Cuffelinks
Connecting investors with ideas

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Where did SMSFs come from, and where are they going?

PJ Keating

When we laid the foundations for the current superannuation system in the 1991 Budget, I never expected Self Managed Super Funds (SMSFs) to become the largest segment of super. They were almost an afterthought added to the legislation as a replacement for defined benefit schemes.

This is the second article which draws on my talk to ASFA in November 2012, and it examines why SMSFs have become so popular.

In 1992, my Government introduced the Superannuation Guarantee Charge (SGC), with major extensions in coverage for working Australians who previously had no easy access to super. It came from the sea change in the economy and society produced by the co-operative political model adopted in 1983, with a productivity basis for improvements in living standards, and superannuation as a form of distribution of those improved living standards. The co-operative model induced and produced a massive increment to real wealth.

Employer contributions to superannuation rose from 4% of salaries in 1992-93 to 9% by 2002-2003. I wanted to reduce the future reliance on the age pension, and over time, give ordinary people a better retirement. Back in the 1980s, only wealthy people were in the stock market, but I felt mums and dads should be able to share in the bounty of the wealth of the nation. Owning a home was fine but they needed more. And through superannuation funds, everyone is now in it, and it's been good for both investors and the nation. We have created a $1.4 trillion pool of capital, and many super members have accumulated significant balances which they want to manage themselves.

It was not generally so initially. In 1992, employers mainly made the decision about which fund an employee's super contributions would be invested in, usually a so-called default fund. This approach was intended to keep the system simple, affordable and understandable. Each year, the employee would see the contributions and the gradually-building balance, without the employee having to take any action. It also kept the accumulations out of the hands of government bureaucracy.

The wealth would address the growing economic problem of an ageing workforce, and realign the mix between capital and labour through labour contribution to real capital growth. Very few countries have developed an adequate retirement income system with no 'false promise' in such a universal way, leaving the age pension – an income and asset tested pension – as an anti-destitution payment, which ceases when the recipient dies.

So the SGC was <u>not</u> introduced as a welfare measure to supplement the incomes of the low paid. It was principally designed for Middle Australia, those earning $65,000 to $130,000 a year, or one to two times average weekly ordinary time earnings (AWOTE). This is not to say that those on 50% or 75% of AWOTE should not benefit equitably from the superannuation provisions. They should. But for Middle Australia, the SGC and salary sacrifice was and is the way forward.

At an SGC of 12% and tax arrangements as now, someone on one to two times AWOTE plus adequate salary sacrifice limits should be able to secure a replacement rate in retirement income of around 70% over a 35 year working life.

That was the basic design, and achieving those targets did not require a lot of risk-taking in the investments. If compound annual returns reflected nominal GDP plus say 1%, the system would be doing well. Indeed, the Treasury forecast of system assets growing from $1.4 trillion today to $8.6 trillion in 2040 represents a compound annual growth rate of around 6.7%.

I mention this to provide context commentary on the rapid growth of SMSFs. As a general statement, I believe people's expectations as to rates of fund returns are too high. The Australian superannuation system is both large in world terms and large in absolute terms. Not only is it forecast to grow to $8.6 trillion by 2040, but currently, the system stands at over 100% of GDP and will mature nearer to 200% of GDP. It is simply too large in aggregate to consistently return high single or double digit returns.

I am certain expectations as to returns and the search for yield have done two things:

- managers have adopted a higher risk profile in portfolios, and
- lower returns than expected have soured expectations, encouraging more people to take the initiative and manage their own assets, including taking on the trustee role when setting up an SMSF.

Returns on APRA-regulated funds averaged 3.8% over the 10 years to 2011, notwithstanding volatility from the unprecedented growth in equities and investment markets between 2002 and 2008, juxtaposed against the impact of the GFC. Over the same period the average cash rate was 5.2% and the average GDP growth 3.1%.

These results indicate that significant risk was taken by superannuation managers to secure returns in line with the risk-free government cash rate. Importantly, these risks were taken on by managers who had limited direct exposure to losses – losses ultimately borne by superannuation beneficiaries. However, if the funds did return a significant amount, those same fund managers are often entitled to performance fees! And these fees are generally calibrated to annual returns rather than long term returns required to fund a retirement income.

I believe returns expectations are inflated and those expectations lead to incentives to drive higher fees for managers, but at much higher risks, as was the case between 2002 and 2011. We only have to look at asset allocations. At December 2011, total Australian super assets were weighted:

- 50% to equities
- 18% to fixed income
- 24% to cash and term deposits
- and the rest across other asset classes including property.

