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This Week's Top Articles

- **The most complex super system in the world** *Nick Sherry*
- **Why LICs trade at premiums or discounts** *Chris Stott*
- **Currency winners and losers** *Hugh Dive*
- **Are bonds liquid?** *Jonathan Rochford*
- **Your bond questions answered** *Warren Bird*
- **Deposit guarantee bill passes but not for super** *Graham Hand*

The most complex super system in the world

Nick Sherry

Over the past 25 years - the last two in particular - I have examined closely, and in some cases worked directly with, a range of defined contribution pension systems around the world. This includes key aspects of their design and operation, particularly in the UK, Hong Kong, Switzerland, Chile, Ireland, Greece (no finalised systems) and Colombia. The analysis includes key benchmarking against a range of countries. Australia is always included.

The Australian strengths are clear and include compulsory, defined contributions; diversified arms-length investment; independent trustee governance; firm prudential oversight; independent dispute tribunal; compensation in the event of theft and fraud and others.

However, on any analysis our system is the most complex compulsory defined contribution system in the world, mainly because of the number of electable options and decision-making choices that can or should be made by an individual.

And I am not referring here to the fund or investment decision or the tax overlay, which receive considerable attention in public policy debate.

Complexity adds to cost

Ideally a system should be simple to understand, so simple that an individual can effectively make decisions themselves, to the extent permitted in a compulsory system. Simplicity matters because complexity is cost and cost reduces a member's return particularly in a defined contribution system.

The costs and various system-wide fee analyses have been highlighted from time to time, for example, in the recent Grattan Institute Report (although they make some good points, I disagree with parts of their analysis and policy suggestions) and the Cooper Review (which I established as a Minister).

The critical question is what drives this cost? Valid reasons include the lack of a centralised administration hub, the number of funds (related to this is a lack of scale in some cases), the number of investment options, the conflicted fees or commission related to advice and product selling and others.

One key aspect of the Australian system that receives little critical attention is the considerable number and range of electable options and decisions available to the individual. The range of electable options is not available in any other compulsory system.

Examples of our highly complex system

Our super funds include, in addition to the availability of fund and investment selection, such complexities as:

- insurance - TPD (Total and Permanent Disability)
- insurance - salary continuance and unemployment insurance
- consolidation - rolling together multiple accounts
- estate provisions
- early access in a range of defined circumstances.

Furthermore, we have made the area of contributions complicated with:

- salary sacrifice (concessional)
- other after tax contributions (non-concessional)
- co contributions for low income earners
- splitting of contributions
- children accounts
- transition to retirement at age 55
- spouse contributions

Some other countries may have a few of these options but nowhere near this range of complexity. The newest defined contribution systems in the UK and New Zealand do not have insurance or estate provisions or most of the above.

Australia also has further complexity in the post-retirement space. In addition to allowing lump sum withdrawals (as many other defined contribution systems do), there is also a means-tested government pension. No other advanced economy with such an extensive defined contribution system has this provision.

Are we maximising retirement incomes?

This complexity drives up cost in two main areas – administration and advice (or selling depending on your perspective). This is on top of the additional complexity and cost arising as a result of individual fund and investment selection.

It further leads to a fundamental question in a compulsory defined contribution system that is supposed to be for retirement. Is all of this necessary to maximise the retirement income of the individual?

A critical analysis and debate should consider some of the following in an attempt to reduce the complexity:

1. Insurance in super. If contributions are inadequate, why is insurance – particularly disablement and salary continuance – appropriate in super? It diverts resources from retirement income.

2. Estate requirements. Why the need for a parallel and separate system to deal with an individual's super property in the event of death?

3. Transition to retirement at the age of 55? The pension age is 65 going to 70!

Concluding comments

Australia has the most complex defined contribution system in the world, both pre- and post-retirement.

Other countries have undertaken a more careful analysis and considered debate. Certainly, the Australian experience as an early mover has been very helpful to other countries in realising, at least in some areas, what not to do. The main point is to avoid complexity to the extent possible and keep it simple.

Nick Sherry was a member of the Australian Senate from 1990 to 2012, Chair/Deputy of the Senate Superannuation Committee (overseeing the Super Guarantee and SIS Legislation), the first Minister for Superannuation and Corporate Law (responsible for ASIC and the superannuation divisions of APRA and the ATO), Assistant Treasurer and many other roles. He now consults to financial providers, governments and international organisations around the world.

