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Saving for retirement faces age pension black holes

Andrew Gale

The key objective of the superannuation and retirement income system is the provision of security and a reasonable income in retirement. The 2015 Federal Budget made significant changes to social security means tests, effective 1 January 2017, which demonstrate a lack of integration between retirement income policy and social security. The changes have some perverse consequences, notably people with lower assets possibly having greater retirement incomes than those who have prudently accumulated more savings.

This article is based on age pension rates and asset test parameters effective from 1 January 2017.

Doubts about fairness

One of the key benchmarks the Government has determined for the assessment of Federal Budgets is fairness.

The age pension asset test and, in particular, the age pension tapering rules, will challenge that notion of fairness. This primarily arises from the interaction of the 7.8% tapering rules and the current (ultra) low rate environment.

It is true that the lifting of the assets thresholds will allow more people to be eligible for a full age pension. For non-homeowners (single and couple), thresholds have risen from $360,500 to $450,000 and from $448,000 to $575,000 respectively, while for homeowners (single and couple) they have risen from $209,000 to $250,000 and $296,500 to $375,000, respectively. The increases will allow about 50,000 more Australians to receive the full pension.

But part-pension thresholds have been reduced. Significantly. For non-homeowners (single and couple), they have fallen from $945,250 to $742,500 and $1,330,000 to $1,010,000, respectively, while for homeowners (single and couple), from $793,750 to $542,500 and $1,178,500 to $816,000, respectively.

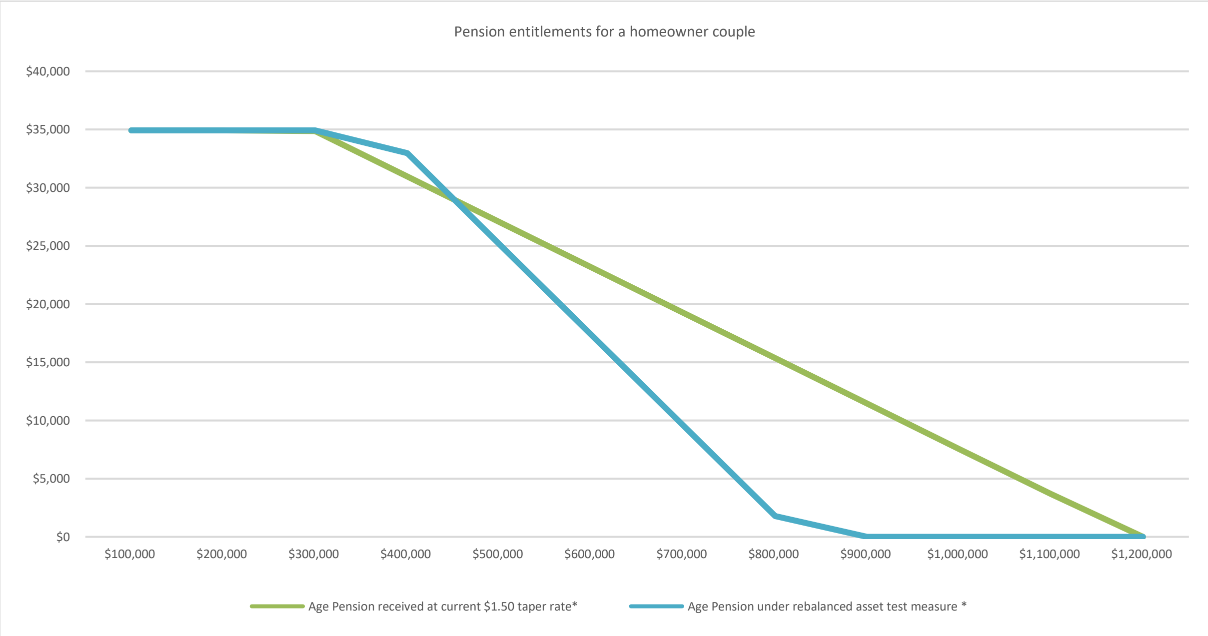
It is estimated the lower thresholds will see 300,000 retirees have their part-pensions reduced and 100,000 will lose them altogether. And the Government casts a wide net when determining assessable assets, including boats, caravans, household contents, personal items, financial investments, and business assets. The family home remains excluded from the age pension assets test.

The bad news does not stop there

The pension taper rate increased from $1.50 to $3. For every $1,000 of assets beyond the assets free area ($250,000 for a single homeowner and $375,000 for a home-owning couple), the pension is reduced by $3 a fortnight or $78 per year. Call this a 7.8% taper rate ($78/$1,000). When this is coupled with the current low interest rates, Middle Australia is the meat in a tasteless sandwich.

