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This Week's Top Articles

In investing, patience is more than a virtue

Stuart Eliot

When was the last time you saw a headline that said something like, "Everything is fine. There is no need to change your portfolio"? This headline wouldn't generate many site visits.

So, in our pay-per-click world, these articles aren't published. Instead, depending upon when you opened the paper during the last year, either the next recession was imminent and cash was the only safe investment, or everything was fantastic and anything less than 100% shares was an underweight. In short, investors have been conditioned to expect extreme views. These opinions are not necessarily wrong, but they are perhaps a little inflammatory. Often, 'doing something' following a bout of market volatility can be a good way to reduce wealth. As has been attributed to Warren Buffett, *"The stock market has a very efficient way of transferring wealth from the impatient to the patient."*

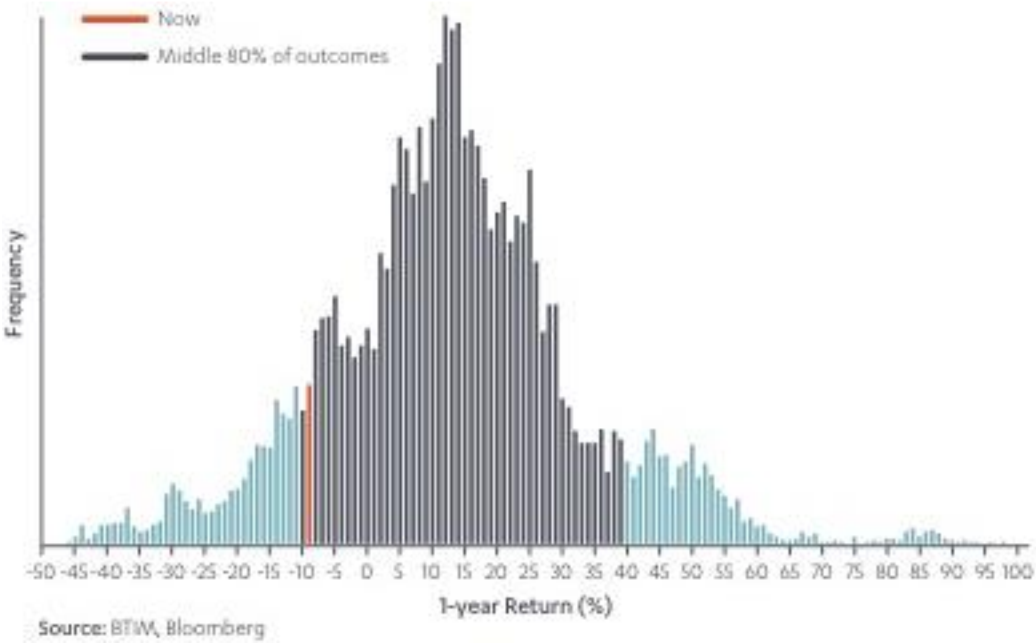
Let's take a deep breath and ask whether the 'turmoil' of the last year has been anything out of the ordinary.

Is the recent experience normal?

Consider the daily returns for the Australian share market, based on the All Ords Accumulation Index. See Chart 1 (next page). Starting with the current rolling 12-month return to early April 2016 (-9.8%, the orange bar), since 1980 the Australian share market has delivered annual returns between approximately -50% (November 2008, the most precipitous part of the GFC) and +100% (September 1987, the month prior to The Crash of '87). History shows that rolling 12-month returns have been worse than the last year just over 11% of the time since 1980. The recent past hasn't been a great time for investors, but neither is it particularly rare.

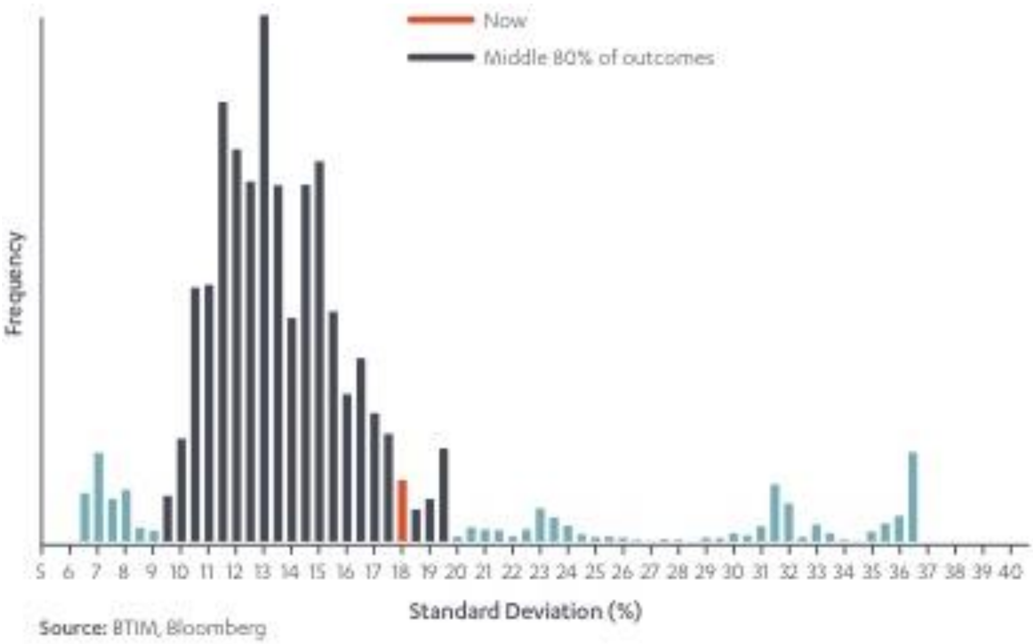
Now let's look at risk: the 'risk' (which we define as standard deviation of returns, or volatility) in the past year to early April 2016 was 17.5% p.a. Since 1980 the range has been between 6% and 36% and, similar to the return chart above, about 12% of observations have been worse than experienced in the past year. Again, this is towards the poor end of 'normal' outcomes, but not particularly unusual. Chart 2 (next page) suggests volatility occurs in two states: less than 20% (the typical situation) or more than 20% (the extreme situation), which can be seen from the relatively high frequency of high volatility outcomes on the right side of the chart.

