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This Week's Top Articles

Taxation reform: is Canberra serious?

Phil Ruthven

The Roman emperor Nero, apocryphally, fiddled while Rome burned in 64 AD.

Few politicians in modern times can play a violin or fiddle but they are very good at rhetoric, filibustering and back-flipping. And this explains why in Australia they consistently score so low on the Roy Morgan ethics and honesty ladder: indeed, below 15 points out of a hundred, sitting with union leaders, but above drug dealers, car salesmen and realtors. If that is any consolation.

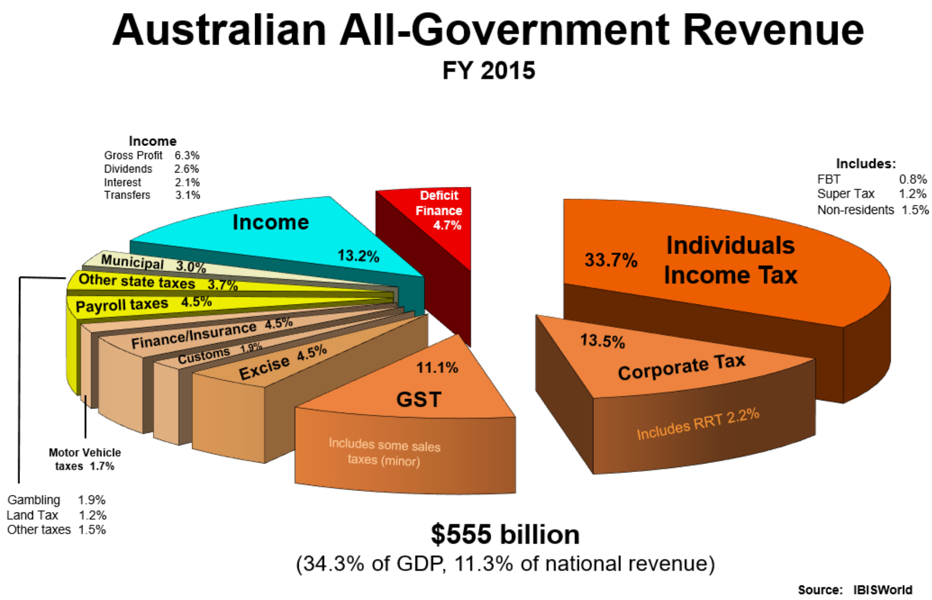
The wasted tax enquiries and summits of recent years testify to the insincerity or lack of courage of governments since the Howard/Costello era.

Facts have rarely been put on the table for the voting population to get perspective, either historical or international. Vested interests, as usual, go as hard as they can to muster support for their rent-seeking, bleeding-heart platforms or political opportunism.

Voters should be advised or reminded that we are living beyond our means, and need to raise taxes - or cut welfare and support (political suicide) - to balance our budgets and arrest the growing national debt being left to our children. The public deserves perspective.

What are the realities?

The first exhibit reveals that government at all three levels raised $555 billion in 2015, just over a third of the nation's GDP. The vast majority of it is via taxes, supplemented by income from GBEs (government business enterprises) and borrowings for the deficit.



It is nearly three times the share of GDP as when the nation federated in 1901, but then and for decades later, helping the less fortunate was a case of charity and family or tribal support. There was no national defence force, no pensions for the olds, no unemployment relief, no free education, little health care, no support for industries nor many other support services which we take for granted today. And want to keep.

If anything, we could be regarded as a bit mean-spirited with a current level of taxation at 27.7% of GDP in 2015. This compares with over 30% not so long ago, and is far below the OECD average of 35% of GDP; but not as lavish as many so-called nanny-states at over 40%.

The mischievous, self-serving and fallacious argument about the damage done by an increase in the GST and removing current exemptions on food, education and health to fixed and low income earners is scaremongering. It ignores the accompanying protection to such vulnerable households that would be given by legislation: governments are loathe to commit electoral suicide when it comes to taxation reform. Pensioners and other disadvantaged individuals and households would be largely compensated.

So let's turn to some of the myths and lies about our current taxation system.

