

This Week's Top Articles

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It's a super Royal Commission, but what can it achieve?

Graham Hand

The media labels it a Banking Royal Commission, continuing the terminology adopted in calls for an inquiry over the last few years, but the [Terms of Reference](#) are much broader. Not only do the requirements focus on both superannuation (and wealth management and financial advice) and insurance, but there are curious inclusions and exclusions. It's difficult to see whether much can be achieved in the relatively brief time available to report.

Amid the flurry of both praise and criticism of the Commission, former Reserve Bank Governor and Treasury Secretary (and more recently, industry super board member), Bernie Fraser, was an example of the widespread concern. He has seen decades of such inquiries, and he said:

"You shouldn't prejudge these things of course but I don't think this sort of politically-motivated Royal Commission is going to make any significant progress."

I have had reservations in the past, such as in [this article](#) on 10 reasons not to hold a bank royal commission. We ran a [reader survey](#) a year ago and 70% of respondents opposed the idea.

None of this matters much now as the decision to proceed has been made. What can we expect when the Commission reports in early 2019?

Banks dodge some of the bullets

The people calling for a Royal Commission into the banks were no doubt celebrating Malcolm Turnbull's policy reversal, even labelling it a 'bankflip'. The Guardian Essential Report showed two-thirds of voters support a '**banking inquiry**'. But would the strong populist support have been directed at a **super inquiry**? It was not mentioned in the survey question:

Would you support or oppose holding a royal commission into the banking and financial services industry?

	Total	Vote Labor	Vote Lib/Nat	Vote Greens	Vote other
Total support	64%	72%	62%	62%	71%
Total oppose	12%	9%	20%	3%	11%
Strongly support	24%	33%	15%	30%	30%
Support	40%	39%	47%	32%	41%
Oppose	9%	8%	16%	2%	5%
Strongly oppose	3%	1%	4%	1%	6%
Don't know	24%	20%	18%	35%	18%

Source: *The Guardian Essential Report*, 28 November 2017

A closer read of the Terms of Reference reveals there might be some quiet satisfaction in the corridors of bank senior executives after they took the gamble to accept the inevitable. The bank chairs and CEOs decided to [encourage the government to hold a royal commission](#), saying "it is now in the national interest for the political uncertainty to end". They felt it was better to have an inquiry where a reluctant Prime Minister and Treasurer set the rules rather than a rabid coalition of Greens and Labor.

The banks will be pleased by the broad focus on financial services. The inquiry is called a "**Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.**" In fact, the Terms of Reference refer to financial services far more than banks, and the text is littered with superannuation directives, such as ensuring large super funds are caught in the definitions:

"an RSE licensee of a registrable superannuation entity (as that term is defined in the Superannuation Industry (Supervision) Act 1993)."

If you want to know more about RSEs, check the [APRA website](#). **SMSFs are not RSEs.**

Perhaps the most controversial reference says the Commission must inquire into:

"the use by a financial services entity of superannuation members' retirement savings for any purpose that does not meet community standards and expectations or is otherwise not in the best interest of members."

The politics are inescapable. The Government, led by Financial Services Minister Kelly O'Dwyer, has been targetting governance and board composition in the industry fund sector, and use of member funds brings fund governance to the fore and will partly distract attention from the banks. O'Dwyer told the Association of Superannuation Funds of Australia (ASFA) Conference the day after the Commission was announced:

"It is disappointing that some industry participants have used members' money in a multimillion dollar advertising campaign and lobbying effort to defeat increased transparency and accountability in the sector. One can only wonder why."

Industry reacts according to impact

Within hours of the announcement of the Royal Commission, media releases and comments from industry participants hit the newsrooms. ASFA, the peak body representing the large super funds, said:

"ASFA is disappointed the Government has included superannuation in the scope of the Royal Commission. A plethora of never ending inquiries, reviews and regulation is at odds with maintaining a system that is serving Australians tremendously well."

Meanwhile, the SMSF Association was pleased to see its sector excluded from the terms of reference, and CEO John Maroney advised:

"A Royal Commission into banking and financial services will provide an opportunity to increase transparency and improve ethics and professionalism across the financial services sector."

At the Australian Institute of Superannuation Trustees (AIST), CEO Eva Scheerlinck said:

"We think this is ideological. It is an extension of the Royal Commission into the unions, where the government probably didn't get the results it wanted. It is another attempt at getting at the unions through the super model."

Former Victorian Premier and now Chair of CBus Super Australia (an industry fund), Steve Bracks, told the ASFA Conference:

