Cuffelinks
Connecting investors with ideas

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This Week's Top Articles

What should you do next?

Roger Montgomery

"It wouldn't surprise me to see a bubble develop in equities, perhaps over the next year or two, before a more serious correction." That was the assessment I gave, shooting straight from the hip, to an investor in rural New South Wales recently who asked me to abandon any 'fence sitting' and offer my unadulterated 'gut feel'.

In the absence of possessing a crystal ball, the equally useless gut feel was all I could offer.

Of course, such musings cannot be inputs into a serious, repeatable investment strategy.

But the subject of the tension between gut feel, even if born of experience, and the execution of a highly repeatable and replicable investment strategy, driven by evidenced fundamental drivers, is the subject of today's article.

Picking market direction consistently accurately is almost impossible. Witness, for example, the stock market's falls whenever Trump pulled ahead of Clinton during the US Presidential campaign. Of course, fears of a *potential* Trump victory gave way to euphoria after its *confirmation*.

Market rally sustained by 'animal spirits'

The US stock market is at the late stages of a rally whose length has few precedents. Indeed, according to one definition of a bull market - a period in which the market rises 20% or more after a decline of at least 20% - the S&P500 is enjoying its second-longest bull run ever. But equally, until recently there has been few indications of euphoria, an ingredient that tends to precede any serious correction.

Since Trump's election the market has extended an eight-year bull run that's seen it achieve its ninth-consecutive all-time high last week, at 20,775.6 and its longest run of record closes since 1987.

Such observations are interesting but meaningless from an investment perspective except that, given historically high price multiples, *if you are a buyer of the broad index today you are expecting immediate returns that history has not delivered.*

The stock market might be rising because investors are paying more attention to the pro-business individuals surrounding Trump than to the President himself. Along with promised tax cuts and deregulation of the financial and energy industries, including rolling back Dodd-Frank, many suggest the market is being driven now by 'animal spirits'.

Curiously the accelerated rally in stock markets is coinciding with a clear end to lower interest rates. Stock market rallies continue during the early phase of interest rate rises amid expectations that the economy is strengthening and earnings growth is due to emerge. But as rate rises continue, and expectations of inflation emerge, the combined effect on present values overwhelms the positive effect from earnings growth, and the market begins a correction.

It certainly appears the combination of excitement over deregulation and tax reform with its delayed delivery provides fuel for an extended period of euphoria. And if euphoria generally precedes a correction, the stage may be prepared for a script-following bubble prior to a bust.

How should an investor respond?

Should we as professional investors join others, back the truck up and fully invest, in anticipation of the expected rally, and then expect to be equally adroit at exiting at precisely the right time? That sounds like ego-fuelled speculation to me.

Instead, should we follow our process, holding almost maximum cash weightings amid a general absence of bargains, knowing that it is better to be six months early than six minutes late. We have to accept being chastised for missing any ensuing rally, because we have written about it presciently here in Cuffelinks.

It is likely that some, if not many, investors will exit our funds if we miss a continuing rally. After merely treading water for the last 12 months, while the market rallied 17%, it's hard to imagine many investors would persist with a fund manager taking fees for two years and delivering naught.

The major driver of the market's recent returns however has been the materials sector. A booming iron ore price has rendered even the highest-cost producers profitable. Understandably, the prices of Rio, BHP and Fortescue have rallied significantly with the latter two up over 70% and 240% respectively in the last 12 months. Expectations of rising steel demand in China has lit a fire under the share prices of our domestic iron ore miners. Strangely, the price of coking coal has collapsed since hitting $308 in November last year.

Putting aside predictions of iron ore prices amid record inventory on major Chinese ports, a simple examination of the economics of the iron ore businesses, and comparing them to the economics of our preferred entities, suggests we would merely be 'lucky idiots' if we bought in and made money from any ongoing rise in share prices of materials stocks.

The rally is about resources, so let's look at BHP

Imagine kicking the BHP business off in 2007 – a decade ago – with $36.7 billion of your own money (equity) and borrowings of $14.6 billion. Now suppose a net profit after tax is realised of $15.9 billion in the first year of business. It's fair to say you would be delighted with the 43% return on your initial equity in just one year.

Following one of the biggest resource booms in history, it would be reasonable to expect that borrowing more money, reinvesting profits and injecting additional equity, to expand the business, would also expand the profits of BHP.

So, let's suppose between 2007 and 2017, you do exactly that, investing an additional $1.4 billion of equity directly, reinvesting $34.4 billion of profits rather than paying out dividends and borrowing an additional $34.3 billion on top of the $14.6 billion already held.

Clearly it would be reasonable to hope that three times as much debt and twice as much equity would yield an increase in profits over 10 years. Unfortunately, BHP's 2017 profit is forecast to be 42% less than it was in 2007. And in 2016, it was 87% less than in 2007! Sadly, if you were the single owner of BHP, every dollar of equity invested and reinvested by you over the last decade, has yielded a return of minus 18%.

To our way of thinking, BHP's longer-run economics are not attractive. And the economics of the underlying business are, unsurprisingly, reflected in BHP's share price being lower today than it was 10 years ago.

