Cuffelinks
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How long are you really likely to live?

David Williams

Longevity is among the most predictable of the major change agents affecting developed societies. Yet ignorance, perhaps a sense of complacency plus a reluctance to engage on a personal basis inhibit a holistic approach to dealing with this challenge – and its opportunities.

Life expectancies continue to increase more than forecast, but this is not new. The table below shows that longevity increases have been taking place for over two centuries in developed countries. Numbers from 1906 onwards are for Australia.

By when	What impacted on longevity?	Baby life expectancy (average in years)
Pre 1800	Very little	35
1906	Reduced infections, disease transmission etc.	57
2001	Antibiotics and a focus on personal systemic problems (cancers, heart disease, strokes etc.)	80
2011	Continuing medical advances	82
2100	Focus on brain?	Over 100? 120?

The increase over the last ten years suggests we still have some way to go. The last century saw a focus on helping babies survive early years, followed by the development of antibiotics and then progressively attacking mid-life problems, including the consequences of smoking. The century ended with an

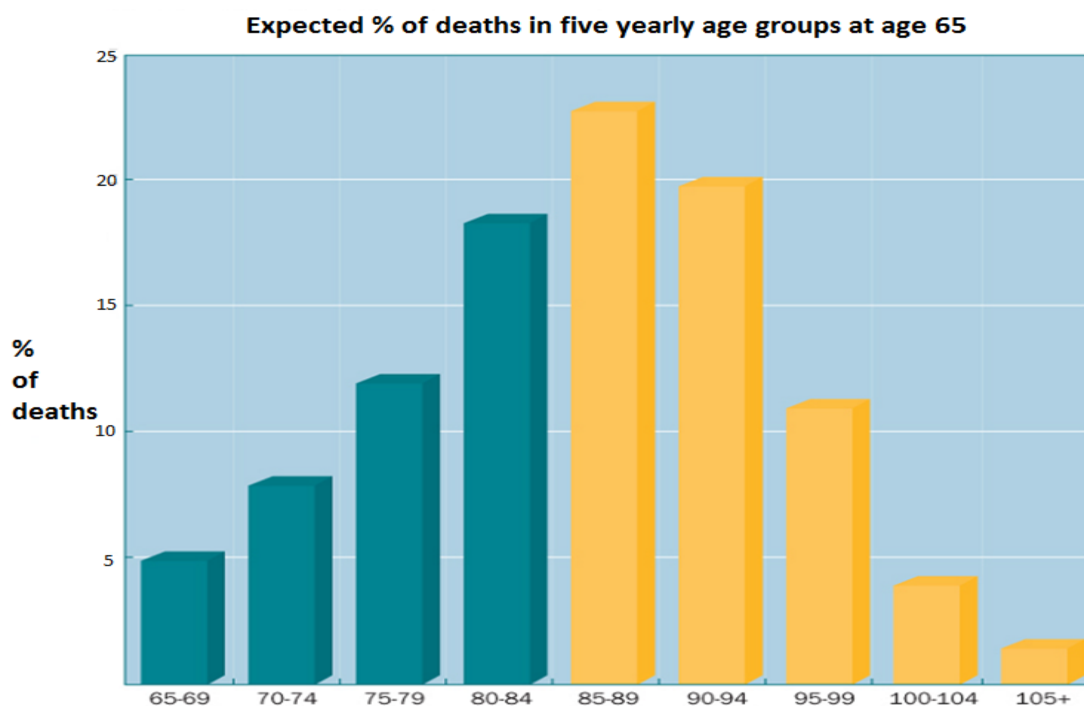
increasing ability to intervene in older age challenges, including mobility and support for independence. Success with DNA mapping underpins growing confidence in earlier diagnosis and treatment of illnesses.

The next big challenges will come from the brain. Building on remarkable developments over the past ten years or so, success in dealing with brain decline will make projections of life expectancy even more challenging. Could baby life expectancy reach 120 or more by the turn of this century? Too early to say but the straws in the wind are blowing that way.

What about you?

