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Five retirement myths doing more harm than good

Peter Vann and Chris Condon

Australia's superannuation industry is obsessed with accumulating account balances. The industry has confused the primary purpose of providing for retirement by fostering the following claims:

1. Members need (much) more financial literacy
2. The 4% withdrawal rule is (or isn't) safe
3. Retirees suddenly run out of money
4. Sequencing risk is a real issue
5. Retirees need a new breed of investment products

We argue that changing the focus of superannuation to retirement outcomes is essential, and will make superannuation meaningful to members. In doing so, we need to retain critical thinking.

Some of these claims do not seem to stack up, but are they myths?

1. More financial literacy

The industry is a victim of its own design. It is obsessed with account balances and what happened over the past year. What does this babble have to do with retirement outcomes?

How many superannuation practitioners can translate a member's account balance and future contributions to what the member may receive in retirement? Very few, as the calculations are complex. If we find it hard, no wonder members don't understand superannuation.

In the defined benefit days, members were simply informed of retirement outcomes. If this was re-introduced as a simple statement for defined contribution members such as,

"Your superannuation account and future contributions have a good chance of delivering \$1,000 per week when you retire."

... then we are expressing the outcome of superannuation in language that most members should understand, their pay cheque.

Result: Myth busted.

2. The 4% withdrawal rule

The often quoted *Trinity Studies* found 4% of the initial account balance at retirement could be safely withdrawn each year, inflating annually thereafter. Critically, this analysis incorporated the impact of investment volatility to arrive at a safe withdrawal rate.

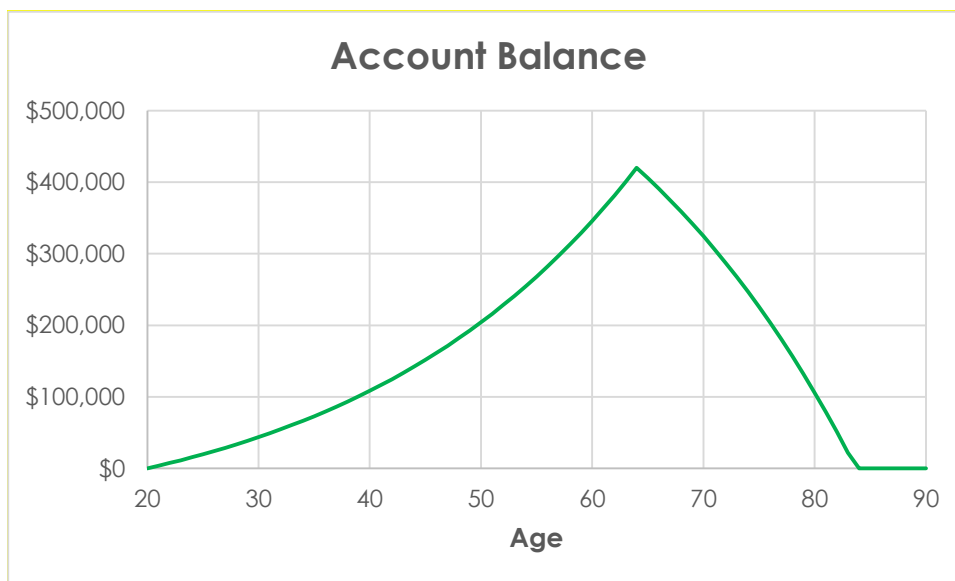
But to our knowledge, no fund in Australia informs members of their safe withdrawal rate. Worse, some funds provide estimates that ignore investment volatility. Even ASIC's methodology under Class Order 11-1227 (see ASIC's [Consultation Paper 203](#)) has been found to be [simplistic and misleading](#).

Using our retirement income calculation engine with moderately conservative investment assumptions (such as ignoring valuation reversions), we found that in many cases, the 4% rate (ignoring ATO allocated pension minimums) is safely funded from a typical balanced strategy. The '4%' rule of thumb is not bad, but each member's circumstances are different. Retirees shouldn't be relying on rules of thumb.

Result: A controversial myth which needs context.

