Firstlinks
Highlights from 2018

Unique and original links first published in Cuffelinks in 2018

Foreword

The Cuffelinks team has selected 10 highlights from the hundreds of articles published in 2018. This ebook, **Firstlinks**, contains original content first published in Cuffelinks.

We receive far more content each week than we can publish in our newsletter, and in 2019, our priority will be 'first links' to unique content.

Our sixth year of publishing was tumultuous for financial services. While the Royal Commission provided a deep well of revealing and often unbelievable content, it was overshadowed by the Labor Party policy on franking credits for number of comments and feedback from our readers.

Many of our articles were viewed over 10,000 times, including the Budget Special direct from the Canberra lockup, and Garry Mackrell's insider view of the changes at CBA. The survey in our Special Edition on the book 'Factfulness' was completed almost 5,000 times.

It was also a year of rapid growth in reader numbers, with over 50,000 Monthly Active Users. We enjoy a mature and intelligent conversation with a community of like-minded investors, who prefer to minimise the trivia and noise often presented in other media.

2019 promises to be tough for financial services and investing. The Royal Commission report in February will set the ground rules for future regulatory and behaviour changes, while rising US rates will temper enthusiasm for risk assets. Cuffelinks will continue to deliver insights to help navigate these changes.

Graham Hand
Managing Editor

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These articles offer general information and do not consider the circumstances of any individual, and should be considered in the context of the date they were written.

Give me the long-term predictability of shares, at any age

Peter Thornhill on 28 February 2018

As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates.

It is a terrible mistake for investors with long-term horizons – among them, pension funds, college endowments and savings-minded individuals – to measure their investment "risk" by their portfolio's ratio of bonds to stocks. Often, high-grade bonds in an investment portfolio increase its risk."

Warren Buffett, 2017 letter to Berkshire Hathaway shareholders, published 24 February 2018.

I noticed with sadness that an article promoting 'life cycle' investing was published in Cuffelinks last week, pushing this asset allocation technique as a sensible retirement alternative.

In 2015 Glenn Stevens, the then Reserve Bank Governor, pointed out the huge cost required today to produce a reasonable level of income and, more importantly, generate a sustainable income for longer retirements.

"In a low interest rate world, the problems of providing retirement incomes will become ever more prominent. The very low level of yields on fixed income assets means that it is very expensive today to purchase a secure stream of future income, which is what someone who is retiring is usually seeking. And there are more of such people, living longer.

The retiree can of course respond to this by holding more of her portfolio in dividend-paying stocks – accepting more risk. She may hope for a dividend stream that is fairly stable from year to year but that tends to grow over time."

Glenn Stevens, 'The Long Run', address to the Australian Business Economists, 24 November 2015

Put simply, from the heady days of the late 80's/early 90's where a $1 million dollar bank deposit would have produced around $140,000 income a year, on this same amount we have seen the income fall to around $30,000 in 2018. I refer to this as the 'cash crash'. If the sharemarket fell by 80%, can you imagine the outcry?

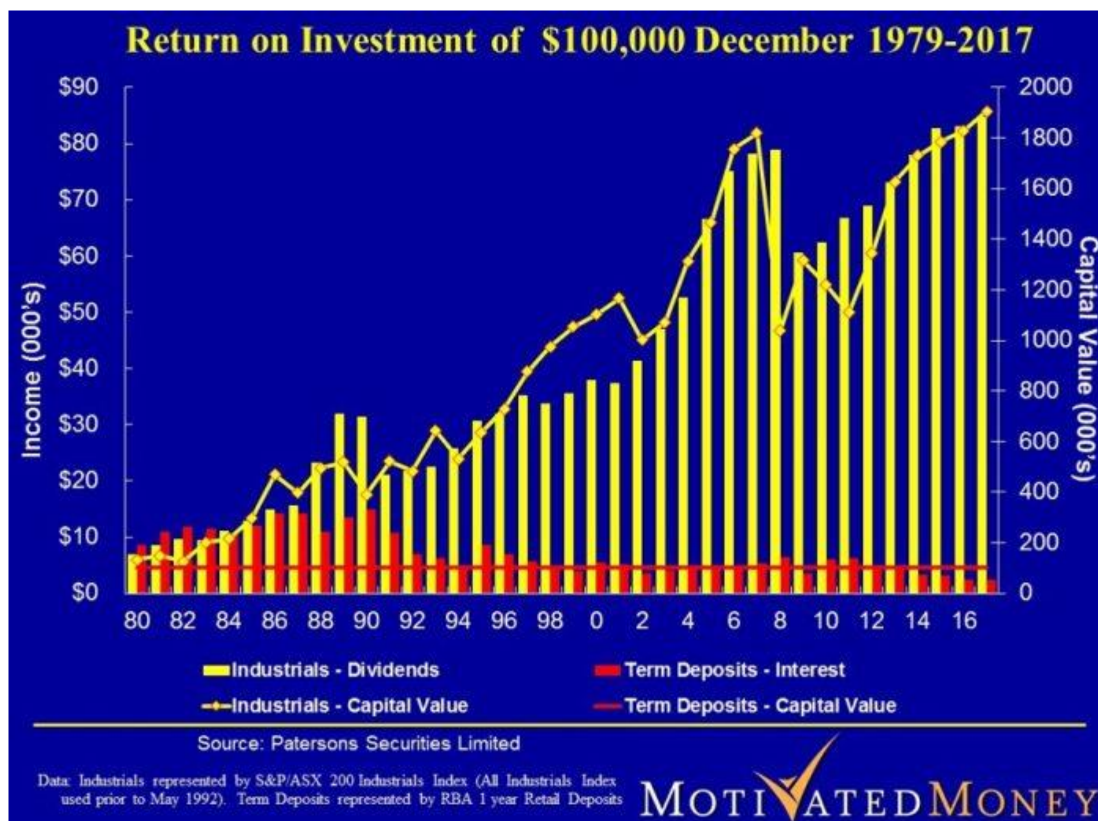
Challenging the definition of 'risk'

Investing is about survival and we are living a lot longer in retirement than most people imagine or plan for. The greatest danger is locking into artificially low rates of return for long periods, such as with bonds, term deposits or annuities. I am reminded of the Law of Unintended Consequence when seeking the 'security' of cash instruments.

Stevens also reinforced my theme when talking about people facing retirement today when he said; *"They have to accept a lot more risk to generate the expected flow of future income they want"*. I accept that he is using the traditional measure of risk and is referring to the volatility of capital. I, however, will not accept that volatility of capital is a satisfactory measure of risk provided one is a long-term 'investor'.

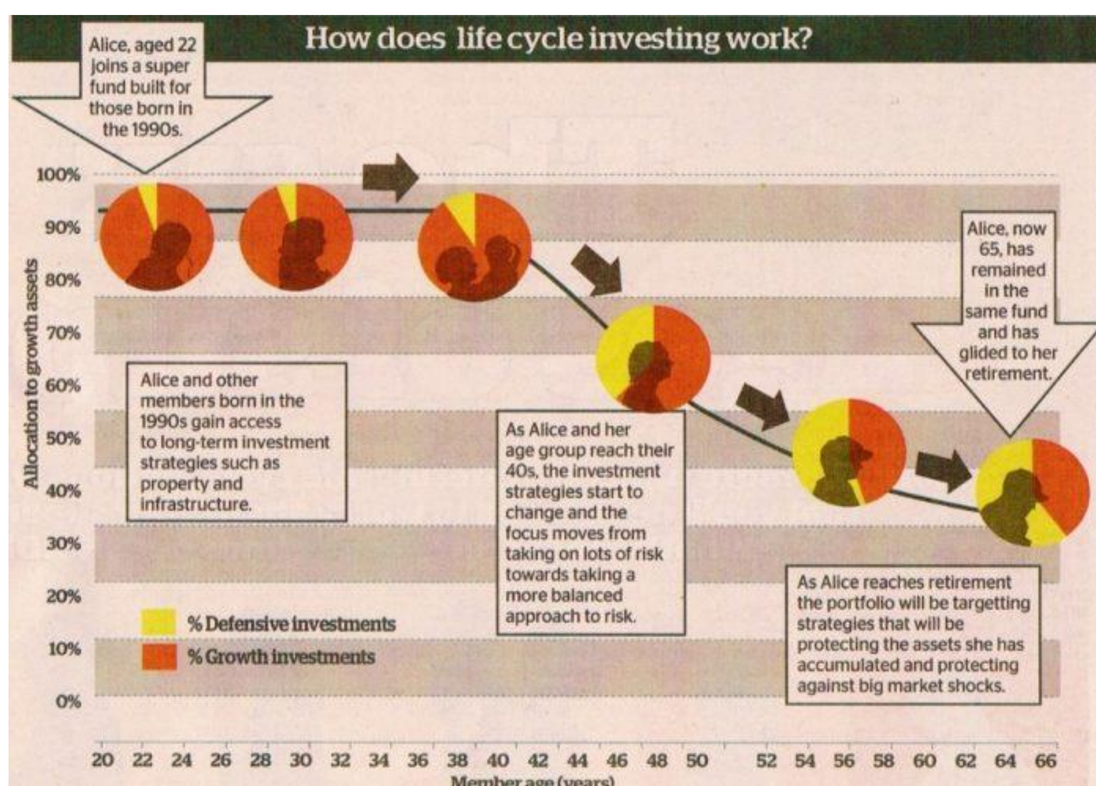
On the basis that a picture is worth a thousand words, the 'mothership' (as I call it) chart below, comparing cash deposits with industrial shares over 37 years, hopefully speaks for itself. This example shows $100,000 invested in both industrial shares and term deposits in 1979, with all income from both investments spent and not reinvested. After receiving interest payments every year, a term deposit is still $100,000 after 37 years whilst shares, in addition to the income received, are now worth $1.9 million. I must add, as with the interest, no dividends have been reinvested during this period.

