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Hey baby boomers, pension is not a dirty word

Graeme Colley

Not everyone looks forward to retirement and starting a pension from superannuation. For some, it is an abrupt reminder they are getting older and it's time to take things a little easier. However, when it's a transition to retirement (TTR) pension, or transition to retirement income stream (TRIS) or whatever you want to call it, things may be seen in a different light. These pensions create the possibility of a tax-effective income stream while continuing to work. Add in the advantages of tax-free income on investments in the fund supporting the pension, as well as a tax offset, and pensions start to look attractive.

A TTR pension can commence once a person reaches their preservation age as defined in Reg 6.01(2) of the Superannuation Industry (Supervision) Regulations (SISR). The preservation age is 55 for anyone born before 1 July 1960. For anyone born on or after that date, the preservation age increases from 55 to 60 depending on their birth date.

TTR and account-based pensions

A TTR pension has the same features as an account-based pension, but with some additional restrictions. An account-based pension is defined as a pension that meets at least the minimum payment amounts calculated in Schedule 7 of the SISR. It can be transferred to another beneficiary only on the death of the primary or reversionary pensioner (usually a spouse or dependant) and the capital value of the pension, including any income it generates, cannot be used as security for

borrowing. The minimum amount of an account-based pension required to be paid during the year is pro-rated on a daily basis. If an account-based pension commences on or after 1 June in a given financial year, there is no requirement to pay any pension until the following financial year.

There are additional restrictions on the maximum amount that can be paid as a TTR pension, and full or partial commutation (conversion to another payment, usually a lump sum). The maximum TTR that can be paid in a financial year, excluding any commutation, is limited to 10% of the pension account balance as at 1 July in that financial year or on the commencement day if the pension started up at a later date during the financial year. There is no requirement for the maximum TTR pension to be pro-rated if it commences during the financial year. There are also rules about how the commuted amount of a TTR can be used.

Is a TTR pension worthwhile?

The first question asked by anyone nearing preservation age should be whether taking a TTR pension is worthwhile. Concessional contributions to the fund are taxed at only 15%, and if they were to receive a fully taxable TTR pension equal to the amount of those contributions, it would be taxed at personal tax rates less a tax offset of 15%.

The main benefit of a TTR pension is that the income on the investments used to support the TTR pension is tax free in the fund. This is an advantage in funds of all sizes as the after-tax rate of return would increase. In addition, any franking credits can be offset against any other tax the fund is required to pay, or any excess refunded to the superannuation fund. There may also be an advantage in delaying the sale of investments with taxable capital gains from the accumulation phase to pension phase because of the tax free status.

Tax savings examples

Let's consider the example of Lee, who is aged 57 and has a balance of $500,000 in her superannuation fund at the start of the financial year. During the year, she generates assessable income and realised capital gains of 12.5% ($62,500). This amount would be taxed in the fund at 15% ($9,375). However, if Lee had commenced a TTR pension, she would be required to draw a minimum of $20,000 of the balance ($500,000 X 4%) if the TTR pension was payable for the whole year. Any income earned on the TTR pension balance in the fund would be tax free, saving up to $9,375.

Depending on the taxable and tax free components of the TTR pension, Lee would pay tax at personal rates on the taxable portion of the pension less a tax offset of 15%. If Lee's minimum TTR pension of $20,000 was fully taxable and she paid personal income tax on it at the rate of 31.5%, the net tax payable would be 16.5% after the tax offset equal to 15%. She would pay tax on the pension of $3,300, far less than the tax saving in the fund. Lee may also wish to salary sacrifice $20,000 to superannuation. The amount Lee salary sacrifices would be taxed in the fund at 15% ($3,000).

The main tax advantage of the arrangement is the tax free status of the income earned by the fund in pension phase. Once Lee reaches age 60, any TTR pension she receives will be fully tax free and the advantages increase substantially.

