Cuffelinks
Connecting investors with ideas

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Free booklet, William J. Bernstein's 'If You Can'

William J. Bernstein is an American investment adviser and financial theorist whose bestselling books include *The Birth of Plenty* and *A Splendid Exchange*. His most recent book, *Rational Expectations: Asset Allocation for Investing Adults*, was recently reviewed in The Economist. He is a principal in the money management firm Efficient Frontier Advisors, a frequent guest columnist for Morningstar, and is often quoted in *The Wall Street Journal*.

Bernstein has given permission for Cuffelinks to provide a complete copy of his 2014 booklet, *'If You Can: How Millennials Can Get Rich Slowly'*. It outlines his simple recipe for young people starting on an investing journey. It is linked here:

If You Can: How Millennials Can Get Rich Slowly

Copy this link or use the 'Share/Save' button above the article to forward to someone.

Bernstein's own introduction to the booklet is:

"For years I've thought about an eleemosynary project to help today's young people invest for retirement because, frankly, there's still hope for them, unlike for most of their Boomer parents. All they'll have to do is to put away 15% of their salaries into a low-cost target fund or a simple three-fund index allocation for 30 to 40 years. Which is pretty much the same as saying that if someone exercises and eats a lot less, he'll lose 30 pounds. Simple, but not easy … The booklet will take only an hour or two to read, it's not a complete solution. It's a roadmap, a pointer in the right direction."

Bernstein identifies five hurdles to overcome to retire successfully:

1. People spend too much money. If you can't save, you'll die poor
2. You need an adequate understanding of finance and markets
3. Don't ignore financial history
4. Know yourself. Your biggest enemy is yourself
5. Exercise care in dealing with the financial services industry.

A few notes for an Australian audience:

- Bernstein talks about retirement vehicles in the US called 401 (k) plans or IRAs (Individual Retirement Accounts). The equivalent in Australia is a person's superannuation fund account, into which concessional or non-concessional contributions can be made (subject to limits). However, if a young person is saving for a deposit on a house, they need to be aware of the lack of access to superannuation, and consider saving outside superannuation with different tax consequences.
- Bernstein identifies three different types of funds, but these apply for Americans. An Australian choosing the same funds would have a foreign exchange risk. Possible substitutes are:
  - An S&P/ASX200 index fund instead of a US total stock index fund
  - An Australian bond fund instead of a US total bond index fund
- An Australian investor could choose a unit trust, a Listed Investment Company or an ETF depending on their own preference or experience. Following Bernstein's paper, the third fund would be a global equity fund.

Some comments on Cuffelinks' perspective

As with all the articles we publish, we are sharing ideas and opinions, but it does not mean we agree with them. For example, Bernstein is a believer in using index funds and not investing directly or using a broker or a fund manager. While Cuffelinks accepts the merits of index funds, especially for novice investors who cannot identify good stocks or managers, we do not promote one method of investing over another. An investor who believes talented fund managers can be identified should back their judgement, and there is a place for the experienced investor to go direct.

However, we do think Bernstein offers a good introductory text and has many useful ideas worth sharing, including:

"If I had to summarize finance in one sentence, it would go something like this: if you want high returns, you're going to occasionally have to endure ferocious losses with equanimity, and if you want safety, you're going to have to endure low returns."

We welcome your opinion on Bernstein in our comments section.

This article and the attached booklet are general in nature and readers should seek their own professional advice before making any financial decisions.

Look beyond market leaders to diversify your portfolio

Anton Tagliaferro

SMSFs are the largest and fastest growing part of the superannuation sector in both number and asset size, accounting for almost one-third of total superannuation assets in Australia. The primary drivers for setting up an SMSF are the increased control and ability to make active investment decisions, so it is not surprising that a large proportion of investors in this sector do not seek professional investment advice.

Why is this important? According to APRA's 2013 Superannuation Bulletin and ATO's 2013 Statistical Report, SMSFs invest a far higher proportion of their assets in Australian equities than do large default investment strategies. The rise in domestic equities-heavy SMSF strategies may be a cause for concern and poses the question: *Are SMSF portfolios adequately diversified?*

Look beyond the mega caps

With investors gravitating towards household names, it is not surprising that the S&P/ASX 20 Index is one of the most widely held and researched indices in Australia.

