Cuffelinks

Connecting investors with ideas

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Retrospectivity ain't what it used to be

Graham Hand

'Retrospective' has become the riskiest word in the election campaign. It's easy not to take sides in the retrospectivity debate because both major political parties are obfuscating. In recent months, both have explained what 'retrospective' really means, and the policies of both meet their own definitions.

Let's start with the words directly from our leaders:

Scott Morrison said

On Thursday, 18 February 2016, at 4.45pm, I sat about 20 metres away from Treasurer Scott Morrison while he presented to the SMSF Association National Conference in Adelaide. I wrote up this article and his exact words are here. He said:

*"One of our key drivers when contemplating potential superannuation reforms is **stability and certainty, especially in the retirement phase**. That is good for people who are looking 30 years down the track and saying is superannuation a good idea for me? If they are going to change the rules at the other end when you are going to be living off it then it is understandable that they might get spooked out of that as an appropriate channel for their investment. That is why I fear that the approach of taxing in that retirement phase **penalises Australians who have put money into superannuation under the current rules – under the deal that they thought was there. It may not be technical retrospectivity but it certainly feels that way. It is effective retrospectivity, the tax technicians and superannuation tax technicians may say differently.**"* (my emphasis)

There was little doubt among delegates that we had just heard the Treasurer say there would be no changes to super rules in the retirement phase.

What is most notable here is that the Treasurer actually defines retrospectivity: "… under the deal that they thought was there … It is effective retrospectivity."

Bill Shorten said

Five days earlier, on Saturday 13 February 2016, Bill Shorten gave a press conference where he said:

*"I'm old school, brought up with the principle that laws should not be retrospective. If you've entered into financial arrangements and investments based on current tax law, I don't believe you should retrospectively change that law. In other words, **when you make a new announcement in the future, it shouldn't change the circumstances of the people who are already invested under the old law.**"* (my emphasis)

Some definitions of retrospectivity

"*Looking back on or dealing with past events or situations*." Oxford Dictionaries

"*The term is used in situations where the law (statutory, civil, or regulatory) is changed or reinterpreted, affecting acts committed before the alteration*." Wikipedia.

The Australian Government's own Australian Law Reform Commission (ALRC) has issued a note on retrospective laws which includes the following common law interpretation (courtesy of 'bigjulie' in our comments section):

"People should generally not be prosecuted for conduct that was not an offence at the time the conduct was committed. More generally, it might be said that laws should not retrospectively change legal rights and obligations."

John Daley of the Grattan Institute put it this way:

"'Retrospectivity', a legal concept, applies if a government changes the legal consequences of things that happened in the past."

Both political parties are arguing their own policies are not retrospective.

What are the major changes in super policies of the major parties?

Consider the two policies of the parties for capturing revenue from large super balances:

Government proposal

The Government has a $1.6 million 'transfer balance cap', described in full here. It states:

"From 1 July 2017, the Government will introduce a $1.6 million cap on the total amount of superannuation that can be transferred into a tax-free retirement account … Superannuation savings accumulated in excess of the cap can remain in an accumulation superannuation account, where the earnings will be taxed at 15 per cent … Subsequent fluctuations in retirement accounts due to earnings growth or pension payments are not considered when calculating cap space … 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."

In addition, there is a new lifetime cap on non concessional contributions (NCC) of $500,000, backdated to 2007.

Opposition proposal

The Opposition's policy is linked here. It states:

"The proposed measure would reduce the tax-free concession available to people with annual superannuation incomes from earnings of more than $75,000. From 1 July 2017, future earnings on assets supporting income streams will be tax-free up to $75,000 a year for each individual. Earnings above the $75,000 threshold will attract the same concessional rate of 15 per cent that applies to earnings in the accumulation phase."

As the table shows, the impact of the transfer balance cap depends on the pension account's earning rate and the amount in the account.

Additional tax due to superannuation policy changes

	Government		Opposition	
Amount in pension	**Earning rate on pension account**			
	5%	**10%**	**5%**	**10%**
$1.0 million	nil	nil	nil	$3,750
$1.6 million	nil	nil	$750	$12,750
$2.0 million	$3,000	$6,000	$3,750	$18,750
$5.0 million	$25,500	$51,000	$26,250	$63,750

For example, at a balance of $1.6 million, the Government's policy creates no additional tax liability, regardless of earnings. However, if the pension earns a healthy 10%, income of $160,000 is well above the Opposition's $75,000 threshold, and the tax on the $85,000 excess is $12,750. In all the examples above, the Opposition policy raises more tax or nil.

How does the Government argue the policies are not retrospective?

Scott Morrison told the Canberra Press Club on 4 May 2016 (the day after the Budget), addressing the lifetime cap on NCCs:

"I don't believe this is retrospectivity but others can have whatever view they may wish to argue for. If people have contributed more than $500,000 up until this point, well we won't be asking them to take it out of their superannuation account. It will be able to remain in that account."