By contrast, the average weighting of OECD country pension assets was:

- 18% to equities

- 55% to fixed income
- 11% to cash and term deposits
- and the rest to other asset classes including property.

So, Australia is 2.5 times more heavily weighted into equities and relatively underweight in other asset classes. We are disproportionately weighted into the most volatile and unstable asset class.

The question is – how does this weighting work to deliver the key objective of the system? 60% of total superannuation assets are held by investors over the age of 50. A large proportion of these assets should be moving towards less risky, more stable asset classes, protecting capital ahead of the retirement phase. When we reach the point where outflows are increasingly matching inflows, the weighting to equities needs to be rectified. As the system matures, a real capital adequacy risk may start to develop, which will need to be seriously monitored by the government.

SMSFs currently represent approximately 32% of system assets, a pool of $475 billion, and growing strongly. As I said earlier, generally this group has unrealistic expectations as to how much is a good return. Single digit returns sour their enthusiasm for managed funds. They think they can do better themselves. Some sophisticated investors probably can, but how many self managers have the required level of investment expertise? And by investment expertise, I do not mean falling prey to financial advisers. Notwithstanding the costs of setting up a SMSF, you need something like $600,000 of assets to make the decision to self manage a better relative fee proposition to management by larger managed funds.

But the main issue gets back to investment skills. How many SMSF investors are competent in matters of asset allocation and general investment savvy? This becomes a real problem for the SMSF system and its deliverability as it occupies an increasingly higher proportion of overall system assets.

For systemic prudential reasons, investment in stable asset classes, such as government bonds or higher rated corporate bonds, could be desirable for SMSFs. That is, perhaps some form of minimum investment will be required which is mandated to mitigate downside risks. As the system reaches the tipping point, where inflows are increasingly being matched by outflows, it will need to be monitored for capital adequacy risk.

What financial advice is worth paying for?

Chris Cuffe

The S&P/ASX200 price index peaked in October 2007 at 6851, a remarkable 2.5 times its level five years earlier, in March 2003, of only 2693. The long bull market had started after 'the recession we had to have' in 1990, and for at least 15 years, financial planners could factor handsome ongoing returns from equity allocations into Statements of Advice.

The market index is now about 5000, 27% below its peak, and it is apparent that the strong market prior to the GFC disguised many shortcomings. As Jack Bogle, the highly respected founder of the Vanguard Group, said, "Never confuse skill with luck, especially during a bull market."

With lower absolute returns from investment markets after the GFC, many market participants (including the funds management industry that I have operated within for the past 30 years) have faced greater scrutiny and criticism, and they will need to work harder and smarter in future to earn their keep.

This article focuses on financial planning and examines the elements of financial advice that are most valuable for clients.

Financial planning has grown rapidly in recent decades, with current estimates of 17,000 planners across Australia. The increase from a small base has been fuelled by:

- relatively complex tax and social security laws, especially concerning retirement planning
- the compulsory superannuation system
- a low interest rate environment causing investors to search for growth, where returns were attractive
- intergenerational transfer of wealth
- opening up of investment markets to 'the man in the street' as a consequence of more knowledge, media coverage, financial advertisements and high profile sharemarket listings (such as AMP, Telstra, CBA, GIO, Qantas, TAB, Woolworths, NRMA).

Prior to 2007, most investors who followed a planner's advice would have been reasonably happy with the results. Advice fees, traditionally a percentage of the assets invested, were a relatively small proportion of the returns generated, and many financial planners received a handsome income. Happy investor ... happy financial planner … happy, growing industry.

But times have changed. To quote another legendary American investor, Warren Buffett, "It's only when the tide goes out that you learn who's been swimming naked."

Increasingly, investors are asking whether the fees paid, either directly or indirectly, to financial planners represent value for money, or indeed whether they need a financial planner at all. No doubt some planners feel this is unfair because returns rise and fall and this is not necessarily a valid reason to either criticise or praise a planner or their fees. Markets move quite independently of what a financial planner says or does.

But the poor returns prior to the 2012 rally were not the cause of the changes required in the financial planning profession, merely the catalyst.

