Cuffelinks
Connecting investors with ideas

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Just when my portfolio was set for the long term ...

Chris Cuffe

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."
Warren Buffett

Imagine two portfolio managers, Jack and John, who are both responsible for Australian equity portfolios for large funds management businesses. They both have offices overlooking Sydney Harbour, and are supported by large teams of analysts. John manages three billion, Jack about four billion. For 20 years, both have arrived in the office by 7:30 am to prepare for the first meeting of the day, having already read their emails and checked Bloomberg and Reuters at home. They are well known in the market and are often interviewed on television to give their market views.

They are both Masters of the Universe, and to the casual observer, they seem to be doing the same job. But they have completely different styles.

John markets himself as index agnostic, and he is not active in terms of portfolio turnover. He prefers to hold a relatively concentrated portfolio of less than 25 stocks, backing his judgement and not owning a bit of everything. For the majority of the time, he is happy with the way his portfolio is set, he has a good understanding of the investee companies' long term prospects, and there's usually little which suggests to him that he needs to change his portfolio. On most days he does not do a single trade, although it has taken him the best part of 20 years to learn this discipline. His portfolio turnover is only 15% annually. In the last decade, he has beaten the index by 3% per annum, making him a top quartile manager. As a younger man, he found he was often trading just to look busy, and it was only when he had nothing to prove that he felt confident doing nothing. In fact, he now has time to spend some mornings with his wife, and he tries to amaze her and leave early to cook dinner.

Jack's portfolio includes 70 of the ASX100, with most large companies close to their index weight. He is continually rebalancing back to index, selling companies which have risen and buying companies which have fallen. He has also delivered good results over the last decade, about 2% over the index. He finds

outperformance, or alpha, through intimate relationships with the major brokers in town. They tell him whenever they hear anything, and he quickly buys or sells a stock before the story is on the street. He often reverses his trade a few hours later. He rarely claims to have any great insights into a company's long term prospects, but he just stays a step ahead of the market. His portfolio turnover is over 200% a year. He stays close to the screens and phones all day, and demands any broker with news contact him first or face a black ban. He pays handsome brokerage, with the large firms earning $5 million a year from him. He does not know or care how long he has held any individual stock. He's never home early.

How do you manage your portfolio?

Who do you want to manage your money? If you are a direct investor, where do you stand on active trading? Both Jack and John have their strengths and weaknesses, and in my career, I have worked with both types and they've done well. In reality, most investors are somewhere between these two extremes, with elements of 'buy and hold' and 'trade opportunistically'.

Personally, for my own investing, I'm more in John's camp of 'buy and hold'. In fact, I find it much easier to recommend changes to other people's portfolios than my own. Maybe I'm less emotive when it comes to other people's money and can see other opportunities, but some of the benefits of John's approach include:

- More likely to detach himself from market emotion and not be spooked by short term movements in share prices
- Low turnover means lower costs and he takes advantage of the capital gains tax (CGT) discount on shares held for longer than 12 months
- Smaller portfolio may mean a more intimate knowledge of the investments.

But it's not all plain sailing. A 'buy and hold' strategy may ignore how poorly some sectors and stocks can perform over time, and fails to recognise the need to change at certain points of inflexion. Few if any businesses are immune from challenging conditions. Just ask the executives and investors in companies like Kodak, destroyed by digital processing, or Blockbuster, impaired by online movie downloading.

It's easy to think BHP must have been a good long term investment, but as Ashley Owen wrote in Cuffelinks on 24 October 2013, its share price in real terms has moved little over 125 years.

"BHP shares peaked at £413 in February 1888 at the top of the late 1880s/early 1890s silver and lead mining boom. That's $34.70 in today's dollars in real terms after CPI inflation and after accounting for all of the splits and changes in capital structure over the years. People who bought BHP shares at the top of the 1888 mining boom had to wait 75 years for the share price to recover in real terms after inflation. BHP is still only $36 today as I write this in October 2013, some 125 years later!"

Why do I resist over-trading?

No doubt there were good trading opportunities in BHP along the way, so what other reasons cause me to resist over-trading?

- transaction costs
- the paperwork (which I dread)
- taxation leakage (if I have made a profit)
- loss aversion (if I am carrying an unrealised loss then, rightly or wrongly, I often just want to 'stay in there' to prove it will come good)
- not wanting to become a 'trader' where gains are taxed on income account rather than capital account (although this is a fuzzy piece of tax law)
- not having carry forward losses that gains could be offset against
- the reported experience of traders, who often seem to lose money by being too flighty in their positions and opinions.

I believe taxation leakage is one of the more important considerations when selling a stock. A portfolio manager may be happier to actively trade on behalf of a tax exempt fund (though always watching the 45-day rule to avoid losing franking credits) but should be more hesitant about realising a gain where

they are a taxpayer (whether 15%, 30% or 45%). The time value of money paid to the ATO becomes an important calculation.

On the other hand, some experienced fund managers believe tax is a secondary issue, and sell decisions should always be made on investment principles. I understand this view, but I'm not impressed if a portfolio manager generates a capital gain by selling a share after owning it for 11 months and three weeks (and losing the lower CGT concessional rate).