This is not accurate. He will require retirees to take money out of a pension account if it holds over $1.6 million. Mr Morrison went on to say:

"We are not taxing the earnings out of retirement phase accounts. We've set a limit on what can go into those retirement accounts. That's a different position and it's one I'm very comfortable with. I'm

not uncomfortable with the fact that we put a cap on how much can go into a tax-free earnings investment made possible by the taxpayer. But I have not changed the tax treatment and nor do I propose to change the tax treatment of retirement phase superannuation accounts."

But it's not only how much can **go into** a pension account. That is arguably prospective. It is also how much can be **left in** a pension account.

Are the policies retrospective?

The most significant impact of the Budget announcements is the uncertainty they bring to superannuation savings plans. Everyone is affected by this uncertainty. It's not possible to believe any statements on policy stability, making planning for the next 30 to 40 years problematic.

We can argue about what 'retrospectivity' is. If we apply the test that it is retrospective if it changes the *consequences of things that happened in the past*, then clearly both the Government and the Opposition are making retrospective changes.

The proposed transfer cap of $1.6 million is retrospective because it applies to amounts built up in the past under the prevailing laws. There is no grandfathering as retirees will be forced to withdraw the excess from a pension account, with no ability to top up if the market falls.

The proposed NCC limit of $500,000 is retrospective because it imposes a cap and counts contributions made before the law was introduced, since 2007. As the Government is now finding, it is tough to argue backdating a change to 2007 is not retrospective. Before Budget night, the after-tax contributions did not count towards a cap, but then they did.

The Opposition is introducing a tax on the earnings above $75,000 on existing pension balances that have been accumulated in the past under the existing rules, and so it is also retrospective.

At the very least, if people want to argue a technical point that the policies are not retrospective, then let's come back to the politicians:

Scott Morrison: *"It may not be technical retrospectivity but it certainly feels that way. It is effective retrospectivity, the tax technicians and superannuation tax technicians may say differently."*

Bill Shorten: "... when you make a new announcement in the future, it shouldn't change the circumstances of the people who are already invested under the old law."

I guess that's politics. It would be better if both parties admitted their policies were retrospective and convinced the electorate they are necessary for revenue and equity reasons.

Please have your say

Our survey asks whether you believe the $1.6 million transfer cap or $500,000 NCC lifetime limit are retrospective. Plus, we have identified 12 superannuation changes in Budget 2016 on which we would appreciate your views on whether you support or disagree with the change.

The survey is linked here.

The vital role of insurance in super for disability care

Alex Denham

This is a sad and true story of a young man – let's call him Mikey – who in July 2015 at the age of 31 suffered devastating injuries whilst participating in the sport he loves, mountain biking. Mikey is now a tetraplegic, meaning his injury affects all four limbs, and with limited neurological recovery expected, he will always have a high dependency for care.

He has been in hospital in the spinal unit for many, many months and soon it will be time to go home. He is lucky to have a loving, caring family and his parents have decided to provide his long-term care in their home. Even his sister has moved back home to help.

Importance of risk insurance

Before his accident, Mikey worked as a roofing contractor, and his Super Guarantee contributions were being made to a retail superannuation fund. Mikey had saved little in his super so far, and had no other savings or assets to speak of. As luck would have it, the fund came with death and Total and Permanent Disability (TPD) cover and Mikey is now entitled to a payment of around $493,000.

Mikey's father came in to seek financial advice on what to do with this sum. Of course, the family home needs alterations to accommodate Mikey's care including a new bathroom off his bedroom, but Mum and Dad are choosing to fund these alterations themselves rather than pay for them out of the insurance payment.

They wish to set aside the TPD payout as a long-term investment for Mikey's benefit in future years. They were in the process of understanding Mikey's entitlements under the National Disability Insurance Scheme (NDIS) which is rolling out in their area on 1 July 2016. They were keen for Mikey to qualify for the Disability Support Pension (DSP) so that they did not have to draw on the TPD payment for his living expenses.

A financial plan for a person with a disability

What should they do with the $493,000 so that it can be invested for the long term, but accessible if needed without affecting the DSP which of course is means tested? Investing the money in Mikey's own name means it will be subject to the Income and Assets test and cut into his Government benefits.

A Special Disability Trust (SDT) is a trust established to pay for any care, accommodation, medical costs and other needs of the qualifying beneficiary during their lifetime. It comes with social security benefits in that the balance up to $636,750 is exempt from the Assets Test, so it would meet the requirement to maximise Mikey's DSP.

However, there is one major hurdle. SDTs are specifically intended for succession planning by parents and immediate family members for the current and future care and accommodation needs of a person with a severe disability or medical condition. As such, only immediate family members can contribute to it and Mikey is not able to contribute himself as the beneficiary.

No SDT for Mikey. If in future Mum and Dad wanted to set one up for him and gift their own assets to it, it can be considered down the track.