So the question is: *what type of financial advice is worth paying significant fees for?*

Access to a wide variety of asset classes can be gained by anyone, regardless of whether they consult a financial planner. This is particularly the case today with a plethora of investment platforms, educational material, managed funds with low minimum balances and easy access to everything listed on the ASX through cheap online broking. Access to investments is not a planner's competitive advantage, perhaps with some exceptions in the rarefied world of exclusive, private banking.

Similarly, the ability of a planner to select the best investment managers, and create an expected superior performance, is often overstated. In any case, this role is carried out by independent specialist research houses who give managers 'star' ratings for their investment skills. Advisers can access these services, and will develop familiarity and preference for certain managers, but last year's league table winner is often next year's laggard. In fact, most money is made or lost each year from being in or out of a particular asset class, not from who is managing the money within the asset class.

What about the planner's role in selecting the correct *short-term* asset allocations? Again, history has shown us that it is virtually impossible for anyone to predict the winning asset class in any particular year. Peter Lynch, famed former investment manager with the Fidelity Group, has stated about market timers, "*…* they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."

Further, Jack Bogle's summary of market timing was less pithy but equally precise, "In 30 years in this business, I do not know anybody who has done it successfully and consistently, nor anybody who knows anybody who has done it successfully and consistently. Indeed, my impression is that trying to do market timing is likely not only not to add value to your investment program but to be counterproductive."

It is not that knowledge of expected *long-term* returns from various asset classes is irrelevant and of no value to a client. It is important for a planner to advise what proportion of a client's money should be invested in each asset class, with a 'through-the-cycle' perspective. But this should not result in regular switching, even as a yearly exercise, because of the volatility of different asset class returns over short time frames and the impossible exercise of predicting this with certainty.

The role of combining a client's investments together into a single, easy to comprehend report, showing consolidated performance, transactions, market values, income receipts, calculators, tax implications and so on was once a significant value-add of a planner. This is now done by administration platforms or software solutions which are increasingly 'all-inclusive', and available directly to the investor. Administration services and reporting tools have become a low value commodity. The adviser has a role to play in ensuring the correct platform is selected for the skills, experience and financial resources of the client, but it is part of the outfit to play the game, not the game itself.

There is some value in all the above, especially in the establishment phase of a plan, but what should be the greater focus of high quality, value-adding financial planning?

Simply stated, the value in good financial planning is understanding a client's needs and <u>setting and adhering to a realistic *long-term* strategy</u> to achieve a desired outcome for that client. Doing this with first rate client service and a strong projection of trust and professionalism are the keys to success. It requires knowledge and skill, and is a lot more complicated that pontificating about the short-term merits of a particular manager, asset class or stock.

Setting strategy requires a good understanding of many aspects of personal finance, including:

- taxation laws, particularly those relating to capital gains tax and superannuation
- social security rules
- expected *long-term* returns and volatility from various asset classes
- estate planning
- asset and income protection
- the role of trusts, companies and partnerships
- personal budgeting
- family law, especially where assets require splitting
- structured philanthropy

This knowledge is worth paying for. Until investors understand the true value in financial planning, the relationship between financial planners and their clients will often become dysfunctional when markets are producing poor returns. The industry needs to move clients away from gauging success by the return appearing on their yearly investment statement, and much more towards the overall strategy.

A financial planner requires reward for execution and adherence to a sound, personalised strategy. Where the fee between a financial planner and an investor is fair and reasonable and sustainable value is being delivered, there is no justification for the criticism of fees during periods of poor returns. However, if the 'sale' by a planner to a client was all about sexy, quick investment returns, then the investor has every reason to complain about fees when investment returns are poor. This is not financial planning. This is speculating.

The financial planning industry must continue to advance into a mature profession that the public understands and properly values. We can look forward to such changes with enthusiasm. Good financial planning advice is an extremely valuable service and increasingly essential as the general population continues to age and the compulsory superannuation system works its way through a full life cycle.

You the speculator

Roger Montgomery

Unwittingly, you are probably a speculator rather than an investor and I'm making it the role of this series of articles for *Cuffelinks* to encourage you to turn your back on speculating forever and to become an investor.

Sustained sharemarket success begins with thinking like a business owner, rather than a trader of stocks. Betting on the next 'up' or 'down' is tantamount to betting on black or red at the casino. It's not investing. Further, when someone says, "I just 'invested' in a tech start up," it's incorrect. Speculating is not investing.