There's no right answer

Investment is more art than science, and I find these trade-offs a real dilemma in practice. Sometimes I think I have *finally* got my portfolio 'set' and then something happens that makes me feel I should change it (yet again!) but deep down this is an uncomfortable move.

I've often thought we need a formula that takes into account our tax rate, our concessional CGT rate, transaction costs, the value of carried forward losses, an estimated valuation on the stock versus its market price (an inexact task at the best of times), etc etc … and, hey presto, the formula would spit out whether selling is a good strategy. And by the way, this issue applies equally to changing asset allocation as it does to changing securities within a specific asset class.

I personally manage an investment portfolio for a not-for-profit, tax exempt organisation that has nil brokerage fees thanks to the generosity of a community-minded stockbroker. I find myself regularly adjusting the portfolio both in terms of security selection and asset allocation (between Aussie shares, international shares, property, infrastructure and various fixed income securities). I find this rewarding (the portfolio performance has been very good, even if I do say so myself!), but at the same time challenging and somewhat tiring, like I am on a never-ending marathon.

But when it comes to my own personal affairs where I am definitely a taxpayer, until someone gives me a black box to work through the myriad of variables, I find myself being much more of a 'buy and hold' investor, unless I need to sell for cash flow reasons. That said, there have been many times where I have kicked myself for not reducing exposure to particular stocks or asset classes when it looked obvious they were stretched in value.

Chris Cuffe is co-founder of Cuffelinks; Portfolio Manager of the charitable trust, Third Link Growth Fund; Chairman of Unisuper and Chairman of Australian Philanthropic Services. The views expressed are his and they are not personal financial advice.

Should SMSFs be allowed to borrow?

Graham Hand

An irresistible combination of four massive numbers is causing a headache for financial regulators but a gold mine for many financial advisers and real estate agents: $4 trillion in residential housing, $1.9 trillion in superannuation, $600 billion in SMSFs and one million trustees. And Australians love property.

Reigning in the grab for a piece of this action is rightly in the sights of David Murray's Financial System Inquiry, which has an entire section on superannuation borrowing: "This Inquiry shares the Super System Review Panel's view that leverage should not be a core focus of SMSFs — or any superannuation fund — and is inconsistent with Australia's retirement income policy."

Financial adviser responsibility

The first priority for any financial adviser meeting a new client should be an explanation of investment risk. Only by determining risk appetite can a portfolio be constructed. Those who start with fund or property selection have the wrong foundation.

The risk discussion must be in terms the client can understand. It's not volatility or standard deviations, but the risk of losing money. For example, the client must realise that over a typical 10-year period, the sharemarket will deliver negative returns in two or three years.

This is where problems with borrowing start, especially for superannuation and SMSFs. The sole purpose of superannuation, and the reason it is given favourable tax treatment, is to fund a retirement, and to do this, it must generate income.

These are the two main issues when a SMSF buys a residential property: risk and cash outflows.

Risk profile

SMSFs can usually borrow up to 80% of the value of a property, requiring the fund to have capital of at least 20%. If the value of the property falls 10%, the SMSF will lose half its capital. The impact of leverage is dramatic, in this case, equivalent to falls in sharemarket values seen in the Global Financial Crisis that nearly brought the banking industry to its knees.

There is too much price complacency among residential property buyers. The Reserve Bank Governor, Glenn Stevens, recently warned on property prices, especially in Sydney, "… in forming expectations about future price gains and deciding their financing structure, people should not assume that prices always rise. They don't; sometimes they fall." The Reserve Bank issued a paper entitled "Is Housing Overvalued?", which quotes research by The Economist (2013) and the OECD (2013) that Australian house prices are 24% and 21% 'overvalued'.

Cash outflows

On an apartment valued at $700,000, an SMSF may borrow 80% or $560,000. With an interest rate of 5%, the annual borrowing expense is $28,000, plus fees. In NSW, the stamp duty on a $700,000 apartment is about $27,000. There are many other costs which new property buyers often overlook, such as body corporate fees $8,000, agent leasing fees $5,000, council rates $3,000. By the time these bills are paid, and allowing for a month of vacancies, the income will be about 2.5%, or $17,500, or at least $10,000 less than the interest cost. For a complete explanation of costs, see this article.

The SMSF trustee will need to find $10,000 a year from within the SMSF plus at least $30,000 up front to buy this property, and probably a lot more on furnishings and fittings. What happens when interest rates rise, or the property has a long vacancy period, or a major repair is required? What if the SMSF trustee loses their job and is not making other contributions to super? It's not possible to sell the bathroom, and the SMSF trustee may be forced to sell the apartment at the worst time in the property cycle.

Property spruikers

The main problem in allowing SMSFs to borrow is that the unwary are targeted. Unscrupulous agents sell off-the-plan apartments at inflated prices paying big commissions to advisers. A few years later when the rental return guarantee has finished the SMSF trustee realises the initial property price was overvalued. There have been many examples in Australia, including the Gold Coast, Melbourne's Docklands and various backwaters, where resales have been 50% of the original purchase price.