Any TTR pension must be drawn down in the order prescribed in SISR 6.22A, which requires the unrestricted, non-preserved component of the TTR pension to be drawn first, then the restricted non-preserved benefit and finally the preserved benefit. This issue should be studied more closely by anyone planning a TTR pension.

Commencing a TTR pension may not be best for everyone

There are some reasons not to commence a TTR pension. Retirement savings are drawn earlier than retirement, meaning the amounts saved may run out earlier than if the pension was delayed. A person may not wish to receive additional income as they continue to work because the amount of TTR pension is greater than the amount they can salary sacrifice to superannuation. Plus even in accumulation, the tax rate is only 15% on assessable income, which does not include unrealised capital gains. Each individual needs to work out the relationship between the tax saved in the pension based super fund, versus the additional income tax payable on the pension.

Of course, a pension provides a greater benefit once a person reaches age 60, when no tax is payable on pension income, including TTR pensions. The main benefit in payment of the TTR pension comes not in its receipt for anyone under age 60, for which the taxable portion is taxed at personal rates less a 15% tax offset. Rather, the main advantage comes from income earned in the fund on the investments supporting the TTR pension being tax free.

From a financial planning perspective, the manner in which the preserved and non-preserved components of the TTR pension are drawn down may also be a consideration, particularly if the pensioner is considering drawing a lump sum from the non-preserved component in future.

Graeme Colley is the Director Technical & Professional Standards at SPAA, the SMSF Professionals' Association of Australia.

Residential property fails simple valuation test

Roger Montgomery

The Herengracht canal in Amsterdam has been a favoured strip of real estate in the city since the 1620s. The Herengracht house index, constructed by finance professor Piet Eichholz of Maastricht University, tracks house prices in the area over a 380 year period – commencing with the Dutch 'Golden Age'. Over that time, real (i.e. inflation adjusted) house prices have only doubled, which corresponds to an annual average price increase of something like 0.1%. This would indicate that despite short-term rises and falls, prices roughly follow inflation.

What could this mean for investors in the Australian residential property market? It may have looked like an attractive option recently. Auction clearance rates have been healthy, but rising prices have prompted media commentary on a possible housing 'bubble'. What do we find if we apply value-investing principles?

We'll start by assuming that residential property, at least the investment kind, derives its value in the same way as other financial assets - by producing cash flows - and obeys the same fundamental financial laws.

Since property income is fairly predictable, the valuation exercise should be straightforward. We just need three numbers:

• discount rate, or rate of return required by an investor

• net rental income generated

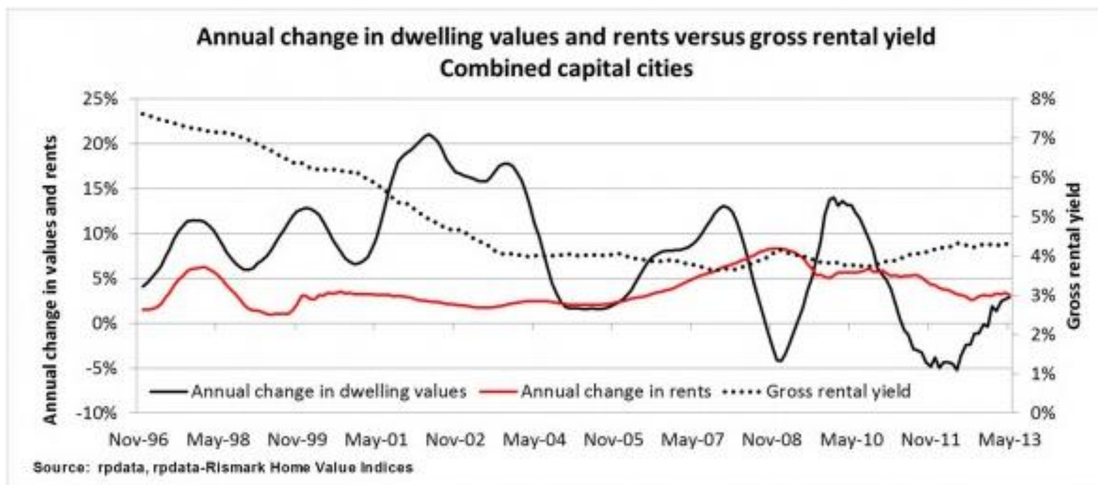
• long-term rental growth rate

We can plug these values into a simple formula that will calculate the present value of the cashflows into perpetuity, following the same principles used to value a business.