3. Retirees suddenly run out of money

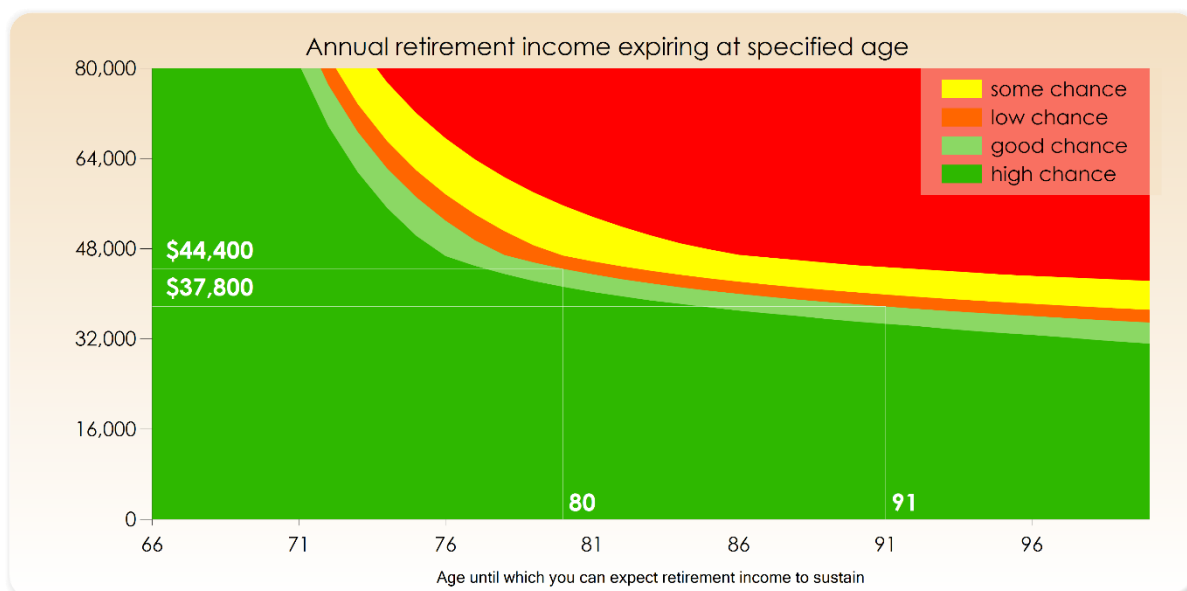
Do they? How often have you seen a chart like this?



The authors of such charts are incredibly patronising. They assume that retirees do not adjust behaviour in light of changing circumstances. Of course, if you don't watch the road when driving a car, then you are likely to crash. The same applies to retirement account balances, they need to be monitored and withdrawals managed.

But it is true that retirees have inadequate tools to help them stay on the road.

Better controls are available. For example, the following chart shows the three-way trade-off between the level of withdrawals, the age that they are likely to last and the impact of investment risk.



Provision of information extracted from this chart can form the basis of a retirement monitoring and management 'control panel' assisting retirees to manage the changing requirements through retirement.

Result: Myth busted.

4. Sequencing risk

This is the risk that the worst returns at the wrong time will greatly impact a member's retirement outcomes. A paper by [Drew and Walk](#) identifies a 'retirement risk zone' as approximately 20 years around the retirement date.

We believe the following points put sequencing risk in context:

- The age pension buffer

The income and assets tests of the age pension make it an excellent hedging instrument for the risks of an eligible retiree's investment portfolio. Falls in asset values and withdrawals will result in an increase in the age pension. Hence the age pension provides some hedging of the impact of sequencing risk for those receiving a partial age pension.

- Asset valuations revert

Valuation measures (e.g. PE ratios) tend to revert to the mean over the medium term (7-10 years). Whether you enjoy or suffer from this reversion will depend upon (a) your pace of saving or dissaving, and (b) changes to investment strategy. This is real, but the impact is idiosyncratic. Much hand waving about sequencing risk ignores this reality and can result in inappropriate scaremongering and poor investment decisions.