Chart 1: Rolling 12-month returns since 1980 for All Ordinaries Accumulation Index



Frequency numbers sum to 100%

Chart 2: Annualised standard deviation of returns since 1980 for All Ordinaries Accumulation Index



Frequency numbers sum to 100%

Table 1: Realised volatility of any single year versus the return in the following year

1 year realised volatility	Average next year return	How often the return next year is positive	Average return in positive years	Average return in negative years
Above 20%	9.4%	78%	19.2%	-24.4%
15-20% (we are here)	9.1%	75%	18.2%	-18.5%
10-15%	12.9%	75%	20.3%	-9.7%
Below 10%	22.1%	96%	23.3%	-3.1%

Can volatility predict return?

We can look at the relationship between historical volatility and future returns to determine whether we can use volatility to predict market direction. Table 1 (previous page) is a comparison of the realised volatility of any single year and the return in the following year (calculated for every day rather than at the end of the month or year).

On this analysis, volatility has no reliable predictive power for future returns, but some general tendencies can be seen:

- Regardless of the level of volatility (column 1), future returns were positive at least 75% of the time (column 3)
- Positive years were best (column 4) when preceded by lower volatility
- Negative years were worst (column 5) when preceded by higher volatility.

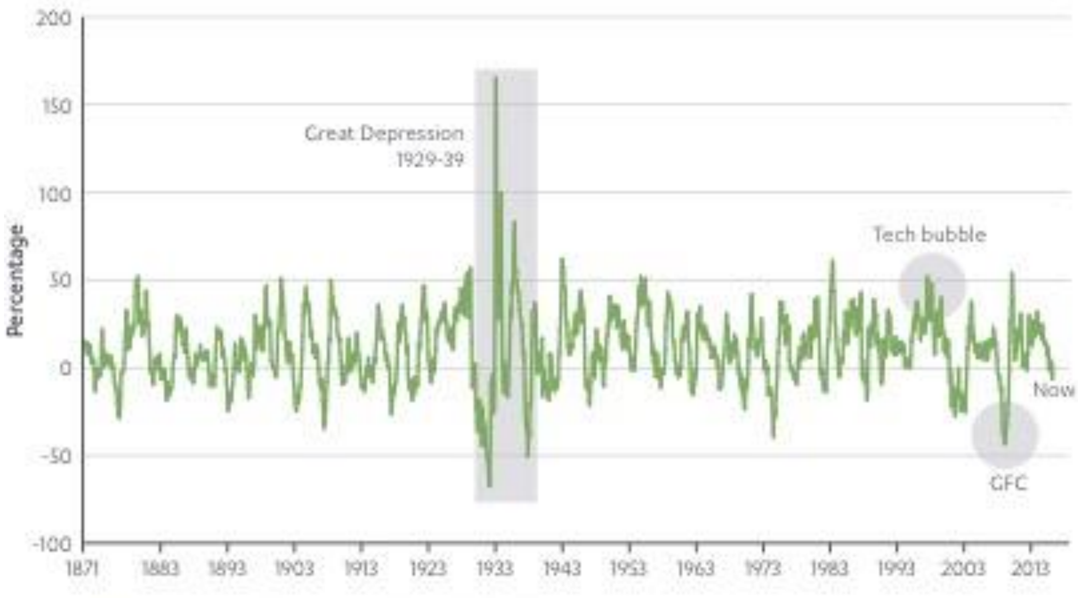
This tendency suggests more caution when recent volatility has been higher, but hardly screams that it's time to throw in the towel. When realised volatility has been between 15% and 20%, returns in the following year still tend to be positive three times as often as they are negative. Pretty good odds! The point is that we just can't reliably use risk to predict return.

But what about the very long term?

We will now switch to a much longer data series, nearly 150 years of S&P 500 Index returns courtesy of Professor Robert Shiller's website. This data, in Chart 3 (below), encompasses a huge range of economic environments. Looking at returns shows investing in shares can be a roller coaster ride. The range of rolling 12-month returns is between -67% and +165%, with 80% of these observations falling between -12% and +34%. Interestingly, the so-called Tech Bubble of the late 1990s doesn't stand out as anything out of the ordinary when seen in such a long history.

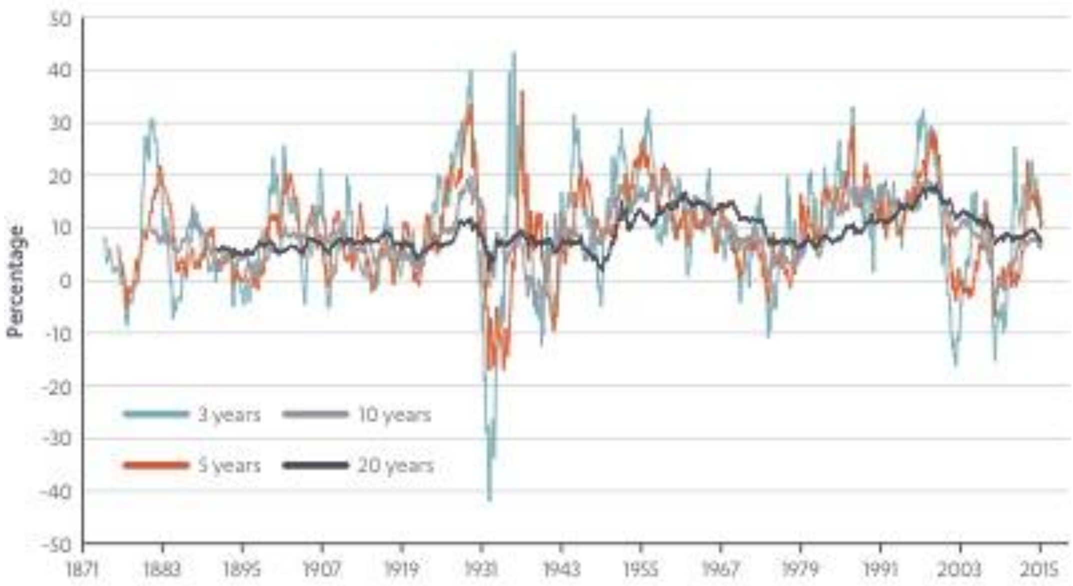
Now look at the 3, 5, 10 and 20-year rolling returns in Chart 4 (next page). It's clear that the longer the investment horizon, the more predictable the outcome and therefore the greater the surety of achieving wealth creation objectives.