Understanding about the community at large is important, but what about you? In an increasingly complex world, is there any way you can plot your personal path with enough confidence to commit to your planning decisions?

The following graph shows death rates in five-year intervals for a person aged 65 as predicted by the Australian life tables. For example, about 5% of 65-year-olds are expected to die before they reach the age of 69, while over 10% are expected to die between the ages of 95 and 99 and about 5% over 100.



Source: Australian Life Tables

Just over 20% of 65-year-olds are expected to die in the five-year group containing the average, which means nearly 80% won't. So for the majority, the life tables are not really helpful. We need to do better than this to give people more information about their own longevity.

The 1980's saw the start of longitudinal studies looking to answer why some people live longer than others (and many other things about longevity). These studies follow the same people over many years. By the early 2000's they were revealing much more about who died, who survived and what made the difference. Using this data in conjuction with the life tables can help individuals to position their own lifespan better within their age group.

As well as giving a sense of personal lifespan, this work helps to reveal why a person may be different from average. People can now make better informed decisions about what they might do to influence their own remaining time frame. It's also becoming clear that the factors that influence longevity are also likely to influence quality of life.

People can already better understand and take more control over their remaining lives. The website at www.mylongevity.com.au has a free life expectancy calculator which helps people in taking this step. While there's a long way to go, we can now begin to answer 'what about me?'

Where is this leading us?

At the personal level, knowing more about your personal longevity has exciting implications for financial, medical and even career advice. Understanding your possible personal time frame invites stronger commitment to decisions about finance (how much money might you really need), health (you can target the things you need to live both well and longer) and career (how long will you seek to maintain the value of your capabilities and experience). Personal time frame considerations underpin all these dialogues.

At the community level, greater longevity awareness provides a context for dealing with the challenges an increasingly older community is creating. Increasing longevity is already changing Australian society. Greater personal longevity awareness will enable us collectively and individually to stay ahead of (and change the rules of) the game.

David Williams began longevity research in 1986 and was a Director with RetireInvest and CEO of Bridges. He chaired the Standards Australia Committee on Personal Financial Planning. David founded My Longevity Pty Limited in 2008, and his free website at www.mylongevity.com.au has provided more than 65,000 personal profiles online.

Age pension reform and its consequences for financial plans

David Bell

The Federal Government appears determined to reduce the budget deficit, and the age pension is one of many potential targets. Although pension reform would be highly unpopular with many voters, some sort of reform over the next 5 to 10 years is likely. This article outlines the issues at a high level and poses an important question for financial planners and those designing the default strategies for super funds.

Is the age pension fiscally sustainable?

The fiscal sustainability of the age pension system was explored in the Intergenerational Report (2010) in which Treasury calculations forecast that age pension expenditure will rise from 2.7% of GDP to 3.9% in 2050. This doesn't sound like a big difference but that 1.2% represents nearly $20 billion per annum in today's terms (Australia's GDP is currently around $1.6 trillion). The potential for variation in these types of forecasts is huge as many economic factors need to be estimated. This projection takes into account two offsetting factors: the higher proportion of elderly people qualifying for the age pension, countered by a more mature superannuation system.

In fact, current annual expenditure on the age pension is similar to the amount of estimated superannuation concessions (approximately $38 billion and $32 billion respectively in the 2012/13 budget). It is important that any policy review takes account of both retirement savings policy and age pension policy in combination.

Past reviews

Australia hasn't been short on financial reviews. Of the recent reviews which addressed the retirement savings and retirement income sector ('Harmer' Pension Review (released 2009), 'Henry' Australia's Future Tax System Review (2009), and 'Cooper' Super System Review (2010)), only the Harmer Review looked at the age pension in-depth. None of the reviews looked at the combination of retirement income

policies (super, drawdowns and age pension), meaning that none have considered retirement income policies from a lifecycle perspective.

The Henry Review looked at post-retirement income policies excluding the age pension. The Cooper Review looked predominantly at superannuation but highlighted the need for a whole of life focus from superannuation funds. The Harmer Review considered the age pension in detail under the principles of supporting a basic acceptable standard of living, being equitable across the population, targeting those who cannot support themselves, promoting workforce participation and self-provision, and a system which is sustainable.