In a recent speech to CPA Australia, ASIC Commissioner Greg Tanzer warned the regulator is monitoring websites and media for evidence of misleading conduct, and attending SMSF seminars. He said that making a recommendation to set up an SMSF to buy property is financial advice, for which a person must be properly licenced, even though the underlying investment – the property - is not itself a financial instrument. "The promoter may not be complying with the law."

I attended a property seminar aimed at SMSFs, organised by one of the highest profile agents in the country, and was shocked at the material presented. It contained many half-truths and exaggerations, and the audience seemed to lap it up. Most of the presentation was made by an SMSF administrator whose fee for the complete package of putting together an SMSF and arranging the property loan was $7,995.

Consider three of the messages from this seminar:

- If you don't have enough money for a deposit, four people can pool their money to fast track to wealth.
- You can reduce the purchase price of the investment property by 40% using concessionally-taxed superannuation compared to after-tax salary for loan repayment.
- If you don't have enough money in super but you have equity in your house, you can borrow against your house and lend the money to your SMSF.

Anyone who defends SMSF borrowing should attend one of these seminars for a real eye-opener. Imagine the future problems if four people own one illiquid asset requiring ongoing management as they head to retirement at different times.

Should property borrowing be banned?

An estimated 85% of borrowings for property by SMSFs are for commercial premises, often then leased to the business of the SMSF trustee. It will be difficult to wind this back, and the valuation and cash flow issues are less of a problem than aggressively-marketed apartments. The SMSF Professionals Association (SPAA) is not in favour of a ban on borrowing, except in the case of spruiker-type promotions. It points out that in 2012, the latest official statistics, SMSF borrowings amounted to only 3.7% of SMSF assets. "This hardly suggests that trustees are borrowing without giving it due consideration," said Graeme Colley of SPAA. However, more recent work by CoreData suggests this has risen significantly in the last two years.

There are clear signs the Murray Inquiry plans to reintroduce a borrowing prohibition: "Removing direct leverage in superannuation is consistent with the concept that superannuation tax concessions should apply to funds that have been saved and not borrowed. There are ample opportunities — and tax benefits — for individuals to borrow outside superannuation."

Many highly leveraged SMSFs would lose all their own equity if there is a decent residential property price correction. Then they'll find an adviser to sue and bad financial advice will be back on the front page. At least the SMSF trust deed has provisions to cover member insanity.

Graham Hand was General Manager, Capital Markets at CBA; Deputy Treasurer at State Bank of NSW; Managing Director Treasury at NatWest and General Manager, Funding & Alliances at Colonial First State.

The defined contribution obsession with liquidity

Bev Durston

This is the first of a two-part series exploring the focus on liquid assets in defined contribution schemes.

Superannuation is a long-term investment strategy. This is being reinforced by proposed increases in the retirement age and trend towards new investment models (like life cycle investing) looking 'through' retirement age for investment strategy. The focus on long term investing should therefore be of paramount importance for superannuation investors.

However, in contrast to the approaches of other long-term investing institutions, the defined contribution (DC) market seems to be obsessed with very 'liquid' investments. Liquid here means the ability to convert investments to cash in a speedy manner (or to be 'cashable'). This trend is particularly evident in Australia as its DC system is one of the largest and well established in the world.

Spot the difference

Comparable long-term investing institutions with superannuation funds include Sovereign Wealth Funds (SWFs), family offices, defined benefit (DB) pension funds, foundations and university endowments. Each has a long-term horizon to meet their investment objectives. Each views its strategic asset mix as a significant decision which establishes the investing framework. And each of these uses a blend of external and internal advisors to assist in setting their long-term asset mix. Essentially, they pay to receive the best advice globally on how to manage money over the long term. So how do they manage their money?

Table 1 illustrates how these long-term investors set out their strategic asset investing framework. Less liquid assets include alternative assets such as direct property, private equity, infrastructure, hedge funds, real assets, timber, physical natural resources and other physical assets:

Table 1: Long-term investors, typical strategic asset allocation

Asset Class Allocation & Type	Endowment	US Endowment	SWF	SWF	Family Office	UK DB scheme	UK DB scheme
Institution	**Avg. US uni endowment**	**Yale**	**Future Fund**	**China Investment Corp**	**Avg. US & European family office**	**Uni Super Scheme**	**BA Pensions**
Listed Equities	40%	17%	43%	32%	33%	51%	50%
Fixed Income	10%	5%	12%	19%	16%	22%	31%
Cash	3%	0%	9%	4%	1%	2%	0%
Property	4%	19%	5%	10%	12%	7%	9%
Alternatives: Abs return, PE, Other, Infra	43%	59%	30%	35%	39%	19%	10%
Total Assets	100%	100%	100%	100%	100%	100%	100%
% in less liquid assets = Property + Alts	**47%**	**78%**	**36%**	**45%**	**51%**	**25%**	**19%**

Source: Latest annual reports and accounts of each institution; Wharton study of global family offices.

The percentage of less cashable assets for these types of long-term investors ranges from a low of 19% to a maximum of 78%.