Myth Number 1: We are highly taxed already

No, we are certainly not taxed highly by international standards, as seen in the second exhibit, and not by historical standards.

Let's put the lie to the suggestion that we are highly-taxed or over-taxed once and for all.

Myth Number 2: Raising the GST is regressive

We are the lowest GST nation in the developed world at an effective average rate of 4½% on goods and services, given the aforementioned exemptions. This compares with an effective average rate of 14% in the OECD; over three times our rate. It is hardly an unprecedented or risky step to raise the level as a way of balancing our budget.

Leaving the nominal rate at 10% but removing exemptions from the present regime would in itself lead to a balanced budget, provide room for compensation of the low and fixed income sectors of our population, and allow for adjustment to the tax thresholds arising from bracket-creep.

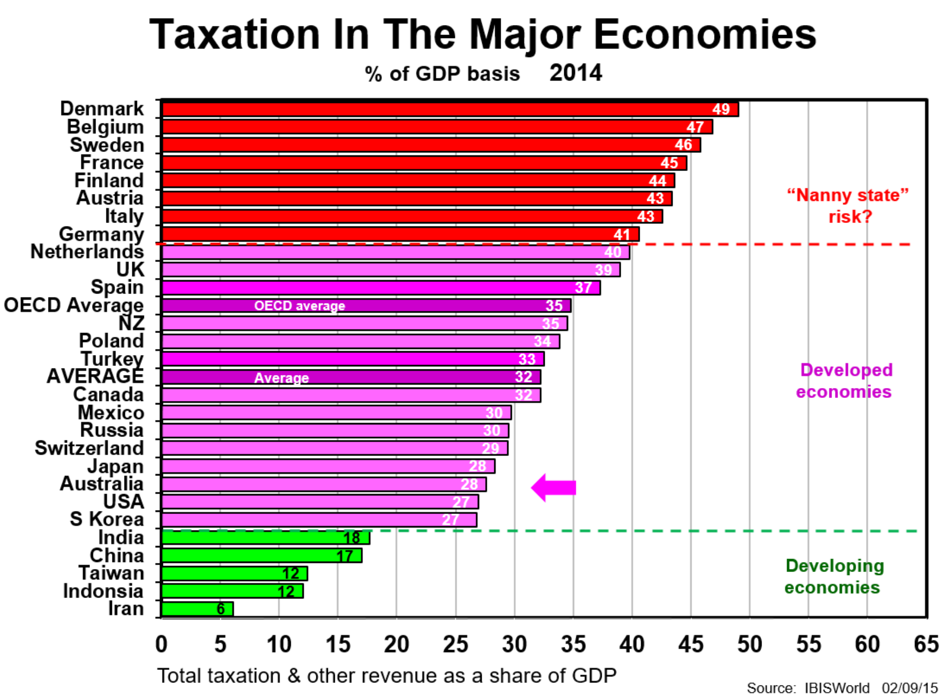
Raising the level to 12.5%, again without exemptions, would create room for a number of other initiatives as well, such as substantive reduction in personal income tax scales; reduction in corporate tax levels; elimination of some state taxes (eg stamp duties, payroll tax), or at least most of them. Doable, one would think.

Myth Number 3: Our payroll taxes are a disincentive to employ more staff

There is always talk of getting rid of payroll taxes, they being one of the bêtes noire of business. However, by international standards, we are low down the ladder of those that have labour taxes. Even if we lump in super payments (although they are not a tax, like social security taxes in other countries) into labour taxes, we are just over half the OECD average.

Myth Number 4: Our corporate rate of tax is uncompetitive

There has been a more recent push to lower our corporate tax rate from 30% to, say, 25% (and lower the Small to Medium Enterprise tax rate of 28.5% as well).



But the Australian corporate tax rates are not really too far out of kilter, being close to the average of developed economies.

There is a case to lower the tax rate if it would lead to higher investment from retained profits, thereby creating growth and productivity in the economy. A 27.5% rate would be a good start.

