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This Week's Top Articles

Grattan's Super Savings flawed but essential reading

David Bell

Following on from the Grattan Institute's 'Super Sting' (of which I was somewhat critical – see *Grattan and the fuss about Chile's pensions*), the follow-up paper 'Super Savings' is worth a read. At a minimum it should be reflectively read by the executive and trustee of every super fund in Australia. Valid and, given my role at a large super fund, sometimes humbling points are made. However now is not the time to proceed to a default tender process. Indeed if default tenders were implemented now it could damage the retirement outcomes of Australians.

What does Super Savings say?

The essence of Super Savings is that the existing industry is inefficient from a cost perspective and that a range of measures need to be implemented to reduce costs. The key efficiency measures recommended are:

1. The government should run a tender to select funds for default superannuation
2. Government should take steps to slow the creation of new excess accounts
3. Encourage less efficient funds to merge with efficient ones
4. Introduce measures to strongly encourage the selection of lower cost products in the choice part of the superannuation market.

The Grattan Institute estimates that these initiatives could save over $1.5 billion per year.

In-depth cost analysis

Super Savings finds that administration costs are too high, because there are too many accounts, too many super funds and many charge high administration fees (compared to what Grattan labels 'lean funds'). Some areas identified as sources of excessive cost are marketing and sales costs, some member communications, and overly diverse product lines.

This is where a system review is most confronting for those in the superannuation industry. Faced with competition for members, funds spend more to retain and attract members to ensure a stable fund base to support the planned implementation of value-adding services. Without a stable membership it is hard to commit to projects with a capital expense, examples being MySuper and the Stronger Super reforms. So at a fund level, marketing and sales are justifiable, but when we step back to an industry or system level, Grattan highlights the negative impact of these costs on the Australian public.

The Super Savings report also claims that investment fees are too high and that active management does not add value. In my article on Grattan's first report I suggested that it is difficult for people with little funds management industry experience to understand all the nuances of the investment fee / fund performance debate. To Grattan's credit this paper provides much more analysis and I can see they have considered seminal academic literature and consulted with the private sector. However the debate around investment fees and outcomes is far more complex than they have presented. It seems that when an outsider looks at the issue of investment fees the recommendation is to head towards a passive solution. This is because many other issues are not considered, simple examples in this case being risk reduction and the quality of passive benchmarks. Unfortunately this is the case with Grattan's report.

Is low cost the solution? A critique of Super Savings

All else being equal, should a reduction in costs improve the retirement outcomes of Australians, as claimed by Grattan? I don't believe so, at least at the present time. Indeed a focus on cost reduction could lead to worse outcomes for superannuants. There is a productivity and cost efficiency persuasion to this report: the primary report author, Jim Minifie, is the Productivity Growth Director at Grattan. However are the conditions right for implementing productivity and efficiency reforms in superannuation? Consider the following:

- Though the Superannuation Guarantee has been around for nearly 25 years, the retirement savings industry is still not fully formed. This may sound strange but consider the lack of a clear direction, changing regulations, and the more recent focus on longevity issues and it becomes easier to accept. This is the same for retirement systems in most countries around the world (the exceptions being the well-established collective systems we see in some European countries). Our post-retirement solutions are embryonic. It is important that these solutions interact efficiently with our costly Age Pension system. What is not well understood is that the design of the post-retirement solution will impact upon the optimal design of our accumulation strategies. The complexity, technology, people and creativity required to create the wonderful fully formed whole-of-life solution that Australians deserve is significant. The solution is unclear – indeed there may be a number of good solutions. Would we reach these solutions and have the necessary discovery process if the focus switched to one of pure cost reduction? The opportunity cost of an inefficiently designed system could easily exceed the cost savings of implementing cost efficiencies at too early a point in time. Recent regulatory reviews such as the Super System ('Cooper') Review and the Financial System ('Murray') Inquiry failed to address key issues which could have guided and accelerated the development of post-retirement solutions (see *Has the FSI missed the elephant in the room?*). In a report where 'fees' and 'returns' are mentioned prolifically, 'mortality', 'longevity' and 'post-retirement' are not mentioned once.

- The Grattan Institute focuses on the core services required of super funds in coming to their recommendations. This assumes that all other non-core services are provided effectively and efficiently by either government or the private sector. Consider the example of financial education. Around Australia and the world, financial literacy levels are appallingly low. Australian schools do not have mandated financial literacy programs and question marks remain as to whether the Government has effectively addressed the problem. (In Australia, ASIC has a National Financial Literacy Strategy and with Financial Literacy Australia, they have projects to improve financial literacy, but they announced in late 2014 that the MoneySmart Week initiative will be discontinued). The cost of financial illiteracy is high but difficult to measure: financially illiterate people are much more likely to be liquidity-constrained, overindebted, and poor (see *A sombre reflection on financial literacy*). Many super funds work hard to improve the financial literacy levels of their members. Yet services such as this are likely to be viewed as not having a direct benefit by Grattan, partly because the undoubted benefits are difficult to measure.

- Nationwide default plans have strong application if all members are generic. This is not the case: for instance members differ by work pattern, wealth path and occupation. A generic plan could have huge opportunity costs on members who are not 'average'. A simple example is occupation. There exists great dispersion of insurance costs for members across different occupations, yet insurance contracts are typically determined at a fund level. A fund which blends members by occupation may face significant member equity issues associated with cross-subsidisation. This is just one example of the costs of treating individuals generically.

Conclusion

The Grattan Institute strongly challenges the super industry to have a good look at itself and justify the fees and added value provided to members. Unfortunately I think it applies a productivity focus to the superannuation industry in absence of recognition of the crucial stage of development the industry is at (and one which previous regulatory reviews failed to provide the necessary guidance to accelerate). I am not confident that Grattan has considered these challenges sufficiently in its analysis (where not a single mention of the words 'mortality', 'longevity' and 'post-retirement' occurs) and I feel it makes potentially incorrect assumptions that some of the highly valuable services provided by super funds, such as financial literacy, will be adequately provided elsewhere. It is too early, and ultimately damaging, to implement the most impactful recommendation of a default tender process. However there is little a rational person could say against recommendations (2) to (4) above. The prospect of (1) in the future should exist to keep efficiency front of mind for the industry. There will likely be a time when the default process outlined is appropriate, but let's reconsider that when the crucial issue of post-retirement solutions has been worked through.