This is why I prefer the safety and security of the sharemarket to risky assets like term deposits. I can live with short-term volatility over 40 years. It is my friend during accumulation phase as I inevitably buy more when the market is cheap and less when it is expensive. In retirement, I want income and for me, the volatility in the value becomes a non-issue.



The life cycle investing argument

In the same vein as the Cuffelinks article on life cycle investing, an article titled, '*Your super can grow old gracefully'* in the Sydney Morning Herald in 2015 caught my eye. The chart below from the article explains graphically how an investor can automatically be transitioned from 'risky' growth assets into more conservative investments as they approach and then enter retirement. It is posited as a sensible and conservative approach.



Source: Sydney Morning Herald, 5 March 2015

Proponents of this strategy explain that this will ensure the security of your financial future. Thankfully, the authors of the article raised legitimate concerns but what annoys me about this simplistic approach is that it intimates an 'account value' without splitting it into the two components of capital and income.

It should be clear from the two charts above that theirs is the antithesis of mine. According to the second chart, as one grows older, investments will be shifted away from the yellow in my chart and more into the red so that by the time retirement comes, having invested for 40 or so years, the retirement future is now jeopardised. In addition, the entire account balance in the life cycle fund will be substantially less than mine as 'they' will have been selling shareholdings over the years and switching to cash.

To give you a sense of the compounding effect during the accumulation phase of life, if I had reinvested the interest and the dividends, the account balances would be **$1.3 million for cash** and **$12 million for shares** over the 37 years. Let's take it a step further. You are now about to retire, and the account balances above can be used to produce an income. So, looking at the chart above, in retirement, your starting point for cash remains the $1.3 million whilst your starting point for shares will be $12 million.

The thought of this life cycle model being applied to our adult children strikes fear into my heart. If 'Alice' had stayed in the yellow, as per my chart, for all of her working lifetime, her eventual retirement pot would have been substantially greater than the outcome as proposed in the shifting asset allocation of the second chart. She, like my wife and I, would have no need for cash as a buffer to smother the volatility. The opportunity cost of the life cycle strategy will be huge. It's the opportunity cost that no one talks about and the largely irrelevant volatility. When one hits retirement, one simply stops the reinvestment and turns on the dividend stream from a substantial asset base as a pension.

Why sell off the best compounding asset?

Commentators are always banging on about compounding, the '8th wonder of the world'. So why do the supporters of life cycle investing undervalue it in the latter stages of the accumulation phase of our lives? They are going to guarantee that as you progress through your working life, the strongest compounding (income-producing) asset will be sold off to buy something that will produce the lowest income stream.

The irony is that we are only now beginning to recognise the longevity risk, and retirements stretching out to equal our working lifespan. With most of your retirement fund in 'defensive' investments for 30-40 years, the experience of the last 37 years, as displayed in my 'mothership' slide, being applied to your retirement years should hopefully ring warning bells.

There is nothing conservative or defensive about term deposits or bonds, in fact, quite the opposite. In the longevity stakes they rank as the riskiest asset you can hold. Why must we cling to the outdated concept promulgated as 'modern portfolio theory' from the 1940's? Volatility does not measure risk, it merely indicates the high level of liquidity.

Personally, I refuse to expose my family to these risky deposits, preferring instead the boring predictability of shares.

Peter Thornhill is a financial commentator, public speaker and Principal of [Motivated Money](). This article is general in nature and does not constitute or convey specific or professional advice. Formal financial advice should be sought before acting in any of the areas discussed. Share markets can be volatile in the short term and investors holding a portfolio of shares will need to tolerate short-term losses and focus on a long-term horizon.

Four SMSF strategies if imputation credits rules change

Michael Hutton on 17 May 2018

Labor's proposal to change the way dividend franking credits are treated has both its advocates and its critics. Some argue that the proposed changes are an issue of fairness. In my view, what is not fair is that Labor's proposal is squarely aimed at SMSFs, and that industry funds and retail funds will mostly be unaffected.

Regardless of one's point of view, any plan that removes imputation credit refunds will negatively impact self-funded retirees, and those hoping to become self-funded retirees, and result in them rethinking their investment strategies.

While the current proposal could impact any share investments held personally – and potentially also investments held through a family trust or investment company – SMSF members feel particularly targeted. At a time when self-funded retirees should be applauded for not relying on government support, the landscape seems to be changing. Such retirees will be penalised for their independence.

It is surprising that a tax change has been suggested that applies solely to one section of the superannuation system, but not to others. This is new and unwelcome. In the past, changes such as to contribution limits or the imposition of $1.6 million pension account balance caps have applied across the superannuation industry.

Possible strategy changes

If the changes come into effect, some SMSF members and self-funded retirees will make changes to their investment strategy to minimise their losses.

First, people will reduce their investment assets to receive both greater tax refunds and larger age pensions. The proposed change will have the greatest impact on self-funded retirees who fall just outside the assets test thresholds. A retiree who is receiving just $1 of the age pension will be entitled to both a personal tax refund or excess imputation credits and also their super pension receiving a tax refund. They will be significantly advantaged over those who fall just outside the assets test limit, which is currently $837,000 for a couple who are home owners or $556,500 for a single person home owner. Assessable assets can be reduced, for example, by renovating the family home or taking overseas trips.

Second, SMSF members will reduce their investments in Australian shares. Full imputation credits add about 1.6% to the return, and where this benefit is lost, the relative attractiveness of Australian shares as an investment sector will be diminished. International shares, cash and property may become relatively more attractive, and allocations here may increase.

Third, people will circumvent the changes by transferring the Australian shares part of a portfolio to a 'super wrap' type retail fund that will refund the imputation credits due on their account. These 'member direct' offers usually allow members to hold managed funds and shares in the S&P/ASX300.

Fourth, with the Government's announcement to increase the maximum number of SMSF members from four to six, there will likely be more families that treat an SMSF as a true family investment vehicle. Younger family members who are accumulating super will be added to use the credits that their parents, in pension mode, may otherwise have lost.

Labor's proposed change is unlikely to boost government revenue to the amount forecast.

Perhaps the only tangible outcome will be to continue eroding confidence in our superannuation system. It is difficult to encourage people to put more into super when the money is locked away for a long period of time and the benefits continue to be taken away. It seems that for many people, they will be better off having a lower amount in super and receive increased age pension payments in retirement.

These latest proposed changes if Labor is in government come on top of the major rejig to retirees' investment situation resulting from the Coalition's changes that came into effect 1 July 2017, including limitations on super contributions, the $1.6 million cap and changes to death benefit payouts, amongst other amendments.

If successive governments are looking for ways to turn people away from saving for their retirement and encouraging them to seek government assistance, they are certainly going the right way about it.

Michael Hutton is a Partner and Head of Wealth Management at HLB Mann Judd. This article is general information and does not coonsider the circumstances of any individual.

10 highlights from Buffett's latest letter

Graham Hand on 27 February 2018

Each year, Warren Buffett writes a letter to the shareholders of Berkshire Hathaway. The letters are not only a record of the progress of the company, but his words become popular quotes for investors and writers for decades after they are written.

This year's letter, released overnight and linked here, is shorter than usual, and Buffett does not write much about his views on the market, beyond share prices being expensive and the US still being the best place to invest.

But his statements about bonds being riskier than shares for the long-term investor will become the most enduring observation from this year. He says (page 13):

"I want to quickly acknowledge that in any upcoming day, week or even year, stocks will be riskier – far riskier – than short-term U.S. bonds. As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates."

Prior to its release, the market was focussed on four main expectations for the letter, but none of these rated much of a mention:

- Succession planning, as Buffett is now 87-years-old.
- How Berkshire plans to spend its US$110 billion cash pile, which even Buffett says is much too high but he can't find suitable, large investments.
- Portfolio changes.
- Health care, on the back of the recently-announced tie up with Amazon and JP Morgan to lower health care costs for employees.

Here are 10 highlights, with the usual gems thrown in:

1. Buffett says nearly all deals examined in 2017 were ruled out due to prices hitting all-time highs. He riles against CEO 'can-do' types who drive acquisitions without considering value, and "*it's a bit like telling your ripening teenager to be sure to have a normal sex life"*. Executive compensation grows with corporate size, and subordinates and investment bankers cheer the CEOs from the sidelines. Spreadsheets never disappoint, although expected synergies are never found. *"Once a CEO hungers for a deal, he or she will never lack for forecasts that justify the purchase."*

2. Buffett estimates the three hurricanes of 2017 in Texas, Florida and Puerto Rico might cost the insurance industry US$100 billion, of which Berkshire Hathaway's share may be US$3 billion. He says that if a 'mega-cat' (massive catastrophe) of say US$400 billion hit the industry, most of the other property/casualty insurers would be wiped out.

