Cuffelinks
Connecting investors with ideas

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What makes a company attractive?

Hugh Dive

In every investment magazine and the business section of every weekend paper you will see a list of hot stock picks from fund managers. Inevitably these picks won't represent the fund manager's top new ideas, but rather five large positions in the funds that they manage. You will never see the fund manager's recently uncovered gems in print, as the managers will be busily building these positions in their portfolios and certainly don't want other investors driving up the price! In the interests of disclosure I have been guilty of doing this myself. In this piece, I am not going to run through our top investment ideas, but rather take a step back and look at what actually makes a company an attractive investment.

Easy to understand

We are attracted to companies with business models that are simple and can be explained to any client in two sentences or less and where it can be easily identified how the company makes money. Woolworths' business model is very simple; they buy groceries and liquor from the manufacturers and have the cheapest mechanism of distributing these goods to the consumer.

This point is frequently forgotten during market and credit booms, where complicated businesses thriving off accounting or credit arbitrage can appear to prosper for a certain amount of time. In 2006 I had several meetings with Allco Finance's management in an attempt to understand the business. The company's share price had risen 120% in the previous year and not owning it in the portfolio was hurting performance on a relative basis. After the management was unable to explain how Allco made money sustainably, we did not invest. It was bankrupt in the GFC.

Low capital requirements

The best companies to invest in are those that require minimal ongoing capital expenditure to generate a profit. When a company is required to continually make investments just to stay in business, this represents less cash that is available to be returned to shareholders. Pharmaceutical company CSL

requires minimal ongoing capital expenditure to produce its medicines outside the company's research and development budget and this has allowed the company to return $6.1 billion to shareholders since 2010 in dividends and share buy-backs. Conversely Qantas is a capital heavy business which constantly needs to invest (an A380 costs US$414 million) just to remain competitive in the aviation marketplace. Since 2010 Qantas' annual capital expenditure has been consistently ahead of the cash flow it generates from its operations, which explains why shareholders last saw a dividend in 2009.

Strong barriers to entry

Another key factor that quality companies have is strong barriers to entry that discourage competitors from entering into the market and thus reducing profit margins. Toll road operator Transurban enjoys high barriers to entry from long-life monopolistic assets. There is zero probability of a competitor building a toll road adjacent to the company's M2 Hills Motorway in Sydney. Conversely, online accommodation company Wotif.com initially enjoyed strong growth after listing in 2006, but has seen its share price and market share fall dramatically, as larger global competitors improved their internet offer. In Wotif.com's case along with many other tech companies, the barriers to entry tend to be quite low. Generally high barriers to entry, if they can be maintained, translate into higher profits for shareholders.

Non-reliance on government legislation or a single customer

Owning companies whose business models depend on favourable government legislation can be soul-destroying for investors. Investors in Timbercorp and Great Southern saw these billion dollar companies disappear after the government changed the tax treatment of their agricultural schemes. More recently salary-packager McMillan Shakespeare's share price fell 55%, wiping $600 million off the company's market capitalisation in 2013 after the government proposed changes to the salary packaging of car leases. Similarly, a month ago, former market darling Navitas' shares fell 30% after key partner Macquarie University announced plans to bring Navitas' university pathways program in-house. Alternatively food and beverage packaging company Amcor attracts very little interest from governments and has a large global spread of customers. Companies with these characteristics tend to have easily forecastable earnings with far fewer nasty surprises for investors.

Quality management

When we invest in a company we are effectively entrusting our investor's funds with a company's management and entrusting them to both grow that capital and provide a stream of income. Consequently a key part of the investment process is an assessment of a management team's competence to run the business and act in the best interests of shareholders. As a fund manager when I walk into a palatial office suite, not only do I see that my investor's money is paying for that flashy office with the harbour view, but also the management are unlikely to be serious in cutting costs during the down times. Walking into CSL's office in suburban Melbourne is like stepping into an unrenovated government office building from the 1960s and then in the boardroom it is clear that management are both highly competent and are focused on shareholders.

Furthermore in assessing all companies in our universe we examine executive remuneration versus total shareholder return and penalise companies that are paying management teams that are not delivering returns for shareholders.

We view that over the long term and across a range of market conditions, outperformance will be delivered by owning a portfolio of companies with stable and growing dividends and earnings that have an easily understandable business with barriers to entry that protect margins, have transparent financial accounts and trustworthy and shareholder-friendly management teams.