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The numbers tell the story for index investing

David Bassanese

With the strong growth in index funds and exchange traded funds (ETFs) in the Australian marketplace in recent years, debate is again swirling on the benefits of active vs. passive investment management. Some commentators have suggested that index-oriented investments are merely for 'dumb' investors, who have no real skills in picking mispriced securities likely to outperform the market. If this were true, it would follow that these investors are leaving money on the table. By either investing in the development of these skills – or hiring talented active managers – they could produce better returns. It has been suggested that over the very long run, 'sensible investing' in 'quality' stocks will beat an index. How true is this?

Report 1: Percentage of Funds Outperformed by the Index

Fund Category	Comparison Index	One-Year (%)	Three-Year (%)	Five-Year (%)
Australian Equity General	S&P/ASX 200	61.44	63.14	77.56
Australian Equity Small-Cap	S&P/ASX Small Ordinaries	23.71	12.24	18.56
International Equity General	S&P Developed Ex-Australia LargeMidCap	80.58	88.21	86.09
Australian Bonds	S&P/ASX Australian Fixed Interest Index	94.12	86.54	85.71
Australian Equity A-REIT	S&P/ASX 200 A-REIT	91.67	80.00	80.22

Source: S&P Dow Jones Indices LLC, Morningstar. Data as of Dec. 31, 2014. Charts and tables are provided for illustrative purposes. Past performance is no guarantee of future results.

The evidence suggests most active managers don't outperform the index

Fortunately for participants in the ongoing active v passive debate, whether active managers outperform a market-cap weighted index is ultimately an empirical question. The evidence seems overwhelmingly in favour of passive investment, both in Australia and overseas. According to the latest SPIVA Australia Scorecard by S&P Dow Jones Indices, charted above, about 78% of active Australian general equity managers underperformed the S&P/ASX 200 Index over the five years ending December 2014. The performance of local international equity managers, Australian fixed-income managers, and listed property managers was somewhat worse. Over the latest 3-year period, the scorecard was slightly better for Australian equities active managers, although 6 in 10 managers still underperformed.

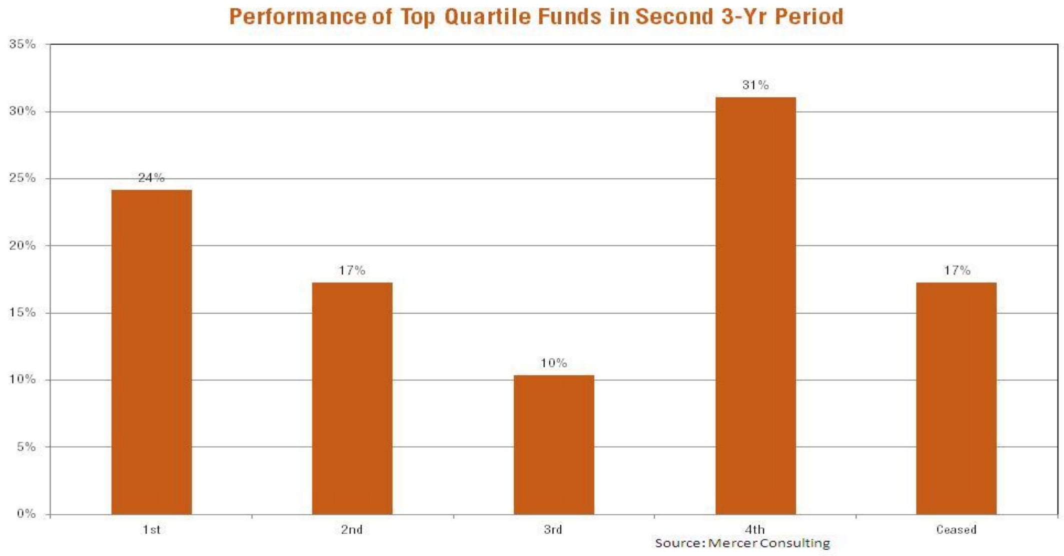
Even if active managers *were* able to consistently outperform the market, moreover, their degree of outperformance would need to *exceed* their management fees to beat some of the low cost ETFs and index funds available. As an example, a fund that charged a 1% p.a. management fee plus a 10% outperformance fee (charged before deduction of fees) would need to generate a return of 10.95% p.a. to offer the same return to an investor in an index product that rose by 10% in the year and charged a management fee of 0.15% p.a.

Any active outperformance is unlikely to persist

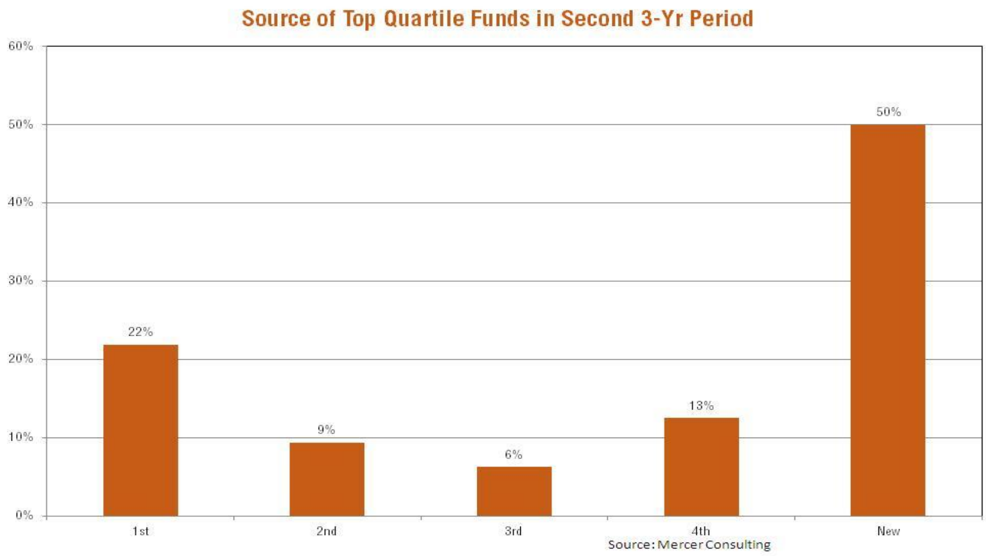
Of course, the above evidence suggests that some active managers can outperform the market. The challenge investors face, therefore, is in identifying these superior managers. The problem is that actually picking active managers that consistently outperform is not easy. As the old truism goes, past performance is not a great indicator of future performance.