The upcoming 'Murray' Financial System Inquiry may also consider retirement incomes policy.

Possible areas of reform

The obvious candidates for reform include:

- age pension amount
- indexing approach – the age pension is indexed on a triple-referencing basis against the greater of wage growth, inflation and a pensioner's inflation measure. The referencing to wages (likely to be the fastest growing reference) represents a view in the Harmer Review to preserve a pensioner's standing in society rather than a strict poverty aversion focus
- age eligibility, particularly given increasing life expectancy
- means testing (assets) – the current assets test which excludes the family residence
- means testing (income) – while income means testing affects the size of age pension payments, the design of the income means test also impacts the incentives people have to work in retirement
- form of retirement income – there has been debate about favouring income sourced from longevity risk hedging products such as life annuities when performing the age pension income means test, or making such products compulsory for a portion of one's retirement savings.

The impact on financial plans

Any changes to the age pension will impact the outcomes of millions of Australians. It would also affect the advice provided by financial planners and the design of default options of superannuation funds. While a financial plan is personalised taking into account the situation of the individual, a default option is more like a mass financial plan for a large collection of people with different characteristics, each of whom the super fund knows little about. Both groups need to use the same toolkit.

The possibility of age pension reform should be reflected in the design of a financial plan or a default option. In designing a plan, we acknowledge that it is best practice to consider the range of possible outcomes from many important factors such as markets returns, mortality outcomes (including idiosyncratic and systemic effects), inflation, savings levels and real wage growth. We know we should consider different outcomes for these factors and assess whether the projected outcome is acceptable. The better practice groups go to great lengths to model different potential scenarios.

Hopefully the outcomes of a designed plan are robust to variability in these factors. The age pension structure itself should be one factor considered as part of this robustness test, especially when these plans often cover 30 years or more. The test could consider different age pension scenarios and assess what retirement financial outcomes would look like. It makes for a better, more robust design.

For many the age pension will be a major component of their retirement financial outcome, so if we model the variability in all these other factors but assume the age pension remains constant, aren't we potentially ignoring the elephant in the room?

David Bell's independent advisory business is St Davids Rd Advisory. In July 2014, David will cease consulting and become the Chief Investment Officer at AUSCOAL Super. He is also working towards a PhD at University of NSW.

Face up to aged care changes now or face higher costs

Alex Denham

In March 2013, I wrote an article for Cuffelinks called 'Facing the daunting prospect of residential aged care' in which I summarised the complex fees and charges involved in moving to aged care accommodation.

It is timely to revisit this topic as major reforms to the aged care system are set to kick in on 1 July 2014. The financing arrangements have been revised, and will affect those who enter residential aged care on or after this date. Those who enter before that date will continue under their existing arrangements.

There is no point reproducing the new rules here - that would make for a very complex and tedious read. Instead, I will list the key points to give you enough to decide whether it's time to get advice if a family member is close to requiring residential aged care.

- There will no longer be 'low level care' or 'high level care', there will only be one type of approval for residential aged care with all post 1 July 2014 residents subject to the same fee structure.
- The basic daily care fee remains unchanged from the current rules.
- The Accommodation Bond and Accommodation Charge will be replaced by an 'Accommodation Payment' which will be determined by a resident's assessable income AND assets. The Accommodation Payment will be able to be paid as a refundable accommodation deposit (RAD), a daily accommodation payment (DAP) or a combination of both.

- Facilities will be required to publish accommodation prices. Currently, the accommodation bond is, in theory, negotiated with the facility. In practice, there isn't a lot of room for negotiation, as most facilities have a set bond that they charge. They just don't have to publish it.
- The 'Income-Tested Fee' will be replaced by the 'Means-Tested Care Fee' which will be determined by a resident's assessable income and assets.