Hugh Dive is Head of Listed Securities at Philo Capital Advisers where he runs a $550 million portfolio of Australian shares. *This article is general in nature and readers should seek their own professional advice before making any financial decisions. Companies mentioned are for purposes of illustration and education only.*

[Grattan and the fuss about Chile's pension system]

David Bell

Recent press would have you believe that Chile's pension system is the solution to the perceived cost problems in Australia's superannuation system. This is due to a combination of media sound biting of a report by the Grattan Institute (and subsequently the Financial Services Inquiry) which, while interesting and a motivator for important discussion, is ultimately incomplete, open to alternative interpretations, and in my opinion flawed. The Australian superannuation system is highly complex – there is no silver bullet which takes it to the next level.

Chile's default fund auction system

Chile has a well-regarded pension system. The overall system, which includes the government- provided pension, was ranked 8th out of 18 countries (each selected as having a developed retirement income system) in the 2013 Melbourne Mercer Global Pension Index (Australia ranked 3rd). The FSI highlighted an important feature of their system in their Interim Report:

"Other mechanisms could also be deployed to drive fees down. One example is the approach introduced in Chile in 2008, where — unlike Australia — superannuation contributions of all new members are placed in the same default fund. Default fund management is auctioned on the basis of fees, creating stronger competition between funds for default fund status. Since these arrangements started, the fees charged by successful bidders in Chile have fallen by 65 per cent, although fees on other funds have not fallen to the same degree."

This comment was likely based on a report produced by the Grattan Institute titled "*Super sting: how to stop Australians paying too much for superannuation*".

Grattan Institute analysis of Chile's pension system

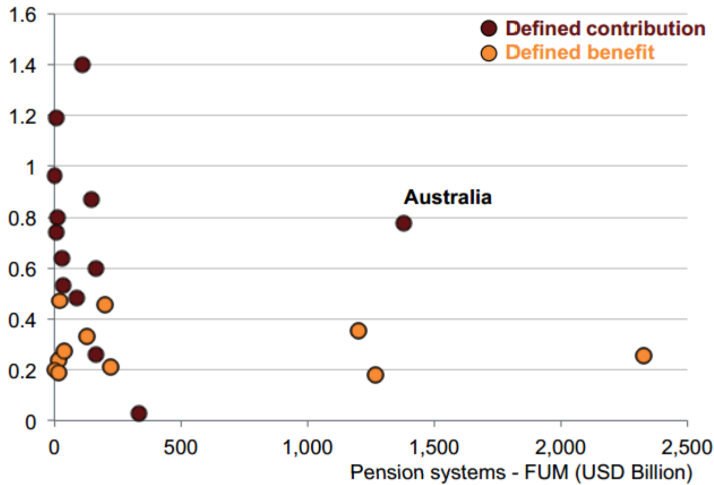
In Chile, workers contribute to approved pension funds, known as AFP's (Administradora de Fondos de Pensiones). Currently there are six AFP's each offering five investment options based on investment risk (simply named funds A, B, C, D and E). The Chilean government implemented a broad range of pension system reforms in 2008, and to address concerns regarding the cost efficiency, the government introduced a tendering process. Every two years, all AFPs tender to be the default fund for new contributing workers. New defaulted fund members cannot leave the directed AFP for two years but can switch investment option. Each option charges the same administration fee. All existing members of the default AFP also have their fees reduced to the new level. Since introduction, the Grattan Institute notes that the successful tenderer fee has fallen 65% to a fee less than 0.20%. This headline number is definitely worthy of attention. Unfortunately AFP's with large memberships have not been winning the tender and so the fee reductions have not benefited the majority of the population.

In my opinion the Grattan Institute adopts the view that a certain way to improve performance is to reduce fees. The logic of such a view, also shared by the Super System Cooper Review, is that investment management makes little difference to performance but fee differences make a large difference in performance. To support their view they undertake analysis which shows that:

- Adjusted for system size, Australia's super fund fees are much higher than those in other countries, as demonstrated in the following chart taken from the Grattan report:

Figure 2: Australia's superannuation system expenses exceed others of similar scale