Chart 3: S&P 500 Index rolling 12-month total returns since 1871



Source: BTIM, http://www.econ.yale.edu/~shiller/data/ie_data.xls

Chart 4: S&P 500 Index total returns since 1871 for different rolling periods



Source: BTIM, http://www.econ.yale.edu/~shiller/data/ie_data.xls

Investment Horizon	1 year	3 years	5 years	10 years	20 years
Worst Return	-67%	-42%	-17%	-5%	2%
Best Return	165%	44%	36%	21%	18%
Range	232%	85%	53%	26%	16%
Average Return	11%	10%	9%	9%	9%
Middle 80% of Returns	-12% to +34%	-3% to +24%	0% to +20%	+3% to +17%	+6% to +14%

Three-year returns still have a wide range of outcomes but are materially better than 1-year, and 5-year returns are starting to become a little more palatable. By 'better', we mean more consistent. Aside from the Great Depression, the occasions where the S&P 500 Index delivered a negative 5-year return were few and brief. By the time we get out to a 20-year holding period, the S&P 500 Index has never had a negative total return. While this sounds like a really long time, it's actually the investment horizon of an investor in their mid-forties.

Essentially, in the above two S&P 500 Index charts, the green line of 1-year returns is what you experience but the black line is what you could get. The key here is that asset classes need to be given long enough to let the short-term noise wash out and for the long-term risk premium to pay off. The longer an investor can stick to the plan, the better. What's more, it's easy to do!

Rules by which to invest

While it's tempting within a diversified portfolio to sell down equities 'if they look toppy' or buy 'if they are cheap', that's speculation, not investing. It's our firm belief that the strategic asset allocation needs to be set with reference to, and maintained for, a period consistent with the investment horizon of the investor. Material changes should really only be made when there is a change in the circumstances of the investor and the temptation to 'just do something' should be resisted. A well-diversified, appropriately positioned portfolio is likely to do the job required of it as long as it is given enough time. Develop an appropriate investment plan and stick to it.

In particular, make use of two powerful tools available to investors:

- Diversification. Sometimes referred to as 'the only free lunch in investing', appropriate use of diversification improves the surety of investment outcomes.

- Patience. You are saving for your retirement and the investment horizon should match. Recent market returns make for entertaining table talk, but it's the long term *average* outcome that determines one's quality of life in retirement. Asset allocations should be set for the long-run balance between risk and return rather than trying to predict what's going to happen in the next few months.

One of the fundamental tenets of asset allocation should be: MORE TIME = MORE SURETY

Be the patient investor and let the market transfer money from the impatient to you.

Stuart Eliot is Portfolio Manager at BT Investment Management. See more details on BTIM's Diversified Funds [here](). This information is for general information only and has been prepared without taking into account any recipient's personal objectives, financial situation or needs.

How do unlisted real estate funds generate high income returns?

Adrian Harrington

[In Part 1 last week](), we looked at the characteristics of unlisted property funds (syndicates) that investors should look for. In Part 2 this week, we look at how the returns are generated.

Many investors must look at an unlisted real estate fund's yield at say 7.3%, on a property acquired with income yield of say 7%, and wonder where the money comes from. The answer is *leverage and cost of debt.* Whilst a syndicate's yield is a function of the net income that the underlying property generates, the ultimate yield to investors depends on the gearing level and borrowing costs.

Higher gearing enhances the yield if the cost of debt is below the yield of the asset, as in the current market. We advocate gearing not to exceed 50% and start with at least a 10% buffer to the bank's loan to value (LTV) covenant, usually 60%. This buffer is in case asset values fall.

Table 1 - Unlisted Fund - Acquisition Costs Not Capitalised				
Gearing	**40%**	**50%**	**60%**	**A**
Property Price / Debt & Equity				
Acqusition Yield	7%	7%	7%	**B**
Annual Net Property Income	3,000,000	3,000,000	3,000,000	**C**
Purchase Price	42,857,143	42,857,143	42,857,143	**C/B = D**
Debt	17,142,857	21,428,571	25,714,286	**D * A = E**
Equity - Asset	25,714,286	21,428,571	17,142,857	**D - E = F**
Acquisition & Establishment Costs				
Acqusition Costs (stamp duty/asset due diligence - 6% of purchase price)	2,571,429	2,571,429	2,571,429	**D * 6% = G**
Debt Establishment - 0.25% of debt	42,857	53,571	64,286	**E * 0.25% = H**
Acquistion fee - 1.5% of purchase price	642,857	642,857	642,857	**D * 1.5% = I**
Fund Establishment Costs (legals, tax, accounting)	100,000	100,000	100,000	**J**
Total Acquisition & Establishment Costs	3,357,143	3,367,857	3,378,571	**G + H + I + J = K**
Fund Equity Required	29,071,429	24,796,429	20,521,429	**F + K = L**
Profit & Loss				
Total Annual Net Property Income	**3,000,000**	**3,000,000**	**3,000,000**	**C**
Recurring Fund Costs (registry, accounting, tax, audit etc)	120,000	120,000	120,000	**M**
Interest - 4.5%	771,429	964,286	1,157,143	**E * 4.5% = N**
Management Fee - 1.3% of Net Assets (Equity)	334,286	278,571	222,857	**F * 1.3% = O**
Total Annual Costs	1,225,714	1,362,857	1,500,000	**M + N + O = P**
Total Net Fund Cashflow	1,774,286	1,637,143	1,500,000	**C - P = Q**
No of Units on Issue - Assume Issued Price $1	29,071,429	24,796,429	20,521,429	**L * $1 = R**
Distribution Yield	**6.10%**	**6.60%**	**7.31%**	**Q / R = S**
NTA ($)	**0.88**	**0.86**	**0.84**	**F / R = T**