3. Buffett and Charlie Munger consider minority holdings of shares as interests in *businesses*, not stock to be bought and sold based on target prices. *"In America, equity investors have the wind at their back."*

4. Stockmarkets do a poor job of detecting growth in value of the short term, with prices rising and falling untethered to the build-up of value. He says Berkshire Hathaway has moved forward year by year and yet its share price has suffered four major dips, two of which were 1973 to 1975 when it fell from US$93 to US$38 (59%) and 2008 to 2009, when it fell from US$147,000 to US$74,200 (51%). He says this is a massive reason not to borrow to buy stocks:

   "Even if your borrowings are small and your positions aren't immediately threatened by the plunging market, your mind may well become rattled by scary headlines and breathless commentary. And an unsettled mind will not make good decisions."

   He says in the next 53 years (ie the time period he has been managing this company), the same level of declines will happen again, and "*The light can at any time go from green to red without pausing at yellow."*

5. He reflects on his winning ten-year bet made in December 2007 where his counterparty selected five 'fund-of-funds' that it expected to outperform the S&P500 index. These funds owned interests in over 200 hedge funds with fixed fees averaging a "*staggering*" 2.5% per annum. "*Performance comes, performance goes. Fees never falter."* The index rose 8.5% per annum on average, while annual returns on the five funds were 2.0%, 3.6%, 6.5%, 0.3% and 2.4%. Buffett easily won the bet, and the single purchase of an index beat the thousands of trades made by the hedge funds.

   "What investors then need instead is an ability to both disregard mob fears or enthusiasms and to focus on a few simple fundamentals. A willingness to look unimaginative for a sustained period – or even to look foolish – is also essential."

6. Buffett gives his own definition of risk, which is too often defined by others with volatility of prices. He says:

   "Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. 'Risk' is the possibility that this objective won't be attained."

   He says that on this measure, long bonds paying less than 1% in 2012 were a far riskier investment than a long-term investment in common stocks.

"It is a terrible mistake for investors with long-term horizons – among them, pension funds, college endowments and savings-minded individuals – to measure their investment 'risk' by their portfolio's ratio of bonds to stocks. Often, high-grade bonds in an investment portfolio increase its risk."

7. Berkshire Hathaway appointed Ajit Jain and Greg Abel as directors recently, allowing them to run the businesses and Munger and Buffett to focus on investments and capital allocation. There was no further mention of the expected succession plan in the letter, but remember those names, because one of them will probably become Chairman one day.

8. The Trump tax cuts were a huge win for the company, and over 2017, the per share book value of the stock rose by 23% with nearly half (US$29 billion) coming from changes in the US tax code. Since Buffett and Munger took over 53 years ago, per share book value has increased 19.1% compounded annually, from US$19 to an unbelievable US$211,750.

9. Buffett does not meet large institutional shareholders one-on-one. The most important shareholder is one of limited means who trusts him with a substantial share of their savings. He announced that the Annual Meeting of Berkshire Hathaway will be held on 5 May 2018, with Yahoo! webcasting the event from 8.45am (US Central Daylight Time) to about 3.30pm. Buffett and Munger are likely to field over 60 questions. Mark the diary.

10. Finally, he reassured investors that when major declines occur, they offer great buying opportunities to those not carrying too much debt. He quotes from Kipling's *If*:

"If you can keep your head when all about you are losing theirs …
If you can wait and not be tired by waiting …
If you can think – and not make thoughts your aim …
If you can trust yourself when all men doubt you …
Yours is the Earth and everything that's in it."

Graham Hand is Managing Editor of Cuffelinks.

How much is really needed in retirement?

Patrick Malcolm on 6 September 2018

In the UK in 2014, The Independent Review of Retirement Income (IRRI) was commissioned to look at retirement incomes. Two recommendations from IRRI were:

"The use of deterministic projections of the returns on products should be banned."

"They should be replaced with stochastic projections that take into account important real-world issues, such as sequence-of-returns risk (and) inflation."

Quite a bit to digest. There is a broader discussion of these issues in a previous article written by David Bell.

What is deterministic forecasting?

In retirement projections, deterministic forecasting is a set of fixed assumptions around investment returns and inflation to produce one scenario to establish whether a retiree has sufficient financial capital.

An example of a deterministic forecast is the superannuation balances required to achieve a comfortable retirement as calculated by The Association of Superannuation Funds of Australia (ASFA). The ASFA Retirement Standard was developed to objectively outline the annual budget needed by the average Australian to fund a lifestyle in their post-work years, providing benchmarks for both a comfortable and modest standard of living.

ASFA details that:

"a comfortable retirement lifestyle enables an older, healthy retiree to be involved in a broad range of leisure and recreational activities and to have a good standard of living through the purchase of such things as: household goods, private health insurance, a reasonable car, good clothes, a range of electronic equipment, and domestic and occasionally international holiday travel".

As of March 2018, for a retired couple, the budget for a comfortable lifestyle was $60,264 per annum. Based on a rate of return of 6.0% per annum and inflation of 2.75% per annum, ASFA has determined that a sum of **$640,000** is required for retirement. This method draws down capital over the period of withdrawal so that nothing is left at the end of an average life expectancy.

Stochastic modelling introduces variability and stress testing

A stochastic model considers different outcomes by allowing for variation in the inputs within the forecast.

For example, the Accurium Retirement Healthcheck is a projection tool that allows the assessment of retirement sustainability. It stress tests a retiree's plans through 2,000 possible future scenarios. The investment return assumptions are provided by Willis Towers Watson and are generated using their Global Asset Model. This Model produces 'random' future sequences of possible investment returns for each asset class. These are generated so that 'as a whole' the simulations represent a full distribution for how 'real world' markets could perform in the future.

Stochastic modelling assists in making a scientific assessment of sequencing risk, which is the risk of experiencing poor investment returns at the wrong time. Stochastic modelling can't predict the nature of 'Black Swan' events. Is the chance of a significant crash 1% or 10%? These models can't estimate these odds, so the best that can be said is that these events don't happen very often.

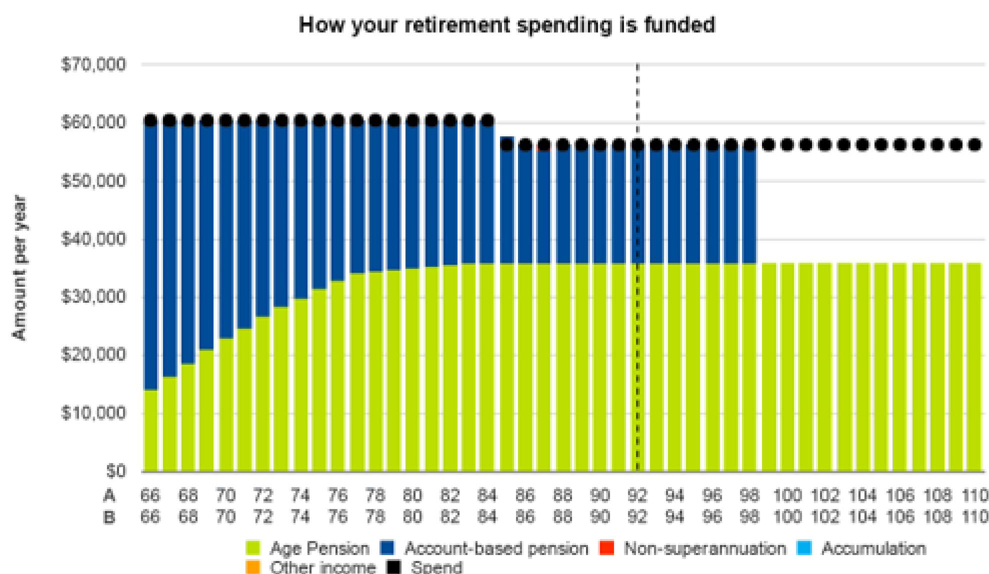
Modelling a 'comfortable' retirement

It is an interesting exercise to model the ASFA example in the Healthcheck software for a two 66-year-olds in a couple couple who are eligible for the age pension.

Let's assume $640,000 in superannuation in a 'balanced' portfolio using the asset allocation constructed to align with the Morningstar Multisector Balanced Market Index (22% Australian shares, 25% international shares, 5% listed property, 33% fixed interest and 15% cash). Fees of 0.9% per annum are assumed. The default long-term asset class return assumptions within the Healthcheck produce a return of 5.3% per annum based on the asset allocation after the deduction of fees. Gross returns of 3.5% for 'cash' and 4.5% for fixed interest are assumed, which could be considered optimistic in the current environment. Nevertheless, the 5.3% per annum is lower than the ASFA assumption of 6.0% per annum.

The Healthcheck also allows settings around the lifestyle of a retiree. ASFA produces budgets for those around 65-years-old and 85-years-old. For those around 85-years-old, the comfortable lifestyle budget is $56,295 per annum, which is approximately 7% lower than that for a 65-year-old. So in the Healthcheck, it has been assumed that expenses reduce to this level at age 85. ASFA also produces budgets for singles and the comfortable lifestyle budget is $42,764 for a single, which is approximately 29% lower than for a couple. Again, in the Healthcheck, it is assumed that expenses reduce to this level at the first death. Personal effects of $25,000 have been assumed for age pension calculations.

The chart below illustrates the misleading nature of a deterministic forecast. It shows that the retirees' money in their account-based pension (the blue bars) should not run out until they are 98-years-old. The dotted line shows where there is a 50% chance that at least one member of the couple will still be alive, and that's in 26 years' time.

