

This Week's Top Articles

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Don't be misled by investment classifications

Chris Cuffe

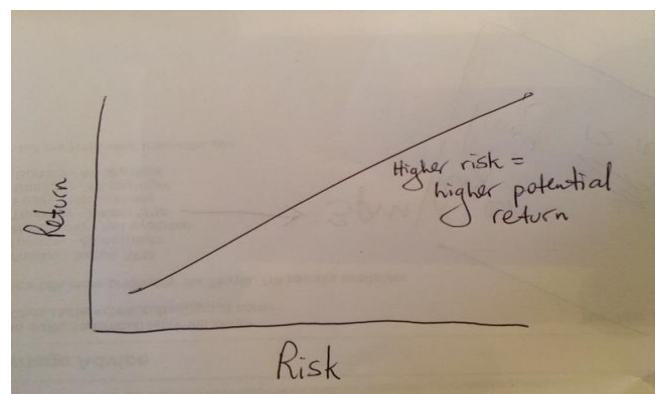
Investment professionals need to communicate as clearly as possible, and some classifications which market experts think are obvious can be confusing. This is a short piece with a few simple ideas on some investment descriptions. Anyone expecting a great piece of gravitas from me here will be disappointed.

In my view, many institutional investors follow herd-type thinking, without robust logic, because everyone before them followed the same line of thought. My many years of experience in investment markets have caused me to dismiss some of this traditional thinking. Much of what is preached is not robust enough in my view and I am not alone in my skepticism, though certainly in a minority. The investment community is prone to putting concepts into neat little boxes, which does not work because investing is more of an art than a science, despite the continued attempts to make it a more predictable subject.

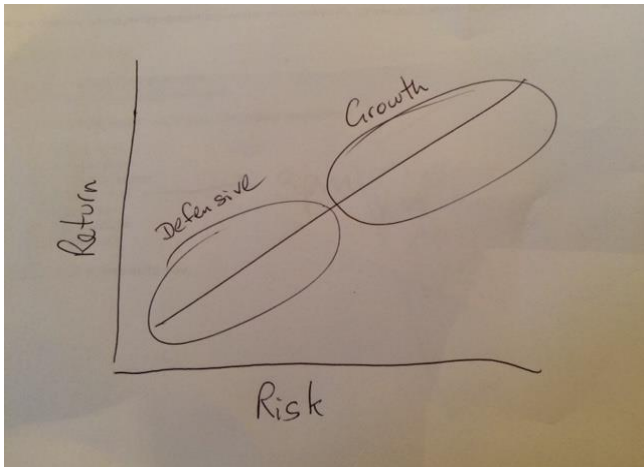
Thinking about risk and return

A good example of what I am talking about is the distinction between defensive assets and growth assets and their relationship to risk and return.

Like many, I think a good and simple way to think about investing is to visualise a line graph with risk on one axis and return on the other and with an arrow pointing from lower left to upper right. It represents the range of possible investment outcomes. This basically depicts the view that the greater the expected return from an investment then the greater the risk. This is a sensible way to think of investing within a framework of *no free lunches*.



Many investment professionals then segment this risk/return line into two sections. The bottom part comprises 'defensive' assets and the top part comprises 'growth' assets.



And most think of defensive assets as comprising cash and fixed interest, with growth assets comprising shares and property.

It's neat, simple and convenient but in my view, these classifications are likely to mislead.

Avoid the word 'defensive'

The largest option category run by institutional superannuation funds is their *Balanced Accumulation option*. Such investment products are usually classified as having approximately 30% in defensive assets and 70% in growth assets. And if the manager is feeling bearish about equity markets, they will proclaim that they are increasing their allocation to defensive assets.

The language is wrong. If we must use a two basket classification, then I prefer the terms 'income' and 'growth' which is a reference to where the majority of the return of a security or asset class is predicted to come from. Generally speaking, assets whose returns are largely from income (on the assumption the income is relatively secure and predicable) are considered less risky than assets whose returns are largely from growth (and hence dependent on many variables, mostly on future prospects).

I dislike the term 'defensive' because it is subjective and makes no reference to current valuations, timeframes or investment objectives. Defensive against what? And if I look in the dictionary the word 'defensive' has positive and comforting connotations like defending, guarding, safeguarding, protecting and shielding. So if the term is used, we need to be sure we know what we are talking about.

Some simple examples to illustrate the point:

- You will lose a lot of money from holding a 10-year government bond (regarded as a risk-free asset and hence one of the more defensive of all

assets) if interest rates move up materially and you are required to sell it before maturity, or if your performance and measurement are judged on a quarterly basis.

- Cash is considered a very defensive asset. But if my investment objective was, say, to achieve a return in excess of CPI over the medium to long term, then cash may be a high risk asset. Many investors who went into cash after the GFC saw their incomes fall significantly, with real returns now below zero. Similarly, holding a portfolio of high quality equities over the long term gives a high probability of beating inflation, and dividends from shares and rents from property usually fall only 20-30% in a recession. But 'cash' is usually the lowest risk (and most appropriate) asset if your investment time frame is very short (say less than one year).
- If the spread (margin above a government bond) on the debt of blue chip company is much tighter than the long-term average, then it may be a high-risk investment. Spreads can easily widen in different economic climates with resultant capital losses.

My point here is that hard-wired classifications can be misleading. It's better to think of defensive as a relative concept, not the absolute that the word implies to most people.

Cash does offer certainty of capital value and immediate liquidity, and those are fine 'defensive' qualities, while bonds offer certainty of capital value and interest income if held to maturity (and assuming no defaults).

What do we really mean by 'risk'?

What does the term 'risk' mean when we are trying to look at the risk/return characteristics of a security on the assumption we have a long-term time frame?

Most investment professionals (and non-professionals) equate risk to the degree of volatility in asset prices, usually measured as some variance around a mean return. However, I don't believe this tells us much at all. In my article titled ['We need to talk about risk'](#) I state that, like Howard Marks (a renowned US investment manager and investment author), I think the possibility of a permanent capital loss from owning an asset is at the heart of what investment risk is truly about. Then follows the possibility of an unacceptably low return from holding a particular asset. Marks believes much of risk is subjective, hidden and unquantifiable and is largely a matter of opinion. He makes the point that investment risk is largely invisible before the fact –

except perhaps to people with unusual insight – and even after an investment has been exited.