The table also identifies one of the icons of alternative investing, Yale Endowment, which boasts the highest allocation to less cashable assets at 78%. Despite living through the global financial crisis, Yale still maintains this allocation, including a substantial 32% to private equity and 18% to absolute return strategies. Its long-term performance is 13.5% per annum over the past 20 years, a track record that is the envy of many other institutions. And despite holding only 22% of its assets in liquid cashable form, the endowment still contributes 34% of the Yale University operating budget. Some commentators would claim that this focus on long-term, less liquid strategies is the hallmark of a true long-term investor.

Looking at Australian DC schemes, Table 2 shows the same asset allocation breakdown:

Table 2: Australian defined contribution schemes, typical asset allocation

Asset Class Allocation & Type	Australian DC	Australian DC	Australian DC	Australian DC	Industry Fund
Institution	**CFS Balanced**	**AMP Balanced Active**	**MLC Balanced**	**BT Super for Life**	Australian Super
Listed Equities	44%	71%	58%	69%	59%
Fixed Income	35%	22%	28%	7%	11%
Cash	16%	5%	8%	8%	5%
Property	5%	0%	0%	9%	9%
Alternatives: Abs return, PE, Other, Infra	0%	2%	6%	7%	16%
Total Assets	100%	100%	100%	100%	100%
% in less liquid assets = Property + Alts	**5%**	**2%**	**6%**	**16%**	**25%**

Source: Latest report and accounts of four public offer (retail) Australian DC funds plus one large industry fund.

The first four red columns are public offer, retail super funds. The table shows how domestic DC schemes have a far greater focus on liquidity, with only 2%-16% in illiquid assets. Whilst average and up-to-date data is hard obtain, many SMSFs also look similar to these four funds. These two segments comprise nearly 60% of the assets in superannuation, making the impact of their decisions significant. And quite surprising given the long-term objective.

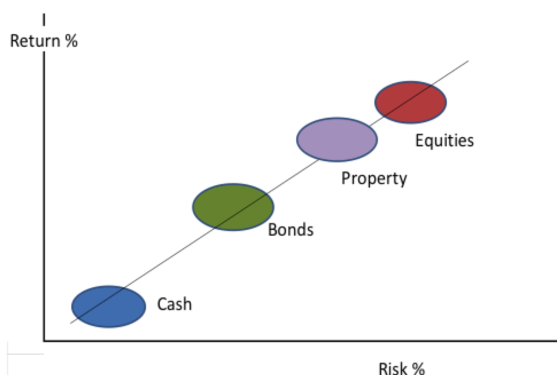
The final blue column in Table 2 is Australian Super, one of the large industry funds. Industry funds collectively represent approximately one fifth of superannuation balances. This fund's asset allocation looks closer to the other long-term institutions. However the asset mix in less cashable investments remains heavily concentrated in just two areas: infrastructure and direct Australian property deals, rather than spread amongst a wide variety of asset types. This implies a less diverse approach to less liquid assets.

Why is DC in Australia so different?

If other global institutions armed with the best advice on how to meet their long-term objectives hold a high proportion of less liquid assets, why is DC in Australia so different? One theory is that the Australian investors confuse liquidity with safety. That is, they like to stay cashable because they are using liquidity as a proxy for risk.

Diagram 1 outlines a typical asset allocation using the scales of 'risk and return'. The asset classes are well spread and appear well-diversified.

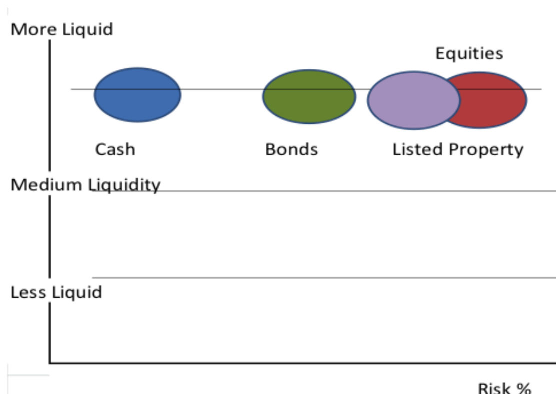
Diagram 1: Risk and return by asset class for DC funds



This looks a diversified portfolio....

Diagram 2 outlines the same investments but with the vertical axis set as liquidity rather than return. The top horizontal line shows more liquid investments. Below are medium and less liquid investments (assets which cannot be easily sold). It highlights that the DC assets all fall into the more liquid category and so the portfolio is one-dimensional.

Diagram 2: Risk and liquidity by asset class for DC funds



Using liquidity: A one dimensional view....

Lost opportunities

The lack of diversification in DC portfolios creates a real disadvantage over other long-term investors because one-dimensional portfolios overlook many other interesting and opportunistic investment types.