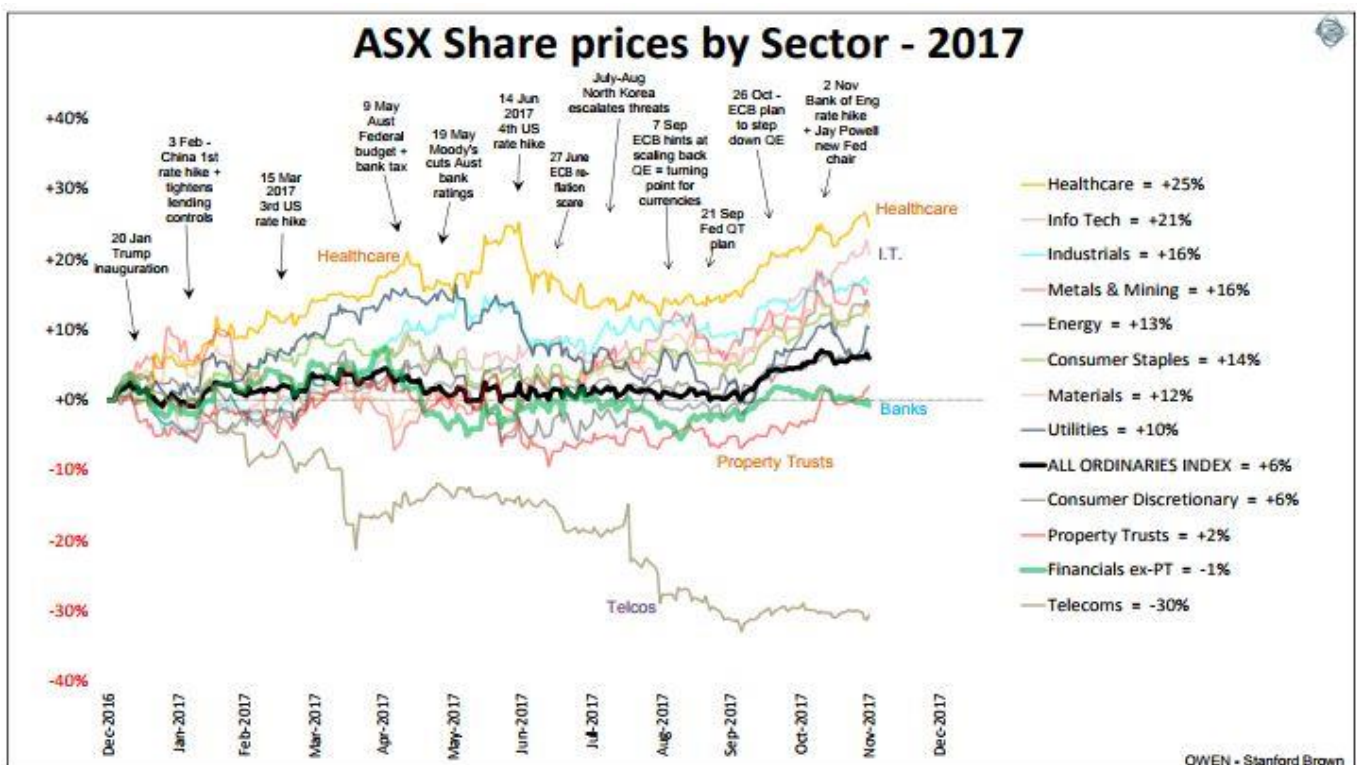
"Australia's super system is world class, and there is no evidence of gouging, fraud or unethical behaviour to warrant a Royal Commission into the industry. I don't think the Government necessarily has an axe to grind against superannuation. I think they are using superannuation as the prism to get something else. Clearly, there is an ideological agenda there, not a commitment to really fundamentally change the system, but to break the model so they can get at the equal representation and trade union involvement in superannuation funds."

The super industry has already demonstrated that 2018 will be filled with public debate on issues the average person saving for retirement neither knows nor cares about.

Implications for investing

The biggest cost is not the estimated \$75 million expense of the Commission itself. It is the massive distraction across the entire financial services sector, forcing executives to respond every day to new claims and accusations rather than running their businesses. Imagine the hundreds of millions of dollars spent on committees, meetings, consultants, lawyers, advisers and the thousands of people who will spend most of 2018 managing the fallout. Many of the Commission's issues will be populist, trivial and borderline irrelevant, but resources will be thrown at them on an enormous scale. The incoming CEO at CBA will have an overwhelming distraction when he or she should be focussing on improving the efficiency and management of the bank. It will paralyse innovation at a time of new competitive forces, especially from fintechs and global platforms, who will be given an easy ride through the morass.

Regardless of what the Commission finds, banks will become more conservative, compliance departments will expand rapidly and risk aversion will increase. There will be even more focus on the core activity of borrowing and lending and less on areas where banks have brought capital and innovation, such as in wealth management.



In 2017, the finance sector has already been a major drag (with Telstra) on the Australian market, contributing to the S&P/ASX300 Index underperforming foreign markets such as the S&P500. Admittedly, the bank scandals have contributed to this malaise, but the days of double digit earnings growth and rising dividends are over. As shown above, Financials and Telecoms are the worst sectors in 2017.

Against this backdrop of struggling growth, bankers should be banking, but instead they'll be reacting. And throughout 2018, executives and board members will file through the doors of the Commission to be interrogated like naughty children, and the media will serve up a nightly diet of undermining stories.

What can we expect from these Terms of Reference?

Yes, the banks deserve much of the criticism (see my book, [Naked Among Cannibals](#), for example), but let's look deeper into the woolly Terms of Reference. There is this curious directive:

"The Commission is not required to inquire into, and may not make recommendations in relation to macro-prudential policy, regulation or oversight."

What is macro-prudential policy? It is defined as: *"policy and regulation ... concerned with containing systemic risk, which can have widespread implications for the financial system as a whole, beyond simply the banking system."*

This seems to instruct the Commission **not to inquire** into matters which have **widespread implications** for the financial system. Strange. And what does *"beyond simply the banking system"* mean?

