Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

Why we can't resist tactical asset allocation

Chris Cuffe

"*We cannot suppress the powerful intuition that what makes sense in hindsight today was predictable yesterday. The illusion that we understand the past fosters overconfidence in our ability to predict the future.*" Daniel Kahneman, Nobel Prize Winner, in *Thinking, Fast and Slow*.

"*The only value of stock forecasters is to make fortune tellers look good.*" Warren Buffett

"*Far more money has been lost by investors preparing for corrections, or in trying to anticipate corrections, than has been lost in corrections themselves.*" Peter Lynch

Like many people who are involved in managing their own portfolios, I actively engage in tactical asset allocation (TAA), despite evidence that it's usually a waste of effort. TAA is market timing with a fancier name, and commonly involves switching from equities to defensive assets and vice versa in anticipation of a major stockmarket move. Unfortunately, nobody rings a bell to show when this is about to happen, so we all have our own techniques.

I think there are two main reasons why people engage in TAA:

- ✓ We think we're good at it.
- ✓ The rewards for correct decisions are fantastic.

At an institutional level, many trustees and asset consultants prefer instead to set a static strategic asset allocation, and rebalance back to these set percentages as markets move. They may tolerate some small range either side of a target allocation, but relatively few public super funds in Australia tactically adjust their portfolios significantly the way an individual investor might.

Is TAA a waste of time?

Of course, academics have an expression to describe the belief that you can outguess the market: *illusory superiority*. People overestimate their positive qualities and abilities, and underestimate their weaknesses. Examples quoted in the research include:

- in surveys of driving safety and skills, 93% of people in the US put themselves in the top 50%
- at the University of Nebraska, 68% of faculty members rate themselves in the top 25% for teaching ability
- at Stanford University, 87% of MBA students rated their academic performance above median
- in a survey attached to the SAT exam in the US (taken by about one million students a year), 70% put themselves above the median on leadership ability, 85% on 'ability to get on well with others' and 25% rated themselves in the top 1%.

There have been many studies showing nobody really knows where markets are going (click this link for an excellent report on the perils of market timing). In 1994, some US academics analysed over 15,000 market timing calls in 237 investment newsletters over 13 years, and found that over 75% of the newsletters produced negative performance. In 2012, Morningstar compared 210 tactical asset allocation funds with a simple Vanguard 60/40 default fund, and with few exceptions, the tactical funds performed worse, were more volatile and ran as much downside risk as the simple fund.

Even those who have a well-researched and systematic approach to TAA often have a timing problem. It can take years after an asset allocation move to know if it is correct. Any fund manager with an open-ended fund who called the GFC markets downturn correctly but altered their asset allocation two years early probably lost a lot of funds as the market kept running until 2008.

This was the case for funds who used long term fundamental measures (like Nobel Prize Laureate Robert Shiller's 'CAPE' ratio model, and Vanguard founder Jack Bogle's real dividend yield model) to under-weight equities as soon as they became expensive two or three years before the boom ended. They underperformed during the best part of the run up and lost a lot of clients. To make matters worse, they also lost when they re-entered the market a year too early, when the long term fundamental models said that the market was 'cheap' in early to mid 2008, right before the worst part of the crash in late 2008 with the collapse of Lehman.

And it's difficult for institutions to do TAA with any conviction as they are obsessed with benchmark risk and competitor risk. Public super funds, for example, 'force' themselves to be in most asset classes all the time rather than avoiding some completely from time to time. Over the last year or so, I have heard many institutional investors say Aussie bonds look very expensive, yet most have an allocation to them.

Individual SMSFs are much better placed as benchmark and competitor risks are not such a worry, and an SMSF can also take a much longer timeframe to make decisions.

I personally think it is still worth giving TAA a go and I believe I do better than the market at least 51% of the time if I have an adequate long term time frame to work to.

If you could do it, is TAA really worth it?

Let me show some simple examples of why so many of us strive for the elusive TAA heaven. I will be drawing my data from calendar year statistics in the Vanguard Australia Asset Class Tool, a publicly available source of returns across all asset classes since 1970.

Assume I have $1,000 to invest, and there are no transaction costs and no tax leakage (these are unrealistic assumptions for many people, but it is needed for simplicity and won't change the message). The measurement period is 10 years from 1 January 2004 to 31 December 2013. The six asset classes chosen for the purposes of this article are:

- Australian shares
- International shares ($A unhedged)
- Australian property (listed REITs)
- Cash

- Australian bonds
- International bonds ($A hedged)

1. Unrestricted and perfect asset allocation

The Vanguard table shows which asset class performed best in each calendar year. If I could invest in any asset class without restriction (0% to 100%) and I had a perfect ability to asset allocate and did not care about diversification, then over the 10 year period from 1 January 2004 to 31 December 2013, I would have invested the initial $1,000 as follows:

1 January 2004, 100% Australian property, for a return over the year of 32.0%
1 January 2005, 100% Australian shares, for a return over the year of 21.0%
Etc, etc, switching between asset classes every year for 10 years.