A discount rate reflects the rate of return an investor needs to compensate them for the risk of investing in a particular asset. A good way to estimate it might be to start with the 10-year government bond rate (a proxy for the rate that applies when there is no risk, currently around 4% p.a.), and add a risk premium.

In the case of equities, the risk premium is commonly thought to be around 5-6%. I think a case can be made for a lower risk premium for property, given that it has a more stable profile, but we should also consider that property is a much less liquid asset than equities, and investors should demand some compensation for this. For the sake of argument, let's choose a risk premium of 4%. This gives us a required rate of return of around 8%.

Net rental yield is the next piece of information we need. The chart below, published by RP Data, shows a current gross rental yield for Australian capital cities of around 4.3% p.a.



To calculate a net rental yield, subtract all the expenses that an investor must incur in generating the gross rent, including property management fees, maintenance, insurance etc. A reasonable estimate may be around 1.0%, which gets us to a net rental yield of 4.3% - 1.0% = 3.3%.

The final number required is the long term growth rate in rents. As shown in the chart above, a figure just above 3% p.a. may be a reasonable estimate. Let's assume 3.2%.

Combining these numbers into a valuation can be done as follows: divide the annual rent earned on a property by a divisor, which is calculated by subtracting the long term growth rate from the discount rate, as set out below.

Value = Net Rent p.a. /(Discount Rate – Growth Rate)

This is the formula for calculating the present value of a stream of cash flow that grows at a fixed rate in perpetuity. If a property generates $20,000 per year of net rent, we would calculate its value as $20,000/(8% - 3.2%) or $20,000/4.8%, equal to around $416,667.

If that property can be bought today at a net yield of 3.3%, it would imply that the market price

of the property today is $20,000/3.3% = $606,061. This is significantly higher than our valuation of $416,667. On the basis of the discount rate and long term growth rate we assumed, buying property on a net rental yield of 3.3% appears hard to justify.

Over the past three decades, there has been a fourfold increase in Australia's indebtedness as a percentage of annual disposable income, to 150%, as well as massive growth in property prices. Together with the above analysis, these facts indicate that the same level of growth is not sustainable. If this is correct, it may pay to be cautious about buying on the basis of a continuation of assumed capital growth.

Of course, the conclusions you reach with this approach depend on the assumptions you put into it, and the purpose here is not to argue that property is overpriced. Rather, it is to set out a framework that allows some basic assumptions to be converted into a fundamental value. By doing this, you can decide for yourself whether there is long term value to be gained.

Roger Montgomery is the Chief Investment Officer at The Montgomery Fund, and author of the bestseller, 'Value.able".

In super, the Danes are great, Australia a close third

Harry Chemay

Australia's superannuation system has been judged to be the third best retirement system in the world, according to the Melbourne Mercer Global Pension Index (MMGPI) Report released this week. The 2013 Report replicates last year's findings, with Denmark's retirement system found to be the most robust, followed by the Netherlands and Australia.

The MMGPI Report ranks the pension systems of countries across a range of indicators to determine an overall index value for each nation. The Report now covers 20 pension systems affecting approximately 4 billion people, or some 55% of the world's population, including China and India. It is a collaboration between global consulting firm Mercer and the Australian Centre for Financial Studies (ACFS), with support from the Victorian Government.

How the Global Pension Index is calculated

The overall index value for each country's system is made up of three sub-indices; Adequacy, Sustainability and Integrity.