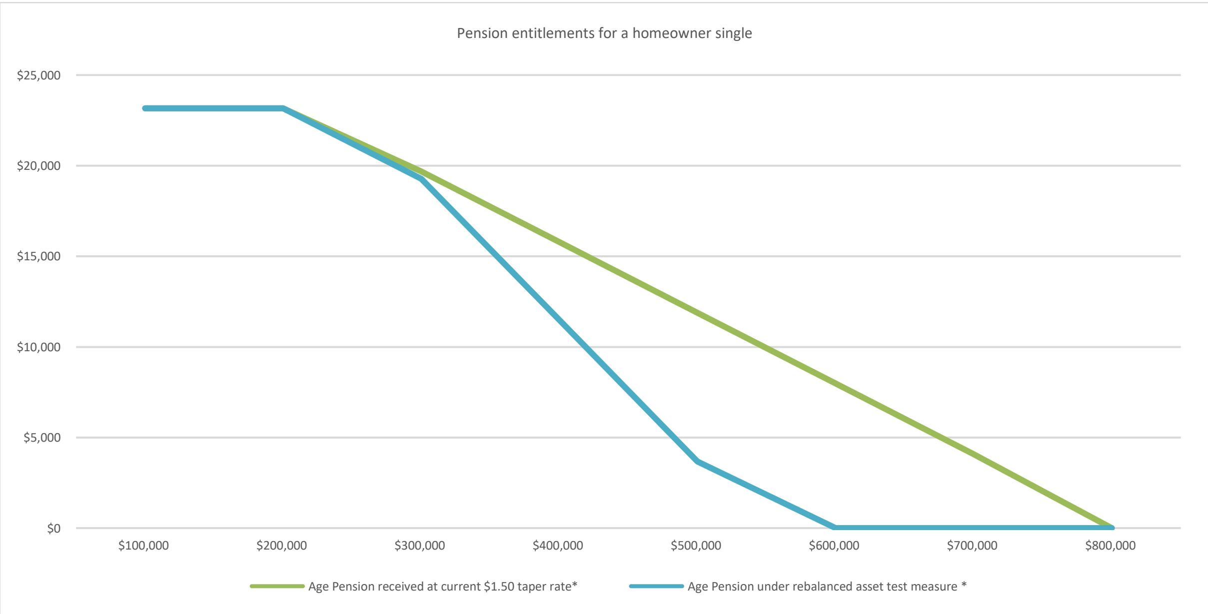
The graphs below highlight the punitive impact of the new tapering rules and asset thresholds. Among those most harshly affected are couples with between $600,000 and $1 million in financial assets (excluding the family home) and singles with financial assets of between $400,000 and $700,000. Non-home owning people are even worse off.

Age pension for a home-owning couple, new asset test (blue line) versus old (green)



Source: SMSF Association

Age pension for a home-owning single, new asset test (blue line) versus old (green)



Source: SMSF Association

Dramatic reductions and perverse results in age pensions

To drill down further into the numbers, a home-owning couple with financial assets of $800,000 faces a pension reduction of about 85%, from about $16,000 to about $2,000. Again, it is worse for non-home owning couples who have rent to pay. A home-owning single with financial assets of $500,000 faces a reduction in the partial pension of about 70%, from about $13,000 to $4,000.

Now consider the following:

- Assuming a 4% earnings rate (conservative portfolio), a home-owning couple with:
  - $300,000 in financial assets will have total investment earnings and pension income of around $47,000
  - $800,000 in financial assets will have total investment earnings and pension income of around $34,000.
- Assuming a 4% earnings rate (conservative portfolio), a home-owning single with:
  - $200,000 in financial assets will have total investment earnings and pension income of around $31,000
  - $500,000 in financial assets will have total investment earnings and pension income of around $24,000.

(The above simple analysis ignores the overlay of the Senior and Pensioners Tax Offset, or SAPTO).

In both cases, the whole purpose of saving for retirement – to produce a decent income in retirement – is largely undermined. The couple with additional savings of about $500,000 or the single with an additional $300,000 are significantly worse off in total than their counterparts who have accumulated less.

The asset means test could encourage people in retirement to take on additional risk with their investments to generate higher investment earnings to offset the 7.8% tapering rate.

Even if one allows for consumption of additional capital over life expectancy, the conclusion remains that the incentive to save for retirement is significantly diluted by the age pension asset test. It may encourage prior capital consumption or increasing capital committed to the family home.

For example, a way to provide an income stream with the same longevity protection as the age pension, inflation protection and consumption of capital, is an inflation-proofed lifetime annuity. If the couple with $800,000 in assets were both aged 65, and each purchased a lifetime annuity with inflation protection and declining liquidity (representing capital consumption) then the currently quoted rates (per $100,000) for an annual income stream from Challenger are:

- Age 65 Male: $4,744
- Age 65 Female: $4,513

Averaging this figure at $4,629/$100,000 or effectively 4.6%, this couple could produce an assured annuity income with inflation and longevity protection (replicating that provided by the age pension) of $37,032 a year, plus receive an age pension of $962, for a total of approximately $38,000 per annum. They are worse off than the couple with $300,000 in assets, who have not had to consume their capital to produce the income!

No incentive to save created by black holes

Surely Middle Australia will question the worth of saving extra retirement dollars if this is the outcome as there is absolutely no incentive to accumulate assets in a certain band. In the case of the home-owning couple, it is between $375,000 and $816,000. It is literally a savings 'black hole'. Remember, too, our home-owning couple with $800,000 in financial assets will now be on a par with the ASFA Modest Retirement Standard for couples of $34,560 a year, and way below the ASFA Comfortable Retirement Standard of $59,619 a year.

How does this come about? Well, quite simply, the 7.8% tapering is much higher than the earnings rate (say 4% in the above example) on additional assets. For tapering to work effectively and provide a modest incentive to save for retirement, the tapering rate ideally needs to be less than the earnings rate – and certainly not substantially exceed it.