No less an investor than Charlie Munger, Warren Buffett's investing partner, said:

"In thinking about risk, we want to identify the thing that investors worry about and thus demand compensation for bearing. I don't think most investors fear volatility. In fact, I've never heard anyone say, 'The prospective return isn't high enough to warrant bearing all that volatility.' What they fear is the possibility of permanent loss."

I agree with him. Market professionals like the traditional measure of risk, volatility, because they can measure it and sound intelligent. But if I am confident about the long-term prospects of a company, and I plan to hold its shares over the long term, then I don't care about the short-term volatility. In fact, I try to ignore the share price except when I'm forced to do my accounts.

Like the word 'defensive', let's also be very careful in how we think about and use the term 'risk'.

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 own and they are not personal financial advice.

'Short selling' and the Australian banks

John Pearce

Short selling (or 'shorting') literally involves selling something you don't own. Here's a hypothetical example of the basic steps involved:

1. An American hedge fund manager thinks the price of ANZ shares is going down.
2. The hedge fund doesn't actually *own* any ANZ shares so it borrows the shares from an Australian fund, and then sells the borrowed stock on the market.
3. At some point the hedge fund will need to buy back the shares and return them to the lender.

The profitability dynamics of those steps are reasonably straightforward. Let's assume the hedge

fund borrowed ANZ shares at \$30. Ignoring the small amount of borrowing and transaction costs involved in establishing the short position (usually less than 1.0% p.a.), the hedge fund will profit if the price of ANZ falls below \$30. However, if the price rises above \$30, its short position will incur a loss when the shares are bought back.

Hedge fund activities raise the ire of some market participants who see them as unscrupulous predators exploiting the very market instability they helped create. There's no doubt that short selling can exacerbate a market panic – sometimes leading to a ban on the practice (the most recent example being in China).

We believe that the ability to short sell is fine in a normally-functioning market, as it actually adds to the liquidity and efficiency of a market.

Short selling is not without risks, as share prices can go up as well as down. Shorting Australian banks has indeed been a losing trade for a long time (referred to as a 'widow maker' in market lingo), but this hasn't stopped hedge funds from continuing with the practice.

Why Aussie banks are perceived to be the next 'Big Short'

The Australian Securities Exchange (ASX) discloses the amount of a company's shares that is shorted. For our major banks, the number is currently around \$7 billion, close to a record high. Although it's certainly a big number, it represents only 2% of the total value of the banks. This compares to Myer, for example, which has around 11% of its market value shorted!

Given the dearth of hedge fund managers in Australia who can short-sell, it's reasonable to assume that most of this activity originates offshore. The term 'Big Short' is the title of a book (and now made into a movie) written by Michael Lewis which (simply and colourfully) documented the GFC through the eyes of four very successful hedge fund managers.

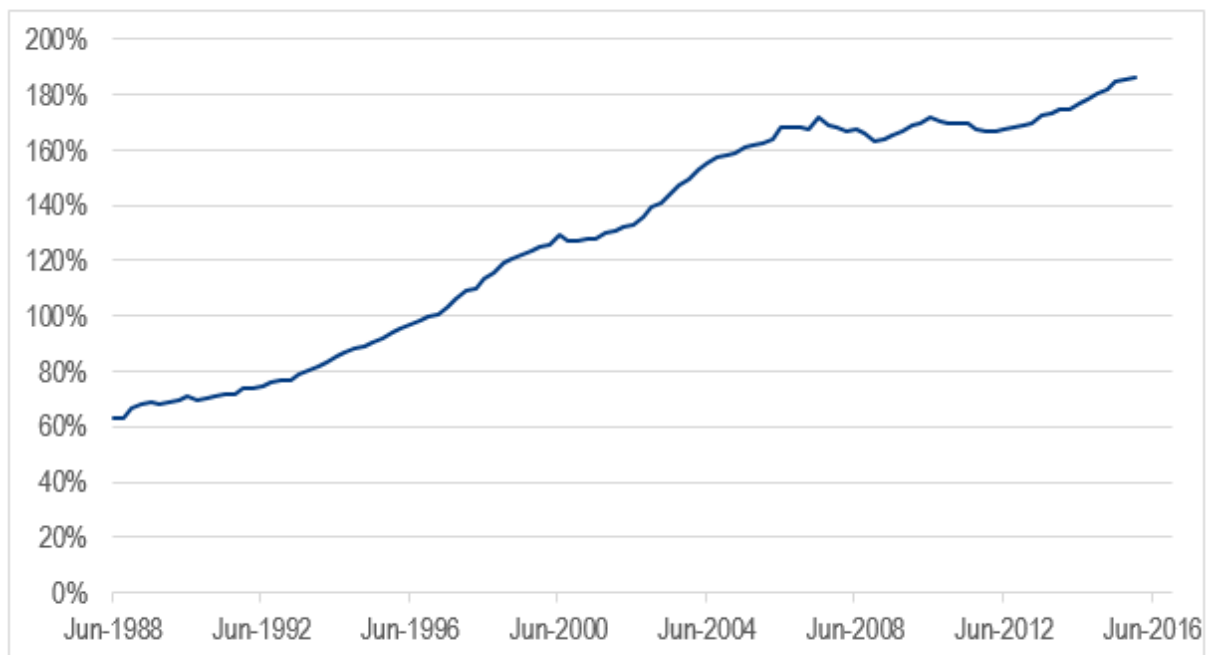
The following two graphs capture the essence of the short selling argument. Graph 1 shows asset prices growing at a rate far in excess of income growth. This has been made possible by increased borrowings as shown in graph 2.

Graph 1: House price to income ratio



Source: Goldman Sachs Global Investment Research

Graph 2: Household debt to income



Source: Reserve Bank of Australia

History tells us that extreme valuations fuelled by high debt is an accident waiting to happen. In the most pessimistic commentators' eyes, the Australian situation resembles the bubble we witnessed in America and Ireland leading up to the GFC – and we know how that ended. Given that around 50-70% of Australian bank loans are secured by housing, the implications of a housing crash are self-evident.

