of your capital. Income is fixed but paid on the growing capital value of your investment, thus also increasing with inflation over time. These bonds are issued by the Commonwealth and state governments and also by banks and corporations. Commonwealth government inflation indexed bonds are the lowest risk, thus have the lowest returns.

Below is a table comparing Commonwealth, state government and territory bonds to a corporate indexed bond. I have assumed an investment of $100,000 face value, for ease of comparison but these bonds are available in smaller parcels.

Issuer	Maturity date	Interest rate at first issue	Yield to maturity*	Interest rate based on current price	Current price	Current value	Cost	Premium / discount	Next interest payment
Australian Government	20/09/2030	2.50%	4.18%	2.25%	122.457	$110,220	$122,457	$12,237	$689
ACT Treasury Corporation	17/06/2030	3.50%	4.83%	3.04%	127.774	$111,010	$127,774	$16,764	$971
NSW Treasury Corporation	20/11/2035	2.50%	4.79%	2.42%	123.829	$119,910	$123,829	$3,919	$749
Queensland Treasury Corporation	20/08/2030	2.75%	4.86%	2.62%	131.344	$125,000	$131,344	$6,344	$859
Sydney Airport Finance	20/11/2030	3.12%	7.00%	3.72%	102.733	$122,640	$102,733	-$19,907	$957

Source: FIIG Securities

Note: Prices accurate as at 24 April 2014 but subject to change

** Yield to maturity assumes inflation at 2.5%*

Reading across the columns, and using the Commonwealth bond as an example, this particular bond matures in September 2030, when investors can expect a lump sum that has risen with inflation. The interest rate at first issue was 2.50%. The current estimated yield to maturity, which includes the premium paid for the bond over and above its value, and income assuming inflation remains at the Reserve Bank's target mid-point of 2.50%, is 4.18%. The interest rate based on the current price of the bond (running yield) is slightly lower than when first issued as investors are willing to pay $122.45 for a current value of $110.22, so income has fallen slightly to 2.25%. Demand for these bonds is high and investors are prepared to pay a premium of $12,237 over its current worth of $110,220. The next interest payment is $689.

The ACT and Queensland Treasury Corporation (QTC) bonds over similar time spans pay higher projected yield to maturity of 4.83% and 4.86% respectively, roughly 0.65% higher than the Commonwealth bonds (yield to maturity is the main comparator).

Income of $971 is higher on the ACT bonds, due to a higher initial interest rate at first issue over $859 for QTC; investors must pay a higher premium for the ACT bonds, which then smooths the overall yield to maturity.

The NSW bond is longer dated with a November 2035 maturity date. The longer term to maturity is generally less attractive to investors and the likely reason this bond trades at the lowest premium of the state government bonds shown. Yet yield to maturity is lower than ACT and QTC, probably due to NSW being perceived as a slightly lower risk.

The Sydney Airport 2030 bond, again with a similar maturity date pays a higher return and is trading at a substantial discount of $19,970 or a current price of $102.73 for a current value of $122.64. Yield to maturity is 7.00%, over 2% higher than the other bonds and significantly higher return than the average lifetime annuity.

While these indexed linked bonds are attractive, they are best used in accumulation phase. For those investors in retirement looking for income to pay the bills, the other type of inflation linked bond, an index annuity bond, may be more effective. These bonds are better to compare to lifetime annuities given principal and interest repayments. The difference being investors know the maturity date of the bond and should they pass, the bond remains part of their estate and payments continue until maturity.

An index annuity bond works like a reverse mortgage. Investors pay a lump sum up front which is then returned over the life of the bond in quarterly interest and principal repayments. The repayments are linked to inflation, which is particularly valuable to retirees wanting steady income with the added inflation protection. The value of your investment is paid down over the life of the bond, so there is no lump sum at maturity. These bonds are more like a lifetime annuity and provide higher quarterly payments compared to the capital indexed bonds. The majority of issuers are highly rated (see some examples in the table below).