The chart below, for example, is based on research on Australian active equity managers from Mercer Consulting which tracked the performance of investment managers across two three-year investment periods. How many of the funds that performed well in the first period also performed well in the second period? In other words, how persistent was outperformance?

Only 24% of the 29 funds identified by Mercer as enjoying top quartile investment performance in the three years to September 2010 were also able to produce top quartile performance in the three years to September 2013. In fact, statistically speaking, the most likely scenario (31%) is for a top quartile performer in the first period to end up becoming a fourth quartile performer in the second period. Meanwhile, almost one in five of these top performing funds ceased operation (or were merged/taken over) in the second three-year investment period.

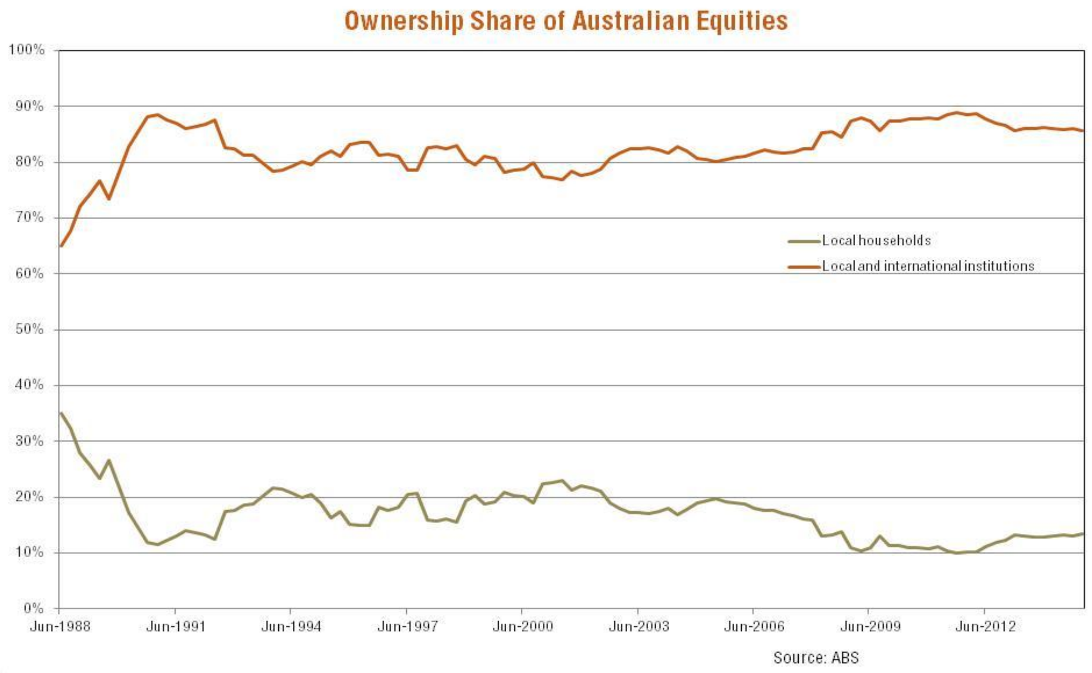


Indeed, according to the Mercer Survey, of the 32 funds with top quartile performance in the three years to September 2013 (among 126 funds covered), 16 – or 50% – of these funds were new to the market.



Active managers dominate the market so it's hard to outperform

Due to the fact that institutional money – which is still predominantly active in nature – tends to dominate ownership and therefore trading in the Australian equity market, not all managers can outperform the market all of the time. This is because for every 'winning' trade, there will equally be a 'loser' on the other side. As seen in the chart below, of the $1.6 trillion worth of 'listed and other' equities in Australia as at end December 2014, a whopping $1.4 trillion – or 83% – was owned either by domestic institutional investors, or foreign owners (which are also largely institutional). Households directly owned only around $200 billion, or 13%. The collective attempt of active managers to beat the market is akin to a zero-sum game.



There is more to indexes than tracking cap weights

Due to the development and continued innovation in indexation, there are now a number of indices which recognise the limitations of traditional cap weighted indices, including some offered in Australia. These 'smart beta' indices, such as fundamental weighted indices, combine the benefits of index funds (i.e. low cost, transparent, diversified, rules based) along with the potential to outperform the market cap benchmark.

We're a long way from passive investment distorting the market

There has been some conjecture that the continued growth of index investing and ETFs may contribute to potential market distortions. We are a long way away from that. According to Morningstar Research estimates, passive investment strategies account for around 8% of Australian managed funds. At these levels it's unlikely rebalances in such products will be a major influence on market pricing. With only about $18 billion funds under management, moreover, Exchange Traded Products account for only about 0.7% of the $2.4 trillion managed funds industry as at March 2015.

Even in the United States – where passive investment is estimated to account for a much larger 24% of funds under management in 2013 – it still seems evident that active managers have a hard time beating the market. According to S&P's latest survey, for example, 88% of large-cap US managers failed to beat the S&P 500 index in the 5-years to end-2014.

There is no doubt that there do exist a select number of active managers who have a strong track record of persistent outperformance. We firmly believe that active management has a role to play in investors' portfolios, and often find ourselves discussing how ETFs can be used in combination with high quality active managers. However, when considering the active versus passive debate, we believe it's important to be armed with the empirical facts.

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Investing in biotech and pharma

Hugh Dive

Biotechnology and pharmaceuticals are probably the most seductive and exciting sectors of the market to invest in. Not only can investors have the warm and fuzzy feeling that they are helping humanity (an emotion not readily generated by buying shares in Westpac or BHP), but when drugs or devices are developed and successfully adopted, it can be very profitable. Furthermore healthcare as a sector exhibits little correlation with Chinese growth, the health of the domestic economy or US interest rates and has some powerful demographic tailwinds.