What will the Commissioner, former High Court Judge Kenneth Hayne, make of the directive to study:

"the particular culture and governance practices of a financial services entity or broader cultural or governance practices in the industry", and

"any conduct, practices, behaviour or business activity by a financial services entity that falls below community standards and expectations."

What can the Commission realistically recommend? What rules can govern culture? [ASIC](#) said recently:

"Culture is not something we want to regulate with black letter law ... It is an issue companies themselves must address."

And whose community standards? Most Australians benefit from healthy bank profits via their superannuation. It was only two weeks ago that Malcolm Turnbull told Channel Nine's *Today* show that a Royal Commission "doesn't do anything other than write a report".

Let me guess at the conclusions: there should be better regulatory oversight, an improved compliance regime and a recognition of the multiple needs of stakeholders. There, that should fix it.

Graham Hand is Managing Editor of Cuffelinks.

Business is more an accordion than an extrapolation

Roger Montgomery

When explaining science to my children, I often remind them that everything humanity learns, it builds on previous knowledge.

Except in finance.

The ability to frequently forget that which repeats seems unique to the investor subspecies of the human race.

Forces beyond their control

Businesses and industries don't operate in vacuums, they are subject to forces beyond their control. Those forces might be social, technological, climatic, competitive, or legislative and those forces all represent changes that can be beyond the ability of company boards to even anticipate, let alone respond.

Companies may be met with different challenges in different jurisdictions, dramatically changing the economics of the enterprise. Change in business appears to follow the expansion and contraction of the bellows of a piano accordion. Expand the accordion: fragmentation. Contract the bellows: consolidation. Fragmentation, consolidation, fragmentation, repeat.

Take, for example, the newspaper business. How different today are our newspapers from only 30 years ago? I can remember delivering the paper, whose weight could be measured in kilograms, on Saturday, to homes that received a morning and afternoon edition.

The classified revenue rivers of gold were not enough to shield publishers from the emergence of more convenient searchable and sortable online versions who would continue to appear and fight until they won. Fragmentation.

Eventually of course, consumers will become impatient with separate apps for real estate, cars, jobs, and the news. Through no fault of their own – perhaps asset prices slump generally, amid a failure of record levels of triple CCC-rated junk bond debt to be refinanced – a new and more exciting offering emerges. Perhaps it's an integrated newspaper with compelling user-directed news and classifieds with the bonus of fully interactive ads and Amazon Prime delivering anything you touch to your door before you've finished reading. Consolidation.

But perhaps we don't even have to be as far-fetched to see the piano accordion in action.

The here and now: Ubers and taxis

Witness the evolution of the personal transport industry. Through legislation and or acquisitions, a handful of taxi companies became regional monopolies. So dominant and unassailable were their legislated moats that customer service was irrelevant. Heck, in some cities, every single taxi changed shifts at the same time. If you were in a rush to the airport – walk! Consolidation.

Then the gig economy emerged, along with ride sharing and transit lanes. With customer service a priority, social momentum drove Uber's expansion. So emboldened by its social imprimatur was the company that it expanded in some countries in the face of government opposition. Fragmentation.

But gig economies, and the companies that monetise them, rely on part-time workers willing to operate without employment contracts and their protections. Concurrently, operators are not required to comply with licencing systems and processes such as insurances and regular mechanical checks designed to protect the public.

In Sydney, a taxi operator is required to submit their vehicle to frequent and costly safety checks. In London, a cab driver is required to sit 'The Knowledge' test and demonstrate that more than 25,000 streets have been committed to memory. Uber vehicle owners have no such requirements.

In 2018, Europe will decide whether Uber should be regulated as a taxi service, bringing its labour-hire practices under the same terms as any other transport system operator and dramatically changing its economics.

But it's not a stretch to imagine the deeper-pocketed Uber surviving the change, and the new regulatory costs dissuading new entrants. Consolidation.

Under another scenario, benevolent Uber shareholders could grow impatient with the lack of return on their capital and cease filling the hat with cash every time it is passed around. Fragmentation? Consolidation?

The piano accordion

Tech stocks have commanded the lion's share of investor attention in the last 12 months and a significant proportion of the market's return can be attributed to their gains. But investors are mistakenly projecting their growth to continue into the distant future, uninterrupted and unimpeded.

He didn't have Airbnb, Uber, Google, or Facebook in mind when he gave his famous Farewell Address but perhaps George Washington had a piano accordion in mind when he said,

"It is in the very nature of power that it will expand until it is checked by an opposite power."

When consolidation of media power, personal data, or plain old return on capital is concentrated among a few, society repels and rejects. And whether through populist governments or by their direct anointing, consumers cause the piano accordion to expand and the industry in question to fragment again.

All the profits of the disruption will not accrue to the disrupter. Throughout history, when new technology emerged to change the world – think cars, air travel, and television – it was neither the innovator nor the industry that earned large profits. In many cases, the consumer benefited the most.

Extrapolating current conditions into the future, and assuming that the rapidly changing forces that birthed the new player will not then challenge it, is a mistake many investors repeat.

Many investors unrealistically assume current circumstances to continue without interruption. It's the basis for our divergent expectations framework in our long/short portfolios.

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.