Issuer	Maturity date	Yield to maturity	Interest rate based on current price	Current price	Face value	Capital value	Next quarter interest and principal payment
NSW Schools	28/02/2031	5.86%	3.92%	94.334	$100,000	$94,334	$1,822
Melbourne Convention Centre	31/12/1933	5.96%	4.11%	98.840	$100,000	$98,835	$1,732
Southbank Tafe, Brisbane	28/06/2035	6.36%	4.61%	102.172	$100,000	$102,172	$1,769

Source: FIIG Securities

Note: Prices accurate as at 24 April 2014 but subject to change

** Yield to maturity assumes inflation at 2.5%*

Importantly, the two inflation linked bonds only continue until they are sold or mature. There are no ongoing or management fees despite being up to 30 year investments. The bonds can be acquired through a bond broker, who takes a one-off brokerage fee between the buyer and the seller of the bonds, much the same as the foreign currency market. The projected returns shown on the bonds are what we project the investor will receive (assuming inflation at 2.5%, the mid-point of the Reserve Bank target range of between 2 to 3%). The bonds do not have to be held until maturity and can be sold if funds are needed.

While there hasn't been a period of high inflation for some years, should inflation again spike to over 10 per cent as it did in the 1980s, the capital value and interest payments would also spike, offering very useful protection to investors in either the capital indexed or the indexed annuity bonds.

Some Australian Commonwealth government bonds are available through the ASX. State government bonds may be purchased from the individual states and territories, while corporate inflation linked bonds are available in the over-the-counter bond market and can only be transacted via a bond broker.

Extracts from the National Commission of Audit

Graham Hand

On Thursday 1 May 2014, Joe Hockey released the National Commission of Audit, accompanied by this statement. It's an important review, the first into the scope and efficiency of the federal government in 20 years. Mr Hockey said it will provide important input to the forthcoming budget, as well as guiding future policy.

For those who would like to read the report, the home page of the Commission is linked here. In the following extracts, we have links to the recommendations on aged pensions and superannuation preservation age, as well as the Commission's statements on age pensions and aged care.

Perhaps the most important graph in the entire report, as shown below, shows the proportion of the eligible population receiving an age pension. While the proportion on full pension is expected to fall from the current level of 50% to about 30% by 2050, part-pensioners rise by the same amount, from 30% to 50%. So the current ratio of 80% of the eligible population receiving a pension remains unchanged out to 2050. A part-pension gives eligibility to a wide range of benefits relating to health, transport and utilities. This will change if the recommendation is adopted to include the family home in the means test for the age pension, and income from super for eligibility for the Commonwealth Seniors Health Card.

The full list of recommendations is linked here.

Recommendation 13: Age Pension – tighter targeting of eligibility

The Age Pension is an essential part of Australia's social safety net. The Commission recommends that changes be made in future to ensure it is more sustainable, affordable and better targeted by:

a. formally linking the eligibility age of the Age Pension to 77 per cent of life expectancy at age 65 from 2033. This will result in the eligibility age for the Age Pension increasing to around 70 by 2053. The proposed change would not affect anyone born before 1965;
b. replacing the current income and assets tests with a single comprehensive means test. Under this approach the existing assets test would be abolished with the income test extended by deeming income from a greater range of assets. The new comprehensive means test would apply prospectively to new recipients of the Age Pension from 2027-28 onwards;
c. including in the new means test the value of the principal residence above a relatively high threshold. The threshold in 2027-28 would be equivalent to the indexed value of a residence valued today at $750,000 for coupled pensioners and the indexed value of a residence valued today at $500,000 for a single pensioner. This change would apply prospectively to new recipients of the Age Pension from 2027-28 onwards; and
d. increasing the income test withdrawal (taper) rate from 50 per cent to 75 per cent. This change would apply prospectively to new recipients of the Age Pension from 2027-28 onwards.

Recommendation 14: Superannuation preservation age

The Age Pension and superannuation are interrelated elements of the retirement income system. The Commission recommends some changes be made to the superannuation system to complement changes being recommended for the Age Pension by:

a. increasing the superannuation preservation age to five years below the Age Pension age;
b. extending the current phased increase in the preservation age by an extra four years so the preservation age reaches 62 by 2027; and
c. increasing the preservation age in conjunction with the Commission's proposed increases in the Age Pension age thereafter.