Table 2 - Unlisted Fund - Impact of Gearing Levels and Debt Costs			
Gearing	**40%**	**50%**	**60%**
Debt Cost - 3.8%	6.52%	7.21%	8.19%
Debt Costs - 4.5% (Table 1 example)	6.10%	6.60%	7.31%
Debt Costs - 6.5%	4.92%	4.87%	4.80%

Table 1 (previous page) shows an example of an asset generating a net income of $3 million per year and purchased on a yield of 7.0%. Let's assume that it is fully tenanted and relatively new so the capital expenditure requirements are minimal. There are three scenarios – the asset has leverage of 40%, 50% or 60% and the acquisition costs are not capitalised.

The distribution yield varies between 6.1% and 7.31% depending on gearing.

The cost of debt also has an impact. Table 2 (above) shows the impact under two other scenarios related to the cost of debt. Firstly, the manager secures debt at 3.75% (assume a 90 day BBSY base rate of 2.3% and a bank margin of 1.5%), which is highly possible in today's low interest rate environment and secondly, interest rates move back closer to long-term levels and debt is secured at 6.5% (a base rate of 5.0% and a margin of 1.5%).

Gearing enhances returns

There is a wide variation in a fund's yield based on the gearing levels and cost of debt.

Leveraging up in a market when asset prices are rising (yields are falling) and debt costs are low, as the table above shows, can generate supersized returns. However, the risk in those funds is significantly heightened when the cost of debt goes up or the real estate cycle turns and prices fall as it inevitably will at some point. Investors need to understand that prudent use of leverage, with appropriate capital management strategies (covenant levels, type of debt, principal and interest or interest only, duration of debt (short or long term) and hedging) can be an effective financial instrument. Abused, the ramifications can be significant.

As real estate yields have fallen, it is pleasing most managers of recent unlisted fund offers are avoiding the temptation of leveraging up to boost a fund's yield. Managers and investors must remain diligent as real estate yields head to cyclical lows, and avoid the temptation. As Warren Buffet said "when you combine leverage and ignorance, you get some pretty interesting results".

Exit strategies, liquidity and term extensions

We are often asked what happens at the end of the syndicate's term? What happens if an investor needs liquidity? Why does the syndicate require such high thresholds to rollover for a longer term? These are all legitimate questions which managers need to clearly articulate to investors.

Unlisted real estate fund is a long-term investment. If investors are concerned about short-term liquidity needs they should consider investing in listed real estate. There are times when a person's circumstances change due to death or divorce and they wish to liquidate the investment.

In a syndicate, the only way this can be dealt with is via an off-market trade in which another investor is willing to buy their units in the fund. There is no secondary market for trading of units although there are some funds that have been established to acquire units from investors, and from time to time, the manager may be approached by other investors who may wish to invest in the fund. The manager may put the two investors in touch with each other to negotiate an appropriate price but the manager is legally not able to create a secondary market in trading the units of its fund.

The GFC highlighted the inadequacy of many unlisted funds whereby they did not focus on the exit strategy which created a misalignment between investors and managers. A number of funds were extended for a further term prior to the GFC and then took a hit as the market collapsed. In effect, some managers 'rolled the dice' and kept their funds running beyond the initial term. This allowed the managers to collect fees for longer when asset pricing started to reach excessive levels and the funds had already delivered strong returns to investors.

Most of the leading managers now use structures that require unitholders to vote to amend the fund term and performance fee structures. They incentivise the manager to recommend to unitholders to wind-up the fund early if they believe the returns from the asset have been maximised or the cycle is nearing the peak. Managers have also inserted early wind-up provisions into the terms of the fund typically based on a Special Resolution ie at least 75% of votes cast by unitholders on the resolution to be in favour of the resolution for it to be passed.

The Special Resolution provision should also apply if the manager believes it is in the best interest of investors to extend the term of the fund. This may arise as the property has an upcoming lease which if renewed or extended can add value to the fund if the sale is delayed until this is actioned, or it could be that the market is soft and liquidating the asset at the time may not optimise the return to investors.

The key with exit strategies is for the investor to recognise that investing in an unlisted fund is long term and the manager's role is to optimise the value of the asset and the return to unitholders which may mean, in certain circumstances, winding-up early or extending the life of the fund. The decision should be relatively straightforward for both the manager and investor if there is an alignment of interests (see Part 1 last week) and there is an appropriate voting mechanism that gives investors a say in what happens.

Adrian Harrington is Head of Funds Management at Folkestone (ASX:FLK). This article is general information and does not address the specific investment needs of any individual.

Just how risky are hedge funds?

Craig Stanford

When speaking with fellow investors and finance professionals, I am surprised by how often I am told that hedge funds are more risky than equities. This article offers thoughts on why I think this belief is largely incorrect.