Future Fund: 5 megatrends are changing everything

Graham Hand

It's always useful to study the asset allocation of Australia's sovereign wealth fund, the Future Fund, as it takes an unusual approach to investing. Whereas most institutional superannuation funds hold at least 25% of their assets in Australian equities, the Future Fund's allocation at 30 September 2017 included only 6% to Australian equities. The main categories where it is overweight versus the industry are private equity at 12% and alternative assets at 15%. Cash is a healthy 19%. That's nearly half its \$134 billion in assets in these three categories, two of which barely move the needle for most SMSFs.

The main reason for this structure is the desire to protect capital. Its investment mandate is to achieve CPI plus 4% to 5% "with an acceptable but not excessive level of risk". In its [investment beliefs](#), it shows why assets such as private equity and alternatives figure highly:

*"Markets can be inefficient, albeit that the degree of inefficiency varies across markets and over time. Skillful management can add value after fees, and such added value can be **uncorrelated** to market returns over time and can therefore be highly beneficial to the total portfolio investment characteristics. Capturing skill-based returns requires an appropriately resourced and disciplined process."* (my bolding)

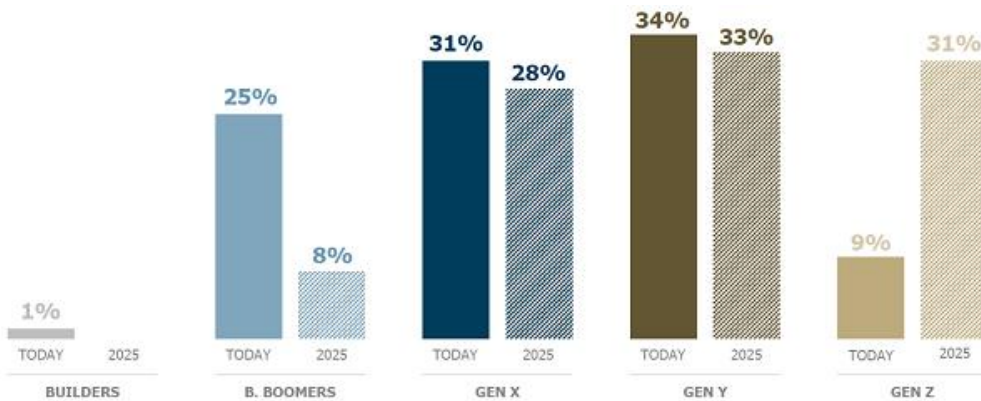
Their beliefs drive them towards long term, illiquid and uncorrelated assets to extract returns for risk.

Five insights from the 2017 Sohn Conference

The Future Fund's Chief Investment Officer, Dr Raphael Arndt, spoke at the recent Sohn Hearts and Minds Investment Leaders Conference. He identified five megatrends changing the world of investing:

1. The end of the leverage tailwind means asset prices are not supported by as much debt, making price growth less sustainable.
2. Declining population growth will reduce economic growth, with the United Nations forecasting global population growth will fall from the current level of around 1.5% to 0.25% by the turn of the century.
3. Changes in the workforce and consumer preferences mean the best future investments will differ from the past, because younger generations consume and work differently. He included this chart showing that by 2025, baby boomers will comprise only 8% of the Australian workforce, while both millennials (Gen Y) and Gen Z (roughly, those born after 2000) will each be about one-third.

Changes in the Australian workforce, today and 2025



Source: Future Fund, Mark McCrindle

- Income inequality is increasing populism and populist policies, with many people in developed countries receiving little growth in wages in the last 20 years. The rich have become richer through asset price growth but populist policies will reduce economic growth.
- Technology is changing how society interacts, with new platforms achieving adoption faster than at any time in history.

Investments can become worthless quickly in the face of disruption by new technologies or competitors, and the past should not be taken as a guide to the future. This is one reason why the Future Fund holds so much cash. He emphasised the Fund’s desire to find returns which are uncorrelated to the equity markets and companies adversely hit by these trends, which explains the alternatives (or hedge fund) allocation.

Over the last seven years, the 9.9% return delivered by the Future Fund comfortably exceeds the CPI+ target of 6.5%.

Graham Hand is Managing Editor of Cuffelinks.

The imposing trajectory of ETFs

Vinay Kolhatkar

An exchange-traded fund (ETF) is an open-ended managed fund listed on a recognised stock exchange. Investors in ETFs own interests in the pooled assets of a managed fund. Open-ended means the funds continue unless terminated.

EY research survey

EY conducted research into the prospects for ETFs, based on interviews with ETF market makers, service providers and promoters who collectively manage 85% of global ETF assets. The results are available in the report titled [Global ETF Research 2017: Reshaping around the investor](#).

The headline finding is: Global ETF assets which were US\$417 billion in 2005, reached US\$4.4 trillion by the end of September 2017. That is an imposing cumulative annual growth rate (CAGR) of around 21% per annum.

EY expects the trend to continue. The forecast is a level of US\$7.6 trillion by the end of 2020, with between 15-25% of inflows coming from new investors. Two-thirds of respondents believe that most fund managers will have an ETF offering in the next five years.