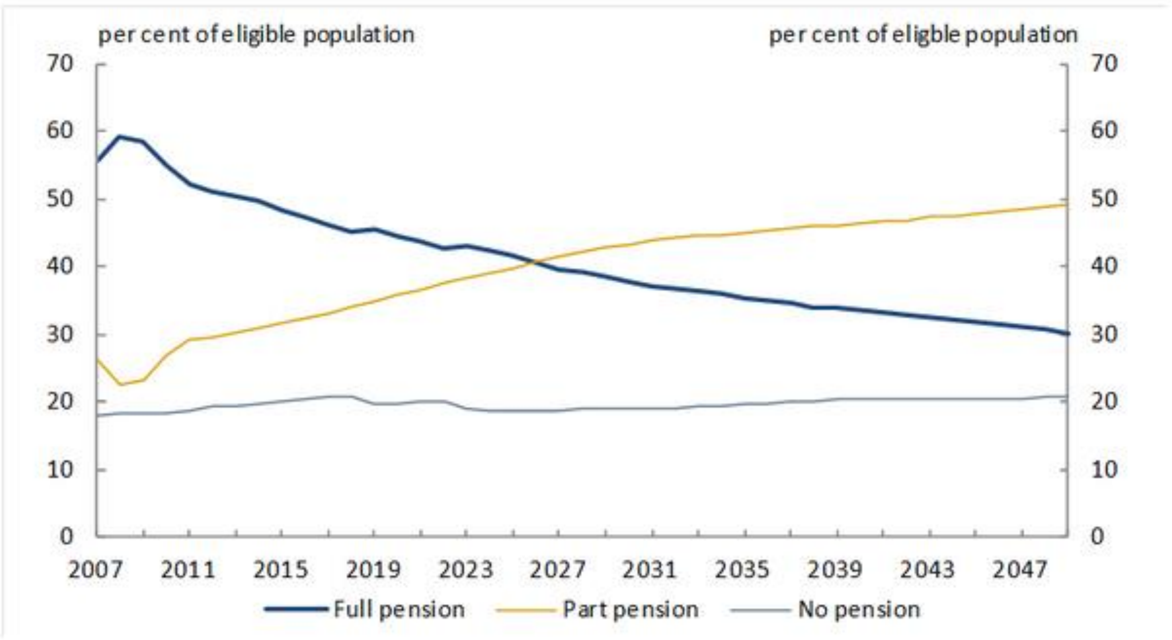
The section on Age Pension is linked here.

In 2013-14, an estimated $39.5 billion will be spent on the Age Pension, benefitting 2.4 million recipients. Expenditure on the Age Pension is currently growing at 7 per cent per year. Age Pension expenditure is expected to continue to increase largely as a result of an ageing population, increased life expectancies and benchmarking to the Male Total Average Weekly Earnings benchmark.

The features of the Age Pension means test, such as a 50 per cent taper rate and high income free area, can mean pensioners with relatively high levels of income (up to $47,000 in annual income) are able to access a part-rate pension.

As shown in Chart 7.1 on current projections there is unlikely to be an increase in the proportion of individuals who are completely self-sufficient and not reliant on the Age Pension despite the significant investment in superannuation over time. Even allowing for a decline in the proportion of people receiving the full pension, a rise in the number of people receiving the part-rate pension will see the proportion of older Australians eligible for the Age Pension remaining constant at 80 per cent over the next forty years or so.

Chart 7.1: Projected proportion of eligible persons receiving an Age Pension



Source: Rothman, 2012.

[The section on aged care is linked here.](#)

Currently around 1 million older Australians receive some form of aged care support. The majority of these are people who receive services in their own home and the community. Around 200,000 people are in permanent residential care.

With the ageing of the population, the number of Australians aged 65 and over will rise rapidly, from 3 million today to over 8 million by 2050. Moreover, by 2050 it is expected that more than 3.5 million people will access aged care services, with around 80 per cent of these delivered in the community.

There is a strong rationale for government involvement in aged care on equity grounds and also to overcome information gaps and protect vulnerable Australians. However, over recent years there has been increased acceptance and use of private co-contributions toward the cost of care.

Formal aged care services are predominantly financed by government, with supplementary user contributions also required in many areas. Public funding is primarily delivered through payments to the providers of the various care services.

Aged care expenditure is expected to be around $13 billion in 2013-14, with strong growth expected over coming years. Expenditure on aged care is currently growing at around 4 to 5 per cent per year in real terms. Residential age care is the single largest area of expenditure. Expenditure is being driven primarily by demographic and health factors.