And for members in the SMSF sector, where about 48% are either transitioning to retirement (60 to 65) or in retirement (65 plus), the need to preserve capital is critically important. So, for these people, matching a 7.8% tapering rate when the official cash rate is at 1.5% is very difficult.

Possible solutions

A few possible solutions to this dilemma come to mind:

- Shift to a single deeming rate (same deeming rate used for the incomes test and assets test), though this would be very expensive, and probably not acceptable to Government in the current fiscal environment
- Have a gentler tapering rate in which case the threshold levels would most likely also need adjustment, or
- Have a two-tier tapering rate, gentle at first (say 4% tapering for assets above a certain amount), and a steeper tapering rate (say 7.8%) for assets above a higher amount. Obviously, the asset figures would vary between couples and singles, homeowners and non-homeowners.

These are not wealthy Australians

Underpinning all these changes is the notion that our home-owning couple with $800,000 in financial assets is somehow wealthy. The concept of a 'million dollars' signifying real wealth persists, encouraged, perhaps unwittingly, by the Government, and certainly by elements of the media, some think tanks and others active in the social policy arena.

It's just not the reality. As demonstrated, in the current low earnings rate environment and earning 4% a year with a conservative portfolio, a couple with $800,000 will be earning $32,000 a year (before tax) and a single person with $500,000 will be earning $20,000 a year. Hardly wealthy Australians. They are simply hard-working Middle Australians who have done the right thing in following their personal goals and Government exhortations to provide for their retirement. Right now, they must be asking why.

This is why there is such a pressing need for much greater integration of public policy for the retirement phase. At the very least, this needs to embrace superannuation and retirement incomes, social security, tax and aged care. It could also embrace health but that's starting to become complex, so starting with the narrower integration framework is more pragmatic and a useful start.

Andrew Gale is Non-Executive Director of various entities in the financial services sector, including Chairman of the SMSF Association. The views expressed in this article are personal views and are not made on behalf of any organisation.

Worrying debt binge main cause of house price rises

Ashley Owen

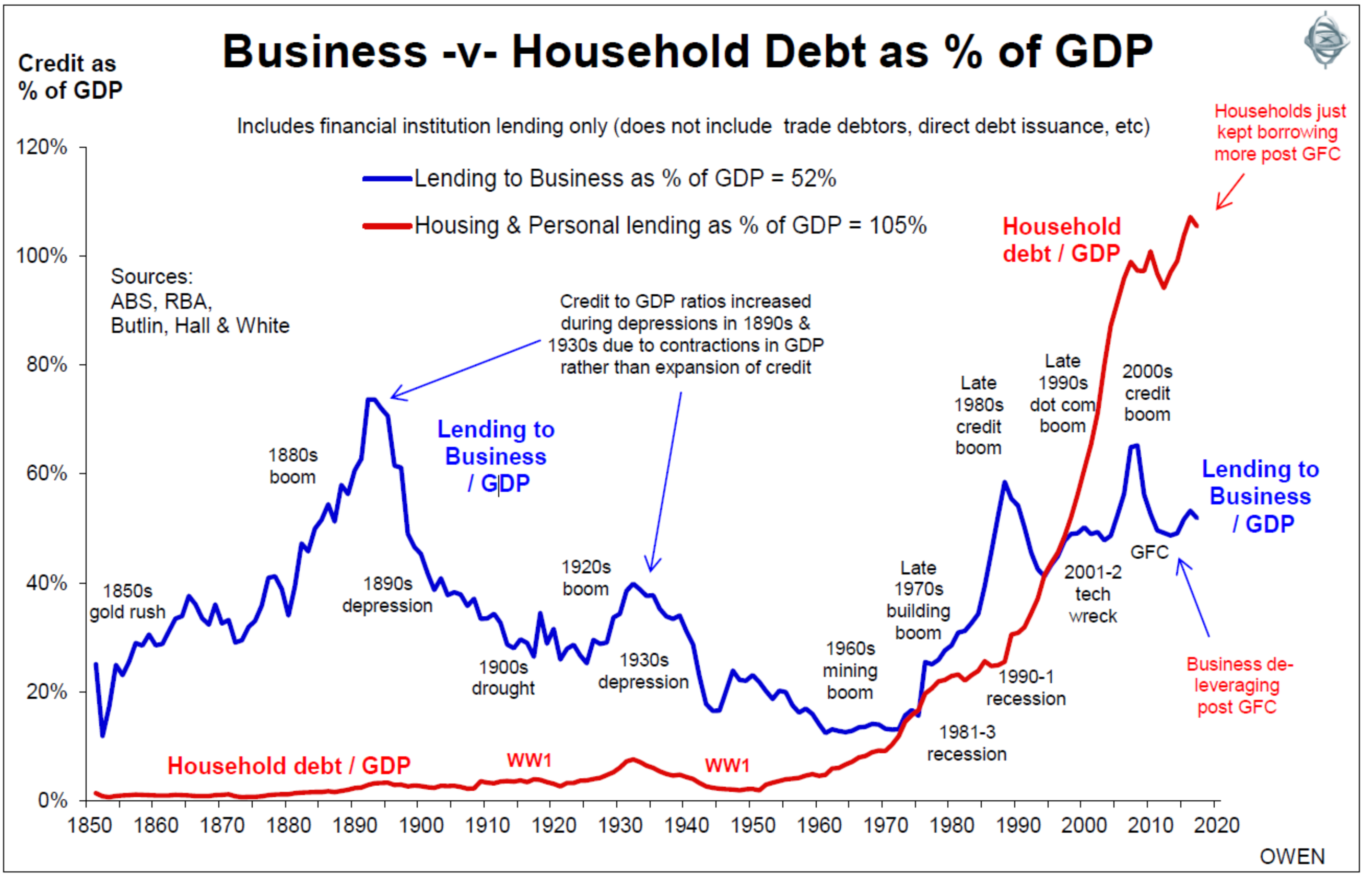
Last month I discussed the long-term cycles in Australian house prices and whether prices are destined to keep rising, crash suddenly, or suffer a mild correction and then remain subdued for several years. In the past few weeks there has been an escalation in the national debate over how to make housing more affordable.