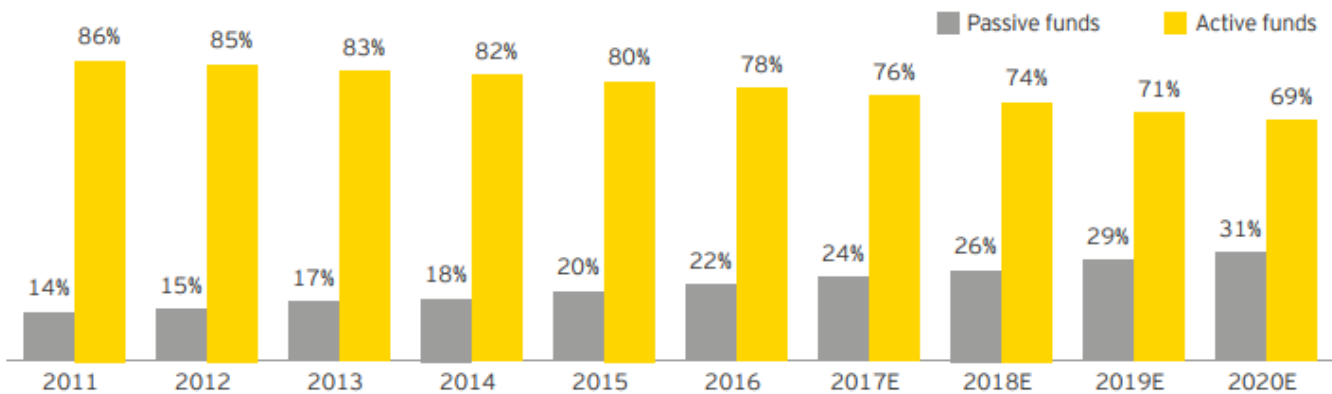
These growth numbers, incessant already for 12 years, projected for at least another three, should make us ask how and why.

It's undeniable that passive investments are winning market share by securing more inflows than active strategies. Says EY: "There is a growing view that, after costs, very few active strategies consistently outperform index-based investments."

Initially, ETFs benefited because they provided index replication at a lower cost. According to EY, other trends that have worked in favour of ETFs are the shift to self-directed retirement saving, low yields, regulation, and digital distribution.

However, as unlisted index providers find ways to cut costs, index-based ETFs will also need to trim theirs to stay competitive. EY research suggests that passive funds will exceed active funds by 2027. In the US, says EY, "the 'shift to passive' has now been at work for 10 years." Market participants nevertheless concede that both active and passive strategies can create value. Active houses are now focusing on illiquid assets that ETF providers cannot easily replicate. They are lowering fees or shifting fee structures to a larger performance-based component. Many managers are issuing ETFs themselves, as well as offering innovations such as offering both listed and unlisted classes of capital. Figure 3 from the Report shows passive gaining market share.

Figure 3 – Market share percentage of total net assets of globally regulated open-end funds
Source: EY



Industry response

The positive outlook for ETFs assumes that the industry will be responsive to such challenges.

Most ETFs have been equity based, but even active institutional investors in search of better but stable yields could look toward fixed-income ETFs. "Active investors are even supplementing portfolios of individual issues with bond ETFs in order to quickly capitalise on investment opportunities," says BlackRock's Brett Olsen.

The area of socially responsible investment (SRI)-themed ETFs could be primed for growth as demand for environmental, social and governance (ESG)-screened investing increases.

The growing economic engine of Asia also makes it a target. The EY report quotes:

"In Korea, an active equity ETF drew the largest inflows in the first half of 2017, and Hong Kong's approval of leveraged and inverse (L&I) funds led the number of Asian L&I ETFs to jump from 79 to 163 in the year to September."

The survey participants stress that the industry must adapt continually to regulation, retail and institutional investors' needs, and to competition from traditional funds even as their managers embrace the product.

Outlook for Australia

EY's Antoinette Elias says,

"In Australia, we continue to experience significant growth, with the ETF market capitalisation increasing by 39% in the last 12 months to \$33.3 billion as at 31 October 2017. The local ETF market is taking a growing share of the traditional managed funds space and continues to be retail investor driven, rather than institutional."

Thus, the Australian growth story is no less spectacular than the worldwide trend, although it has started later.

Other research corroborates the EY view, such as the CFA Institute Research Foundation release called, "[A Comprehensive Guide to Exchange-Traded Funds \(ETFs\)](#)". Their take:

"... on any given day, ETFs typically represent between 25% and 40% of the total dollar volume traded on US exchanges. In short, in just over two decades, these innovative financial products have gone from an afterthought to one of the most important forces shaping how investors invest and how the market itself functions."

Brief pros and cons for investors

Retail investors need to keep in mind the essential pros and cons of ETFs, including:

Pros

1. Investors can usually buy and sell an ETF on an exchange at very close to the Net Asset Value, often at a cheaper cost than unlisted managed funds.
2. Through ETFs, retail investors can access investment strategies normally reserved for large or institutional investors, such as shorting, long/short bullion or commodity prices, and other riskier investments.
3. Investors can sometimes short an ETF, thereby creating the inverse outcome of the ETF itself.
4. ETFs make it feasible to get exposure to multiple overseas markets and complex investment strategies with a relatively small amount of money.

