Edition 45, 20 December 2013

This week's top articles

Highlights of *Cuffelinks* 2013

In our final edition for 2013, we take a look at some of our most popular articles among the 400 posts to our website since we commenced on 8 February 2013. Some of these articles have received 10,000 pageviews. Happy Christmas reading!

The Hon Paul Keating on living longer and so should our superannuation.

Chris Cuffe on how to choose the correct investment horizon.

Roger Montgomery on Ben Graham's three most enduring investing principles plus residential property investment fails a simple valuation test.

Graham Hand on the need to bring 'industrial strength' quality to every SMSF, plus watch out for property spruiking targeting SMSFs plus returns to expect from gearing into shares.

Ashley Owen on why he has sold mining stocks after a decade invested, plus his three-part series on investing against the herd plus economic growth does not drive share prices.

David Bell on lifecycle funds as MySuper products plus the variability of retirement outcomes.

Warren Bird on term deposit investors not understanding the risks they were taking.

Jack Gray with an irreverent, irritating, irregular dictionary narrative on 'c' words.

[Justin Wood on spending guidelines for retirees and endowments.]

[Peter Kell, Deputy Chairman of ASIC, on FOFA's five red flags.]

Our apologies if we did not list your article as we had literally hundreds to choose from.

A sustainable economy: it's about making money, stupid

Paul Gilding

Watching the media's coverage of climate and sustainability issues, it would be easy to miss just how firmly those questions have arrived into global economic thinking in the last few years. For most of my 20 years of focus on corporate strategy in this area, and for all of my 20 years in activism before that, it really was ethically-driven, this was 'the right thing to do' – for our children and their children. There's always been something powerful about that as a motivator, but there's also something inherently weak about it in a market context. It implies 'you *should* do this', as opposed to you *want* to do it! It was not be about making money or economic success. For decades, that was the context for sustainability, both as investors and in business strategies.

This has now shifted. A whole range of issues around sustainability, both social and environmental, have arrived in the economy. I could give you a two hour talk about the data without talking about the science or moral issues, and quote Dupont, Unilever, the OECD, the International Energy Agency or investors and financial analysis like Jeremy Grantham or HSBC, all people who look at this issue economically. It's now about the market and making money.

Why the big shift? Very simply, we have hit the limits of the earth's resources to support the global economy's continued growth in the old model. We've reached the point where the physical evidence of sustainability limits is now playing out in the economy, in prices and availability. Not the literal availability but supply at the right price, right time and right place. It's the beginning of a process that's been long understood –infinite growth has its limits. So now people are responding by necessity, and that's very different from doing it because we should or because we ought to, or our long term future depends on it.

This is also not like any other social question we think about in history. This is not about 'it's not as good as it could be'. For example, if we didn't ban slavery in most countries, that would have been tragic, but we would have carried on regardless. This issue is not about making the world a better place. If we don't change, we're quite simply screwed. The system won't work any more – at least not in the way we've come to expect it to.

If you doubt the inevitability of change, look at China. Think about all the issues and constraints on growing their economy at the moment at 7% pa, a quadrupling in only 20 years, and then consider all their current constraints on water, on air quality and on social instability and multiply the challenges by four in 20 years. You just can't imagine that they're not going to change. If they don't, both the Communist Party and the Chinese economy are in trouble. That's the global situation on steroids. Our model of growth will break if we don't change.

So change is no longer optional. Business as usual and the assumptions on which every company and government operates are fundamentally wrong. The scale and pace of change are bigger than any of us are expecting. And when it happens, we're all going to be surprised. And it's not philosophy or ideology – it's basic physics, chemistry and biology.

When we see shifts in regulation and policy, business leaders often talk about it being unexpected change and seek compensation, as the coal-driven power companies complained when the carbon tax came in. Like they were surprised by the climate change issue coming to the market after 20 years of forecasts! This transformation is like that - inevitable, clear and straightforward. There will be major changes in technology, transport, buildings and energy, or it's the end of growth. Given that choice, you know what we'll do.