Analysis by CBA shows that the top 20 stocks are held by approx 8.3 million individual shareholders compared to the broader S&P/ASX ex20 segment held by 5.7 million individual shareholders. This represents an average shareholder base per company of 417,000 across the top 20 stocks, some 20 times larger in volume than the shareholder base of the S&P/ASX ex20, at 21,000.

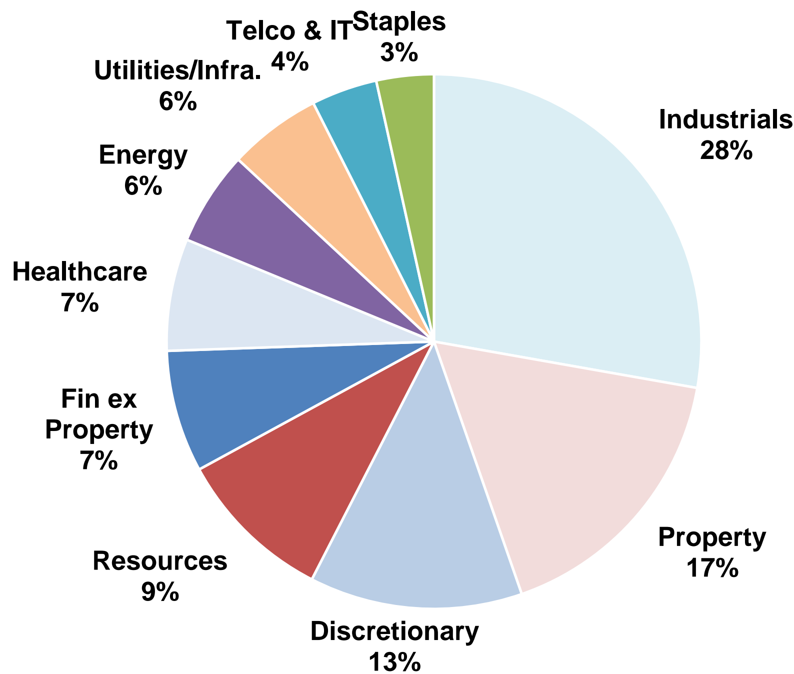
Consequently, direct investment activity is highly concentrated in nature with the top 20 'mega cap' entities listed on the ASX accounting for approximately two-thirds of the S&P/ASX 300 index. The top eight securities - CBA, BHP, WBC, ANZ, NAB, TLS, WES and WOW – cumulatively make up 50% of the S&P/ASX 300 index and the S&P/ASX 20 is heavily concentrated by industry sector, with 69% dominated by the financial and resources sectors as at 30 May 2014.

Code	Name	Market Cap ($bn)	Mkt Cap Weight of ASX300 (%)	Cum. %
CBA	Commonwealth Bank of Australia	132.3	9.6%	10%
BHP	BHP Billiton Limited	118.8	8.6%	18%
WBC	Westpac Banking Corporation	107.0	7.8%	26%
ANZ	ANZ Limited	91.9	6.7%	33%
NAB	National Australia Bank Limited	78.8	5.7%	38%
TLS	Telstra Corporation Limited	66.4	4.8%	43%
WES	Wesfarmers Limited	49.6	3.6%	47%
WOW	Woolworths Ltd	47.1	3.4%	50%
CSL	CSL Limited	34.2	2.5%	53%
WPL	Woodside Petroleum Ltd	26.3	1.9%	55%
RIO	Rio Tinto Limited	25.8	1.9%	57%
WDC	Westfield Group	20.8	1.5%	58%
MQG	Macquarie Group Limited	19.3	1.4%	59%
SUN	Suncorp Group Limited	17.2	1.2%	61%
ORG	Origin Energy Limited	16.6	1.2%	62%
AMP	AMP Limited	15.6	1.1%	63%
BXB	Brambles Limited	14.9	1.1%	64%
QBE	QBE Insurance Group Limited	14.2	1.0%	65%
STO	Santos Limited	14.0	1.0%	66%
IAG	Insurance Australia Group Limited	13.9	1.0%	67%
Ex-20		451.3	32.8%	100%
Total		1,376.1	100.0%	

It follows that many typical client portfolios, including SMSFs, would have high levels of concentration risk by being overly exposed to the financial and resources sectors through a handful of big name Australian companies.