Diagram 3: Risk and liquidity by asset class for other global investors

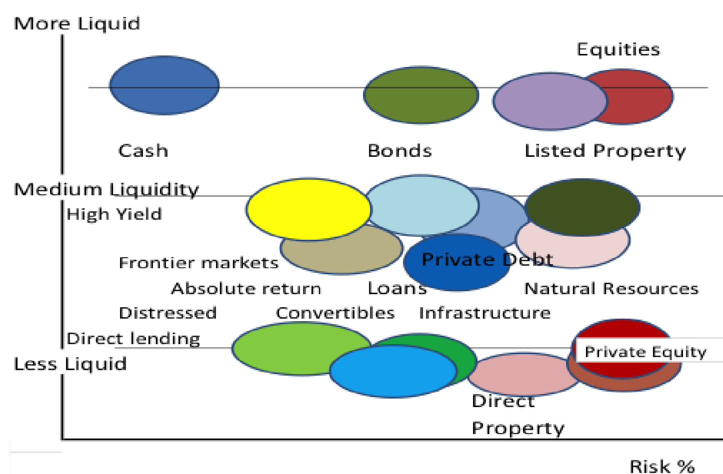


Diagram 3 highlights some of the less liquid opportunities that most DC investors miss. These include absolute return, emerging market credit, frontier markets, structured products, natural resources and infrastructure. These assets don't all need to always be in a DC portfolio – far from it. In fact, with less cashable assets an opportunistic approach is preferable to pouring in monies simply because there is an allocation bucket to fill. One secret with less liquid assets is to generally invest in areas where others are not herding and look for the 'less crowded' trades.

Allocating a proportion of a portfolio into medium and less liquid investments provides three distinct advantages: a different return stream, a mixture of novel market returns which cannot be accessed passively; and a blend of different manager skills (including leverage, shorting, structuring using options and unique pricing models). Not having access to these less liquid investments disadvantages DC investors as they don't have the opportunity to play to their strengths as long-term, patient and opportunistic investors.

Confusing liquidity with safety

If investors confuse liquidity with risk, it creates perverse outcomes. Consider the liquidity, pricing frequency and horizon of different asset classes.

Table 3: The characteristics of liquid and less liquid investments

Asset Class	Liquidity (ability to cash in / out)	Frequency of pricing	Investment time horizon (years)
Listed Equities	High	Daily	**7 - 10**
Private Equity	Low	Quarterly	7 - 10
Listed Bonds	High	Daily	**1 - 7**
Private bonds	Low - Medium	Quarterly	3 - 7
Listed Property	Medium to High	Daily	**7 - 10**
Direct Property	Low	Annual	7 - 10
Listed Infrastructure	Medium to High	Daily	**7 - 10**
Unlisted Infrastructure	Low	Quarterly	7 - 20
Distressed investing	Low	Quarterly	5 - 10
Absolute return assets	Medium to High	Monthly	1 month - 5 years
Cash	High	Daily	Daily

Across different types of investments, Table 3 assesses various characteristics: liquidity (high, medium or low), the typical frequency of pricing, and the recommended investment time horizon with red text identifying where frequency of pricing is daily. What is apparent is that in most cases the private market assets have a similar time horizon for investment purposes as the listed version. For example in private equity the recommended time horizon is seven to ten years for both private and public market assets. So an investor using skilled external funds should in theory be ambivalent about investing into either private equity (where the investments are not cashable) or in public equity (where they are cashable).

Focus on the investment time horizon

Believing that an equity security is safe simply because you can exit it on a daily basis belies the investment time horizon that should be incorporated for that type of investment (assuming the investor uses external funds rather than investing themselves). If we assume that DC superannuation investors are not traders nor specialists at market timing then the ability to get into and out of equities on a daily basis is an unnecessary characteristic, given the high-risk level of equity investment.

This highlights a major disconnect: equities are the riskiest asset class and yet because they are priced daily investors feel comfortable investing in them. The same applies broadly to property (direct and listed) as well as infrastructure investing – investors mistakenly confuse liquidity with safety. If a fund manager were to impose a minimum seven-year lock up on an equity fund, it is unlikely that they would attract many investors. Yet most investors should be looking at equities with a long-term, seven year or more investment horizon, not as a daily trading opportunity. Perverse indeed.

The Australian DC super fund obsession with liquidity can be detrimental to retirement outcomes as investors may miss out on many interesting medium and less liquid investments. In part 2, I will examine other reasons for this obsession, and question whether DC member choice (as defined in Australian legislation) may be incompatible with long-term investing and leads to sub-optimal investor outcomes.

Bev Durston has over 25 years' experience in implementing investment solutions for pension funds, sovereign wealth funds and fund managers. She now runs her own advisory business for institutional clients, Edgehaven Pty Ltd.

The richest man in Babylon also lives in Australia

Noel Whittaker

The Richest Man in Babylon is one of the greatest books on accumulating wealth ever written. Its basic premise is that part of all you earn is yours to keep.

Most people work hard at their jobs, yet at the end of the week they pay everybody ***but*** themselves. Heaps of dollars go to places like the bank and the supermarket, but the workers get to keep precious little.

What is the point of working for 50 years if most of what you earn ends up in somebody else's pocket? Too many people pay rent all their lives and have no money invested for retirement. When they retire they have no hope of buying a home so are dependent on rented accommodation and the pension for survival. They are never in control of their lives.