This perfect approach turns **$1,000 into $9,628 after 10 years**, an annual compound growth rate of **25.4%**. And for completeness, the worst allocation would have resulted in $1,000 turning into $445 after 10 years.

2. Set 70/30 asset allocation

Most institutions have a 70/30 asset allocation for their key balanced funds. Let's assume, using our six asset classes, the average asset allocation was:

- Australian shares (35%)
- International shares (25%)
- Australian property (10%)
- Cash (5%)
- Australian bonds (15%)
- International bonds (10%)

With $1,000 invested at the beginning and the above set asset allocation, $1,000 becomes $1,962 after 10 years, a compound average growth of 6.98% per annum. This assumes the asset class allocation at the beginning was not rebalanced each year. If the standard asset allocation was rebalanced each year, then $1,000 turns into $2,094 after 10 years, a compound return of 7.6% per annum.

3. Allowing tactical asset allocation around the benchmark

Let's now assume institutions are permitted to do tactical asset allocation around the standard asset allocation with ranges as follows:

- Australian shares (35%) – range 25% to 45%
- International shares (25%) – range 15% to 35%
- Australian property (10%) – range 5% to 20%
- Cash (5%) – range 0% to 10%
- Australian bonds (15%) – range 10% to 25%
- International bonds (10%) – range 5% to 20%
- Overall growth assets (70%) – range 50% to 80%

Using TAA discretion and allocating to the best returns, we have 80% growth (shares and property) and 20% (cash and bonds) from 2004 to 2006, then we switch to 50% in 2007 and 2008 (and thereby reduce the impact of the GFC), back up to 65% growth for the 2009 equity recovery, down to 50% growth in slow equity years of 2010 and 2011, and 80% growth since then. While this is far less extreme than the perfect results in example 1 with no diversification, these numbers are within the range assigned to many asset allocators within a balanced fund.

The results? The $1,000 invested at the beginning turns into $3,457 after 10 years, a compound annual return of 13.2% per annum. Compared with the above static 70/30 asset allocation that is rebalanced each year, this tactical asset allocation with perfection yields an additional $3,457 - $2094 = $1,363 after 10 years, a significant improvement.

We chase the Holy Grail

In a theoretical extreme, an asset allocator could have turned a $1 billion fund into $9.628 billion in 10 years with perfect vision, or a 70/30 balanced fund could have delivered 13.2% per annum instead of 7.6% per annum with excellent TAA. It's little wonder the attraction of trying proves difficult to resist.

And, of course, there's a third reason a lot of us do it. We enjoy it, it gives meaning to our role of managing money, and for many it's a lot more fun than setting and forgetting 70/30 and going to the races. But I'll leave the last words to John Bogle, the Founder of Vanguard:

"Sure it would be great to get out of the stock market at the high and back in at the low, but in 55 years in the business, I not only have never met anybody that knew how to do it, I've never met anybody who had met anybody that knew how to do it."

Listed versus unlisted infrastructure

Gerald Stack

There are key differences between investing in exchange-listed infrastructure securities versus unlisted infrastructure assets. These differences have important implications for investors and give rise to some commonly-held misconceptions.

The value of a typical infrastructure asset, or any long-dated asset, is determined by just two factors:

1. The cashflow forecast to be generated by the asset.
2. The risks associated with those cashflows actually materialising.

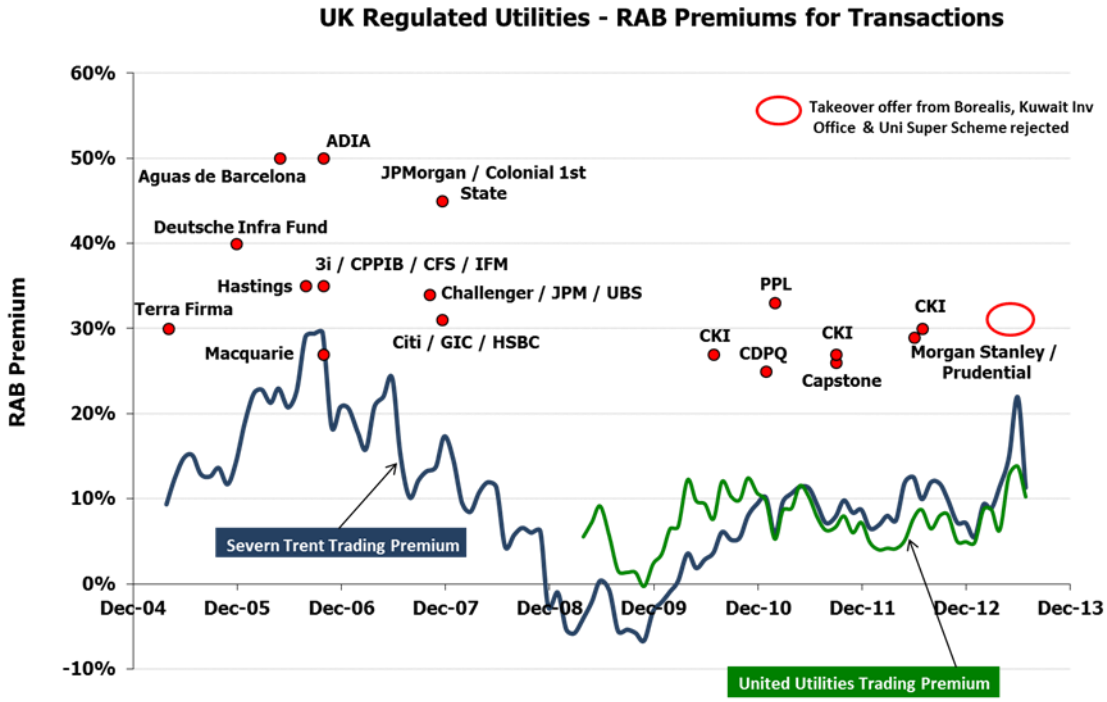
For an investor, the value of any asset is also impacted by the factors that stand between them and the cashflow generated by that asset. In relation to collective investment vehicles, there are three main factors:

1. Leakage of cashflows to the asset's controlling entity, e.g. fees paid to a fund manager.
2. Reinvestment of the asset's cashflows in the capital stock, e.g. for an airport, the use of asset cashflows to fund expansionary capital expenditure.
3. The use of cashflows by the controlling entity to acquire other assets, e.g. a fund investing in unlisted infrastructure assets acquiring another asset.

A common misconception is that a listed infrastructure investment is more risky than an identical unlisted investment because of the inherent volatility in the former's daily pricing. This view is both disingenuous and incorrect, as it confuses volatility in pricing with the volatility in cashflow. While some investors are attracted to the apparent comfort of a quarterly (or worse semi-annual) valuation of their unlisted assets, this ignores day-to-day developments.

Leaving aside the illusory benefit of not being subject to daily pricing, one would expect that a long-term investor might gain an advantage by investing in an unlisted infrastructure fund. In theory, the assets owned by such a fund should be cheaper than their listed equivalents as it is generally accepted that investors are prepared to pay a premium to have the ability to buy or sell an asset at any time. Indeed, it is somewhat counterintuitive to think that an inability to buy or sell an asset reduces the risks associated with it. Despite this, overwhelming evidence suggests that the imbalance between demand from funds looking to invest in unlisted infrastructure and supply of appropriate investment opportunities has led to the opposite being true.

For instance, the following graph, showing the ratio of various entities' Enterprise Values to their Regulated Asset Bases (RAB), which can be thought of as their net tangible assets, describes the history of utility acquisitions in the UK over the last decade. Each dot represents a deal done in the unlisted market, while the continuous lines show the equivalent trading multiples of the only two regulated utilities still trading at the end of the period in question:



Source: Magellan

Regulated assets in the UK are allowed to earn a return on their RAB. The regulatory regime in the UK is highly developed and utilities generally earn a small premium to the underlying cost of capital. Consequently, one would expect that the fair value of these utilities would be at a small premium to their RAB, which is indeed where we typically observe the listed assets to trade. However, the graph clearly shows a consistent pattern - unlisted asset transactions taking place at a 30% premium to underlying RAB. Note the rise and fall of Severn Trent's share price in 2013, when news of a potential, but ultimately unforthcoming, takeover was made public.

The benefits of listed infrastructure funds

We believe that listed infrastructure assets benefit in comparison with unlisted assets:

1. Listed infrastructure assets have been, and remain, cheaper than their unlisted equivalents.
2. Fees charged by listed infrastructure funds are lower than those charged by unlisted infrastructure funds. Given that the infrastructure sector, when properly defined, should only provide modest, high single-digit returns over time, the difference in fees can be very meaningful.
3. The listed market offers a significantly increased opportunity set.
4. Daily liquidity allows investors to utilise more effective dynamic asset allocation, particularly in rapidly changing macroeconomic circumstances.
5. Listed assets are able to provide greater diversity of asset exposures due to investment size limitations. This can be particularly important when a substantial proportion of an unlisted infrastructure fund is exposed to a single regulated asset (and is therefore heavily exposed to a potentially unfavourable regulatory decision at some time in the future).
6. Regulated utilities, which make up the majority of the infrastructure investment universe, have little opportunity for the sort of value creation normally expected in private equity vehicles. This is because regulators generally do not allow such businesses to generate high levels of excess

returns. As a result, it is favourable to achieve as cost-effective an exposure to the asset class as possible, i.e. through listed assets, as opposed to unlisted assets.

7. Better transparency, given the strict conditions for disclosure imposed on listed entities.

There are, however, advantages in investing directly in unlisted infrastructure assets for certain institutional investors, i.e. owning positions in those assets directly on their books rather than through the medium of a fund managed by a third party. In particular, owning a large position in an asset directly reduces agency risk (the risk that the investor will not enjoy the full benefits of the asset's cashflows). However, realistically speaking, only very large investment institutions with specialised internal infrastructure teams can expect to be successful when competing for such assets. Only a relatively small number of investment institutions globally would be adequately resourced for such an endeavour.