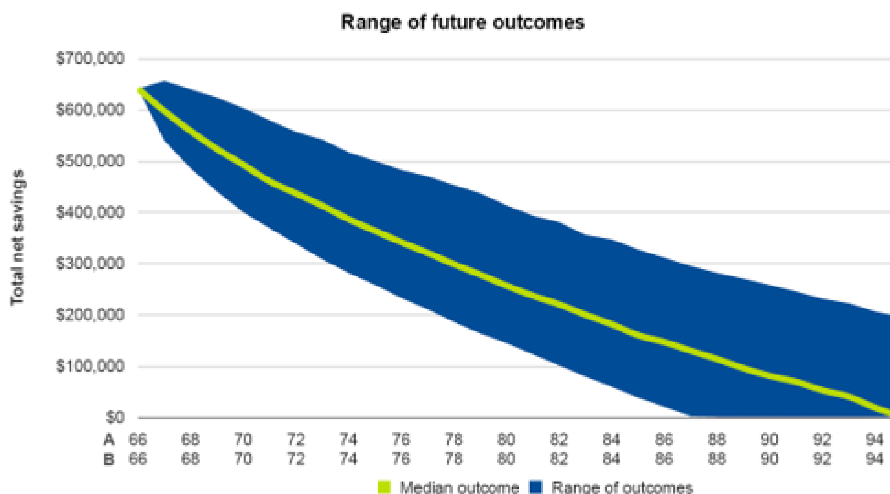


What if a greater range of outcomes is considered?

However, the stochastic modelling produced via the Healthcheck shows that in 64% of the 2,000 scenarios tested, the retirement lifestyle is sustainable. This means that the couple has a 36% chance of **outliving** their savings.

I'm not sure what readers think about a 36% failure rate, but I wouldn't feel comfortable crossing a bridge if it had a 36% chance of collapsing!

The chart below details where variability has been allowed for. There is an 80% chance that the retiree's future savings will fall within the blue shaded area. The bottom of the blue range represents a 'worst case' outcome at each age. There is a 10% chance of running out of money after 22 years. The top of the blue range represents a 'best case' outcome at each age. The green line represents the median of 2,000 scenarios.



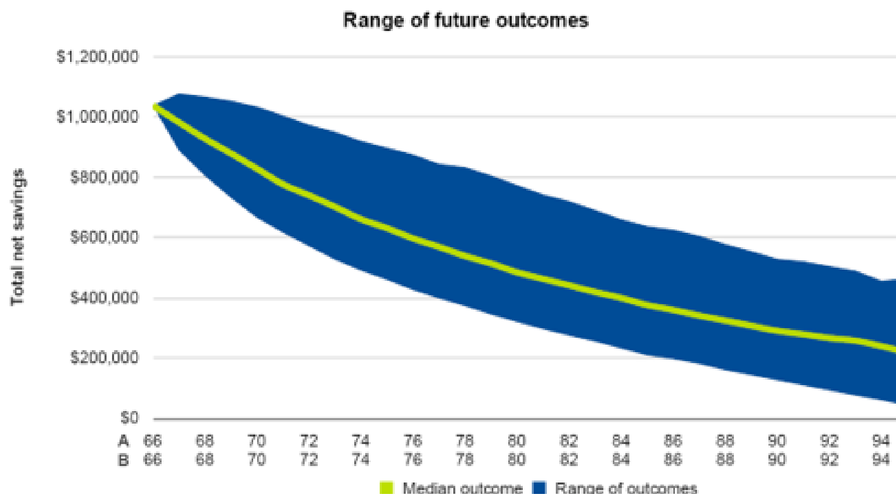
When presenting the deterministic forecast, I don't think anyone could reasonably imagine that there was a 10% chance of running of money after 22 years. The deterministic forecast illustrates that the retirees should be fine until they are aged 98, which is 32 years away.

So how much does a retiree need to be 'safe and comfortable' with 95% confidence?

Let's assume that we want 95% confidence that the retiree would not run out of money. I am risk averse, so I still wouldn't walk across a bridge if it had a 5% chance of collapsing. Nonetheless, it is better than walking across a bridge that has a 36% chance of collapsing.

By reverse engineering within the Healthcheck software, based on the previously detailed assumptions, it is estimated that a retiree couple would need **$1,036,000** to have only a 5% chance of running out of money. This is 62% greater than the amount estimated by ASFA. However, it is lower than that implied by some safe withdrawal rate articles that suggest drawdowns of not more than 4% ($1,506,600). This is due to the benefits of the age pension, but if social security laws change significantly in the future, as they have in recent times, then this would impact the results produced by the model.

The chart below is based on $1,036,000 in superannuation at retirement. There is a 10% chance of savings being approximately $40,000 in 29 years' time and a 10% chance of being roughly $460,000.



There is no doubt that a deterministic forecast is easier to explain, easier to understand and still has its place. However, stochastic modelling, while more complicated, considers a vast range of possible scenarios and estimates the most significant financial risk for retirees, which is the likelihood of running out of money.

As David Bell succinctly notes in his article mentioned earlier: *"Many other industries develop complex products which are explained effectively to consumers … Too hard … cannot be an excuse."*

Patrick Malcolm is a Senior Partner and Financial Planner at [GFM Wealth Advisory](). He has attained the Certified Financial Planner® designation, completed a Master of Applied Finance and is also a SMSF Specialist Advisor™. This article is general information that does not consider the circumstances of any individual.

Let's get the numbers right on imputation

Graham Horrocks on 7 March 2018

[Managing Editor's note: This is Part 1 in a series that Graham Horrocks has written due to "a miserable level of discussion and to relieve my frustration" relating to the Australian tax, dividend and superannuation system. Graham is an actuary and was my first financial adviser 30 years ago, when we spent most of the day talking about strategy and long-term structure, and nothing about picking fund managers or stocks.]

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The Government proposal to lower the corporate tax rate in Australia has prompted a heated debate about the impact on shareholders. The widespread inaccuracy in reporting the consequences has prompted me to put together some figures and comments as background. For example, one prominent adviser/commentator recently wrote incorrectly that "*at a 25% corporate tax rate, personal taxpayers would suffer because of their higher marginal tax rates and face additional tax bills on franked dividends.*"

Income tax payable by an Australian investor receiving a franked dividend

The Australian system of full dividend imputation should be front and centre in any debate on the rate of company tax in Australia. Dividend imputation was introduced after a long campaign by business to avoid the double taxation of company dividends. Australian shareholders only pay tax on dividends once, at their own tax rate, but the company tax rate and the amount paid by the company is irrelevant to Australian shareholders.

Calculations in the table below are based on a company tax rate of 30% and tax rates for Australian shareholders of 47% and 34.5% (including Medicare Levy) for individuals, 15% for superannuation funds in accumulation phase (super funds) and zero for superannuation funds in pension phase (pension funds).

Shareholder tax rate and tax rate paid under dividend imputation

Shareholder	Individual	Individual	Super fund (accumulation)	Super fund (Pension)
Shareholder tax rate	47%	34.5%	15%	0%
Company profit	$100	$100	$100	$100
Company tax	($30)	($30)	($30)	($30)
Net profit after tax	$70	$70	$70	$70
Cash dividend (franked)	$70	$70	$70	$70
Franking credit	$30	$30	$30	$30
Taxable income to shareholder	$100	$100	$100	$100
Calculated tax	($47)	($34.50)	($15)	$0
Less franking credit	$30	$30	$30	$30
Tax payable	($17)	($4.50)	$15	$30
Dividend after tax	$53	$65.50	$85	$100
Tax rate paid	47%	34.5%	15%	0%

The company tax rate is irrelevant because regardless of the level, tax is subtracted from profits and then added back for investors as a franking credit. These figures can be recalculated with a lower tax rate of 25% (or any other figure) and it will reduce the company tax payable, increase the after-tax profit, increase the cash dividend and reduce the franking credit. But, the dividend after-tax received by the shareholder on the various tax rates will be exactly the same: $53 (47% tax rate), $65.50 (34.5% tax rate), $85 (15% tax rate) and $100 (tax free).

Company tax rate has no impact on the after-tax dividend

In each case, the total tax payable and hence the amount of the dividend after tax reflects the profit of the company before tax and the Australian shareholder's tax rate only. The company tax rate has no impact on the amount of after-tax dividend received by an Australian shareholder.

Some additional comments:

- The value of a company is the present value of the dividends which are expected to be earned in the future, after tax payable by the shareholder. Even when the company is sold, its value then will still be the present value of expected future after tax dividends. The amount of dividend received by an Australian shareholder after tax reflects the shareholder's tax rate and is independent of the company tax rate, so the value of a company to an Australian shareholder is also independent of the company tax rate.
- In many cases the after-tax position for an overseas shareholder is much the same as for an Australian shareholder. Tax rules in USA, UK, much of Europe and other countries, together with double taxation arrangements generally mean that any tax paid by the company in Australia is offset against tax payable overseas by the parent company. Thus, lower tax paid in Australia by a company will mean more tax paid overseas, i.e. a subsidy from Australian taxpayers to overseas countries – unless, of course, profits are passed through a tax haven on the way. Figures published recently suggest that the proposed reduction in the company tax rate in Australia for large companies would represent a huge subsidy from the Australian taxpayer to overseas countries, hardly in Australia's best interest.
- The proposed reduction in the company tax rate is expected to result in a significant cost to tax receipts received by the ATO. Some figures suggest that much of this cost comes from the subsidy from Australian taxpayers to overseas companies described above. Another component of the cost is likely to be retained (after-tax) profits within Australian companies where franking credits are retained rather than being distributed to shareholders. This is discussed in Part 2 next week.