Other features of the Australian environment also bear an unfortunate resemblance to the American experience. In particular, there's mounting evidence of an apartment oversupply projected to continue for the next couple of years as developers complete the current construction pipeline. Sharp falls in prices (up to 30%) are now being recorded on some apartments bought off-the-plan at the height of the

boom and some developers and investors will lose money.

The major banks claim they have limited exposure to high-risk property developers, although there's little doubt that they have played their part in fuelling the boom. In 2014, around 40% of all housing loans written were interest-only investment loans (as distinct from loans to people who are buying a primary residence). According to our analysis, we believe at the peak, some banks were writing over 50% of new business in interest-only investment loans.

Fortunately, the banking regulator, APRA, clamped down on such practices in mid-2015, limiting investment loan growth to 10%. While it's comforting to see bank lending on a more prudent path, it is somewhat of an indictment of bank management that it has required the 'big stick' of the regulator to make it happen.

Not all bubbles burst; some just deflate

Forecasts of a crash in Australian house prices are not new, and of course the property market didn't come through the GFC unscathed. Property prices will always remain vulnerable to large systemic shocks, principally recessions. However, a general collapse in housing prices leading to a sharp rise in bad loans and write-offs for the banks is far from inevitable, given some mitigating factors.

Compared with the commonly referenced data in the first two graphs, graphs 3 and 4 paint a very different picture of the state of household finances. Unlike graph 2 which compares the amount of debt to annual income, graph 3 compares debt to total assets.

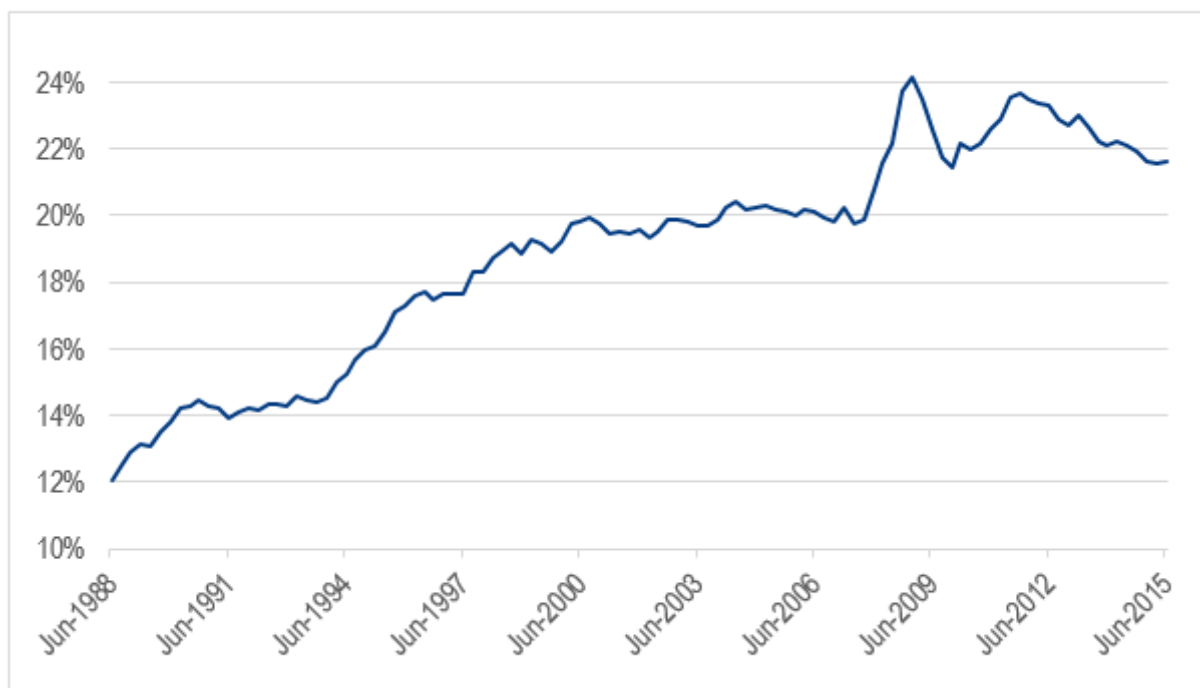
Based on this data, Australian households – on average – currently look far from a debt crisis, with the value of assets about four and-a-half times greater than the value of debt.

Clearly, there are individuals above and below the average. However, we gain some comfort from the stricter lending criteria in recent years, which should help limit borrowers from over-extending.

To complete the picture, we also need to look at debt serviceability. That is, how onerous is it for Australian households to meet their interest payments? Graph 4 shows that on average, at current interest rates, only 7% of income is required to meet interest bills. On this measure, household affordability is nearly as cheap as it's ever been.

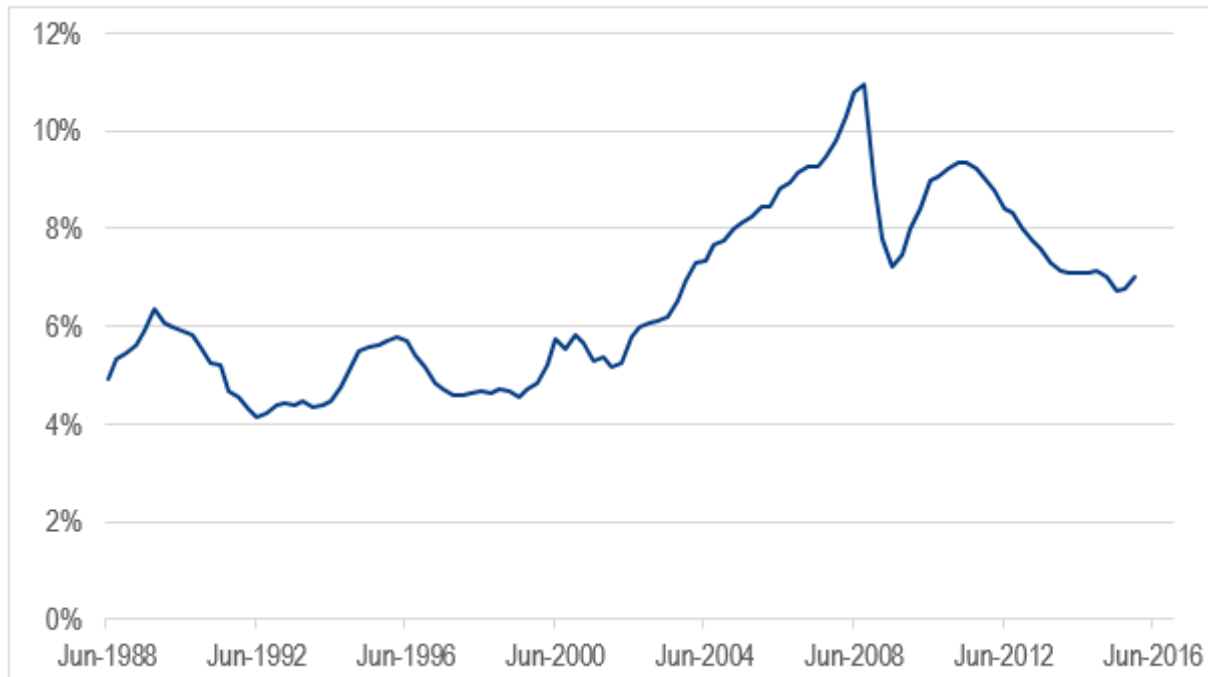
Nevertheless, assets can go down in price whereas outstanding debt only falls with actual repayments so Graph 2 is not totally irrelevant. It is arguably useful in estimating the potential extent of a debt crisis rather than drawing firm conclusions on the probability of it occurring.

