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This Week's Top Articles

Is bank bias worth the risk?

Graham Harman

The *2015 Russell Investments/ASX Long-term Investing Report* encouraged investors to stop relying on local investments and consider the full range of asset classes available. Given the 'Big 4' banks make up nearly 30% of the Australian share index, many investors are highly exposed to the sector. Australian shares themselves make up a significant proportion of most multi-asset portfolios, so even 'diversified' investors can find themselves with 10% of their investment in just four stocks. It's time investors took steps to address this concentration of risk.

Australia leads the world in stock market bank domination. In contrast to Australia's almost 30%, banks account for around 20% of the London Stock Exchange and 10% of the New York Stock Exchange.

Since bank profits have been driven by strong growth in mortgage lending, those who believe they are 'diversifying' by investing in local shares **and** local property actually have both of these choices hitched to the same wagon.

In recent years, that wagon has been rolling along just fine, with the major banks proving to be highly profitable and solidly-yielding stocks. Bank stock returns were strong in 2012 and 2013, as investors seeking both safety and yield pushed them higher.

But then 2014 turned into a mixed year for returns, helping Australian equities to lag overseas markets for the second consecutive year. Now, in 2015, we're seeing the banking sector falling, and taking the market with it.

Not surprisingly, some investors are starting to ask: are the wheels falling off?

Our answer is: not yet. The Reserve Bank of Australia is unlikely to raise interest rates any time soon, and may cut them. And the rumours that the tax review will lead to the removal of franking credits are in our view just that. However, looking ahead, investors need to understand the risk they are taking on if they persist in relying on the bank-dependent local share market.

Understanding the three layers of risk

Bank sectors contain three types of risk on a sliding scale from (1) superficial share-price volatility through to (3) deep-seated systemic risks that threaten the security of deposits.

1. Share price volatility – regardless of the health of the institution and the security of depositors, bank stocks are relatively volatile in the current environment. We saw this when the 20% jumps in January and March 2015 were given back in April and May. However, we're probably at the bottom of the current zigzag, so the immediate risk of further loss is relatively low.

2. Bank capital impairment – the banking system seems incredibly calm at the moment, with the charge for bad and doubtful debts as a percentage of assets down at about 0.2%. However, investors need to take into account that banks are geared at 15:1 (as opposed to most non-financial blue chips, which are currently sitting at around 2:1). This means if the housing cycle turns down, or unemployment gets worse, any impact on bank asset values would have a 15-fold impact on shareholders' equity. To make matters worse, these impacts on the share market rating of book values, and on the book values themselves, can compound. Easily imaginable events, such as a 15% fall in the price-to-book ratio of the banks and a 15% fall in the book values themselves, quickly add to a 30% drop in the portfolio value of bank stocks. All of a sudden, the banks have very little room for error.

3. Another financial crisis – external economic shocks could rock the asset markets, destabilising consumer and business sentiment. For example, a savage bond default or a string of corporate collapses could trigger a correction in global credit markets. Although this type of meltdown is unlikely, we need to remember that it's been nearly 25 years since Australian banks ran into serious issues. Our banking system collapses, in 1974 and 1991, were out of sync with the rest of the world, which took its turn in 1982 and 2008. Australian banks tend to have a major solvency crisis every 20-25 years. Our last one was in 1992 ...

Realistically, we believe investors need to focus on the first two layers of risk. Most will be able to live with the first one. But the second one, although probably only a medium-term risk, is a real issue, if only because of the number of factors that could go south. And remember, too, that there's an earnings dimension to bank stock valuations. The big four Australian banks earn $30 billion a year between them. That $30 billion is currently highly valued by the market, as measured by bank price-to-earnings ratios. But, like the equity base of the banks, that earnings stream faces a range of threats.

Increasing areas of vulnerability

- Housing market – Australian banks are exposed to one of the hottest housing markets on the planet, driven mainly by falling interest rates. But now, with almost nowhere left for rates to fall, that same level of capital appreciation is unlikely to be repeated. If, as ASIC believes, signs of dangerous property bubbles in Sydney and Melbourne are accurate, residential housing prices could conceivably slump in years to come. Some of the warning signs are already appearing: based upon NSW's dwelling approval rate, for example, overbuilding may start to quench demand. If unemployment climbs, the housing market will be in trouble. With economists warning that the capital investment outlook has gone from 'bleak' to 'recessionary', it's not a huge leap to imagine a number of other economic indicators worsening next year.