The solution is actually remarkably simple: keep it in super in the accumulation phase, but roll it to a new fund. The payment from the new fund will be classified as a 'disability superannuation benefit'. A formula is applied to the payment to calculate a tax-free component, and in this case it will be a significant amount, around $479,000.

The remaining $14,000 is a 'taxable' component, taxed at 21.5% if and when he withdraws it from the superannuation system as a lump sum.

For more information on how disability superannuation benefits are taxed refer to the ATO site here.

As Mikey has met the 'total and permanent incapacity' condition of release, he can access the money at any time. Lump sums will be withdrawn in proportion to the tax-free and taxable components, and taxed accordingly.

Best of all, as he has left it in accumulation phase (as opposed to starting an income stream), and he is under his age pension age of 70, it is exempt from the Income and Assets test and he qualifies for the full rate Disability Support Pension which is tax-free.

Super is, in fact, a very tax-effective and flexible vehicle to hold money for those who are young and suffer permanent incapacity. There's no need to go fiddling around with complex trusts. Although it is worth noting that the recent super announcements in the Federal Budget – namely the $500,000 lifetime limit on non-concessional contributions – puts the brakes on being able to contribute large compensation payouts to super.

In Mikey's case, once he moves home to his parent's house, they will meet the interdependent relationship definition. This means that they are treated as each other's dependants for both tax and superannuation purposes. Mikey will do a non-lapsing binding nomination to his parents, and if he predeceases them, the money passes to them tax-free. As he has no other assets, this negates the need for him to do a will.

The ripple effect of this terrible accident runs wide, and has changed the lives in this entire family. Mikey's Dad needs to cut down his working hours from full time to part time to care for Mikey. He is in a defined benefit super fund, with the end benefit paid being based on a formula relying on a multiple (including part-time adjustments) and Final Average Salary. Cutting down his hours is going to cost him in terms of his own retirement benefit.

But imagine the position Mikey would be in if a) he didn't have such a loving, supportive family and b) he didn't have the insurance cover in his super fund. It's a strong argument for compulsory insurance cover in super for the young.

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Do investment principles stand the test of time?

Robin Bowerman

Time travel is a skill that would dramatically transform the world of the investor. Sadly, despite all the technological advances of the past two decades, the ability to go back or forward in time remains the realm of science fiction novels, not a killer app on an investor's smartphone. While time travel may still be the domain of TV and film producers, the passage of time is a real-world test for investment ideas even if - as we are constantly reminded - history is not a great predictor of future returns.

What has changed over 20 years?

Twenty years ago, Australia was a country of 18 million people with a median age of 37 and the median weekly household income was $637 while the cash rate was set at 7.5%. The fledgling superannuation system had accumulated assets of $262 billion some four years after the super guarantee contribution had been introduced.

In 1996 a new, more modest undertaking was getting started - it was the year Vanguard established its Australian business which was its first outside the US. It seems an appropriate time to look back and see how the underlying investment principles that Vanguard has used in guidance to clients has stood up to the test of two decades.

The market has changed markedly. Of the top 10 companies by market capitalisation on the Australian share market in 1996, half have either dropped out of the top 10 or are no longer on the ASX.

With help from actuarial firm Rice Warner, we decided to look at the past 20 years through the time capsule of three different investors in 1996 – a 40-year-old, a 20-year-old and a newborn baby – and test how our investment principles have stood up to 20 years of significant geo-political shocks, stunning market rises and dramatic declines that included a global financial crisis.

All our investment strategies are underpinned by four core principles:

1. Goals: Create clear and appropriate investment goals
2. Balance: Develop a suitable asset allocation using broadly diversified funds
3. Cost: Use low-cost, transparent investment options
4. Discipline: Keep perspective and long-term discipline

Outcomes for our three investors over two decades

One of the first lessons is that investors have been rewarded for taking extra risk.

An investor who invested $10,000 at the start of 1996 in cash would have seen the nominal value grow to $26,800. Someone who had invested in the Australian sharemarket index would have seen the portfolio value grow to $51,400. The US sharemarket index was just slightly behind at $48,100 while Australian bonds grew to $37,600.

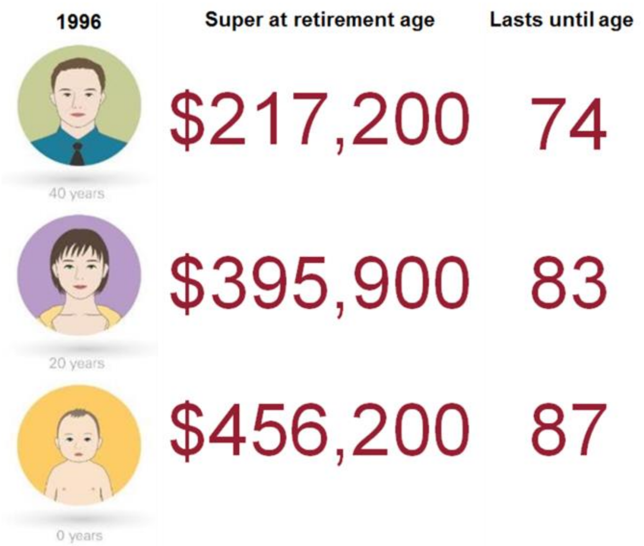
For our three investors, Rice Warner was asked to model the superannuation outcomes. Remember back in 1996, super was really just getting started, so our 40-year-old did not get the benefit of a full career under the super guarantee nor the higher rate we have today.