Cons

1. Having an instrument listed is no guarantee of sufficient liquidity, such as where the market is the underlying securities is disrupted (high yield bonds are a good candidate). Exits could be harder, or costlier, than from a managed fund during volatile market conditions.
2. Set rules define and calculate repurchase values in managed funds, but ETF share values depend on market sentiment and the activities of market makers.
3. An ETF does not make the underlying investment any less risky. Some retail investors may lose sight of this.

It's the last of the cons that is worth repeating. Listing an asset class does not change its investment outcomes.

Vinay Kolhatkar is a freelance journalist, novelist, and finance professional. This article is general information and does not consider the circumstances of any investor.

IPOs, information asymmetry and house prices

Ashley Owen

One of the reasons I generally don't buy into company floats (initial public offerings or IPOs) is a little thing called information asymmetry. This term was popularised after George Akerlof (US Federal Reserve chair Janet Yellen's husband) wrote a [paper](#) in 1970 about the used car market entitled 'The market for lemons'. It earned him a Nobel Prize in 2001.

Why sell a good company?

It's a fancy term for a simple idea. If the seller of an item is singing its praises, why would they want to sell it? They are the ultimate insiders so they must be selling it for more than what they know it is really worth. The owner knows much more about it than I do? Before I buy anything, I stop and ask myself: *What does the seller know that I don't?* If it's such a good company, why don't they want to keep it or buy more?

Company floats are an example of how this can often lead to bad outcomes for unwitting buyers, especially where the owners are taking cash out of the float. In some floats, the vendors are the founders, and at other times they are private equity firms seeking to offload their stake for a profit. Dick Smith and Myer are prime examples.

When a company floats, the founders are the ultimate insiders. They have spent years learning everything they possibly could about the company, the market, competitors, profitability, cash flows, assets, liabilities, the outlooks for supply and demand – much more than I could possibly ever know. If they know all of this and they come to the conclusion that they want to sell it, why would I want to buy it?

There are several cases of good floats where the vendors cashed out, notably when governments sell for strategic reasons or because they can't afford to keep injecting the capital required for growth. Commonwealth Bank and Cochlear were outstanding successes for investors in their floats. But not all government sell-offs are good. Telstra is a prime example of the government taking advantage of a crazy bubble market to sell out at ridiculous boom-time prices that never made any fundamental sense.

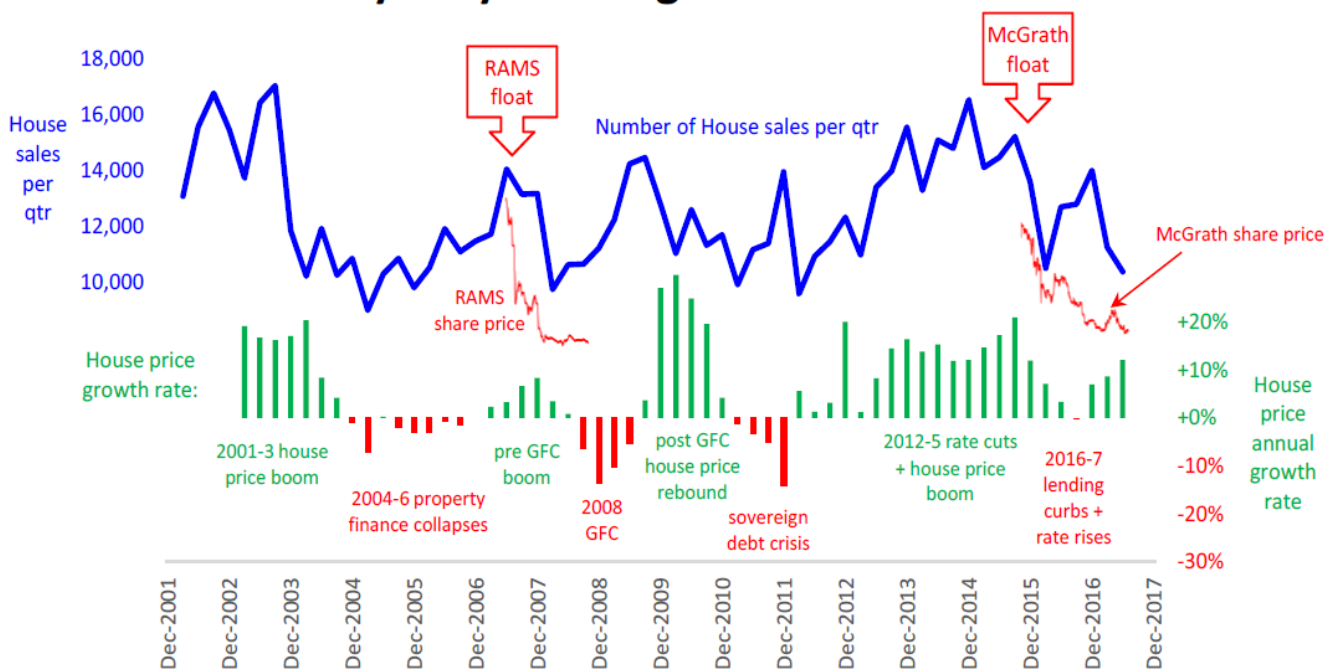
IPOs of private companies can tell us a lot about how the founders/vendors view its prospects. Look at what they do rather than what they say. In the case of the float of mortgage lender RAMS in 2007, nobody knew more about the mortgage market, the bad debt cycle, and the internal books of RAMS than founder John Kinghorn. In the float, he pocketed \$650 million cash at the top of the mortgage market just before the sub-prime crash. Within weeks, RAMS issued profit downgrades and corrections to its accounts. Within three months, the share price fell 90%. The [New York Times](#) called it the 'worst IPO of the decade'.