Myth Number 5: The rich don't pay enough taxes

One of the few ugly genes in the Australian ethos is envy and covetousness, in stark contrast to the aspirational genes in the USA. Fairness and equanimity is one thing – and we are good at those things by and large – but pulling down the 'tall poppies' is just plain silly.

The rich and well off, 40% of Australian households, pay the vast bulk of all taxes anyway, a stonking 87%! Some 60% of households pay less than 13% of all taxes. So, there is a lot of humbug and politicking in the area of who is copping the tax load. As usual, facts ruin a good story, or lie.

That said, bracket-creep in the individual income tax regime - the automatic follow-on from rising wages and inflation - is an issue that governments must, and do, address from time to time.

Our maximum individual income tax rate sits uncomfortably near the top of the international ladder, so threshold rates do need addressing as part of a reform package. The Treasurer is addressing this issue in the government's deliberations. We are taxing our citizens - rich and middle class alike - too highly. We should be lowering these direct taxes and replacing them with higher *indirect* taxes, especially the GST. The rich and well-off will pay much more of this GST as a result anyway, compared with the lower income households.

After all this, what should we do?

We are blessed with a very low national debt in 2016 that acts as a fiscal safeguard to our economy, but we need tax reform nevertheless. We are living beyond our means, primarily by not raising enough taxes by historical or international standards to cover spending, although that is not wildly out of control.

To try and save our way into balanced budgets is regressive, and unachievable anyway. We would lose services considered essential by 21st century standards, and equanimity in the community.

We should alter the mix of taxes in favour of the *indirect* (wealth spending) taxes to encourage savings, investment and productivity. The GST should be increased. Income taxes should be lowered. And the potentially disadvantaged poor and fixed income earners need to be compensated at the same time. All doable, with vision, courage and salesmanship.

Phil Ruthven is Founder of IBISWorld and is recognised as one of Australia's foremost business strategists and futurists.

Learning from my investment mistake

David Bell

I recently made what I consider to be an investment mistake in my personal portfolio. Strangely, it doesn't look like a mistake on paper, but you only become a better investor by admitting and learning from your errors. Whether a work or a personal investment, a post-mortem is an important process to go through whether the investment was successful or not.

I will share my broad reflections of this experience with you. For confidentiality reasons, I cannot provide all of the details but I don't think that stops me giving some useful insights.

For personal background context, you should know that I work in wealth management, study and have a young family. I love my work and have had a history of prioritising my work and my study above my personal finances. I have a lifelong trail of personal operational slippages which have cost me through the years, for example, not claiming refunds on expenses and not completing paperwork to accept free staff share offers at previous companies. At least things now align better as my super is invested in the fund that I manage at Mine Wealth + Wellbeing.

A little while ago, I made a private equity-style investment. For much of the time I was invested, I felt uncomfortable with the exposure. Recently it was restructured and I was fully paid out, both principal and interest. Overall, if you just looked at my outcome (low double digit annualised returns) you would say that it was a good investment. But deep down I know I made some fundamental mistakes.

What were my mistakes?

The first, and largest, mistake was the time I spent undertaking due diligence. Due to time constraints, I put in what I thought was a sufficient amount of time, but on reflection I should have put in a lot more. How much time is the right amount? The answer to this question is not known at the start of the due diligence process; rather a point is reached where you feel confident you have an appropriate amount of insight. Allocating time for due diligence is especially important in the case of illiquid investments where there is no opportunity to capitalise on subsequent learnings (unlike listed stocks for example when you can change your mind and exit the position with little cost). Different types of investments require different levels of due diligence. In the case of a private investment a large amount of time should be dedicated to the business model, competition, financial analysis and the structure of the transaction.

The related mistakes were broadly flow-on effects from the first mistake. When you are time poor you do less primary research (your own independent research) and take shortcuts such as relying on the information presented to you and taking confidence from the quality of the co-investors. These are examples of shortcuts that work well often but not always.

It's also important to reflect on what went well. I was involved in the structuring of the original investment and overall this was well-designed in the sense that it provided lots of protection for investors. Also by investing alongside some high quality investors it did prove that they were able to have some positive influence on the final outcome as the investment wavered (and it did get hairy: at one point, interest payments were missed).