We're surprisingly passive about the inevitability of this. I've spent the last couple of years travelling the world and talking about my book *The Great Disruption*, and almost nobody challenges the core analysis. And then they say, "Isn't that interesting". My response no, it's not "interesting" – it requires a response or the market change will leave you in its wake.

Business needs to think deeply about their strategies in this context. Think about how markets will change, because as a company, you otherwise may fail in that changing world. Frankly, as a society, we don't care if a particular company survives, we don't care if you go away and get replaced by other companies. The value that you add is the products you create and the jobs that go with them – not your existence. But if we no longer want your products, the market will sort it out and sort you out in the process. That's how markets work. But if you're running a company, you don't want to be running things when your company fails. So it matters to you.

So what does this mean for investors?

First, accept the inevitable. Many past assumptions on how the economy works will no longer apply. That does not give you the answer on what to do, except to say your current strategy is probably wrong.

Second, it's about to get messy. The world will not come to some simple ordered agreement to restructure. There won't be a disaster hitting New York which leads to a meeting of world leaders reaching an agreement to change. It won't happen because life's not like that and markets are certainly not like that. It will be ugly, a lot of people will go broke and a lot of people will become rich. And that makes it an investment question.

I use as an example the incredible way the German utility industry has lost half a trillion dollars in market capital in recent years by not seeing what was coming in the huge growth in solar and the transformation of the energy sector. To summarise, German feed-in tariffs favouring solar drove large scale production in China to meet the demand, which led to phenomenal falls in prices and large installations of solar panels globally – even in places without strong climate policy like America. This drove further Chinese production, with the resulting 80% drop in solar prices meaning it now makes economic sense to put solar panels on your roof in places with no climate policy. The collective result was significantly reduced cost of generating electricity in Germany and a collapse in the margins for utilities at peak consumption times - thereby causing huge loss of value for utilities in Germany.

Thus German policy drove Chinese production which drove price drops that led to high US installations. Messy, complicated, unexpected and at the cost half a trillion dollars in market cap to investors in previously reliable utilities. There are similar examples everywhere, such as reductions in security of coal mine investments due to uncertainty around climate change, huge growth in solar and growing supplies of shale gas in the US. The Australian installation of solar is also an incredible story, a million installations in four years – watch that space for more disruption.

Change is coming. It will be messy and hard to manage but get ready or face the consequences of being asleep at the wheel.

This is an edited transcript of the keynote address at the 2013 Responsible Investing Association of Australasia Conference in November 2013. Paul was the executive director of Greenpeace International, and for the last 20 years, has consulted to corporations globally on sustainability strategies. He is the author of The Great Disruption*. Paul's talk at the opening of the annual TED event in Long Beach, California in 2012, entitled 'The Earth is Full', is linked here.*

Advantages of splitting superannuation contributions

Graeme Colley

A subject we often hear about in general terms – but I'm not sure most people understand – is super splitting. What are the rules, how do you do it, when is it worthwhile and when is it more trouble than it's worth, how common is it, are there any proposals to change the rules, and is there any need to do it sooner rather than later?

There are two types of superannuation splitting with a spouse. The first is where a member is able to split concessional contributions up to 85% of the cap limit and the other type is for family law settlements. In this article we cover the pros and cons of splitting concessional contributions as permitted by Division 6.7 of the Superannuation Industry (Supervision) Act.

Contribution splitting provides a superannuation member with the opportunity to split up to 85% of concessional contributions received in a financial year with their spouse. As a general rule the split is permitted in the year after the contribution has been received by the fund. However, where a member is closing or rolling over their account in the fund, the split can take place in the year of the concessional contribution.

Share the benefits

The main advantage of splitting is to share the amount saved for retirement between a member and his or her spouse. This can:

- give access to the low rate threshold for each member if they are younger than 60
- provide an effective way of providing superannuation to a non-working or low income spouse
- pay for insurance premiums for a non-working or low-income spouse
- provide superannuation benefits earlier by splitting contributions to the older spouse
- improve the client's Centrelink position by splitting contributions to the younger spouse, or
- protect the member and their spouse from the impact of potential government proposals. One example, which did not go ahead thankfully, was the 15% tax that was to be introduced on a member's income from pension assets in the fund worth more than $100,000. By using contribution splitting, it is possible to keep income in the fund below the relevant threshold. In the past, splitting of contributions also helped even out a member's superannuation balance for purposes of his or her Reasonable Benefit Limit.