- Through retirement, not to

Obsession with account balances leads many to make dramatic changes in investment strategy at retirement, such as selling equities to purchase a fixed rate income stream. This creates unnecessary sequencing risk. It runs the risk of a double hit: selling equities after a crash and buying bonds when interest rates are low. On the other hand, if the retiree is managing THROUGH retirement, then this self-generated sequencing risk is avoided, and the benefits of mean reversion can be enjoyed.

- Manage with feedback

Prompt, relevant and objective feedback is the best way to learn about anything. With the tools discussed earlier, a retiree can understand the consequences of their investment and drawdown decisions. If this is provided regularly in terms they understand (i.e. future sustainable retirement

'pay cheque'), then they will make sound decisions. Imagine the peace of mind that retirees would derive from seeing that their projections of safe retirement rates have not moved much in times of market volatility.

Result: Put myth in context.

5. Need for new retirement investment products

It is not surprising that financial service providers are touting new retirement investment products: this is how much of their revenue is derived.

But, as is evident from our earlier comments, we believe that the key missing component is useful information in a language that retirees understand. Indeed, most superannuation funds already have a comprehensive range of diversified investment options. This range will often be sufficient (perhaps with some tweak for tax etc), provided retirees can assess each investment option in terms of safe withdrawal rates.

So do retirement products such as lifetime annuities have a place? Yes, but not as much as you might think.

Members with low account balances at retirement already have a significant lifetime indexed annuity from the Government. And members with substantial balances can live off dividends and income. In between, members can obtain financial flexibility and longevity through a retirement 'control panel'. Sure, lifetime annuities and deferred annuities may play a partial role, but they are not the total answer. And they can be expensive and inflexible.

Result: Myth busted.

Conclusion

Myths and confusion have been perpetuated by the industry's focus on the journey through the accumulation phase, together with a lack of understanding or use of the impact of investment volatility. The industry must communicate with members in the language they understand, i.e. their sustainable retirement 'pay cheque'. Providing retirees with a 'control panel' that they understand will stop them driving off the road (i.e. running out of money) thus empowering them with the right information to make sensible decisions.

Chris Condon and Peter Vann have been in the institutional investment industry for over 25 years. CV Solutions is a partnership between Chris Condon Financial Services Pty Ltd and Peter Vann, which provides retirement adequacy services to superannuation funds.

An idiot's guide to bond funds

Warren Bird

A question from Cuffelinks reader, James

I appreciate your readership includes many professional investors as well as advisers who would be all over this, but I think there are a lot of average Australians, including many who look after their own SMSF, who don't fully understand the machinations of bond funds – there appear to be more moving parts than a simple, old equities fund. May I suggest a series of articles that might consider the following topics:

- an idiot's guide on how to analyse a bond fund. What is the significance of duration vs credit risk? Should one invest in them for income or capital gain? Are there some bond funds that should be included

in the growth section of a portfolio as opposed to the defensive? Is a 70/30 split crazy when interest rates are at all time lows?

- a discussion of the merits of passive vs active investing in bonds (it is my understanding that most bond funds have underperformed passive funds over the past ten years, much like active equities funds)

- an explanation of these new-fangled 'unconstrained bond funds'. Are they just a fad? Are they a genuine solution to the duration risk argument? Have they been created in response to bond fund managers wondering where the next dollar will come from after a 30 year bull market?

The term 'idiot's guide' is colloquial, of course, but the workings of bond funds seem more complicated to many than equity funds. Perhaps the real issue is that investors don't understand equity risk as well as they should and have misguided beliefs about how straightforward their share fund actually is. But that's another story!

There's no doubt that anyone considering investing in a bond fund faces an array of information about the various products on offer that can make their choice seem anything but straightforward. Take the names of the funds they can choose, for example. There are Australian Fixed Income, Income Focused Bonds, Australian Corporate Bonds, Global Credit, Diversified Fixed Income, Global Bonds, High Yield and many more. Even the same manager will have at least a couple of these options on their list.

This article aims to cut through the confusion and provide a guide to understanding the world of bond funds. When an investor looks at the 'fact sheets' of bond funds, what are the important features to take note of? What do they need to know to make a decision that suits their investment needs?