Graph 3: Household debt as a percentage of assets



Source: Reserve Bank of Australia

Graph 4: Debt servicing (housing interest payments to income)



Source: Reserve Bank of Australia

In summary, the pessimists will point to statistics which on face value look alarming, but are also potentially misleading. The reality is that 'on average' Australian households have assets well in excess of debt and even if asset prices fall, the ease with which the debt can currently be serviced provides a cushion if income is maintained.

And this is the crucial point – it's all about employment. If Australia can maintain unemployment around current levels, there's no reason why the bubble has to burst. It can simply deflate, with a gradual decline in house prices and gradually rising incomes.

Fuelling the fire are bad corporate loans

With our major bank shares currently trading around 30% below the highs of March 2015, the short sellers appear to have the upper hand, despite the absence of a housing crash. How so?

The latest swoon in the share prices followed ANZ's announcement that impairments (i.e. expected losses) on their corporate loan book would be "at least \$100 million higher" than previously guided. Recent failures such as Dick Smith, Slater & Gordon, Arrium and Peabody Resources are well known to the market so an increase in impairments (particularly from a historically low level) should not come as a surprise. However, in the week following the announcement \$8 billion was wiped off ANZ's market value!

The market's reaction reflects concerns that ANZ's announcement is the tip of the iceberg, and talk of dividends being slashed to shore up capital is gaining traction. While a cut in dividends is possible, it is premature for anybody to be predicting that they will be 'slashed'. And by no means are all of the banks equal.

During the GFC the major banks cut their dividends on average by 20%. However, to put this in context, at that time CBA's ratio of bad debt costs to total loans was around 4.5 times higher than the level reported in their latest announcement of financial results.

At this point, it seems that the bank short sellers are right, but for the wrong reasons.

John Pearce is Chief Investment Officer at [Unisuper](#). This information is of a general nature only and has been prepared without taking into account any individual objectives, financial situation or needs. Before making any decision in relation to your personal circumstances, you should consider whether to consult a licensed financial adviser.

ETFs playing bigger role for investors

Ilan Israelstam

The annual BetaShares/Investment Trends Exchange Traded Fund Report was released recently. BetaShares has been associated with this Report for the past five years and it provides a snapshot of the key statistics and drivers in the Australian ETF industry, from the perspective of individual investors, SMSFs and financial planners.

The insights are based on the responses of 9,418 investors and 676 advisers.

Key findings of the Report

- the number of ETF investors increased 37% to an estimated 202,000 in 2015
- a record number of investors intend to make their first ETF investment in the next 12 months, estimated at 110,000
- 41% of current ETF investors (~83,000) invest through an SMSF

- financial planner usage of ETFs continues to increase. with 64% intending to start or continue using ETFs in the next 12 months
- Strong latent demand for exchange traded managed funds is an unmet opportunity for industry growth.

For a copy of the 2015 Exchange Traded Funds Summary Report, [click here](#).

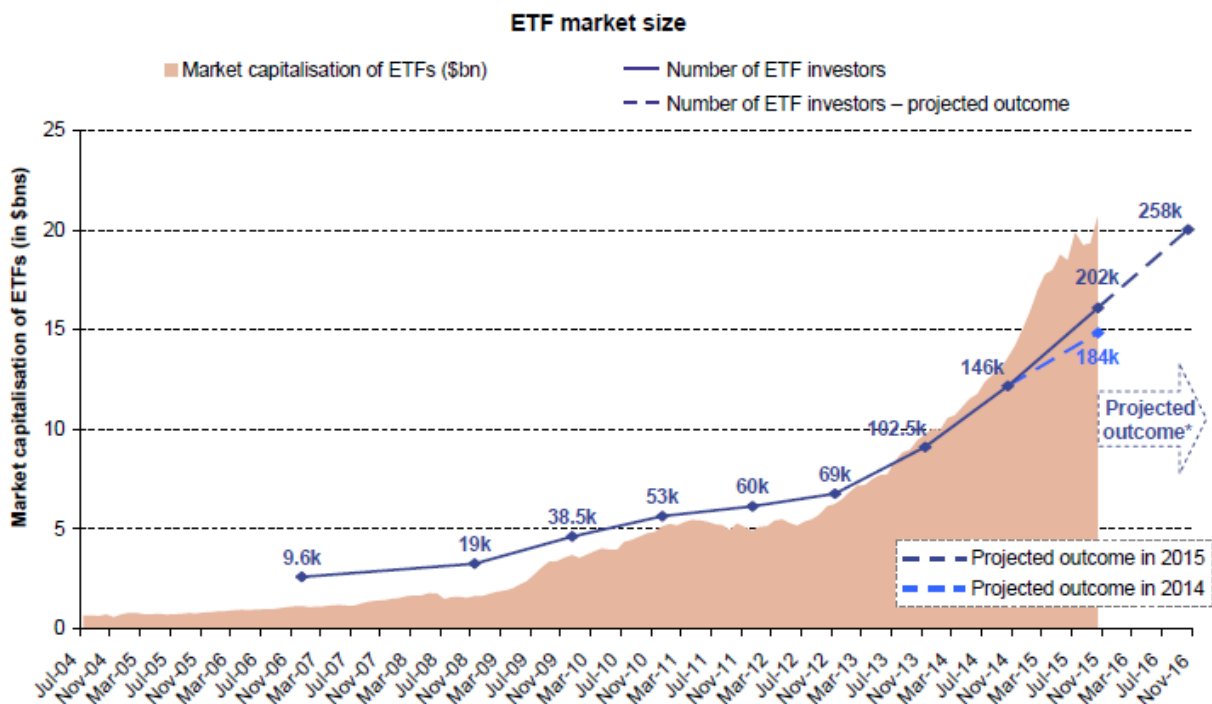
The chart below shows the market capitalisation growth of the ETF market (currently at about \$22 billion), the estimated user numbers and future projections.