- Those on the full rate age pension will not pay a means-tested care fee.
- The means-tested care fee will have an annual indexed cap of $25,000 and a lifetime indexed cap of $60,000 and cannot exceed the resident's cost of care.
- Both a resident's assets AND income will be used to determine their 'means-tested amount'. This is calculated by working out an asset-tested amount and an income-tested amount and adding them together.
- The income-tested amount will be calculated in a similar way to the current income-tested fee.

- The asset-tested amount will be calculated as a percentage of assessable assets at increasing thresholds:

    - 17.5% of assets between $40,500 and $144,500
    - 1% of assets between $144,501 and $353,500
    - 2% of assets above $353,500

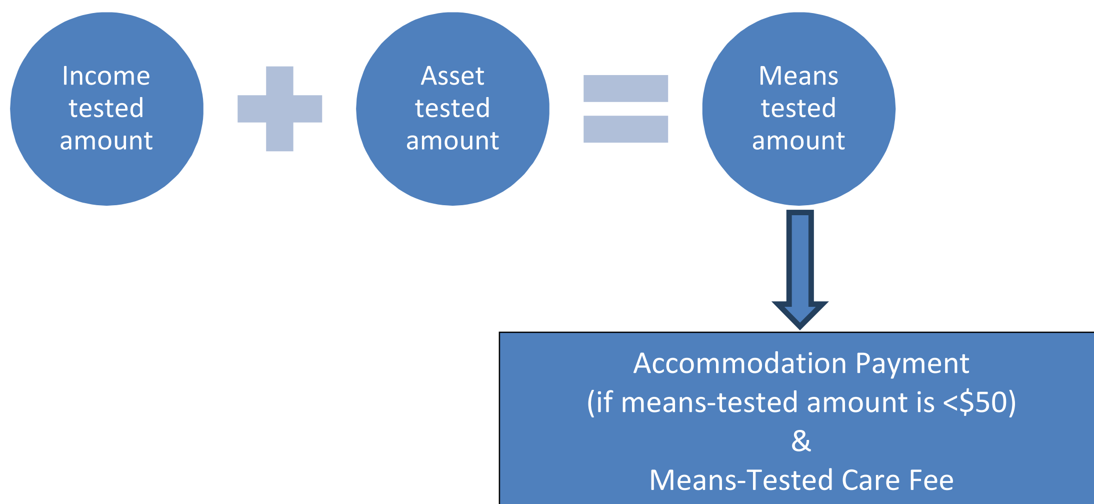
- In calculating the asset-tested amount', the former home up to a cap of $144,500 will be assessed as an asset if unoccupied by a spouse (or relative in some circumstances).

    - if a person's only asset is their unoccupied house, their asset-tested amount would be 17.5% x ($144,500 – $40,500) = $18,200.
    - divide that by 364 and you get $50.

- Whilst accommodation deposit amounts are published by the facility, if the means-tested amount comes to less than $50, the accommodation payment is subject to a maximum. If the means-tested amount comes to $50 or more, the accommodation payment is the published amount.

  This is a confusing but important point. The outcome is that those entering care from 1 July 2014 could be hit with higher accommodation costs than if they entered under the current rules.

- The means-tested amount will determine how much a resident pays for both their accommodation payment and their means-tested care fee.



If you followed any of that, you are doing well. As I said in the beginning, I'm reluctant to go into any more details as it requires a lot of numbers and will be a tough read.

The upshot from all this is:

1. If a family member needs to go to residential aged care this year, it is worthwhile getting advice to determine if they will be better off (financially) going in under the current rules prior to 1 July 2014. Of course, this isn't just a financial decision, but in many cases ingoing residents will pay higher costs under the new rules.

2. The decision whether to keep the family home or sell it has always been a difficult one. In terms of the new means-tested care fee, the scales are tilted towards keeping it. This is because only a portion of it is assessed ($144,500) as an asset as opposed to all of the proceeds if it is sold.

3. I haven't decided if these rules are more complex than the current ones. They seem to be, but that could just be because I'm not familiar with them yet. What I do know is that costs will be higher for those with 'greater means'.