The growth in the super system has clearly been one of the major developments in the Australian financial landscape in the past 20 years with it now being the second largest financial asset in average Australian households and the system growing into a savings pool of more than $2 trillion.

Our 40-year-old in 1996 is now turning 60 in 2016 and with retirement firmly in sight, Rice Warner project their super balance at retirement (assuming compulsory Superannuation Guarantee only contributions, average wages and a 7.5% gross return on investments) to be $217,000 in today's dollars. That is projected to last until they are 74-years-old.

For the person turning 20 in 1996, and effectively just starting out in their working life, who is now 40 in 2016, the projected retirement balance is $395,000 when they reach retirement age. This money is expected to last until they are 83-years-old.

For the baby in our investor trio who is now 20, the projected super account balance accumulated during their working life is $456,000 – more than double what the 40-year-old is likely to get. It should last until they are 87.



Source: Rice Warner. Assumes default super with no additional concessional contributions.

Based on the ASFA comfortable retirement standard, the baby of 1996 could reasonably expect her super to last 13 years longer than their older baby boomer counterpart.

Higher contribution rates and a long-time period to allow compounding to work is driving these outcomes but it is interesting to reflect that even after more than 20 years, our super system is not yet at maturity. The challenge remains for those in the older age bracket to be able to contribute enough to fund their retirement lifestyle.

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A world-class retirement income policy?

Ron Bird, Joe Hu and Hardy Hulley

Retirement usually means the loss of a regular income from working. As the need to spend does not stop with retirement, survival depends on either accumulating sufficient savings prior to retirement or relying on the social welfare system. Enter superannuation as one avenue for accumulating the required savings. The Australian government evidently did not believe that citizens were saving sufficiently for their retirement when it introduced compulsory superannuation in 1992. The government chose to provide tax subsidies which have become more generous through time. The rate of compulsory contributions has grown to 9.5% and the assets of funds now exceed $2 trillion.

Transfer of consumption from working life to retirement

Compulsory and voluntary superannuation contributions along with the age pension form the three pillars of the much-lauded Australian retirement income system. Indeed, the wisdom of our system is hardly ever questioned with any attempt to do so regarded as akin to questioning the virtues of motherhood. The view foisted on the community is that more is always better when it comes to retirement savings and that it is essential that balances be left untouched until retirement. What is missing in this discussion is a realisation that people have to survive up to retirement as well as during retirement. Many argue superannuation is a magic pudding whereas all it is doing is substituting consumption during a household's working life to consumption in retirement.

Is our compulsory superannuation system as good as we are led to believe? The approach we take is to simulate the impact of the existing system for households with three disparate levels of income: Low income (20th percentile of earnings), medium income (50th percentile) and high income (80th percentile). The income is assumed to fund three different activities: consumption, taxation payments and superannuation contributions with any positive residual going into savings and any negative residual being funded by a loan. The detailed information on the consumption of each of our three households comes from the HILDA Survey. The actual tax rates are applied to calculate the tax obligations and each group is assumed to have to allocate 10% of their earnings to superannuation. We further assume that the households begin earning income at 25, work for 40 years (until the age of 65) and live for 20 years beyond retirement.

We run simulations to track each household's consumption, savings and investments (including superannuation) over this 60-year period allowing for some volatility in household earnings and in investment returns. The two outcomes that we track are:

- the present value of each household's lifetime consumption (which we assume they would want to maximise) and
- the probability of them running out of resources while they are still alive (which we assume they would want to avoid).

The findings show the merits of subsidised superannuation vary according to household income:

A. For low income households, compulsory super does nothing

We first run the model ignoring the age pension and also assuming that everyone rents. We find that compulsory superannuation does absolutely nothing for low income households – about 90% of them run out of funds with the average low income household being totally dependent on the social welfare system over their last 16 years.

Further, the tax subsidies are net negative for these households who would be better off investing any savings outside of superannuation. Compulsory superannuation is completely ineffectual for low income households (about a third of all households) being akin to moving deck chairs around on the Titanic making their life a bit more miserable in their early years and not even going close to funding their retirement. The age pension will always be the salvation for low income households irrespective of what is done with retirement income policy. Indeed, the age pension funds about 93% of their post-retirement consumption.