Why LICs trade at premiums or discounts

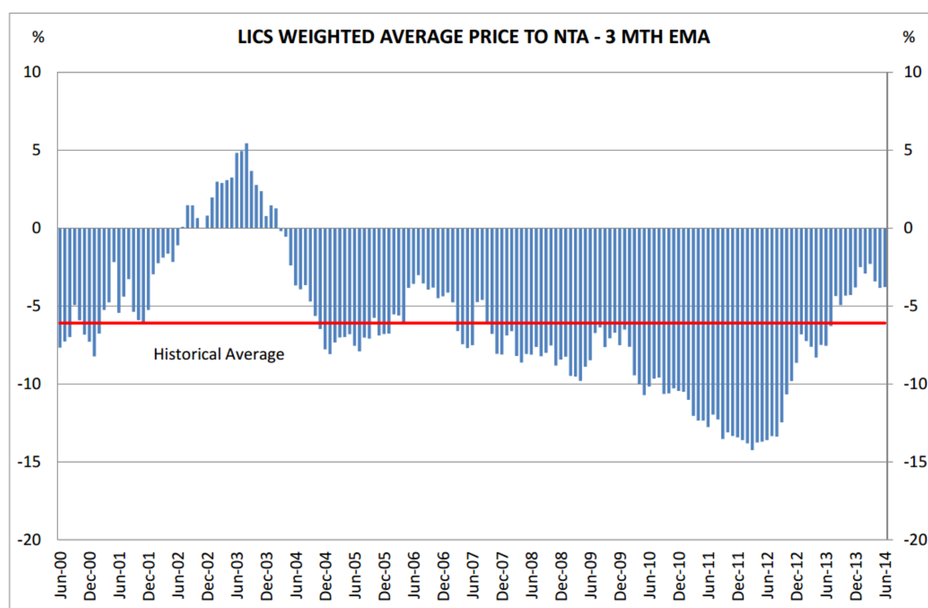
Chris Stott

With a surge of Listed Investment Companies (LICs) coming to market recently in Australia, there are now over 60 LICs listed on the ASX with a combined market capitalisation of more $25 billion – up 15.1% over the last 12 months and a remarkable 52.1% over the last 24 months. A key feature of this investment vehicle is that, unlike unlisted managed funds, they can trade at a premium or a discount to their underlying assets. Over the last ten years, Australian LICs have traded at an average discount to net tangible assets (NTA) of 6%. Today the median discount is 4%, with some LICs trading at significant premiums to NTA including Djerriwarrh Investments Limited (ASX:DJW) and WAM Active Limited (ASX:WAA) with share price premiums of 24.0% and 34.0% respectively (as at 10 October 2014).

Increasing profile of LICs

This trend of reducing price discounts has been driven by a number of factors including the increased popularity of LICs following the introduction last year of the FOFA (Future of Financial Advice) reforms banning upfront and trailing commissions payable by other managed funds to investment advisers and financial planners. This development helped raise the profile of LICs and their benefits. In addition, while valuations of LICs traditionally focused on their discount/premium to NTA, in their 'hunt for yield' investors are now more focused on fully franked dividends, an important feature of LICs.

In this article, I look at the factors that may cause an individual LIC to trade at a premium or a discount to its NTA and discuss the potential consequences of each.



Source: Patersons 'Listed Investment Companies' Quantitative Research report – 27 June 2014

Trading at a *discount* to NTA

There are a number of reasons why a LIC may trade at a discount to its NTA including:

- Poor investment portfolio performance, or for newer LICs, having no established past performance.
- Lack of fully franked dividends, a poor track record of paying them, or a perceived inability by the market to pay fully franked dividends in the future.
- Ineffective marketing and communications resulting in the failure of the LIC to raise its profile amongst prospective investors or build an understanding relationship with existing shareholders.

The consequences for a LIC and its shareholders when it consistently trades at a discount to its NTA are generally negative.