It is not possible to say categorically that hedge funds are more risky than equities or not, because the hedge fund universe is heterogeneous and different funds run different levels of risk that could be above or below that of equities. In my experience however, the majority of hedge funds run levels of risk that are far below that of equities, using most definitions of risk.

What risk is being measured?

It is also important to define 'risk' and how it can be measured. Most risk measures are based on historical returns and don't say much about the actual risk that was taken to produce the observed return. A one dimensional number based on historical performance (such as return or volatility) only takes account of the single outcome instead of the range of possible outcomes that could have occurred. To put it another way, an asset that generated a positive return was not necessarily less risky than another asset that generated a negative return over the same period.

We prefer to take a multi-dimensional view of risk and find it counter-productive to reduce risk to a single number. The main risk faced by investors is the permanent impairment of capital and this is what we aim to protect against. Although it is beyond the scope of this short article, hedge funds are subject to a different set of risks (as a result of using leverage and shorting for example), which are not easily comparable to long-only managers. That said, just because a hedge fund uses leverage or sells short doesn't automatically make it riskier than equities. In most cases the managers use these techniques to reduce rather than increase risk.

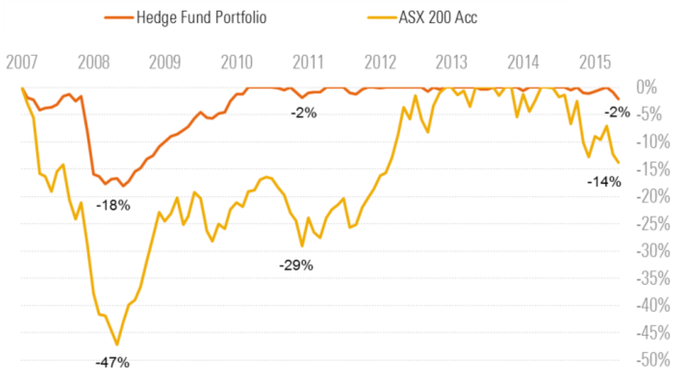
The perception of large hedge fund losses is almost certainly due to negative press coverage of a very limited number of failures or frauds. These extreme examples were typically avoided by the more astute hedge funds and are not consistent with our history of investing in hedge funds. Of course, if an investor had too high a percentage of their portfolio in any vehicle that failed it would be devastating, but to extrapolate that specific experience to the entire universe is like refusing to invest in equities because HIH Insurance failed.

This article compares the performance of the Ibbotson Alpha Strategies Trust, which is an actual portfolio of hedge funds (Hedge Fund Portfolio) after all fees, against the S&P/ASX 200 **Accumulation** Index (ASX 200) which is fee-free and outperforms the average long-only manager. This removes the impact of survivorship bias and other factors that are often cited as providing an artificial boost to the hedge fund indices, and also gives a slight boost to the equity portfolio.

Different methods of examining losing periods

Figure 1 is a drawdown chart, which shows the total losses sustained by the Hedge Fund Portfolio and the ASX 200 since the launch of the Hedge Fund Portfolio in late 2007. During the GFC, the Hedge Fund Portfolio lost a little over 18% whilst the ASX 200 lost 47%. If you consider capital loss as a measure of risk, the Hedge Fund Portfolio has been substantially less risky than the ASX 200 during all losing periods for the ASX 200.

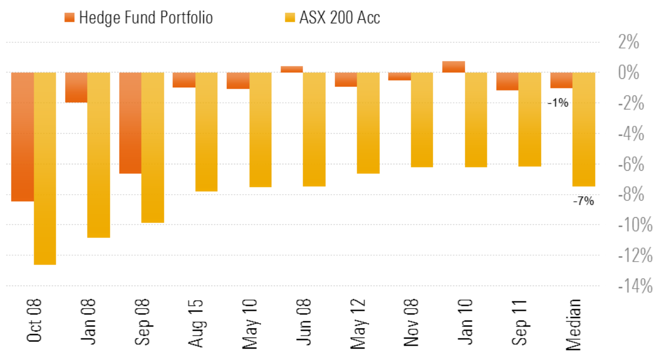
Figure 1: Drawdowns for the Hedge Fund Portfolio and ASX 200 since October 2007



Minimising capital losses is crucial for any investor. It leaves a larger pool of capital to generate future returns. From the GFC low, the Hedge Fund Portfolio recovered its losses in 21 months whilst the ASX 200 took almost three times as long, 55 months, despite the ASX 200 having a far higher average return over the period (and the ASX 200 **Price** Index remains more than 20% below its 2007 high after more than eight years). If you consider time to recover your losses as an important risk, the Hedge Fund Portfolio was substantially less risky than the ASX 200.

Figure 2 looks at performance during difficult periods in another way, by comparing the performance of the Hedge Fund Portfolio to the ASX 200 during the 10 worst months for the ASX 200 since late 2007. The graph shows that the median loss for the ASX 200 over this time period was 7% whilst the median loss for the Hedge Fund Portfolio was around 1%.

Figure 2. Performance of the Hedge Fund Portfolio and the ASX 200 during the 10 most difficult months for the ASX 200



Returns and volatility since 2007

Although we don't think that realised volatility is a very useful measure of risk in isolation, it has gained widespread acceptance. Figure 3 shows the Hedge Fund Portfolio has returned more than three times as much as the ASX 200 with one third of the volatility. On the basis of realised volatility, the Hedge Fund Portfolio has been a substantially less risky investment than the ASX 200. Figure 4 shows the value of $100 invested in late 2007, with the Hedge Fund Portfolio far more consistent.

Another observation is that the goal of fee minimisation without taking account of the actual investment outcome is narrow-minded. An investment in a low-fee ASX 200 tracker has experienced lower and more volatile returns.