There are two main ways to make houses more affordable - cut prices or give buyers more money. Bringing down house prices would be political suicide. Many recent buyers have so little equity in their houses at current prices and debt levels that cutting prices via savage bank rationing or big interest rate hikes could trigger widespread defaults and a collapse in construction activity causing an economic recession.

Instead, governments have focused on making housing more affordable by giving buyers more money. Simple! Every state already provides free (ie tax-payer funded) gifts to first home buyers and there is a range of discounts and waivers of property taxes like stamp duties. The debate has recently turned to allowing buyers to use their retirement funds to buy housing. There has even been a proposal whereby the government (tax-payers again!) would contribute 25% of the cost for first home buyers. None of this works. Giving buyers more money to spend inflates prices even further.

The real problem is credit. High prices are a function of high levels of credit extended by ever-willing lenders to ever-willing borrowers. Bank regulations are skewed toward favouring housing loans over loans to businesses. Even after the massive losses on housing debts in the US, UK and much of Europe over the past decade, banks and their tame regulators still have their heads in the sand in thinking that housing debt is virtually risk-free.

This chart shows lending to businesses and households in Australia as a percentage of national income since 1850.



There is something very worrying about this. The wealth and lifestyles we enjoy today were built by companies, and much of that was funded by business debt. In a healthy economy, household borrowing should not exceed business borrowing. Ever since bank deregulation and the housing-skewed bank capital rules (known as 'Basel') were introduced, lending on housing has swamped business lending. Household debt is now double the level of business debt.

After the GFC, companies in Australia and around the world de-leveraged. However Australian households piled on more and more debt thanks to our Reserve Bank's rate cuts and bankers who keep on lending on 'risk-free' housing to keep their bonuses rolling in.

Business lending in the US and Europe has finally picked up, and that is driving their economic recoveries, especially the US. In Australia, it may take another crisis like the 1973-74 credit squeeze or the 1990-91 recession before regulators and banks return to a more healthy and productive balance between business and housing lending.

Ashley Owen is Chief Investment Officer at independent advisory firm [Stanford Brown] *and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.*

When directors sell, should you sell too?

Tim Kelley

When directors buy or sell shares in their company, most people believe they are sending a strong signal to the market about the firm's prospects. But how strong is the correlation between director trades and share price movements? And should you buy or sell because a director has too? We did some research to get closer to the truth.

It seems reasonable to think that company directors have better insight than the rest of us into the performance and prospects of a business, and that they may be more willing to buy when they see a rosy outlook, and sell when the outlook is dim.

Of course, regulation and governance should greatly limit the extent to which company insiders take advantage of their privileged position, but one suspects that these constraints may mitigate against the application of insider insight, rather than completely eliminate it.

This discussion has become more topical recently, with some high-profile examples of director selling that now look to be fairly prescient. These include cases like Aconex, Sirtex, Bellamys, Vocus, Brambles and Healthscope, where directors managed to sell shares ahead of falling prices.

Don't make too much of recent experience

There's no doubt that director sales have been telling in these recent examples, but there is a strong tendency for investors to extrapolate from limited recent experience, and it's always good to be a little wary of this. A better approach is to look at what the data says over a reasonable time period to try to gauge objectively how much comfort we can draw from insider purchases, and how much concern we should feel when they sell.

The academic research evidence has been a bit mixed. Some studies have shown that trades by company insiders contain information, but others find little effect, and good research evidence for the Australian market is lacking.

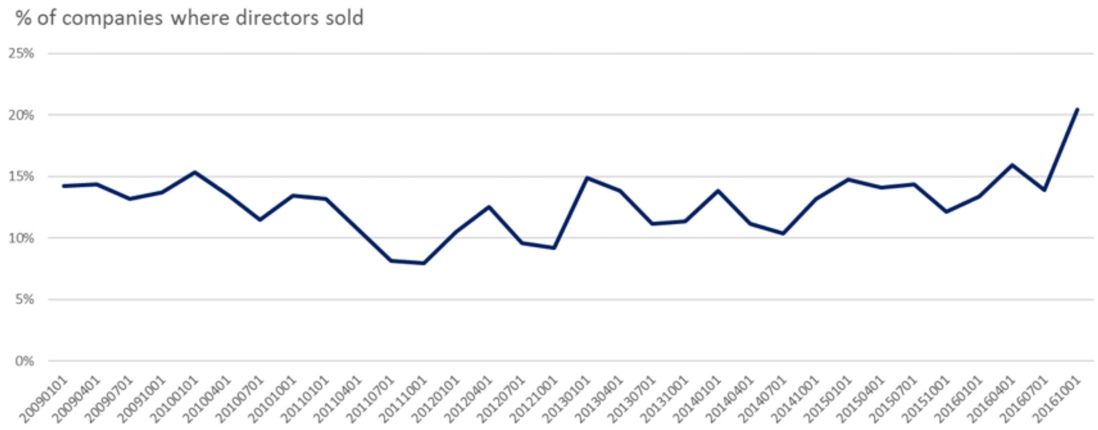
We did some research on ASX director trades. Our work is not of the quality that you might expect from published academic research, but it offers deeper insight than anecdotes.