Kerr Neilson floated his funds management company Platinum at the top of the boom in 2007 right before the GFC crash. It was a stroke of market-timing genius. The \$5 IPO price was hyped up to \$8.80 on the first day of trading, but the *very next day* it started an almost straight line 70% decline to \$2.75. It is still below its high more than 10 years later.

What about the Sydney housing market?

Not many people know more about residential property than John McGrath. He picked the perfect time to pocket \$37 million in cash when he floated his McGrath real estate agency in December 2015. If he was bullish about housing, he would have kept his company. The share price peaked at \$1.88 the day after it listed and the *very next day* it started its almost straight line 70% slide to where it is now. The market cooled, regulators introduced new controls to slow lending and clamp down on foreign purchases, and banks raised rates.

Sydney Housing market + IPOs



OWEN

I have missed out on a few of good IPOs over the years, but I have avoided hundreds of duds by watching what people do rather than what they say. Successful investing is mostly about not blowing up your money in the duds.

Ashley Owen is Chief Investment Officer at 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.

SMSFs and the control over estate planning

Peter Hogan

The basic requirements of an SMSF include having one to four members, where each member is a trustee. The rules of any particular SMSF, set out in clauses of the trust deed and related documents (the 'governing rules'), determine how to reconstruct the trustee structure and death benefits upon the death of a member.

SMSFs provide members with additional control over their estate plans compared with typical retail, industry and employer funds. This is why the trust deed and related documents are critical in the estate planning process to determine what rules apply for SMSF trustees and members.

Implementation of deceased member's wishes

There are various ways an SMSF's governing rules may deal with the provision of death benefits to dependants. Depending on who is controlling the SMSF after the death of a member and the provisions in the trust deed on who should be paid a death benefit, the risk is that the deceased member's wishes may not be implemented.

An SMSF trust deed may give total discretion to the surviving SMSF trustees to evaluate all potential eligible dependants of the deceased member and choose to whom and how much of the death benefit will be paid.

This type of clause can be invoked where these are the wishes of the deceased member, in order to provide maximum flexibility to determine who should be paid at the time of their death.

Alternatively, such a clause could apply where a binding death benefit nomination has failed, and by default, it falls on the trustees to decide who is to be paid and how much. A binding death benefit nomination may fail simply because a person nominated was a dependant at the time the nomination was created but was not a dependant at the time of death. For example, a former spouse may have been nominated and no alternative provided for.

Executor acting as trustee

Unlike other super funds, the executor of the deceased SMSF member's estate can, and usually does, step in to act as trustee in the place of the deceased until all death benefits are paid or start to be paid. Where there is more than one executor, any number of these executors can act in the place of the deceased member as a trustee.

Once appointed, the executor takes on the full responsibility of a trustee and is subject to the same obligations and liabilities as the other trustees of an SMSF. Their appointment should be confirmed and accepted in writing. An ATO trustee declaration should be signed, and retained with fund records. Trustees are obligated to maintain records of changes to individual trustees or directors of a corporate trustee of their SMSF for 10 years.

Trustee succession

The tensions and risks that occur when wills and the distribution of an estate are managed poorly by an executor or court-appointed administrator can also arise with an SMSF. This is particularly so when trustees have discretion to decide how and to whom a death benefit will be paid.

Where there is no provision in the SMSF trust deed to allow a binding death benefit nomination or reversionary pension nomination, or none have been made or have been made invalidly, most trust deeds will give surviving trustees the power to determine which of the eligible dependants of the deceased should be paid and how.

To help ensure the payment of death benefits and smooth operation of the fund, it is important that the governing rules of the SMSF deal with trustee succession and the parameters of the trustee's duties and powers.

The law allows, but does not compel, the executor of the deceased's estate to act in the place of the deceased as a trustee of the SMSF in which the deceased was a member. Further, the appointment is only from the date of death until payment of, or the commencement of the payment of, the death benefit.

Once a death benefit has been paid or starts to be paid, the executor must resign as trustee and the SMSF has up to six months from this time to rectify its trustee structure to satisfy the definition of an SMSF under superannuation law.

Trustee succession planning is important in funds where a member would prefer the remaining trustees to exercise discretion after their death rather than binding them to any course of action.

Alternative structures

Alternatives to having an executor step in as trustee are:

- Another eligible person is appointed to act as a second individual trustee if the SMSF becomes a single-member SMSF. This person does not need to become a member of the SMSF but must otherwise satisfy the eligibility criteria required to be appointed as a trustee. They must accept their appointment in writing and execute a trustee declaration within 21 days of being appointed, as is the case with any new trustee appointment.
- Such a new trustee does not need to resign once a death benefit has been paid. Their appointment also means that the SMSF continues to meet the definition of an SMSF and so no further action is required to amend the trustee structure.
- Where the SMSF has a corporate trustee, a sole surviving member can continue as the sole director of the corporate trustee. The fund will continue to satisfy the definition of an SMSF. ASIC would need to be informed of the removal of the deceased member as director.
- A second director, who also does not need to become a member of the SMSF, may be appointed. The appointee must satisfy the requirements to be appointed as director. They need to accept their appointment in writing, execute the trustee declaration and ASIC would need to be informed of their appointment as director. No further action is then required to amend the trustee structure.
- In circumstances where a sole surviving member of the SMSF does not wish to continue with the SMSF for whatever reason, there may be no need to appoint anyone else as a second individual trustee or second director of the corporate trustee.