Potential for future market leaders

In comparison, the S&P/ASX Ex20 offers more diverse entities in terms of market capitalisation and industry sectors, providing investors with a far greater breadth of investment opportunities. With the largest individual stock representing less than 3.0% of the Ex20 segment, a portfolio of securities outside the S&P/ASX 20 Index can provide an investor with valuable diversification to their direct holdings and provide some balance to the current concentration.



In addition, while Ex20 securities are not as widely held or researched as the top 20 securities, they can still be leaders in their field with competitive advantages over their peers and strong recurring and predictable earnings.

Diversification through quality Ex20 securities

Making a sound investment decision is about establishing if the company has the following four clear quality characteristics:

- a competitive advantage over its peers
- recurring, predictable earnings
- a capable management team
- the ability to grow over time.

A portfolio based on these key principles with a prudent investment style and a long-term focus can achieve consistent returns for its clients. Sonic Health Care is a good example of an Ex20 stock that fits the above criteria. With a market cap of $7.3 billion, it is one of the world's leading medical diagnostic companies, providing laboratory and radiology services to medical practitioners, hospitals, community health services, governments and industries. Sonic is the largest pathology player in Australia, Germany, Switzerland and Belgium as well as number three in the US. Listed since 1987, Sonic benefits from a long standing, very capable management team that differentiates themselves from competitors through a strong medical culture as well as superior service. Operating in an industry which favours scale players, Sonic is able to grow earnings through accretive acquisitions around the globe.

With many portfolios overly concentrated within the top 20 'blue chip' stocks, looking beyond this space provides investors with a key to diversification as well as enhanced growth opportunities for direct equity portfolios. By establishing a portfolio of high quality stocks with sound growth and dividend prospects outside of the top 20, an investor can complement their direct holdings, generating a diversification solution, and managing downside risk.

Anton Tagliaferro is the Investment Director of Investors Mutual Limited, a leading Australian value manager. He is also the Investment Manager for QV Equities Limited, a newly incorporated Listed Investment Company with a diversified portfolio of entities outside the S&P/ASX 20 Index. *This article is general in nature and readers should seek their own advice before making any financial decisions.*

Stock market winners versus losers

David Bell

There is no one single magic formula for successful stock picking. Here at Cuffelinks we have seen articles espousing many different ways of picking stocks, notable examples being to focus on value and quality. These ideas all have merit. In this article, I work through one example: the phenomena that winning stocks continue to outperform losing stocks, known as 'the perseverance of winners versus losers'. It sounds rather novel, simple and surely too good to be true …

The theory

In 1993 academics Narasimhan Jegadeesh and Sheridan Titman wrote what has become a well-known paper titled, *"Returns to buying winners and selling losers: implications for stock market efficiency"*. They found in the US stock market that buying the top performing stocks from the previous period (3 to 12 months) and selling short the bottom performing stocks from the same period resulted in significant outperformance over a holding period of 3 to 12 months.

For the academic world this caused a lot of kerfuffle as it threw a spanner in the works of those who proclaim that markets are perfectly efficient: how could such a simple look-back strategy perform so well?

Subsequent research demonstrated that the effect has worked internationally, and recent research suggests it continues to work today. Researchers have attempted to explain the perseverance of winners versus losers, some as a reward for taking on some risk loading and others as a behavioural phenomenon. The behavioural arguments sit better with me.

Applying winners versus losers to Australia

Does the strategy work in Australia? Cuffelinks isn't really the forum for academic research tests of such detail, so I produce a simplified analysis. For each of the last 10 financial years I run the following analysis:

- At the start of each financial year I go long an equally-weighted portfolio of the previous financial year's top 10 performing stocks on the ASX 200
- I also short an equally weighted portfolio of the previous financial year's worst 10 performing stocks on the ASX 200
- I hold this portfolio for the subsequent financial year (ie a 12 month holding period).

