Cuffelinks
Connecting investors with ideas

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Airlines and indices

Roger Montgomery

Welcome to the first of many value-investing insights. Each fortnight you will find our insights and ideas published here at *Cuffelinks*. Montgomery is committed to investing in businesses of extraordinary quality and we are delighted to be associated with a newsletter that has the same quality commitment to its own content. I am delighted to be invited to provide our insights indefinitely and I personally look forward to your feedback.

Focus on the quality of the business

Frequently, value investors focus only on the 'value' part of the eponymously labelled investment philosophy. Absorbed in calculations, as they inevitably become, many investors fail to step back and ask if the business is of sufficient quality to be included in a portfolio in the first place.

Equally disturbing is the focus on the index. Not only is the rise and fall of the All Ordinaries reported on a daily basis but most of the research reports examining returns available to shareholders focus on the gains and losses of the broader indices. This is folly, as you will see.

Our approach is relatively simple and it's one we advocate for your own investing. If we aren't happy to own the entire business for a decade, we won't be comfortable owners of even one share for just a few minutes. In other words, because we aren't in the business of betting on the rise and fall of stocks, we need the economics of the business – measured over years - to justify a purchase and estimate a valuation.

Back in 2010 on the Sky Business network, Peter Switzer asked me whether I thought the hiring of John Borghetti – a highly regarded manager and business leader - as CEO would make me change my mind about Virgin Australia Holdings. With his exceptional experience in the industry, would I be willing to concede that the fortune of the airline had improved? With the greatest respect to Mr Borghetti, I noted that it did not matter how hard he rowed – indeed he could be an Olympic rower - the boat he was paddling had an irreparable leak. A whopping great hole in the side of the boat would stymie the efforts of even the expertise of Mr Borghetti. Peter replied with words to the effect, "Thanks for that Roger … coming up after the break, Mr John Borghetti …"

Cue uncomfortable greeting as John replaces me in the guest chair on set.

Despite the discomfort, no apology should be required because John know that he would indeed need to produce a herculean rowing effort in order to keep the tide of the business's economics at bay. Warren Buffett once proffered,

"When a management with a reputation for brilliance tackles a business with a reputation for poor fundamental economics, it is the reputation of the business that remains intact."

And this month, Virgin's latest performance and trading update revealed that any CEO of an airline might have more success holding back the tide than changing the economics of the airline business. This is not a recommendation to buy or sell shares in Virgin or any airline but what I hope to achieve is an understanding of the economics of a business as it relates to the owner's relationship with it. We will see what happened later in this story.

What are the real returns to the owner?

Exactly what does that mean? It means before buying any business, you must understand what the real returns to an owner are. Such an understanding of course need not concern the speculator or market 'trader' who merely wants to purchase any stock that is going up. His activities are tantamount to speculation and are as far removed from investing as night is from day.

You may also ask why any such analysis is required when dividend yields, price to earnings ratios, sales and profit forecasts are so ubiquitously offered by any number of desk-bound airline experts all willing to encourage you to compare their understandings of load factors, passenger yields and even seat densities?

The reason only becomes obvious when it is highlighted. The nexus between ownership of a business and the economics of that business are broken by the stock market itself. An individual who owns 5,000 shares of BHP does not, over any memorable period, experience what it is like to actually own BHP. The stock market makes sure that distracting rising and falling share prices divert the focus from profits and capital expenditure. But there's more…

Consider the company that perpetually dilutes its owners by raising fresh capital for acquisitions. The shareholder receives a prospectus in the mail inviting him to participate by, for example, taking up an entitlement to 15,000 additional shares at a discount to the recently traded price. This clearly seems like a delightful turn of events and the shareholder gladly stumps up the cash. But when aggregated, the additional equity may massively dilute the owners, the returns or both and the effects won't be felt until well down the road and perhaps even after the CEO and board have turned over.

Today's story, using Virgin Australia as an example, will attempt to do two things. First, bring the economics of a business back into the decision-making phase of investing, and second, reveal that Virgin's latest woes are symptomatic not of one-off special circumstances but of the unchanging structure of the industry it operates in.

Going back to the beginning in 2003

Let's suppose the year is 2003 and I ask you to consider an information memorandum to invest $184 million in a new business. I'll run it for you. Write a cheque for $184 million and to make sure we have enough to get going, we'll run down to the bank and borrow another $139 million.