When colleagues tell you about a hot stock they own and you buy it, or a newspaper story makes a compelling case for selling a stock and you sell it, you are not acting like an investor. When a broker publishes an aggressive research note on a stock and you buy, or maybe you have a hunch that China will grow faster than expected, so you punt on quick gains in commodity and resource stocks, you aren't investing either.

Not only are the above approaches a common way to construct a portfolio, but the one that results is a hotchpotch of ideas and beliefs that will usually amount to little. Worse, when something inevitably does go wrong, you have learned nothing from the experience because none of it was systematic, replicable or repeatable. Not only was the focus on *stocks* rather than businesses but it was also on *price* rather than *value*.

In fact, by listings volume, the sharemarket is far more geared towards speculation than investing. A simple search of listed Australian companies that earned more than $1 in their latest reporting period reveals that only about a third of the 2,188 ASX-listed entities made a profit and a large number of those were barely in the black. Two in every three listed companies could not cover their costs, and many will have to rely on capital raisings to stay alive. Owning such stocks requires a leap of faith that the company will eventually be profitable and while faith may prove beneficial spiritually, there is little place for it in investing.

There's nothing wrong with experienced day-traders punting on loss-making companies, provided they understand the risks of speculation, and have enough skill to overcome the enormous odds stacked against them, including:

- the impossibility of properly valuing loss-making companies
- the potential for higher price volatility in such stocks
- the huge dangers of illiquidity.

You don't need to trade the two-thirds of loss-making companies on the ASX to boost your portfolio's value over time. There are more than enough opportunities in the universe of profitable businesses to make double-digit returns from the sharemarket without excessive risk. My company does this successfully as a manager of other people's money.

Become an informed investor

It's among the profitable companies where you should truly start to think like an owner of a business rather than a renter of pieces of paper that are represented by wiggles on a screen in some broker's office. And it's here where you'll find extraordinary businesses at bargain prices.

Arguably, the best long-term risk adjusted returns come from buying exceptional businesses and holding them for as long as they remain exceptional, continue to have bright prospects for intrinsic value growth and share prices do not diverge too far above forecast intrinsic values.

Sustained equity investment success requires two core skills and the right temperament – the latter is up to you and your parents. The two core skills are the ability to identify a superior business and the ability to value that business.

While myriad investment studies have shown that asset allocation is also a meaningful driver of overall investment returns, my view is that the top-down approach is fraught with errors from which little can be learned for the purposes of future exclusion. However, ability to value businesses produces a list of those that are expensive and those that are cheap. When the vast majority of companies are expensive and there are few securities worthy of investment, the only conclusion is that more funds must be allocated to cash. In one sense, a bottom up approach, such as the one contemplated here, produces the only sensible asset allocation.

Don't be an unwitting speculator

If you don't have an estimate for the value of a business and you buy its shares, you are, by definition, speculating and betting someone will be willing to pay more at a later date than you just did.

This is a critical point. Speculation is not just owning an unprofitable exploration or biotech company and hoping it will one day make money. It also occurs when investors buy a profitable company, perhaps even a so-called blue-chip, without having a view on its valuation, or how that valuation is changing over time. In effect, the person is unwittingly speculating rather than investing.

Imagine if a friend or colleague asked you to invest in a private company. Your first question would probably be, "What are the chances of the business going bust?" That is, is the business profitable, how much debt does it have, and can it comfortably meet its interest repayments?

Your second question might be, "Is it a good business?" Does it operate in an attractive industry, sell a good product, have an excellent reputation and client list? Does it have a long-term record of rising profits and, more importantly, a rising return on equity (ROE) or return on shareholder funds? Do you believe the ROE will continue to rise over time and lead to a higher company valuation? And will the ROE be sufficiently high to compensate for the risk in this investment?

Your third question would probably be, "How much do I have to pay to own X% of the company?"

From the answers, you determine what the company is worth, and assess that against the asking price. A view of the company's worth (its intrinsic value) helps you make astute decisions when prices rise or fall because you understand the difference between value and price.

Don't be swayed by market noise

So what stops us thinking like a part-owner in a business when it comes to listed companies, and instead act like part of a herd? Market noise plays a big role. We are seduced by media headlines, magazine stories on "*hot stocks under $1"*, television finance channels, and broker reports. We fear missing out more than we fear losing money. We latch on to supposed expert views and succumb to ever-larger waves of stock commentary, failing to realise that the entire machine has been set up to promote noise and activity.

Investors instead need a quiet, controlled detachment from the sharemarket. Step number one simply involves turning the sharemarket noise off.