Wealth is like a huge tree that grows from a tiny seed. It takes a long time to grow but, provided it is watered and fertilised regularly, it will slowly but surely grow at a faster and faster rate.

If you go to the Gordon River area you will see magnificent Huon pine trees. Then you see little straggly ones that are no more than two metres tall and it may come as a surprise to discover these tiny specimens are already nearly 100 years old. Everything that is worthwhile – whether it be a good marriage, a huge tree, or a sound financial position – takes time to develop.

The problem with financial losers is that they can never wait for anything. They are like a child who plants seeds and then digs them up every day to see how much progress they have made. Of course the seeds never progress at all and the child soon loses interest.

Remember the miracle of compound interest and how it can sensationally increase the amount of money we can accumulate. Our savings are the 'seed corn' for our money tree and compound interest (plus added investments) is the fertiliser that causes the fast, lush growth. If you wish to travel down the road of financial independence you will need to start, and then maintain, a money tree.

Consider what material things the average couple has to show for a lifetime of working. If fortunate, they probably own their own home and have some superannuation. Both of these were acquired on the principle of keeping something out of each pay packet. If they had not practised that rule, unconsciously or otherwise, they would own nothing but a few clothes, a car and some household appliances.

The house was probably purchased on a small deposit and paid off over many years. Although the initial payments were mainly interest, a tiny portion went to reduce their loan. That was the foundation of their money tree. Think of the interest as rent and the small debt reduction as compulsory savings. As the years went by the loan got smaller so the interest portion of each payment reduced. Because the interest was less, the debt reduction part automatically increased. Without necessarily knowing it, they were practising one of the rules of becoming wealthy.

Their superannuation is there because employers are required by law to put money into superannuation on behalf of their staff. The amount was small at first, but grew faster and faster due to a combination of employer contributions and super fund earnings. Smart employees topped it up with their own money. That was the next limb of their money tree.

The only way we can exist if we stop work is by having our own money working for us, or by accepting government benefits. If our money tree is planted early enough, and helped to grow quickly by frequent mulching with savings, it will bear more dollars than we are likely to need when we wish to retire.

Noel Whittaker is the author of Making Money Made Simple *and numerous other books on personal finance. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.*

Changes to Centrelink treatment of account-based pensions

Melanie Dunn

From 1 January 2015 the way account-based income streams (including account-based pensions) will be assessed under the income test for Centrelink purposes is changing.

The age pension rules

Any account-based pension commenced on or after 1 January 2015 will be treated as a financial asset and deemed under the income test.

Account-based pensions commenced prior to 1 January 2015 where the pensioner is in receipt of Centrelink benefits at 1 January 2015 will be grandfathered under the existing rules.

Where the grandfathering conditions are not met or where a person ceases to receive Centrelink entitlements, their pension will be treated under the deeming rules when the person next applies for the age pension. As such any existing pension held by persons who are *not* receiving Centrelink entitlements at 1 January 2015 will be assessed as a financial asset under the income test.

Also, consider a household on the 'border' currently receiving a small age pension entitlement. If good investment returns are experienced, the value of their assets may increase and this may cause them to lose their age pension entitlement. Following this, the pension is then assessed as a deemed income stream for future age pension entitlements.

The table below outlines the changes. Please note the treatment for the assets test is not changing.

	Prior to 1/1/2015	**On or after 1/1/2015**
Income Test Assessable Income Amount	Annual Payment - Deduction Amount	Deemed Income (as per other financial assets)

Deciding what to do before 1 January 2015

There has been a lot of discussion around what decisions could be made to maximise the income test and ultimately the long term age pension outcome for clients with existing pensions who are in receipt of Centrelink benefits prior to 1 January 2015 including:

1. Would 'rebooting' (ie. commuting and recommencing) any existing pensions prior to 1 January provide a better deduction amount?

As the social security changes relate to pensions commencing on or after 1 January 2015, rebooting a pension before that date will lock in the relevant deduction amount for any future age pension assessment.

If the pension is rebooted after 1 January 2015, the deduction amount will be irrelevant as the pension will be assessed as a deemed income stream for future age pension entitlements.

2. Would a change to death benefit nominations affect the grandfathered rules for the pensioner's spouse?

Where a pensioner with a grandfathered account-based pension passes away, the pension will only continue to be treated as grandfathered under the income test where the pension automatically continues to be paid to a reversionary beneficiary, and where the beneficiary is also in receipt of Centrelink benefits.

Unless the terms of the pension specify an automatic reversion, the death benefit pension may fall under the new deeming rules. Note that changing the death benefit nominations of a pension to be automatically reversionary may involve rebooting the account-based pension.

Age pension implications

The age pension entitlement under the income test for a deemed account-based pension in the short term may lead to lower pension entitlements, but there may come a point during retirement where the entitlement using the deeming rules is greater than the entitlement under the grandfathered rules. At this point, depending on the person's particular circumstances, the member may consider whether or not to reboot their pension (to be assessed under the deeming rules) to help maximise their age pension entitlement as highlighted in the following case study.