One year later …

After a year in business, suppose I report to you the first year's profit of $110 million. Given you invested $184 million, I suspect you are delighted with the 59% return on your funds. Encouraged, you leave me to run the business for you for the next decade and you return in January 2013 to receive reports on the progress of the business.

The first piece of news you receive is the fact that the profit has fallen. In fact for the year ending 30 June 2012, the profit was $43 million – less than half the profit generated a decade earlier. For 2013 the guidance is expected to be a loss of approximately $30 million provided so-called 'one-offs' are excluded. Because you own the business outright, 'one-offs' feel like real losses to you so you request that I report the totals including the one-offs. OK then, FY2013 might be a loss of about $100 million.

Not good news.

The story gets worse. Recall that in 2003, you made a capital contribution of $184 million. Since then however you have made additional contributions directly in the form of capital raisings and indirectly through the retention of earnings worth more than $900 million. And remember your profits have now more than halved. Even though you have been tipping capital into this venture, the returns have been declining precipitously. That 59% return on equity is a distant memory and you are now earning less than bank interest on your money.

But just before you get too depressed, remember that money you borrowed in 2003? It was $139 million. You may have hoped that the earnings of the business have helped to pay off that debt. Well here's a shock for you; you now owe the banks $1.7 billion. Yes, true, that is now their problem but you would have expected that borrowing money would lead to growing earnings and returns. In this case, it hasn't.

And why? Because the business is an airline. And the economics of airlines change little … and rarely for the better.

Capital intensive, labour intensive, irrational competition, a price taker for inputs and commoditised product offerings means measures such as Load Factors, Passenger Yields and Cost per Available Seat Mile (CASM) are about as useful to an investor as a microscope is to an astronomer.

Beyond the numbers

Looking at businesses by studying their economics as described here has enormous and favourable implications for investors willing to consider the unconventional. This approach won't help you pass your CFA examination but as a reliable, long-term money-making exercise, it is without peer.

Ben Graham, the intellectual dean of Wall Street noted that in the long run the market is a weighing machine – that price follows the economic performance of the underlying business. The share price of Virgin in 2003/04 was above $2.00. Today it languishes below 45 cents.

An investor in Virgin shares would have experienced the same proportional economic calamity over a decade as the individual who owned the entire business. This is why an investor unwilling to own the whole business for ten years, shouldn't own a little piece of it for ten minutes.

It is useful to keep in mind that the index is populated with many such business – large, mature but mediocre businesses that have added little or no economic value over a decade.

Now recall the popular investing advice that implores you to invest for the long term. How often have you been told to simply invest for the long–term? How often have you given this advice to your own clients? Time is the friend of the extraordinary business but the enemy of the business with poor economics. The longer you remain invested in a business with wealth-eroding economics, the more you will lose – be it opportunity or money or both.

As Virgin-type companies, economics and share prices over the last decade demonstrate, the relationship between long run share prices and a business's economics is highly correlated. If you

can identify businesses with superior economics, you should be able to identify those businesses that will produce superior long-run share price performances.

And do you recall the recent work by Ashley Owen published over three parts here at Cuffelinks? You can view Ashley's report **here**. Ashley tested the theory that if we invested against the herd by selling some of our shares when sentiment is bullish, and buying more shares when sentiment is bearish, then we ought to be able to avoid some of the buy-high, sell-low mistakes and be better off in the long run. Ashley's analysis revealed that doing the opposite of what the herd is doing – ie selling in booms and buying in busts – is not actually necessary to be a successful investor. If all you do is ignore the herd and avoid buying in booms and avoid selling in busts, then you are avoiding the two most dangerous wealth destruction zones, and you are still going to be better off than probably 90% of investors and fund managers in the market.

More importantly Ashley's analysis was conducted by looking at the index. The index is populated with businesses that are large. It is not populated necessarily with businesses that are good and many of the index constituents harbor economic performances like Virgin.

Those who complain or suggest that the index is hard to beat cite the fact that it is always invested in the very best performing stocks. If however we remember that over the long run stock prices track business economic performance, and that the index is always invested in terribly performing businesses, then beating the index should be relatively easy.

Not only do we need to follow Ashley's suggestion to avoid selling when sentiment is poor and avoid buying when sentiment is irrationally exuberant, but we should also avoid those businesses with poor economics and seek out those with superior economics.

Roger Montgomery is the Chief Investment Officer of The Montgomery Fund.