Contrast BHP with REA Group for the same period

Now assume you kick REA Group off in 2007 with $67 million of your own money (equity) and borrowings of $8 million. In the first year of business a net profit after tax is realised of $15 million. It's fair to say you would also be delighted with this 22% return. Over the subsequent decade, you inject an additional $41 million, reinvest $573m of profits and pay off the debt.

With almost 10 times as much equity, profits in 2017 are forecast to be almost 17 times higher than in 2007. Every dollar of equity invested and reinvested by you, as the owner of REA, over the last decade, has yielded a return of 38.8%.

Warren Buffett, quoting Ben Graham, once said, "In the short run the market is a voting machine, but in the long run it is a weighing machine." In other words, in the short run the market price might disengage from the fundamentals of the business thanks to popularity and fads. But in the long run the market price cannot escape the performance of the underlying business.

Buffet added, "If you aren't prepared to hold the whole business for 10 years, don't own a little piece of it for 10 minutes."

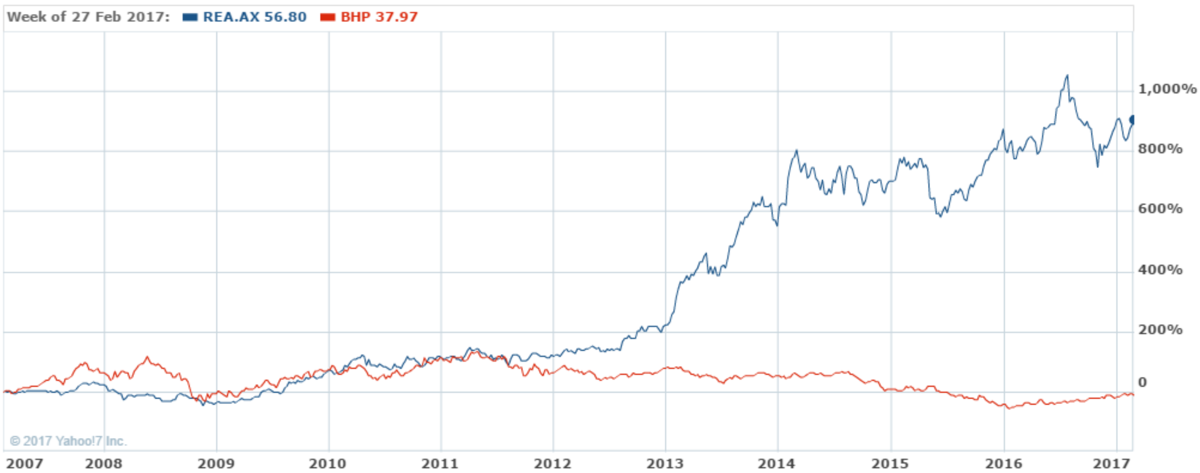
BHP's share price is lower than it was 10 years ago, while REA Group's share price is more than 10 times higher than its $5.00 price of early 2007.

Sadly however, many investors miss wonderful opportunities such as REA because the share price doesn't always reflect its superiority. In the short run, share prices can rise and fall on fads, fashions and factors that have no relevance to the underlying business.

Last year was a case in point. While BHP's share price rose over 75% in 12 months, REA's share price slipped 30% from its high in July 2016 to its low in November 2016. And while REA's share price has recovered since November it remains below its July highs. Contrast this 12-month picture with the far more meaningful last decade.

BHP v REA Group, 12 months to February 2016

BHP v REA Group, 10 years to February 2016



Source: Yahoo!7 Finance

For many 'investors' it matters not whether the economics of the business are attractive. For those people, all that matters is that the share prices are rising, and a rising share price is a sign of a good business and a falling share price is a sign of a poor one.

Never take a cue from share prices. We might be a smaller fund manager because we don't pick the next sector 'rotation' but we'll do just fine in the long run.

Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](). *This article is for general information only and does not consider the circumstances of any individual.*

Post-Trump, has the world really changed much?

Anton Tagliaferro and Hugh Giddy

Following the election of Donald Trump, instead of the large correction that many experts predicted, developed equity markets and commodities have staged a strong rally. The market hopes the new President's economic policies will be the panacea to the low-growth world we have been muddling through in the wake of the GFC. Most economists and forecasters are now confidently lifting their economic growth expectations.

Investors Mutual (IML) will readily admit that we cannot with any great accuracy forecast the performance of the economy over the next year or two. While many economists like to make confident predictions about the future, we would rather stick to our own investment philosophy of identifying undervalued quality companies that can grow their earnings and dividends in the years ahead.

'Trumpflation'

Trump's pro-growth rhetoric and proposed stimulatory policies have led to predictions of higher inflation in the US, with the implication of further US interest rate increases through 2017. Federal Reserve officials have already readied the markets to expect three interest rate increases throughout 2017.