Funded pension expense, per cent of funds under management, annual

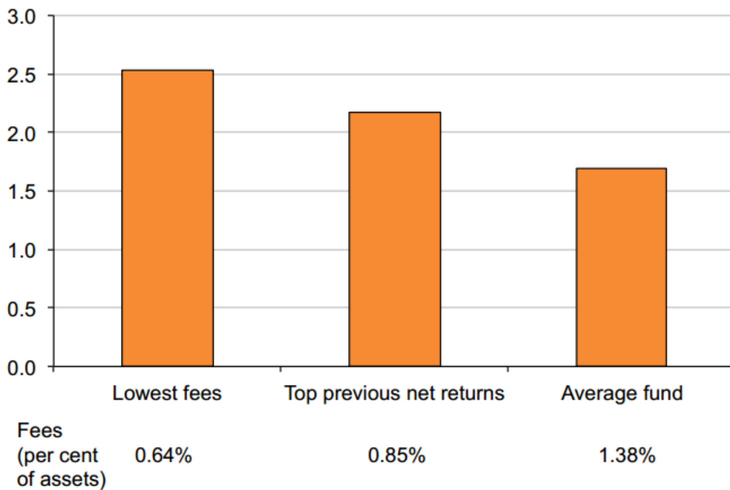


Note: Year: 2012 or latest prior to 2012. For the purpose of this chart 'defined benefit' is a system where greater than 60% of assets are in defined benefit plans; others are allocated to defined contribution. The chart includes 22 countries, the US Thrift Savings Plan (the defined contribution fund for US public servants) and the Swedish private pension system. See Appendix 3 for a version of this chart with countries identified.
Source: Thrift Savings Plan (2014), Swedish Pensions Agency (2013), Swedish Pensions Agency (2014a); OECD.Stat (2014a); OECD.Stat (2014b); OECD (2013).

- Outperformance does not persevere (if a fund outperforms in one year there is little continuation of that outperformance in subsequent years). This argument is summarised in the following chart:

Figure 9: Low fees are a better guide to future returns than are previous returns

Subsequent net real annual returns of funds based on previous fees and previous returns. 2006-2013, per cent, annual



Note: In each year in the sample from 2006 to 2011, three sets of funds are compiled. The first are the 10 per cent of funds with the lowest fees. The second are the 10 per cent whose historical returns (for history back to 2004) are highest. The third is all funds. The orange bars indicate the average of the subsequent returns for all decision years.
Source: Grattan analysis of APRA (2014a) & SuperRatings (2014).

- Fees are high because of the failure of account-holders and employers to put sufficient pressure on super funds to reduce fees
- Super funds seek to differentiate by providing a range of product features and services, rather than focus on fee reduction
- MySuper will not result in substantial fee reductions.

To reduce fees the Grattan report proposes a two part solution:

1. Select default funds in a fee-based tender (similar to the Chilean process)
2. Encourage a more active choice program through the Australian Tax Office hosting a 'choice platform' which compares an individual's current fund to that of the default fund (tender winner), and allow an opportunity to instantly switch to the default fund.

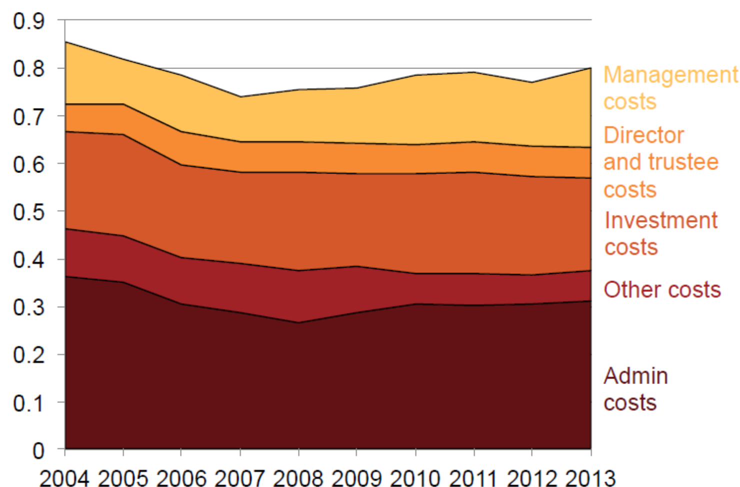
(As a sidenote the Chilean experience of tendering is not viewed as a universal success. In 2013 a special committee of the Senate approved a range of measures including creating a publicly administered alternative to the current privately operated system. This is in response to concern that the tendering process has not delivered population-wide benefits).

The Grattan Institute deserves commendation for producing some analysis and venturing some opinions which should, at the least, require self-reflection amongst super fund providers. Ultimately I disagree with their views and believe that their proposal would fail if implemented. Understandably there will be differences in opinion when a report is produced by people who are not directly involved in the superannuation industry (the three principal contributors are from an economics / academic background). While sometimes great industry innovations are generated by those from outside an industry, I don't think we have a plausible game-changer in this case.