The three main features of any fund to check out are: **yield, duration and credit quality.**

Yield

A fund's yield is a weighted average of the yields of the individual bonds in the portfolio. It will usually be referred to as the 'yield to maturity', or the 'effective yield'. It's analogous to the dividend yield of an equity portfolio. However, whereas dividend yields relate current dividend payments to share prices, bond yields factor in all the future interest payments, through to the bond's maturity. This is possible because the payments are fixed, or based on formulae that can be predicted. A bond fund's yield gives a good estimate of the income return it will pay over time. Usually, it will also give a decent estimate of the total return over a several year period.

Yield estimates aren't perfect predictors of income returns, however, for the following reasons.

First, it's assumed in the yield calculation that all bonds are held to maturity. This may be the case in an indexed bond fund, but is rarely true in an actively-managed fund. Active managers make decisions to sell bonds that they no longer find attractive and buy bonds that they believe will perform more strongly. If they are successful, then they will achieve a combination of realised capital gains and/or higher yields that produce additional income and return, over and above the initial yield estimate. And vice versa if their decisions don't work out.

Another important assumption is that all cash flows will be reinvested at current market rates. This rarely works in practice. If yields rise then reinvested cash flows will earn the new, higher, interest rate. That will enhance the income return compared with the yield, and vice versa if yields fall.

Those caveats aside, if you know that a bond fund has a yield today of X% then you can have a high degree of confidence that it will give you an annualised income return of close to X% per annum over the next few years. Exactly how many years depends on duration.

Duration

The duration of a bond fund gives you an idea of the time period over which the yield will play out. Duration is a measure of the period over which the cash flows of the bonds in the fund will be received; it therefore gives a guide to the time period over which investors should consider the fund's performance. The main difference between investing in an individual bond and a fund is that the individual bond's duration gets shorter over time, falling to zero at maturity. A fund, however, doesn't mature. Instead, maturing bonds are reinvested so that a fund's duration is managed within a stated range.

Short duration funds own either lots of short term to maturity bonds or floating rate notes, and thus haven't locked current yields in for long. Investors can expect to earn the yield for a year or two, but after that will depend heavily on future market conditions.

Longer duration funds – which are typically those that just have the term 'bond fund' in their name – own a mix of fixed income securities that mature from one to ten or more years. These have locked in current yields for longer.

Duration also gives an idea of the short term volatility you can expect in the unit price. When market yields fall, the value of bonds increases and so will the unit price of a bond fund; vice versa when market yields rise. These movements are more significant for longer duration funds than for short duration funds. This was explained in [an earlier Cuffelinks article](#) so the mechanics won't be repeated here. However, it's important to realise that these are not permanent gains or losses, and don't affect the income return of the fund. They are literally just short term price volatility.

The capital price risk that is really important to be aware of comes from credit risk.

Credit risk

Bonds are promises by an issuer to meet payment obligations. If all goes well the investor receives those payments, including their money back at maturity. There is no capital upside. If all does not go well for the issuer, then the investor may lose some or all of their capital.

Therefore, the credit quality of a bond fund gives an idea of the downside risk from capital loss if any of the bonds held in the fund defaults. A related measure, the credit spread, tells you both how much extra yield above government bonds the fund is earning, as well as how sensitive the unit price could be to changes in spreads.

Credit risk and credit risk management have been discussed in [this previous Cuffelinks article](#) and [this one](#) and [also this one](#). Managed funds come into their own in relation to credit risk, because pooled vehicles can diversify far more effectively than individual investors.

Information on the credit risk in a bond fund can be provided in a couple of ways:

1. The % of the portfolio that is invested in different credit risk ratings and in different types of issuers. This gives an overview of whether the fund focuses on high quality bonds (AAA to BBB) or includes some high yield (BB, B) in the portfolio, and if so how much.
2. The credit duration contribution of each rating category. For example, if the 'non-financial corporate' sector is contributing 0.5 year duration to the portfolio then that will tell you that a 0.2% widening of the gap in yield between those bonds and government securities would detract 0.1% from the portfolio's total return in the short term.