Lessons for other investors

A post-mortem is a valuable process for all investors. It allows you to reflect on what went right and wrong and to consider improvements to your investment process. If you are reflecting as a group (for instance, we do this at Mine Wealth + Wellbeing) there can be moments where people may feel defensive but if the session is run positively then a lot of good can come from it.

The reflections I make are largely for personal investors, and particularly those who have an SMSF:

- As much as investing is interesting, do you have the skill to select your own investments? What is your personal investment edge that justifies selecting your own investments rather than relying on professional fund managers or using passive investments?
- If you believe you have the skill, do you have the time to appropriately assess investment opportunities and conduct ongoing monitoring on each of your investments? In my case I believe I have the skill but time was the issue.
- Are there investments that you are considering because they sound interesting and would be a great conversation starter? If yes, do you have the skill and time to appropriately assess and monitor these opportunities? Sometimes these skills need to be even more specialised. Strategies like hedge funds and private equity sound exciting but they can be much more complex to assess.
- If you are considering private (illiquid) investments, then the issues raised about skill and time are even more important: you cannot easily reverse your decision once it is made.

Following on from my self-reflection I changed the way I invest my personal portfolio. I acknowledge that I don't have enough time to undertake due diligence and conduct ongoing monitoring on a range of investments. Indeed, my personal investment process is well below the investment process I apply at work. I came to the view that this makes investing in private, illiquid investments a bad match for me at this stage of my life. So now I invest in liquid assets through managers that I know very well and trust. As my personal situation changes then the scope of my personal portfolio management activities may also change.

Being honest with yourself is an important starting point when designing and evolving your personal investing strategy. How well does your current strategy line up against your skills and time availability?

David Bell is Chief Investment Officer at Mine Wealth + Wellbeing. He is working towards a PhD at University of New South Wales.

There's still time for some SMSFs to use 'anti-detriment' provisions

Noel Whittaker

Amid all the rumours about changes to superannuation, one of the hottest is that the government will soon abolish the anti-detriment provisions.

I am referring to the ability of some superannuation funds to refund a lump sum to the member's estate on death, in compensation for the 15% contributions tax that was deducted from their contributions during their working life.

How did this generosity start?

To understand how this unusual burst of generosity came about, you need to cast your mind back to July 1988, when Federal Treasurer Paul Keating introduced a 15% tax on deductible contributions to superannuation. Until then, there was a tax of 30% on exit, but no tax on entry.

Keating had promised there would be no new taxes during that term of government, so his method of changing the taxes was to chop the 30% tax in half, and put 15% on the front, leaving 15% on the back. Of course, the government claimed the 15% tax was not a new tax, merely a reshuffling of the existing one.

The new contributions tax was called 'detrimental' to qualifying dependants and, to compensate them, legislation was passed to enable all contributions tax paid to be refunded to the estate – hence the term 'anti-detriment provision'.

An anti-detriment payment can be made only to a spouse or former spouse of the deceased, a child of any age, or to the estate provided the ultimate beneficiaries are the spouse, former spouse or a child. It can only be made when an accumulation death benefit is paid as a lump sum, or when a pension is commuted to a lump sum on the death of a pensioner (or reversionary pensioner) within the prescribed period. This is usually three months from grant of probate or six months from the date of death.

Payments could be substantial

The calculation of the payment is complex, but in many cases the fund may use a simple formula. This is between 13.68% and 17.65% of the taxable component (excluding insurance) if the eligible service period commenced before 1 July 1988, and 17.65% for service that commenced after that date. For example, for a fund of $600,000, the anti-detriment payment could be $105,900.

As always, the devil is in the detail. The payment does not come immediately from government revenue but is created by allowing the fund a tax deduction. This means it comes from future tax payable by the fund.

Even though SMSFs can make an anti-detriment payment, it seldom happens in practice, because the payment must be made before the tax deduction can be claimed. Usually this means the fund needs to pay a benefit that is greater than the member's account balance, and the fund needs to have substantial reserves to do this. Most don't have them.