It can be volatile, too. Recently, for example, Sirtex (STX) announced that trials of its eagerly awaited SIRFLOX liver cancer treatment had failed to show a statistically significant increase in survival in patients with liver cancer, though the company noted that liver cancer ultimately has a 90% level of morbidity. The announcement of this news wiped $1 billion off Sirtex's market cap as the stock fell 55%.

For reference the difference between biotech and pharmaceutical companies is that biotechs like CSL use microorganisms or biologicals to perform a process, whereas pharmaceutical companies such as Pfizer employ a chemical-based synthetic process to develop small-molecule drugs.

Fat profit margins

Most large corporations require substantial and continuing capital investments to maintain the quality of their assets. The major banks are required not only to set aside capital to back their lending, but have consistent expenditure on information technology (IT); for example the Commonwealth Bank spends over $1.2 billion per year on IT services. As the other banks match this expenditure, it does not result in any improvement in profit margins. Similarly, manufacturing companies such as Bluescope produce cardboard boxes and steel from capital equipment that can readily be bought by their competitors. This results in minimal barriers to entry beyond a company's cost of capital and thus gives low single digit profit margins and growth in line with GDP.

Conversely biotechnology and pharmaceutical companies can enjoy both high growth and high profit margins when a treatment they own and develop is successful and is adopted. For example in 2009 when Sirtex gained traction with their targeted liver cancer treatment SIR-Spheres, the company saw an annual revenue increase of 72% and profits increase from $1.2 million to $18.2 million. Demand for new and potentially life-saving treatments is relatively price inelastic. Furthermore patents and the time and effort required to obtain regulatory approvals for new drugs provide strong barriers to entry for other companies looking to produce competing products.

At the larger end of town in 2014 Pfizer, Hoffmann-La Roche, AbbVie, GlaxoSmithKline (GSK) and CSL all generated profit margins in excess of 20%. Conversely global car makers delivered a profit margin of only 3% and steelmakers -4%. For many drugs, the marginal costs of producing these drugs is small. The best selling drug of all-time is Pfizer's cholesterol drug Lipitor that generated US$123 billion in sales from 1998 until its patent expired in 2011.

Pitfalls

As the Sirtex announcement showed, the sector can be a challenging place for retail and professional investors alike. Aside from determining whether a company's drugs will be successful, investors also require that the product be adopted by physicians and often that it be included on a government's list of approved and subsidised treatments such as Australia's Pharmaceutical Benefits Scheme (PBS). In 2014, Australian taxpayers spent $9.1 billion on the PBS and listing every medicine on the PBS would quickly make the scheme unsustainable. For example, there is a good chance that an expensive new drug might not be listed on the PBS if it is deemed to only provide a marginal benefit over existing alternatives. Governments globally are looking to curtail healthcare spending that has been consistently growing at a multiple of tax revenue growth.

What to look for before investing

1**. Security of patents.** What is the life of the new and existing patents? After Lipitor's cholesterol patent rolled off, the cost of the treatment dropped from US$500 per month to US$50. The impact of this was an 81% reduction in sales in the US for Pfizer. Investors should be aware whether competitors have similar treatments undergoing approval or if another entity is disputing a company's patents.

2. **Approval status.** Where is a company's treatments in being registered for clinical use with the US FDA (Food and Drug Administration)? FDA approval is a requirement for sale in the most profitable healthcare market in the world. Companies with at least one product in end-stage trials are safer investments than those just beginning the investigative phases of development. I have seen many companies issue exciting prospectuses and raise capital based on the results of their treatment on mice, with minimal further developments many years later. On average it takes 12 years and over US$350 million to get a new drug from the laboratory onto the pharmacy shelf, with a 3% success rate for drugs to move from pre-clinical trials to full approval.

3. **Financial strength and cash reserves.** Whilst this point is germane to investing in all companies, the length and cost of the approval process for a drug is greater and more uncertain than for a new gold miner or retailer. If the company is required to make multiple dilutionary share issues just to keep in the game, its attractiveness as a potential investment declines.

4. **Diversity of the company's pipeline.** The number of investors that have made huge gains in one tiny biotech are dramatically outweighed by those that have seen share prices crater after a company's only drug failed to win FDA approval. CSL shrugged off the failure of a competitor's parallel trial of a plasma-derived product used to treat Alzheimer's, as it had a range of other treatments both in the market and in clinical trials.

5. **Size of the addressable market.** Whilst investing in companies treating niche ailments can be profitable, the addressable market is far greater in areas such as HIV/AIDS, cancer, heart disease, diabetes, neurological disorders and immunological diseases. Furthermore companies operating in these areas are more likely to attract a takeover bid from the big pharma companies looking to restock their pipelines.

Complex sector

Looking across the biotech and pharma sectors in the table below, there are 70 companies listed on the ASX, but only six pay a dividend and out of the 70 only 14 are profitable! Furthermore the pharmaceuticals and biotechnology sector encompasses a wide range of companies specialising in very niche areas. Even where an investor possesses a strong understanding of a particular area of medicine such as liver cancer, this knowledge may be of little use in evaluating CSL's blood plasma treatments. Conversely when investors are analysing the prospects for Boral, insight can be gained from examining competitor CSR's building products division and speaking with their management team.