- Government bonds – As the US Federal Reserve goes into a tightening cycle, we can expect turbulence and sell-offs in the US Treasury markets. If there are flow-on effects in Australian bonds, it won't damage banks, but the rising yields certainly won't help with the share market valuations of these yield-based securities.

- Traditional margins – Bank reporting is pretty opaque when it comes to the real drivers of margins. However, we can make some well-educated guesses about where some meaningful chunks of the $30 billion come from. One likely candidate is credit card lending, with many billions of dollars borrowed by the banks for only 2 or 3%, and on-lent to undisciplined credit card holders at rates in the high teens. Another juicy source of profit is currency conversion, with uninformed customers, historically, being price-takers in the market. Both these profit sources are facing headwinds at present: credit card profits from a new-found consumer conservatism, post-GFC; and currency profits from enhanced transparency in an internet-age.

- Disruptive technology – in a world run by smart phones and apps, the retail banking and home mortgage segments are ripe for disintermediation. Amazon, PayPal and Google are growing consumer payments, SocietyOne is pioneering peer-to-peer lending, new mortgage providers are taking market share with superior processes and savvy consumers looking for competitive pricing and product choices are cheering from the sidelines. At the same time, cybercrime, scams and hackers are defrauding

Australians of millions every year and the banks are in many cases picking up the tab. In the process, both profits and confidence in bank security are being depleted.

Even without a crash, these headwinds are highly likely to reduce the performance of bank stocks for the next 5-10 years, causing the banks to drag on the Australian share market.

Revisit home country and bank bias

Domestic investments can continue to have a role in Australians' portfolios, but investors with a home-country bias would do well to revisit their allocations; reduce their exposure to residential property and start investing a portion of their equity allocation offshore.

At the very least, they need to understand the percentage of their portfolio tied to the Big 4 banks and watch for the warning signs. If bond rates and unemployment continue to rise, and if the national housing market slows, that will be a shift from green to amber and a signal to rethink portfolios – before the rush gathers too much pace.

Graham Harman is a Senior Investment Strategist at Russell Investments. This article provides general information only and does not take into account your individual objectives, financial situation or needs.

How VicSuper evolved its retirement income model

Michael Dundon

The recent release of VicSuper's new non-account based pension (NABP) products for retirees signalled the first of a number of innovative solutions in the retirement income space. More importantly, we have evolved the philosophy and process we follow to help members achieve income security in retirement.

Our previous retirement planning approach

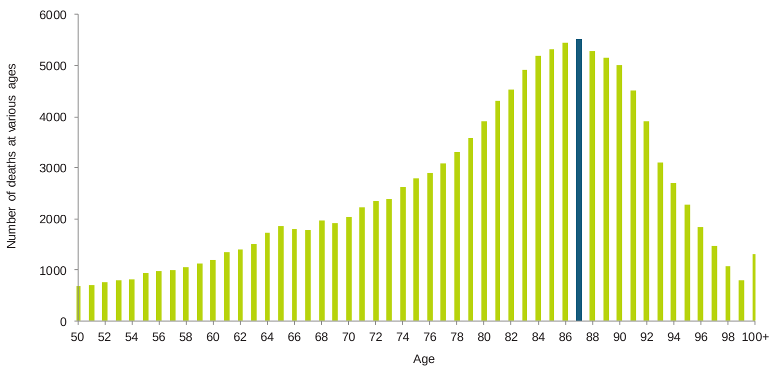
Until recently, VicSuper financial planners used a managed payout approach. In the main, they would recommend a strategy incorporating our account based pension (ABP) with an investment portfolio mix based on the member's risk profile. The higher the member's capacity for risk, the more aggressive the investment portfolio and a higher total return would be assumed. We would factor in other forms of income available to the member including the age pension, defined benefit pensions and investment income, in preparing our advice. We were aiming to deliver a real level of income that was sustainable, with minimal volatility, which provided members with the flexibility to access capital as needed. Cash flow projections were based on a constant rate of expected return.

There were significant advantages to this approach: the member's control of investment capital was fully maintained, any returns above expectations could increase the income available, and it was easily implemented by risk profiling a member and investing into the ABP.