I make a number of points in response to Grattan:

- Global cost comparisons have historically been a difficult area because every country's retirement income system has a unique structure providing different features and services. Some services are provided or subsidised by governments. A simple chart (the first one above) as provided Grattan does not tell the full story (but clearly raises important questions)
- The assessment of active management skill is flawed, most notably in the statistical tests applied against the objectives of the system. Super funds focus on long term performance and ultimately retirement outcomes, yet the statistical testing by the Grattan Institute focuses on the perseverance of short term performance. I question the relevance of this statistical test, especially when we know that the large differential in fees observed in the early 2000's no longer exists. Perhaps the short term test is conducted because it is more difficult to test longer term performance, as a much lengthier set of data is required. The key question is whether quality active management applied in well constructed portfolios will improve a fund member's long term retirement outcome. This doesn't just mean higher returns; it could also mean reduced risk. Surely the debate on active management needs to be a broad and forward-looking one. Based on the flawed construction of many passive indices, evidence of costly behavioural biases, and my own personal experiences of the impact of high quality active management on the return and risk outcomes of a portfolio I believe that active management does have potential benefits. Surely super funds should have the choice about whether and how much they incorporate active management, rather than have that choice regulated away.
- The report fails to address the issue of where cost reductions can be derived, rather alluding to the potential for cost savings similar to that experienced in Chile. Yet the Grattan report itself provides a useful chart on this very issue:

Figure 23: Fund expense ratio has changed little; some components have varied
Superannuation fund expenses, 2004-13
Per cent of funds under management,



Note: Expenses exclude commissions, and trading costs such as buy-sell spreads. Costs are weighted by funds under management. APRA regulated funds only - excludes SMSF and some public sector funds.
Source: APRA (2014b).

Based on the chart above, from which areas can cost reduction be derived? It appears that investment costs are already quite low at circa 0.20%. Even if we assume a more conservative (higher number) for investment costs, we can see that the impact of a shift to passive management will deliver far lower benefits to those achieved in Chile. Indeed we can see that administrative costs alone are higher than the total fee for Chile's last AFP tender!

- Finally, recommendations need to have a high chance of succeeding in practice. In this case success should be measured as system cost reduction. Undoubtedly the creation of a super choice platform would be a costly exercise. It is debatable how much choice would actually take place given the disengagement of many and the alignment of workers to their industry super fund. It would also not surprise to see funds increase advertising expenditure around tax return time – another cost to members with no investment return benefit.

Cost is a crucial issue on which regulators and the industry need to maintain constant focus. The Grattan report serves as an important reminder. However I believe the cost debate has many nuances to it. Does the system as it stands provide too many services and features? What is the economic cost of the substantial choice provided to Australians? What is the cost versus benefit of the substantial regulatory requirements placed on super funds? Which areas of the cost structure (as per the third chart) have the greatest potential for cost reduction? Unfortunately given the complexity of our system, a simple solution is unlikely to succeed; rather an ongoing collection of micro reforms, combined with ongoing fund merger activities, will lead to system cost reduction.

A final comment on the active management debate: in my opinion the investment management industry is experiencing a period of unprecedented dynamic change. The focus on member lifecycle outcomes, post-retirement solutions, the balanced versus lifecycle debate, smart beta and minimum volatility investments, represent just a small number of the current challenges, or opportunities, depending on your view. The lens through which performance outcomes are assessed needs to be refined further. It is those from within the industry which need to provide greater leadership in this area. From here we can then justify the sensible use of active management strategies.

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What *types* of people should manage your money?

Jack Gray

Warren Buffett, who claims that high IQ and investment success are not correlated, suggests a trade: swap 20 IQ points for a *better temperament*. Again the Sage of Omaha challenges a shibboleth, and again the challenge will be dismissed as 'Warren being Warren'. Yet Ben Graham, too, has declared that "the main point is to have the right general principles and the *character* to stick to them".

Seth Klarman of Baupost poses a pithy first filter for value investors:

"Ultimately, value investing needs to fit your character. If you're predisposed to be patient … appreciate the idea of buying bargains, you're likely to be good at it. If you have a need for action, if you want to be involved in new and exciting technological breakthroughs … you're not a value investor, and you shouldn't be one*."*

Answers to two questions might help develop such simple filters into operational ones:

1. **Which characteristics of temperament inhibit or enhance investment success?** A decisive temperament is crucial in much investing but is only tested under pressure. John Meriwether of Long-Term Capital Management (in)famously had it until confronted by two Nobel Prize–winners with stratospheric IQs.