Pharmaceuticals & Biotechnology Sector

	Company		MarketCap $M	PE	Yearly Dividend (Cps)		Company		MarketCap $M	PE	Yearly Dividend (Cps)
1	Acrux Limited	$	127	13.0	8	36	Narhex Life Sciences Limited	$	5	-6.0	
2	Alchemia Limited	$	19	-1.1		37	Neuren Pharmaceuticals Limited	$	166	-19.3	
5	Anatara Lifesciences Ltd	$	10	-19.9		38	Novogen Limited	$	53	-5.4	
6	Antisense Therapeutics Limited	$	16	-4.5		39	NuSep Holdings Ltd	$	11	-1.9	
7	Avexa Limited	$	16	-7.0		40	OBJ Limited	$	129	-55.7	
8	Avita Medical Ltd	$	26	-4.1		41	Oncosil Medical Ltd	$	33	-10.8	
9	Benitec Biopharma Limited	$	95	-10.4		42	Orthocell Limited	$	21	-10.9	
10	Bionomics Limited	$	217	43.3		43	Patrys Limited	$	7	-1.0	
11	Biotron Limited	$	38	-12.2		44	PharmaNet Group Limited	$	2	-0.9	
15	Cellmid Limited	$	19	-6.2		45	Pharmaust Limited	$	14	-8.3	
16	Circadian Technologies Limited	$	24	-1.7		46	Pharmaxis Ltd	$	44	-1.1	
17	Clinuvel Pharmaceuticals Limited	$	156	-15.1		47	Phosphagenics Limited	$	49	-4.9	
18	Cryosite Limited	$	18	34.2	2	48	Phylogica Limited	$	24	-6.5	
19	CSL Limited	$	44,759	30.1	139	49	Phytotech Medical Limited	$	11	0.0	
20	Cynata Therapeutics Limited	$	63	-10.7		50	Polynovo Limited	$	31	-9.5	
21	Dorsavi Ltd	$	22	-5.9		51	Prana Biotechnology Limited	$	71	-9.6	
22	Genera Biosystems Limited	$	27	-8.9		52	Prescient Therapeutics Limited	$	5	-5.6	
23	Genetic Technologies Limited	$	58	-2.4		53	Prima Biomed Ltd	$	43	-2.8	
24	IDT Australia Limited	$	36	-2.0		54	Probiotec Limited	$	10	-0.4	
25	Immuron Limited	$	14	-8.9		55	Progen Pharmaceuticals Limited	$	8	-4.2	
26	Imugene Limited	$	12	-15.0		56	Proteomics International Laboratories Ltd	$	-	0.0	
27	Innate Immunotherapeutics Limited	$	31	-15.9		57	pSivida Corp.	$	37	11.8	
28	Invion Limited	$	22	-2.2		58	Qrxpharma Ltd	$	2	-0.2	
29	Living Cell Technologies Limited	$	23	-3.5		59	Regeneus Ltd	$	24	-4.6	
31	Mayne Pharma Group Limited	$	749	32.9		60	Reproductive Health Science Limited	$	6	-0.9	
32	Medibio Limited	$	11	-4.1		61	Rhinomed Limited	$	9	-1.3	
33	Medical Developments International Limited	$	128	107.8		62	SciGen Limited	$	0	-5.0	
34	Mesoblast Limited	$	1,284	-12.5		63	Sirtex Medical Limited	$	1,236	40.6	14
35	Monash Ivf Group Limited	$	345	31.8	3	64	Solagran Limited	$	13	-1.8	
37	Neuren Pharmaceuticals Limited	$	166	-19.3		65	Starpharma Holdings Limited	$	137	-8.6	
38	Novogen Limited	$	53	-5.4		66	Suda Ltd	$	44	-11.0	
39	NuSep Holdings Ltd	$	11	-1.9		67	Tissue Therapies Limited	$	65	-6.6	
40	OBJ Limited	$	129	-55.7		68	Tyrian Diagnostics Limited	$	2	-7.5	
41	Oncosil Medical Ltd	$	33	-10.8		69	Viralytics Limited	$	85	-35.4	
42	Orthocell Limited	$	21	-10.9		70	Vita Life Sciences Limited	$	82	11.2	4

Source: IRESS

Hugh Dive is a Senior Fund Manager for Aurora Funds Management Limited. This article is general information and does not address the personal needs of any individual.

The technical disruptions coming to financial advice

Giulio Russo

A summary of the PHAROS/Madison Financial Group White Paper No. 1

Faced with recent market problems, government and financial advice businesses have focused on minimising the likelihood of past product and advice failures being repeated. There are also other distractions such as licencing restrictions, skill shortages, asset class bubbles etc. These events will lead to *evolutionary changes*, much as occurred following previous reforms (such as SIS Act 1993, MI Act 1998, FSR Act 2001), product and service innovations (such as mastertrusts, wraps, SMSFs etc.) and competitor entries and exits. But most importantly, the industry is confronting significant challenges that will cause *revolutionary changes* and will impact the way financial services advice is delivered and paid for.

Digital tsunami

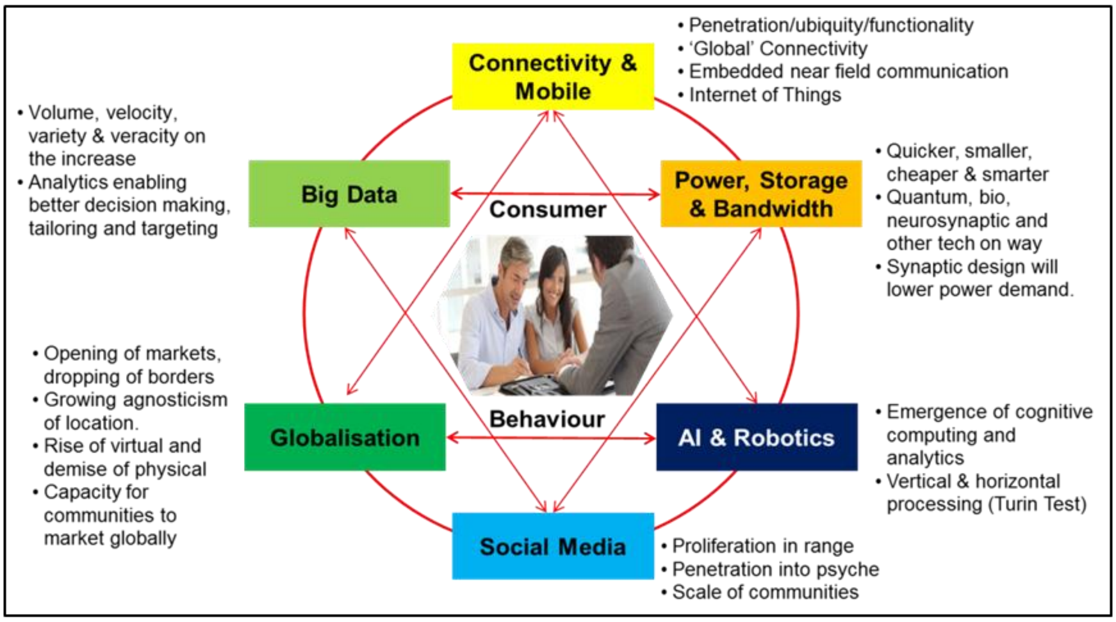
These revolutionary changes are occurring in the areas of digital transformation and technology take-up and are likely to be game-changing to many industries, including financial advice services.