Market noise amplifies those two great investing emotions: greed and fear. Market noise triggers the purchase of low-quality companies in the hope of making a quick buck, and market noise triggers the sale of high-quality companies because there was no appreciation that a sharply rising price was simply following the company's rising intrinsic value or was all occurring well below that value. Having a clear yardstick for company value helps you know when to be greedy and fearful, usually well in advance of the herd that uses sharemarket noise as its decision-making trigger.

In the next instalment, we'll look at how to assess a business's quality. For now, remember the following:

- the focus on price movement, and the expectation of profit from it rather than from business performance, is pure speculation, not investing.

- instead of renting bits of paper and hoping they will go up in price tomorrow or next week or next month, investing involves buying a slice of a business after considering the facts and applying common sense.

- buy shares in order to own businesses, don't buy shares merely to sell them.

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Super misses out on the government deposit guarantee

Graham Hand

It's called the Financial Claims Scheme, better known as the government deposit guarantee, and it provides comfort to millions of Australians who hold their savings in deposits with Australian banks, building societies and credit unions (collectively called Australian Deposit-Taking Institutions, or ADIs). Indeed, when the Treasurer, Wayne Swan, announced the revised scheme in September 2011, he wrote:

It will ensure that we continue to have one of the most generous and secure deposit insurance schemes in the world, and builds on the Government's record of ensuring our financial system remains among the strongest in the world.

But here's the bothersome fact: the government guarantee on deposits does not apply to deposits offered in public superannuation funds.

Many financial experts and financial advisers are unaware of this, even the highest profile writers who are read by millions, which suggests nobody has corrected them. For example, I enjoy George Cochrane's column in The Sun-Herald, down-to-earth and practical, but in response to a reader question, George wrote on 18 November 2012, "Looking at term deposits within super funds … term deposits are protected by the government guarantee up to $250,000 per individual per institution and are net of fees." Sorry, George, not so.

Then the financial commentator with the highest profile of them all, Mark Bouris, in the same newspaper on 9 December 2012, writing about superannuation, said, "Transaction accounts, cash-management accounts, term deposits and accelerated savings accounts are all capital guaranteed by the government up to $250,000 per person. They are all zero-risk." Sorry, Mark, not when they're in public super funds.

Advisers and investors are failing to understand the legal structure of public superannuation funds in Australia in the context of the guarantee. All superannuation money must be invested through a trust that complies with the Superannuation Industry (Supervision) Act 1993 (the 'SIS Act'). A superannuation fund is a trust controlled by a trust deed, and all members of a superannuation trust must be natural persons.

Therein lies the problem for the government guarantee. When an investor chooses a deposit option in a superannuation fund, it is the superannuation fund's trustee which invests with the bank. The contract is between the bank and the trust, not the bank and the customer, and the trust is a single entity. This is unlike when an investor places a deposit directly with a bank, which it is a contract between the customer and the bank.

The Financial Claims Scheme applies *per account holder* per ADI. An account holder is defined as an *entity*, and both trusts and superannuation funds are entities. Therefore, the $250,000 cap applies to the entire trust, which might have several billion dollars of 'deposits', making a meaningless contribution to recovering money for an individual depositor if the underlying ADI cannot honour its obligations.

Public superannuation funds should never have allowed this to happen. Their clients are as much 'natural persons' as direct bank depositors, and they have left their clients in an inferior credit position, without telling them. They should have lobbied the government to amend it.

Why should this be a concern, when all ADIs are regulated by APRA in accordance with the Banking Act 1959? Well, just because an institution is regulated does not mean it cannot run into severe financial problems. Most people identify the term 'ADI' with the major banks, since they control about 80% of the deposit market. But take a look at APRA's List of ADIs, which includes:

- 18 Australian-owned banks
- 8 foreign subsidiary banks
- 40 branches of foreign banks (to which the Financial Claims Scheme does not apply)
- 9 building societies
- 91 credit unions

The potential for financial difficulties somewhere in these 166 institutions, notwithstanding the best will in the world by the regulator, is obvious. Any one of them could be accepting the investments of a public superannuation fund.

Most super members are probably assuming they have a full government guarantee if their own deposits are less than $250,000. You can expect that if one of these ADIs were unable to meet its obligations, and a financial adviser had placed client money into a deposit in a superannuation fund with exposure to that ADI, action against the adviser would follow for not knowing the operation of the Financial Claims Scheme.