Conclusion

Appropriately diversified exposure to the infrastructure sector, when conservatively defined, should provide investors with a return of inflation plus 5-6% before fees. Such a return may be earned through exposure to either listed or unlisted infrastructure assets. However, the listed market offers investors superior post-fee return prospects, particularly given current and foreseeable market conditions.

Gerald Stack is Chairman of the Investment Committee and Head of Research at Magellan Financial Group and Portfolio Manager of the Magellan Infrastructure Fund. He has extensive experience in the management of listed and unlisted debt, equity and hybrid assets on a global basis.

Building a better retirement world

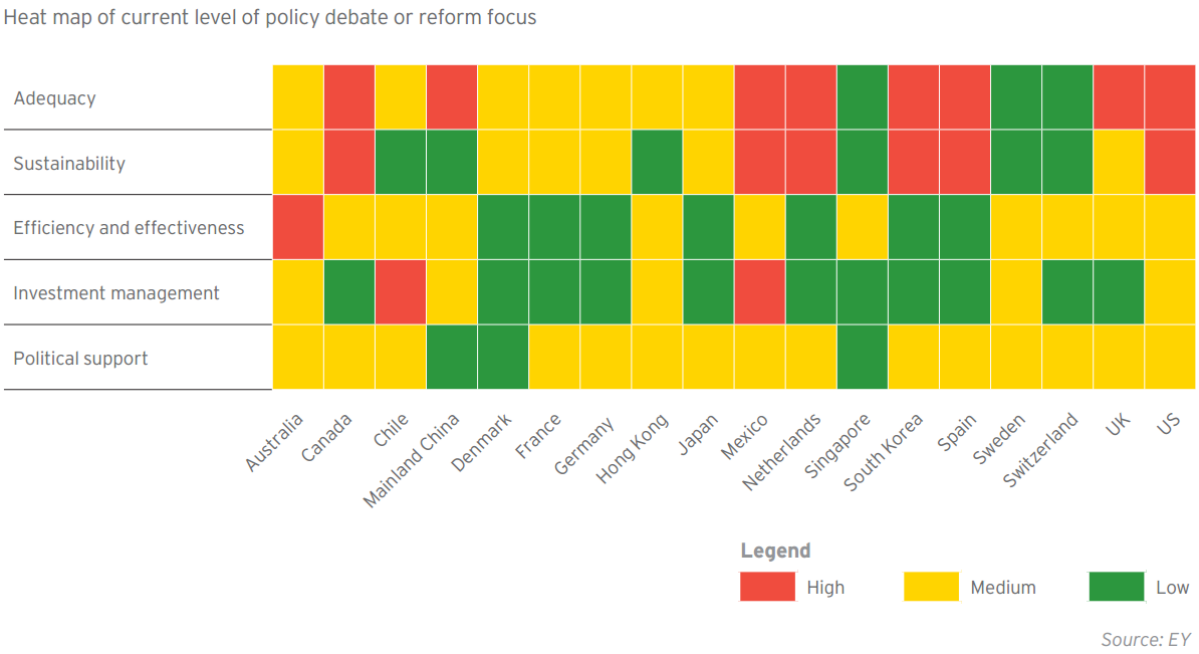
Graeme McKenzie

All developed countries are struggling to adequately support their aging populations. Increasing fiscal pressure on budgets due to ballooning health and pension costs means this is an increasing issue around the world.

The EY 2014 report, *Building a better retirement world: insights for better outcomes in the global pension and retirement market,* highlights how new challenges and opportunities exist for all participants in the global pension market. Their responses to these issues will have significant long term impacts for all governments, citizens and financial services providers.

The report draws on more than 80 interviews in 18 countries across the Americas, Asia Pacific and Europe to develop a 'heat map' to assist policymakers and industry leaders to make informed decisions on policy reform, especially for pensions and retirement incomes.

The GFC acted as a catalyst for stakeholders to focus on the long-evolving financial challenges in retirement. While political and vested interests may impede necessary fundamental reform in many countries, there is general acceptance by industry experts, policymakers and governments that change is needed to rebalance pension retirement systems. Making long-term decisions in an uncertain environment with many moving parts requires significant experience, leadership, discipline and a vision of the big picture. Top policymakers, regulators and industry leaders want to learn about other countries' insights and experience.



The heat map shows the importance of the five key components of a robust pension and retirement system in the 18 countries analysed.

1. Financial adequacy. How much will different beneficiaries need for their financial well-being in retirement? How much will governments and public and private sector employers need to provide in retirement benefits to attract and retain employees?

2. Financial sustainability. How much can governments, private sector plan sponsors, public sector entities and future beneficiaries afford to save over the long term to pay for pension and retirement benefits?

3. Performance. How can we maximise outcomes and predictability of investments of pension and retirement assets?

4. Efficiency and effectiveness. How can we deliver promises efficiently and effectively to all stakeholders while meeting their service expectations?