Shareholders are likely to become disgruntled, particularly if they bought their shares when the LIC was trading at or around its NTA. Consider a shareholder who bought their shares when the underlying assets were worth $1.00 per share which later trade at 80c each. Trading at a discount means a LIC's ability to raise capital is constrained and its growth is stunted. The LIC may then be forced into a share buyback or to undertake other capital management initiatives. Attempts to grow by raising capital at a discount are often highly dilutive to existing shareholders, further exacerbating or causing shareholder frustration. As a publicly listed company, disgruntled shareholders have the ability to call for the company to be wound-up, as with India Equities Fund Ltd (ASX: INE) and Van Eyk Three Pillars (ASX: VTP) in recent years.

Over time, if shares consistently trade at a discount, it can attract agitators or activists to the share register who may take a short term approach to their investment. For example, during the GFC, investors Weiss and Carousel Capital took positions in discounted LICs and then cashed-out as soon as they were trading closer to their NTA.

However, this does provide upside for prospective investors who want the opportunity to gain exposure to the LIC's underlying securities for less than their value. Also, investors can exploit occasions where a LIC's shares trade at a discount to its NTA by buying shares in anticipation that, in future, the value of the underlying assets may trade at a premium to its NTA (or closer to its NTA) creating the potential for some gain.

Trading at a *premium* to NTA

In our view, there are some common factors that contribute to a LIC trading at a premium to its underlying asset value including:

- Experienced management – in recent years, newer LICs have traded at discounts (or more significant discounts) than their older counterparts, such as AFIC (ASX: AFI), founded in 1927, and Argo Investments (ASX: ARG), founded in 1946, suggesting investors value companies with long term experience trading through various market cycles.
- Solid investment portfolio performance – a track record of consistently good performance of the LIC's investment portfolio in absolute or relative terms to a benchmark.
- Stream of dividends – the LIC's track record of paying a regular stream of fully franked dividends over time is a particularly important factor for investors lately with the rise of SMSFs in recent years.
- Effective marketing and communications initiatives that raise the profile and improve the reputation of the LIC and its manager. For example, investor presentations, regular market updates and media appearances.

For a LIC trading at a premium to its NTA, its ability to raise capital in order to grow the company is enhanced. Over the last year, we have seen numerous LICs raise capital through placements (in addition to Share Purchase Plans and Dividend Reinvestment Plans) such as Cadence Capital (ASX: CDM) and WAM Capital Limited (ASX: WAM). Last calendar year, almost $1 billion was raised by LICs (including Initial Public Offerings) – a record for the sector.

Existing shareholders generally welcome an increase in the value of the shares relative to the LIC's assets as it increases the value of their investment. For example, a shareholder may have bought their shares when the LIC's underlying assets were worth $1.00 per share and they later trade at $1.20 per share. In the shorter term, this may translate into larger than usual gains in the performance of the investment portfolio however, this is often short-lived with history showing that LICs normally return to trade at or around their NTA.

The downside is for prospective investors who must pay in excess of the value of a LIC's NTA in order to invest in the company and gain exposure to the underlying portfolio of assets its holds.

In general, the premium to NTA trend has contributed to attracting considerable capital to the LIC sector over the past year with more LICs listing in the last 12 months than over the previous decade.

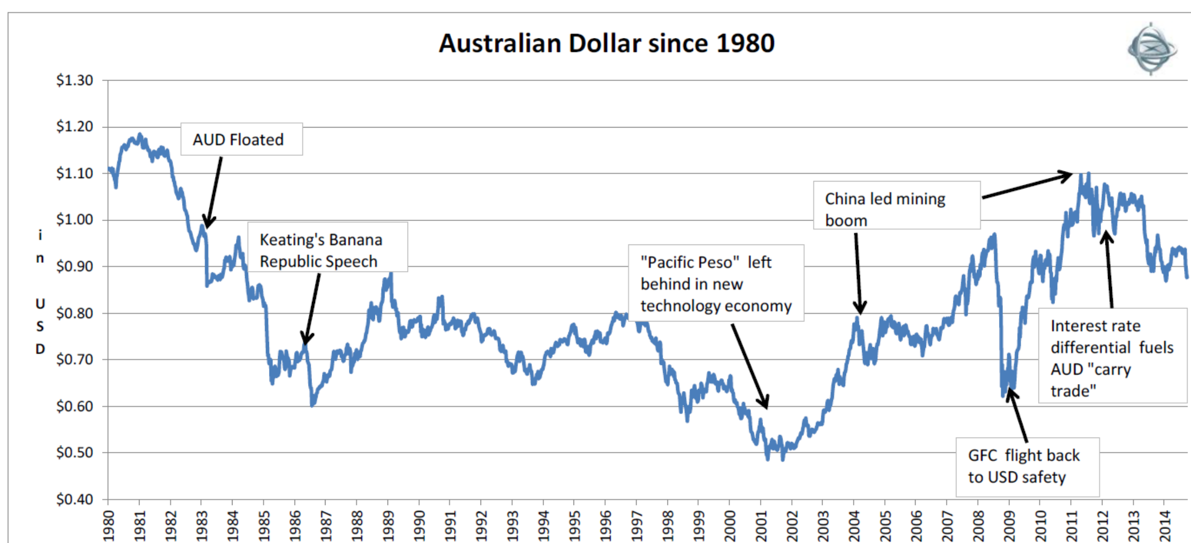
Chris Stott is Chief Investment Officer at Wilson Asset Management. His views are general in nature and readers should seek their own professional advice before making any financial decisions. Wilson Asset Management is a major manager of LICs.