A worthwhile option, if you are in a position to do so, would be to withdraw a large chunk of your superannuation tax free after you turn 60, and then re-contribute it as a non-concessional contribution. For our $600,000 fund, this could increase the non-taxable component by $540,000 and reduce the tax that would be payable if the superannuation was left to a non-dependent, by $91,800. This would reduce the negative impact of any changes in the law.

Factors such as conditions of release, contribution caps and work tests all need to be satisfied, which is why expert advice is essential before adopting this strategy.

Another option, if you have an SMSF and think you are close to death, would be to roll the balance into a large retail fund. This fund may well have the ability to make an anti-detriment payment because it would be able to use up the tax concessions generated.

For some people, there is really nothing you can do to protect yourself against the removal of the anti-detriment provisions except cash in your super before your day of passing. That just leaves you the challenge of predicting this day, which should be easy compared to keeping up to date with superannuation changes.

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. See www.noelwhittaker.com.au.

Ten rules of thumb for more effective ETF investing

Alex Prineas

A number of exchange-traded funds (ETFs) traded at substantial discounts to net asset values (NAVs) during bouts of substantial volatility in late 2015 in the United States and Chinese share markets. While funds' prices quickly snapped back and came into alignment with their underlying NAVs and the trading anomalies were short-lived, it was a reminder of the need for caution in ETF trading in tumultuous markets.

We haven't seen anything like those disparities in Australian-listed ETFs, but it is worth revisiting some rules of thumb for transacting in ETFs which, if followed, should reduce the chances of local investors being impacted by such events.

1. Use limit orders rather than market orders

Market orders (ie an order to fill the trade at the best available price) tend to be used when time is of the essence and price is of secondary importance. Investors using market orders want to execute their entire order as soon as possible. For very large, very liquid ETFs that trade contemporaneously with their underlying securities, market orders will likely result in fast execution at a good price.

But there are smaller or less liquid ETFs, and there are also ETFs that trade out of sync with their constituent securities (such as U.S. equity ETFs where there's no overlap between Australian and U.S. trading hours). Limit orders (ie an order to fill with a specific price limit) will ensure favourable execution from a price perspective. A buy limit order will fetch the buyer a price less than or equal to the limit price, while a sell limit order will transact at a price greater than or equal to the limit price.

2. Avoid trading at open, close, or in the auction period

For ASX-listed ETFs, this means at the very least, avoiding trading earlier than 10:15am or later than 3:45pm. At these times, market-makers may not be watching the market as closely, and some underlying stocks may not be trading, making it more difficult for the market-maker to calculate an accurate price.

3. Be wary of transacting when the underlying securities are not open for trading

With transparent pricing of the underlying stocks, trading volumes should be substantially higher, and bid/ask spreads will typically be lower. For example, trade Asian ETFs in the afternoon, once the Hong Kong, Singapore, and Shanghai exchanges are open.

4. Check the bid/ask spread

If the bid/ask spread is wide, it may indicate that something is amiss, and it might pay to delay your trade or dig further.

5. Check trading volumes and ETF size

An ETF's on-screen trading volume doesn't tell the whole story. The liquidity of the underlying assets is arguably more important, because the market-maker can create or redeem ETF shares to balance supply and demand, as long as the underlying market is liquid. However, the size of an ETF and on-screen volume are worth monitoring, particularly for ETFs where the underlying assets trade outside Australian hours.

6. Use the available tools

ETF providers offer tools such as the intraday NAV (iNAV) which can help gauge whether an ETF is trading near its net asset value (NAV). Although there's no guarantee the iNAV will be an exact representation of the NAV, it's a useful indicator. Check the iNAV before trading.

7. Apply a common sense check

Ask yourself: is there anything unusual here? Is the ETF price substantially different from the previous day, or even from a few minutes ago? Is the ETF price stable while underlying markets are rising or falling? Are markets going through extraordinary volatility? If so, further research or patience may be required before placing a trade.