Figure 3: Return and Volatility

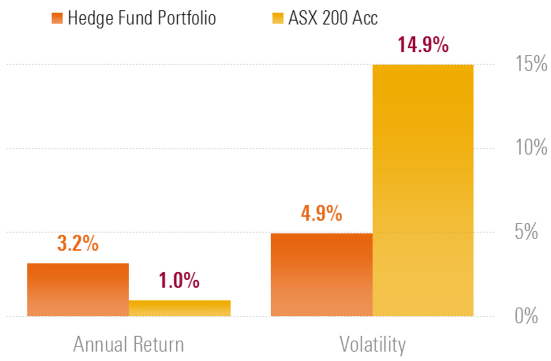
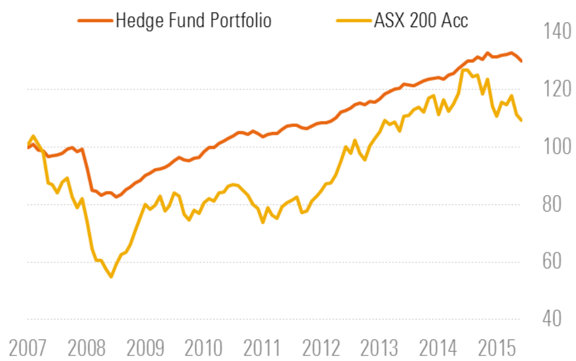


Figure 4: Value of $100 invested at inception



The purpose of this article is to counter the commonly held belief that 'hedge funds' are riskier than 'equities'. Although we believe the key risk that investors face is the permanent impairment of capital, we included a number of popular risk proxies including drawdown, performance during difficult months and volatility. We believe investors and financial advisers should consider the role and benefits that an allocation to hedge funds can play in a diversified investment portfolio.

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How to make in-house investment management work

Geoff Warren

In-house investment management is a hot topic in the Australian superannuation industry. Organic growth and industry consolidation mean many funds are attaining a size at which managing their investments in-house becomes a serious proposition. SuperRatings data reveals that about 60% of superannuation funds manage some assets in-house, with nearly one-fifth reporting a substantial commitment of 20% or more of assets.

Why does in-house management matter?

Managing assets in-house aligns with the policy agenda of improving the efficiency of the superannuation industry. Managing in-house, rather than contracting out to external investment managers, can not only reduce investment expenses for larger funds. It can also provide opportunities to access additional returns, tailor the portfolio towards member needs, and address capacity constraints as funds under management grow. It helps funds address the problem that active managers are only able to handle mandates up to a certain size. Thus, in-house management can invest in ways that not only enhance member outcomes, but are also more scalable and hence better able to accommodate asset growth and perhaps consolidation.

A natural progression

The shift to in-house management can be seen as a natural extension of historical trends. Traditionally, most superannuation funds have been outsourcers: initially of the entire investment process to a balanced manager (the 1980s model); then later by appointing specialist external investment managers, often under advice from asset consultants (the 1990s model). The construction of multi-manager asset portfolios, oversight of cash and currency management, and active asset allocation has required the creation of internal investment management teams. Indeed, much of the activity around in-house management can be traced to funds putting in place internal teams that possess the skills and confidence to directly manage the assets.

Examining the how and why

The 2016 CIFR study *In-House Investment Management: Making and Implementing the Decision* explores the contrast between the traditional model of outsourcing to external investment managers and in-house management. The research includes field interviews with 20 senior industry executives from superannuation funds, asset consultants, and research houses.

The motivations to adopt in-house management are varied, including:

- return impact
- capacity considerations
- governance structures
- alignment and culture
- ability to attract, retain and incentivise experienced investment professionals
- risk management

Each participant in the research seemed to have a different approach to deciding whether assets should be managed in-house. Some believe that in-house management can provide access to higher returns, while others expect gross returns to fall, but net returns to increase because costs will fall even further. Some consider the ability to tailor investments to be of prime importance, while others argue that tailoring can be effectively achieved using external managers. Some perceive staff management and culture as major challenges, while others think that these problems can be solved by targeting culturally-aligned staff. Some view systems as critical and a significant source of risk, while others trivialise the difficulty of establishing reliable systems. There is little industry-wide consensus.

There are some common elements in how in-house management is being addressed. All participants approach the decision on an asset-class-by-asset-class basis. They recognise that in-house management may not work for all assets or strategies. Cash is often the first candidate for managing in-house, given that investing in cash is relatively straightforward, can be implemented with modest resources, and has complementarities with fund liquidity management. Beyond that, there is only limited consistency across superannuation funds on what assets they prefer to manage in-house.

Structuring options

Four broad approaches for structuring in-house management were encountered during the interviews:

1. Dedicated internal structure, where an asset class is managed entirely in-house
2. Hybrid external/internal models, under which the in-house team is responsible for a slice of the assets in conjunction with external managers
3. Co-investments, where the fund piggy-backs on the ability of an external manager to identify and source assets through taking a 'slice on the side' and
4. Partnerships, either between funds or with an external manager, involving the fund providing capital while some management functions are performed externally.

The hybrid model appears popular in Australia, especially in core listed assets like equities and fixed income. Within the hybrid model, there is a further choice regarding the degree to which the in-house capability is *segmented* and treated as just another manager within the portfolio; versus being *integrated* and used to 'complete' the portfolio in some way. The hybrid model also raises the issue of respecting the intellectual property rights of external managers: again, there is a variety of views.

CIFR's input: A decision framework, and some views

The study presents a framework that asset owners like superannuation funds might use for making and implementing decisions to manage in-house. It addresses four elements: *capabilities*, *costs*, *alignment* and *governance.* It weighs up the potential impact on *net returns* along the way, each with a checklist of potential aspects for consideration.