5. Political aspects. What is our long-term pension and retirement vision? What short-term trade-offs must be made to secure political backing?

These five tenets are applicable to most countries but their relevance varies globally and over time.

The increasing importance of pension and retirement systems to ensure dignified long term retirement requires an improvement in the quality of regulation, supervision, governance and transparency to align to higher consumer expectations.

While Australia's superannuation system is well positioned relative to many other countries, the local industry still faces challenges. Given the importance of superannuation to Australians, and the compulsory nature of the system, further regulatory change and focus is inevitable. This is evident in the release of the Financial System Inquiry's interim report. The industry should be taking this opportunity to work with government and regulators to develop a strong framework that will ensure the future health of the system.

More work is still required to boost consumer confidence in the system. There is a need to see an improved focus on members to ensure their needs are being met both before and after retirement.

The report also identified seven key areas that present opportunities for superannuation and retirement providers across the globe:

1. **Rebalancing benefit expectations with financial resources.** Increasing longevity, evolving demographics and pension and retirement system promises are creating a financial gap for consumers and opportunities and challenges for providers. Concerns about funding long-term liabilities are a major public policy issue that will only increase in the years to come.

Three broader aspects in the pension and retirement debate

1. WORKING LONGER	2. DEMOGRAPHICS AND POLITICS	3. EMPLOYMENT AND LABOR RELATIONS
Increased life expectancy means more retirement time. The 'third age' demands innovative solutions regarding spending, offering opportunities and challenges for government and private sector providers to develop products and services. With a declining workforce in several countries, people may need to work longer.	The increasing percentages of older citizens impact public policy formulation and social and productivity decision-making. Further research for the new 'age' is needed to better understand and prepare all parts of society across most countries.	Pension and retirement promises are a vital employee benefit tool to attract and retain talent. Future benefit promises may require more flexibility to award, refine and eliminate pension and retirement promises made.

Source: EY

2. **Local financial markets need to evolve concurrently with growth in pension assets.** In many emerging markets, assets are increasing at a far greater rate than local capital markets are developing. To maximise and balance outcomes, different levers in the local market need to evolve and better align to limit further stress on the system.

3. **Acceptance of a new level of regulation, supervision, governance and transparency.** In many countries, the pension and retirement industry is as large as the banking sector or the annual GDP. This growing market and inherent risk to social and economic stability will inevitably result in a higher level of political and public attention.

4. **An increasing focus on operational excellence.** Lacklustre capital market returns have forced the pension industry to step up efforts to lower costs, improve customer delivery and service and enhance risk management. These initiatives come at a substantial cost and will require significant change in behaviour, infrastructure and delivery systems.

5. **A recalibration of investment functions and investment management.** The GFC provided a wake-up call for systems and providers to re-evaluate their investment strategy, asset allocation policy and operating models. Focusing on short-term results has been a challenge at a time when there is a shift from often underfunded defined benefits to defined contributions or unfunded pay-as-you-go promises.

6. **Find simplicity in complex systems.** Low voluntary savings rates, low participation of young savers and low take-up switching or voluntary superannuation and retirement solutions are indicative of a lack of engagement by ultimate plan beneficiaries. Improving buy-in, understanding and informed decision making among members is vital.

7. **Need to connect and become customer-centric.** Through better customer engagement, governments and providers can influence persistency, reputation, understanding and action. Providers are seeing the value of pension and retirement systems as more than a balance of payments, assets, price and product features; instead they are focusing on delivering customers what they want and improving the experience.

Policy reform is never easy but all participants in the survey affirmed their acceptance of the need for change. They are interested in building a better working world in relation to the critical topic of pensions and adequate retirement savings.

Graeme McKenzie is the Global Pension Leader for EY.

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Cheap stocks: how to find them and how to buy them

Karl Siegling

People often refer to themselves as either 'fundamental' or 'technical' investors and feel so strongly about one style of investing compared to another that they engage in heated debates. We believe investors should use whatever tools are at their disposal to try to beat the market, and that fundamental analysis combined with technical analysis has a greater probability of achieving this than one style alone.

Understanding fundamental analysis

When we refer to fundamental analysis we mean the process of determining accounting profits, operating cash flows, free cash flows, balance sheet debt, cash and overall balance sheet strength, as well as estimating these metrics two years into the future.

There are about 2,250 stocks listed in Australia (2.5% of the world's listed market capitalisation) and in any given year 600 to 700 of these companies actually make a profit - so about 75% of Australia's listed companies do not. We are unable to analyse companies that do not make a profit.

Of the profitable companies, 5% are usually cheap and 5% are really expensive in any given year. This equates to a 'sweet spot' of about 70 companies that meet our fundamental criteria. We hope to construct a portfolio of between 30 and 40 core positions in any given year.

This approach is outlined in Diagram 1 below. Importantly, we need an open mandate to implement this investment strategy (that is, few restrictions on the fund's investment style). Investing with an open mandate is unusual in Australia and particularly in the superannuation investment industry, although this is changing. We estimate that around 85% of all super money invested is invested on a restricted mandate, effectively reducing the number of really good opportunities available to a portfolio manager.