In fact, Wayne Swan himself would probably be on shaky ground because his press release said the Financial Claims Scheme covered, "$250,000 per person per institution to protect the savings held in around 99 per cent of Australian deposit accounts in full." The actual definition is not '*per person*' but '*per entity*', and this would be critical in a financial crisis.

So how do financial institutions offering both direct bank deposits and deposits in super funds handle this complex communication to customers? The simple answer is, in effect, they don't.

For the best example, take a look at ING Direct, which offers all its products on one home page. It even has a home page notice, "For information about the Australian Government Deposit Guarantee, click here." This click takes a client through to a full page on how the guarantee works, all the bank accounts it applies to, and a large FAQ section. Wonderful stuff for a well-informed investor, but no mention that it only applies to direct deposits with the bank.

Now click from the same home page to their new Living Super product, a high profile and impressive move into retail superannuation. Not one word can be found on the government guarantee, even though cash and term deposits are an important part of the product range.

Why is this? Because the guarantee does not apply to the super deposits, but like most financial institutions, ING does not let its super customers know.

It's amazing the regulator, APRA, does not issue a clarifying statement, and the public superannuation industry does not demand a change. Or are they both hoping the issue will stay buried?

The application of the guarantee is yet another free kick for SMSFs, which can invest directly into bank deposits, and as the fund is a single entity, gain protection of the full $250,000 '*per entity per institution'*.

The superannuation essentials

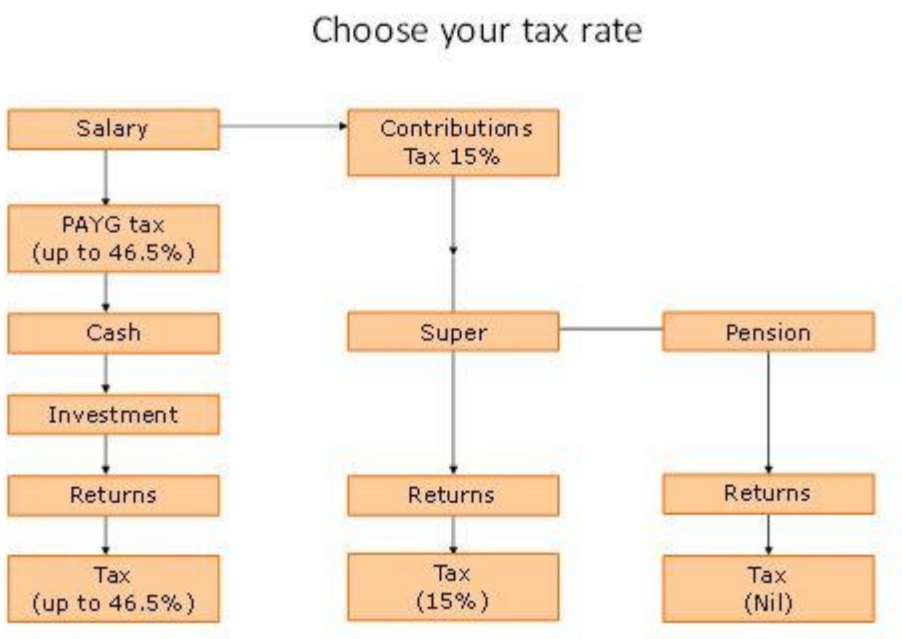
Rick Cosier

Superannuation was introduced to assist people to save for their retirement. In exchange for locking some money away for the future, Australians are given some attractive tax concessions. Employers are legally obliged to pay 9% of an employee's salary into super, and in order that self employed people are not disadvantaged, they can claim a tax deduction on super contributions up to the annual limit (currently $25,000).

Superannuation has some powerful tax features:

- pre-tax contributions (from employer and salary sacrifice) are taxed at 15%, and after-tax contributions (from other sources like a bank account) have zero contributions tax.
- performance returns generated by the super account are taxed at a maximum of 15%, and at retirement when you convert your super from the 'accumulation' phase to the 'pension' phase, there is no tax on performance returns.