The evolution of our methods

However, there were also some weaknesses to this approach which meant we had to resolve.

1. Firstly there was no protection for members against outliving their savings and the approach wasn't able to fully address longevity risk by basing the analysis on average life expectancies. This can be relevant to a significant cohort of members (see numbers to the right of the blue line).



Source: ABS

2. The managed payout approach doesn't effectively mitigate against sequencing risk where the order and timing of returns could materially impact a member's income in drawdown phase. Historically, members

responded to market volatility by taking less income and the 50% reduction in the minimum drawdown following the GFC allowed for this. However, taking a hypothetical 65-year-old member with $600,000 in their pension account, we felt that an income based on a minimum drawdown that was halved from $30,000 to $15,000 would not be a desirable outcome.

3. Much of the risk in retirement (inflation, longevity and market risk) was also borne by the member. This was traded off against the prospect or possibility of higher returns, however it differed from our approach in accumulation which is to provide default life and income protection insurance to members, and specific needs-based tailored insurance if the member saw a VicSuper financial planner.

4. Lastly, there was no direct asset-liability matching for the member in retirement. So if the member had a need for essential income, with anything below that being unacceptable, our approach in pension phase did not directly manage it. We actively manage this risk in accumulation by providing advice to the member (where appropriate) to use income protection and death and disability insurance to provide needs-based protection.

The probability of outliving savings is real

The Australian ABP minimum drawdown requirements for a 65-year-old starts at a higher point (5%) than much of the recent research on safe withdrawal rates suggests is appropriate to provide a sustainable, indexed income stream with a minimal chance of failure.

This research based on Australian data suggests there is an almost even chance that a typical conservative 25% growth/75% defensive portfolio would be exhausted over a retirement period of 20 years assuming a 6% pa drawdown rate, adjusted for inflation (see table below).

As part of a retirement strategy review we looked carefully at the approach outlined above to determine if there was a better way of achieving our members' goals.

Our new approach – income layering

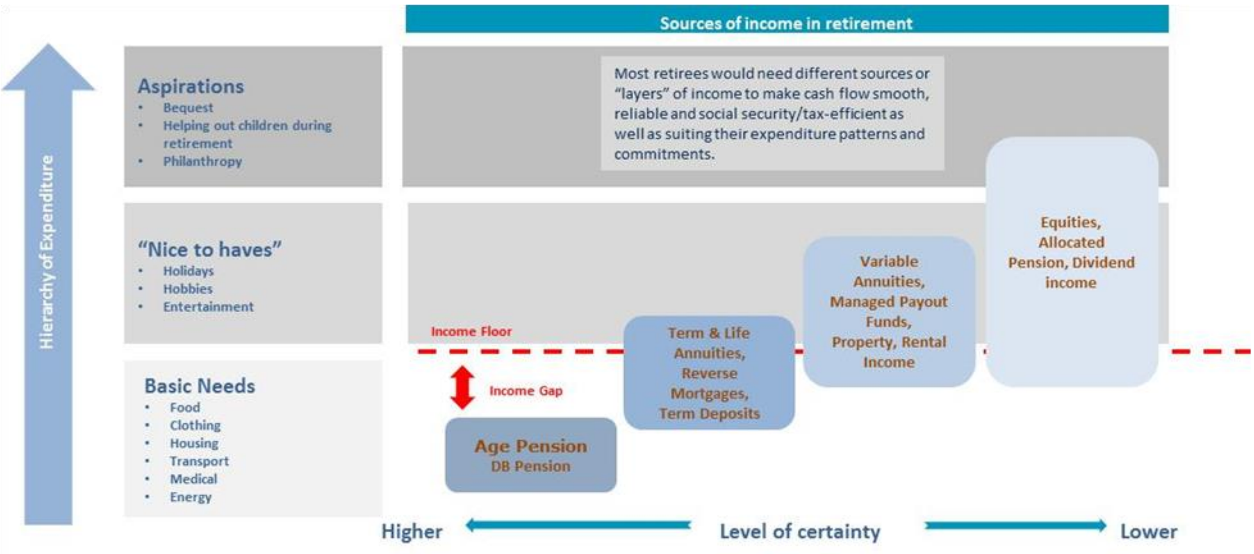
Recent research from Investment Trends supports the idea that guarantees and protection (associated with income that lasts for life, guaranteed minimum income payments, protection against market falls and indexed against inflation) become stronger drivers than high returns when retirees are considering retirement income products.