2. **How do these characteristics vary across asset classes, investment styles, and strategies?** The temperament needed for success in long-only equity management is likely almost orthogonal to that needed for short-biased management. The former tend to be positive and optimistic; the latter, sceptical and pessimistic.

The Oxford English Dictionary defines *temperament* as "*a person's nature especially as it permanently affects their behaviour*; from the Latin 'temperamentum', correct mixture". What, then, are the "correct mixtures" for investors?

Temperament, being unmeasurable, is likely to be ignored, yet in politics, war, and sport its importance has long been recognised. Franklin D. Roosevelt was described somewhat positively as having a "first class temperament and a second class mind" (Walter Lippmann, qtd. in *Different Class* 2009). The temperament to craft stable coalitions, not raw intellect, was the key to his success. Leon Trotsky's temperament was ideally suited to the post-revolutionary chaos in which he transformed a rabble into the fearful Red Army, but was ill-suited to the (relative) order that later prevailed. While the strong *functional* parallels between investing and warfare (low signal-to-noise ratios, a mix of strategy and tactics, and, as Napoleon well knew, immodest doses of luck) are well known, of potentially greater value are the *temperamental* parallels implicit in Norman Dixon's *On the Psychology of Military Incompetence*.

Successful investors are likely to be overweight a number of the following traits:

- A paradoxical blend of arrogance, to discover and arbitrage opportunities ahead of the market, and humility, to simultaneously be sceptical about those discoveries.

- A commitment to 'knowing thyself'. For instance, recognising that previously justified contrarianism had degenerated into unjustified stubbornness.

- The ability to make effective decisions under uncertainty, ambiguity, and pressure. A temperament that seeks comfort and stability will likely be ill-suited to investing.

- The confidence to encourage and absorb dissent yet to know when to act. Almost all *organised* human endeavours have at their core a paradigm of broadly agreed beliefs, stylised facts, and patterns of thought that impose a uniformity of views. Ideas that challenge the paradigm tend to be ignored, not absorbed: Markowitz's thesis was not rated as genuine economics, while Akerlof's ground-breaking *Lemons* paper on the pricing impact of information asymmetry was twice rejected. Both eventually won Nobel prizes.

- The wisdom to know when to cooperate, a rare trait in a culture that imbues competition with religious status. Much (but not all) investment information is 'non-rival', whereby its value *increases* through sharing, as evident in open-source ventures. Yet by temperament, training, and incentives, many are antithetical to sharing. One study engaged students in a game where participants do better by cooperating. 60% of general students cooperated while only 40% of economics students did.

- The self-control to value patience, and so resist the short-term imperative and its eternal concomitant, being busy.

- A willingness to question and be curious, traits lacking in many boards that oversee other people's money. After being embedded in US pension funds, the anthropologists O'Barr and Conley reported "a surprising lack of interest in questioning and surprisingly little interest in considering alternatives".

Isaiah Berlin bequeathed a crude but useful typology of people: hedgehogs view the world through the lens of a single defining, and usually substantial, idea; foxes view it through multiple lenses. Both types are needed in investing, but we are over-populated with hedgehogs who better fit compartmentalised corporate structures and are more fecund. We need more foxes, people with broader perspectives willing to trespass — a notion coined by Albert Hirschman — into foreign fields. No investment organisation would hire a sociologist; yet Winslow Jones, who created the first ever hedge fund, was one. One of the best analysts of Jim Chanos, a famous short-seller, is an art historian. "She had no formal business school training. She was so good because she was very intellectually curious. She was never afraid to ask why ... This is almost something that you can't train." The Bank of England showed similar courage in seeking insights on complexity from a theoretical biologist, recognising that markets behave more like evolving, adaptive non-stationary biological systems than physical engineering systems.

Cultural change is needed to recognise, support, and reward foxes, who tend to be spurned by tribal hedgehogs as soft-headed dilettantes. To Charlie Munger, having different mental models is *the* most important thing in investing, because they expose new opportunities and drive a dialectic of risk. Investment organisations should seek more people with "contrary imaginations", as the psychologist Liam Hudson phrases it: people with exceptional intelligence in alternative but meaningful ways; people with intelligence about the humanities, especially history and psychology, the disciplines that underlie and drive markets; people with emotional intelligence to direct and manage others; and people with organizational intelligence to get things done.