Melodramatic? We don't think so! Look at the impact digital technologies has had and are having on some other industries: Amazon and ereaders replacing firms like Borders, RIM and Nokia suffering due to changing digital landscapes, Skype impacting fixed line telcos, LinkedIn and Seek affecting traditional recruiting firms, Uber and Airbnb challenging taxi and hotel industries respectively.

In financial services, over 75% of US trades are performed by 'algo-trading' engines. Into the future it is foreseeable that cryptocurrencies like Bitcoin will pose a threat to payments processors (banks), tax collectors (governments) and foreign currency traders.

Superficially it is easy to argue that our industry is vastly different to music, travel, books etc, but much of the financial services offered are intangible, standardisable and consequently, digitisable.

Let's dive a bit deeper. At a macro level, our industry is confronting a veritable 'digital tsunami' which will have multiple fronts hitting concurrently. We will consider the following six fronts:



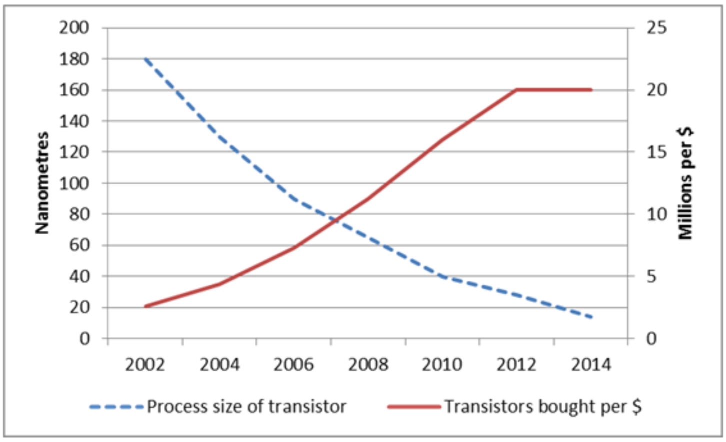
1. Big data: Volume and velocity of data is rapidly increasing with the growth of the internet, mobile connectivity and 'Internet of Things' (IoT) devices. In the process of creating data, we leave digital footprints which can be monitored, analysed and used for predictions about our purchasing behaviour. Even though privacy of such 'footprints' are an issue, firms can now develop new products and services and provide enhanced customer experience by harnessing capabilities such as data analysis, predictive modeling, social network mapping and listening.

2. Power, storage and bandwidth: Smaller, faster, cheaper and smarter could describe the inexorable growth in these three infrastructure enablers of the tech revolution.

This 'power of exponential development' means, what has been achieved to date will pale into insignificance with that on the horizon. The biggest leaps are coming!

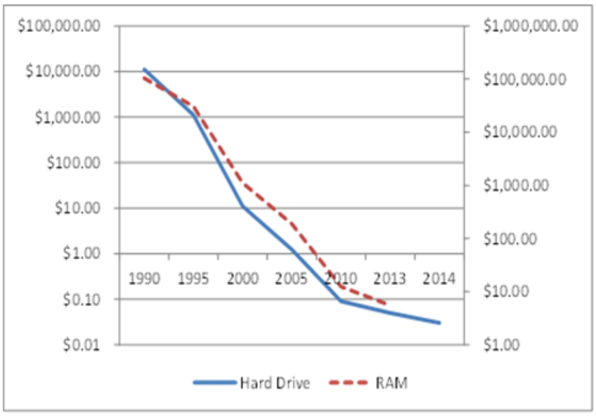
As demonstrated in the diagrams below, dramatic improvements in cost-performance are contributing to exponential growth in digital technologies. These have also been the key drivers of innovations in mobile and cognitive computing, IoT devices and AI.

Number and size of transistors bought per $

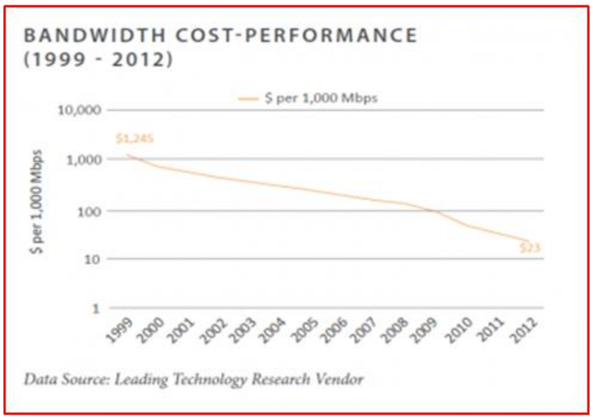


Source: *Extremetech*

Cost per GB – Hard drive LHS; RAM RHS



Bandwidth Cost-Performance (1999-2012)



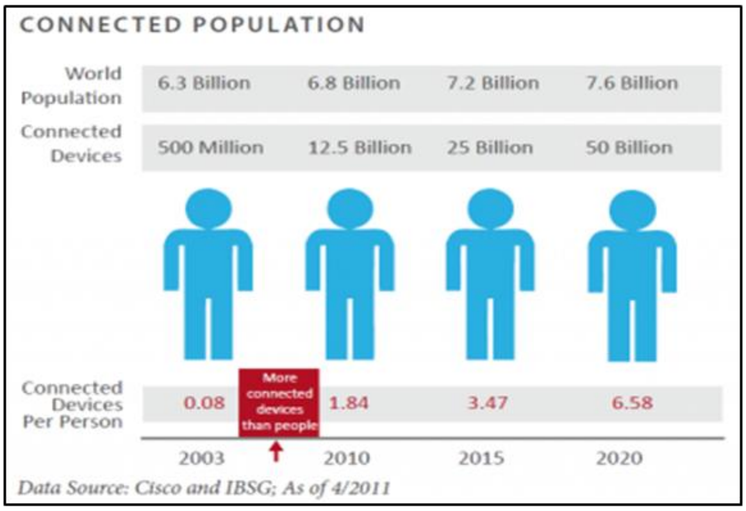
Source: *StatisticBrain*

3. Social media: The emergence of social media and the volume of user-generated content that it has produced is one of the greatest sociological phenomenon in human history.