The truth is that Trump's reflation rally could run out of steam before it begins, with the impact that higher borrowing costs courtesy of higher bond yields could weigh on the US economic recovery. The US 10-year bond yield has already moved from its all-time low of 1.4% in July 2016 to around 2.5% as of December 2016, with significant impacts on the affordability of new houses for borrowers in the US.

The rise in US interest rates has also sent the US dollar to its strongest level in over 13 years against its major trading partners. The strength in the US dollar is another obstacle that Trump must overcome as he looks to rebalance the economy in favour of US manufacturing and US exports. The strong rhetoric from the White House towards supposed 'currency manipulators', namely China and Germany, is an attempt to talk down the US dollar.

Trump's much anticipated growth policies

Now in its eighth year of expansion since the GFC, the US economic recovery is mature and is already running at close to full capacity in certain areas. Removing regulatory burdens, as proposed by the new President, will be favourable for businesses, but extra spending on areas such as infrastructure could put further pressure on labour markets and the supply of materials.

Trump's team has not placed much emphasis on infrastructure spending since the election and little in substance has been provided to date. The new President must also get his policies through Congress. Although dominated by Republicans, many of these are unwilling to watch the US deficit balloon any further and they may well demand spending cuts to match any such spending initiatives. Trump's answer to this is that stronger levels of economic growth will provide the plank to pay for the additional stimulus. This is political rhetoric at its best in our view.

Trump's proposed tax cuts for corporate America, while encouraging on the surface, also need to translate into higher investment spending by companies to boost economic growth. In the last few years, rather than build new plants, many US companies have used the low interest rate environment to focus on capital management via share buybacks, which have soared to record levels. Share buybacks may be good for companies' earnings per share (EPS) and help increase the value of CEOs' stock options, but they do not create many new jobs except possibly at investment banks and legal firms!

The low interest rate environment has not meaningfully boosted US investment. Instead, it has boosted leverage as companies have opted for financial engineering. Trump's mooted corporate tax cuts have the potential to increase company earnings by up to 10-15%, but unless corporate behaviour changes, real economic growth will not jump as high as many are predicting.

Trump's intention of raising taxes on foreign-sourced production and effectively favouring domestic US production may lift US output, but it will do so via the substitution of overseas manufacturing. Consequently, global growth might be little changed as companies shift production in response to changing tax regimes rather than produce more overall.

Australia and China

The health of the Chinese economy remains crucial to the Australian economy. As witnessed at the beginning of 2016, commodity prices, including our most significant exports, coal and iron ore, sold off heavily on concerns of a hard landing in China. Chinese policy makers responded by loosening bank lending requirements and increasing infrastructure spending that helped double the price of iron ore and coal through the remainder of 2016.

The performance of Australia's resource sector remains heavily dependent on the strength in demand from China. The price rally of 2016 helped propel Australia's income and will provide some respite to the Federal Government's growing Budget Deficit, which is coming under closer scrutiny by the ratings agencies.

Positioning in a low growth environment

At IML, we are conditioned to the mindset of investing without overreliance on strong world growth. Our style has always focussed on the quality and value of the underlying companies we own. With so many potential uncertainties still facing the global economy, we favour companies that can grow from their own initiatives rather than relying on higher GDP growth. These initiatives include **market share gains**, **cost outs**, **restructuring**, **contracted growth** and **accretive bolt on acquisitions**, where management has the capability to execute on their strategies effectively and where we are confident earnings can grow without relying on much help from the economy.

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Harvard shows pitfalls of internal funds management

Jonathan Rochford

The decision by Harvard to terminate half of its investment staff and outsource funds management bucks the global trend to internalise funds management. The underperformance achieved in the past decade came despite Harvard having all the factors necessary to recruit and retain excellent fund managers. Harvard has a great brand name, patient and substantial capital to invest, and a willingness to recruit and pay for the best talent yet internalisation failed. Given this, is internal management the sure thing many claim?

Why internal management is so popular

The primary reason internalisation has taken off is that many fund managers are awful. They fail to outperform after fees, they communicate poorly and their products do not suit their clients' needs. Given how poorly institutional investors have been treated, it is no surprise that internalisation, index funds, and ETFs have all grown substantially. These take market share and fees away from active managers.

Yet the blame for this cuts both ways. Many fund managers are poor because they have been allowed to get away with it. Many institutional investors and their asset consultants have opposed a more competitive industry and failed to redeploy capital to managers who would do a better job. By failing to advertise mandates and locking out emerging managers who would deliver better outcomes, capital allocators have unconsciously chosen to be treated badly.

In theory, internalisation holds out the promise of fixing these problems. By employing fund managers directly, fees can be lower and institutional investors can have more control and flexibility over their capital. If great fund managers are hired, alpha will be generated. Top-notch fund managers will be attracted to working for an internal team as they will no longer need to spend time on the laborious task of fundraising. The logic is so simple, yet Harvard has shown that it is far easier said than done.

Where Harvard went wrong

Harvard forgot several of the brutal realities the industry has proven over time.

In most asset classes, generating alpha after fees is difficult. A few exceptions in Australia are small capitalisation shares and credit, which both have substantial information gaps that hard-working fund managers use to create sustainable, long-term alpha. In highly competitive, information-rich sectors such as large capitalisation shares, private equity and hedge funds, managers as a group are taking most of the alpha generated.