Graham Horrocks is an actuary specialising in financial planning and superannuation, and a former General Manager, Research & Quality Assurance, with Ord Minnett. Since 1999, he has been an independent financial adviser. The article was reviewed by Geoff Walker, former Chief Actuary at the State Bank of New South Wales and winner of the 1989 JASSA Prize for published research on the implications of the then relatively-new dividend imputation system.

Grandfathered commissions: what's it about?

Rick Cosier on 22 November 2018

Investment Trends recently released its 2018 Financial Advice Report, an in-depth survey of the appetite and use of financial advice among Australian adults. The Financial Services Royal Commission has profoundly affected perceptions of the financial planning industry and trust in financial planners and banks is at all-time lows.

Among the major issues at the Commission, fees for no service, charging fees to dead people and dud insurance policies are easy concepts to grasp. However, grandfathered commission is more difficult for most people to get their head around. Various groups have been vocally calling for blanket bans, and banks have been backing away from commitments made to financial planning groups in order to placate an angry population.

How did it all start?

The dictionary definition of grandfathering is to exempt someone or something from a new law or regulation. In the financial advice context, grandfathering concerns investment commissions, superannuation commissions and insurance policies linked to super accounts.

Let's step back. In the 1980s, financial institutions started marketing managed investments, where investors could access the share market by pooling their money with other like-minded people in a managed fund. The investment managers did not have a means to sell the concept: no sales force, no client service departments and no real way to communicate with potential end-investors. They enlisted the support of intermediaries. They charged the investor entry fees into the managed fund which they passed to the intermediaries as upfront commission. Since July 2013, these commissions have been banned.

The intermediaries were also paid ongoing (trailing) commission, usually 0.3% or 0.4% per annum on the value of an investor's account balance. It is these commissions which most of the fuss is about. The payments were intended to subsidise the cost of providing ongoing service to people who bought the managed funds.

Who pays it and who gets it?

Two important factors to note.

First, the trail commissions were paid by the investment manager out of their management fee. It was not an added fee that was deducted from the investor's account. Consequently, it did not (and still doesn't) show up specifically as a debit on investor statements. If an investor didn't invest via a financial adviser, the fund manager invariably retained the money and didn't rebate it to the investor. These managers didn't really want a direct relationship with investors, and they certainly didn't want to jeopardise their adviser distribution arrangements. At the time, any fund manager who 'went direct' or discounted fees risked being blacklisted by angry advisers.

Second, these commissions were not paid directly to financial advisers, and still aren't. The vast majority of financial advisers are authorised representatives of a 'licensee' (sometimes referred to as a 'dealer group') rather than take on the responsibilities and risks involved with having their own licence. This spawned the creation of a group of independent licensees, some of which attracted large numbers of financial advisers. Investment managers paid commissions to the licensees who passed them on to financial advisers after deducting a percentage to cover the costs and profit margins of the licensee.

Along came vertical integration

In the late 1990s, banks recognised the profit opportunities that vertical integration could deliver, and retail banks bought fund managers, administration platforms and licensees. They derived profits from the management fees created by fund managers, admin fees from the platform and a share of the commissions created by financial advisers. Furthermore, their profits were bolstered by the mushrooming size of the superannuation market which grew from virtually nothing in 1992 to more than $2.7 trillion today.

Over time, the legal and compliance demands on financial planners grew to such an extent that trail commission was nowhere near enough money to cover the costs of financial advice. Consequently, many advisers tacked on an adviser service fee to the client's account. This fee had to be agreed with the client in writing, via a signed copy of the application form, and was directly deducted from the client's account and was specifically itemised on the client statement.

Some adviser groups rebated the entire trail commission and covered their costs by charging adviser service fees. Others used a combination of trail and adviser service fee.

The ban on commissions

Rumblings about commissions had been growing for a while but really blew up when the industry funds started spending big money on advertising. These 'compare the pair' advertisements graphically revealed how much money could be 'lost' by ordinary Australians over the course of a lifetime. The Labor Government introduced a package of measures designed to eliminate commissions and increase transparency, including:

- A ban on upfront and trail commissions on all new investments.
- Super funds had to invest all new super contributions into new low-cost investment options which didn't pay commissions.

- All existing super accounts would have to be transferred to the new low-cost investment option unless the member had actively selected a non-default option, or the fund received notification from the member saying they wanted to remain where they were.
- Advisers had to provide Fee Disclosure Statements every year.
- Clients had to sign an Ongoing Service Agreement every two years which clearly stated the services that were to be provided and what they were being charged.

The key date was 1 July 2013 but many of the measures had grace periods and different implementation dates. This confusion was amplified when the Coalition won power and announced they would roll back some of the changes, but the cross benchers objected.

Grandfathering of commissions

The measures that were eventually introduced contained some sweeteners, omissions or mistakes, depending on your view. The major concession was that **trail commissions on existing investments were grandfathered**. In other words, if an investor remained in an investment, trail would continue to be paid until the investment was redeemed, in theory forever.

Due to the forcible transfer of commission-based superannuation accounts to commission-free accounts, grandfathered commission was expected to die out relatively quickly. However, they are an important part of the revenue structure of many advice groups, although certainly not all.

What isn't generally recognised is that many superannuation members are actually better off in commission-paying investment options.

First, low cost super funds often underperform other investment options, even after fees. **Second**, when MySuper and FoFA were introduced, many retail super funds found other ways to earn revenue, ostensibly because of the additional legal and risk costs. While they deducted the trail from the management fee, some increased their administration fees, inserted an adviser service fee or added a regulatory reform fee to cover the costs of compliance. Overall, management fees went down but perhaps not as much as expected.

Some workplace super funds also changed their fee structure so that management fee discounts were lower on the new MySuper products. These discounts often started when the workplace super fund reached $1 million but following the introduction of MySuper, the starting point for the discounts on some new low-cost options moved $5 million. This sometimes wiped out any cost savings accruing from MySuper. Also, many financial advisers were rebating some or all of their trail commission, and this benefit was lost to MySuper members under the new fee regime.

Grandfathering rights were also extended to allow advisers job flexibility and retirement options:

- If a financial adviser leaves his current licensee and joins another licensee, the trail continues to be grandfathered and the new licensee receives the commissions instead.
- If the adviser retires and sells his business to another financial adviser, the new financial adviser can inherit the commissions.
- If the adviser's licensee buys his business the licensee inherits the trail commission.

In my opinion, these allowances are reasonable otherwise it creates a restriction on advisers to practice, dramatically limits their employment options, decreases the value of their business and reduces their retirement choices. Grandfathering is an expected concession when changes are made to legislation (and listen to the howls of complaint when it is denied!) so why should financial advisers be treated any different?

Bigger FoFA mistakes

I believe the biggest mistake the government made when introducing FoFA was that Fee Disclosure Statements and Ongoing Service Agreements did not have to disclose trail commissions. This gave advisers the opportunity to be economical with the truth, and it is probable that many investors remain completely unaware of exactly how much money advisers are making on their investment. Many advisers did not disclose trail commissions. In their view, commissions are payments made by the super fund from their management fees and not a direct cost to the client.

While history is on their side, the future is not.

Before retiring in June 2018, I spent 26 years in the investment and financial planning industry including with two fund managers, two banks and three financial planning organisations. Even with this background, I may have overlooked an important aspect of commissions so please feel free to chime in!

Prior to retirement, Rick Cosier was a financial adviser for 26 years and Principal of Healthy Finances Ltd. This article is for general information only and does not consider the circumstances of any individual.

Royal flush: 15 questions to ask a financial adviser now

Jonathan Hoyle on 3 May 2018

The Royal Commission has highlighted some appalling financial advice practices. Transparency, greater professionalism and higher standards are required. Corruption, cronyism and incompetence must be weeded out. A torrent of new regulations is a racing certainty, although how that will look is still to play out.

Hopefully, we will look back in a few years and say the Royal Commission was the best thing that happened to the financial planning profession. Financial planning matters. It matters because quality advice has the power to transform lives. It matters because poor, unethical advice has the power to destroy lives.

Start with two quick checks

How do you find a good financial adviser from more than 24,000 licensed Australian advisers? In November of 2017, I wrote this article for Cuffelinks on the *25 questions you should ask your financial adviser*. This is an updated version in a post-Royal Commission world.

First, as before, start with the pamphlet, entitled *Questions To Ask A Financial Adviser* compiled by our industry regulator, ASIC.

Second, conduct a search of your adviser on the ASIC register. This provides a list of their qualifications and records any banning orders or disqualifications made against them in the past.

Then, insist on getting answers to the following questions in writing. They won't guarantee you a good adviser, but they will reduce the odds of a dud or a crook.

The questions to ask

1. Who owns your business?

Most advice firms are owned by a handful of individuals. Be wary of those with institutional ownership, especially when those institutions also manufacture financial products, encouraging massive conflicts of interest.

2. Who provides your licence (AFSL) to operate?

You might prefer firms who have their own licence, but there are plenty of shoddy independent operators (as the RC showed), and there are plenty of excellent advice firms who are licensed by a major financial institution. You want to learn about potential conflicts of interest that might compromise your best interests. The one key advantage of being self-licensed is that these firms are free to recommend a broader universe of funds and insurance products.