How splitting rules work

To make the split, subject to the caps mentioned above, under reg 6.44 a member elects the amount he or she wishes to split in the year after the concessional contribution has been made, or in the year of income in which the concessional contribution was made if the account is to be closed or rolled over to another fund.

It should be noted that contribution splitting is subject to the rules of the fund and is limited to concessional contributions made to an accumulation fund, and the member's accumulation component (if any) in a defined benefit fund.

Amounts that cannot be split include:

a) benefits rolled over from another fund
b) amounts previously rolled over as a contributions-splitting superannuation benefit
c) superannuation lump sums paid from a foreign superannuation fund
d) contributions that are not included in the assessable income of the fund, including non-concessional contributions and amounts subject to the capital gains tax cap amount
e) contributions to a superannuation interest that are subject to a payment split or subject to a payment flag under the family law provisions.

As an example, during the 2012-13 financial year, Jordan, who was aged 60, salary sacrificed $25,000 to his SMSF. The maximum sum that Jordan may split with his spouse Amy is 85% of his concessional contributions up to the concessional cap amount. That is 85% of $25,000 which is $21,250.

Timing the split

In order to make the split, the contribution must first be made to the superannuation fund and credited to the member's account where it is taxed. It is important to note that the contribution is not made directly to the spouse's account. The next step is for the member to make an election to split the contribution to the spouse and indicate the amount.

To meet the requirements of a valid application, it can be made prior to the member's spouse reaching preservation age. An application to split can be made between the spouse's preservation age (which is 55 for those born before 1 July 1960) and age 65, providing they have not met the condition of release of retirement. Also any application must be for no more than the maximum splittable contribution for the member for the relevant year.

Only one split may take place for concessional contributions received by the relevant fund for each financial year. The ATO has provided a form on its website that can be used by the member and given to the fund that is to make the split.

Once the split has been made, the sum may be transferred to the spouse's account in any superannuation fund, approved deposit fund or retirement savings account. The amount credited to the spouse's account does not count against the spouse's contribution caps for the financial year in which the contribution was made, nor for the year in which the split took place.

Applying this to Jordan's example, in 2012-13, the following contributions were made to the fund: concessional contributions of $25,000 and $5,000 of non-concessional contributions. The maximum amount Jordan is able to split in 2012-13 is 85% of $25,000, which is $21,250. Jordan will have the whole of the 2013-14 financial year to make an application for the split to his wife. Once the 2013-14 financial year has ended, Jordan will not be able to make an application to split the contribution made in 2012-13.

Tax components of a spouse splitting amount

A contributions-splitting superannuation amount is treated as a taxable component and does not have a tax-free component as provided for in section 307-140 of the Income Tax Assessment Act 1997. This is the same component as the original taxable contribution prior to the split to the member's spouse.

Eligible spouses

A spouse for purposes of the splitting rules is defined in section 10 of the SIS Act. A spouse is the person to whom the member is legally married, a person in a registered relationship with the member, or a person who, although not legally married to the member, lives with the member on a genuine domestic basis.

Any application must be for a spouse who is:

- under their preservation age; or
- has attained preservation age but is under age 65 and has not met the retirement condition of release.

This means that a member is only able to make an application for splitting if their spouse is older than their preservation age but under age 65 and has not retired. The definition of retirement depends on whether the spouse is between preservation age and 60 or between age 60 and 65.

In summary, any strategy for splitting a member's contributions is a long term strategy, as the maximum amount that can be split to a member's spouse is limited to a maximum of $21,250 (85% of $25,000 for those under age 60) or $29,750 (85% of $35,000 for those who are 60 and older). The splitting strategy may help even out the superannuation balances of the member and his or her spouse. It can be used to allow an older spouse to gain tax benefits once they reach age 60 and meet a condition of release. In the case of a younger spouse, splitting can allow members to meet income test and social security asset requirements.

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

When does an SMSF qualify as a 'wholesale' investor?