We began looking at different ways we could help our members achieve their goals and meet our best interest duty. One way to deliver this was to develop an objectives-based approach that used an asset-liability matching framework to generate retirement income. Since a member having insufficient income to meet their essential expenses was an outcome to be avoided at all costs, it was perhaps better to not target a strategy that will perform best if we guessed correctly about future market returns, so we took a member's worst case scenario off the table. One way of doing this was by implementing an income-layering strategy, defined as:

Income layering is a strategy that locks in a secure stream of retirement income before investing any remaining retirement savings in market-based

Asset Allocation 25% Equities, 70% Bonds, 5% Bills	Withdrawal rate as a percentage of initial portfolio value							
	3%	4%	5%	6%	7%	8%	9%	10%
10 Years	100%	100%	100%	100%	97%	89%	82%	76%
20 Years	100%	88%	67%	51%	36%	30%	27%	18%
30 Years	85%	56%	33%	28%	17%	10%	6%	2%
40 Years	63%	33%	24%	11%	6%	3%	1%	0%

Sources: Portfolio Success Rates in Australia based on 25% growth/75% defensive portfolio (Drew and Walk 2014), and How Safe are Safe Withdrawal Rates in Retirement? An Australian Perspective (Finsia).



Source: Adopted from Retirement Incomes Options, PIMCO 2014

products. It is based on the belief that securing income to meet the essential or basic needs should be of primary importance to the member.

Income-layering starts with detailed budgeting (as much as possible) for the amount of income a member requires each year in retirement, and splitting up this income into essential income and income that can be considered discretionary. 'Essential' income should cover the must-have basic expenses like food, clothing and shelter and also those items that define a member's lifestyle. That is, those things that are non-negotiable because they represent the essence of the member's life. The discretionary income covers lifestyle requirements that members would be willing to do without if their retirement savings take a turn for the worst.

We've now implemented a new advice process that takes into account a member's health, expected longevity, liquidity needs and balances security with flexibility via internal business rules which guide an appropriate allocation between our various product solutions.

The income-layering approach has protection against longevity risk, and offers upside potential to improve a member's standard of living. As a priority, essential income is then secured over an appropriate timeframe by a combination of the age pension, any defined benefit pension entitlements, and our VicSuper NABP products. Of critical importance, however, is that the floor income provides as much protection as possible against inflation, longevity and market risk.

Other superannuation money can be invested in the ABP, in a portfolio that aligns with a member's risk profile. The capital allocated to meeting these two priorities is balanced against other factors, for example if a member has a particular liquidity need requiring significant capital to be available at short notice.

There's no single silver bullet solution

Whilst investing a member's entire super into an ABP may (or may not) result in a superior outcome, this depends on investment returns and the sequencing of those returns. The income-layering approach recognises that there is no one 'silver bullet' solution in that it uses both guaranteed income streams and an ABP to deliver an appropriate outcome for the member. It provides the member with peace of mind, flexibility, and the opportunity of a growing income in retirement if investment returns are good.

Michael Dundon is the Chief Executive Officer of VicSuper.

Super fund directors and Independents' Day

David Brown

In many countries that were once ruled from afar by a despotic overlord, their Independence Day is a cause for celebration, a day off and few fireworks. In 'super' land in Australia, the imposition of 'independents' is being met with the opposite reaction.

A short consultative period has recently ended for draft legislation that will require all APRA regulated super funds to have a minimum one-third independent directors, and an additional independent chairperson. APRA further proposes a majority of both the Board Audit & Risk and Board Remuneration Committee be composed of independent directors. The regulator will be given sweeping powers to assess individuals on their independent status.

Why do we need independence?

While the new law is now seen as being largely inevitable, the debate has turned to the detail of the legislation. What does *independent* mean?

Much of the initial discussion mistakenly danced with a definition borrowed from the world of listed companies. However, super funds are trusts where the members have no direct ownership of assets, have no right to vote in its affairs and have only a fractional economic interest, making it impossible for even the best paid fat cat to amass *a substantial holding* (within the meaning of The Corporations Act 2001).

There may be applications of this in retail or corporate super, where the trustee might conceivably become a creature of an 'owner' of the trustee, but the one-third independent rule has already been put in place voluntarily by members of the Financial Services Council (FSC).