Case study: income test decision point

Consider Fred and Jane:

- a 65-year-old couple
- assets of $500,000 all held in Fred's SMSF
- spend $58,000 per annum increasing in line with inflation.

Fred retired during 2014 and commenced an account-based pension with all of his SMSF assets.

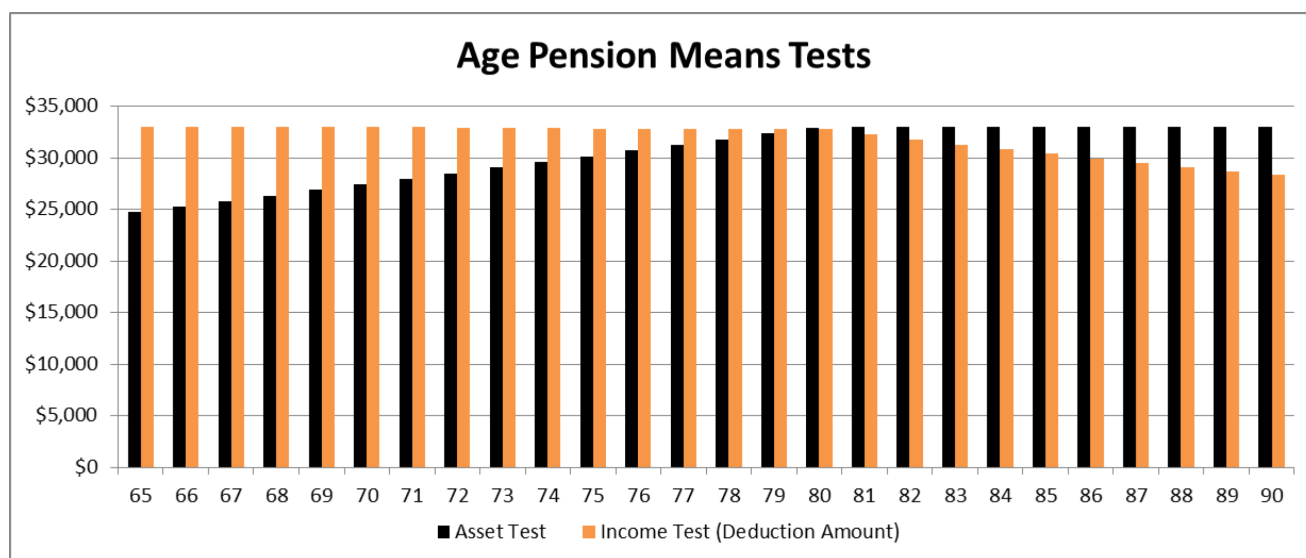
Fred and Jane are currently eligible for a part age pension from Centrelink and the income test rules applying to Fred's account-based pension will be grandfathered from 1 January 2015. Their $58,000 of spending will be partly sourced from the age pension and partly from the SMSF assets.

If the SMSF earns 4% p.a. real returns (over and above inflation) then in this example we would expect their SMSF balance to reduce over time. By modelling the drawdown of the SMSF assets we can compare all three Centrelink means tests in future years:

(a) income test under the grandfathered rules
(b) income test under the new deeming rules
(c) assets test

(a) Age pension entitlements – grandfathered rules

The graph below shows the projected age pension entitlement under both the assets test and the grandfathered income test rules.



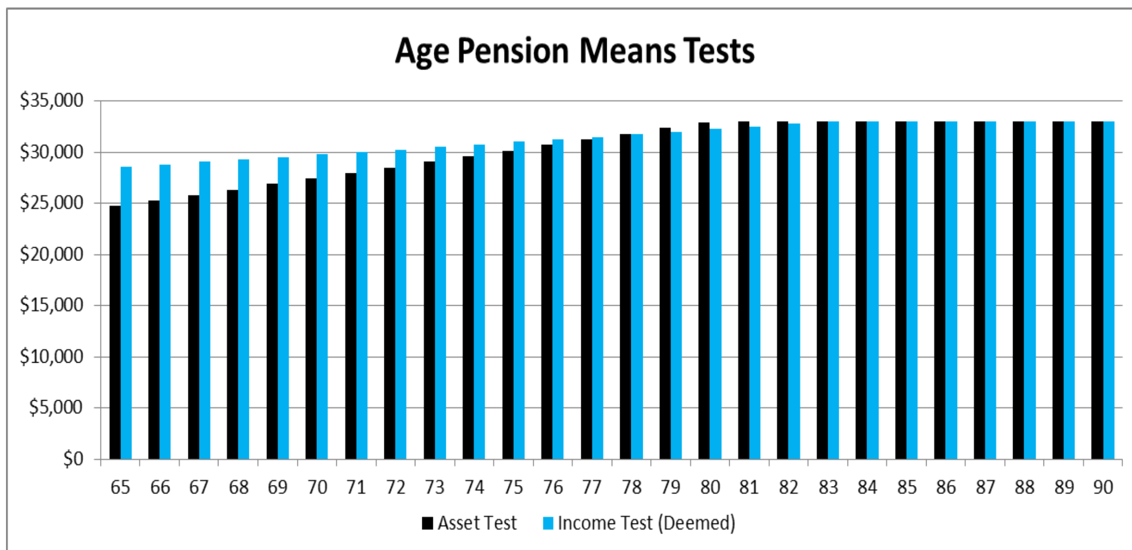
The black lines represent the asset test entitlement in each year, and the orange line the income test entitlement based on the existing deduction amount rules.