Currency winners and losers

Hugh Dive

When the Hawke Government came into power in 1983 one of its first decisions was to float the Australian dollar (AUD), assuming that this action would cause the AUD to fall and improve our international competitiveness. Before 1983, the value of the AUD had been set each day by the Reserve Bank of Australia (RBA) and the Federal Government. Since then, rises in the Australian dollar are often presented in the press as a vote of confidence in Australia as a nation. A falling Australian dollar is viewed as a negative event, raising the cost of online purchases, imported flat screen TVs and skiing holidays in Colorado.

Since 30 June 2014, the AUD has fallen 7% against the USD, as the 'carry trade' (*borrow cheaply in USD and invest the proceeds in higher yielding AUD securities*) quickly unwound and foreign speculators fled back to USD. The AUD was sold off more than almost every other developed and emerging market currency, just like it was in the May-June 2013 'QE taper' scare and also in the 2008-2009 GFC. Whilst this move is negative for a government wanting to buy F-35 Joint Strike Fighter jets, the falling AUD benefits many investors, as both asset allocation into unhedged international equities and Australian equity portfolio construction can be designed to benefit from a falling AUD.



Since floating in 1983 the AUD/USD has averaged 76 cents, however as one can see from the above chart the AUD was in a downward trajectory from 1983 to 2002. This was broadly due to Australia's higher relative inflation rate. The strength in the AUD over the past 10 years has been a result of China's industrialisation and its associated unprecedented explosion in demand for Australian minerals since China joined the World Trade Organization in 2001. As the impact of this one-off event diminishes, we would expect the AUD to move towards fair value based on purchasing power parity, which we estimate is approximately USD66 cents.

Winners

Broadly speaking the companies that are likely to benefit from a weaker AUD fall into four categories:

1. Companies that manufacture or provide a service in Australia and compete with the now more expensive imports such as steel (BlueScope), fertiliser (Incitec Pivot) or tourism (Crown).
2. When a falling AUD results in inflation, companies like Woolworths and Transurban should see an expanding profit margin. Their product prices from cans of tuna to road tolls will increase with inflation, whilst a proportion of these companies' costs remain fixed, thus resulting in higher profits.
3. Companies that have production costs in AUD but export products like natural gas (Woodside) and iron ore (Rio Tinto) which are priced in USD. A falling AUD translates into higher AUD revenue from the same USD level of goods sold. For example, every 1c fall in the AUD increases BHP's profit by USD100 million and Rio by USD57 million.
4. The falling AUD also benefits companies with substantial offshore operations such as CSL and Orica, as their USD- or Euro-denominated earnings when translated back into AUD for Australian investors are now worth more.

Losers

The companies that are typically hurt by a falling AUD are those that buy goods offshore for resale to Australian consumers such as retailers Myer and JB Hi-Fi. Over the last 12 months, the 8% fall in the AUD/Korean Won effectively results in a price increase for that new 140cm Samsung LED TV that some may have their eyes on for the upcoming Cricket World Cup.

Similarly, a falling AUD presents a challenge for companies like Qantas that earn revenue in AUD from domestic consumers, but have significant USD-denominated costs such as aviation gas. Further companies that have significant un-hedged USD borrowings such as Boral will see their interest costs increase, especially when the company does not have USD earnings to service their debt. For example Boral's US building materials businesses last generated a profit in 2007.