Based on the research, CIFR is generally supportive of in-house management, with the caveat that the conditions must be right for the fund, and that it needs to be implemented appropriately. Done properly, in-house management can generate improved net returns with increased control, allowing assets to be managed in a way that is better directed to member needs and delivered with greater confidence. It establishes a platform for the future, if designed as scalable and flexible. However, integrated hybrid models still have merit. These structures allow the portfolio to be managed in a manner that can enhance returns while supporting tailoring and flexibility, yet retains many of the self-disciplinary benefits of having external managers within the structure.

Some mistakes will inevitably be made by funds who manage in-house. However, fear of error should not prevent in-house management from being embraced where benefits are evident. In-house management is rarely of sufficient size to 'sink a fund' in its own right, as it typically occurs as discrete strategies across a range of asset classes. Rather, it is investment functions that cut across the entire portfolio – such as asset allocation and currency management – that carry more inherent risk.

Looking forward

The trend towards greater in-house investment management by superannuation funds has much further to run, driven by industry and fund growth, competitive tensions and innovation. The pioneering and successful efforts thus far provide encouragement. While members should benefit on balance, some bumps and set-backs are to be expected along the way. One interesting issue is the impact on external managers – their pricing, product offerings and engagement – given that they are facing the rise of a powerful new player on their turf: their former clients, the asset owners.

Geoff Warren is Research Director at the Centre for International Finance and Regulation (CIFR), UNSW. The study, [In-House Investment Management: Making and Implementing the Decision](), *is co-authored by Geoff Warren, David R. Gallagher and Tim Gapes, from the CIFR.*

Results from superannuation changes survey

Graham Hand

In last week's Cuffelinks Newsletter**,** a Reader Survey asked about potential changes to superannuation rules. Showing the passion and engagement of our readers, it has attracted over 700 responses so far. We will leave it open for another week.

It was impressive how many people wanted the system to be sustainable and eliminate inequities, even if they were personally disadvantaged. But most people are tired of changes which compromise retirement planning and outcome certainty.

The full survey results are linked here.

Highlights include:

- Two-thirds of responses were in favour of reducing the earnings level where the extra 15% tax on concessional contributions ('Division 293') kicks in. Many comments argued high income earners can afford to pay more tax, concessions should go to lower paid, and some support taxing at a Marginal Tax Rate less 15%. Super is not meant to be about tax minimisation.

  BUDGET OUTCOME: Adopted at the $250,000 level.

- A high 85% of people do not support changing the annual concessional caps, as it allows people to top up super through salary sacrifice without the current level being excessively high. But it falls to 62% for non-concessional, as the level is deemed too generous and allows balances to build to unsustainable amounts.

  BUDGET OUTCOME: Concessional caps reduced to $25,000 a year.

- 77% supported retaining the 'bring forward' rule, while those in favour said it allows retirees to put affairs in order around retirement.

  BUDGET OUTCOME: Lifetime cap of $500,000 on non-concessional contributions.

- Likewise, 77% did not want a tax on pension income introduced, as retirees had already been taxed along the way, and it would become a disincentive to save. Many concede it is generous.

- Fairly equal on the merit of lifetime concessional caps (46%/54%) and non-concessional caps (47/53), although sounds like the old RBLs. Need to be at a high level, though.

  BUDGET OUTCOME: Lifetime cap of $500,000 on non-concessional contributions.

- 45% support abolishing Transition to Retirement pensions, with a mix of people saying they play an important role versus those who say being misused.

  BUDGET OUTCOME: Earnings on assets supporting TTR pension to be taxed at 15%.

- Strong support at 77% for retaining the Low Income Super Contribution (LISC) scheme, as proposal is not fair on low income earners.

  BUDGET OUTCOME: LISC to be retained.

- A high 77% say leave super alone for at least 3 years to stop it being a political football.

- Many general comments about the family home exemption, eg person with a $3 million home can draw a full pension.

Thanks to all the people who responded. We have opened the full text of the responses because the comments are at least as valuable as the statistics.

Graham Hand is Editor of Cuffelinks. The Survey is released for general information and no responsibility is accepted for any of the opinions.

Budget shocks limit large super balances

I'm shocked by the number and severity of changes to the superannuation rules announced in the 2016 Federal Budget. The next generation of people saving for retirement will not be able to build the high super balances achieved in the last decade, and some of the changes are retrospective. Alternatives such as negative gearing, the tax-free family home, family trusts and investment (insurance) bonds will now receive more support, so it is impossible to know how much the budget will save.

Although there were 10 amendments, they have been covered extensively in the media (and we include links to three summaries in the Sponsor Noticeboard on our website), and this article focusses on the three new caps.

I realise having large amounts in super is a good problem to have, so let's get that one out of the way. I have taken advantage of the generous levels, and while I always doubted they would be sustained for new money, I did not expect retrospective treatment. People who have used the rules as intended by the government of the day have now been told they must unwind their financial plans and take the money out of their pension accounts. Wait a minute … it was as recently as 2014/2015 when the non-concessional annual cap was **increased** from $150,000 to $180,000. Pre-retirees in their 50s who planned to build their super balances after their mortgage, school fees and other expenses had gone will be severely constrained.

What finally drove the current limits to become politically unacceptable was the dramatic deterioration in the budget deficit, and the need to find revenue somewhere. In 2014, the forecast for this financial year was a deficit of about $10 billion, but it has risen to $37 billion. We are heading for even larger deficits that nobody expected when the previous limits were set, and something has to give. Large superannuation balances, with the benefits skewed to the 'rich', have become an easy target.