Diagram 1. Identifying good and bad stocks from the listed universe

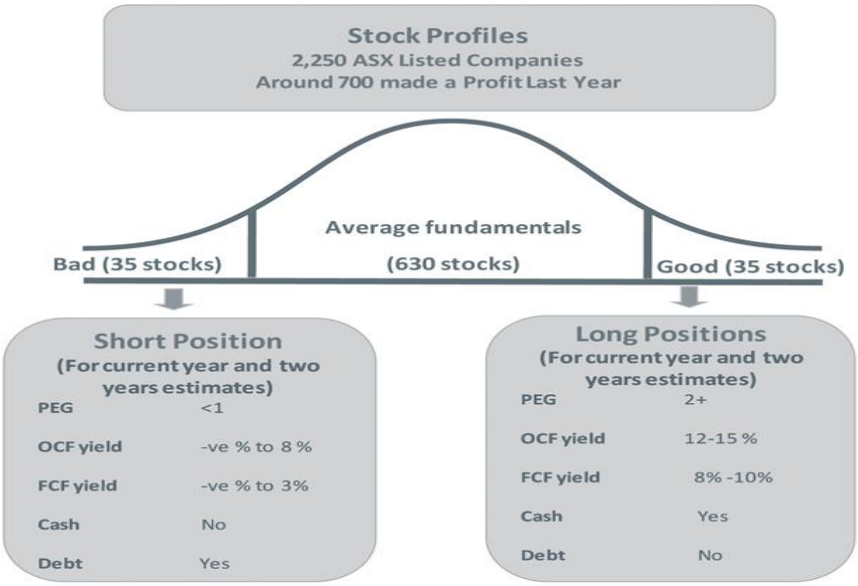


Diagram 1 shows that a typically cheap stock may have:

- earnings growth of around 20% per annum
- price-to-earnings (PE) multiple of around 10 times
- 12 to 15 per cent operating cash flow (OCF) yield
- 8 to 10 per cent free cash flow (FCF) yield
- minimal debt on the balance sheet
- (a *'long position' means the fund will buy that stock*).

Conversely, an expensive stock may have or be:

- growing at 10% per annum
- trading on a PE multiple of 20 times
- negative to 3% operating cash flow
- negative to 3% free cash flow yield
- lots of debt on the balance sheet
- no cash
- (a *'short position' means the fund will sell that stock*).

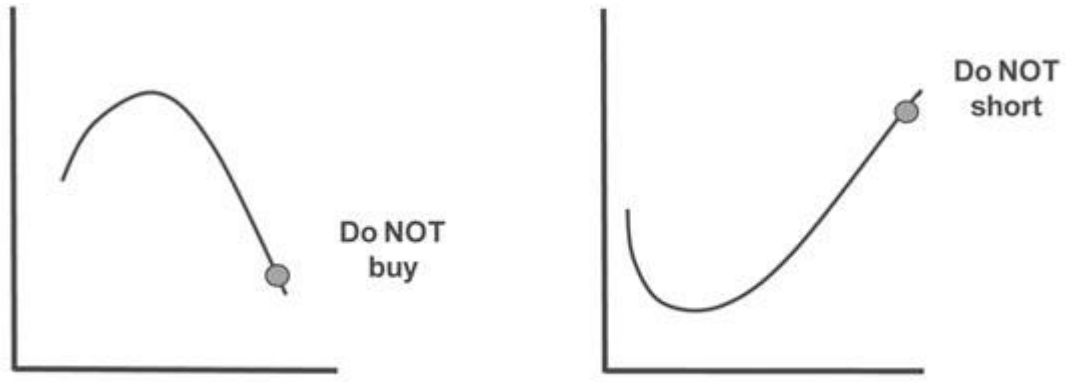
The process of trying to identify cheap and expensive stocks is ongoing, and just as individual stocks exhibit cyclical earnings and valuations, so too does the overall share market.

At the time of writing, several sectors in the market are showing high valuations, and a smaller, more discrete, group of stocks are presenting as fundamentally cheap. This is often the case.

Using technical analysis

Diagram 2 shows how we buy and sell stocks. No matter how cheap we think a stock is, we are not allowed to buy if it is falling in price or in a downward trend. Conversely, no matter how expensive a stock, we do not sell or short-sell if it is in a price uptrend.

Diagram 2: Do not buy a falling stock, do not sell a rising stock



Buying stocks that are falling and selling stocks that are going up are probably the two biggest mistakes that investors make. There are deeply engrained reasons for this and many psychological barriers within investors' psyche that often prevent them from buying stocks that are going up and selling stocks that are going down. In fact, investors are often compelled to do exactly the opposite.

An entry strategy to buy cheap stocks

Diagram 3, below, shows the process that we undertake once it has identified a stock to be cheap. We wait for the falling share price trend to finish (this is how a stock becomes cheap - people sell it). Once the price starts to recover we initiate a 1% (of our portfolio) position. At this point conditions are ideal to generate good risk-adjusted returns. We then add 1% and another 1% as the price rises, up to a maximum of 5% of our portfolio at cost into any one position.