Strong demand from retail and SMSF investors

Repeat investment into ETFs is high with 71% of investors indicating they would consider re-investing in ETFs in the next 12 months.

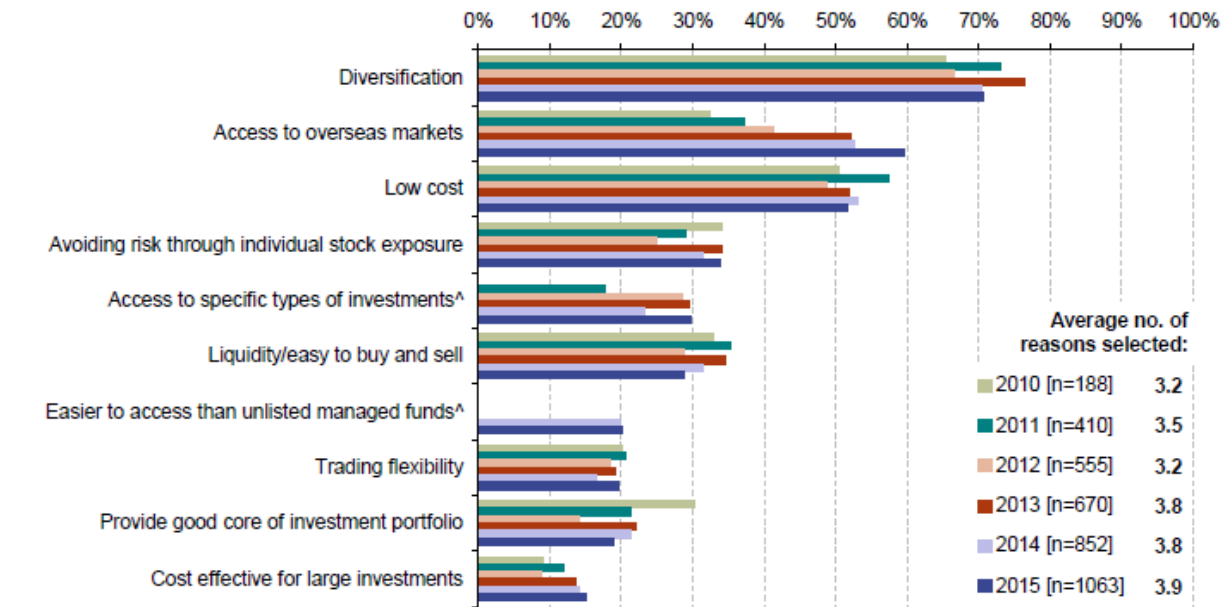
The number of SMSFs holding ETFs has grown in line with the increase in the number of ETF users, with an estimated 41% of ETF investors using an SMSF. This also indicates that 59% of investors are buying these products outside of SMSFs, showing the adoption of ETFs by mainstream investors.

The number of ETF investors grew at an annualised rate of 37% in the 12 months to October 2015, exceeding projected growth expectations



*Note: Projected figures based on Investment Trends modeling. Note that actual outcomes will be influenced by a range of factors, but particularly share market performance. Sourced from Investment Trends 2015 ETF Report.

**Q150 Why do you use ETFs? (Multiple responses permitted)
Among current ETF investors (Top 10 reasons shown)**



[^]New options added in later years

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Diversification remains the primary reason individual and SMSF investors use ETFs. However, for the first time since the Report has been published, access to overseas markets has become the next most important reason individual investors use ETFs, overtaking low cost.

The Report revealed that the majority of ETF investors did not reduce usage of any other form of investment in order to invest, with 56% of investors in ETFs investing via money that was not currently invested in shares or managed funds.

Financial planners want more from ETFs

Financial planners’ appetite for ETFs continued to increase, with the Report showing 44% of advisers currently use ETFs, with an additional 20% considering ETFs in their practice over the next 12 months.

In addition, the extent of ETF usage is set to increase. While ETF flows comprise only 6% of total financial planner flows, current users have allocated 13% of new client flows to ETFs and expect this to increase to 18% by 2018. 90% of financial planners cited low cost as the top reason for recommending investment in ETFs.

Additionally, advisers who recommend ETFs allocate 46% of new ETF investments to international equities, up from 40% in the previous year, overtaking domestic equities for the first time.

While diversification is the primary driver behind ETF adoption for individual investors, about 90% of financial planners indicating low cost is the key reason for using ETFs in their practice. The Report also indicates that ETFs are used by financial planners who typically have higher levels of funds under advice and higher inflows versus those that do not use ETFs.

Strong outlook for exchange traded managed funds

One of the more exciting developments for the exchange traded product industry has been the launch of exchange traded managed funds. The Report revealed a strong latent demand for such actively-managed funds in the next 12 months. For example, 61% of financial planners indicated an interest in using these types of products, which includes 34% of planners who are not currently using ETFs at the moment.

The Report revealed a record number of 258,000 investors intend to make an ETF investment in the next 12 months (including new and existing investors).