Adequacy is 40% of the total, and represents benefits, tax support and asset allocation. Sustainability has a 35% weighting based on the likelihood that the current system will continue providing benefits into the future. It includes coverage, the level of current government debt and trends in labour force participation rates for older workers. The Integrity sub-index is worth 25% and considers governance, protection, communication and costs, all of which impact on public confidence.

An 'A' grade system requires an overall score above 80 and is "a first class and robust retirement income system that delivers good benefits, is sustainable and has a high level of integrity".

Danes hold off the Dutch and Aussies (again)

In a repeat of last year's podium, Denmark's pension system had the highest overall index value 'A' grade at 80.2, followed by 'B+' grades for the Netherlands (at 78.3) and Australia (at 77.8). Switzerland and Sweden were close behind, while the UK slotted into 9th place (65.4) at the lower end of the 'B' grade. It was judged to have an inferior pension system to Canada, Singapore and Chile. The US fared no better, placing 11th (58.2). Japan is the only mature, developed economy with a retirement system rated 'D', having been given an index value of just

44.4. Japan’s low overall score was primarily due to a woeful Sustainability sub-index score of 28.9, the equal second lowest with China across the 20 nations.

When it comes to retirement, what makes the Danes great?

According to the Report’s lead author, Dr David Knox, Senior Partner at Mercer, Denmark has design features that would be the envy of most other nations:

- a universal age pension that equates to 17% of Danish average earnings. This is reduced if an individual’s income from employment is greater than 75% of average earnings
- in addition to the basic pension, there is an income-tested supplementary pension of up to a further 17.1% of Danish average earnings. This means that the poor receive a pension of 34.1% of average earnings
- both pensions are adjusted in line with movements in average earnings. According to OECD tax revenue data, the average wage in Denmark for 2012 was US$49,887 versus US$48,199 for Australia
- a nation-wide statutory fully-funded system covers all employees and provides a lifelong pension in retirement. Contributions to this system are based on hours worked per month
- occupational schemes round out the system, with fully-funded Defined Contribution (DC) schemes enjoying almost universal coverage where end benefits are usually taken as annuities rather than as lump sums.

The level of mandatory contributions in Denmark is more than 12% for most employees, versus the current 9.25% Super Guarantee rate in Australia.

Denmark is also held in high esteem for its universal government-funded health and education systems, but it comes at a price borne by the Danish taxpayer. Danes are amongst the highest-taxed citizens in the world, with a top tax rate of 60.2% phased in at 1.1 times the average wage. Australia’s top tax rate of 47% (plus Medicare) phases in at 2.4 times our average wage.

Can Australia turn its ‘B+’ into an ‘A’?

Australia’s ‘B+’ rating indicates “a system that has a sound structure, with many good features, but has some areas for improvement that differentiates it from an A grade system”. Improvements could come from:

- increasing the labour force participation rate amongst older workers
- increasing the age pension age as life expectancy continues to rise (note: it is already scheduled to move to 67 for those born after 1 January 1957)
- increasing the minimum benefit access age so that preserved benefits aren’t available more than five years before age pension eligibility
- removing legislative barriers to encourage more effective retirement income products, and
- introducing a requirement that part of the retirement benefit must be taken as an income stream of some description.

The final two issues received much discussion at the MMGPI launch. As Dr Knox put it, “Developing effective and sustainable post-retirement solutions has to be one of the most critical challenges for policy makers and retirement industries around the globe.”

SMSFs – the $500 billion ‘joker in the pack’?

Australia’s overall index value rose 2.1 points year-on-year, mainly due to a significant jump in its Integrity sub-index, which scored the highest of any nation. A major factor was the introduction of the Stronger Super reforms that are already leading to improved governance and stronger regulation. Australia is now one of only three countries that require public offer funds to have a conflicts of interest policy in place.