There are a small number of truly great fund managers and these people generally often set the terms on which they work. They are generally closed to new capital and in some cases are returning capital.

Getting great talent to manage your money requires a similar set of skills to that of a great fund manager. You must work hard to find the best opportunities, monitor existing positions and free yourself from as many distractions as possible to remain successful.

Brutal realities ignored

There's often a naivety among capital allocators that these brutal realities won't apply if they internalise fund management. Capital allocators ignore the roadblocks that stop them building successful internal teams, such as:

- Setting up internal teams targeting areas that have little or no net alpha. Why go to the effort and expense of targeting large capitalisation shares, private equity and hedge funds which can easily and very cheaply be replaced by an index fund or ETF?
- Being unwilling to pay sufficient incentives to attract and retain the best talent. If an internal fund manager is substantially beating an index there is good reason to pay them 5-10% of the outperformance. If they are paid many times more than the CEO that reflects their greater contribution to the financial outcomes.
- Taking away discretion on investment decisions and loading up fund managers with administration and office politics. These will detract from their investment performance and job satisfaction, making an internal environment a less appealing place to work than a boutique fund manager.

Don't forget the cultural differences

Proponents of internalisation often forget that fund managers can have a different work culture. Fund managers that think and act the same as others are almost guaranteed to underperform. Some are eccentric or egotistical and likely to clash with a more bureaucratic culture. Requests for perfunctory reporting and attendance at general meetings may be ignored. Such actions can have a debilitating impact on staff morale. It's also forgotten that when things go badly wrong, it is easier to terminate a fund manager than an employee.

Internal and external aren't the only choices

It's tempting to see internal and external funds management as the only choices, but they are simply two ends of a spectrum. Between these positions is a range of options that can lead to better outcomes. Some capital allocators have set up external teams, which share compliance, legal and HR functions but have separate offices and a clear mandate. Others have seeded new managers, or bought part or full stakes in existing managers. Some capital allocators give their fund managers broad mandates, allowing them to be opportunistic in allocating capital within or across several asset classes.

Another strategy is to reduce the number of managers used, with low-alpha sectors indexed, leaving more time for deep relationships with managers that can generate meaningful alpha. These deeper relationships benefit both parties with capital allocators getting higher returns, lower fees and a rich source of insights that informs their investment decisions. Trust is built such that fund managers can make the call that there isn't value in one area and know that they will be given the opportunity to redeploy capital to another area with better value.

Sometimes you just have to ask to get what you want

For many capital allocators, the pathway to better outcomes isn't to internalise but to change the managers they have. It is common business practice to run a competitive tender for the provision of services, yet capital allocators rarely do this. They largely eliminate the competitive tension that a public tender would create. Even worse, many capital allocators and asset consultants refuse to take meetings with managers that have higher returns and lower fees than their current managers.

This raises the issue of whether the underperformance problem is mostly due to capital allocators rather than fund managers. Before investment committees sign-off on internalising funds management, they should ask whether existing staff are doing a good job at picking managers. If the existing staff don't know how to discover, select and negotiate with high-performing fund managers, what chance does a capital allocator have of finding and selecting these same people to work for them internally?

Conclusion

Internalising funds management is a growing trend, mostly in response to the poor performance of many fund managers. However, before signing off on internalising funds management, capital allocators should consider whether their existing staff are willing and able to select great fund managers.

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

Reduce drawdowns by using Allocation Switch

George Bijak

Investors have a problem. Strategic Asset Allocation (SAA) does not sufficiently protect capital on the downside during stock market crashes, when protection is most needed. Unfortunately, most stocks crash together, regardless of their quality, sector or region.

This analysis uses US market data but it applies to a significant extent to the Australian market, and the lessons are the same.

Investors tend to 'follow the market' with their equities asset allocation. They buy more shares at the top of the market just before it falls and sell at the bottom when the market is about to recover.

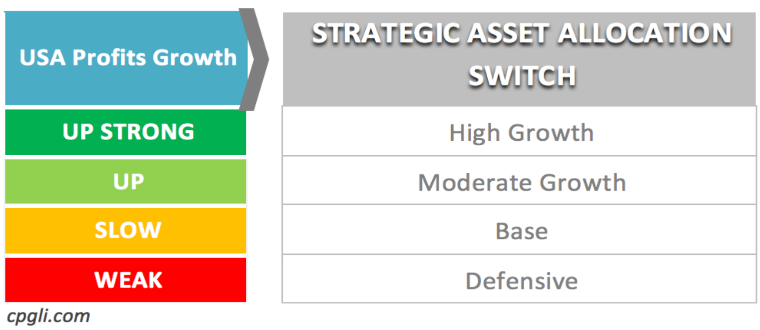
Allocation Switch is a powerful risk mitigation tool

Investors should switch SAA in line with corporate profits growth trends. The allocation should be more defensive when profit growth is weak and towards a growth option when profits are clearly rising.