4. Getting advice will make a real difference to the outcome. An adviser experienced in aged care matters can determine investment strategies that give the best outcome in terms of fees, structuring the accommodation payment to optimise Centrelink and DVA benefits, and investment of funds.

5. Give yourself plenty of time if you want to make the move prior to 1 July 2014. Now is the time to act as it can take time to get assessed, find a place, sell your home, get advice and move in.

This is general advice only and does not take into account your financial circumstances, needs and objectives. Before making any decision based on any information posted, you should assess your own circumstances or seek advice from a financial planner and seek tax advice from a registered tax agent. Information is current at the date of issue and may change.

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Equity income investors should focus on reinvestment rates

Matt Olsen

I wish I had a US dollar for every time an Australian equities fund manager has said to me in the last two years, "With earnings growth hard to come by, investors are focusing on yield."

Should income investors focus exclusively on dividend yield? Or is this missing the forest for the trees? How should value investing fit into the income investor's process?

Pre-retirement, an investor may want income strategies to form a defensive part of their portfolio, with the income generated complementing other growth or higher risk strategies in their portfolio.

Post-retirement, there is an array of needs. The income investor may seek to preserve the longer term purchasing power of their income. Growth in that income, and if possible the underlying capital, would still be a priority. Somebody who is deeper into retirement might be less concerned with income or capital growth, wanting just income to live on.

On top of this is the legacy factor. Some retirees set a high priority to 'leave their portfolio behind' for a dependent spouse or other family members, or they may have a charitable goal. In these cases, growth is still a priority.

The characteristics of an ideal income stock

In an ideal world, an income stock would provide all of the following characteristics:

- a high dividend yield
- a dividend yield that increases over time
- preservation of capital
- low risk of large drawdowns (decline in value), to avoid sequencing risk
- favourable tax characteristics, full franking if possible
- a high level of liquidity.

The reality is often far different from the ideal. The best future income-producing businesses may have stock which is overvalued, and hence trading on a fairly low dividend yield. In volatile market environments, stable, safe and high quality businesses may also trade at a premium.

Various academics have suggested that dividend yield is a sustainable market anomaly, in addition to more traditionally recognised factors such as value, size and momentum. Whilst this claim is a matter for

continuing debate, perhaps we should think of dividend yield as a hybrid market factor, capturing the value risk premium, but adding another dynamic – the ability of the business to produce free cash flow and hence pay out ready income.

A higher payout ratio may in fact reduce the intrinsic value of a business, particularly if that business has the opportunity to reinvest those funds at high rates of return (as explained in James E Walter's, '*Dividend Policies and Common Stock Prices'*, Journal of Finance, 1956).

Despite this fact, Elroy Dimson, Paul Marsh and Mike Staunton, from the London Business School published a study spanning the years 1900 to 2010 on the returns shown by the lowest to highest yielding markets over time. The results showed a near linear relationship between yield and return, with positive correlation. That is, the higher yielding markets did the best. In their book '*Triumph of the Optimists'*, they stated that the real reason for the superior performance of stocks over other asset classes was the reinvestment of dividends.

But this doesn't help many income investors. Don't they want to spend the dividends?

Focus on stocks with high rates of reinvestment

I suggest that rather than focusing on high initial yields, there is a far more important driver for income investors and early stage retirees with maybe 20 years or more left in retirement: <u>stocks with high rates of reinvestment.</u> Whilst the income investor is not reinvesting the dividend, the underlying business, if doing a good job, is continually growing its capital base by reinvesting retained profits, enabling dividend growth over time.

Presumably, the wish list item of capital growth would be satisfied as long as the market recognises the growth in book value by increasing share prices over time. History has shown that the market usually does reward book value growth.

So what are some of the key things to look for in a stock that will give these high rates of reinvestment?

Firstly, look at the most recent and 5-year average Return on Assets (ROA). A ROA higher than 15% is good. I prefer to filter on ROA rather than Return on Equity (ROE), as it captures leverage on the balance sheet and thus penalises highly geared businesses. Then, obviously, you need to make a call on whether that ROA can be achieved going forward.