Nominal and real interest rates matter in different ways

Don Stammer

Interest rates can be viewed in either of two ways: in nominal or real terms.

It's the **nominal interest rates** (or nominal yields) paid on deposits and bonds that determine the cash returns investors receive from their interest-bearing investments. And it's nominal interest rates that determine how much borrowers pay on their debts. Current examples of nominal rates in Australia include 3.9% on a two year term deposit and 3.6% on a ten year government bond.

Nominal interest rates are important for another reason: changes in them are the main influence on the market prices of bonds (bond prices move inversely with nominal yields) and other financial assets traded on financial markets.

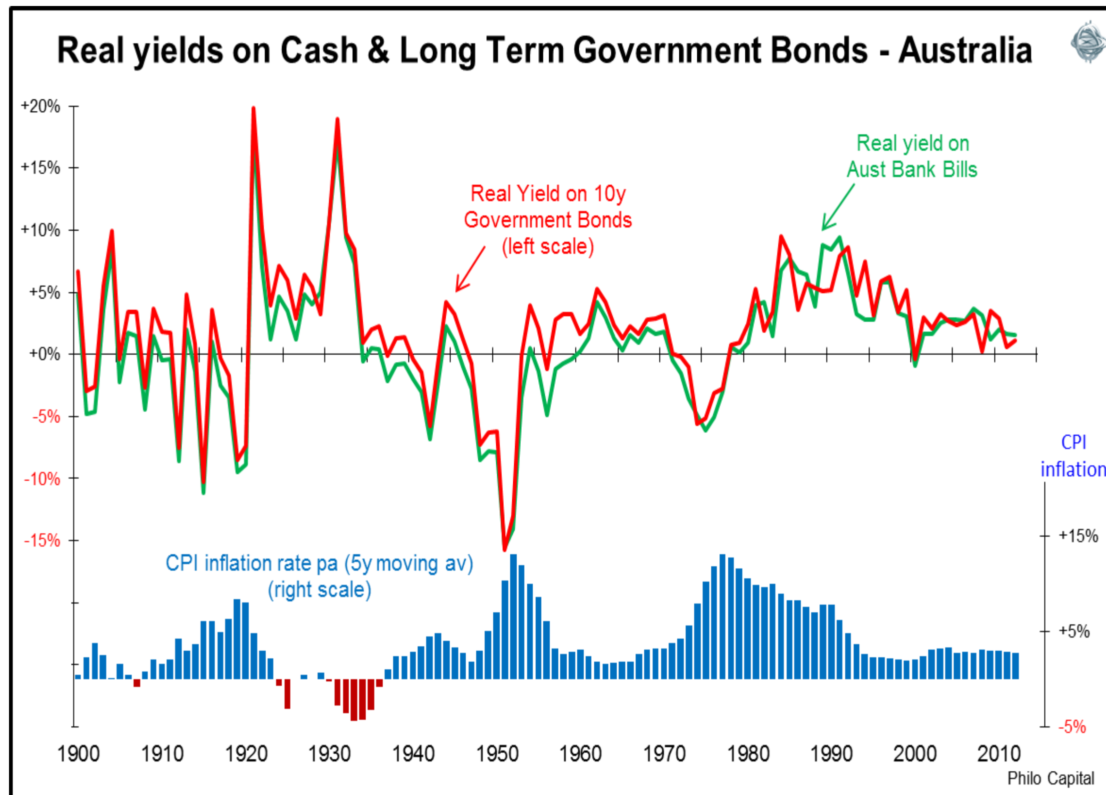
Real interest rates (or real yields) are nominal rates adjusted for inflation. A real interest rate is usually calculated by taking the relevant nominal interest rate and deducting the inflation rate recorded over the preceding 12 months.

An alternative is to calculate an **expected** real interest rate – by taking the relevant nominal interest rate and subtracting the expected rate of inflation. The problem is we don't have good measures of expected inflation.

Real interest rates are important. They measure the percentage return from an investment in terms of what it does to the purchasing power of the investor – and they also show how the percentage cost of paying interest on a loan in terms of the purchasing power of the borrower.

Real interest rates are also a useful guide to whether monetary policy is easy or tight. For example, low (or negative) real interest rates suggest that monetary policy is accommodative or stimulatory; high real interest rates suggest that monetary policy is tight.