3. What percentage of my portfolio is invested in funds owned by your licence provider?

It should be close to zero.

4. How many insurance providers are on your Approved Products List?

It should be a lot more than one. This gives sufficient diversity and an ability for an adviser to add value through choosing the most competitive policy.

5. Is there any connection between the investment platform you have chosen and your licence provider?

There might be. This may be ok, but it's a potential conflict as this may be the only platform offered to you as a client. Ask why they selected that particular platform for you.

6. May I see your last Compliance Audit please?

Every adviser is audited annually by an independent team. Ask to see the last three audits as they could be quite revealing.

7. How do you charge your clients?

Fees should vary depending on the job you want done. For specific project work, an adviser might bill by the hour, but not for ongoing advice. Hourly charging encourages inefficiency. Nearly all advisers will increase their fees in line with the assets to manage, but the relationship should not be linear. Managing $2 million is not twice as involved or complex as managing $1 million. Charging clients a fee-for-service is becoming more popular and, in our opinion, will eventually replace percentage-based fees.

8. Are your fees negotiable?

We believe fees should *not* be negotiable. Clients should be charged by the same methodology. Existing clients should not subsidise new clients (unlike certain cable TV providers we could mention), nor should those with superior negotiating skills receive favourable terms.

9. Do you receive an annual bonus?

Most advisers are paid an annual bonus for a job well done. Nothing controversial about this, but ensure that the bonus is not solely driven by introducing new clients to the firm. It should reflect exemplary client service, a spotless compliance track record, a team ethic and a commitment to ongoing education and training.

10. Can you tell me about your conflicts of interest, orally and in writing?

These must be disclosed orally and in writing. Ask to see their Conflicts Register. Some conflicts of interest are inevitable and may not be a problem, provided they are disclosed.

11. Do you pay referral fees to generate new clients?

Many advisers pay referral fees to lawyers and accountants to refer new clients. Provided this is fully disclosed, there is no conflict. It's more an issue for the referrer than the adviser.

12. What are your professional qualifications?

The Certified Financial Planner (CFP) is the gold standard in the US and Australia, but there is difference between those CFPs that were 'grandfathered' and those that were earned by hundreds of hours of hard

slog. The CFP is now a difficult examination to pass. It doesn't guarantee great advice, but it reduces the odds of engaging a dud. Make sure to ask for the qualifications of the Investment Committee too. The Chartered Financial Analyst (CFA) is the certificate of excellence for portfolio analysis.

13. Who manages my money?

Financial advisers are not money managers. They are not trained to do this. Look for a professional Investment Committee run by an experienced CFA.

14. How do I exit this relationship if I don't like it?

There should be no lock-ins. Financial advice firms are not mobile phone companies. Account portability is essential.

15. Can you provide me with testimonials of clients in a similar situation?

Always ask for this. We would recommend checking out a website called Adviser Ratings. It contains testimonials from the adviser's clients and a rating.

Choosing your financial adviser is a significant decision

We suggest asking people in your life whose financial opinions you respect. These might be your accountant or an educated friend. And meet plenty of advisers during your due diligence. A good adviser adds value. We hope this list will help you in your search.

Jonathan Hoyle is Chief Executive Officer at Stanford Brown. This article is general information and does not address the circumstances of any individual.

It's as much Smashing Pumpkins as smashed avocado

Graham Hand on 10 May 2018

There is no greater accolade for a social commentator than having an idea enter the national lexicon. So it was with due pride that demographer Bernard Salt showed his unmitigated delight at the way his 'smashed avocado' reference now sums up an entire generation of Millennials and their spending habits. Salt was speaking at a Colonial First State Global Asset Management Forum on 1 May 2018, and he explained how media companies from all over the world have contacted him to discuss his smashed avos.

Salt's reference to $22 avocado on toast for breakfast in the original article in *The Australian* has become a touchpoint on housing affordability and even intergenerational conflict. He said of young people:

"Shouldn't they be economising by eating at home? How often are they eating out? Twenty-two dollars several times a week could go towards a deposit on a house."

However, at the panel discussion, he said the real purpose of the column was misunderstood, as he subsequently wrote:

"It was intended not as a criticism of youth but as a parody of middle-aged moralisers, using the setting of a hipster cafe to showcase the conservatism of middle-aged thinking."

The mistaken message has more merit

Notwithstanding most people mistaking the original interpretation, the incorrect meaning surely carries more gravitas. This struck me while attending a concert at the ICC Sydney Theatre a few days after hearing him speak. It was the highlights from the BBC series, Planet Earth II, 'live in concert' with the Sydney Symphony Orchestra playing an original score to match the action. The theatre holds about 9,000 people, and the only empty seats were the cheap 'bronze' sections at the side.

Cost

Bronze: $71.20

Silver: $101.50

Gold: $132.30

Platinum: $183.25

BBC Earth Lounge: $449.00

Book tickets >

Now here's the thing. The audience was overwhelmingly young people, say under 30, and most of the tickets were in the 'platinum' and 'gold' categories. The ticket tiers are shown in the extract. With mediocre wine in a plastic cup at $10 a pop, many

young couples were up for $400, and the 'BBC Earth Lounge' was full at $1,000 a couple. People queued impatiently to buy drinks and chips while the free water sat unloved.

For what? It was a great show, but BBC nature documentaries and David Attenborough are at saturation levels on free-to-air and pay television. They can be watched for free online 24/7. Most people have big flat screens and good sound systems, and could watch the animals with great sound any night of the week. This was not a once-in-a-lifetime chance to see a music legend. It was a good night out watching something readily available, acknowledging that the SSO made it extra special.

Smashing Pumpkins 30th anniversary tour

In a couple of months, the legendary band Smashing Pumpkins will start a 30th anniversary reunion tour in the United States, the first time most of the band has toured together in almost 20 years. The band has a big Australian following, and if the tour makes it here, they will sell out at an average of $200 a ticket.

In 2013, Pink sold out 46 concerts for over 600,000 fans, with the cheapest seats at $150 and the 'True Love' package of meaningless stuff at $400. Justin Bieber's recent VIP experience was over $500. Adele sold 200,000 tickets for two open-air Sydney concerts in 2017 with D Reserve, up in the heavens at the ANZ Stadium, costing over $100, and A Reserve nearer the stage at over $300. Ed Sheeran's 2018 Australian tour sold over 1 million tickets with 225,000 in three shows in Sydney, slightly more than AC/DC in 2010.

The list is endless, week after week, worth billions a year, and Australia can't get enough of it.

What do some young people earn?

Clearly, many young people are well-paid and $400 is the cost of a decent night out, but it is common to read young journalists bemoan their inability to ever buy a house in Sydney or Melbourne. The gig economy is making more jobs part-time and removing job security and benefits. Many struggle to make rental payments, never mind borrowing half a million.

Writing in *The Sydney Morning Herald* on 7 May 2018, a Fairfax contributor, 27-year-old Joshua Dabelstein said he does not know anybody who has ever considered buying property. He said his generation is more concerned with paying the rent.

"A friend of mine's boss convinced her that paying $17 per hour at a café was a great deal because she wouldn't have to pay tax on it … In the past 48 hours, two close friends have been fired. One has spent seven months working for a restaurant that paid him a flat rate of $19 an hour."

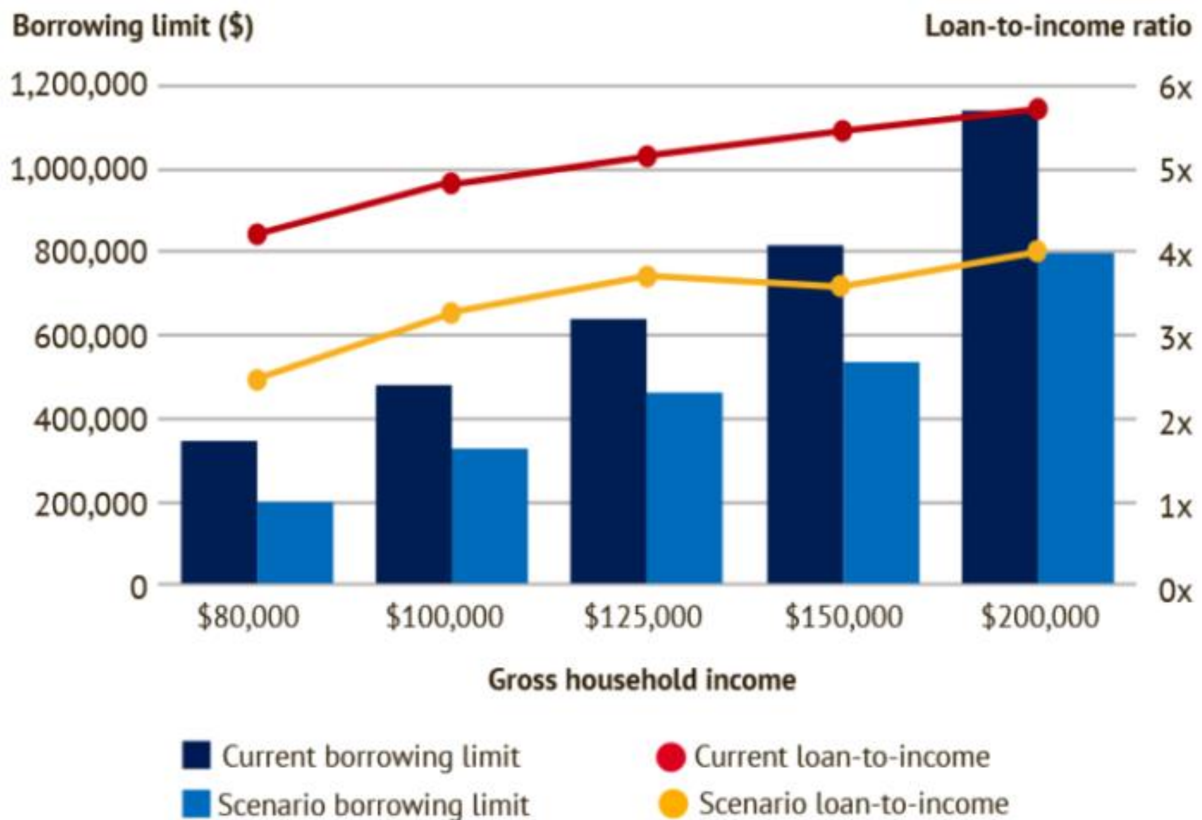
So without entering the debate on what's fair and whether small business can afford to pay penalty rates, there are vast numbers of young people earning less than $20 an hour. Perhaps these are not the people going to many concerts, but when Ed Sheeran sells one million tickets and Pink and Adele sell 600,000, there are a lot of gig economy and casual workers among the audience.