However, these reforms apply primarily to 'APRA-regulated' funds, which account for approximately 66% of the nation's superannuation. SMSFs are not, other than at the margin, affected by these regulatory changes. SMSFs will not have to create an operational risk reserve, nor supply members with a 'Standard Risk Measure' statement outlining the likely frequency of negative returns over a 20-year period. SMSFs trustees need to prepare an investment strategy but, unlike their public fund counterparts, do not need a risk management strategy nor a conflicts of interest policy. SMSF members do not have access to the Superannuation Complaints Tribunal, a government body that arbitrates on member grievances made against super funds.

It would not be unreasonable to question whether, if the SMSF sector continues to grow apace, the differing governance standards between APRA-regulated fund and SMSFs will affect Australia's Integrity sub-index score over time, compromising Australia's overall place in the list of elite retirement systems. Recent signs are that regulators are watching closely.

Enhanced focus on delivering sustainable incomes

The Melbourne Mercer Global Pension Index is an ambitious undertaking, but one that pays dividends in the quality of data it brings to the comparison of pension systems around the globe. The Report is now keenly anticipated by superannuation professionals and global pension managers globally. It is a key source of insight into the health and robustness of pension systems and how these systems might be improved. Australians should be justifiably proud that work of such global importance is being undertaken here.

One of the key messages from the latest report is the need to 'start with the end in mind'. Pension systems exist to provide benefits in retirement, and the best systems deliver that goal to the greatest number by the most robust means possible. A mind-shift away from focussing primarily on capital accumulation and more toward post-retirement income generation is needed.

Harry Chemay is a consultant to superannuation funds, an alumnus of Monash University and a member of Finsia. Both organisations are consortium members of the Australian Centre for Financial Studies. He previously worked for Mercer.

1979 US Government defaults: what happened next?

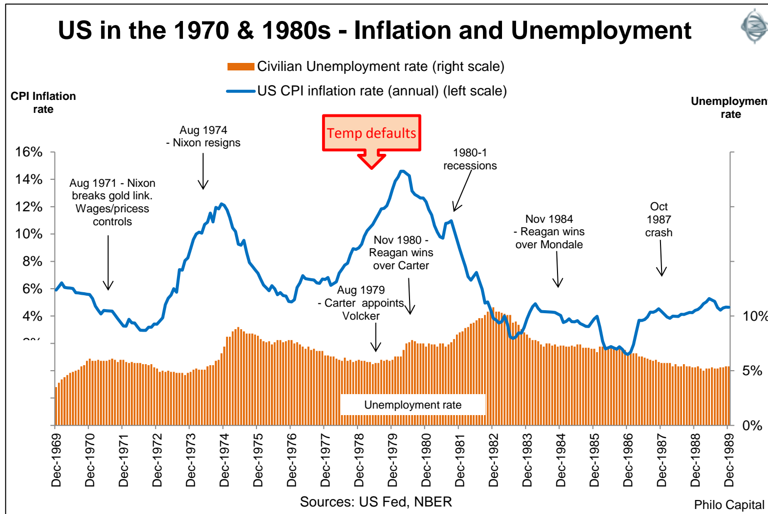
Ashley Owen

In last week's article, we showed that the US Treasury defaulted three times on its treasury bills in 1979. They were 'temporary' defaults, but a default is a failure to pay debts promptly when due. Investors sued the US government in court for lost interest but they failed. The default crisis was a shock to Americans who thought that the US government would always pay its debts on time. The article was covered in some depth by Phil Baker in The Australian Financial Review, under the heading, "Think the US won't default? It has before – three times". Given the high profile of this issue, we thought it useful to take a quick look at what happened next.