Andrew Bloore

Introduction by Graham Hand

If an investor has sufficient assets or income, there may be benefits in their accountant providing a certificate confirming their status as a 'sophisticated investor'. It may give access to investments normally reserved for the wholesale market, especially unlisted bonds. There are many long term annuities or inflation-linked bonds available which are useful for retirement planning.

A couple of months ago, I wanted to invest through my SMSF in a Social Benefit Bond issued by The Benevolent Society. The lead managers were Westpac and CBA. Although I have a large SMSF, after much time and exchange of emails, I received this reply from Westpac:

"There have been some on-going internal discussions with our Legal and Compliance areas around what constitutes a sophisticated investor from an SMSF perspective and I just wanted to update you on how this has played out.

We have been advised yesterday that for the Social Benefit Bond, any Investment via a SMSF must actually meet the Professional Investor test as follows:

*"a regulated superannuation fund, an approved deposit fund, a pooled superannuation trust, or a public sector superannuation scheme within the meaning of the Superannuation Industry (Supervision) Act 1993 if the fund, trust or scheme has net assets of **at least AUD 10 million**"*

This is a change from our previous understanding where an SMSF with more than $2.5m in net assets would satisfy the test.

Can you please advise if this change will affect your requirement to invest in your Super Fund?

If so, is there another name you could possibly look at investing in (Company or Personal) where you do obviously meet the $2.5m net asset test that your Accountant can sign off on?"

I wrote this reply to Westpac:

"I realise you are only following legal instructions, but I believe Westpac is way out of market with this interpretation. Not only have I been investing and working in markets for about 35 years, and now write a financial newsletter, but I have a large SMSF with about $X million in assets. As trustee of my SMSF, I deal with many brokers based on the $2.5 million threshold, as signed by my accountant. I buy 'wholesale' bonds not intended for retail distribution.

How many SMSFs do you think have over $10 million of assets? You are ruling out a major market. I only want to hold this investment in my SMSF so it is not relevant what my other assets are …. I guess you can cancel my order."

Westpac replied as follows:

"I fully understand your commentary below and before contacting you, I had specifically put your case forward for an exception to the ruling (having researched your experience etc). However, it has been decided that there will be no exceptions in regard to this particular SMSF ruling.

I believe the CBA at this point in time will be taking a similar stance.

Over the next few days I will monitor if there are any AFSL Holders that will be putting a "group" bid for clients in under their name and this may provide me with the ability to refer you through to a different contact to access the Bond.

Obviously I am disappointed with this outcome and that we are not able to assist you."

I then contacted the other lead manager, CBA, and Westpac was correct. CBA would also not sell to an SMSF with less than $10 million in assets. But I could invest in my own name.

What's happening? Other fixed interest brokers accept the SMSF of which I am a trustee as a sophisticated investor. This is a recent reminder notice from one of my brokers, which allows my SMSF to invest:

"Your Accountant Certificate classifying you as a Sophisticated Investor will expire shortly. Accountant Certificates are only valid for up to two years after they were issued. By providing an additional Accountant Certificate we can ensure that you continue to be classified as a

Sophisticated Investor under 708(8) of the Corporations Act 2011, and as such are able to trade Wholesale bonds.

Updating your Sophisticated Client classification ensures that we can continue to provide you with a more comprehensive and diversified portfolio of fixed income investment services and research than what we can make available to Retail Clients.

To retain your Sophisticated Investor status for a further two years please arrange for the enclosed Accountant Certificate to be completed and certified by your Qualified Accountant."

Why is there doubt about such an important issue? SMSFs are one-third of superannuation, with a million trustees holding $500 billion, yet both CBA and Westpac say they must have over $10 million to invest in the wholesale market.

What's going on? Andrew Bloore explains.

In accordance with section 708 (11) of the Corporations Act, the SMSF itself can be a wholesale or sophisticated investor only where its assets are greater than $10 million.

So how can a SMSF utilise the wholesale or sophisticated investor rule?

One of the benefits of the SIS Act for an SMSF is section 58. This section allows a member of an SMSF to direct the trustees on the investments it can make. Outside of the trustee not allowing the investment because it breaches another provision of the SIS Act or another Act, the trustee must make that investment.