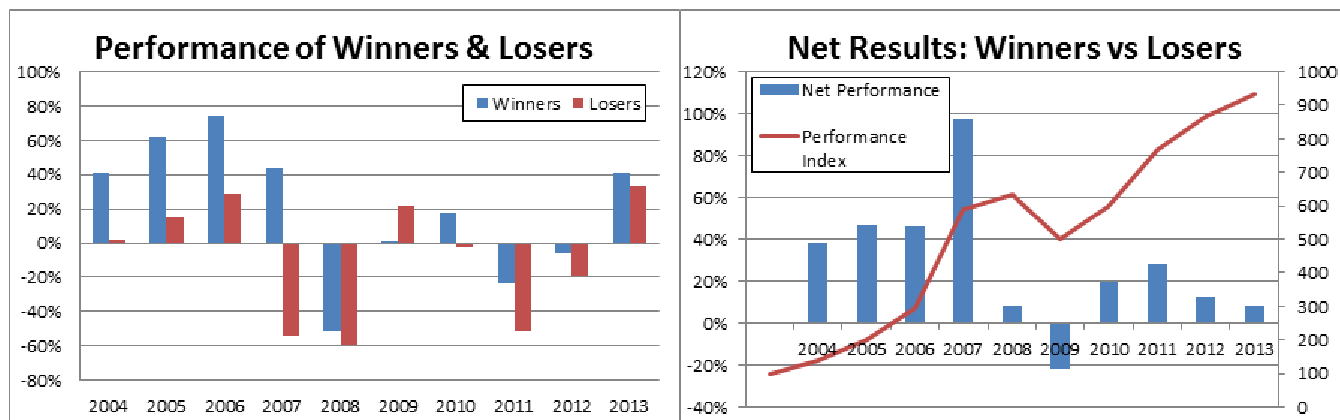
As an example, the table below lists stocks I would have held during the previous financial year (2013/2014), along with subsequent performance.

Long Portfolio			Short Portfolio		
Stock	Previous FY Performance	Subsequent FY Performance	Stock	Previous FY Performance	Subsequent FY Performance
SIR	3477%	74%	DML	-90%	-81%
MFG	371%	17%	BBG	-85%	276%
BSL	188%	16%	PRU	-82%	-5%
GEM	172%	93%	SDL	-80%	22%
FLT	115%	17%	GRY	-79%	23%
TPM	110%	59%	SAR	-79%	266%
IIN	109%	21%	SBM	-79%	-74%
REA	106%	57%	SLR	-79%	-14%
JBH	103%	13%	RMS	-77%	-30%
SRX	98%	42%	GBG	-73%	-53%
Total Long Portfolio Average Subsequent Performance		+ 41%	Total Short Portfolio Average Subsequent Performance		+ 33%

Data: Acadian Asset Management (Australia) Limited

Using the table above if I subtract my short performance (+33%) from my long performance (+41%) I end up with a total performance of 8%.

The last financial year has been one of the least impressive for this strategy but is still positive; looking back this quite simple strategy looks to have been highly successful. The charts below present the 10 year track record.



The left chart displays the subsequent performance for both winner and loser portfolios, while the right chart shows the annual net returns from going long winners and short losers, along with an index of compounded performance (starting at value 100). Positive performance is seen in those years that the winners on average outperform the losers, which is seen in all except one year. In 2007 the winners perform very strongly over the subsequent 12 months, and the losers continue to underperform leading to a very strong net result. However in 2009, the winners only marginally outperform, whereas the shorts hurt net performance with the rally in previous loser names as the market turned strongly positive in March 2009.

This strategy appears to have surprisingly good performance. The annualised performance would have been 25%, but the results are highly volatile (the standard deviation of annual returns was 32%). And though a rather naïve strategy, the results appear significant (see this Cuffelinks article for an explanation of a significant result). The strategy has no inherent market exposure as you are taking equal sized positions long and short. In fact you would earn some additional cash deposit returns in your portfolio (I won't bog you down with an explanation of why).

To be honest, 'strategy' is too generous a word to describe this simple analysis. It shows no concern for sector exposures nor does it rebalance stock positions or net market exposures throughout the year. There are also some practical limitations to implementing such a strategy. The main one is shorting, as it may prove difficult to achieve a short position in each loser stock. Someone needs to be happy to lend out their stock, thereby adding to the downward momentum in the stock price.

Nonetheless the strategy is interesting and can be used in benchmarked funds as well, where losers may not be held in the fund giving a benchmark underweight without requiring shorting. The winners versus losers phenomenon forms the basis on which the momentum signal, used by many global quantitative equity managers, is built.

Behavioural explanations

There are many explanations proposed for the perseverance of stock market winners versus losers. One explanation was the possibility of uninformed traders who simply follow the trend in prices. Another example suggests that investors switch from underperforming to outperforming funds and this creates a flow of capital that creates momentum. It is likely that there are many reasons that contribute to explaining the momentum phenomenon.