Our core positions start as 1% positions initially so we do not have too much capital invested in any one new idea. Starting with a small position is another way of mitigating risk.

Diagram 3: Staged entry and exit points

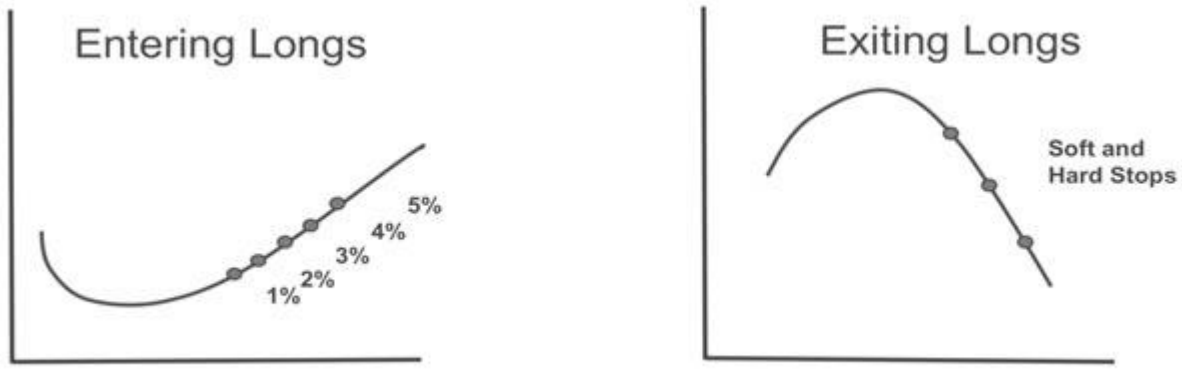
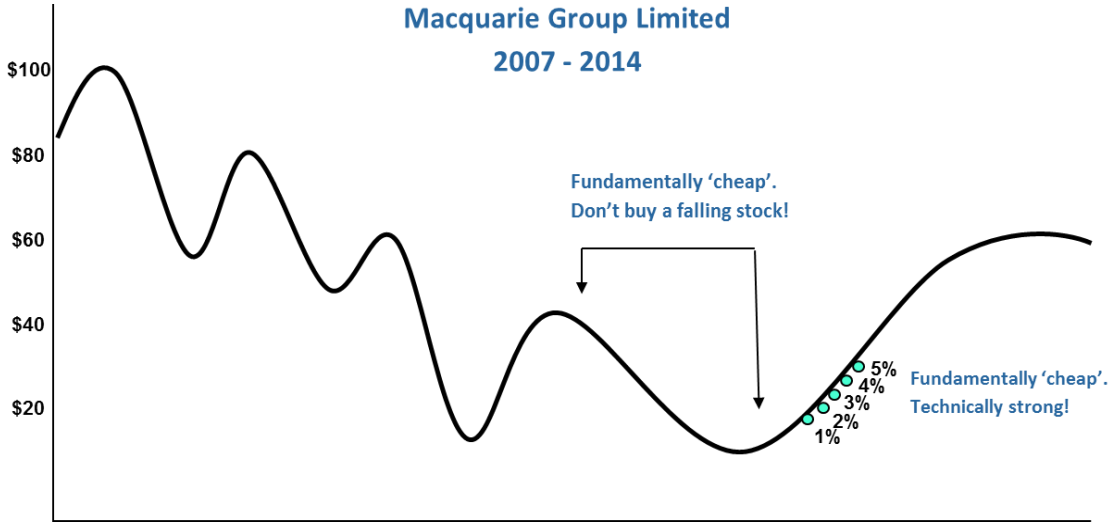


Diagram 3 also shows how we exit our positions once the long-term trend has ended and the stock becomes expensive. We sell a third of the position initially then another third and eventually the final third. In this way we are not making decisions about an entire position on a day-to-day basis.

The fundamental and technical processes in practice

Diagram 4, below, shows the combination of fundamental and technical analysis operating together using Macquarie Group as an example.

Diagram 4: Combining technical and fundamental analysis



Shortly after reaching a peak of nearly $100 (on our fundamental analysis at the time, reasonably expensive), the GFC brought havoc and Macquarie's earnings fell substantially, along with its share price. It continued falling and at around $40 started to look reasonably cheap from a fundamental perspective. However, as outlined, we don't buy a stock that is cheap but still falling in price.

Macquarie subsequently traded as low as around $17 and then recovered to its current price of around $57 ($61 if you include the recent spin-off of Sydney Airports). Once the fundamental and technical picture for Macquarie lined up (that is, the stock was fundamentally cheap and technically going up), our approach was to buy with an initial 1% position at $23, then add to it again around $26, $28, $35 and $41, accumulating a 5% position at cost over time.

We believe, in this example, had we started buying when we identified Macquarie as fundamentally cheap when the share price was still falling, we would have been taking unnecessary risk and incurring large losses before the stock price had finished falling and started to rise.