8. Be careful about using stop-loss strategies

Stop-loss strategies caused serious problems for some U.S. investors in the recent market turmoil. The U.S. sharemarket gapped downward because of a lack of liquidity at that moment, which triggered stop-loss orders. Because some of these stop-losses were market orders, they were filled at any price available, and with limited liquidity at the time, may have caused an even bigger drop in prices. We advise caution using stop-loss strategies, especially if they're triggered automatically, or use market orders.

9. If in doubt, contact the ETF provider or market-maker

The ETF provider (or for large investors, the market-maker) can answer questions about trading an ETF and explain anomalies. If in doubt, contact the ETF provider or market-maker before trading.

10. Remember – it's all about your investment strategy

Investors investing for the long term may have fewer worries when transacting ETFs. If a volatile market causes bid/ask spreads to widen, a long-term investor can be patient, waiting to execute their trade when volatility has subsided. In contrast, a short-term trader may be forced to exit a trade quickly, no matter what the cost. Nevertheless, if an ETF doesn't help you achieve your investment goals and strategy, or fit with your tolerance for risk and investment time horizon, then it's unlikely to be the best fit for you, no matter how attractive an investment proposition it seems.

Alex Prineas is a Research Analysts at [Morningstar](). This article is general information and does not consider the investment needs of any individual.

Smart beta: watch the details

Marlena Lee and Gerard O'Reilly

New index-based strategies known as 'smart beta' appear to be growing in popularity, but not all these strategies are created equal and investors should be mindful of implementation. These indices seek to outperform conventional market cap-weighted indices by breaking the link between a stock's desired weight and its market cap, instead deriving desired weights from characteristics such as book value, earnings or recent performance.

While many names are used for this approach, smart beta is the most common. The chart below shows assets managed under the smart beta label have grown to more than $US500 billion over the last 15 years. While still a small percentage of the overall market, this growth implies they are becoming a more popular choice. But are they the *right* choice?

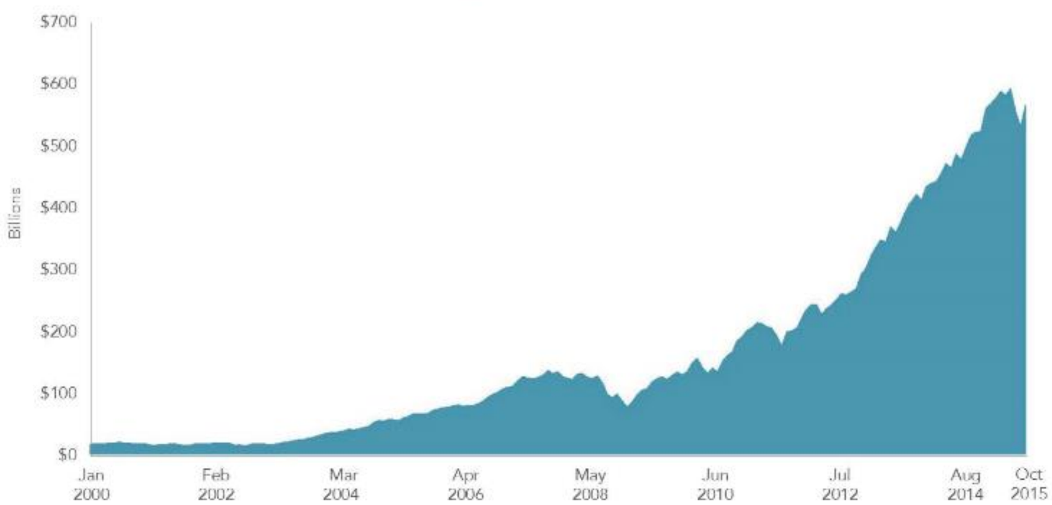
Data show smart beta indices can provide exposure (sometimes inadvertently) to size, value and profitability premiums, but they may do so inefficiently and may subject investors to unnecessary risks. Also, there is no compelling evidence that aggregate long-term demand at the security level has changed because of inflows to smart beta strategies.

Without such evidence, it's not possible to say that there is 'more money chasing value' today than in the past. Instead, flows into these indices may represent a transfer of assets from managers who target a similar set of securities using a more traditional active approach.