The chart shows the history of two important real interest rates in Australia, those on three month bank bills and ten year government bonds. These real rates, which fluctuate widely over time, are affected by moves in nominal interest rates and by inflation. Real interest rates have generally been high when inflation was falling (1920s, 1930s and 1990s) and low or negative when inflation was rising (early 1950s, 1970s).



Since 1990, Australian real rates have trended markedly lower – that's because nominal interest rates have declined by more than inflation. Some real interest rates have fallen from over 8% – how good was that for savers but how tough on borrowers! - to less than 1.5%.

Around the world, real interest rates are now unusually low or even negative. That's the aim of the policies of the major central banks, with the exception of China. The US central bank has kept its nominal cash rate close to zero for almost five years and frequently reiterated its 'forward guidance' that it will maintain the ultra-low cash rate 'for an extended period'; it's been buying US bonds at the rate of US$1 trillion a year and expects to 'taper' that programme only as the economy gains strength; and via 'operation twist', it is lowering long-term real yields by purchasing long-dated bonds and selling bonds with shorter-dated maturities.

My guess is that the central banks of the US, Japan and Europe will continue to maintain real yields at quite low levels - often accepting negative ones - as they try to nurture their economic recoveries. (Yes, even Europe now has some 'green shoots' of recovery).

This means the hunt for real yield that's become a preoccupation of investors both here and abroad is likely to remain a dominant feature of investment markets for several years at least.

People with savings will need to continue to seek out the higher real yields that quality corporate bonds can offer relative to the low real yields available on government bonds. Savers should also be prepared to 'shop around' for the best deals on term deposits and at-call deposits to ensure they are getting the best possible real returns on these assets. And shares paying good and

growing dividends – especially those carrying franking credits – will have enhanced appeal to investors keen to earn an attractive rate of real returns.

Anyone thinking about what might happen to real interest rates over the medium-term and beyond may have to allow for what might be another powerful influence keeping real interest rates at low and at times negative levels.

Governments and central banks in debt-laden countries seem likely to be more tolerant of inflation than they've been in recent decades. As Pictet Asset Management observed recently,

"Policy makers in advanced countries are not the strict disciplinarians they once were … Higher inflation and negative real interest rates present heavily-indebted countries with a less disruptive way to reduce the real value of government debt compared with alternatives such as sovereign default or deep spending cuts."

In the early years after the Second World War and again in the 1970s, governments of many industrialised countries, including Australia, tolerated inflation and negative real interest rates to reduce the huge increase in the real value of the government debt they'd issued and the interest costs of servicing those swollen borrowings. Investors holding deposits and bonds suffered badly, as the graph reminds us.

Recently, Japan has adopted a policy of 'let's have inflation'. If the US and Europe, both of which also have much-increased levels of public debt, follow this lead, investors around the world might have to cope with rising inflation and low or negative real interest rates in the medium term. That would be a worry for investors – particularly self-funded retirees.

Don Stammer is former Director, Investment Strategy at Deutsche Bank Australia and is currently an adviser to the Third Link Growth Fund, Altius Asset Management and Philo Capital. The views expressed are his alone.

Diversification works?

Ashley Owen

Every finance text book extolls the virtues of diversification. Diversification is the holy grail of investing, we are told. Diversification is said to be the only 'free lunch' in the world of investing. We are constantly being reminded that we must diversify - to not 'put all our eggs in one basket'. We need to spread it around, preferably into different sorts of things, into different types of assets, in different industries and in different markets, to give ourselves the best chances of success, and to minimise the chances of loss.

If any one thing doesn't work out or loses money or fails, then something else is bound to work if we spread it around into enough different things.

We need to have a fall-back plan, a plan B in case plan A doesn't work, and even a plan C in case plans A and B fail. The more fall-back plans we have the better. Three different asset classes with different characteristics are better than two, and four is even better than three, etc. The more different each one is, the better, so they are not all affected by the same adverse events.

My perfect plan

All this sounds like it makes sense, so years ago I decided to follow the textbooks and diversify in order to give myself the best chance of succeeding in life and making money. Here is my ultimate diversification plan for success:

On Mondays I'm a magician in Mumbai, on Tuesdays I'm a tiler in Tunisia, on Wednesdays I'm a welder in Wellington, then on Thursdays I'm a thoracic surgeon in Thessalonica. But on Fridays I'm a fruiterer in Frankfurt and on Saturdays I'm a sax player in Sacramento. Then I sleep in Sydney on Sundays, before doing it all again the following week.