Takeout messages

Of course I am not recommending you go out and replicate this 'strategy' – I wouldn't myself. The point of my article is to illustrate that there are many different ways to pick stocks. Some are based on company analysis, some are technical, and some are behavioural. You need to pick out the approaches that you believe you can execute well and understand the strengths and weaknesses of your approach and the environments in which it will work and in which it may struggle.

David Bell is Chief Investment Officer at AUSCOAL Super. He is also working towards a PhD at University of NSW.

The great fee debate: resetting manager and investor expectations

Jonathan Rochford

The recent push by the SEC in the United States and ASIC in Australia for greater transparency on asset management fees has reignited the debate about what is fair and reasonable. Managers are cast as greedy and investors are portrayed as ungrateful and focussed more on fees than on total returns. The battlelines have shifted for some in Australia with the introduction of MySuper, which adds to the pressure to reduce the total fees paid by fund members. Having been on both sides at different times in my career, I believe I can comment on the reasonable expectations each side should have.

Factors in picking a manager

I'll first touch on three key factors when picking a manager: integrity, outperforming a relevant benchmark, and taking a small share of the outperformance.

The first point is often accepted as a given, but clients of Bernie Madoff found this assumption can be financially fatal. A portfolio can recover from underperformance of an unskilled and honest manager, but not from a complete capital loss. This applies equally when taking advice from accountants and financial planners who recommend products, with many pre-crisis timber schemes and mezzanine mortgage funds in Australia relying on extraordinary commissions to drum up sales.

The second criteria superficially appears simple. The trick comes when a manager compares itself to an irrelevant benchmark such as an investment grade bond index for an unrestricted bond fund or an overnight cash rate for an absolute return strategy. One recent study found that private equity earns around half its total performance from using leverage and from timing its entry and exit points (multiple expansion), thus muddying the comparison with a vanilla equity index. Some asset classes have much easier benchmarks to beat than others. For instance relatively few large cap managers materially outperform their index after fees yet almost all small cap managers do.

The last factor is where this debate really takes off. Once you've found an honest manager who you think is likely to outperform in the long term, how do you fairly reward that manager? What's the right split between the base management fee and the performance component?

I'll focus first on resetting manager expectations before moving on to investor expectations in Part 2 of this paper.

Resetting manager expectations

In my time acting as an institutional investor a number of things commonly frustrated me:

1. Where I thought the manager was being paid way too much to get out of bed, and then took a decent chunk of any outperformance as well. Why are managers entitled to be paid so much merely for fund raising not for raising the value of my capital?

2. Where I believed the manager was acting for their financial interest rather than giving investors a choice of what would best suit them. How can a manager pretend that something is unequivocally the best thing for me when they are clearly conflicted?

3. Where I didn't know what was happening with the investments and then faced stonewalling or hostility when I asked for information. Was the manager hiding something?

These situations and many conversations along the way shaped what I think about what managers should expect.

Managers are not entitled to a million dollar lifestyle until their clients are richly rewarded. If you can't beat a relevant index in the long term you are wasting an investor's time and money.

When I see managers charging 1% or more in management fees on multi-billion dollar portfolios I see that as excessive and unjustified. The cost of salaries for good people, decent systems and modest office space simply doesn't require it. Some managers seem to believe that being able to craft a nice story about their investment process including a pretty slide pack means that they are doing their job. For investors to benefit, managers need to be rewarded for performance not presentation.

Investors are entitled to 90% of the outperformance over the index

This one is partly economics and partly conscience. Having done the calculations before setting up an asset management business I believe a 90/10 split well-rewards managers who outperform. But it is also a matter of conscience and I note that many managers will see 80/20 or 70/30 as the fair split. For the vast majority of managers, they are easily replaceable with another manager of equivalent or better skill, including index managers. Even in bullish markets when there is much capital around looking for an investment home, the demand/supply balance ultimately rests with investors.

Fees should be easy to explain and transparent

The recent SEC reviews of US private equity managers has highlighted the chutzpah of many managers in charging underhanded fees and the indolence of many investors in allowing the situation to exist unchecked. Managers should be able to fully explain their fees in one page or less. A standard base and performance fee model should suit almost all manager/investor relationships, with the incentive then placed onto the manager to minimise their costs of doing business. Where a specific additional service is required, this should be subject to investor sign-off.