The latter are rare, because our training idealises companies as rational profit maximisers populated by *homo economicus*. The anthropologist and investment banker Karen Ho (2009) paints a more realistic picture: "Capitalist organisations are not simply motivated by … profit or governed by rational actors. They are *sociocultural* organisations with complex contradictory world views." Getting things done in such organisations requires a temperament different to that required in ideal ones. The investment industry should adopt a strategy of 'mental and temperamental heterogeneity'. That will require another Buffett-style trade: swap much of the prized but value-detracting 'comfort' for the much-avoided but value-enhancing 'courage.'

Dr Jack Gray is a Director at the Paul Woolley Centre for Capital Market Dysfunctionality, Faculty of Business, University of Technology, Sydney, and was recently voted one of the Top 10 most influential academics in the world for institutional investing. For a full list of references or an expanded version of the paper, contact jackgray08@live.com.au.

From building BRICs to building blocs in emerging markets

Michael Power

The BRICs concept (investing in Brazil, Russia, India and China) captured investors' imagination like few others. But, above and beyond its acronymic catchiness, did it given us a deeper understanding of the risks and rewards that come with investing in emerging markets, thereby allowing us to profit from this asset class?

I have long had my doubts. These have been confirmed by a close examination of how emerging markets have performed since 2000, rising and falling with the ebb and flow of the commodity tide and, post 2008, the veritable tsunami of central bank-created liquidity that has washed over financial markets.

Time to regroup emerging markets

It's time to move away from the prism – one might say prison – of the BRICs approach (in its original form, so excluding South Africa) and instead frame the emerging market investing opportunity in terms of country blocs that perform broadly in line with each other as the macro environment evolves. I have identified four main blocs, derived from a 2x2 matrix that:

- distinguishes between whether a country tends to run a structural current account deficit or surplus, and
- whether it is primarily a commodity or manufactured goods exporter.

Current Account (right) vs Export Character (below)	Structural Deficit	Structural Surplus
Commodity Exporter	NW	NE
Manufactured Goods Exporter	SW	SE

For emerging markets, countries can be assigned as follows:

- the oil exporters are generally found in the North East (NE) bloc
- South Africa and the rest of sub-Saharan Africa, South America and Indonesia are in the North West (NW) bloc
- the *maquiladoras* (Mexico; most of Eastern Europe and Turkey) plus the Indian sub-continent are in the South West (SW) bloc
- China-centred East Asia is in the South East (SE) bloc. Recession-hit Czech Republic and Hungary are also recent arrivals to the SE bloc.

It is important to note that this matrix is not unique to emerging markets: the developed world can also be handily described by it. Oil-exporting Norway is in the NE; Australia, Canada and New Zealand are in the NW; the US and the UK are in the SW; and Japan, the Eurozone (which includes emerging markets Greece, Slovakia and Slovenia), Switzerland and Scandinavia are in the SE.

The main distinction lies between the eastern (NE and SE) and western (NW and SW) two blocs. The latter will experience currency depreciation unless they can attract capital inflows to balance their external account; the former are essentially self-financing and are prone to currency appreciation unless their central banks suppress it and instead add to foreign exchange reserves, sometimes via funding sovereign wealth funds. The financial health of the two western blocs is closely correlated to the state of global liquidity.

Northern bloc depends on commodity cycle

A secondary distinction exists between the northern (NW and NE) and southern (SW and SE) two blocs. Over the long term, the former will likely experience relative terms of trade loss versus the latter as commodities see their pricing power versus manufactured goods erode. From the late 1990s, the advent of the commodity supercycle reversed this trend, though since 2011 the normal relationship appears to have resumed, more for metals and coal than for oil and gas. This has weighed on the NW bloc's prospects more than that of the NE. The financial health of the northern blocs is correlated to the state of commodity markets.

These two distinctions are driven by two dominant players: the United States largely determines the status of global liquidity whilst China determines the health of global commodity markets. (Note that in 2013, China even overtook the US to become the world's largest oil importer.)

Metaphorically, this means that – to adapt a phrase from the Bard – there are not one but two tides in the affairs of emerging markets: the liquidity tide which is governed by the American moon and the commodity tide which is ruled by the Chinese moon. Over the past decade, these two moons have not waxed and waned in synchrony, so neither has the ebb and flow of these two tides been coordinated.