How to position a portfolio

Investors who view the AUD as overvalued on fundamentals can position both Australian equity portfolios and unhedged global equity portfolios to benefit from a falling AUD. Favoured companies might be those with significant offshore earnings and strong franchises (CSL, Orica or Sonic Healthcare), rather than structurally challenged companies that need a declining AUD to compete with imports (BlueScope Steel or CSR). Additionally, mining and energy holdings such as BHP, Rio Tinto and Woodside will benefit from a rising price per tonne of ore or a barrel of oil sold in AUD terms.

Hugh Dive is Head of Listed Securities at Phil Capital Advisors. These comments are general in nature and readers should seek their own professional advice before making any financial decisions.

Are bonds liquid?

Jonathan Rochford

Investors are increasingly asking whether bonds are liquid and what risks exist if they aren't. In recent years Blackrock has written frequently on this topic with their latest piece noting that despite the growth in the total value of bonds outstanding globally, the market is becoming increasingly fragmented. They point out that some US banks have more than 1,000 bonds outstanding, with some large corporates having dozens of bonds on issue. Other articles have pointed to the decreasing size of trades and with new regulations, banks are increasingly becoming trade arrangers rather than middlemen using their balance sheets. The problems are known, but there's seemingly little momentum to change the status quo.

Proposals to improve bond liquidity

Blackrock has proposed that issuers should move to fewer, larger bonds (perhaps a maximum of one maturity per year) with standardised terms. This would dramatically reduce the total number of bonds outstanding as well as reducing the seemingly subtle differences in terms that govern each bond. The recent push to include 'collective action' clauses in all sovereign bonds is an attempt to standardise terms.

Another suggestion to improve liquidity is for trading to migrate to exchanges rather than through brokers, with a centralised order system making it easier for buyers and sellers to find their match. Listed notes in Australia have achieved good levels of trading helped by transparent prices and orders. If the brand name and yield is attractive, issues of more than $1 billion are possible with the latest Commonwealth Bank issue gathering $3 billion.

However, listed notes come with increased volatility in prices relative to unlisted bonds, with non-institutional investors arguably having less of a focus on fundamentals and more of a focus on sentiment.

An example of why all of this is important is highlighted by recent news on Pimco, with the departure of Bill Gross triggering a wave of redemptions from both its Total Return Funds. The ETF version of the Total Return Fund is currently being investigated by the US securities regulator (the SEC) over its pricing mechanics. The SEC investigation is dealing with one of the long-standing issues with bonds: how do you value holdings of unlisted securities of varying sizes and different terms, when some have traded recently and others haven't? The initial claims are that the Pimco ETF was buying small parcels of bonds, which trade at a discount to larger parcels due to their lower liquidity, and then having those bonds marked up in value to the levels that larger parcels had most recently traded at.

In normal times there wouldn't be any concerns about the liquidity of the ETF. However, with redemptions of approximately 15% in two days following the departure of Bill Gross concerns have been raised. Could the ETF become illiquid if the redemptions continue at a high rate? Could the previously profitable strategy of buying smaller discounted bonds come back to bite Pimco?

Watch liquidity risk as well as credit risk

Illiquidity issues can become a self-fulfilling prophecy as the more liquid positions are sold to fund redemptions leaving a rump of illiquid positions. ETFs and managed funds with daily or weekly liquidity are particularly susceptible to being caught out. These vehicles should only be holding the most liquid securities, matching the very high level of liquidity they offer their clients. Australians with a decent memory will remember the billions locked up in mortgage funds when the financial crisis hit – a classic case of liquidity mismatch. Long dated illiquid mortgages, although in many cases very low risk, were unable to be sold to meet redemption requests flooding in.

Increasingly, bond investors need to consider not just the credit risk but also the liquidity risk of their holdings. Very small or very large holdings of individual issues, as well as esoteric securities, are particularly prone to being difficult to trade. Liquidity is also cyclical, with this summed up in the common fund manager euphemism that "liquidity is always available except when you need it". This was seen for both listed and unlisted securities during the financial crisis with the buy/sell spread widening from basis

points to percentage points in some cases. Buying smaller ticket securities at a discount is a legitimate strategy to generate alpha but it is suitable only for investors who have a 'buy to hold' outlook. Some investors want to receive a liquidity premium on the securities they invest in but they don't want any limitations on the liquidity of their investment. You can't have the best of both worlds. It will end badly.