B. For high income households, tax subsidies are a gift

The findings for the high income household are the obverse. Members of this group have more than they require to meet their consumption needs during their working life and with or without compulsory contributions have a minimal probability of running out of funds. Less than 0.5% of these people will ever draw an age pension which makes minimal contribution to their post-retirement income. Compulsory contributions are again ineffectual for this group (about one-third of the population) with the exception that the tax subsidies provided represent a gift in excess of $1 million for most members of this group. Typically, this gift from the government just increases the size of their bequest and perpetuates the wide spread in the income distribution which is the source of all problems in the first instance.

C. For medium income households, subsidised super makes sense

This leaves the remaining one-third of households (medium income group) whose consumption needs to leave some room for savings but not of the magnitude of high income households. Only 4% of these households totally run out of funds but 40% draw on at least a partial pension which funds approximately 20% of their post-retirement consumption. Further, the tax subsidies provided to medium income households are upwards of $200,000 which may be justified because the retirement balances of this group results in a reduced demand for the age pension. We now have a group for which subsidised compulsory superannuation may make some sense but it is questionable whether it justifies a retirement income strategy which is ineffectual for the majority of households and results in a sizable waste of taxpayers' money.

Surviving and the impact on home ownership

There is a fourth pillar of retirement income that we have not considered – home ownership. A household that retires not owning a house cannot survive on the age pension. They will have insufficient funds to meet their consumption needs (defined as 75% of their pre-retirement consumption). Low- and medium-income households without a sizable inheritance have almost no chance of affording the deposit on a house in a major capital city. This is consistent with the rapidly falling levels of home ownership. One form of help that is spasmodically raised is to allow households to use their superannuation balances as a contribution towards the deposit required to acquire a first home. Such a proposition always results in an outcry from the industry typically based on the negative impact that this will have on their retirement savings. It is as though acquiring a house is like taking the money to the casino and gambling it away.

We find that allowing superannuation balances to be used in this way would be of little benefit to low-income households who in most cases still could not afford to enter the housing market. However, for medium-income households, it would increase the proportion who can afford to buy a house from almost zero to almost two-thirds. Further, having access to their superannuation balances is the difference in getting many high-income householders into the housing market. Assuming historical increases in housing prices persist, those who are able to acquire a house are able to increase their post-retirement consumption by a factor of two. The growth in housing prices would have to fall to 2.5% per annum before the advantages of owning a house are eroded. Other than self-interest, it is difficult to understand the industry's resistance to allowing balances to be applied towards the deposit on a first home.

What are the policy implications of our findings?

The retirement income policy in Australia is nowhere near as good as the government and the industry would have us believe. This is largely a consequence of looking at retirement in isolation and paying no regard to the need for people to survive through their working life. Compulsory contributions are only of consequence for about one-third of households.

Low-income households should be given exemption at least during the period when they are establishing themselves and raising a family. With respect to the tax subsidies, they are pretty well a waste of taxpayers' money. One option would be to reduce its magnitude and only make it available to those earning less than medium income on the proviso that at worse it is tax-neutral for low-income households.

Home ownership, along with the age pension, is probably the most important pillar of retirement income policy. The government should divert a significant proportion of the savings due to diminishing the existing tax subsidies to assisting low-income households to enter the housing market. Such a policy has the potential to increase the welfare of these households by around 30%.

Of course, no government would be willing to introduce such policy changes as they would be subjected to the wrath of the finance industry that would turn fund members against the government through a misinformation campaign. In the May 2016 Budget, the current government has shown its temerity to tackle such issues by only being willing to make changes to a flawed system which by their own admission will only affect the top few percent of income earners. As a consequence, the inequities remain in the system along with the huge wastage of taxpayers' money.

Ron Bird is Emeritus Professor at the University of Technology Sydney and Director of the Paul Woolley Centre for Capital Market Dysfunctionality. His long career in the private sector included head of global research for Towers Perrin and establishing the Sydney-based quantitative funds management business of GMO. The research is done with Joe Hu and Hardy Hulley of the UTS Business School.

Anti-detriment abolition: death duty on the sly?

Ramani Venkatramani

Among the budget measures aimed at making super more sustainable, the abolition of anti-detriment benefits was little noticed, and even less remarked.

On their own, super and tax both disengage most people, given their complexities and the need to forgo current cash-flow, temporarily or forever. Combined, they are positively off-putting.

Anti-detriment benefits combine the demerits of both, go back decades, involve convoluted calculations that would do an actuary proud and are complicated. No wonder many trustees, not to mention members, have not been up to speed in the arcane formulae.

What is anti-detriment?

In July 1988, Paul Keating as Treasurer had to fill a revenue hole with super (sound familiar?) and decided to bring forward half the 30% tax that was payable on accumulated super. The 15% tax on super contributions was born.

In introducing the contributions tax, he had to tackle the fact that tax was not payable on death benefits. By bringing it forward, he had created a detriment for those savers who might die and hence take a death benefit.