The prospects of each bloc depends upon interaction between the two tides: for instance, 2011 saw the high tide for commodities coincide with strong liquidity flows arising from the Federal Reserve's quantitative easing programme being in full flood. This synchronicity was ideal for the NW bloc and both the Brazilian Real and the Australian Dollar reached their peak values during 2011.

Bloc helps to identify risk better than BRIC

Over time, one can observe that risk in emerging markets, mainly represented by volatility, is lowest in the SE bloc and highest in the NW. And, for most of the past decade, the relative positive derived from the current account surplus nature of the NE bloc has outweighed the relative negative arising from its commodity-exporting nature. Net result? The NE bloc has been less risky than the manufactured goods-exporting but deficit-running SW bloc. But in 2014, geopolitics intervened as the fallout from Ukraine weighed on the financial prospects of NE bloc's largest member, Russia.

Determining where a nation, emerging or developed, fits into this 2 x 2 bloc matrix is far from discovering the Holy Grail of global investing. As evidenced by the Ukraine crisis, specific events can and do impact individual countries, both positively but more often negatively. But for investors, I believe the bloc approach is far more useful than the BRIC approach which, in essence, is but an exercise in sizeism. The irony is that, and this is purely a coincidence, there just happens to be one BRIC in each of the four emerging market blocs.

Michael Power is a Strategist with Investec Asset Management.

Superannuation and terminal illness, disability and death

Monica Rule

We never know what each new day will bring and unfortunately for some the new day could be the last. Sudden and unexpected illness, death or disability hits us all at some stage, either ourselves or someone we know. This article explains the different superannuation entitlements that are available if you are faced with a terminal illness, death or disability.

If an SMSF member is diagnosed with a terminal illness, they need to consider how they would like their superannuation entitlements to be paid. Options include taking superannuation entitlements as a terminal illness benefit, a permanent disability benefit or a death benefit to their family after they are deceased. The choice of superannuation benefit could make a difference to how much is retained in the family instead of the Taxation Office.

Terminal illness benefit

For a benefit to be released under terminal illness grounds, the SMSF member will need to satisfy the following conditions:

- two registered medical practitioners have certified, jointly or separately, that the person suffers from an illness, or has incurred an injury, that is likely to result in their death within 12 months
- at least one of the registered medical practitioners is a specialist practising in an area related to the illness or injury and
- the benefit is taken within 12 months of the certification.

The member can elect to receive the payment either as a lump sum benefit or an income stream benefit (eg. a pension).

If the member elects a lump sum benefit, the benefit will be paid to the member tax-free, regardless of the member's age, provided the above conditions are met. You may also be able to claim a refund of tax withheld from super payments received while you had the illness up to 90 days prior to advising the fund of your condition.

If the member elects to receive a pension benefit, the benefit is taxed as a normal superannuation income stream. If the SMSF's trust deed only allows for a lump sum, then the member would be unable to take their benefit as an income stream.

The member also needs to be careful if they are considering transferring their terminal illness benefit to another superannuation fund for payment as an income stream. Under the Income Tax Assessment Act 1997 the transfer would not be treated as a rollover and therefore would count towards the member's non-concessional contribution cap. This could result in the member incurring an excess contributions tax liability.

On the other hand, if the member elected to have their superannuation savings transferred to another superannuation fund prior to applying to have their benefit released on terminal illness grounds, then it would be treated as a roll-over and it would not count as a contribution to the new superannuation fund.

Permanent disability (PD) benefit

To claim a PD benefit, the trustee of an SMSF must be reasonably satisfied that the member is unlikely to engage in gainful employment in a capacity for which the member is reasonably qualified by education, training or experience. A medical certificate is not a requirement as it is up to the trustee to decide what standard of proof will reasonably satisfied them. A PD benefit can be paid in the form of a lump sum or an income stream.

If a person chooses to take the benefit as a lump sum, the entire lump sum is tax-free if paid to a person aged 60 or over. For a person under 60, tax is payable on the lump sum depending on its tax-free and taxable components.

A lump sum PD benefit qualifies for an increased tax-free component, where two legally qualified medical practitioners have certified that, because of ill-health, it is unlikely that the person can ever be gainfully employed in a capacity for which they are reasonably qualified. The increased tax-free lump sum amount is calculated using the following formula:

$$\textbf{Amount of benefit} \times \frac{\textbf{Days to retirement}}{\textbf{Service days + Days to retirement}}$$

Days to retirement is the number of days from the day the person stopped being capable of working to their last day of work (which for most people will be their 65th birthday).