From a fundamental perspective, it does not matter how cheap or expensive investors may think a stock is, should the share price still be falling it is not a good time to buy technically, and should the share price still be rising, it is not a good time to sell technically.

Karl Siegling is a Portfolio Manager at Cadence Capital Limited (ASX: CDM). This article provides general information, does not constitute advice and should not be relied on as such.

ATO ruling affects assets after divorce

Sarah Hendry

Individuals hold their assets in a variety of entities, such as companies, trusts or other types of arrangements. In the context of family law, divorcing spouses often funded their divorce settlements using assets held by private companies. This was because family law settlements did not attract tax in the way normal commercial transactions might.

However, on 30 July 2014 the Australian Taxation Office (ATO) issued a final public ruling making it far more difficult for spouses to use income and other property held in a private company to fund property settlements tax-free. Instead, payments made from private companies will now be considered 'dividends' and subject to personal income tax. Depending on the marginal tax rate of the spouse involved, a tax of up to 49% of the gross figure could be payable, reducing a divorce settlement by almost half. The difficulty applies to all couples, regardless of whether their companies have $100 or $1,000,000 worth of assets.

In addition to the increased cost of divorce, some commentators have warned that the need to fund a divorcing spouse's tax bill could convert a 50-50 settlement into a 60-40 settlement or worse, resulting in an obvious inequity between the parties. Further, for those companies that are already struggling financially, the need to make a large payment to a divorcing spouse and also fund that spouse's new tax bill could have dire consequences for the company's success.

To reduce the tax liability, parties might choose an alternative way to divide their assets upon divorce. For example, it might be possible to provide the divorcing spouse with another asset, such as a property or a motor vehicle, or a spouse might be paid from a non-company entity, such as an individual or a trust, by using the company's assets as security. Alternatively, a company restructure might enable a spouse to receive shares in the company instead. In this regard, a spouse can take advantage of the Capital Gains Tax (CGT) rollover provisions and defer any tax payable until another CGT event occurs (such as selling the asset to someone else). However, divorcing spouses must ensure that such a restructure does not contravene any of the ATO's anti-avoidance rules.

Unfortunately, not all divorcing spouses will have these options available and in such circumstances, the extra tax liability must be considered early on and apportioned appropriately between the parties. A good understanding of the tax ramifications of any property settlement will be key to ensuring the after-tax split between the parties is not a nasty surprise. Accordingly, it will be important for divorcing spouses to receive specialist advice from experienced family lawyers and in some circumstances, accountants.

Sarah Hendry is a Solicitor at Foulsham & Geddes Solicitors and Attorneys.

This article provides general information, does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken.

Tax and the financial planning process

Gordon Mackenzie

With the forthcoming Government White Paper on the Australian tax system and some comments that the Murray Inquiry made with respect to tax and the financial system, it is timely to have a look at where tax fits into financial planning.

Perhaps the starting point with taxation is that an indicator of a good tax system overall, as the public finance economists love to say, is that tax should not impact on economic behaviour. Or, to put that another way, taxes should not 'distort' economic activity, which in the context of financial planning, means taxes should not 'distort' where individuals save because, after all, financial planning is just saving and investing.

All very well in theory. However, this is not the case in the real world and taxes can have a significant effect on how individuals save. In fact, the Murray Inquiry highlighted six different ways in which the Australian tax system distorts the way individuals save and it is these that will come under review with the Government White Paper.

So what are they and how do they affect the way a person saves?

1. Tax affects **asset selection** by individuals. That is, tax impacts on which assets an individual (or SMSF) will hold. Probably the best example of this is Australian company shares that pay imputation credits. Investors will actively seek out this class of investment specifically to get the tax effect of dividend imputation.

2. Taxes affect **asset allocation** by individuals. That is, tax impacts how much a person will invest in or allocate their savings to each type or class of asset. Perhaps the outstanding example of this is the family home, which is tax exempt and is the asset class owned by the majority of Australians.

3. Tax affects how much individuals will **borrow**. The Henry Review noted that the Australian tax system of negative gearing actually incentivised people to 'gear up' for favourable tax advantages.

4. Tax affects **asset location**. In other words, tax affects where the assets are held. SMSFs are the best example, and they have become the preferred holding vehicle for many people's wealth.

5. Tax affects whether individuals will invest **directly** or use a **financial intermediary**. The tax affects here can be subtle, such as the use of carry forward tax losses, which is not as effective in financial intermediaries when compared with investing directly. Some retail and industry superannuation funds do not handle the transition from accumulation to pension efficiently when compared with SMSFs.

6. The Australian tax system affects when to **dispose of an asset.** Individuals get a 50% tax discount and SMSFs get a one-third tax discount if they wait at least 12 months before disposing of the asset.

Although the theory is that the tax system should have no bearing on how people save and invest, these six differences will come under serious scrutiny by both Murray and the Government White Paper.

Gordon Mackenzie is a Senior Lecturer in taxation and business law at the Australian School of Business, University of New South Wales.