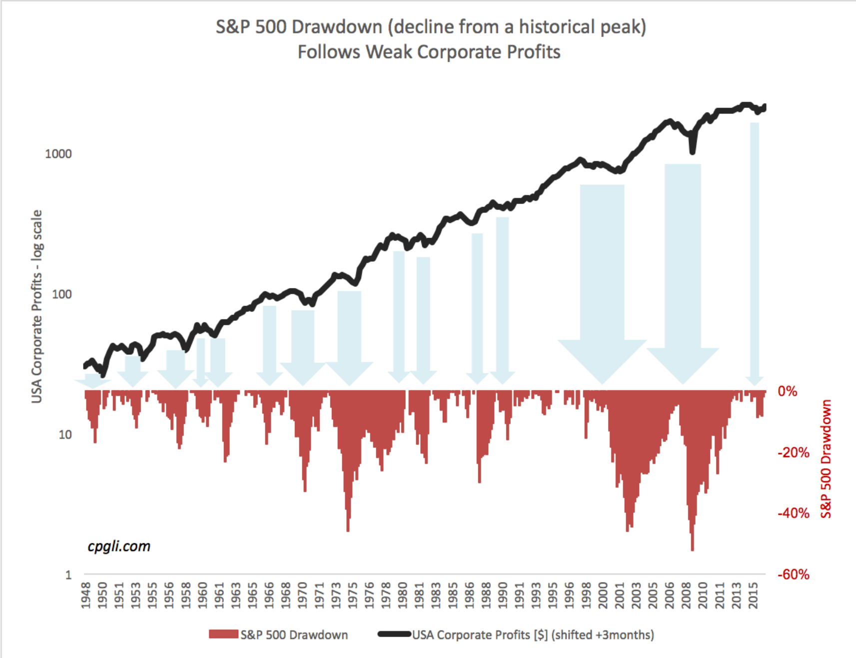
The Allocation Switch methodology requires switching the SAA every one to five years. The long periods between SAA switches make the strategy a powerful risk mitigation tool that financial advisers can use at their annual client reviews.

Allocation Switch follows the profits

Switching from 'follow the market' with asset allocations to 'follow the profits' is summarised in this graphic (right).



The Allocation Switch is particularly applicable to risk tolerant investors, who choose as default a High Growth SAA with maximum exposure to equities. Any switch by high



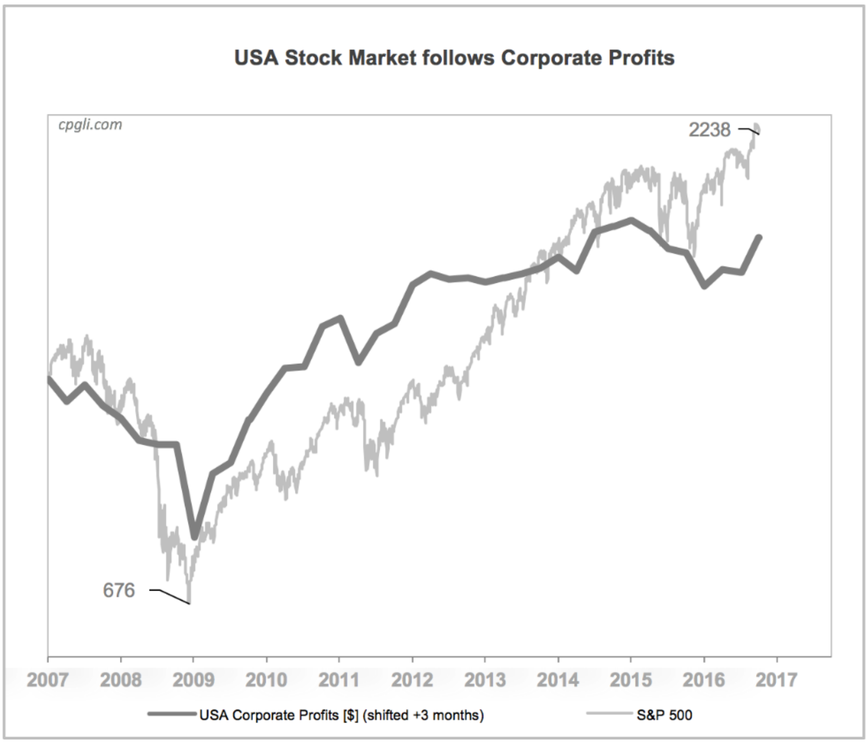
growth investors can only reduce allocation to risky equities and, hence, reduce portfolio drawdown. Reduction in shares allocation can also result in lower returns but investors value downside protection more.

Historically, almost half of the 'weak' profits growth periods experienced a stock market crash with falls exceeding 20%. Chasing the last profits in a cycle with exposure to large drawdown is not worth it. The drawdown (defined as a decline in the market from an historical peak) deepened when profits growth was weaker, as shown the chart (right).

No need to forecast

There are models that attempt to forecast profits growth. However, to implement the Allocation Switch in its basic form, investors can watch actual quarterly profits and switch the allocation in line with the main emerging profit trends.