Service days is the number of days in the service period for the lump sum (usually the period from when the person began contributing to super).

Example: Bev had an accident that stopped her from being able to work on 3 September 2007. She received a PD lump sum benefit of $160,000 from her SMSF. The total value of Bev's superannuation account was $400,000 (a $100,000 tax-free component and a $300,000 taxable component made up solely of an element taxed in the SMSF). Her days till retirement (the day she turns 65) total 6512. Her number of days in service were 8099.

Bev's PD lump sum benefit of $160,000 will therefore consist of an initial tax-free component of 25% and a 75% taxable component mirroring the components of the entire super account, that is, $40,000 tax-free and $120,000 taxable. The above formula is then applied to work out the *increased* tax-free component.

$$\$160{,}000 \times \frac{6512}{6512 + 8099} = \$71{,}310.68 \text{ additional tax-free amount}$$

Bev's PD lump sum benefit paid from her SMSF will now have a $111,310.66 ($71,310.68 + $40,000) tax-free component and a $46,689.34 taxable component. The tax treatment of the recalculated lump sum will be as per normal lump sum benefits paid from a complying superannuation fund.

If a person chooses to take the PD benefit as an income stream, they are not entitled to the calculation of a larger tax-free portion. The income stream is taxed at the person's marginal tax rate with a 15% tax offset available if the person is under the age of 60. If the person is aged 60 or over, then the disability income stream is tax-free.

Again, trustees of SMSFs must follow the rules in their SMSF's trust deed as to whether benefits can be paid out under permanent disability grounds as well as the form of the benefit.

Death benefit

Death benefits are mainly paid as a lump sum, but can be paid as an income stream to a spouse, a child under 18 years of age, a financially dependent child aged 18 – 24 years, or a child with a disability. This means a child who is considered a dependant of a deceased member can receive a death benefit pension until the age of 24 or longer if the child suffers a disability.

The tax treatment of a lump sum death benefit depends on whether the recipient is a dependant of the deceased member. A dependant is defined as:

- a spouse or former spouse of the deceased (including a spouse of the same sex)
- a child of the deceased under the age of 18
- a person financially dependent on the deceased at the time of death
- a person who had an interdependent relationship with the deceased just before death.

A lump sum death benefit paid to a dependant is tax-free. If it is paid to a non-dependant, then tax is payable at 0% on the tax-free component, a maximum of 15% on the taxable component already taxed within the fund, and a maximum of 30% on the untaxed component. The Medicare levy is payable whenever the tax rate is greater than 0%. Also if a death benefit is paid to dependants they may be able to take advantage of the anti-detriment provisions and receive a larger death benefit.

An anti-detriment payment is essentially a refund of the 15% contributions tax paid by an SMSF. It is an additional amount that may be paid to provide a death benefit of an amount that would have been payable if contributions tax was not deducted from the deceased member's account.

The tax payable on a death benefit income stream depends on the age of the deceased, the age of the dependant and the component of the income stream. If either the deceased or the dependant is aged 60 or over, then no tax is payable on the tax-free component and the taxable component. The untaxed component is taxed at the dependant's marginal tax rate with a 10% tax offset. If the deceased and the dependant are both under the age of 60, then the tax-free component remains tax free, the taxable component is taxed at marginal tax rate with a 15% tax offset and the untaxed component is taxed at the marginal tax rate. The Medicare levy is payable whenever the tax rate is greater than 0%.

Other considerations

There are other considerations which should be examined. For example:

- an anti-detriment payment is not payable if a benefit is accessed under a terminal medical condition or a PD condition, as it is only payable on death benefits
- it is important to consider whether your SMSF holds any life insurance for you prior to rolling money into another superannuation fund
- if you receive a lump sum terminal illness benefit, it may affect your entitlement to a disability support pension.

Superannuation savings are important whether you enjoy them in retirement or pass them on to your dependants when you die. Carefully considering how your savings will be passed on could be one of your greatest legacies.

Monica Rule worked for the Australian Taxation Office for 28 years, is a SMSF Specialist Advisor, and is the author of The Self Managed Super Handbook*, recently released in its fourth edition. Monica is running SMSF Seminars in various states. For more details visit www.monicarule.com.au. This article is general in nature and readers should seek their own professional advice before making any financial decisions.*

(See the Cuffelinks website for a tabulated summary of income and lump sum superannuation and death benefits).

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