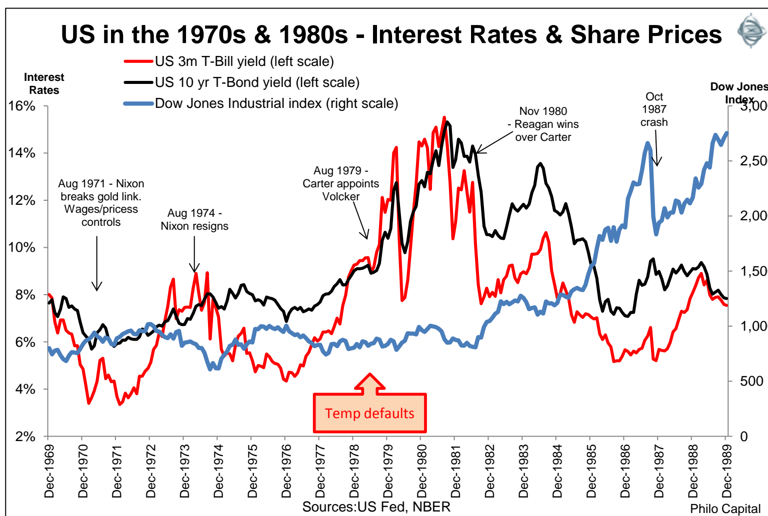
Although the temporary defaults were a shock, they provided a catalyst that marked a complete turnaround of American fortunes, from the high inflation, high unemployment, high tax, stagnation of the 1970s, to the low inflation, low unemployment, low tax, booming 1980s. 1979 was the turning point and the start of the 1980s which saw the victory of monetarism and market capitalism over state-directed Keynesian, socialism and communism. In China, Deng Xiao Ping turned his back on communism as an economic system and started down the capitalist road, and within a decade the Soviet system and communist eastern bloc had collapsed.

The following charts are the same as in the previous article except they show the 1980s as well as the 1970s, illustrating how each of the measures turned the corner in the 1980s.

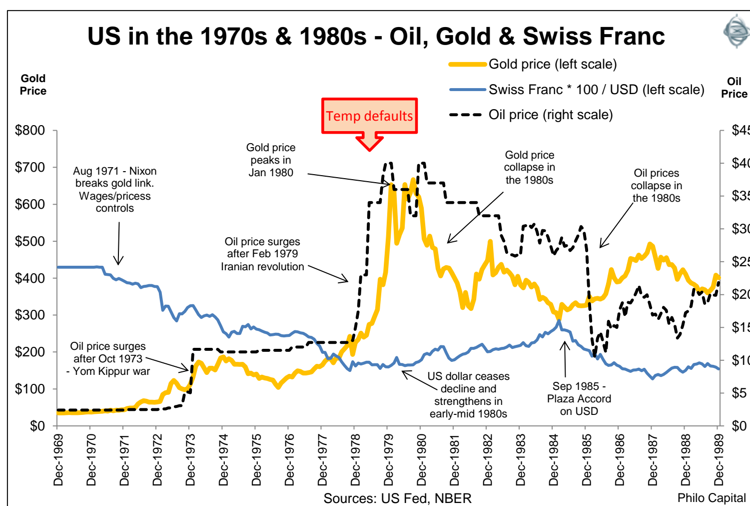
The first chart shows inflation and unemployment rising in the 1970s but both then falling in the 1980s following the 1979-1980 turning point.



The next chart shows short and long term interest rates rising in the 1970s but then falling in the 1980s. It also shows how the stock market shrugged off the default crisis and turned the corner, shifting from the stagnant 1970s into the booming 1980s.



The final chart shows oil and gold prices rising in the 1970s, but then collapsing in the 1980s. It also shows how the US dollar ceased its 1970s decline, turning into strength in the 1980s. The dollar returned to such strength in the early 1980s that the US had to engineer a major international intervention, the 1985 Plaza Accord, to prevent its further rise.



It shows how the US dollar was then, and still is, the global 'safe haven' currency. The US dollar strengthens in crises, even when US is the cause of the crisis, as it was in the 1979 treasury default crisis, the 2008 sub-prime crisis and even in the US credit rating downgrade crisis in 2011.

Thus the deep financial, economic and political crises that came to a head at the end of the 1970s became the dawn of a brand new era of growth and prosperity for Americans.