Warren Bird has been in financial markets for over 30 years and he writes regularly for Cuffelinks. His comments on the changes probably echo the sentiments of many who enjoyed the high limits:

"A part of me acknowledges that the system Peter Costello introduced was 'too generous', and that in the long run it has turned out to be too expensive for the nation to afford … And lower income people have had to deal with this uncertainty for years as government payments have chopped and changed from Budget to Budget. So those who have more than $1.6 million in pension phase should not complain too loudly lest they sound like they're simply being greedy.

But it is nonetheless an indictment on our political process that uncertainty is continually being heightened, rather than governments helping to create an environment in which sound plans can be made and rewarded."

$1.6 million cap on the amount that can be held in a pension with earnings tax-free

For the last decade, superannuation policy encouraged large balances and self-reliance for those who could afford extra contributions and were willing to forego other expenditures (for example, buying an extra-large, tax-free family mansion) for super contributions. There was the $1 million one-off Peter Costello injection, the annual limit on non-concessional contributions (NCC) of $180,000, a $540,000 'bring-forward' rule to make it easier to manage a windfall, and the concessional contribution cap was as high as $100,000 in 2008/2009. Successive governments exhorted the public to save for retirement, to avoid becoming a future burden on society by drawing age pension benefits. Planners warned that with an ageing population, nobody should expect the spiralling cost of health care to be met by the public purse long into the future. The self-funded retiree label became a badge of honour, and government policy wanted it that way.

Many retirees are highly risk-averse, and leave large balances in cash and term deposits. They cannot face the prospect of capital destruction when the money might have to last another 40 years. With the cash rate at 1.75%, a decent capital-secure interest rate might be 2.5%. On $1.6 million, that is $40,000 per year. It's not much even if the retiree owns their own home.

The main disappointment is the retrospective treatment of this amendment and others. Thousands of hours of financial advice to clients about pumping as much money as possible into superannuation to take advantage of tax-free pensions are now compromised. Retirees with more than $1.6 million will need to transfer the excess, and some Transition to Retirement plans will be unwound due to a new tax treatment.

One look at the financial planning reports issued the day after the Budget shows the windfall for the advice industry. Within hours, planners were finding ways to manage the impact of the changes, such as realising capital gains on assets prior to the 1 July 2017 start date. Far from simplifying the system, the new rules make if even more complex, and nobody around retirement age should go through the next 12 months without some expert, highly-qualified financial advice.

And what about the compliance issues required to determine the fund balance at a particular date? Retirees will need to estimate how much to take out of the pension account a few days before 30 June (to allow for settlement or processing of transfers on share transactions). Many assets are not traded daily, such as real estate, and unlisted bonds have wide valuation spreads. The retiree may be hit with a penalty if the market rallies on say 29 and 30 June 2017 and the balance goes over the $1.6 million cap. The new rule states: "Individuals who breach the cap will be subject to a tax on both the amount in excess of the cap and the earnings on the excess amount."

There is also no detail on whether taxable or non-taxable amounts can be allocated between pension and accumulation accounts to ensure the best outcomes.

Caps on concessional and non-concessional contributions

The NCC door was slammed shut as Scott Morrison stood up at 7:30pm on Tuesday night. Anyone who had placed $500,000 or more into NCCs since 2007 cannot make additional contributions. The potential for error here is considerable when all the potential NCCs over nine years need to be identified.

This is probably the tightest of the new caps in practice. The previous $540,000 every three years allowed people who had poor balances in super to catch up and plan a decent super balance in their retirement years. The expectation of placing over $1 million in super in just over three years was attractive (OK, and generous). But this one-off limit of $500,000 now can only be supplemented at $25,000 a year. It will take many years plus some good performance to reach the $1.6 million cap for new savers.

The annual caps and the 'bring forward' rule are no longer necessary. In the past, financial planners produced tables like the following, showing their clients how to maximise contributions by waiting until just before they turned 65 to make the final 'bring forward' contribution of $540,000. Oops, not such a happy 65th birthday now it is impossible on 1 March 2017.

FINANCIAL YEAR	AGE AS AT 1 JULY	NON-CONCESSIONAL CONTRIBUTION
2014/15 (current)	62 years old	$180,000
2015/16	63 years old	$180,000
2016/17	64 years old	$540,000*
Total non-concessional contributions		$900,000

*Contribution needs to be made before his 65th birthday on 1 March 2017, otherwise he would need to meet the work test in the year of contribution (2016/17) prior to the contribution being made.

It's also worth remembering that high income earners have already paid almost 50% in tax on earnings to establish these NCC savings.

OK, it could have been worse

Many people will say this article reflects the disappointment of people who took advantage of rules that should never have been so generous, and the result is not something to whinge about.

In addition, while the balance over $1.6 million must be taken out of the tax-free environment, it can remain in an accumulation account taxed at only 15%. Arguably, a decent result for someone who might otherwise pay 47% or 49% on earnings outside super.

There is also no change to imputation credits or capital gain concessions, creating the ability to reduce the effective tax rate, even in the accumulation fund.

While annoying and disappointing, the evidence that the outcome for people with large pension balances is not terrible is the fact that the best option is probably to leave the excess (over $1.6 million) in an accumulation account. Moving out of super takes earnings into the personal tax domain, where the tax-free threshold is $18,200, after which the marginal tax rates start at 21% (including 2% Medicare levy). At $37,001, the tax rate rises quickly to 34.5%.

What is the answer to the question: what would I have done differently versus putting money into super in the last decade if I had known these amendments would be introduced in 2016/2017?

The answer is complicated by the knowledge that property prices in Sydney and Melbourne in particular have done so well in the last three years. The money over $1.6 million may have been better placed in a tax-free, expensive family home, or used to negatively gear other property (or shares with the right timing).

But the more likely response is that more people would have used the 'bring forward' rule last week to put MORE into super, protected in the 15% tax environment. At least until the rules change again.

Graham Hand is Editor of Cuffelinks.