If the individual member meets the sophisticated investor or individual wealth rule, in my opinion, that member can direct the trustee of the SMSF to make the investment.

Therefore provided that the individual's accountant, AFSL holder or other person that is allowable under the Act who is able and familiar with the client's full position, signs the declaration and that individual member meets the criteria, then by utilising section 58, the individual can direct the trustee to make the investments.

What are the key tests for meeting the standards?

Test 1: Product value

Product value applies if the product being invested in or advised on has a value exceeding $500,000. This does not apply in relation to risk-based products (such as life insurance) or to the extent that investment funds are sourced from a superannuation fund.

If a person meets this test in relation to a product then they can be treated as a wholesale client in relation to that product for as long as they hold it.

Test 2: Individual wealth

This test requires a person to have net assets of at least $2.5 million or gross income for each of the last two financial years of at least $250,000, as certified by an accountant. The certificate lasts for two years before requiring renewal.

In determining the net assets or gross income of a person, the net assets or gross income of any entity controlled by that person can be included. The general rule is the SMSF assets are excluded unless the assets are segregated to the member being tested.

Test 3: Professional investors

This category includes a range of investors with one of the following specific attributes:

- an AFSL holder
- a body regulated by APRA, other than a trustee of a superannuation product
- a body registered under the Financial Corporations Act 1974
- a trustee of a superannuation product with more than $10 million in assets
- a person having or controlling more than $10 million in gross assets (including moneys held by an associate or on trust)
- a listed entity and its related body corporates
- an exempt public authority
- a person who carries on an investment business that is offered to the public or
- a foreign entity that would meet one of these requirements had it been established in Australia.

This only applies to large superannuation funds and not the overwhelming majority of SMSFs.

Test 4: Sophisticated investor

This category includes persons who the AFSL holder has determined to be experienced in using financial services. The test consists of five elements which can be summarised as follows:

- the product is not general insurance, a superannuation or an RSA product
- the product or financial service is not used in connection with a business
- the client signs a written acknowledgement in relation to certain matters.

Make your own enquiries

Legal departments within major financial institutions are making different determinations. Some are imposing the $10 million minimum on the SMSF itself, while others are accepting the qualification of the SMSF member. While this goes on, some bond dealers are developing their unlisted bond distribution, while others wring their hands in frustration. Given the industry uncertainty, every person affected should take their own personal advice.

A footnote from Graham Hand

When my accountant gives me the certificate is respect of sophisticated/wholesale/professional status, he does it based on the assets of my super fund. And the brokers I use to access wholesale bonds accept this. So who knows what’s going on!

Andrew Bloore is Chief Executive Officer at SuperIQ.

The Australian-based gas exporters

Roger Montgomery

There are seven Australian based Liquid Natural Gas (LNG) projects coming on stream over the next five years, which have a combined capacity of 83.2 billion cubic metres (bcm) and account for around 60% of the 138 bcm under construction worldwide. These are:

Project	Million Metric Tonnes	Billion Cubic Metres	Number of trains	Major owners	Expected to commence
Queensland Curtis CSG to LNG	8.5	11.6	2	BG, CNOOC, Tokyo Gas	2014/2015
Gorgon LNG	15.6	20.4	3	Chevron, Shell, Exxon Mobil	2015/2016
Gladstone CSG to LNG	7.8	10.6	2	Santos, Petronas, Total, Kogas	2015/2016
Australia Pacific CSG to LNG	9.0	12.2	2	Conoco Phillips, Origin, Sinopec	2015/2016
Wheatstone	8.9	12.1	2	Chevron, Apache, KUFPEC, Shell	2016/2017
Prelude Floating	3.6	4.9	1	Shell, Inpex, Kogas, PCP	2017
Ichthys	8.4	11.4	2	Inpex, Total	2017/2018
TOTAL	61.8	83.2			

The current crop of LNG projects under construction represents a combined $188 billion in investment. Aggregate revenue from LNG is expected to increase five fold over the next five years to at least $60 billion per annum.