But investors still want liquidity

The two main reasons I've found that people want liquidity are:

- they want the ability to sell if their situation changes, or
- they want the ability to sell if the investment outlook changes.

Each is understandable, but they impact the way investments should be made and limit the risk that should be taken. If liquidity is needed for personal situational changes then short tenor securities or very low risk securities are the best match. There has to be a compromise and that will be a reduced credit spread earned.

Liquidity for investment outlook changes is a different story. I'm a strong believer in the Warren Buffett maxim that investors should only buy securities that they are happy to own if the market closes for 10 years. If the long term return for risk isn't acceptable now then that is ripe for a future correction. Many investors believe they can foresee the signs of a market peak, yet very few have acted correctly and consistently at market peaks. For the vast majority of investors, by the time they've recognised the signs of a downturn the prices have shifted down well beyond their desired selling level.

Other benefits of bonds

When there is a comparison between investment opportunities in different asset classes there are two additional points that are critical. Firstly, debt securities have the added benefit of either a hard maturity date or an amortisation pathway. Secondly, debt securities have a slice of equity below them that takes the first losses.

If you get the initial investment call a little bit (but not a lot) wrong, the security price will likely be marked down but then gradually work its way back to face value as it approaches maturity. You're not stuck forever hoping for a business or market turnaround: there's an approaching date when things will come good. A maturity date is effectively a second form of liquidity, but with a far more reliable timeframe and price. In a time of crisis, an approaching maturity is doubly valuable as it allows for the cash received to be re-invested into other securities at cyclically low levels.

Jonathan Rochford is Portfolio Manager at Narrow Road Capital. This article has been prepared for educational purposes and is not meant as a substitute for professional and tailored financial advice. Narrow Road Capital advises on and invests in a wide range of securities.

Your bond questions answered

Warren Bird

Warren Bird's previous article, *An idiot's guide to bond funds*, was written in response to a message from James, a Cuffelinks reader, who asked for an explanation of bonds in layman's terms. This article wraps up the series, addressing the remainder of James' questions. Warren has again stepped in to provide his insights into the realm of bonds:

Should one invest in bonds for income or capital gain?

Bond returns are income returns over time; you can speculate about short term market movements if you want, and try to time your entry to achieve capital gains, but the nature of bonds and bond funds is income returns.

Are there some bond funds that should be included in the growth section of a portfolio as opposed to the defensive?

Funds that invest in lower rated corporate bonds and high yield are more closely correlated with equity market returns and thus don't perform the same defensive role as a portfolio of Australian government bonds. But they still aren't 'growth funds' so they don't belong there. Some funds have a category for 'middle risk' or 'alternative defensive' assets that they put credit and high yield into.

Is a 70/30 split crazy when interest rates are at all time lows?

Not in my view. The concern seems to be that bonds will perform poorly when rates go up. However, just because rates are low doesn't mean they are going to go up significantly; even if they do, it means your expected future returns will ratchet up as rates go up. And equities are pretty fully valued so it's quite possible that they will fall sharply when bond rates go up.

What are the merits of passive vs active investing in bonds (it is my understanding that most bond funds have underperformed passive funds over the past ten years, much like active equities funds)?

It's not true that most bond funds have underperformed - in fact, most have outperformed passive funds. The issue for many super funds, etc is that the amount of outperformance from bonds is much less than in other asset classes, so they would rather allocate fees to seeking higher excess returns than bond managers can deliver. I think you should focus on after-fee returns and if you can get value add from any asset class you should be willing to pay for it.

Please explain these new-fangled 'unconstrained bond funds'.

The gist is that they are funds that try to get value out of trading short term views of bond markets and sometimes equity markets, too. The specific strategies are unique to each fund and the skill set of the managers on their team.

Are they just a fad?

I gave a short response to this very question in the comments section of this piece, *What's that UBS bond benchmark in the annual statements?*. I personally invest in them so I don't think they are a fad. They have a place in the risk-return spectrum.

Are they a genuine solution to the duration risk argument?

That's not the reason I would invest in them. Duration risk is worth taking - with positively sloped yield curves you get paid to take duration risk.

Have they been created in response to bond fund managers wondering where the next dollar will come from after a 30 year bull market?