As with duration, credit risk generates mark to market valuation changes, rather than permanent gains or losses of capital. The GFC saw massive losses for a while through values falling in corporate bond funds, but these were almost all temporary and have now been unwound completely. There were some actual capital losses – eg Lehman Brothers had a bond that was held in many Australian portfolios – but these were fairly small in most managed bond funds in Australia. The high profile credit losses occurred in portfolios that were heavily geared and structured into sub-prime mortgages and the like. This writer believes, therefore, that for most investors it is % of portfolio exposure data that is more important to focus on so you know how much of your portfolio is exposed to the various types of credit risks.

Conclusion

When you look at any investment you need to have an idea of its expected return and risk. With bond funds, the yield tells you the expected return, while duration and credit risk information gives you an idea of the risks that you won't earn that return.

There's more to know about bond funds than this, of course, but if you have these three pieces of information you'll be in a good position to distinguish among different funds and make an informed choice which one might suit you.

We will return to the rest of James's question in a subsequent article.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest. His comments are general in nature and readers should seek their own professional advice before making any financial decisions.

Investor behaviour and lump sum bias

Aaron Minney and Phil Sainsbury

Australian superannuation funds face a number of barriers in providing an adequate and sustainable level of retirement income for their members. This article looks at one such barrier, an investor behaviour known as 'lump sum' bias.

What is lump sum bias?

Public superannuation funds accumulate capital for people to retire on. But most people find it difficult to calculate how much retirement income their capital can reliably produce from year to year. They tend to over-estimate the amount of annual income it can reliably produce.

Anecdotes about such behaviour are common place. Retirement expert, Don Ezra, suggests that if you ask an intelligent, but non-mathematical, person how much yearly income a lump sum of \$100,000 could reliably generate for the rest of their lives, their usual response would be in the range of \$10,000 to \$20,000. Most experts would put the correct figure at around \$5,000 per annum, perhaps even less.

Lump sum bias is where people place a higher value on a lump sum than the actuarially fair and sustainable income stream it could produce.

In rational economic theory, a person should choose the payment outcome that has the highest discounted value. Behaviourally, however, people have a bias towards a lump sum payment. There are a number of factors that explain why people exhibit such bias, including:

- wealth illusion – one simply looks bigger than the other
- affect heuristic – people make a rapid, intuitive judgment because it feels like a good amount
- simple temporal discounting – people generally prefer dollars today over dollars tomorrow
- preference for certainty – people perceive the future as uncertain, and by taking a lump sum payment today, they eliminate a degree of uncertainty, even if they potentially sacrifice some ultimately higher value
- opportunity cost – people believe that having a single large sum might enable them to create or exploit an otherwise unavailable opportunity
- utility of money – people expect the utility of money to decrease as they age and that they will have fewer and less attractive opportunities to enjoy the money.