Australian LNG projects are now costing close to US$1,500/tonne of capacity, compared to US$200/tonne in the year 2000 and US$600-$900/tonne in the US. Unless the industry cost structure changes and productivity improves, there are unlikely to be any new offshore 'green fields' LNG projects, except for floating LNG facilities.

Floating LNG facilities are a new technology, and are expected to drive 35% to 50% 'life of field' cost savings. These are to be introduced at Shell's 3.6 million tonne per annum (mtpa) Prelude field and Petronas' 1.2 mtpa Kanowit, Malaysian field from 2016-17.

There are no platforms, pipelines, shore-based liquefaction and storage facilities, roads, jetties or dredging requirements.

As the floating LNG technology expands over the long term to service the 140 trillion cubic feet of Australian stranded gas (according to CSIRO), it is likely the Australian resource service companies will be somewhat bypassed for the massive Korean builders and their sub-contractors.

That's fewer jobs for Australians. The Australian government, however, should do well from the additional tax revenue it will receive from Australia's vastly expanding LNG exports.

Japan is now the world's largest LNG buyer, with its gas demand boosted by nearly 25% after shutdown of all nuclear power generating capacity after the Fukushima nuclear disaster in March 2011.

While Australia has benefited, Japan is about to sign with three LNG handling terminals in the US to start shale exports of almost 20 mtpa from 2017. This means the US, traditionally an energy importer, will soon become a competitor in the export LNG market. For context, Japan and South Korea combined import 120 mtpa.

The Japanese are trying to change the pricing model for LNG. Rather than being linked to the oil price index, they instead want it based partly on the US domestic gas price, as measured by the so-called Henry Hub price. This has fallen to multi year lows at around US$3.50 per MBtu as the US shale gas boom has opened up vast reserves of LNG. Even adding the cost of liquefaction, shipping and regasification, the US landed price could potentially arrive at a significant discount to the current Japanese import price.

So what is the Henry Hub price? The Henry Hub itself is located in Louisiana, near the US Gulf Coast, and is the site where a number of major interstate gas pipelines converge and large storage facilities are close at hand. It is a major trading point for the physical delivery of gas and the major marker price for North American gas.

The Henry Hub price is the major reference for the NYMEX gas futures market. BP Singapore is currently negotiating to supply a Japanese customer at a gas price linked to the Henry Hub price, even though the gas may not be supplied from the USA.

Asian LNG buyers are naturally encouraging greater supply from the US, Canada and Russia. Australian producers, which currently sell 70% of their LNG exports to Japan, will be watching this space with interest. As will Australian resource investors.

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

How does a retail investor access stocks before listing?

Caveat Emptor

Question from David Endean

This Caveat Emptor feature is a great new addition to Cuffelinks.

How does a small retail investor get access to new stocks before they are listed on the Stock Exchange. They invariably seem to be sold to the institutions before they are listed?

Response from Roger Montgomery

At the primary schools in Sydney, every kid gets a prize and nobody misses out. At birthday parties, pass the parcel no longer has a toy at the end with one winner taking all. Today pass the parcel has a prize under each layer and the ever-watchful parents all contribute to when the music stops so that every child wins.

This is not the real world and even fund managers feel it as acutely as you.

Those that pay the most brokerage to the underwriting broker or lead manager get first choice. Upon reflection that seems entirely reasonable. The investment bank is working for the company being listed, spun out or raising capital and the company wants to see the funds raised as efficiently as possible. It means that a few participate - those who are willing to take risk in size and with some time-limited information - but many do not.

That doesn't mean however you will miss out as the factors that cause temporary disconnects between fundamentals and prices in the secondary market will also work on new companies after they list. As the spotlight of the IPO fades and the humdrum of running a business returns, investors can easily become impatient, pushing prices below their issue price or below an estimate of intrinsic value.

If your strategy is to buy high quality companies cheaply - that's our approach - there will always be opportunities to profit even if you miss the new listing on the ground floor you may still be able to take advantage of the market's bi-polar tendency and enter on level 1 or 2.

Comment from Graham Hand

The ASX has promised a paper on its BookBuild feature in early 2014.

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