Solution: he enacted the anti-detriment benefit whereby funds would top up any death benefits payable by the amount forgone as a result of paying contribution taxes from 1 July 1988 until death. After so topping up, the fund in its tax return would claim a deduction by grossing up the payment for the fund tax rate of 15%. This would fully recompense the fund for the top-up. The top-up allowed for the refund of not only the contribution taxes, but also earnings thereon.

Over time, many funds started providing the top-up. This is perhaps because the trustees realised that they owed a fiduciary duty to act in the best interests of the members by clawing it back from the ATO. APRA had routinely pointed this out (see pages 8 to 10 of this APRA document).

For a full explanation, see Monica Rule's Cuffelinks article '*Tax paid by your SMSF can be returned to your dependants*' (February 5, 2015).

Myths abound, now it's to be abolished

Given the large and increasing burden on the budget, the authorities have not been enthusiastic about funds claiming the benefit. A number of requirements (hurdles) have been imposed, some reasonable and others not.

To claim, the funds must first pay the top-up. The sourcing of such payments (from reserves?) has been questioned, especially in SMSFs and two member funds in getting the tax refund. Once funds realised the competitive advantage of paying it and claiming it from ATO, the claims have become routine.

According to the budget papers, the integrity and fairness of the system will be improved by removing the 'outdated' anti-detriment provision from 1 July 2017. It is inconsistently applied by superannuation funds and removing it will better align the treatment of lump sum death benefits in super and the treatment of bequests outside super. Plus, it will generate revenues of $350 million over 2017/18 and 2018/19.

What does it all mean?

- A beneficial measure aligned with Australia's aversion to death duties has been removed without mentioning its re-introduction.
- For most members the benefit would be large and with further contributions, mounting. Those subject to the higher 30% contribution tax rate would be eligible for a higher top-up.
- Non SMSFs would have no problem paying it and claiming off the fund's liability.
- Many SMSFs would also be able to pay and claim.
- If current taxable income cannot absorb the grossed-up deduction, a tax loss can be carried forward to cushion future fund taxable income including contribution taxes.
- The removal is not just for accruals after July 2017, but a total abolition. Translation: full-blown retrospectivity.
- The budget impact of $350 million is only over two years. Being an ongoing benefit (before its abolition), the real impact will run to billions of dollars.
- Like a life insurer repudiating future death claims after having received premiums, the Government having collected the contribution taxes ('the detriment') from members since entitled to a death benefit, is now declining to payback. If the Treasury was regulated by APRA, the prudential concerns would be loud and ear-filling.
- Whether this involves acquisition of the contingent right to future top-ups without compensation, and hence might fall foul of the constitutional requirement under section 51(xxxi) of 'just terms', is a matter for constitutional experts. Where is the fictional QC Lawrence Hammill (of 'the Castle') when we most need him *pro bono*?
- More plausible is the case for the estates of deceased members who were not paid the top-ups since 1988 suing the trustees for breach of fiduciary duties and compensation, resulting in cascading claims on the ATO. In the age of champerty, class action lawyers and litigation funders, this prospect is real.

Will the change be waved past due to lack of understanding?

Has the Government perhaps triggered more trouble than it is worth, by this move? Should the anti-detriment dog have been left alone in its slumber? Or do so few people understand it that it will be swept under the carpet?

Of greater concern, the measure imposes a burden on deceased estates. Nothing wrong with that, as I have argued in the past for an ***open*** inheritance tax regime in previous articles, such as 'Death duties, where angels fear to tread' and here.

What is unseemly is the back-door approach in the hope this will pass unnoticed, relying on the widespread disengagement. Its sibling, disenchantment, may not be far behind. Does the move presage a political courage to introduce inheritance taxes down the road? Only a cash-strapped future treasurer can know.

The silence from the industry and the professions is deafening.

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What credit spreads reveal about share markets

Ashley Owen

In this story we look at credit spreads, how they relate to share prices and what they can reveal about where we are in the stock market cycle.

What is a credit spread?

The 'credit spread' on a company bond is the extra yield demanded by investors over and above the yield on a government bond for the same term, to compensate the investor for the higher risk of loss if the borrower were to default on payment of interest or principal.

The 'riskier' the bond, the greater the extra yield (spread) demanded by investors. For example, a 5-year government treasury bond may trade on a yield of 2.0% per year (in early May 2016), but a 5 year 'investment grade' company bond might trade at 3.5%, a 1.5% credit spread above the yield on government treasuries. A sub-investment grade 'high-yield' ('junk') bond might trade at 7%, a 5% credit spread above treasury yields, because of its greater risk of default.

The extra yield return on a high-yielding bond might look attractive to investors at first sight, but if the company defaults during the term of the bond, the investor might only recover say 70% of their capital in a liquidation, creating a 30% capital loss, so the higher perceived return via higher yield may be illusory. Although bond markets are far from efficient and rationally priced, there is a good chance that the higher income yield on a risky bond will be offset by a capital loss on the principal and/or loss of interest, leaving the investor no better off than they would have been with a treasury bond.