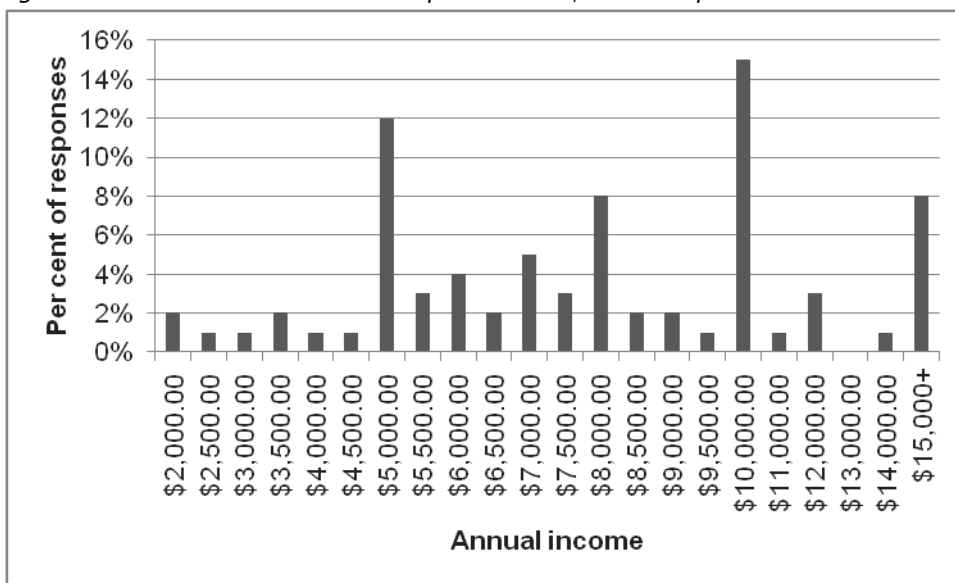
Evidence of lump sum bias

United States academic Dan Goldstein conducted an experiment where participants were asked to rate their satisfaction with either a \$100,000 lump sum or monthly payments of \$300, \$500 or \$900 for life. For a 65-year-old, such a lump sum is roughly equivalent to \$500 a month for life.

Respondents had clear preference for the lump sum, even compared to the much more actuarially valuable \$900 monthly payments. In fact, Goldstein calculated that the 'indifference point' (ie where people would take either) between monthly payments and a \$100,000 lump sum was \$1,065 a month, nearly twice what it should have been.

Australian financial research firm Investment Trends conducted a similar survey in Australia. They asked people 40 years of age and over how much minimum guaranteed annual income they would need for the rest of their life, in return for a \$100,000 investment. Figure 1 outlines the results. The average response was \$8,200 per annum, with \$10,000 per annum being the most selected option. This is well above the actuarially fair amount of approximately \$5,000 per annum.

Figure 1 Lifetime annual income required for a \$100k lump sum



Summary

When it comes to developing an income plan for retirement, lump sum bias can negatively impact the planning process. People who are unable to determine an equivalent income stream from a lump sum might not be saving enough. In particular, people with smaller amounts of retirement savings feel that a lump sum is more adequate for retirement than an equivalent income stream.

Most super fund members get their periodic statement with their latest account balance on it. If they also received a projection of their annual income in retirement in today's dollars (while highlighting the likelihood of a range of outcomes deviating from the average) it would help prevent them from falling short of retirement adequacy by over-estimating the value of their lump sums.

Aaron Minney is Head of Retirement Income Research and Phil Sainsbury is a Research Analyst at Challenger Limited.

[Pay attention to how company growth is financed](#)

Roger Montgomery

With iron ore slumping to five-year lows and Peter Reith suggesting Australia is headed for an 'inevitable' recession, the subject of growth should be a major focus for investors. Our previous article on understanding growth showed some tools available to companies to manipulate revenue growth. In this article, we look at understanding earnings per share growth and its funding.

If the point of investing is to forego expenditure today with the objective of improving purchasing power in the future, then this goal is enhanced by the pursuit of both value and growth. Value cannot be estimated in the absence of an estimate for growth. 'Growth' and 'value' must be two sides of the same coin.

Capital required to generate growth

Analysts and investors tend to focus purely on the growth that flows out of a company as measured by earnings and dividends. You will also find references to earnings per share growth in corporate communications about executive remuneration and mergers and acquisitions. Companies will explain that a proposed acquisition is earnings per share 'accretive' without much discussion about the impact of funding choices on investor's long-term returns.

Focusing only on earnings growth can lead investors astray. Take the example of ABC Learning Centres. For years, the company attracted a legion of fans as earnings swelled from \$12 million in 2003 to \$143 million in 2007. Focusing only on the earnings growth however ignored the funding that was employed to drive it and ultimately entrapped those investors enamoured only with headline earnings growth numbers.

In my experience, business owners tend to focus on the capital required to generate a dollar of earnings much more than equity analysts covering stocks. Indeed, how many dollars are required to fund the growth in earnings is arguably more important than the dollars of earnings themselves.

Suppose \$1 million is invested in a manufacturing business that produces a cash profit after tax of \$400,000, representing a 40% return. Visions of grandeur cause the owner to expand the operations geographically and after investing another \$1 million the following year in a second factory, profits grow 25% to \$500,000.

A 25% growth in after-tax earnings is nothing to sneeze at. Indeed, such growth rates are pursued vigorously by professional investors.

However, thinking beyond the earnings growth reveals what a poor investment the second factory is. While earnings have grown, more equity has been contributed to the business to achieve that growth. Invest more funds in a bank account and interest earnings will rise and the only property, plant and equipment (PP&E) required is a rocking chair.