Or so it seemed. The 1980s boom under Reagan was financed by a massive build-up of government debt, in which the US went from being the world's largest creditor nation to the largest debtor nation, and the prosperity was built on a mountain of debt. It was good while it lasted, but it led to the 1995-1996 government shutdown crisis as we described here.

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Painful transition to FOFA will pay off in the long term

Andrei Ivanov and Tim Stephen, IBISWorld

The Future of Financial Advice (FOFA) reforms have overhauled the way financial advisors operate, to the benefit of financial advisors and the major banks. FOFA came into effect on 1 July 2013, and aims to reduce conflicts of interest within the financial planning and investment advice industry. The legislation has fundamentally changed the way financial advisors are remunerated for their services. Consequently, some advisors have come under significant pressure, while others have capitalised on opportunities to strengthen their business models and emphasise value propositions. Meanwhile, the major banks are following developments closely, ready to pick up the pieces – as they tend to do when a part of the financial sector is set to disintegrate.

FOFA has introduced a ban on commission payments. Previously, financial advisors would receive a commission on the sale of retail financial products, such as investment schemes and insurance policies, to retail clients. This commission would be paid by the product provider. Thus, retail customers themselves did not have to pay directly for financial advice. Rather, the financial advisor would inform them on a product, sign the clients up and receive a commission from the upstream institution**.** Essentially, the advisors were part of the upstream cost structure and were incentivised to push through as many products as they could, regardless of a client's financial situation. The ban on commission payments, along with the introduction of a fiduciary duty, has

changed this. Subject to grandfathering on some existing payments, financial advisors now have to receive upfront payments for their services directly from clients, and it is now law that they act in the best interest of clients.

The fundamentals of financial planning and investment advisory operations have not changed. The success of these businesses is still underpinned by the quality of advice and the established relationships between clients and advisors, and between advisors and financial institutions. The FOFA reforms only apply to advisors working with retail clients — that is, clients that are not classified as wholesale or sophisticated investors. What has changed is the remuneration of retail advisors. The model will now largely move towards a salary-based package for advisors. The days of cap-free and trailing commissions are all but over.

Financial advisors have had over a year to adjust their platforms. In early 2012, the Federal Government announced that the reforms would be compulsory from July 2013. Many firms implemented the fee-for-service model much earlier (notably NAB, which began implementation in 2008). The performance of advisors that introduced a fee-for-service model before FOFA became mandatory suggests that demand is unlikely to plummet due to the reforms. However, the demographics of the markets for financial advisors are expected to change, and the long-term effects on the financial planning and investment advice industry remain unclear.

The reforms create an opportunity for savvy advisors with established reputations. The legislation improves the quality of financial advice because it removes the patent conflict of interest that existed previously. It also attracts clients previously put off by the feeling that a financial advisor was just another salesman. Overall, IBISWorld expects the industry to continue its healthy growth path over the five years through 2018-19.

The changing pay structure is spooking some advisors, who have turned to the big banks for security. The banks have started to consolidate their financial planning businesses by acquiring smaller boutique advisories that depended on the commission structure. The Big Four banks are still able to offer free financial advice as part of their overall value proposition, spreading the related costs across their traditional products. Furthermore, some advisors with strong ties to particular institutions, such as superannuation firms or insurance underwriters, have been able to find refuge with these establishments. The FOFA reforms offer the banks an opportunity to further diversify their businesses and reduce their dependence on mortgage lending.

Although it may be painful, FOFA demands higher professionalism, improves client confidence and presents opportunities for the banking sector and reputable advisors. The cleansing effects of the legislation are expected to outweigh the costs in the long term, especially as the wealth of the general public continues to grow.

Andrei Ivanov is Industry Analyst, IBISWorld, and Tim Stephen is Industry Research Manager, IBISWorld. IBISWorld is Australia's best-known business information corporation. Related IBISWorld industry reports include K6419b Financial Planning and Investment Advice.

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