The Government turns for justification to David Murray's Financial System Inquiry which echoes research from across the globe. Improving pension fund governance improves pension outcomes. Further, the best governance comes from competent board leadership.

The very question that outcomes need to improve has come under attack. A media release from the Australian Institute of Superannuation Trustees (AIST) categorically refuted the Government's premise, quoting Tom Garcia, CEO of AIST:

"There is absolutely no evidence to suggest our governance model is broken or that forcing boards to include a mandated third of independent directors would benefit members."

However, the research has been around for a while, and is quite clear. As the line from Hamlet goes: "The lady doth protest too much methinks."

The 2008 OECD report (Fiona Stewart and Juan Yermo, *Pension Fund Governance – Challenges and Potential Solutions*) says:

"Many of the problems in pension fund governance emerge from a weakness in the governing board. These can take several forms: … Selection on the basis of representatives of stakeholders: … often selected on the basis of their status in a trade union or employer, rather than their specific knowledge or experience on pension issues."

Keith Ambachtsheer from the Rotman Institute at the University of Toronto has several studies linked with him which show a positive link between performance enhancements in the region of 1 to 2% pa and good governance, robust discussion at board level, and boards composed of experienced investors with specific knowledge of markets.

Implications for investment insourcing

As a proponent of the so called 'Canadian model' of super funds insourcing investment expertise, what we seem to forget in Australia is that Ambachtsheer only advocates such a technical move of skills in-house within the context of an expert board. His definition of *governance* includes:

"Oversight effectiveness issues involving clear delegation to management but within appropriate skill and knowledge set at board level."

(Ambactsheer, Capelle and Lum, Rotman Institute, June 2007, *'The State of Global Penion Fund Governance Today: Board Competency Still A Problem').*

Roger Urwin from Towers Watson, a similarly outspoken advocate of insourcing investment skill also supports this only within a context of what he describes as "Selection of the board and senior staff guided by their numeric skills, capacity for logical thinking, ability to think about risk in the probability domain" and " leadership being evident at the board, investment committee and executive level".

(Gordon Clark and Roger Urwin – *Best practice pension fund governace*, Dec 2007, Journal of Asset Management Vol 9).

What are we expecting from independence?

Within super funds, the conflict which this legislation seeks to remove is the influence of the well-meaning founders of the system. As much as unions have contributed significant benefits to the welfare of all Australians through the advent of our present superannuation system, there remains the potential that a proprietorial influence could be hindering the introduction of the best-practice described by a growing body of international research.

Whether the employer rep or the union rep, both groups claim a paternalistic right to set an agenda beyond that of returns for members. No matter how well-intentioned their motives, the modern world of public offer super does not sit easy with an historical view of collectiveism expressed through super. Quite simply, the sytem has moved on from its original collective industrial-relations agenda to a widespread series of individualised investment accounts.

Additionally, the conflicts manifest in the very collectivism that was a virtue of the industry fund movement from the beginning. The instinct to pool resources through related parties under the umbrella of the industry funds brought much needed scale to an infant industry.

However, for many trustees in the past, that meant wearing several hats both as provider and buyer of services. Similar conflicts are common across corporate life, but trustees acting as promoters for fund managers and sitting as directors of related-party providers has been a characteristic of super from the start.

While Ambachtsheer and Urwin want to legislate for competence, the Australian government wants to legislate for robust and self-critical board discussion. It is difficult to see how the one or two independent directors presently on boards could have had a numerically effective voice in some of the sacred cow issues of recent years.

Furthermore, the current classification by super funds of independence is partisan. The former Labor Premier of Victoria, The Hon. John Brumby, is the independent chair of MTAA as well as Deputy Chair of Industry Super Australia, the umbrella organisation for several providers of services including funds management. The Hon. Steve Bracks AC was originally appointed as independent chair of Cbus (2009-2013), (although now an ACTU appointee). Angela Emslie is the independent chair of HESTA as well as a Director of Frontier Advisors, their asset consultant, and a Member of the Industry Super Australia Advisory Council. Previously Angela was simultaneously a director of several super funds.

In a strict sense, these directors may meet requirements of independence, and retired members of related 'bodies corporate' (in the words of the proposed legislation) may qualify after suitable periods or by degrees of separation. However, while governments certainly can't legislate for competence, so too should they never try to legislate for political thinking.