Over the past 70 years, the corporate profits for the whole USA economy were over 90% correlated with the S&P500 index, a representative of the broad USA equities exposure. Two lines trending together on the chart below depict the fundamental relationship during and post GFC.



The profits indicated on the chart are the seasonally adjusted National Income and Product Accounts (NIPA) Corporate Profits. They are calculated quarterly by the USA Government Bureau of Economic Analysis (www.bea.gov).

An SAA that is matched initially to the client's risk profile (call it a 'Base' SAA) requires committing to the static asset allocation for the long term, typically 10 years. This commitment is in the hope that all asset classes should return their historical averages over time. In reality, the static SAA mantra of 'staying put' is not practiced by individual or professional investors, who quite often switch their asset allocation at a wrong time.

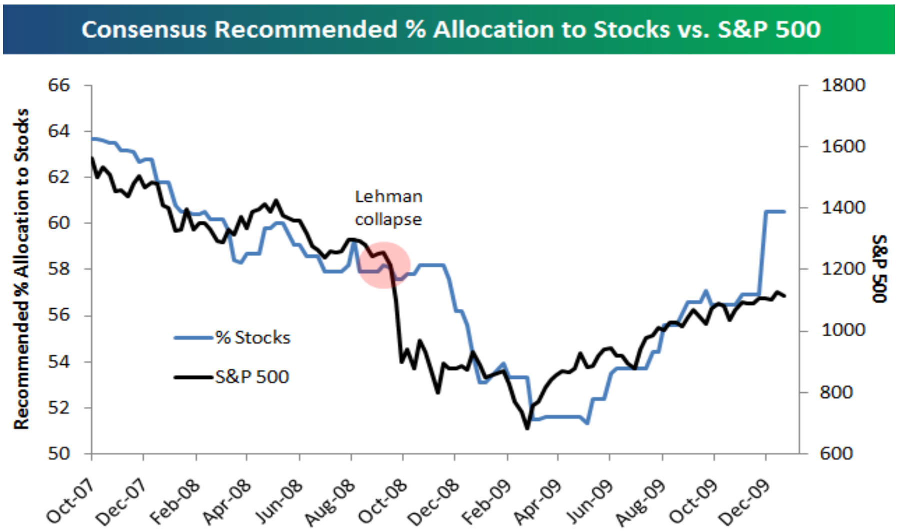
The Allocation Switch, based on corporate profits, calls for moving up or down (i.e. more or less exposure to equities) from the Base SAA option in response to changing market risk. It provides investors and their advisers with a rational tool to stop them making the wrong emotional re-allocation choices. In the process, application of the Allocation Switch to the initial Base SAA should reduce portfolio drawdown.

Investors sell at the worst time

Allocation adjustments are made irrationally at the wrong time by investors responding emotionally to extreme stock market swings, resulting in painful losses. Financial advisers are usually not involved in making re-allocation decisions but rather are blamed by investors for not trying earlier to protect them on the downside. Investors tend to panic when the stock market crashes 20% to 50% and many sell at the worst time.

Professional investment strategists who advise large fund managers are on average no different to individual investors in this regard. Perhaps they are also reluctant to stand up against the prevailing mood of the market, influenced by their fiduciary duties.

For example, consensus allocation to stocks on the chart below was reduced in line with the falling stock market through to early 2009 and then only gradually increased with the rising market.



Source: Bespoke Investment Group, Bloomberg Survey of Wall Street Strategists, Jan 2010. Reproduced with permission.

The point of lowest allocation to equities coincided with the March 2009 market bottom. Looking back, it was the best time to switch to a High Growth SAA option at the beginning of the multi-year V-shape rally.

Perception of risk depends on the state of the market

The SAA methodology measures risk in terms of a long-term historical average volatility without referring to current valuations. It implies that the market can move in either direction by the same magnitude from any entry price point.

But surely, the entry price does matter. And one does not need to forecast the market to know that the risk of a fall is bigger at very high valuations because history shows that markets are cyclical. Yet, static SAA expects the same allocation to equities at both low and high valuation entry points. Clearly, there is a need for rational asset re-allocation tools. Investors look at the drawdown of their portfolios on a given day when they think about their downside risk. Investors' perception of risk changes with market performance.

Warren Buffett, among others, illustrated how irrational investor behaviour is. When we see a 'sale' sign in a shop, we rush to buy more of the goods at discounted prices and when prices rise we buy less. However, when it comes to the stock market, we do the reverse: we buy less when shares are cheap after a crash and buy more when shares are expensive and likely to fall. That is how humans react to painful loss thus there is a clear need for rational tools to counter such irrational and costly behaviour.

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This article is for general educational purposes and does not consider the circumstances of any investor.

HNWs using less advice but little change in asset allocation

Graham Hand

In an advanced look at the results, the 2016 Investment Trends High Net Worth (HNW) Investor Report updates research on the use of advisers and the latest asset allocations.