What do banks now require for a home loan?

In the last year, qualifying for a home loan has changed dramatically. Lenders want to know far more details than they did at the start of the residential property boom that has now ended. The Financial Services Royal Commission produced much evidence in Round 1 on how easy it was to obtain finance. Now, lenders want to know about day-to-day living expenses, down to details such as how much is spent on fuel, eating out and, yes, going to movies and concerts. There is more checking of bank statements by line item, and reports of lenders asking why borrowers needed luxury items like gym memberships. The Royal Commission's honing in on responsible lending obligations has changed mortgage industry procedures. ANZ Bank CEO Shayne Elliott said the more risk-averse mood would make it harder for some consumers to borrow for a home.

The investment bank UBS has done an estimate of how borrowing conditions have changed, as shown below, with a decline in loan size for given levels of household income, and lower loan-to-income ratios based on new lending scenarios.

Following the Royal Commission, much larger deposits will be required, and most people will only achieve this by reducing their spending or going to the Bank of Mum and Dad.

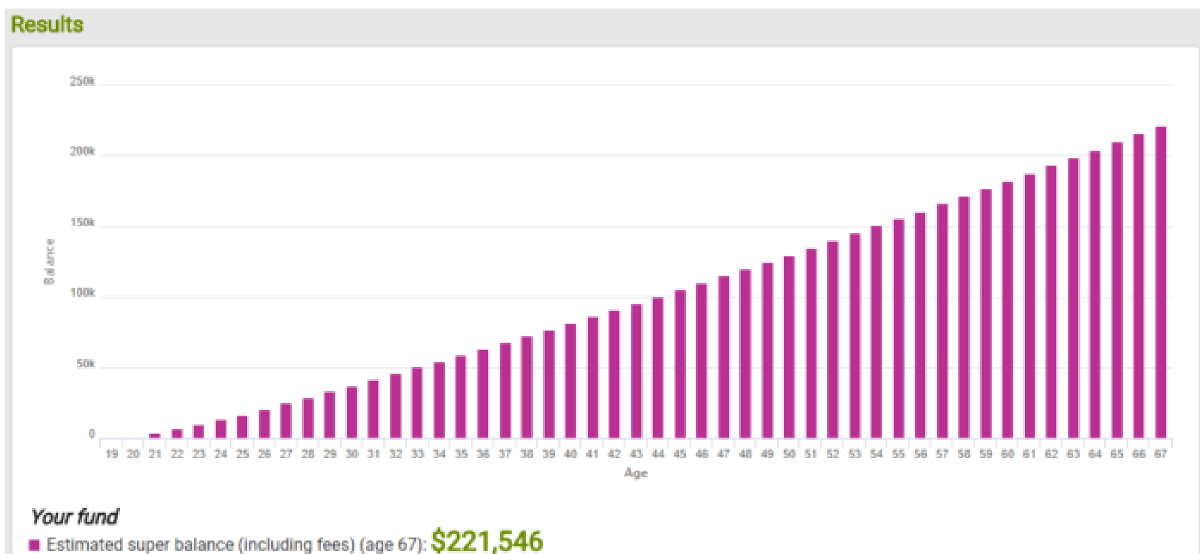


What could be achieved by smashing the concert desire?

Life is for living and café breakfasts and concerts are fun and part of the joy of an Australian way of life. I get that. But for the sake of the exercise, let's see what could be achieved by salary sacrificing into superannuation instead of buying a $200 concert ticket (or finding some other saving) each month.

These calculations are made using ASIC's MoneySmart Superannuation Calculator where anyone can experiment with the numbers. Check the website for the underlying assumptions but this example uses the following:

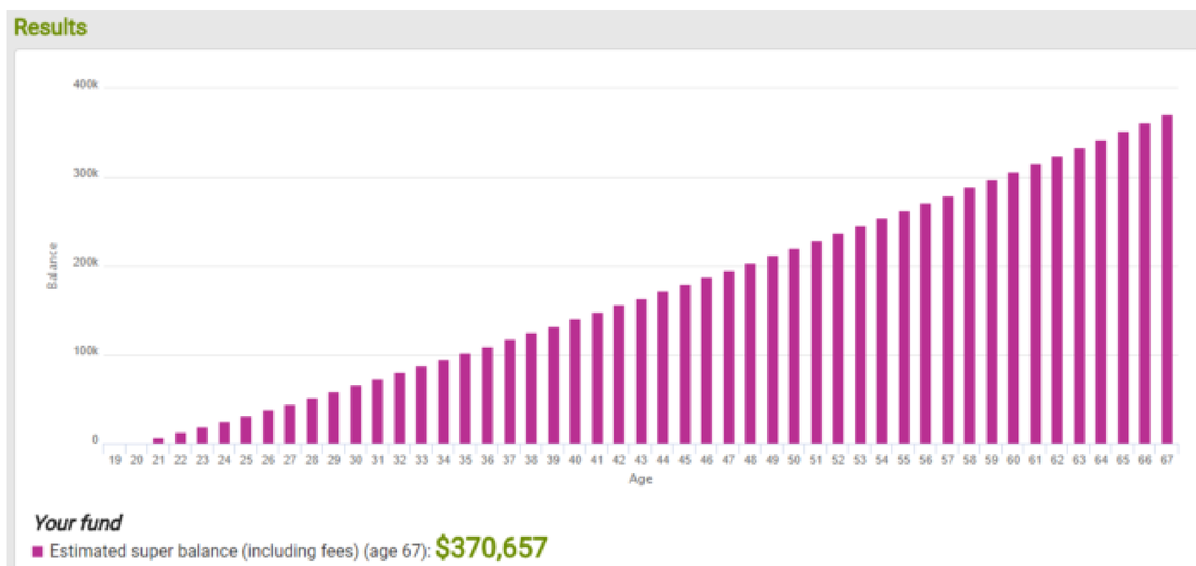
- Age at start, 20
- Annual income before tax and super, $40,000
- Desired retirement age, 67
- Employer contributions, 9.5%
- Low-Medium fund with fee of 0.9% pa plus $50 pa admin fee
- Growth fund with investment return of 5% pa.



The estimated fund balance at age 67 is $221,546. Of course, investments markets do not deliver smooth, predictable results as this chart implies, but it's an ASIC-approved picture of long-term potential.

Now let's change only **one** assumption, with the saver making additional salary sacrifice contributions to superannuation of $200 a month. All numbers are adjusted for inflation.

The balance at age 67 is now $370,657, an increase of about $150,000 or nearly 70%.



Sacrifices are needed

It doesn't matter whether the $200 a month comes from missing a concert or avocado on toast, the numbers show the remarkable impact of disciplined saving and a relatively modest amount extra each month. Of course, many people would struggle to find $50 a week, but missing a coffee a day would go half way there. It's a matter of lifestyle and future financial security at the cost of current consumption and enjoyment.

Seeing Smashing Pumpkins, Pink, Justin Bieber and animals on a big screen are all fun to somebody, but having financial security at age 67 is fun for everybody. Bernard Salt was right when he wrote that saving all the little extras for many years could go towards a home deposit or a decent retirement.

If his original article was a "parody of middle-aged moralisers", the queue starts here.

Graham Hand is Managing Editor of Cuffelinks.

SMSFs, member-direct and Labor's franking

Matthew Collins on 23 May 2018

The refund of excess franking credits has been available since 2000. Many SMSF trustees have become accustomed to receiving a large deposit into their bank account at the end of each financial year. If Labor's proposed changes to dividend imputation become law, the refund will be a thing of the past and trustees will need to rethink their investment and tax planning strategies.

Franking credits will still be beneficial for superannuation funds that have taxable income as the franking will reduce their tax liability. However, many funds, especially those paying a pension, have little or no tax payable and currently receive a refund. They will be the funds that lose out the most.

A flaw in the policy proposal is that the burden of the extra tax will affect one group of investors, those using an SMSF, more than any other. Most large industry and retail funds will generate enough income from contributions and investment earnings to use their franking credits and pass on the benefit to members. This creates the unfair situation where two investors with the same investments, one in an SMSF and one in an industry or retail fund, will be treated differently.