Barring a trustee because of former or present union sympathies seems an impossible task for APRA and unless we opt for a far-off despotic overlord to impose such rules, I am hoping that someday, in our comfortable retirement, we can all come to celebrate Independents' Day.

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The underfunded world of fund manager research

Andrew Fairweather

Standing between financial advisers and the fund managers recommended to clients is a research function, either internal staff or outsourced to a Research House. However, this research work is often under resourced, under appreciated, over worked and under paid and is not delivering to the extent that it should be. Many financial advice groups see the role of research as a compliance function, rather than a unique source of competitive advantage, and the role is considered a 'cost centre' rather than a 'profit centre'.

How fund manager research is paid for

As a result of this constant pressure to reduce costs, Research Houses have developed sources of revenue which potentially compromise their independence if not managed properly:

1. They require fund managers to contribute to their revenue line by paying fees to be rated
2. They build multi manager products (eg van Eyk, although that did not work out so well)
3. They bundle services together for their customers.

All of these responses are natural in an environment where the owners of research businesses (and advice groups which purchase their services) are keen to grow their own shareholder value.

The issues that have been highlighted at IOOF's research department can emerge when insufficiently resourced. These problems have forced their Managing Director, Chris Kelaher, to front a Senate Inquiry, whilst another individual has had his reputation left in tatters. PWC has been appointed (no doubt at vast expense, post facto) to review the total research function within IOOF. It's a bad look, yet again, for a fine industry. But it would be folly to believe that the issues currently being investigated at IOOF are not occurring elsewhere. Did the IOOF research function expand sufficiently to deal with the multitude of acquisitions they had undertaken? Some other groups that I know have less than two people doing full time research, serving hundreds of advisers and thousands of end clients. They are under constant pressure to do more with less.

The research flywheel in motion

The 'flywheel in reverse' demonstrates the demise of research into fund manager abilities:

- Advice groups do not see research as a source of competitive advantage. Few have enough internal resources to manage the sheer complexity of the research task and over-rely on external Research Houses instead, who themselves are capacity constrained.
- The 'cost centre' mentality flows down to the external Research Houses who have to survive on wafer thin margins to deliver a reasonable service. To cover the bulk of their operating costs, they require fund managers to pay to be rated or build products. It's a flawed model but what is the commercial alternative? This shrinks the product pool to only those managers who can pay, versus all managers that should be given a chance to be rated (after sensible screening).
- Because margins are so thin, one of two things emerges. Either the talent pool is of a lower relative standard because the Research Houses are competing for talent against higher paying brokers, bankers or fund managers etc OR, they can pay top dollar but have to have smaller teams. Maybe the answer is in the middle.
- The end result? Lower quality of research, in time, to the detriment of the end investor.

Why should this component of the value chain have such poor economics, if we consider the role the research function fulfils? In summary, they have to be across global and domestic political and economic issues, have in-depth knowledge of the multitude of strategies available to investors (especially so in a 'best interests' world), know everything there is to know about fund managers in real time, emerging themes, product structuring, asset allocation, asset class valuations, direct equities, have views on ETFs, ETPs and LICs, specific fixed income offers, offer model portfolios and APL assistance, respond to individual adviser queries, do one off consulting jobs, research products not on the APL (a requirement of Regulatory Guide 175) and the list goes on and on.

These are highly complex undertakings. Why must they do all of these roles? Because the law states that this is what they are required to do.

Welcome to ASIC's Regulatory Guides

Regulatory Guide 79 *Research report providers: Improving the quality of investment research* is a ripper of a read. The opening stanza begins with the following:

"Research report providers are important gatekeepers, preparing investment research for retail and wholesale investors. The quality of this research has a significant impact on the quality of advice retail investors receive."

Focussing on the lack of resourcing in this function at the industry level, the following is highlighted in the guide:

- RG 79.38 – The constituent parts of a high-quality research service are the human and other resources applied to the research task.
- RG 79.75 – As the complexity of some financial products increases, it is essential that research analysts have the requisite skills and experience supported by an appropriate level of supervision and adequate sign-off processes to produce high-quality research.
- RG 79.76 – Human resources are a key input to research report providers' processes and output. Research report providers should allocate sufficient resources to support the effective performance of their research staff.
- RG 79.79 – To analyse financial products well, research report providers need to allocate appropriate resources to each research task. This includes allocating sufficient numbers of staff with suitable qualifications for the research task and setting appropriate timelines for the completion of tasks.