Investors are always entitled to know where their money is and why it has been invested

If a manager truly believes they have the recipe for a secret sauce and that revealing their positions will divulge the recipe, then that must be something everyone signs up to on day one. At least quarterly, managers should sit down with their investors and tell them where they see their sector positioned. I suspect many managers don't do this as they fear being exposed as not having anything meaningful to say, or that an honest conversation might result in their investors recognising that other sectors present better risk and return prospects.

Investors are entitled to know the risk and return prospects and be given a choice to change

Whether it is has come about by bad experience or is simply an irrational fear, many managers are not able to say to their clients that their sector is not offering great value at a particular time. I've recently attended a number of presentations where US high yield debt managers have put forward the thesis that other cycles have made further gains from this point so investors should remain invested for now.

Stripping away the hyperbole, their message could be rephrased "historically markets have become more overvalued then they are now so be greedy and squeeze the last few percent of gains out of this cycle." This is short term, self-serving advice. Managers should trust investors that if they offer to give some cash back now when prices are high, they'll be first in line to receive more capital when prices are lower and the prospects for performance fees are much higher.

Managers need to accept that investors may have valid fee or liquidity constraints that rule them out

I cringe when I hear the whining of some managers that investors should ignore fee, liquidity or return targets, often mandated by regulation. Why should an investor change their business model or lobby government for a change in regulation so that a private equity manager can earn high fees? Why should venture capital or agriculture managers be entitled to special treatment if historical returns don't point to their sector outperforming in the future? Why should an investor take greenfield infrastructure risk because it is good for the economy rather than a good risk and return proposition? If a manager isn't able to put forward a convincing case of future outperformance and appropriate fees they shouldn't complain about investors passing on their 'opportunity'. They should be looking to either change their business model or to pitch to other investors who have different views and constraints.

Managers should start changing their business models now to reflect a lower fee future

Managers need to start reducing their standards in their salaries, offices, flights, accommodation, entertainment and use of professional services ahead of a sea change in fee levels in the next decade. More large investors are increasing their index positions as they accept that the few managers that can materially outperform an index would be swamped if given a meaningful allocation of the investor's total capital. An Australian superannuation fund told me that their cost of adding another dollar to an index equity product was 0.01% per annum. That's increasingly what managers are competing against. Without the ability to survive in a lower fee environment, managers must excel in either performance or marketing, or accept that they are in a dying business.

In Part 2 next week, we'll look at resetting investor expectations and find some middle ground.

Jonathan Rochford is a Portfolio Manager at Narrow Road Capital. Narrow Road Capital advises on and invests in various credit securities. His advice is general in nature and readers should seek their own professional advice before making any financial decisions.

The unseen environmental costs of companies

Jack McGinn

In 2010, Puma pioneered a new form of corporate reporting. The company produced an Environmental Profit and Loss account, which estimated the company and its supply chain to have caused €145 million of environmental damage that year, relative to €202 million net profit. In other words, if Puma expensed the costs to the environment of its activities and those of its suppliers, earnings would fall by over two thirds.

Conventional bookkeeping allows companies to ignore such damage. The activities of Puma's supply chain involve myriad environmental and social costs, for instance through chemical pollution of waterways via the dumping of untreated wastewater. But because these costs are imposed on outside parties, and therefore fall outside the scope of suppliers' P&Ls, there is no obligation to quantify or expense them. Instead they go unrecorded and, one way or another, are borne by the rest of us.

This is what economists call market failure. Firms are not forced to pay their full costs, leading to socially inefficient outcomes. The results are all-too apparent. In China, the global centre for textile production, the government acknowledges that nearly half its rivers are so contaminated with hazardous chemicals

as to be 'unsuitable for human contact'; Greenpeace estimates the proportion is much higher. In a country where 70% of people rely on groundwater for drinking water, of which 90% is polluted, the health outcomes are devastating.

Evidence suggests that Puma and its supply chain are not unusual in this regard. The activities of the largest 3000 public companies globally are estimated to cause environmental damage equal to 50% of combined earnings. The scale of private sector externalities demands we stop ignoring them in how companies report on their operations.

The same fundamental issue is triggering a parallel debate at a macroeconomic level. National accounting centred on GDP captures everything "except that which makes life worthwhile" [*Bobby Kennedy, 1968*]. Chinese GDP includes the output of the factories polluting into rivers, the necessary clean-up projects and the medical expenses of the villagers poisoned by lead, mercury and arsenic. It ignores the associated loss of life, livelihoods and ecological vitality.