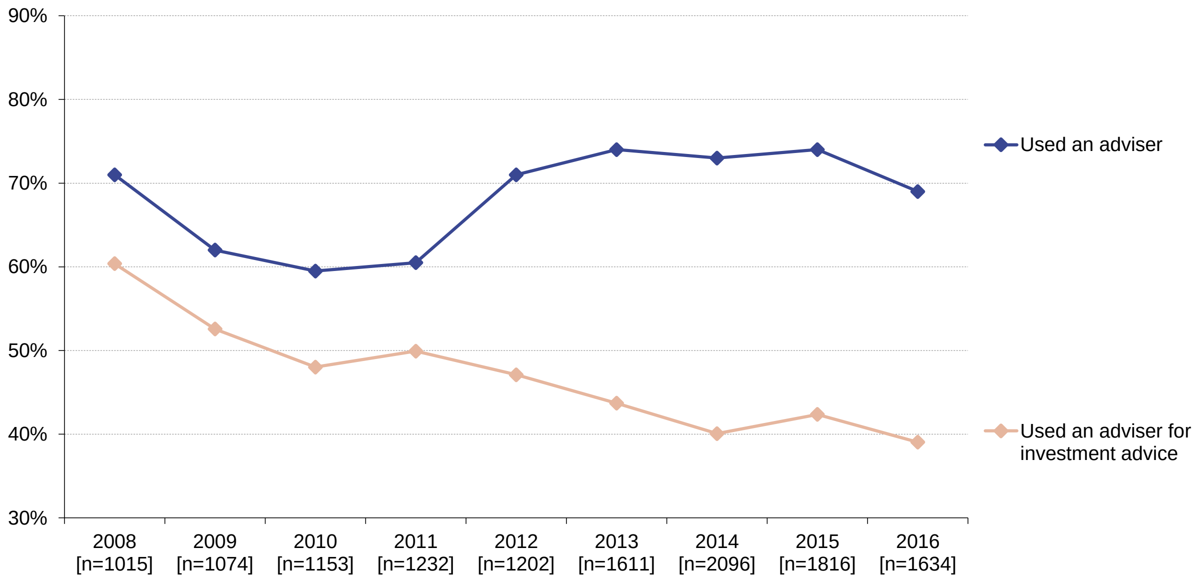
The study is based on 2,500 responses from HNWs with investible assets (excluding super in public funds but including SMSF balances) of over $1 million, net of debt. This group is estimated to control about $9 billion of the $1.5 trillion held by all HNWs in Australia.

Some highlights include:

1. The number of HNWs in Australia fell to 425,000 in 2016 from 440,000 in 2015, partly due to market conditions and partly because of using debt to invest in property. The number with $2.5 million and above is growing.
2. The main investment problem identified by half the respondents is they are seeking growth in their portfolios but don't expect it will come from Australian shares in 2017 (their return expectations have recovered somewhat since bottoming in September 2016, but they are still bearish). They know they should not allocate significantly to cash.
3. As expected in such uncertain times, there is an increasing unmet need for advice. Says Recep III Peker, Research Director at Investment Trends, *"Over half of HNWs have large unmet needs for advice. In spite of this, they are increasingly reticent to seek advice, and the use of advisers is falling. Financial planners and full service stock brokers are losing ground, especially for investment advice."*

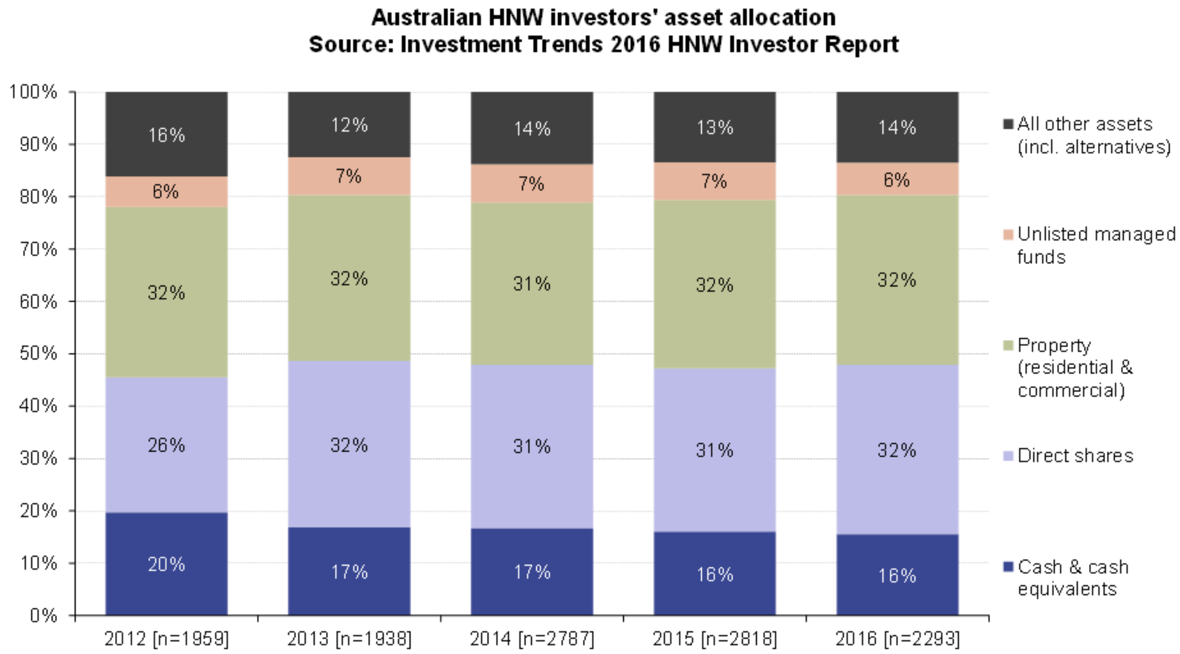
   The changes for full service stockbrokers are particularly challenging. Those who have retained clients have a more holistic relationship, including in asset classes other than equities. But only 40% will actually call themselves a stockbroker, with most preferring names such as 'wealth managers', signifying a more diversified offering. They have not become 'financial planners', but their businesses are changing. For example, they commonly sell global ETFs to give their clients an international equity exposure.