ETFs are well on their way to becoming mainstream, based on their diversification, cost, transparency and access. There are also more sophisticated requirements from investors and their advisers. In our own business, for example, we are seeing increasing appetite for outcome-oriented products

such as managed risk exposures that are starting to be used as complements to 'plain vanilla' index-based ETFs.

Ilan Israelstam is Head of Strategy & Marketing at [BetaShares](#). For a comprehensive summary copy of the 2015 Exchange Traded Funds Report, [click here](#). This article is general information and does not address the needs of any individual.

Landmines in the Field of Dreams

Roger Montgomery

Whether the focus is on shares, property or other financial markets, we have entered an environment of low returns. Anyone believing they will see double-digit returns from stock market indices is not just optimistic but misguided. It is therefore more important than ever to find other avenues to generate alpha (the active return over an index). Every bit of alpha will be that much more valuable in a low return regime. Thanks to the many instances of structural industry declines and disruption, there is a rich vein of opportunities, for anyone with the right framework, to profit and add alpha from short selling. That is why we launched a global long/short fund last year and we will soon offer a similar structure in domestic equities.

Struggling to stimulate

In 2014, the low point for the S&P500 was 1782. Shortly afterwards, the reported earnings for the S&P500 was \$106.00 per share (September quarter). Today, the S&P500 is almost 16% higher at 2066 but earnings have declined to \$86.44 per share, a fall of 18.5%. It is true that in the short run the market is a voting machine, so factors other than earnings have clearly influenced the multiple of earnings investors have been willing to pay for a share. And right now, the market is willing to pay 24 times earnings. But in the long run, the market is a weighing machine and prices generally reflect underlying economic performance. Unless the trend in earnings reverses, share prices could be under pressure.

Clearly, quantitative easing (QE) is doing part of the job that was intended.

During the GFC, banks significantly reduced their lending, retaining excess reserves. The effect of this behaviour was a decline in the money multiplier

(credit) and total money supply. Amid fear (thanks Japan) of deflation, the US Federal Reserve tried to increase demand for credit by reducing interest rates. High pre-existing debt levels, however, failed to spur spending rendering this conventional lever of monetary policy ineffective.

Quantitative easing commenced and as with cutting interest rates, its intent is to stimulate the economy by encouraging banks to provide more loans. And if it also convinces investors that the Fed is serious about fighting deflation it can raise confidence and economic activity.

Since the GFC, there has been a global drive to cut interest rates and purchases of bonds now exceed US\$12 trillion, yet anaemic growth (or negative growth if you're looking at S&P500 earnings) remains with us.

What QE has done is triggered the sort of reckless financial behaviour that presaged the GFC. Asset prices have soared but income growth has not.

Fundamentally, asset prices cannot remain detached from the fundamental drivers, in particular earnings. Either earnings must rise or asset prices must fall.

To the extent that there are always risks to earnings and growth, it is worth examining if any current facts suggest we should be more concerned or more sanguine.

The numbers are not pretty

In the US, a record \$US947 billion of junk debt – euphemistically called 'high-yield debt' – matures by 2020 and in 2020 itself the highest ever amount of junk debt in history, \$US400 billion, matures. By itself this fact is not something to be concerned about but other facts produce a reason to worry.

According to Moody's Investor Services, there were 109 US junk-rated defaults in 2015, double the number in 2014 and the value was more than 30% higher. The number is expected to climb again in 2016. More importantly, the default rate for all US corporate issuers rated by Moody's is expected to rise by a third to 2.1% this year – the highest rate since the GFC.

The number of stressed borrowers appears to be increasing and the stress is not confined to energy, oil and gas. Data shows that technology and telecoms carry the largest debt burdens and Moody's Liquidity Stress Index has hit its highest level since December 2009 and recorded its largest one-month jump since March 2009 during the depths of the GFC.

Of course, maturing debt that remains unpaid causes defaults, which leads to job losses, declining consumer spending and broader impacts on economic growth, but maturing debt can be refinanced so the wall of maturities and rising stress doesn't immediately lead to the conclusion current levels will get worse.

Moody's also report a refunding index for three-year maturities. This index measures whether sufficient liquidity exists in the credit markets to refinance the coming debt maturities. Sadly, the index is also at levels only seen at the depths of the GFC in 2009.

The worries are not confined to shares. In my [last column](#) I ruminated on the possibility of a crash in the property market, concluding; "... the probability of a bargain is higher than the probability of prices running away from you. There's no need to rush." Since then, the media have been replete with observations that apartment prices are falling.

Across all markets, there are reasons for great caution, lower return expectations and looking for new sources of alpha, such as shorting.

Roger Montgomery is the Founder and Chief Investment Officer at The Montgomery Fund, and author of the bestseller 'Value.able'. This article is for general educational purposes and does not consider the specific needs of any individual.

A tax-effective complement to superannuation

Neil Rogan

Superannuation is a tax-effective vehicle for long-term retirement savings. Currently, both contributions and investment earnings (in accumulation phase) are taxed at 15% for people with taxable incomes less than \$300,000 - significantly less than the highest personal marginal tax rate of 47% (2015-16 marginal tax rate plus Medicare levy of 2%, excluding the Medicare levy surcharge). Less tax paid through the accumulation phase helps maximise retirement income in pension phase.

However, there is no certainty that superannuation's current tax benefits will remain in the medium to long term. An increase in tax payable on either superannuation contributions or earnings would reduce its appeal as a retirement saving vehicle. For example, it is rumoured that the \$300,000 threshold will be reduced to \$180,000 in the coming Federal

Budget (the level where the additional 'Division 293' tax rate of 15% kicks in).

Superannuation restrictions

While tax effectiveness of superannuation is a key benefit, it comes with restrictions on contributions and access. A quick reminder of the main rules:

Contribution restrictions

Access to superannuation benefits is not unlimited, and to contribute, an investor needs to meet eligibility rules and contribution limits.

The investor must be under age 65, or if aged 65 to 75, needs to meet a work test. Contributions from an employer (including amounts paid under a salary sacrifice agreement) and contributions for which a personal tax deduction is claimed cannot exceed \$30,000 in a financial year if aged under 50 and \$35,000 if aged 50 and over. Personal after-tax contributions (that is, non-concessional where no tax deduction is claimed) are not taxed further on amounts up to \$180,000 each financial year. Where an investor is under 65, they may be able to combine the limits for up to three years to contribute up to \$540,000 in a single year.