Identifying differences in expected return

Just as it is reasonable to expect equities to have higher expected returns than bonds, it is reasonable to expect different securities to have different expected returns. Different stocks can provide different hedging needs and risks. This may be

Exhibit 1: Total Net Assets in Smart Beta Funds, January 2000–October 2015



Data source: Morningstar.

investor-dependent if some investors are the natural holders of certain risks and others are not. Alternatively, in behavioural finance, tastes and preferences drive expected returns without associated 'real' risks or hedging preferences. Under either framework, there is a very low possibility of all stocks having the same expected return.

To identify information that can be used to determine differences in expected returns between securities, it is useful to begin with the valuation equation which links expectations about a firm's future profits to its current price through a discount rate. A low relative price is one indication that the market has discounted a company's expected future profits more heavily. Applying the same valuation logic, companies with similar price characteristics but different levels of expected profitability should have different expected returns.

What happens if everyone becomes a value investor? The answer is that it isn't possible. Collectively, all investors must hold the entire equity market. For every investor who wants to overweight stocks with low relative price, there have to be investors who want to overweight stocks with high relative price.

As long as market participants apply different discount rates to different stocks, a strategy that uses a combination of current market prices and up-to-date firm characteristics can identify those differences today, tomorrow and into the future. Using current prices is the key to identifying these differences in discount rates.

The risk from ignoring prices

While we expect positive size, value and profitability premiums, not all strategies that pursue those premiums are created equal. Investors always have the option to invest in a plain vanilla broad market index fund. This is a decent option as these funds are transparent, low cost, low turnover and well diversified. The success of conventional market cap-weighted indices can be explained in part because they have delivered what they set out to deliver - market rates of return.

However, it is not clear whether smart beta indices will be able to deliver their goal of outperforming the market. Unfortunately, good back-tested research does not provide enough information to make this assessment. The implementation details matter.

For example, if a smart beta index ignores market prices, it is difficult to infer if it will have a higher expected return than the market going forward. In back-tested research, the index may have provided inadvertent exposure to stocks with low relative prices and high profitability, and outperformed the market. If current market prices are ignored in index construction, this implies the index is not directly managing that exposure and may not outperform in the future.

A smart beta index also may generate excessive short-term demand for less liquid stocks and create unnecessary turnover. As the assets attached to that index increase, there may be a drag on returns due to an index reconstitution effect.

So when evaluating a strategy, there are a number of questions to consider, including:

- **Does the strategy use current prices when choosing securities?** If a strategy ignores current prices, a vital component of what drives differences in expected returns is omitted.
- **Is there unnecessary turnover?** Security weights that are not tied to market cap weights may incur excessive turnover that increases implementation costs without increasing expected returns relative to a market cap-based approach.
- **How is the strategy rebalanced?** Trading that demands immediacy from the market can be costly, even if turnover is low.
- **Are there avoidable risks and is the portfolio well-diversified given its mandate?** Investors should be cautious about an approach that allows for extreme positions in a few securities. While this can yield good back-tested results, it can also result in significant company-specific risk.

An alternative solution

A better approach is to begin with research into how markets work. A sensible story can boost one's confidence that a premium is positive in theory, while a low-cost approach improves the chances of capturing premiums in practice. No premium is a sure thing. Costs, on the other hand, surely lower investors' net returns. Investors should consider whether a strategy would be a good investment even if the premiums are smaller in the future or do not appear at all.

It's important to have a solution that will be at least as good as the market portfolio in most scenarios, including if the premiums do not show up. A strategy with high implementation costs will have lower expected returns than the market portfolio if the targeted premiums do not exceed the costs.

Keeping opportunity costs low helps a strategy maintain market-like expected returns even if premiums do not appear in the future.

A well-designed strategy that seeks to capture size, value and profitability premiums should minimise its opportunity cost relative to a broad market index. Key tools for doing that include using current prices in every part of the investment process and remaining well-diversified. As well, one should pursue premiums that lead to low strategy turnover and that eliminate unnecessary turnover. The final key is adopting a flexible approach to portfolio management and trading that balances competing premiums and considers explicit and implicit trading costs.

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