See? I'm diversifying across different skills, across different markets in different countries and even across different time zones and different regions of the world. It's the perfect plan!

If the market for magicians in Mumbai melts, I can always turn to tiling in Tunisia. And if that market turns turtle I can always work as a welder in windy Wellington, and so on. Actually the market for thoracic surgeons in Thessalonica is rather thin at the moment, but that's ok because fortuitously the market for fruiterers in Frankfurt is fantastic right now. Diversification works!

That's nonsense of course! By diversifying you end up being bad at everything. Nobody ever became good at anything by diversifying.

Nobody ever built a great business, or created a great nation, or amassed a great fortune, or became a great painter or musician or sportsperson or anything else, by diversifying. The only way to become good at anything, or to build wealth, or to build a great company, or become a great doctor or scientist, or to do anything else well in this world is to specialise, concentrate and focus. You need to specialise, concentrate and focus on a single skill, or a single idea or a single business, or a single sport or talent. You need to specialise, concentrate and focus on just one thing and then make that one thing your life's work.

Warren Buffett, the world's greatest investor, says: "put all your eggs in *one* basket, but watch that basket very closely". Buffett has been following and refining his investment strategy since he bought his first shares at age 11 in 1941. Broadly his strategy is to take big concentrated bets in a small number of companies that he makes it his business to know back-to-front and inside out. He almost always takes controlling stakes or large minority stakes in the companies he invests in, so he can dictate or at least influence their board, strategy and direction, and almost all of his investments have been in the US.

Specialise, concentrate and focus only on what you know best.

No safety nets

Ever noticed how the people who built great companies and made great fortunes often dropped out of high school or college? Even in today's world when we are told that education is everything? Think Bill Gates (Microsoft), Steve Jobs (Apple), Larry Ellison (Oracle), Mark Zuckerberg (Facebook), Michael Dell (Dell Computers), Ted Turner (CNN), Larry Page & Sergey Brin (Google) and countless others. They didn't say "I'd better just finish this degree - just in case things don't work out." They ditched their fall-back plans and went after their dreams without a safety net, without a fall back plan and without any thought of 'diversification'.

The best way to go forward is to burn your bridges behind you! To have no plan B or plan C, "just in case". I'll bet Mao Zedong never said, "I'll give this long march thing a couple of weeks and see how it goes, but I can always go back to being a dentist, or tiler". The same goes for Alexander the Great, Napoleon, John D Rockefeller, or JP Morgan, or anybody else who built a great nation or a great business or a great fortune.

Australia

In the case of Australia, take a look through BRW's 'Rich 200' list in any given year. Almost every single person in the list every year got there by their single-minded focus on their narrow field of expertise, by sticking to it and making it their life's work. Gina Reinhart, Andrew Forrest and Clive Palmer (iron ore), Harry Triguboff, Bob Ell, Lloyd Williams, Ron Walker, Lang Walker (property development), Frank Lowy, John Gandel and Maurice Atler (shopping centres), Len Buckeridge and the Grollos (construction), Len Ainsworth (poker machines), James Packer (selling his father's media empire at the top of the market and then focusing instead on casinos), Dick Pratt's family

(packaging), Ivan Glasenberg (commodities trading), Lindsay Fox, Paul Little and Peter Gunn (transport), Solly Lew, Gerry Harvey, John Van Lieshout and Morry Fraid (retailing), Bob Oatley (wine), Bob Ingham (chicken farming), Graham Turner and Geoff Harris (travel agents), are good examples. All are the result of single-minded dedication and focus on their narrow area of speciality, and sticking to it for decades. Sticking to their focus, staying on the narrow path, and never allowing their attention to be diverted into *diversions* (‘*Diversification’* after all is allowing oneself to be *diverted* into *diversions*!).

On the other hand there are only a few isolated examples of real success attained in more than one field. One is Kerry Stokes, who made his fortune in shopping centre developments first, and then in media, and more recently in mining services in China (via Caterpillar). Another is Ralph Sarich, who made is first fortune with his orbital engine and then used the proceeds successfully in property development.

Diversification usually spells trouble

For most successful people, diversification gets them into trouble. Their life stories are littered with examples of diverting off the straight and narrow and into areas outside their narrow area of specialty. This is usually in booms when it is hard for even them to avoid getting caught up in the frenzy.