Access restrictions

Access to money in superannuation is restricted until a 'condition of release' is met. This generally means that the investor will not be able to withdraw or use the money until they have reached a 'preservation age' and have retired. Preservation age is 55 for an investor born before 1 July 1960 but increases up to age 60 for those born after this date. Earlier access may be allowed in exceptional circumstances, such as permanent disability.

Tax-effectiveness of investment bonds

An investment bond (sometimes called an insurance bond) structure presents a tax-effective vehicle which can complement superannuation in saving for retirement, particularly for investors with higher marginal tax rates. A key benefit is where funds remain invested for 10 years or more, personal tax obligations are permanently removed. An investment bond also acts as a life insurance policy, and can be used in estate planning to simplify wealth transfers external to a will.

With both superannuation and investment bonds, tax is paid within the investment vehicle, not personally by the investor. Investment bonds pay a maximum a tax rate of 30% on investment earnings

and growth, although franking credits and tax deductions can reduce this effective tax rate further.

If an individual's taxable income is at least \$37,001 p.a. the tax paid on any additional personal income will be greater than on investment bond earnings. At this threshold, the marginal tax rate increases from 21% to 34.5%, higher than the 30% on investment bonds.

If the investment is fully or partially withdrawn after 10 years, the investor pays no personal income tax. If a withdrawal is made within the first 10 years, the investor will pay tax on the assessable portion of growth (100% within first eight years, two-thirds in year 9 and one-third in year 10). If investments are withdrawn within the 10 years, the investor receives a full 30% tax offset from tax already paid within the investment bond. For example, a \$10,000 growth component would have tax implications for the various individual marginal tax rates as shown in the table below.

Simplicity and flexibility

Earnings on investment bonds are automatically reinvested in the bond and taxed within. Income and capital gains are not distributed to investors and do not need to be annually tracked or included in personal tax returns.

If investors' financial goals or views change, they can switch easily between investment options within their bond without incurring any tax or Capital Gains Tax implications and without affecting the bond's 10-year tax period.

There is no limit on either the initial contribution amount or total contributions in the first bond year. Contributions can also be made at any time thereafter according to the 125% rule. As long as contributions in any subsequent bond year do not exceed 125% of the contributions in the previous year, all contributions and growth will be free of personal income tax after 10 years. This means that additional contributions can have a term of less than 10 years, and their growth or earnings will still be tax-free.

For many investors the ability to progressively increase contribution amounts over time is consistent with life events and greater disposable income, for example through paying off the

| Marginal Tax Rate | 21.0% | 34.5% | 39.0% | 47.0% |
|---|---------------|----------|----------|-----------|
| Up to 8th year (100% Assessable) | \$10,000 | \$10,000 | \$10,000 | \$10,000 |
| Marginal Tax Payable | \$2,100 | \$3,450 | \$3,900 | \$4,700 |
| 30% Tax offset | \$3,000 | \$3,000 | \$3,000 | \$3,000 |
| Net tax | \$900 benefit | (\$450) | (\$900) | (\$1,700) |
| 9th year (2/3 Assessable) | \$6,667 | \$6,667 | \$6,667 | \$6,667 |
| Marginal Tax Payable | \$1,400 | \$2,300 | \$2,600 | \$3,133 |
| 30% Tax offset | \$2,000 | \$2,000 | \$2,000 | \$2,000 |
| Net tax | \$600 benefit | (\$300) | (\$600) | (\$1,133) |
| 10th year (1/3 Assessable) | \$3,333 | \$3,333 | \$3,333 | \$3,333 |
| Marginal Tax Payable | \$700 | \$1,150 | \$1,300 | \$1,566 |
| 30% Tax offset | \$1,000 | \$1,000 | \$1,000 | \$1,000 |
| Net tax | \$300 benefit | (\$150) | (\$300) | (\$566) |
| After 10 years (Nil Assessable) | \$Nil | \$Nil | \$Nil | \$Nil |
| Tax | \$Nil | \$Nil | \$Nil | \$Nil |

Note: Includes 2% Medicare levy but excludes Medicare levy surcharge of up to 1.5% which may also apply.

mortgage, lower outgoings in school fees, or investing proceeds from an inheritance. Under the 125% rule an investor making an initial contribution of \$25,000 can invest up to a further \$6,250 in year 2, and progressively build savings as illustrated in the table below.

| Bond Year | Contribution | Total Contribution |
|-----------|--------------|--------------------|
| 1 | \$25,000 | \$25,000 |
| 2 | \$31,250 | \$56,250 |
| 3 | \$39,063 | \$95,313 |
| 4 | \$48,828 | \$144,141 |
| 5 | \$61,035 | \$205,176 |
| 6 | \$76,294 | \$281,470 |
| 7 | \$95,367 | \$376,837 |
| 8 | \$119,209 | \$496,046 |
| 9 | \$149,012 | \$645,058 |
| 10 | \$186,265 | \$831,323 |

Over 10 years, \$831,323 has been contributed but only \$25,000 for the full 10 years. The investor can withdraw their investment plus any growth or earnings tax-free at the end of the 10-year term. Or the investor may keep the investment bond open and make additional contributions beyond 10 years with these investment amounts also tax-free on withdrawal.

Caution is needed in relation to additional investments that exceed the 125% limit in any year, as the 10-year tax period will restart from the year in which the excess contribution is made. In a similar vein, if the investor does not contribute in a particular year, then a contribution in any subsequent year will restart the 10-year tax period. Either of these might be a deliberate investment strategy, or be the result of a life event impacting the investor's ability to contribute. However, with a minimum additional investment of \$500 per year

there is great flexibility for investors to maintain their 10-year tax benefit.

Flexible estate planning

An investment bond's life insurance component enables tax-effective estate planning and simple wealth transfers external to a will. It gives the life insured significant flexibility and control in determining beneficiaries of any 'death maturity' payments.

In superannuation, death benefit tax concessions apply only to dependents of the life insured. However, an investment bond's death benefits can be directed tax-free to any nominated beneficiary, including adult family members, or the estate. How long the bond has been held does not impact the tax-free status. This flexibility may reduce the risk of disputes over estates and enable benefits to be paid more quickly.