Provided the trustee can pay out the required death benefit, rollover entitlements to alternative superannuation arrangements, and wind up the SMSF within six months of the death of the member, then the fund is deemed to have satisfied the definition of an SMSF for that period. No additional appointments are necessary.

Peter Hogan is Head of Technical at the peak industry body, the [SMSF Association](#). This article is general information and does not consider the specific circumstances of any individual.

Investors should loiter around the lifeboats

Jonathan Rochford

Imagine it's 1912, you find yourself on the Titanic's maiden voyage and you know that the ship will sink. However, you're sketchy on when it's going to happen. What should you do?

This scenario is similar to the current predicament for investors where almost all asset classes are expensive when using standard valuation techniques. The answer for both situations is the same. You should loiter around the lifeboats.

The current environment

In recent months many have called out the predicament faced by investors. Global price/earnings ratios for stocks are high and the [quality of earnings](#) used in those ratios is questionable. Credit spreads are low for both

investment grade and high yield debt in pretty much every jurisdiction. Commodities have performed well this year, largely due to the credit-inflated economic growth of China. Emerging markets can look cheap, but their continued growth could be threatened by a weaker China, a stronger US dollar or domestic instabilities. Returns on cash and short-term debt instruments are profoundly negative after tax and inflation in Europe, Japan and the US. Investors seem trapped everywhere they turn.

The temptation to just keep dancing

The former CEO of Citigroup's infamous comment that "as long as the music is playing, you've got to get up and dance" highlights a major behavioural impediment to solid long-term returns. The temptation is to ignore the risk right in front of you and buy investments that hold out the prospect of a quick win. Institutional fund managers are measured quarterly or monthly and can feel pressure to constantly outperform, especially if they charge substantial fees. Individual investors can lose focus when their friends and neighbours brag about how much they have made on the latest fad investment. We all struggle to keep the discipline and focus needed in these exuberant times.

Don't play 'pick the trigger'

Many investors spend their time speculating what will be the trigger that starts the next downturn. The theory is that if you pick the trigger you can sell out prior to others, capturing all of the upside and none of the downside. In practice, the trigger for market peaks is rarely knowable in advance. Most times, the trigger event is a narrative created after the event to fit the facts.

Rather than focussing on potential triggers, investors should focus on the risk/return characteristics of what's in their portfolios. Stock prices and credit securities follow earnings and cashflows over the medium term. Time spent on detailed earnings and cashflow analysis (which increasingly few do) will be far more fruitful than time spent analysing the widely-known economic, political and geopolitical risks.

The lifeboats in credit

In my home ground of credit, loitering around the lifeboats means staying short in credit duration and staying senior in the capital structure. Fortunately, making these shifts is often easy to execute when markets are exuberant as the increase in yield for taking extra risk is minimal.

For instance, the gap between spreads on BB rated and B rated credits is currently low as is the gap between senior secured leveraged loans and subordinated high yield bonds. Going against the trend will cost a little in the yield achieved now, but that gap can be made up 10 times over when the next downturn occurs. If correctly implemented, in the next downturn an investor will have cash from maturing assets to redeploy into bargain credits rather than a portfolio of distressed debt with substantial mark to market losses.

The lifeboats in equities

Equities is a tougher sector to implement a loitering-around-the-lifeboats strategy as there is more potential upside to be missed by keeping a conservatively-positioned portfolio. Stocks that are based on hope and hype rather than fundamentals, like Netflix and Tesla, have the potential to push much higher before correcting. Greater discipline is required to persist with a value orientated approach when growth stocks are shooting the lights out.

In this regard, I look to the equities managers I respect most, who have a track record of long-term outperformance of benchmarks. Whilst they each have slightly different approaches, there are consistent themes in their recent commentaries.

First, they are all holding higher than usual cash levels.

Second, there's a willingness to push beyond the large capitalisation benchmarks in order to find cheap stocks.

Third, there's a strong focus on finding companies that are savvy in their deployment of capital, shown by consistently high returns on equity.

Fourth, their preferred stocks have a low market capitalisation relative to their future earnings. This might be a low P/E for a mature company or an average P/E for one with above average growth prospects.

Lastly, there's minimal exposure to cyclical stocks.

Conclusion

The innate human desire to want to keep up with the Joneses is an investor's worst enemy in bullish markets. Ultra-low cash rates and quantitative easing have helped markets to continue to post gains beyond what company earnings and GDP growth support. [Investors are increasingly all-in](#), having become numb to risk in a time of record low volatility.

By implementing a loitering-around-the-lifeboats strategy, investors will likely miss out on some late-stage gains. However, the potential pay-off is far larger than the missed gains if the overdue correction occurs. The more investors believe that markets are unsinkable, like the Titanic, the more likely it is that an iceberg is dead ahead.

Jonathan Rochford is a 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.

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