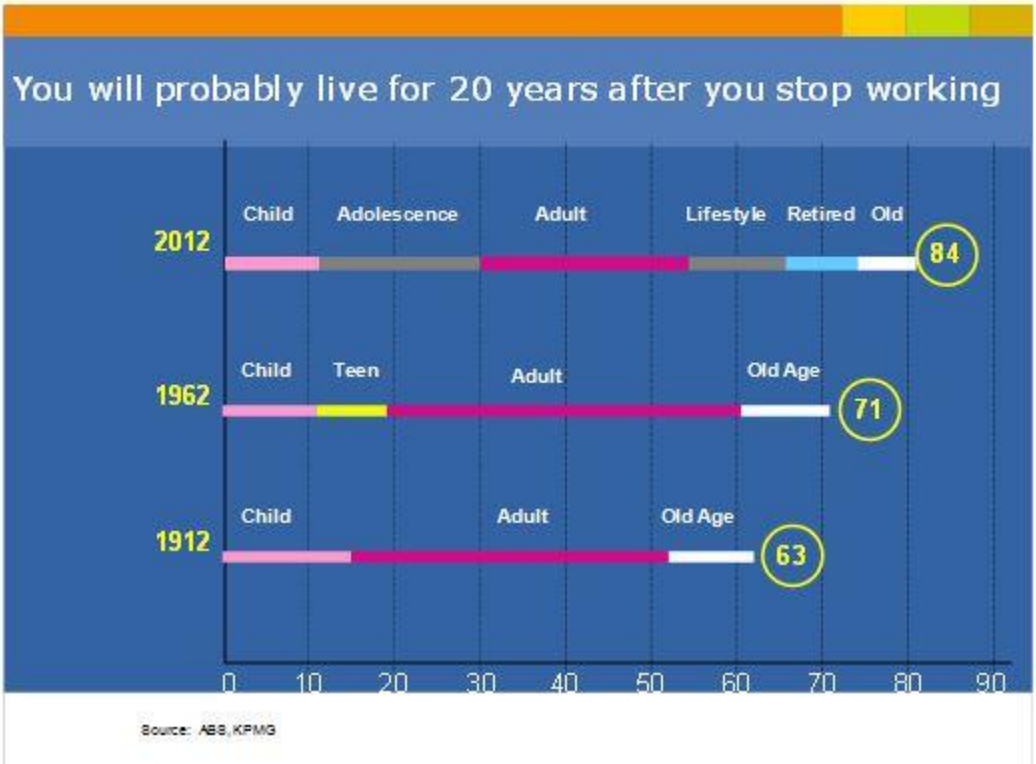
One way to represent this is:



When you reach the age of 60, there is no tax on your superannuation account. However, there are trade-offs. You are not able to make lump sum withdrawals from super until you meet a 'condition of release'. Usually, this is when you either permanently retire or reach age 65, whichever comes first. For some, the permanent retirement condition is age 55 to 60, depending when you were born.

Super and financial planning

The chart below gives an idea of how our lives have changed over the last 100 years. In 1912, your probable future was fairly simple. You went to school, you got a job, you got old and you died.



It's a completely different story now. Not only can you reasonably expect to live till you are at least 84 (and maybe much longer), but the chances are that you will spend more than 20 years in retirement after finishing work. The key messages are that you need to start planning now and you need to understand how super can help.

I don't know how many times I've heard someone complain about the performance of their super, and tell me that they'd rather have the cash. There are two key points to note:

1. Superannuation is a disciplined way of accumulating money. When I was a kid, I had a money box where all the spare change went. I didn't think about the 'return on investment', I thought about the money I was saving. It was amazing how much was in that box when I eventually counted it. It helps to view your super in this way.
2. Superannuation contributions are tax effective. Let me give you an example. Peter and Grace both qualify for a salary bonus. Peter doesn't like super so he takes the bonus in cash and puts the money in a term deposit that pays 6% interest. Grace asks her employer to contribute the bonus to super. One year later, Grace's contributions have delivered a minus 6% performance return. If both Peter and Grace pay tax at 30% plus Medicare, who has more money at the end of the year?

As you can see from the chart below, Grace has 12% more money than Peter.

Superannuation – you can lose money and still be better off

	Peter Cash salary	Grace Super
	$10,000	$10,000
After tax	$6,850	$8,500
Return	$411	Minus $510
Minus tax on performance returns	$129	$0
Net financial position	$7,132	$7,990

This chart assumes pre-tax returns of 6%pa for non super, (0% franking) and minus 6% return for super. Marginal tax rate is 31.5%. Results not adjusted for inflation.* This chart is for illustration purposes only and does not represent actual returns.