In financial services, smaller firms should be cognisant of several aspects to social media. A LinkedIn-Cogent study found a disconnect between an investor's preparedness to engage through social media and what advisors do, i.e. potential 'service mis-alignment'. Other opportunities in this space are 'social listening' and 'customer collaboration'.

4. Connectivity and mobile: Connectivity has become ubiquitous for most of the world's population and connected devices are dematerialising many other devices and businesses by converging the capabilities into the one device. (For a thought-provoking read see Harvard Business Review's 'How Smart, Connected Products Are Transforming Competition.') For instance, 28% of Australians in 2013 owned at least three connected devices which is up from 10% two years earlier. Gartner believes that 26 billion units will be deployed and incorporated by 2020.

Financial services is an information-based business. Consequently IoT presents incredible opportunities to tailor products and services, provide special offers etc.



5. Artifical Intelligence (AI): We are inching ever-closer to the time where machines will exhibit intelligent behaviour indistinguishable from that of a human and interact in natural languages using 'cognitive analytics and computing'.

For example, IBM's Watson has been opened up to the financial space and is now capable of performing deep content analysis and evidence-based reasoning to accelerate and improve decisions, reduce operational costs, and optimise outcomes.

6. Globalisation: Technology can be seen as one of the most potent enablers and drivers of globalisation which opens up a world of competent and available resources.

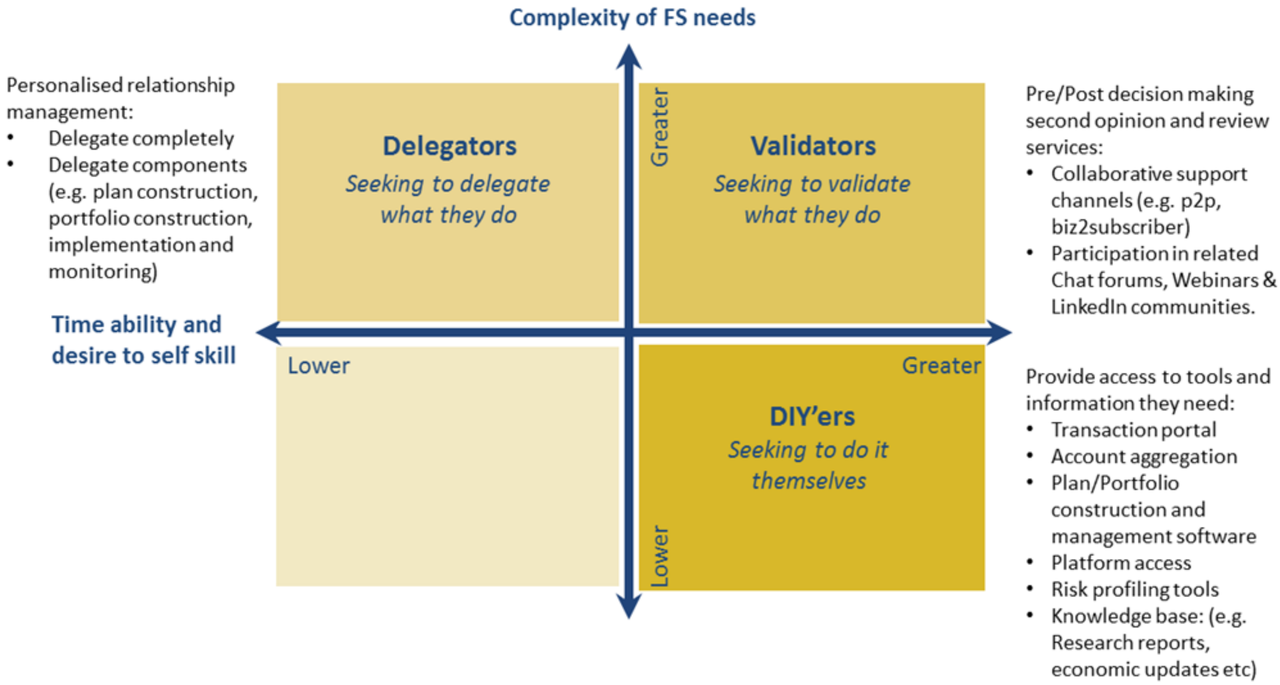
Traditionally, large players have taken advantage of the globalisation conveyor but smaller players now could consider outsourcing administrative functions such as meeting note transcriptions, data entry, paraplanning, SMSF administration etc.

We should also be concerned about potential entries from global players because access to our market may be more cost effectively attained via technology (platform engines and robo advice tools etc). For instance, leveraging off US-based investment platforms or account aggregation systems.

The point of convergence

If all these six fronts do converge then the financial services advice space is about to be disrupted. The ensuing change is set to unleash on traditional consumer behaviour and their decision-making frameworks, on what services people want, when they want them and at what price. Hence, how we react will determine how we prosper.

As demonstrated below, investors can be grouped into three major camps depending on their financial services needs, lack of time and inclination etc. An increasing number of investors are being categorised as 'self-directed' and we believe strategic planning should consider the following 2x2 schematic and the listed suggestions:



Source: PHAROS Financial Group

In summary, consumer behavioural change is set to rock to its core our traditional 'delegated' advice model and the way we do business. The two key takeaways from this article are: 'Power of exponential growth' means great technological leaps are ahead not behind and investor behaviours are changing towards 'self-directed' driven by innovations in financial services. Although, some may not be concerned with these developments due to their existing client base and belief in that 'people buy from people', the rest – especially those building a business for the future – should start to enquire and research.