To assess the reinvestment rate, you can apply the following simple formula:

% of profits reinvested = 100% - (dividend yield% x PE ratio)

Whilst these stocks with high reinvestment rates will most likely have a low current dividend yield, their ability to compound book value and grow dividends over time might mean a higher average yield over 10 or 20 years than current high dividend yield stocks.

A great example of this was nine years ago, comparing the yield on CSL with Telstra. CSL was trading at around $5.95 per share after adjusting for subsequent stock splits, and its yield was quite low, 2% or less. However if you still owned that stock today, the last two half-year dividends delivered a yield of around 19.4% on that $5.95 initial purchase price. The dividends have grown so much that it is now an extremely high income producer on that initial price. The simple average of these two yields is 10.7% over the period. CSL's share price has also gone from $5.95 to $67.55 as I write. The capital investment has multiplied itself 11 times.

In contrast, Telstra at the time was trading around $5.00 on a high yield, and while it is still on a good but lower yield, it has experienced little capital growth, currently trading at $5.19.

Telstra has had minimal reinvestment, due to a high payout ratio, whilst CSL has reinvested substantially in its long term growth. Perhaps CSL was a much better 'income stock' (if there is such a thing) than the traditional yield play of Telstra, particularly for the retiree with a long retirement ahead of them. Capital gains could have been harvested along the way also, supplementing that lower initial yield.

Valuation is always important

The other obvious fundamental piece of analysis is to determine whether the stock is initially trading at a valuation discount. If so, this discount should further augment the positive effects of reinvestment and the initial yield. If the stock is currently trading at a premium (which I believe is the case for many such quality stocks at present), then your total rate of return over a 10 year period will be slightly lower if valuations normalise. For investors with a very long holding period, and long retirement ahead of them, this might not be as crucial as it would be to the investor with a much shorter time horizon. A high valuation would however create increased drawdown risk.

So to summarise, the key sources of equity income are:

- the initial yield
- the future growth in dividends, caused by a business retaining profits and reinvesting
- capital gains that may be harvested as quasi income
- franking credits, particularly for the low tax rate investor
- your initial purchase price relative to intrinsic value, as a discount will likely augment total return while a premium will likely reduce it.

Equity income can also be generated by fund managers that employ option writing strategies, but these are complex and require almost a lifetime of experience in options markets to implement successfully. For retail investors who like to participate in the benefits of compounding reinvestment in a quality business, a buy and hold approach is an appropriate investment style.

One final point to note is that the income investor should seek other diversified sources of income which have low correlations to equity market beta. Examples of this might be equity market-neutral funds, or market-neutral absolute return fixed income products.

Matt Olsen is Head of Research at Select Investment Partners.

More SMSF myths debunked

Andrew Gale

Last week, I outlined 'Four Big Fat Myths of Superannuation': three relating to the superannuation system overall, and one relating to SMSFs in particular.

In this article, I consider five other SMSF myths. In dispelling these, I offer a health warning: I rely on the most recent detailed public domain data, the ATO's "*Self-managed super funds: A statistical overview 2011–12*" (released December 16, 2013). The excellent data on SMSFs such as done by Investment Trends and CoreData are normally available in detail only by purchasing their reports. There is strong consistency in the results of these various factual sources of information.

SMSF Myth #1: There are too many small and sub-scale SMSFs

There are exaggerated claims regarding a preponderance of SMSFs which are too small. Based on the Investment Trends April 2013 SMSF Investor Report, around 80% of SMSFs had assets in excess of $250,000, and ATO statistics as at June 2012 show similar results. Some funds below $250,000 may be in the early growth stage, and anticipating prospective significant concessional or non-concessional contributions. That said, there is a small portion of SMSFs for which size and viability should be questioned.

SMSF Myth #2: SMSFs are expensive

In the 12 months to 30 June 2012, ATO figures show the operating expense ratios of SMSFs at about 0.56%, falling from 0.69% over the five years to 2012. These expenses generally do not include advice fees or the cost of investments, which are usually relatively low given the high portion of direct investments in SMSFs.