Our analytical process

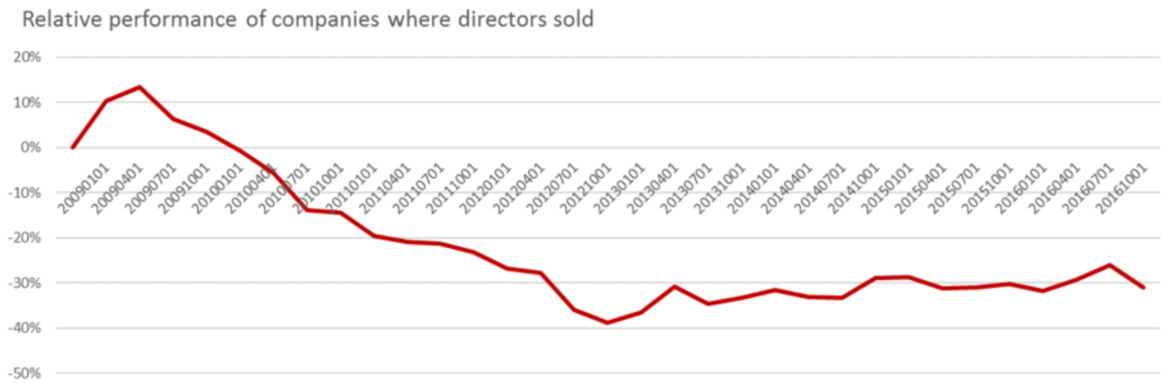
- We downloaded the pdfs of ASX300 company announcements made over the past eight years where the title of the announcement indicated a "change in director's interest" or "Appendix 3Y" (but excluded initial and final director's interest notices).
- We scanned the text of these announcements and used some rules to identify cases where the 'Nature of change' section indicated an on-market trade, and excluded cases where the change appeared to result from an issue of shares under company incentive plans and the like.
- We used some further rules to extract numbers from the 'Interest Acquired', 'Interest Disposed' and 'Value/Consideration' sections of the announcements. We will have missed some trades for various reasons but we had a good representative sample of either years of data.
- We then looked back six months (ie. considered director trades made in the six months prior to our observation date) and examined risk adjusted returns over the subsequent three months.

Our research findings

- Director selling appears to contain more information than director buying. This is consistent with some academic research which indicates selling is a more powerful signal than buying.
- On average, we found that around 20% of companies had one or more director share sales occurring in any given six month look-back period. Interestingly, the most recent data shows a relatively high proportion of director selling, which could indicate a general perception by directors that prices currently are at elevated levels.



- Seasonality to director selling is apparent, with the peaks in January indicating that the second half of the calendar year – and the final quarter in particular – is the most popular time to sell.
- Because the director sales occur in a relatively small proportion of our universe (about 20%), we need to keep the returns analysis simple. We divide our companies into two groups: those where no director sales have been identified in the past six months, and those where at least one director sale has been found. We form equal-weighted portfolios from these two groups and rebalance every three months.
- As a general rule, the companies where directors had sold shares tended to perform worse than companies where no director sales had occurred. On average the difference between the two groups seems to run to a couple of percentage points per year, but the pattern is far from consistent. Most of the performance differential occurred between mid-2009 and late-2012. In recent years, we have seen only a small differential (although the final quarter of 2016 was a good time to avoid companies with director sales).



It's worth watching director sales

We conclude that when company directors sell shares, it is not necessarily an overwhelming signal that others should follow suit. However, it clearly should be considered as part of the analysis. As is often the case, common sense should prevail, as a sale should prompt you to:

- Consider the specific circumstances and whether it may be motivated by a negative view on firm prospects or something more benign.
- Think about whether the relevant director has a large information advantage and is much better placed than you to gauge long term value.
- Reflect on your valuation assumptions and importantly, your level of conviction in them.

Tim Kelley is Head of Research and Portfolio Manager of [The Montgomery Fund](). This article is general information that does not consider the circumstances of any individual.

Five urban myths about super changes

Graeme Colley

Much of the conversation about the superannuation reforms relates to reducing pension balances to a person's transfer balance cap, resetting the Capital Gains Tax (CGT) cost base for investments and making last minute contributions before the caps drop on 1 July 2017. This article covers a few urban myths that have developed among some trustees and their advisers concerning these new regulations.

As a general rule, from 1 July, a person's transfer balance cap of $1.6 million is the maximum value of pensions that can be transferred to retirement phase after that date including the value of pensions in place as at 1 July 2017. It is possible for a person to have a higher transfer balance cap if they receive a defined benefit pension because of the restrictions placed on receiving lump sum withdrawals. Transition to retirement income streams (TRIS) are excluded from measurement against the transfer balance cap as the income earned by the fund on investments that support a TRIS will be taxed at 15% from 1 July 2017.