We see initially the asset test is dominant, and then at age 80 the income test takes over to determine the age pension received. The age pension entitlement reduces after age 80 because the income test deduction amount is reducing in today's purchasing power.

The total payments from the age pension between now and age 90, in today's purchasing power, is approximately $763,000. The example assumes that the Centrelink thresholds and rates keep pace with inflation over time.

(b) Age pension entitlements – deeming rules

If Fred decided to commute and recommence his pension at 1 January 2015 then the pension would be deemed under the income test. The means test results using the deeming rules is shown below in blue.



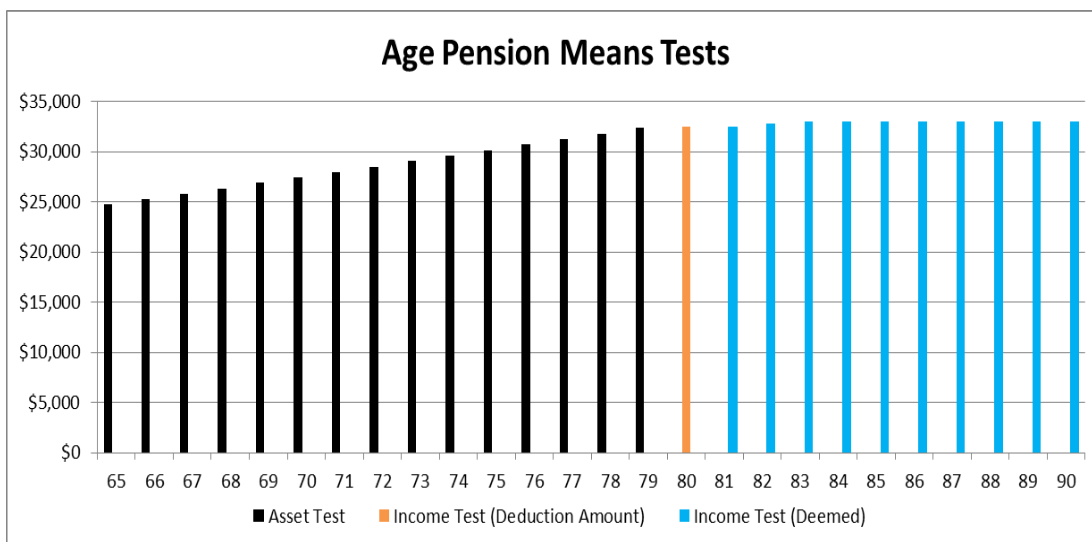
The income test takes over at age 78, two years earlier than under the grandfathered rules. The total payments from the age pension between now and age 90, in today's purchasing power, is approximately $789,000.

What Fred and Jane really need to do is look at what this means overall …

Centrelink entitlements – grandfathering, then switching

Examining both graphs in this case study; we can see that Fred and Jane will receive less age pension from age 78 to age 80 under the deeming rules, then from age 81 onwards the deeming rules provide a higher income test entitlement.

The graph below illustrates all three means test outcomes:



Switching over to the deeming rules by rebooting the grandfathered pension at age 81 may help maximise the age pension during the period that the income test determines the pension received.

From the date of commutation onwards Fred is then locked in to the deeming rules and can't re-elect to have the grandfathered rules apply. But we can see that under these assumptions the highest Centrelink entitlements come from opting for the deeming rules as assets deplete. In this example, the age pension

entitlement increases to the full age pension in later years rather than continuing to decline. The total payments from the age pension between now and age 90, in today's purchasing power, is approximately $790,000.

Fred and Jane's actual decision would need to be monitored over time to take into account fund values, ongoing spending plans and Centrelink rates and bands at the time.

Grandfathering considerations

There may be some advantages of commencing or rebooting account-based pensions before 31 December 2014, thereby locking in existing rules for clients who are in receipt of Centrelink entitlements. These include:

- The income test entitlement may be lower in the short term under the new deeming rules, so if the income test is determining the client's age pension entitlement, the existing rules may be more advantageous.
- Grandfathered pensions won't be exposed to the risk of increased deeming rates in the future.
- A pension may be rebooted at any later date to enable the pension to be assessed under the new deeming rules.

Based on the above, it appears that grandfathered pensions will provide the most flexibility in potential social security outcomes for clients. However, rules continue to change and retirees need to stay on top of entitlement amendments.

Melanie Dunn is SMSF Technical Services Manager at Bendzulla Actuarial. This information illustrates social security treatment of income streams only and is not intended to be financial product advice, legal advice or tax advice, and should not be relied upon as such. Individuals should seek appropriate professional advice before making any financial decisions.

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