One prime example was Frank Lowy’s failed adventure into television, retailing and oil via Westfield Capital Corp (1986) which collapsed in 1989, losing $300 million. Even within the shopping centre industry, Lowy had several false starts in expanding into the US market - Westfield International (1988-9), Westfield America Trust (1996-2004), and Westfield America Inc (1997-2001). Investors in Lowy’s companies since 1960 have done extraordinarily well, but only if they avoided these ‘non-core’ departures from his single-minded focus on shopping centre development in Australia.

What about ordinary people?

Ok, at this point you may be saying to yourself - “I don’t want to be a billionaire. I just want to make a bit more money.”

This strategy of single minded specialisation, concentration and focus doesn’t just apply to people who ended up being super rich and/or famous. It applies to everybody. Most people play a sport or an instrument or have some type of hobby. Everybody knows that the only way to become even half good at any sport or any instrument or any hobby is to specialise, concentrate and focus on that one sport or instrument or hobby. There are no short cuts. To be half good at anything still takes several years of focus.

This principle applies to people building even modest amounts of wealth. The biggest source of wealth for most moderately wealthy Australians (say $2-5 million) is from their business or profession. Business success comes for specialising, concentrating and focusing on one specific customer need and then sticking to that single narrow focus for many years through thick and thin, through boom times and busts. Professional success also comes from specialisation - whether it is for dentists, architects, lawyers or doctors. In most cases the way to get ahead and build a profitable and valuable practice is to specialise.

Very often, where business people and professionals tend to blow up their money is when they try to diversify into other areas - for example when they venture into other things like a winery, or a property development, or a race horse, or forex trading, or shares in dot-coms, mining explorers, bio-techs or whatever the latest fad is.

I test this principle on people all the time, and readers can ask themselves the same question. When I am talking to investors who have accumulated say $100,000 or $1 million or even $10 million so far in their lives I ask them how they started out with nothing when they were young and ended up with what they have today. In 99% of cases the wealth they have today has come from the fruits of their specialisation, concentration or focus. They built their wealth up to the current

level by specialising in what they do best, whether they are a dentist or a boat builder or a plumber.

If I am talking to a lawyer I ask them what they would do if they wanted to make more money - invest some time/money in doing a course to get them into a specialist part of legal practice, or invest time/money in a dentistry course to become a dentist on the week-ends? The answer is simple - you make more money by specialising in what you know best.

So if they have built the wealth they have today from their specialisation and focus, what makes them think they could or should suddenly build the next stage of their wealth by diversifying into a new area (or worse still, a whole bunch of new areas) about which they know very little or nothing. It doesn't make any sense.

Against human nature

The very idea of expecting better results through diversification goes against the whole history of human advancement and development.

Specialisation, concentration and focusing on specific skills and roles is what got early humans out of caves and into agriculture, and then beyond agriculture into the industrial revolution, and then into the post-industrial information society we live in today. We are all better off today, individually and collectively, because our ancestors specialised, concentrated and focused instead of trying to be good at more than one thing.

The whole modern capitalist system and the standard of living it has generated for us all, is built on the principle of specialisation of each individual, firm and even each country. Each individual, firm and country specialises on what it does best and then trades with other individuals, firms and countries for everything else. For example, we live longer and healthier lives today because our forefathers (and foremothers) specialised, concentrated and focused on what developed into what we know today as the medical profession. Without specialisation, concentration and focus in all areas of human endeavour we would still be grunting to each other in the back of caves and living very short brutish lives.

So, if the key to success with building wealth, or building anything else of value to ourselves, our families or society is through specialisation, concentration and focusing on doing just one thing well, surely diversification is a backward step?

Why are we constantly being told that diversification is the key to building wealth?

In future articles I will explore what role diversification plays in investing - where it works and where it doesn't. But for now I gotta go. Tomorrow is Monday, so it's off to the Mumbai magic market for me!

Ashley Owen is Joint Chief Executive Officer of Philo Capital Advisers.

Implementation is a hot issue

Pauline Vamos

It is often said, "Take care of the big issues and the smaller ones will fix themselves." The role of the superannuation pool in the economy and the evolution of the super system are clearly complex and important conversations to start now and continue over the longer term. Much information (for example the ASFA White paper on evolving the system) contributes to the depth and effectiveness of these conversations. When we embark on these conversations we need to have regard to the environment both now and in the future.

But there is another conversation that is going on at this time that is the challenge of the implementation of Stronger Super and FOFA regulatory reform. Many of you will immediately cease reading this article on the basis that such a conversation is too technical and detailed or just not sexy enough.