Urban myth no. 1

Amounts transferred from retirement phase to accumulation phase cannot be withdrawn from superannuation.

Incorrect. Any amount used to provide an account-based pension must have met a condition of release of retirement after reaching the person's preservation age or age 65, whichever is the earlier. Meeting either of these conditions of release means that the benefits are totally non-preserved and can be withdrawn from superannuation at any time.

Urban myth no. 2

A minimum amount equal to a percentage of a person's accumulation account is required to be withdrawn from the fund each year.

Incorrect. Only account-based pensions and transition to retirement pensions require a minimum set percentage of the account balance on commencement or as at 1 July each year to be paid to the pensioner. Where defined benefit pensions are paid from the fund, the amount required to be paid annually is determined through an actuarial valuation.

Urban myth no. 3

Only one pension is able to be paid from retirement phase under the rules from 1 July 2017.

Incorrect. There is no limit to the number of pensions that can be paid from superannuation for an individual. A person may have a number of valid reasons for commencing more than one pension, which may be due to the manner in which contributions were made to the fund, changes in the pension rules or use of pensions to gain the greatest taxation advantage.

Urban myth no. 4

Any pension balance in retirement phase must be reduced to $1.6 million each year.

Incorrect. The value of the relevant pension measured against a person's transfer balance cap occurs at the time an account-based pension commences from 1 July 2017 or on the amount supporting account-based pensions on 30 June 2017. The withdrawal of regular pension payments or changes to the pension account balance due to investment gains or losses do not impact on the amount measured against the person's transfer balance cap.

Different rules apply to the valuation of defined benefit pensions, which are based on the pension payable and a special valuation factor.

Urban myth no. 5

The amount a person is permitted to have in superannuation is limited to $1.6 million.

Incorrect. There is no limit to the amount a person is permitted to accumulate in superannuation. However, the value of pensions measured against a person's transfer balance cap for amounts in retirement phase is not permitted to exceed $1.6 million (which is subject to indexation). Also, if a person's total balances in all superannuation funds exceeds $1.6 million, it is not possible to make more non-concessional contributions.

The new superannuation rules will impact on the amount of tax paid in the superannuation fund for members with a pension value of more than $1.6 million or receiving a TRIS pension. Any excess over $1.6 million will be required to be transferred to a taxed environment in accumulation phase or taken from the fund as a lump sum. Investments supporting a TRIS will be transferred from a tax exempt to taxed environment in the fund. While there are a number of decisions to be made, members should understand the facts and ignore the myths that confuse and complicate some relatively straightforward changes.

Graeme Colley is the Executive Manager, SMSF Technical and Private Wealth at SuperConcepts, a leading innovator in SMSF services. The material in this article is for general information and does not consider any person's investment objectives.

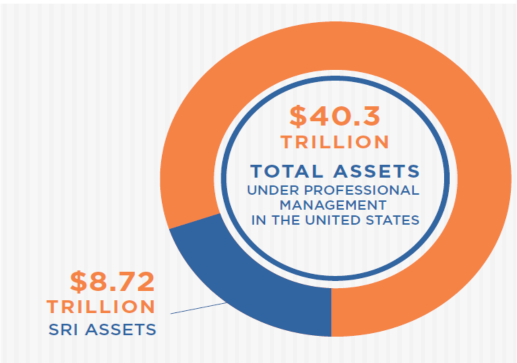
Can socially responsible investing and good returns coexist?

Chad Slater

"Do the right thing. It will gratify some people and astonish the rest." Mark Twain

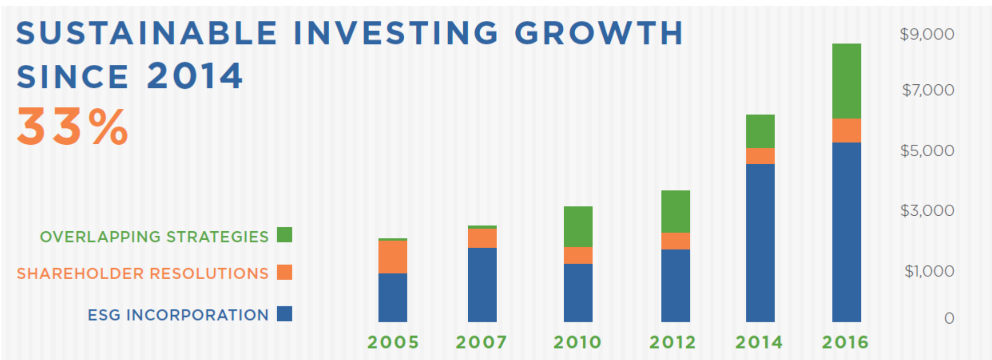
In the past few years, there has been a significant increase in the interest in environmental, social and governance (ESG) investing. According to a paper released recently, more than $8 trillion of the $40 trillion of money managed in the USA is now under some form of Sustainable and Responsible Investing (SRI) or ESG, up 33% since 2014 and up fivefold from $1.4 trillion in 2012 for money run by fund managers.