Proportion of HNW investors who have used an adviser in the last 12 months
Source: Investment Trends 2016 HNW Investor Report



4. Asset allocation has not changed significantly in last few years. The top-level asset distribution is 32% direct shares, 32% property, 16% cash and TDs and the rest in listed or unlisted managed funds and alternatives. Geographically, the proportion of assets overseas averages only 5%, although for the wealthy with assets $10m+, it is a much higher 10%.

Uncertain times and stretched market values seem to have paralysed reallocation. The amount in cash and TDs has fallen slightly by 1% to 16% in the last two years, despite uncertainty in the share market, due to low rates. HNWs in Australia are estimated to be holding $240 billion in cash, with $100 billion temporarily waiting for better market conditions.



The proportion of HNWs planning to invest in managed funds remained at 20% in 2016. About half of these HNWs want actively managed international equity funds, and two in five seek active Australian equity funds. Says Peker, *"It's been a bit of a missed opportunity that the industry has not grown its share of the HNW pie, but there is still good appetite for managed funds."*

The number of HNWs who have direct property has increased but average holding size has come down, perhaps indicating property is held in an SMSF.

Graham Hand is Managing Editor of Cuffelinks and this preliminary release is courtesy of Investment Trends.

Do new rules create incentive for single member SMSFs?

Rick Turner

Are you a member of an SMSF or small APRA fund (SAF)? Are your circumstances, aims, goals and objectives similar to those of your fellow members? Particularly, are you in the same phase of superannuation? No? Well your position will be changed dramatically from 1 July 2017.

Contrary to the statement in Treasury's *Budget 2016 Making a fairer and more sustainable superannuation system* fact sheets and Q&As that "In the superannuation system, and most areas of tax, people are taxed and treated as individuals not families or households", for members of SMSFs and SAFs the tax outcome of earnings on assets owned by one member will depend on the tax position of other members.

This reflects that in seeking to avoid members with accumulated super benefits in excess of $1.6 million segregating assets in pools to achieve a tax advantage, the new rules also prevent segregation of assets by member when it comes to calculating the fund's tax liability.

A simple example of the issue is an SMSF or SAF with only two members, one in pension phase and one in accumulation phase. When the fund realises an asset in order to make a pension payment and so makes a capital gain (inevitable with the working of the increasing pension factors) that capital gain will be taxed solely because the other member is still in accumulation phase. Which member should bear the cost of this tax? – the pensioner, who if in any other fund would have no tax liability, or the accumulator, who would have no need to realise the asset?

Those members of SMSFs and SAFs finding themselves in this unexpected position of their benefits being taxed because of the other member may find it difficult to extricate themselves because rolling their benefits out to an unaffected fund will trigger a potential capital gains tax event in their current SMSF or SAF. Given the imminent implementation date, you need to be talking to your superannuation advisor ASAP.

In this simple move away from people being taxed as individuals not families or households or SMSFs and SAFs, the new system is not fairer and the Government has created an advantage for the industry and large retail funds and an impetus to single member SMSFs.

Rick Turner is a client adviser at a leading stock broker. This article is for general information only and does not consider the circumstances of any individual.

SMSF expert, Monica Rule, has provided her feedback on the points made in this article:

Rick Turner is saying that if there are two SMSF members and one is in accumulation phase and the other is in pension phase, then their SMSF would need to pay tax on earnings from assets and capital gains from the sale of assets that are supporting the pension account from 1 July 2017. This is because you can no longer segregate assets to support a pension if your superannuation balance exceeds the transfer balance cap of $1.6 million. The tax payable will be on the portion that represents the members' accumulation accounts.

He is also referring to the fact that if the same member was in a retail superannuation fund, due to the number of members and pool of assets, the member would possibly incur less cost in his superannuation account.

Going forward from 1 July 2017, SMSFs will incur more costs due to the amount of additional work accountants will have to do to keep track of members' personal transfer balance accounts as well as keeping records of the actual members' pension and accumulation accounts.