This function is not resourced enough to meet the objectives stated above and to do the role justice, and the organisation charts of the major Research Houses covering each asset class are not large.

As importantly, Regulatory Guide 175 also provides some important considerations:

*RG 175.310. Advice providers often use research produced by external research report providers to identify products that may be suitable for their clients. This research **may** assist in the development of approved product lists or in the preparation of SOAs. **Advice providers are expected to make inquiries and research the products that they give advice on.***

So it is fine to partner with an external Research House to develop Approved Product Lists (APLs) etc, but that is not enough. The advice group is also "**expected to make inquiries**". But many advice groups have a simple APL process such as 'If you have an investment grade or above rating from any of the major Research Houses, you can approach our advisers.'… Is this enough given the complexity of the task, and in light of the takeaways from RG79 and RG175? No, your honour, it is not.

Ian Knox, the Managing Director of Paragem, was recently quoted ('Why consistent research governance is critical for licensees and advisers', July 19, 2015) on this subject:

"Paragem outsources its investment research to Lonsec, only accepting products onto its approved product list (APL) that are rated 'recommended' or higher by this research house. Investment managers with similar ratings from other research houses are not permitted automatic entry to its APL."

Additionally, Ian then applies a 'sniff' test.

*"My background, and time in the industry, allows me to have a little bit of a common sense 'sniff', if you like, around what's right and what's wrong … you get a few warning bells … **Part-time research is dangerous.** Filtering it when you have suspicions about something is more sensible … I manage risks once [the products] are there."*

Amongst the gloomy outlook, there are many groups that have invested heavily in this important function. At the big end of town, groups like Perpetual and Westpac/BT have considerable teams. And at the smaller end, there are examples of Independent Financial Advisers (IFAs) who have appointed highly capable people to their investment committees. Groups like Paul Melling Retirement Planning, WLM, Julliard, the IFAs in partnership with Select Investment Partners like DMG, Stonehouse, Profile and MGD, and those supported by Atrium, another well-resourced team.

Where to from here?

- Firstly, for the good of the industry, and counterintuitively, for better economics, Research Houses should no longer be able to accept payments from fund managers. The industry needs to be rebased because it is subsidised in a conflicted way (although there is no evidence that this is leading to any negative biases). Having the function stand on its own two feet will focus the model on quality and the industry will know the true costs of providing such a service.

- Secondly, the industry should consider having an internal ratio of people devoted to research relative to the size of their financial adviser force (but with some scale benefits). As such, every time a major dealer purchases another dealer, the research function would no longer be an automatic 'synergy' benefit. These costs could be passed onto clients if the evidence that superior research is worth the money, and I believe it is.

- Thirdly, dealers should not be able to just rely on their Research Houses to fulfil this task (remember RG175). They should be required to employ their own teams, in line with the second recommendation. Where a dealer is small, it could work with other similarly-sized groups to pay for this function.

- Finally, the industry needs to do a better job of showing how great research has avoided many of the blow-ups (more groups avoided Trio and Astarra than invested).

In conclusion, there are not enough human resources applied to research because the economics are so poor. Everyone is trying to save money in delivering a reasonable service, resulting in Research Houses cross subsidising their pure function, alongside advisor groups, who are also looking to save money in this area by "outsourcing" (abrogating) the research function.

It is time for change and that change may cost the industry more, but in doing so, it will lift the industry's reputation and become a source of competitive advantage. The quality of this research has a significant impact on the quality of advice retail investors receive. And who doesn't want that?

Andrew Fairweather is a Founding Partner of Winston Capital Partners.

Property excitement, a Saturday auction and an SMSF

Craig Day

If you want to save some money and heartache, there are some potential solutions for those who jump the gun with SMSF property investing.

The scenario

It's Saturday morning, and James and Marie, armed with some awareness of SMSFs, attend an auction. They are convinced the property will make a perfect investment for that SMSF they keep meaning to set up. They make the winning bid. They then sign the contract and hand over a personal cheque for the deposit. On Monday morning, James and Marie call their adviser requesting that an SMSF be set up straightaway.