Figure 1 - Sustainable and impact investing in the United States



Source:US SIF Foundation

Figure 2 - Sustainable investing growth in the United States (Billions) between 2005 and 2016



Source:US SIF Foundation

Australian fund managers caught unready for this change

If we look at the Mercer survey data for January 2017, the Global Equities strategy section contains 127 global funds sold in Australia. Of this, only five are classed as SRI funds. It is somewhat better for Australian equities with 157 funds in the survey, of which 13 are SRI. If we were to use the ratio of assets in the USA, the number of SRI funds should be 27 and 34 respectively.

One reason could be the view among many people, particularly fund managers, that 'you can't have your cake and eat it, too', that SRI means lower returns for investors.

This misconception of accepting lower returns for being ethical goes against another tenet of conventional investing wisdom: buy good businesses. In his letters to Berkshire Hathaway shareholders, Warren Buffett often discusses the importance of ethics and the quality of the character of the people running the businesses he owns.

Implicitly he is saying that businesses which have an ethos and focus on 'doing the right thing' by staff and customers should generate higher returns. Admittedly, he is discussing the character of the people rather than the nature of the business, and some people would find owning Coca-Cola shares unethical. It's this differentiation between good people and bad unethical businesses that opens an interesting next line of inquiry.

What do the statistics say?

UBS recently published an excellent summary of academic literature which concluded that SRI did not negatively affect investor returns.

Verheyden, Eccles & Feiner (2016) wanted to look at whether a portfolio manager would be at a disadvantage in terms of performance, risk, and diversification if he/she were to start from a screen based on ESG criteria. The empirical evidence shows that all ESG-screened portfolios have performed similarly to their respective underlying benchmarks, if not slightly outperforming them. Put differently, the findings of the paper show that, at the very least, there is no performance penalty from screening out low ESG-scoring firms in each industry.

This is consistent with our own experience as portfolio managers at Hunter Hall, where we outperformed against an all-inclusive benchmark, despite having a restricted ownership list.

Nagy, Kassam & Lee (2016) wanted to see not only if highly-rated ESG companies outperform, but if businesses are rewarded for improving, going from okay to good? The answer was unequivocally yes. Both outperformed, but the improvers outperformed at double the rate.

The most interesting article by Statman and Glushkov (2016) created what they called "Top Minus Bottom" (TMB) where stocks were ranked on their ESG criteria and then modelled how being long the 'better-ranked' versus the 'worse-ranked' performed. This concept is similar to the studies above and could be called the 'good screen'.

The innovation was to look at 'Accepted Minus Shunned' (AMS) separately. Here the authors looked at the returns from stocks commonly accepted in SRI funds versus those that are typically avoided. Shunned companies are those with operations in the tobacco, alcohol, gambling, military, firearms and nuclear industries. Call this the "negative screen".

Like the earlier studies, it was found TMB outperformed the broader market but interestingly the AMS (the bad screen) stocks didn't outperform, that is, the excluded stocks did better than the broader market. But AMS under-performed by less than the TMB screen outperformed. That is, it was a net positive for investors. I think it is this AMS effect that fund managers have focused on in their view that SRI/ESG does not work.

What does this mean for fund managers?

Investors globally are demanding more focus from their fund managers on ESG issues. The implications of these studies are that ESG does not detract from returns and investors are therefore not irrational to ask for more focus on ESG and SRI issues by their money managers.

But it also says running a positive screen in combination with running a negative screen is a better way to generate returns for investors while also satisfying investor's ethical investment needs.

Chad Slater, CFA, is Joint CIO of [Morphic Asset Management](). This article is general information that does not consider the circumstances of any individual.

Of Blackberrys, pineapples and trade

Ian Stewart

Free trade helped power a dramatic rise in living standards in the West in the nineteenth and twentieth centuries. In the last three decades, it has had a similar impact on the welfare of billions of people in emerging economies.

Yet in the face of a backlash against globalisation, free trade is arguably more at risk than at any time since the 1930s. Those who want to limit trade see it as a way of 'bringing home' high-quality jobs and reinvigorating industry.

Argentina's recent experience with trade barriers tells a different story.

Argentina has pursued relatively restrictive trade policies since the Second World War. Starting in 2007 Argentina's former president, Cristina Kirchner, adopted new protectionist measures as part of a 'Made in Argentina' drive.

Some categories of imports were limited or subjected to long delays. Companies were required to seek permission before importing goods or services. Other rules required importers to match the value of imports by exporting an equal value of goods. It resulted in a Porsche dealer exporting wine to offset imports of cars. Other car importers found themselves in the business of exporting soya, peanuts and biodiesel.

Faced with these restrictions, Apple withdrew from the Argentinian market. To retain its access to the Argentinian handset market, where it was a major player, Blackberry was obliged to shift production from Mexico to Argentina.

In 2007 Blackberry set out to create a manufacturing operation in Tierra Del Fuego, a remote, sparsely populated part of southern Argentina whose main industries are agriculture, fishing, tourism and gas and oil extraction. The choice of location was the government's.

To attract workers to the region Blackberry had to pay a salary premium. The Economist estimates wages were some 15 times higher than in Asia and costs were far higher than at its Mexico plant. The Tierra Del Fuego factory cost $23 million to build, much of it paid for by the government.

When production finally started the first Blackberry model was two years out of date and cost significantly more than the Mexican-made version.

Unsurprisingly, Argentinian consumers were unwilling to pay an above-market price for an older model. Almost immediately travellers started to smuggle cheaper, more modern Blackberrys into the country.