The patent absurdity of using this as a guide to public policy has led to the formation of a number of alternative, broader conceptions of progress. Such ideas are slowly seeping into public discourse and policy formation around the world.

Chinese agencies, for instance, attempted to calculate a 'Green GDP'. Despite the results ultimately being blocked by the government, the idea survives. Chinese public policy is slowly reorienting to pursue 'balanced growth'. Pilot emissions trading schemes are in place, 74 cities have been forced to publish real-time air quality data and companies in polluting industries made to procure compulsory insurance to ensure they can provide compensation to victims for the damage they inflict.

In China and elsewhere, political and regulatory threats to business as usual are rising. Privatisation of profits and socialisation of costs is increasingly unacceptable to the public and the principle of 'polluter pays' has gained widespread policy acceptance, in theory if not yet in practice.

The consequence is that the ability of the private sector to externalise costs is waning. Companies in numerous jurisdictions are already forced to pay for the most obvious aspects of their environmental damage through carbon taxes and cap and trade schemes, as well as emissions charges. To combat the threat they pose to public health, tobacco and alcohol producers and retailers are being regulated more onerously. In future, such state intervention is likely to broaden in scope and deepen in nature, be it to expand emissions schemes to more sectors and pollutants, or to target excessive fat, salt and sugar content through taxes, caps or greater restrictions on advertising and selling practices.

These threats present clear business risks to a very wide range of companies and industries. Executives and investors need to consider these not as ESG (Environment, Social, Governance) concerns or a part of some vague concept of Corporate Social Responsibility, but as core business and investment issues. Corporates ought to act pre-emptively to mitigate these risks by managing and reducing external costs wherever possible, and long-term investors ought to encourage and demand they do so. Not doing so means running the risk of losing long-term social licenses to operate.

Quantifying external costs is a powerful step in this direction. Puma's 2010 Environmental P&L is the first step of three that will attempt to incorporate the environmental, social and economic impacts of the company and its supply chain. The final version should represent a pioneering set of Full Cost Accounts which allow managers within the firm to identify risks, audit the supply chain and take remedial action. Putting a monetary value on external costs is particularly useful, since this allows companies to incorporate thinking about how to alleviate them directly into existing financial and operational systems.

Momentum is gathering behind such initiatives. A dozen companies are reported to be joining Puma in publishing 'EP&Ls' and creating an industry coalition to push for broader adoption. More widespread disclosure should be welcomed and encouraged by long-term investors attempting to identify businesses that are well-positioned for coming challenges.

Jack McGinn is an Analyst with First State Stewart, part of Colonial First State Global Asset Management, specialising in Asia Pacific, Global Emerging Markets and Global Equities funds. This article is general in nature and readers should seek their own advice before making any financial decisions.

Key changes for SMSFs and ATO penalty powers

Andrew Bloore / Monica Rule

Andrew Bloore, Chief Executive of SuperIQ, summarises the three key changes SMSF trustees and advisers must be aware of from 1 July 2014.

1. Increases to super thresholds for 2014/15

- the general concessional contribution cap increases from $25,000 to $30,000
- the temporary concessional contribution cap (applying to those aged 49 years or over as at 30 June 2014) is $35,000
- the annual non-concessional cap increases from $150,000 to $180,000
- the non-concessional cap under the bring forward rule increases from $450,000 to $540,000. However, if the bring forward provisions have already been triggered (in the 2013/14 financial year or earlier) the cap remains at $450,000 and is not indexed to the higher limit
- the Superannuation Guarantee rate increases from 9.25% to 9.5%.

2. Changes to insurance definitions for superannuation funds from 1 July 2014

SMSFs will only be able to provide an insured benefit to a member that aligns with a condition of release, allowing the following policies to be provided:

- death
- terminal illness
- permanent incapacity
- temporary incapacity

However, polices such as trauma insurance, which do not have a condition of release, are now prohibited.

Also many policies have ancillary benefits imbedded in them that also do not strictly align with a condition of release (for example, often an Income Protection policy will pay a lump sum for a specified injury, such as a broken limb), but because this does not align with any condition of release from superannuation, the same policy inside an SMSF will not be able to provide this ancillary benefit.

3. New ATO administrative penalty powers effective 1 July 2014

These measures provide the Australian Tax Office with powers to levy penalties for breaches of superannuation law, including rectification and education directions for SMSF trustees and a financial administrative penalty regime.