Transitioning to retirement

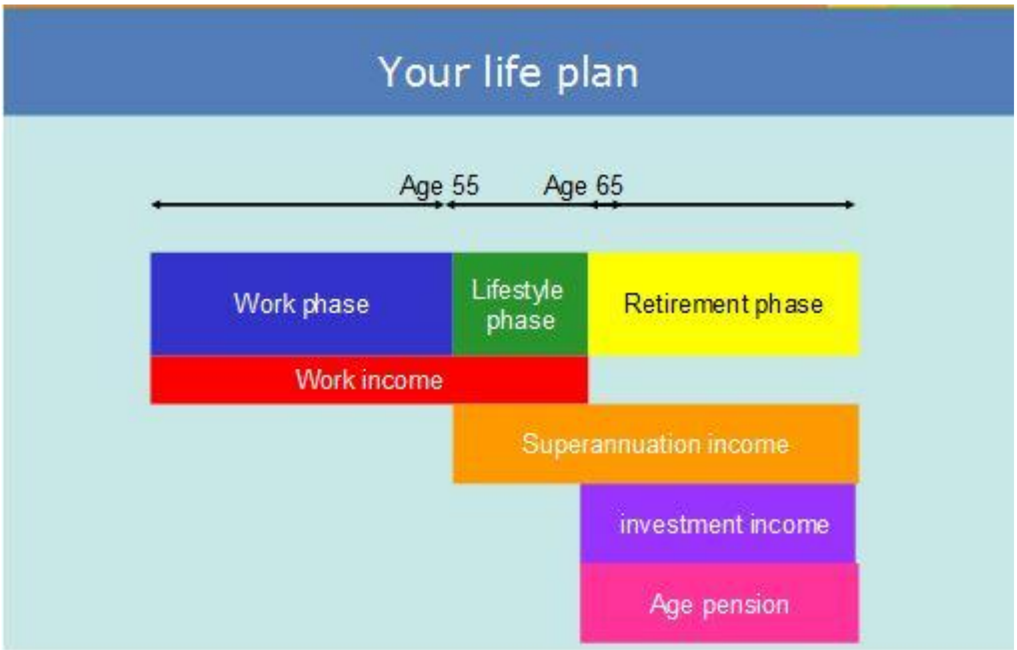
It's a reasonable assumption that more people will end up working part-time. In the first place, most people will not have accumulated sufficient money to be able to retire comfortably for longer than 20 years. Secondly, it suits employers to employ part-timers and contractors as it is a more flexible way of controlling their wages bill.

This brings us to an innovative part of superannuation – the ability to convert your super to a pension whilst you are still working. This means that you can choose to work fewer hours, and top up your lost income by drawing down from your pre-retirement pension.

As you might expect, there are limitations. Firstly, you have to be 55 or older to take advantage.

Secondly, you must withdraw between 3% and 10% of the account balance each year, and up until age 60, this pension income is taxable. However, you will receive a 15% tax rebate which reduces the tax.

Once you reach 60, any withdrawals, income, capital gains and pension payments become tax free. When you retire completely, the pre-retirement pension converts to a normal retirement pension, and there are no limits to the amount that can be withdrawn.



Making 'after tax' contributions to super

Many people are aware of the $25,000 pre-tax contributions limit but don't know they can make substantial 'after tax' contributions as well. After tax contributions (called 'non concessional' contributions) have an annual limit of $150,000 per annum, but an averaging policy means that you can put in $450,000 in any one financial year by using up the next two years' allowance. Non concessional contributions have several benefits:

- there is no contributions tax
- performance returns are taxed at a maximum of 15%
- once you meet a condition of release, there is no tax on withdrawals
- when you die, non concessional contributions are inherited tax free by non-dependants.

Spouse contribution splitting

One spouse can transfer up to 85% of last year's pre-tax super contributions to the other spouse. Only the previous financial year's contributions can be transferred, and you must do it before 30 June of the following year. For example, say one spouse made $25,000 pre-tax contributions in the 2012 financial year. Between 1 July 2012 and 30 June 2013, they could request their super fund to transfer $21,250 to their spouse's super fund. No additional tax is payable on the transfer.

This is a useful strategy in two instances:

1. Transferring a younger spouse's contributions to an older spouse brings forward the accessibility of these contributions.
2. Transferring an older spouse's contributions to a younger spouse may enable the older spouse to claim some age pension in some circumstances.

Superannuation has many nuances and complexities, but understanding these basics will go a long way to helping investors make the most of their superannuation opportunities.