Sales of Argentinian-made devices plummeted and, after two years, the Tierra del Fuego plant closed.

The episode illustrates a wider truth. Free trade gives consumers the best products at the lowest prices. For this reason, protectionism tends to be self-harming. Import controls increase costs for consumers and create an untaxed, unregulated black market. In Argentina's case state aid for the Blackberry plant diverted resources from sectors, such as agriculture and commodities, where Argentina is internationally competitive.

'Bringing back' good jobs and making things 'at home' are good slogans and have a simple appeal. But they make little economic sense.

Consider an extreme example. It would be possible for the UK to meet its demand for pineapples by growing them at home. Indeed, the eighteenth and nineteenth centuries' fashion for pineapples led to their being grown, under glass and using a variety of sophisticated techniques, in a number of estates. The costs were sky high. In an experiment five years ago, the Lost Gardens of Heligan, in Cornwall, produced a crop of pineapples using traditional Victorian techniques. The cost per pineapple was about £1,200.

Cheap, refrigerated transport killed home-produced pineapples. The UK could produce them today, but they would be hugely expensive and, unless imports were restricted, unviable – just like Argentina's home-produced Blackberrys. The pineapple would go from being an everyday food to the preserve of the rich.

Many other products that industrialised nations import today, from electronics, to textiles to toys, could also be made 'at home'. Were that to happen, prices would soar and resources that could have been used to develop the industries of the future would be used to prop up low-cost, low-tech industries and activities.

People are better off if the market, not government, decides where Blackberrys and pineapples are produced.

Ian Stewart is Deloitte's Chief Economist in the UK. This article is reproduced with permission from Ian's blog, The Monday Briefing.

Understand the new RG 97 disclosure requirements

Darren Handley-Greaves

Many fund managers and trustees are struggling to understand how to apply the increased disclosure obligations of *Regulatory Guide 97 – Disclosing fees and costs in PDSs and periodic statements (RG 97)* to their business models.

ASIC's RG 97 requires managed investment fund and superannuation product issuers to provide more detailed data about fees and costs, including from underlying investment vehicles. These changes are designed to create a more level playing field, giving customers greater transparency and allowing meaningful comparisons between products.

Product providers struggling, ASIC extends deadline

The new requirements differ between superannuation and managed funds and implementing them is proving a challenge. One-third of industry attendees at a recent EY forum on RG 97 admitted they were still struggling to understand the requirements.

Recognising these concerns, ASIC recently extended the transition period for PDSs until 30 September 2017 (from the original 1 February 2017) but there are no plans to issue further extensions. PDSs must be fully RG 97 compliant by that date, while periodic statements have until 1 January 2018.

Only 2% of attendees at the recent forum said they had completed their new fee disclosures process. So, what exactly should funds be doing to prepare for and implement the changes and what are the likely impacts?

Interpreting the disclosure requirements for implicit costs

Much of the confusion lies in the complexity of how to calculate implicit transaction costs, with some applications requiring several estimates. While the ASIC guidance does not specifically reference implicit costs, it categorises these transaction costs as the difference in price between the purchase and immediate sale of an asset. The limited industry guidance for some of the more exotic assets is leading to difficulty in calculating reasonable estimates.

Making reasonable efforts

RG 97 requires a 'reasonable estimate' in determining fees and costs where exact amounts are unknown, but the guidance does not specifically define materiality. Issuers will need to consider industry standards and investors' perspectives and keep clear records on their methodology and results. Estimates should include the information available, relationships with third-party providers and data integrity, absolute and relative size of costs, relevant time periods and causes of change.

There may be circumstances where issuers are aware that future costs may be materially different to disclosures in the PDS, and this will require an explanation. For example, where a change in investment strategy is planned.

Calculating costs of OTC derivatives

The calculation and materiality of OTC derivative transaction costs is more complex and may require professional judgement because transaction costs are often implicit within the price of these derivatives.

These transactional costs must be disclosed as indirect costs except where fund managers use derivatives for hedging purposes, such as hedging currency or interest rate exposures, in which case they should be disclosed as transactional and operational costs.

Average fee metrics likely to increase

Overwhelmingly, attendees at our forum said they expect the more detailed fee estimation methodology and diagnostics will lead to a significant rise in disclosed fees. Almost a quarter (24%) expect a high impact because of the changes, with fees rising more than 50 basis points (0.50%). 37% expect an increase of between 20 to 50 basis points, and a further 37% expected a 5 to 20 basis points rise. Just 2% of attendees said they were not expecting any material change in fees.

While ASIC is aware that the new requirements could make some products appear more expensive, the regulator believes cost is only one of a range of factors customers consider when evaluating products. Asset allocation, investment strategy and performance also play a part. Greater consistency, transparency and visibility of fee disclosures will allow investors to make better-informed choices.

Issuers will need to consider how an increase in fees will be perceived by consumers and factor that into their plans. The new disclosures will make it easier to benchmark and compare fees across products and providers. A communications strategy that includes clear, timely engagement with customers should be an essential component of each organisation’s implementation process.

Darren Handley-Greaves is a Financial Services Partner with Ernst & Young Australia. The views expressed in this article are the views of the author, not Ernst & Young. The article provides general information, does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Liability limited by a scheme approved under Professional Standards Legislation.