The administrative penalty will fine trustees for breaches that in previous years have escaped punishment. Where a penalty is imposed it must be paid by the trustee personally (i.e. not from the assets of the SMSF). The fines are based on penalty units, which is currently $170 per unit. Fines range from $850 for failing to comply with an ATO education directive (5 penalty units), all the way through to a $10,200 fine for a fund that, say, lends to a member or relative of a member (60 penalty units).

Monica Rule provides more detail on the ATO's new administrative penalties.

From 1 July 2014, the ATO has new penalties to impose on SMSF trustees who contravene the superannuation law. The new penalties apply to contraventions that occur from 1 July 2014 as well as contraventions that were made prior and remain unrectified.

The old penalty regime only allowed the ATO to take the following limited, and in my opinion, quite harsh options on trustees for contravening the superannuation law:

- issue a notice of non-compliance to the SMSF (i.e. remove the tax concessions)
- disqualify the trustee
- accept an enforceable undertaking from the trustee to rectify the contravention
- take civil or criminal action on the trustee.

The old penalty powers did not allow the ATO to take appropriate action based on the severity of the contravention. The new penalty powers allow the ATO to tailor the penalty to fit the contravention, including:

- rectification directions
- education directions
- administrative penalties

With rectification directions, the ATO can direct an SMSF trustee to rectify the contravention within a certain timeframe and upon completion provide the ATO with evidence.

Education directions allow the ATO to direct an SMSF trustee to undertake specific education to improve their superannuation knowledge within a certain timeframe. Within 21 days of completing the course, the trustee must provide the ATO with evidence that they have completed the course and sign a trustee declaration form confirming their understanding of the trustee's duties. Any costs incurred for the education cannot be paid or reimbursed from the SMSF.

Administrative penalties will be imposed for specific contraventions. The amount of the penalty will vary depending on the seriousness of the contravention and applied at the full rate. The trustees or directors of corporate trustees will be personally liable for the penalty ranging from $850 to $10,200. The penalty must come from the corporate trustee or the personal resources of the company's directors or individual trustees. If an SMSF has individual trustees, then each individual trustee will be liable for the penalty (e.g. $10,200 penalty x 4 individual trustees, totalling $40,800). If an SMSF has a corporate trustee, then each director will be jointly liable for the one penalty (e.g. $10,200 penalty divided by 4 directors). The ATO does have power to remit the penalty and will consider remission based on a trustee's past compliance history, whether trustees have been reckless or incompetent in the operation of their SMSF; and the likelihood of complying in the future.

The new penalties can be imposed by the ATO in addition to the other enforcement actions.

Although trustees may rely on their accountant, financial adviser, lawyer or auditor to help manage their SMSF, the ultimate responsibility and accountability lies with the trustee of the SMSF. If you are planning to take more interest in the superannuation and SMSF laws, it is much better to do it on your own terms than be directed to do so by the ATO.

Monica Rule worked for the Australian Taxation Office for 28 years and is the author of 'The Self Managed Super Handbook – Superannuation Law for Self Managed Superannuation Funds in plain English'. Monica is currently presenting a series of SMSF seminars around Australia.

A summary of the new administrative penalties

Section and rule	Administrative penalty
s34(1)- failure to comply with prescribed operating standards	$3,400
s35B – failure to prepare financial accounts and statements	$1,700
s65(1)– prohibition on lending/providing financial assistance to members and their relatives	$10,200
s67(1) – prohibition on borrowing, except as permitted	$10,200
s84(1) – contravention of in-house asset rules	$10,200
s103 (1),(2) – failing to keep trustee minutes for at least 1o years	$1,700
S103(2A) – failure to retain a copy of section 71E election	$1,700
s104(1) – failing to keep records of change of trustees for at least 10 years	$1,700
s104A(2) – failing to sign trustee declaration within 21 days of appointment and keeping for at least 10 years	$1,700
s105 (1)– failing to keep member reports for 10 years	$1,700
s106(1) – failing to notify ATO of an event that has significant adverse effect on the SMSF's financial position	$10,200
s106A(1) – failing to notify ATO of change of status of SMSF (e.g. ceasing to be an SMSF)	$3,400
s124(1) – failure to appoint an investment manager in writing	$850
s160(4) – failing to comply with ATO education directive	$850
s254(1)- failure to provide information to the regulator	$850
s347A(5)- failure to provide the regulator with statistical information	$850

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