The second factory required an additional investment of \$1 million and despite this 100% increase in equity, earnings grew only 25%. Putting aside issues relating to ramp up, the second factory has returned just 10% and that presumes all the growth came from the new factory, not from the older facility.

Not all growth is good

There is good growth and there is bad growth. Focusing only on the earnings cannot differentiate between the two. Growth is only good when each dollar used to finance the growth creates more than a dollar of long-term market value.

Table 1.

	Year 1	Year 2
Equity at Beginning	\$1,000,000	\$1,050,000
Return on Equity	5%	5%
Net Profit	\$50,000	\$52,500
Dividend	\$0	
Equity at End	\$1,050,000	
Price Earnings Ratio	10	10
Market Capitalisation	\$500,000	\$525,000

Table 1 shows a company whose shares are trading on a price earnings ratio of ten times. In Year 1 when the company earned a profit of \$50,000, the stock market was willing to pay ten times that profit, or \$500,000, to buy the entire company. The company begins Year 1 with \$1 million of equity on its balance sheet, and in the first year, it generates a 5% return on that equity (or \$50,000). Management decides that they need that money to 'grow' the business and so decide not to pay any dividends. That decision will cost shareholders dearly.

By keeping the profits, the equity on the balance sheet grows from \$1 million at the start of the year to \$1.05 million at the end. In the second year, the company again earns 5% on the new, larger equity balance, giving a profit of \$52,500.

So on the surface things look rosy. The company is growing. The equity has grown, the profits have grown and management is drafting an annual report that reflects their satisfaction. But management has, perhaps unwittingly, duded shareholders.

Shareholder returns are made up of dividends and capital gains. If a dollar is earned but not received as a dividend, it should be a capital gain. If not, it has been lost and management may be to blame. Every dollar that a company retains by not paying a dividend should be turned into at least a dollar of long term market value through capital gains.

The company in Table 1 has not achieved this, and although the company appears to have grown, shareholders have lost money. How? The company 'retained' all of the \$50,000 of the profits it earned in Year 1. The shareholders received a gain of only \$25,000. The company failed to turn each dollar of retained profits into a dollar of market value. If this were to continue, investors should insist that the company stop growing and return all profits as dividends and if that is not possible, the company should be wound up or sold.

The characteristic to search for, and avoid, is declining returns on incremental equity. This is precisely what happened to ABC Learning Centres and even an investor without a forensic accounting background could have spotted it.

Today, we see this at a range of businesses. Over the last decade, Virgin and Qantas have both seen declining returns on incremental equity. Equity contributed by shareholder owners of AMP has increased from \$5 billion in 2010 to \$9.7 billion in 2013 and yet profits have declined from a reported \$775 million to \$672 million. Over at Brambles, equity contributed by owners has risen from \$1.4 billion in 2005 to \$6.4 billion in 2014, but reported profits have grown only from \$528 million to \$619 million. At Newcrest, ten years ago the company earned \$130 million on \$802 million of equity. By 2014, shareholders have contributed \$13 billion and despite this altruism the company has managed to earn just \$315 million.

Ben Graham's observation that the market is a weighing machine in the long-run is timeless. The share prices of all of the above examples have produced uninspiring and even some negative returns over a period of ten years.

Not all growth is good but you will do just fine as an investor by focusing on those businesses whose earnings march upward over the years at a faster rate than the rate of increase in the capital used to finance that growth.

Roger Montgomery is the Chief Investment Officer at [The Montgomery Fund](#).

Watch your neighbour in managed funds

Graham Hand

This short series looks at some product shortcomings which could materially affect whether an investment is appropriate. An investor wanting a broad exposure to the market in a single investment has three main alternatives: unlisted managed funds, listed investment companies (LICs) and exchange traded funds (ETFs). We will focus on some weaknesses in each of these three product types. The [first part in the series looked at LICs](#), and this article goes inside managed funds.

The main problem for unlisted managed funds is that investments are combined with all other money in a pool, and the actions of others in the pool can adversely affect an individual. The 'open-ended' structure requires shares to be bought and sold within the fund as investors come and go. This contrasts with a 'closed-ended' product such as LICs where purchases and sales are made on market with other investors.