I have news for you – implementation is the hot issue! It is filling the minds, the time and devouring resources across the industry. We have so much to implement, in so little time and without a full picture of the regulatory framework that nervousness pervades our daily lives. ASFA recently embarked on an exercise to centralise and document all the implementation issues across Stronger Super (ASFA does this work so that the industry does not waste member's money by duplicating non-competitive activities).

We came up with three tables. The first table outlines issues that need an adjusted policy setting because the regulatory outcome is unworkable - there are 13 of those. The second table outlines gaps or mistakes in the legalisation - there are also 13 of those. The third table outlines all the issues where there is interpretive confusion or the need for further guidance – again the magic number is 13. We of course have outlined what the solution is and which body or regulator should fix it. The fixes fall on the shoulders of ASIC, APRA, Treasury, parliament and the ATO. Often it needs two bodies or two regulators to fix an issue.

The tables reflect a point in time and the list grows weekly as funds and super providers implement and engage with the detail and as such the tables will change and in the end hopefully disappear.

What we have asked for and what we need is a pragmatic and open approach to implementation by regulators. We have called on all of them to provide written public statements so that the industry can manage costs as well as risks. There are different implementation issues across disclosure, SuperStream, data collection and MySuper and in many cases there are good reasons to delay implementation based on risk alone.

This cry is not about shirking our responsibility to fund members: this cry is about being able to implement with the best interest of members in mind, not a regulatory stick!

But there is a silver lining. We have seen a level of collaboration across the industry that is unprecedented and I have no doubt that this collaboration will be built upon over the coming months and years.

Pauline Vamos is Chief Executive Officer of the Association of Superannuation Funds of Australia (ASFA).

Death benefit pensions and the recent amendments

Graeme Colley

The amendments to the *Income Tax Assessment Regulations* 1997 on 4 June 2013 have clarified issues surrounding the calculation of exempt current pension income and the calculation of the taxable and tax-free components of a death benefit arising from a non-reversionary pension.

However, there are still some issues that need to be ironed out with the requirement to pay a minimum pension in the year of the pensioner's death and subsequently.

What was the issue?

Investment earnings on assets in superannuation funds which support a pension are exempt from income tax. However, there has been a degree of uncertainty as to what happens with this exemption upon the death of the pensioner. The uncertainty increased following the issuing by the ATO in 2011 of Draft Ruling TR 2011/D3 which specified that a pension would cease at the member's death, unless it was automatically reversionary. Where a pension was not reversionary, it would revert back to accumulation phase.

One possible consequence was capital gains on assets sold after death were subject to tax, and all capital gains may have become taxable, eroding the value of the death benefit available for beneficiaries. This was especially a concern when assets were sold in the financial year after death.

What is a reversionary pension?

A pension which has a reversion provides an automatic and immediately continuing right to future benefits to a beneficiary on the pensioner's death, usually payable as a pension but may be payable as a lump sum or combination. In the case of a non-reversionary pension, the superannuation income stream is considered to cease on the death of the pensioner and beneficiaries may be provided with an option to draw the residual as a lump sum, newly created pension or a combination. Whether a reversionary pension is better than the other depends on the situation. For example, a reversionary pension may have Centrelink implications for income test purposes which do not arise with a non-reversionary pension.

Taxation Ruling TR 2013/5 which is the finalised ruling provides the Commissioner's view on the commencement and cessation of account-based pensions, as well as other pensions. These permit the income on investments supporting a non-reversionary pension to continue to be treated as exempt current pension income after the death of the member and up until the time a death benefit lump sum has been paid and/or at the time a pension commences subsequent to the pensioner's death. In addition, the amendments provide rules concerning the calculation of the tax free and taxable components of any benefit paid subsequent to the cessation of the account based pension. The law as it has operated for reversionary pensions is not affected by the amendments and the relevant rules for these pensions continue to operate without change.

Exempt current pension income

The Commissioner's stance relating to non-reversionary pensions was published by the in ATOID 2004/688, confirmed in Taxation Ruling TR 2011/D3 and finalised in Taxation Ruling TR 2013/5. In cases where a pensioner had died the ruling indicates that any income and taxable capital gains earned on the assets which previously supported a superannuation income stream benefit became taxable on the death of the non-reversionary pension. This position remains until a subsequent death benefit income stream became payable. If a lump sum is paid from the cessation of the non-reversionary income stream any income and taxable capital gains were taxable in the fund at the

rate of 15%. In the case of self managed funds in particular if there was a taxable capital gain arising from the sale of a fund asset the tax payable may be significant.