How credit spreads change over time

Credit spreads do not remain static over time. They rise (widen) and fall (tighten) with the changing level of pessimism or optimism about the health of the corporate sector. This same pessimism or optimism is also a major driver of company share prices.

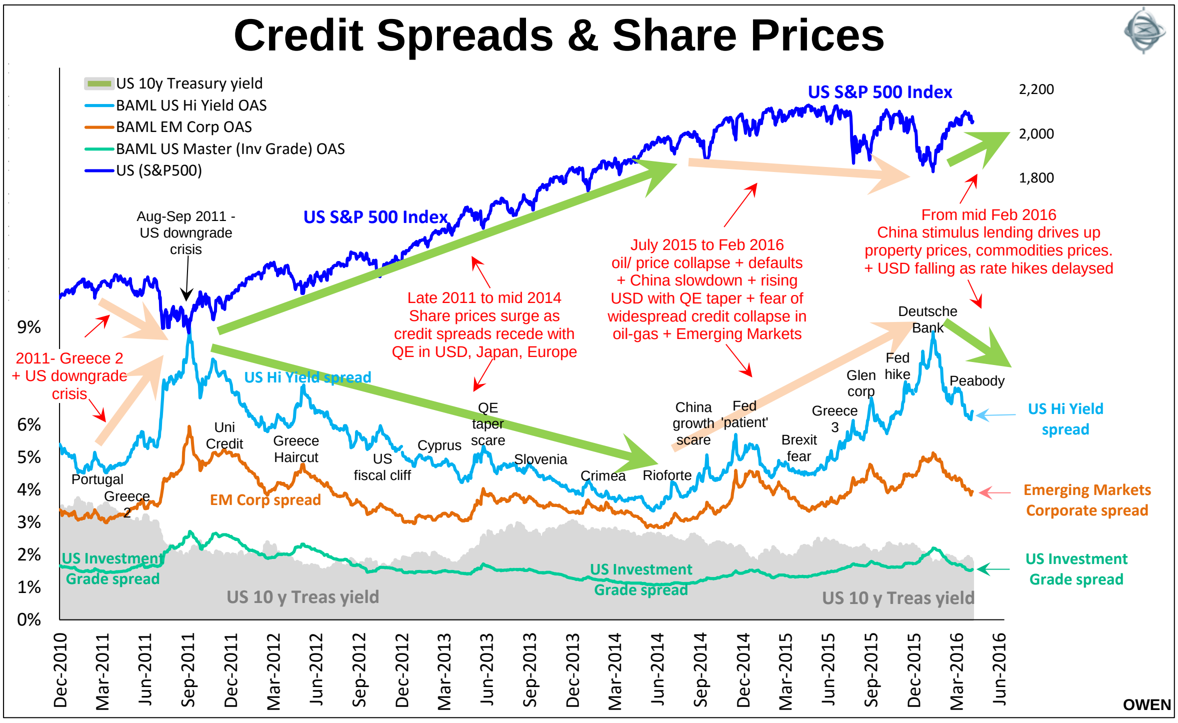
Shares tend to do well when spreads are declining (tightening), and shares tend to do poorly when spreads are increasing (widening). One does not cause the other – they are both measures of investor sentiment about the health of the corporate sector. This phenomenon has been evident over the past century of market data but here we focus on the past couple of credit cycles to highlight where we are at the moment.

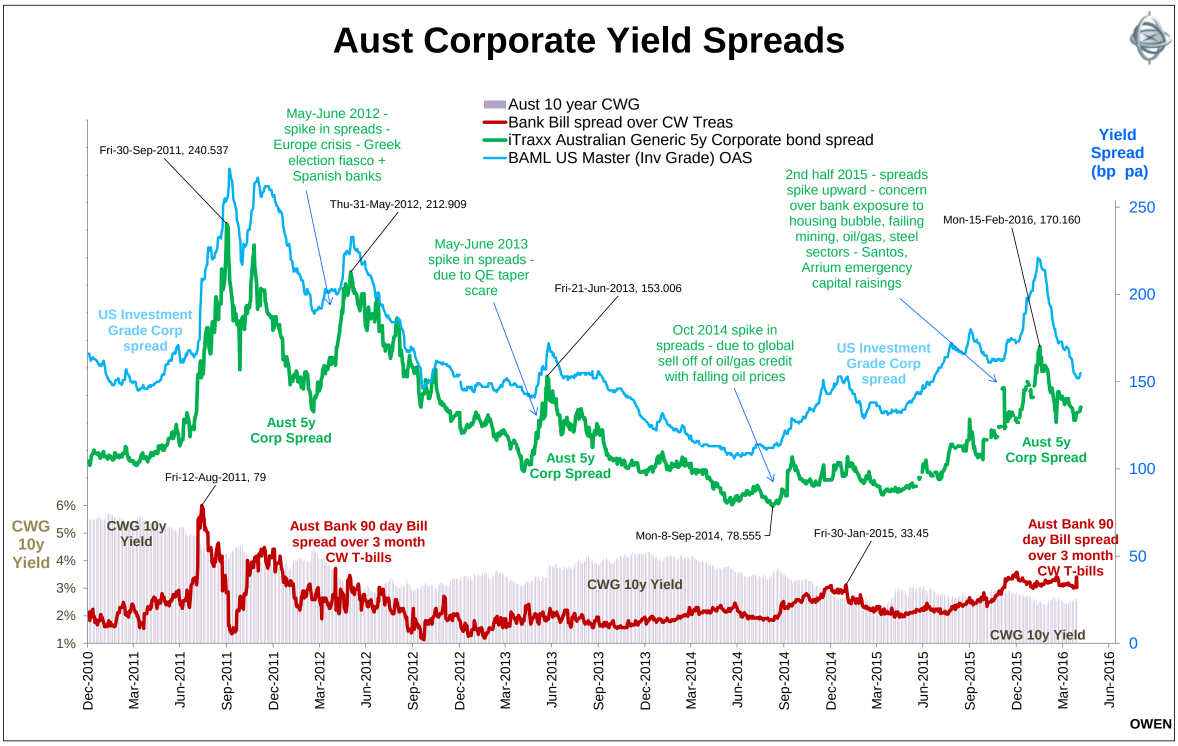
The first chart (next page) shows the US S&P500 share price index from 2011 (top of chart) and three different credit spread measures (bottom section).