Investment bonds can also be established on behalf of children, providing simplicity in managing the tax that applies to children's income. It may also be assigned to a child in the future (subject to parental or guardian consent) without tax or legal complications. The child has the option to continue holding the investment bond without affecting the original 10-year tax period start date.

For a summary comparing superannuation and investment bond strategies, see the table on the next page.

Neil Rogan is General Manager of [Centuria Life's Investment Bond Division](#). Suitability of investment bonds will depend on a person's circumstances, financial objectives and needs, none of which have been taken into consideration in this document. Prospective investors should obtain professional advice before making a decision to invest.

Summary comparing superannuation and investment bond strategies

| Factor of comparison | Investment Bond | Superannuation |
|---|--|---|
| Tax concessional contributions | N/A | Currently taxed at 15% Annual limit of \$30,000 if aged under 50, or \$35,000 if over 50 |
| After tax contributions | No annual limits, but 125% cap on previous year's contribution to maintain 10-year tax free withdrawal option. | Annual limit of \$180,000. Contributions above \$180,000 taxed at 49%. |
| Contribution eligibility | No restrictions | Investor must be under 65, or meet work test if aged between 65 and 75. |
| Tax on growth and earnings through accumulation | Headline rate of 30% Paid within structure | Headline rate of 15% Paid within structure |
| CGT when switching options | Nil | Nil |
| Withdrawal eligibility | No age limits or other restrictions | Preservation age of 55 or 60 subject to year of birth |
| Disability / hardship release | No restrictions Tax free for all disabilities | Subject to procedural rules Tax concession limited to terminal condition |
| Tax on growth at withdrawal | Within 8 years 100% In year 9 two-thirds In year 10 one-third No tax after 10 years | No tax if aged over 60 |
| Death benefits | Tax concessions for any beneficiary or estate | Tax concessions only for dependents |
| Ownership | Can be joint owned, established on behalf of other person, or assigned to child in future | Sole owner, not transferable |

The time has come for actuaries

David Bell

The combination of the retirement income challenge and the big data opportunity will create the age of the actuary. The skill set possessed by actuaries is central to delivering solutions in both these complex areas. An actuary's toolbox contains a unique combination of technical and problem solving skills. Successful firms will make the most of their talents and skills.

But first, two disclaimers. Firstly, I am not the David Bell who is the CEO of the Actuaries Institute (though I am helping his cause here!). Secondly, I am not an actuary so my views are strategic and come from the outside looking in.

Sometimes the training and skill set of an actuary are not well understood or appreciated. This is partly

because of stereotyping and partly because we are all too quick to pull out actuary jokes (which I have banned myself from making in this article, for a change).

Actuaries are equipped with the highest quality technical tool kit for quantitative financial analysis, drawing on mathematical, statistical, economic and financial analysis techniques. This may not surprise most readers. In my view the skill sets are more technical and advanced than most other finance-related professions.

What is not well understood is the emphasis on application, communication and problem-solving. A large part of the training program for actuaries is focused on developing the ability to apply their tool kit of skills to real world problems.

Insurance has been the stereotypical occupation of actuaries due to their abilities in risk modelling and pricing; the Actuaries Institute note that around half

of their members work in the insurance sector. However, the skill set of actuaries means they are valuable for many other industries, finance and non-finance.

The retirement income challenge

The superannuation industry faces many challenges, with the largest surely the retirement income challenge, ensuring that the industry delivers appropriate and sustainable retirement incomes. While undoubtedly a multi-faceted problem, at the heart of this challenge lies a highly complex problem with many moving parts, most notably variability in investment and mortality outcomes.

Despite the undoubted appeal of adding actuarial talent, the superannuation industry appears anchored to acknowledging investment risk while directing little attention towards mortality risk. With a clean sheet of paper, would the ratio of investment professionals to actuaries be as it currently is? I would hazard a guess at a ratio of 10:1 minimum.

Why is this so? My view is that it is because the complexity of a whole new range of technical risks and terms is daunting for senior management and trustee boards (for example 'idiosyncratic mortality risk' isn't exactly an easy term to get your head around, but it is one of the most crucial risks to a member's retirement outcome). A recent example illustrates my concerns. I attended an industry conference on post-retirement. The conference started at a technical level, but acknowledged the communication challenge (to members). The challenge of keeping the communications simple somehow morphed into the need for simple solutions and the banning (somewhat light-heartedly) of important words for the rest of the day such as 'stochastic'. If the industry is not ready to address a complex problem within closed doors, how can it be solved in a public environment?

Consider the way the major asset consultants are structured. Two have significant actuarial capabilities (it was a separate business line) while the other two less so. If solving the retirement outcome challenge is a top priority for super funds, which asset consultants are best placed to deliver a holistic solution? The interesting challenge being addressed by the two consultants with significant actuarial and investment skill sets is to ensure these two areas

work together on solutions rather than working down traditional business line silos.

As all these barriers erode away it is likely that super funds will increase the actuarial headcount within their business.

Big opportunities in big data

The world of big data creates big opportunities for actuaries. Big data applications cross many industries and sectors and it is likely that more actuaries will find a home in big data roles than in retirement outcome work.

Big data refers to the collection and analysis of large amounts of data and analysing it to make predictions and design responses and activities. The data sets can be huge, as can the applications. Speed and accuracy are both important. What is notable, particularly from a strategic perspective, is that no single career discipline is recognised as the go-to for big data analytics. Big data is a relatively new industry and it takes time for undergraduate degrees to accommodate these changes. Programmers, statisticians, econometricians and marketers would all stake a claim and in many cases add much value. However, actuaries are potentially the best resource of the lot: they have many of the technical skills found in each of the other disciplines. Incoming changes to the actuarial undergraduate degree curriculum will make data analytics a greater component of the actuarial degree.

To become a fully qualified actuary is a difficult path. The typical path is a degree and then attainment of the full actuarial qualification takes a further three years of part-time study. Last year, the ATAR entry requirement for the Bachelor of Actuarial Studies was 97.5, so the filtering process is strong.

The strategic opportunity for business leaders is to make sure they have the right amount of actuarial skills in the business, and give them the opportunity to use the unique skills they have developed.

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