In the industry, it's called 'watch your neighbour' – what are other investors in the pool doing?

Examples of unwelcome impacts of pooling

The pooling of investors can have a significant impact on the returns of an individual.

1. Capital gains tax liability

When an investor withdraws from a fund, some shares may be sold to meet the redemption, potentially creating a capital gains tax liability. However, the capital gains liability does not go to the departing investor, but is left for those remaining in the fund when distributions are made. This can be a particular problem if many investors leave and few remain. When the fund makes its distribution, a large taxable capital gain liability may fall on the 'last man standing'. In other words, because investors move into and out of managed funds at different points in time, taxation liabilities in respect of gains that benefited past investors may be passed on to subsequent or remaining investors.

2. Loss of franking credits

Franking credits are only paid to investors receiving a distribution, and the value of the franking is not included in the unit price. An investor who departs a managed fund just prior to distribution leaves the full franking behind, and this may be a material part of the entire return. In fact, those in the know can arbitrage the fund if they know a large franking credit exists for a limited number of investors at distribution time. (Note, one fund recently started grossing up its unit prices for franking credits).

3. Managers forced to sell as investors panic

Investors are notorious for selling when the market falls and buying when the market rises. This can be problematic for open-ended funds because portfolio managers may be forced to sell even when they think the market offers excellent value. If they have to meet redemptions and no new money is coming in, it does not matter what the manager thinks about the market. They become frustrated net sellers at discounts to their own valuations, then as the market recovers and inflows return, they become even more frustrated having to invest at higher prices. While one investor can remain patient, the fund is forced to act due to other investors in the same pool. A closed-end fund does not need to meet redemptions when prices are low nor invest when prices are high.

4. Unrealised gains or losses

There is no allowance in the unit price for unrealised gains and losses in the portfolio, and this can have implications for the future taxation of the fund. Two funds may be otherwise identical but the one with large unrealised gains will give a higher capital gains tax liability to its investors after shares are sold than the one carrying unrealised losses.

5. Suspension of withdrawals

During times of market disruption, such as experienced by mortgage funds during the GFC, the liquidity of the underlying assets may not be sufficient to match the level of redemption requests. The fund manager may have no choice but to suspend redemptions. Managers advise in their PDS something like:

"Any decision whether to process withdrawals will be made in the best interests of investors as a whole. Under abnormal market conditions, some normally liquid assets may become illiquid, and we may restrict or delay withdrawal payments."

Again, the actions of some investors in panic mode may lead to the suspension of redemptions for the more patient and calm investors, and if the latter need to withdraw for some reason unrelated to the market, their funds might not be available.

6. Converting capital to taxable income

Distributions from a managed fund are based on the number of units that an individual owns on the distribution date in proportion to all units in the fund. The unit price (similar to the price listed on the ASX) of the fund will fall by the amount of the distribution immediately after it is paid. An investor buying units immediately before a distribution may be generating a tax liability without a return on the investment. For example, assume a unit price of \$2 and a 10 cent distribution on 7 July. On 8 July, the unit price falls to \$1.90 and the investor may receive a taxable distribution of 10 cents. Capital has been converted to taxable income due to the timing of the investment.

Your neighbour can bite you

Managed funds are far more complicated than most investors realise, and behind the scenes, trustees often have to deal with problems related to fair treatment between unitholders. The investor who does not know the portfolio's realised and unrealised capital gains, the potential loss of franking credits, the timing of distributions, the inflows and outflows of the fund and the risk of suspension is buying into a world of uncertainty.

Graham will be presenting on SMSF Portfolio Construction at the SMSF Owners' Alliance Technical Workshop on 9 October 2014 in Sydney. For the full agenda, please see www.smsfoa.org.au.

Graham Hand was General Manager, Capital Markets at Commonwealth Bank; Deputy Treasurer at State Bank of NSW; Managing Director Treasury at NatWest Markets and General Manager, Funding & Alliances at Colonial First State. Nothing in this article constitutes personal financial advice.

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