With the subsequent growth in asset values of SMSF investments, and the fixed operating costs of SMSFs which are subject to competitive pressures, this operating expense ratio has likely reduced further since June 2012. Due to the fixed costs of operating a fund, SMSFs with low balances will have higher average expense ratios.

SMSF Myth #3: SMSFs don't make a meaningful contribution to the nation's long term capital

Based on the Investment Trends report, around 50% of SMSFs are invested directly in Australian shares, listed investment companies (LICs) and Real Estate Investment Trusts (REITs). These are all investment vehicles for the provision of long term capital to fund commercial enterprises and the nation's future prosperity. They are also investments in a suitably liquid form. Investment in illiquid infrastructure investments would often be inappropriate, unless SMSF investors consciously 'sign up' for limited liquidity, whilst investments in listed infrastructure assets would be sound.

SMSF Myth #4: SMSFs have loose regulation and compliance

SMSF prudential oversight and compliance are often criticised, leading to claims SMSFs should come in under a single superannuation regulator (and by implication, APRA prudential regulatory provisions). A recent example was a survey conducted at the 2013 ASFA Conference where roughly 75% of participants expressed the view that SMSFs should come under the umbrella of one superannuation regulator, presumably APRA. These survey results are not surprising given the vast majority of ASFA conference attendees are representatives of APRA-regulated funds.

The facts are that the SMSF sector is functioning well, as concluded by the Cooper Review, and the latest ATO statistics indicate the percentage of the SMSF population with auditor contravention reports (ACR) remains relatively stable at approximately 2% of all SMSFs each year. There's room for improvement, but such a low non-compliance rate doesn't accord with alarmist comments about the sector. Further, calls for a change in regulatory oversight do not recognise the fundamental difference between APRA-regulated funds, which are collective vehicles for many unassociated superannuation investors (thus requiring prudential supervision) versus SMSFs where the trustee is intimately involved. SMSFs have a very limited number of members, which are typically 'associated', with no 'collective' coverage and hence no need for the same prudential regulatory provisions.

SMSF Myth #5: APRA-regulated funds offer complete consumer protection while SMSFs don't, and hence SMSFs should be part of the super fund compensation scheme

Andrea Slattery, CEO of the SMSF Professionals Association of Australia (SPAA) said on 7 February 2014, "The guiding philosophy underpinning self-managed super is that trustees and members take responsibility for their own retirement income outcomes … (they) have to appreciate that decisions rest with them, although they can get advice, either directly or indirectly, from specialist SMSF advisors."

Andrea further said, " … any compensation scheme should only be part of a broader financial services scheme where clients have suffered financial losses because of the misconduct or insolvency of a provider of a product or service, and that the compensation should be funded by a levy imposed on that industry sector where the misconduct occurred."

APRA-regulated funds are entitled to compensation under the Superannuation Industry (Supervision) Act 1993 (SIS) Act but this is not automatic and is not a guarantee. It is at the Minister's discretion, and only where it is in the public's best interest to approve compensation for APRA-regulated funds.

SMSFs are not entitled to compensation under the SIS Act provisions, but are entitled to other legal avenues of redress in the event of fraud, theft, or inappropriate advice. These include but are not limited to personal indemnity schemes, actions under the Corporations law, and the Financial Ombudsman.

Consumer protection can be strengthened by tightening professional indemnity requirements, and strengthening compensation for misconduct or insolvency in managed investment schemes. Trustees of APRA-regulated public offer funds are responsible to a wide collective of their members, who need to be offered protection. SMSF trustees and members need to operate on self-responsibility.

Along with last week's myth, 'SMSF investments driving a property bubble', that makes a total of six SMSF myths. In a competitive industry, any sector with a million trustees and $500 billion in assets can expect such myths to be propagated.

Andrew Gale is co-owner and Executive Director at Chase Corporate Advisory and a board director for the SMSF Professionals Association of Australia (SPAA). The views expressed in this article are personal views and are not made on behalf of either Chase Corporate Advisory or SPAA.

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