No doubt that was the motivation for some of them, but since most of them were developed several years ago before talk of 'the end of the 30 year bull market' took hold, it's probably not true for the sector as a whole. A less pejorative view is that end-investor demand for more income-focussed products that weren't constrained to just bonds led to products being developed to meet that demand. I personally think that funds with duration have a place in many portfolios and I have some in my own SMSF.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management. His roles now include consulting, serving as an External Member of the GESB Board Investment Committee and writing on fixed interest. His comments are general in nature and readers should seek their own professional advice before making any financial decisions.

[Deposit guarantee bill passes but not for super funds]

Graham Hand

The government guarantee on deposits seems to have been around forever, but it finally cleared its last legislative hurdle on 18 September 2014. The so-called Financial Claims Scheme (FCS) was introduced during the GFC in 2008, but the list of 'protected accounts' covered by the guarantee was formally regulated only a few weeks ago in the Banking Amendment (Financial Claims Scheme) Regulation 2014. It's worth knowing which types of accounts are not covered, including accounts at a foreign branch of an Approved Deposit-Taking Institution (ADI) and foreign branches of Australian ADIs.

For completeness, the protected accounts include: savings, at call, cash management, cheque, current, debit cards, farm management, first home saver, mortgage offsets, pensioner deeming, term deposit, transaction accounts and trustee accounts.

Last week APRA also released a revised FAQ summary on technical issues. It includes Section 5, which states:

"Are products marketed as superannuation or retirement products, such as accounts held by SMSFs, protected products?

If a product, which is used for superannuation purposes, satisfies the definition of a protected product account, it is covered under the Financial Claims Scheme … the definition does not depend on what the account is used for, provided it has the legal features of a protected account."

So that sounds fine for superannuation, but there is a point most commentators are missing.

Lack of coverage of most superannuation deposits

A number of articles on the FCS have appeared in recent weeks making statements such as, "All deposits with Australian ADIs up to $250,000 are covered." One article then went on to say all term deposits and government bonds are exactly the same credit risk since the government backs both. In seeking the best deal, investors should just find the best rate from an ADI for any particular maturity.

Depositors believe this means that if they place up to $250,000 in a bank (or any ADI) deposit in a public super fund, they will be protected for the full amount. This is incorrect, and here is why.

(This point has been explained in more detail in Cuffelinks previously here, but it is repeated because of the recent passing of the legislation and the incorrect interpretation in other places).

All superannuation money must be invested through a trust that complies with the Superannuation Industry (Supervision) Act 1993. A superannuation fund is a trust controlled by a trust deed. When an investor chooses a deposit option in a superannuation fund, it is the superannuation fund's trustee which invests with the bank (or ADI). The contract is between the bank and the trust, not the bank and the customer (the 'natural person'), and the trust is a single entity. This is unlike when an investor places a deposit directly with a bank, which is a contract between the customer and the bank.

The FCS applies ***per account holder per ADI***. An account holder is defined as an *entity*, and both trusts and superannuation funds are entities. Therefore, the $250,000 cap applies to the entire trust, which might have several billion dollars of 'deposits' in a single trust. A recovery of $250,000 under the guarantee may make a meaningless contribution to recovering money for an individual depositor if the underlying ADI cannot honour its obligations. The deposit is not effectively covered by the government guarantee.

In other words, there is no 'look through' from the trust to the end investor.

This can have important consequences. Any depositor placing $250,000 into a deposit with a public super fund should know which ADI the money is then placed with. If it is a second-tier ADI, the security may not be as good as the investor expects, and there may be little protection from the government guarantee, notwithstanding the super fund placed the money with an ADI.

In fact, if you check the website of various financial institutions, you will find much fanfare about the government guarantee on 'normal' deposits, but no mention of it for deposits in their super fund offerings.

One day, money will be lost in a super fund deposit

The full implications of this difference will only be felt when an ADI is unable to honour its obligations and the government covers the bank deposits but not the superannuation deposits. To make matters worse for public super funds, SMSFs can access the full $250,000 per ADI.

Graham Hand was General Manager, Capital Markets at Commonwealth Bank; Deputy Treasurer at State Bank of NSW; Managing Director Treasury at NatWest Markets and General Manager, Funding & Alliances at Colonial First State. Comments are general and not personal financial advice.

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