The rules now permit the income on assets which supported the income stream benefit at the time of death to continue to be treated as exempt current pension assets until any lump sum or subsequent death benefit pension commences. This allows the trustees of the fund to dispose of assets that supported that income stream until the ultimate payment is made from the fund.

While the income on assets supporting the superannuation income stream continue to remain exempt, amounts which relate to the proceeds of an insurance policy or from an anti-detriment payment will not form part of the exempt current pension income by definition. This can be illustrated in this short case study:

> *Andrew was in receipt of a non-reversionary superannuation income stream when he died on 1 April 2013. At the time of his death the balance in his income stream interest was $200,000. Subsequent to Andrew's death the trustee of the fund added $15,000 as an anti-detriment payment plus earnings on the account balance of $10,000 when it was payable as a lump sum on 30 November 2013. The amount of $210,000 is taken as supporting the income stream benefit from Andrew's death on 1 April 2013 until 30 November 2013.*

Calculating the tax free and taxable components

Section 307-125 of the Income Tax Assessment Act 1997 provides the rule to calculate the taxable and tax free components of a superannuation benefit which is referred to as the proportioning rule. Subsection 307-125(3) indicates the time when these proportions are calculated. For example, in the case of a pension the tax free and taxable proportions are calculated immediately before the commencement of the pension on the taxable and tax free amounts in the member's accumulation interest(s) in the fund. Para 307-125(3) provides that the regulations may provide an alternative method to calculate these proportions for certain superannuation benefits.

The new regulation 307-125.02 which applies from 1 July 2012 provides in the case of a non-reversionary superannuation income stream that was payable to a deceased member prior to their death that the tax free and taxable proportions will continue on the same basis as the original pension. However, anti-detriment payments or insurance related amounts are excluded from the calculation if they are added to the pension account balance after the pensioner's death.

As an example, here's how the new regulations work in relation to the tax free and taxable components of a non-reversionary superannuation income stream benefit:

> *George was receiving a superannuation income stream which was non-reversionary at the time of his death on 1 May 2013. The tax free portion of his superannuation income stream was 45% and the taxable proportion was 55%.*
>
> *At the time of George's death the balance of his non-reversionary income stream account was $500,000. In addition, an anti-detriment increase of $20,000 as well as the proceeds of an insurance policy of $400,000 was added to the account.*
>
> *Under the rules of the fund George's adult son, Harry, is entitled to a lump sum. The lump sum of $920,000 will consist of a tax free component of $225,000 (45% of $500,000), the taxable component of $275,000 and the anti-detriment increase as well as the insurance component which will have different tax free and taxable components.*

An anti-detriment increase relates to an additional amount which is made under the fund rules to compensate for the tax paid on taxable contributions that form part of the death benefit lump sum.

The superannuation fund is able to claim a tax deduction that relates to the anti-detriment increase, also referred to as the tax saving amount. Under the new legislation any anti-detriment increase which is added to a death benefit lump sum is treated as a taxable component and is not apportioned on the same basis as the taxable and tax free components of the original non-reversionary pension.

Where the proceeds of an insurance policy are added to the deceased member's account, in the fund it will have a separate taxed and untaxed element. This will depend on whether a deduction has been claimed for premiums under section 295-465 or the future service liability under section 295-470 of the Income Tax Assessment Act 1997. Where no deduction has been claimed the proceeds of the insurance policy will be treated wholly as a taxed element. However, where the fund has claimed a deduction the proceeds will be apportioned under section 307-290 by the 'service days' divided by the total of the service days plus days to retirement. This will result in the amount having a taxed and untaxed element which results in tax of 15% and 30% respectively plus Medicare. In practice this treatment applies only to lump sums paid to people who are not a death benefits dependant in terms of section 302-195. As a general rule, that is, adult children of the member except for some limited exclusions.

In summary, the changes have clarified the continuation of the tax exemption and allow for the disposal of pension assets on a tax-free basis to the superannuation fund, increasing the value of the death benefit payments to the beneficiaries.

Next week, in Part 2 of this review of death benefit pensions, we look at which is best – a reversionary or non-reversionary superannuation income stream.

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