What can SMSFs do to reduce the impact?

Given the possibility that Labor will be in power by this time next year, SMSF trustees and their advisers are already contemplating strategies to limit the effect of the potential change. These strategies include:

- Changing the investment mix to include investments that don't provide a franking credit such as property trusts, overseas investments, and companies that pay unfranked dividends.
- Many high net worth super fund members currently receive a pension simply to reduce the tax liability of their SMSF and not because they need the income. In future, this strategy may simply increase the amount of franking credits that are lost, and members may leave their superannuation in accumulation.
- Children who are making taxable superannuation contributions may join their parents' SMSF. The taxable income of the fund will rise and use up some of the excess franking credits.
- Closing the SMSF and have their investments managed by an industry or retail fund.

There is another strategy that may be of benefit to some investors: member-directed investments.

What are member-directed investments?

Generally, when joining an industry or retail fund, investors are given a choice as to what fund category they will invest in. For example, they may be asked if they are a 'Conservative', 'Balanced', or 'Growth' investor. Some funds also provide another alternative where the member can choose specific investments. This alternative is generally known as 'member-directed investments'.

The member-directed investments option allows the member to buy and sell investments, similar to using an SMSF. It is managed through the superannuation fund website. Brokerage is charged at rates comparable to the major online brokers, and the administration fee, usually under $400 through industry funds, is reasonable when compared to fees charged to administer an SMSF.

Where an SMSF provides almost unlimited investment choice, this is not the case with the member-directed investment option. Investments are generally limited to:

- ASX 300
- A selection of listed investment companies
- A selection of exchange traded funds
- Term deposits
- Cash

It is not as flexible as an SMSF in other ways. There are limits on how much can be invested in any one asset, usually 20%, along with a requirement to hold a portion of your balance in cash.

Despite these restrictions, this type of product may be beneficial to some investors as shown in the examples below:

Example 1

Fund balance:	$1 million. 1 member. 100% pension phase
Investments:	75% in ASX shares (mostly blue chip), 25% term deposit
ASX dividend yield:	5% ($37,500)
Franking credit:	$16,071

If no action is taken, the franking credits will be lost. The member would have the option to shift to the member-directed investment platform and limit their investments choice. This could potentially result in a full refund of franking credits.

Example 2

Fund Balance:	$3.2 million. Two members. $1.6 million each in pension phase
Investments:	Global equities, direct property, ETFs, LICs, and ASX listed shares ($1.5 million is in investments on the member-directed investments list)
ASX dividend yield:	5% ($75,000)
Franking credit:	$32,143

The members could shift $1.5 million into a fund providing member-directed investments and maintain their SMSF for the balance. If the new fund pays an account-based pension, a franking credit refund of $32,143 could be received.

Some final words of caution

Superannuation law (SIS Reg 5.03) states that the trustee is required to allocate income between members "in a fair and reasonable way". What does "fair and reasonable" mean? In the case of member-directed investments, the good news is that currently the benefit of all credits relating to shares held are allocated to the member's account. It is hoped that this practice continues if there is a law change. However, we have no guarantee at this point.

In commenting on an article by Michael Hutton last week, a Cuffelinks subscriber, Ramani, did an excellent summary of this issue:

"The option of moving from a SMSF to an APRA (industry or retail) fund such that franking credits that would be wasted in the SMSFs can soak up the fund-as-a whole tax liability would make sense, but only if the APRA fund would equitably distribute the credits so saved back to the members who gave raise to the credits in the first place.

I would urge caution against such an automatic presumption. The black-box of calculating member earning and crediting rates (or the related unit pricing if the fund is unitised) as well as the fuzzy nature of equity among member cohorts, not to mention generic member apathy, militate against it. It would be feasible to check if the trustee would so distribute, and having confirmed it would, prosecute any failure in the new dispute resolution authority might be required. Otherwise, the SMSF members would be 'donating' the excess credits to other members without being aware of it, instead of to the Treasury as wasted franking."

Given the issue's importance, I suspect clarification will be provided by the funds before any change in the law.

It's an important opportunity. According to the Class SMSF Benchmark Report of March 2017, listed shares account for 30.2% of money invested in SMSFs. Therefore, there will be plenty of investors looking for strategies to keep their franking credits if refunds are no longer allowed. Assuming there are no legislative or other administrative impediments, member-directed investments may be a viable alternative.

[Editor's note: We expect a large industry fund to comment on their intended approach on their member-direct offer next week.]

Matthew Collins is a Director of Keystone Advice Pty Ltd and specialises in providing superannuation tax and structural advice to high net wealth individuals and their families. This article is general information and does not consider the circumstances of any individual investor. It is based on a current understanding of related legislation which may change in future.

Three market scenarios, including a 30% fall

Hamish Douglass on 26 July 2018

We are cautious about global equity markets at present and running a defensive portfolio. This is because we face an extraordinary cocktail of circumstances that skews risks to the downside, including:

- Asset prices are at, or near, record levels

  Prices for sovereign, corporate and high-yield bonds and equities are at, or near, record levels thanks to the ultra-low policy interest rates and the massive quantitative-easing programs of the G3 central banks (the US Federal Reserve, the European Central Bank and the Bank of Japan) over the past decade.

- Central banks have commenced quantitative tightening

  In response to the strengthening economic environment, the Federal Reserve is raising the cash rate and has commenced a pre-set programme to shrink its balance sheet while the European Central Bank has announced that it will cease its asset buying program by 31 December 2018. The combined

impact of announced balance sheet activities of the Federal Reserve and the European Central Bank will remove liquidity from global markets, resulting in a reduction in demand for bonds and other assets by these central banks of about US$1.5 trillion on an annualised basis from October 2017 to the end of December this year. We believe that a change in demand by the central banks of this magnitude is likely to have a meaningful impact on longer-term bond yields by early 2019.

- Late-cycle US fiscal stimulus

  In our view, the Federal Reserve's strategy to tighten monetary policy in a smooth and well-foreshadowed manner has been complicated by the large fiscal stimulus being implemented by the Trump administration at the tail end of an extended economic expansion. The tax cuts and additional spending will make a fiscal injection into the US economy of nearly 2% of GDP per annum for the next two years. The US unemployment rate at 4% is near an 18-year low and the US economy has added jobs over the past 93 months, which is the longest such consecutive stretch on record. While there appear to be powerful longer-term secular forces at work that are likely to result in low inflation over the longer term, there is a significant risk that the size and timing of the US fiscal stimulus could trigger a jump in US inflation, in particular from stronger wages growth, over the next year or two. This could be highly problematic for the Federal Reserve and complicate its efforts to engineer a gradual tightening with a soft landing. We cannot think of a similar combination of circumstances in modern history. The cocktail of circumstances could be explosive. The best hope for investors is that either the US tax cuts and extra spending have limited effects on growth and inflation in coming years or the secular forces that have kept inflation low accelerate to offset any inflationary pressures from the fiscal stimulus.

The possibilities of three scenarios

We assess that there are three possible scenarios for markets over the next 12 to 18 months:

- <u>The first scenario is a continued US economic expansion without triggering a material increase in US wages growth or inflation.</u> In these circumstances, we would expect the Federal Reserve to increase short-term interest rates and to shrink its balance sheet broadly in line with current expectations. In these circumstances, it would be reasonable to expect that over the next, say, 18 months the US cash rate would rise to 3% to 3.5% and the 10-year Treasury yield would increase to about 4%. In this scenario, defensive equity assets, longer-term bonds and emerging-market equities are likely to underperform growth assets and economically cyclical assets, and some commodities are likely to outperform driven by the economic expansion. We would place slightly less than a 50% probability on this scenario.

- <u>The second scenario is where the Federal Reserve is forced to act more swiftly and forcefully than expected to counter inflationary forces.</u> It would be reasonable to assume that US longer-term bond yields could jump suddenly and meaningfully (above 4% compared with 2.86% for the US 10-year Treasury bond at the end of June), which could trigger the biggest slump on world share markets since the global financial crisis. In our view, a 20% to 30% global stock market correction in the next 12 to 18 months is conceivable. In these circumstances all equities are likely to be affected. We would put a similar probability on this scenario to the first or, in other words, we don't know which of these two scenarios is more likely.

- <u>The third scenario is where an external event occurs that causes the Federal Reserve and the European Central Bank to reverse course and put on hold any further tightening of monetary policy.</u> We believe that this is most likely to occur in circumstances of a significant event and, therefore, this scenario is likely to be negative for share markets. There is a remote possibility of a 'Goldilocks moment' where the central banks stop their plans to tighten money policy, longer-term bond yields fall and equity markets don't fall or even rise.

While global stocks have set record highs over the past 12 months, we are cautious on the outlook for equity markets and consider that risks are asymmetrical to the downside. Our caution is reflected in the defensive positioning of the Magellan Global Trust with cash at 30 June 2018 representing 21% of the portfolio.

Conservative investors sleep well

Some people might consider that having such a large cash holding exposes investors to underperformance if equity markets rise. We have no fear of missing the tail end of an extended bull market. Renowned investor Sir John Templeton was perhaps best known for saying:

"Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."

In our view, only conservative investors sleep well. Implicit in conservative investing is the focus on the conservation of capital. As Warren Buffett has said, there are two rules in investing: 1. Don't lose money. 2. Don't forget the first rule.

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