Giulio Russo is General Manager at Madison Financial Group Pty Ltd.

An SMSF journal entry is not enough

Monica Rule

Some things in life are not easy and some things don't make much sense. Unfortunately superannuation often falls into both categories.

Take the situation where a husband and wife have established an SMSF. After many years of managing their SMSF successfully and accumulating much wealth in their fund, the husband passes away.

Under the superannuation law, the death triggers a compulsory payment where the deceased member's superannuation savings must be paid out as a lump sum death benefit either to a dependant or to his estate as soon as possible.

In this case, the wife does not need the lump sum death benefit payment as she has enough income without it. She would rather the money be retained in the SMSF. In fact if the lump sum payment is made to her, she would simply deposit the money back into her SMSF. So the wife, with the agreement of her accountant, records a journal entry in the SMSF's financial accounts that reflects a lump sum death benefit was paid to her and then was deposited back into the SMSF.

Sounds fine, what's the problem?

There was no problem in the wife being able to put the money back as she hasn't exceeded her contribution caps and she also meets the work test in order to make contributions into her SMSF. So what is the problem?

Well, superannuation law requires the death benefit payment to be 'cashed'. This means, it must be paid out of the SMSF. If assets need to be sold to fund the payment, that must be done. Once paid, it can then be contributed back into the SMSF if the recipient so wishes. You cannot simply make a journal entry without physically making the payment.

The ATO has recently issued two publications, ATOID 2015/2 and ATOID 2015/3 that address this issue. In these documents, the ATO explains that cashing involves an SMSF making a payment which reduces the member's benefits in the fund. A journal entry to reduce the deceased's member account would not amount to cashing, and therefore, would not satisfy the law.

Even if there are no tax implications, in order to comply with the superannuation law, a death benefit must be paid out. Otherwise you would have contravened the law. It's a silly law and one that doesn't make much sense to those who are already grieving the loss of a loved one.

Monica Rule is an SMSF Specialist and the author of The Self Managed Super Handbook – Superannuation Law for SMSFs in plain English – www.monicarule.com.au

Reader questions on operating an SMSF

Liam Shorte

Over the past few months, Cuffelinks has received many questions from readers in response to articles covering powers of attorney, enduring guardianships, succession planning and limited recourse borrowing arrangements (LRBAs) within an SMSF. We asked Liam Shorte of Verante Financial Planning to provide some answers, which have been collated here for easy reference.

Ross: Can a corporate trustee of an SMSF execute a Power of Attorney which is limited to only take effect after the death of the sole member/director/secretary?

Liam: An Enduring Power of Attorney is not valid in this case as it terminates after the death of the donor. The deceased person's Legal Personal Representative is the one who may take control in the case of death subject to the constitution of the corporate trustee and trust deed but there can be complications. Accordingly, it is often recommended that either another director be appointed from the outset to act alongside the sole member, or the company trustee appoints someone as the company's attorney, so that this person can act on behalf of the company if the member dies.

In terms of managing the risk of mental or physical incapacity then you can use an Enduring Power of Attorney and prescribe the instances under which that power is activated such as "on loss of mental capacity as confirmed by two specialists". This option is becoming more common as the values of SMSF balances increase, dementia and Alzheimer's cases grow more prevalent and elder financial abuse cases are on the rise.

Wayne: Is it possible for an SMSF corporate trustee to have three directors but only two members with the third director being a non-member?

Liam: The answer is no, I am afraid. The rules are that all trustees must be a member except in single member funds. For SMSFs other than single member funds, an SMSF is one where:

- there are four or less members
- all members are trustees, or directors of the trustee company
- <u>there are no trustees or directors who are not members</u>
- there are no members who are employees of other members (unless they are relatives).

It may be prudent to have a trust deed and company constitution that allows for the automatic appointment of a Legal Personal Representative/Executor as a company director on death of a member.

An alternative in funds where voting power is based on balances is for the third director to have a small balance and the main two directors still control the fund with majority voting rights.

Ryan: If a property with development potential was purchased under a LRBA and then the loan was paid off over many years, can the house then be developed assuming one has the cash to do so?

Liam: Yes it may be possible to develop the property but there are pitfalls to be aware of in entering development contracts where the SMSF is involved. An SMSF trustee is prohibited from giving a charge over assets of the fund so the venture could not have an overdraft or credit facilities with suppliers where their terms commonly include a lien or charge over fund assets. Likewise many building contracts include clauses that provide protection for the builder by way of a charge over the customer's assets or an encumbrance preventing the SMSF trustee dealing with the land and again these would both contravene regulation 13.14 of the SIS Regulations.

The big question is: Is the SMSF trustee engaging in the business of property development?

A widely-held view is that a fund trustee cannot operate a business as it would be inconsistent with the sole purpose test. This is a common misunderstanding - the sole purpose test does not necessarily prohibit a fund trustee carrying on a business. It merely requires a fund to be established and maintained for the purpose of providing retirement benefits to members and/or death benefits to members' dependants.

The ATO has stated that 'if a superannuation fund is conducting a business, then it is not being administered for the sole purpose of providing benefits for the members and beneficiaries of the fund' (NAT 2061). However, an SMSF trustee will not necessarily be carrying on a property development business just because it develops land. The nature and scale of the development, and whether the land once developed will be held or sold, will determine whether a business is being operated.

The Commissioner stated in SMSFR 2009/1 that the usual investment activities of a trustee will not be considered as carrying on a business, which could include developing vacant land. Thus the development of land may simply be the realisation of a capital asset. If the land development is likely to satisfy the requirements of a business, the fund trustee should ensure that the activities being carried out comply with the provisions of the Superannuation Industry (Supervision) Act 1993 (SIS Act) and in particular, the sole purpose test.

For the ATO's current view, see Carrying on a business in an SMSF.

In summary, it may be possible but seek personal legal and tax advice and also consider alternative structures such as an Ungeared Unit Trust for the development.

Liam Shorte is a specialist SMSF advisor and Director of Verante Financial Planning. These responses are for general information only as the full circumstances and context of the questions is not known. Professional personal financial advice should be sought before taking action.