The SMSF must already exist

Unfortunately for James and Marie, there are some major issues with their 'I'm sure it will all be fine' approach to SMSF property investing. James and Marie's first and most pressing problem is that under general law, it is not possible for an asset to be acquired by an entity that does not exist yet.

As James and Marie had not already set up their fund, they will be treated as the legal purchasers in their personal capacity and will be liable for completing the transaction and paying any transaction costs, including stamp duty. If James and Marie were then able to negotiate with the vendor to amend the sale contract to name the corporate trustee of their SMSF as the purchaser of the property, they will then have entered into a sub-sale arrangement. In this case, James and Marie would incur ad valorem stamp duty on the original sale arrangement and the corporate trustee of their fund would also incur ad valorem stamp duty on the second arrangement to transfer the property into the fund. As a result, depending on which state or territory the property is located and any stamp duty concessions available, James and Marie may effectively incur double stamp duty.

Potential issues when buying in the wrong name

Were James and Marie to proceed with this course of action they would also be faced with a number of other issues.

Prohibition on acquiring assets from related parties – If James and Marie were to change the name of the purchaser to their corporate trustee of their SMSF, it could be argued that unless the property was a Business Real Property (BRP) they will have breached the prohibition on trustees acquiring an asset from a related party, as the corporate trustee will have acquired the property from themselves.

The deposit – Where the property was a BRP, James and Marie also need to consider what they want to happen with the deposit. They could either treat the deposit as a contribution to the fund or arrange for the fund to reimburse the deposit back to them. However, a reimbursement may take some time depending on how long it takes to set up the fund and then transfer monies via rollovers. This may cause problems with the requirement that a reimbursement be paid immediately to avoid it being treated as a borrowing by the fund.

The potential solution

To resolve their double stamp duty issue James and Marie could consider rescinding or annulling the original contract and then entering into a new contract naming the corporate trustee as the purchaser once the fund was properly established. While in this case stamp duty would still generally apply to the rescinded contract, concessions may apply to exempt it from stamp duty in certain situations.

For example, in NSW a contract for the transfer of dutiable property that is subsequently annulled or rescinded will be exempt from stamp duty (or eligible for a refund) where the purchaser under the original contract and the purchaser under the new contract are related parties. In this case, a related party of a person includes a trustee of a trust (other than a public unit trust) of which the person is a beneficiary. Therefore, assuming NSW rules, if James and Marie were able to rescind the original contract and then enter into a new contract with the corporate trustee of their fund as the purchaser, ad valorem stamp duty would generally only apply to the new contract and not the original contract.

Annulling the contract would also avoid any problems around the acquisition of assets from related party rules as it would involve the fund acquiring the asset from the unrelated vendor. However, the deposit would likely need to be refunded by the vendor and then paid by the fund.

In this case, the timing of the arrangement should ensure the fund will have the necessary cash at the bank to fund the deposit. Finally, any arrangement to annul or rescind a contract will require the consent of the vendor, who may not agree. Alternatively, where the vendor did consent, James and Marie would also need to consider the risk that the vendor could then put the property back to market or try and negotiate for a higher sale price. Given the complex stamp duty rules that apply in the different states and territories and all the additional issues that will need to be considered and negotiated, it will be essential that a client seek specialist legal advice before entering into any such arrangement.

The 'long shot' solution

An alternative solution could be for James and Marie to complete the purchase as per normal and to then take the view that they had already established the required SMSF trust arrangement at the time of the auction. That is, they could argue they had previously verbally expressed their intention to establish an SMSF and appoint themselves as trustee, and they were acting as individual trustees at the auction, and they made the initial contribution to establish the trust by paying the deposit.

The benefit of this is that James and Marie will not have entered into a sub-sale arrangement and therefore they will avoid having to pay double stamp duty. While it may be technically possible to create an SMSF by verbal declaration under general law, clients generally don't wake up on Saturday mornings intending to do so. It is also highly likely that such an approach would not be viewed positively by the relevant state revenue authorities and could also cause issues with the fund's auditor and the ATO. In addition, such an arrangement would likely set the fund up for legal problems should there ever be a dispute in relation to the fund's establishment or governing rules in the future.

Craig Day is Executive Manager, Technical Services at Colonial First State. This article is for general information only and readers should seek professional advice on their personal circumstances before taking action.

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