Credit spreads tend to move in parallel paths, but credit spreads and share prices have tended to move in opposite directions, as illustrated by the pairs of green and orange arrows on the chart. The chart highlights the key events that have driven market sentiment, credit spreads and share prices through the past couple of credit spread cycles.

What about Australia?

Since the Australian bond and stock markets are mostly owned and driven by foreign money, our local markets tend to follow global trends. The next chart shows average 5-year Australian corporate bond spreads (green line) following the same ups and downs as US investment grade spreads (light blue) over the same period as the first chart.





The peaks and troughs in US credit spreads are echoed consistently in Australian spreads.

The second chart also shows Australian bank spreads (maroon line), which is the spread between the 90-day Australian bank bill yield and Commonwealth 13-week Treasury bill yields. This bank spread represents the perceived degree of short term credit risk of banks. Yes, Australian banks are risky! (This bank spread pattern is also useful in helping determine when securities priced off bank bill yields – e.g. floating rate securities like bank hybrids – are expensive or cheap).

What lessons can we learn?

Both the charts show that spreads widened rapidly in early-mid 2011 as the banking crisis escalated in the European PIIGS (Portugal, Ireland, Italy, Greece, Spain) and in particular during the

Portuguese bailout and as Greece headed toward its second bailout. Spreads widened further and peaked in August-September 2011 with the US credit downgrade crisis when rating agency Standard & Poor's took the radical step of stripping US government debt of its AAA rating. There was a fear the US government would default on its debts. The US government did indeed have to close down the government for a month in 2012 because it could not pay its bills. Credit spreads were at their highest since the 2008 sub-prime crisis.

The most recent peak in credit spreads and trough in share prices was in February 2016. Several factors were causing the general market pessimism, such as:

1. worries over the pace of US rate hikes and their possible impact on company profits and share prices
2. a possible hard landing in China, exacerbated by the crash in Chinese share prices
3. the escalation of oil/gas/steel bankruptcies
4. cracks in the European banking system led by fears of possible default by Deutsche Bank.

February 2016 compared to 2011

To me the level of fear and pessimism (measured by spreads) in 2016 was significantly over-done as conditions were not nearly as severe as they were in 2011. In mid-2011 we under-weighted shares in portfolios before they sold off heavily during the US downgrade crisis. This time, we did not take evasive action because it appeared that spreads (fear) had over-shot reality, and shares had been sold down too far.

Three key factors are likely to see spreads fall from their February 2016 levels and share prices stabilise and even recover:

1. the renewed resolve of the Chinese government to fund investment and credit to support growth (this was subsequently formalised at the National Congress in March)
2. the continued dominance of Fed Chair Janet Yellen over the 'inflation hawk' dissenters, and the resultant 'go-slow' on US interest rate hikes
3. the ECB's continued commitment to negative rates and broadening QE in Europe.

These factors led to a degree of confidence that the sell-off in stock markets would probably not continue much longer or further, unlike in 2011 and 2008. Since mid-February, share prices have recovered a little while credit spreads have eased (tightened).

Credit spreads represent only one factor, but they can be a barometer that helps determine where we are in the share market cycle.

Ashley Owen (CFA, BA, LLB, LLM, Grad. Dip. App. Fin) has been an active investor since the mid-1980s, a senior executive of major global banking and finance groups, and currently advises HNW investors and advisory groups in Australia and Asia. This article is general information only and does not consider the personal circumstances of any individual. Readers should obtain their own advice before taking action.