

This Week's Top Articles

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Kitces Part 1: How robo misunderstood the advice model

Graham Hand

Introduction to Michael Kitces (MK), interviewed by Graham Hand (GH)

Michael Kitces is recognised as the publisher of the #1 financial planning industry blog in the United States, based on awards and surveys. His website, kitces.com, is also home to the popular Nerd's Eye View. He speaks at 50-70 conferences a year, consults widely to financial planning groups, and is a Partner and Director of Wealth Management with Pinnacle Advisory Group (Washington DC).

I met with him in Sydney at the Portfolio Construction Forum's Finology Summit 2018, where he presented two keynote addresses including 'Robo-advisors are NOT the future (but technology is)'. He presented a slide which showed total robo-advisor assets at US\$20 billion versus total US investable assets of \$33.5 trillion. That is 0.06%.

GH: Your writing highlights how standalone robo advice businesses have struggled in the US. Putting aside the potential of robo as a technology, do you see a future for a pure robo advice business model?

MK: Not much of one. My expectation in the US from the beginning when all these startups were proliferating was that one or two would survive, they would be the first to get to some level of economies of scale and they would be the brand leaders in the space. Ultimately, all they really are is an asset management company in the distribution business. Asset management distribution is highly competitive, it has horrific client acquisition costs and it's dominated by brand. So one or two could grow large enough to establish themselves, at least in a niche. And everybody else would die on the vine.

The robo advisors took financial advice job titles too literally. They figured what financial advisers do to create portfolios seems relatively simple, so we can replicate that for a fraction of the cost. They did not understand that the overwhelming majority of financial adviser compensations are commissions for product distribution. They are not actually paid for advice. They are paid for product distribution. And the robos brought an operational efficiency solution to a marketing problem. It was like bringing a knife to a gun fight ... it doesn't go well.

During the dot com era, there were 100+ online brokerage platforms that tried to emerge. One or two independents were survivors, like etrade, the rest was dominated by incumbents such as Schwab and

Ameritrade and Fidelity. I expect the same thing with robo, as I forecast from the start. One or two like Betterment or Wealthfront might at least survive, although I don't know that they will ever justify the valuations they have set.

All the rest are gone. When FutureAdvisor was bought, I said this is the highest price you will ever see for a private transaction for a robo advisor. BlackRock was willing to pay a premium for a first mover opportunity, but now they seem unable to capitalise. The gap is so far between B2C and what enterprises now need that even BlackRock has been leapfrogged by the second-coming players – the rise of what we're now calling Model Marketplaces – and now BlackRock is trying to push their funds through any technology company as a distribution channel. In theory, they bought FutureAdvisor so they did not have to do that, but they are pushing the others because FutureAdvisor did not work out as well as hoped.

GH: The other problem is that most robo advice offers in Australia are priced around 80 to 100 basis points, while many large incumbents are priced around 60 basis points (0.6%). Robos are not even achieving a fee structure like Wealthfront and Betterment have done at 15 to 25 points.

MK: It's a market-sizing thing. The dynamic for all these are: assume you've achieved scale then work backwards to your pricing. The hope is the VC funds bridge their funding needs between here and scale. The US market is deep enough that if you get that scale, you can justify that price point, but here the market is not as large. When they work backwards through the math, ironically you end up with companies that are less cost efficient than existing products.

GH: The other issue you write about a lot is the Cost of Acquiring the Customer (CAC). Do you think startups completely misunderstand that?

MK: A few of them are learning it now watching the troubles of the others, but again, Betterment and Wealthfront thought the problem was the cost to deliver advice. It wasn't actually advice delivery. It was the cost to distribute asset management through advisers with commission compensation. Literally, the compensation was a distribution charge of the asset manager.

They didn't come to the table with a superior asset management distribution strategy, they came with a superior financial advice portfolio application system, which is not what the cost was and not what advisers were being paid for. We had put this 'adviser' label on our business cards and they took us at our word, that this was our primary value proposition.

GH: I look at the US robo offers and see the price point at 15 to 25 points, and would have expected a lot more success. Why is it at such low pricing that Betterment and Wealthfront have not done better? They are not startups anymore, they've been around for eight years.

MK: These are asset management distribution challenges. It's not 'If you build it, they will come.' If price were the only determinant, why doesn't Vanguard have a 99% market share? As immense as they are, Vanguard's market share is about 12%, which took 40 years of brand building. Investors are not hyper-rational, extremely efficient consumers who can identify the best deal, identify legitimate players from illegitimate ones, and then be willing to move.

Financial services is one of the lowest trust industries around the world, but we built something that should have been intuitively obvious in the lowest trust industry out there. People think a) it's a fake price and I'll be stung on the back end, or b) you can't possibly know what you're doing because nobody else is using it. It gets back to, "I don't trust the brand promise that your software is making." Building a high trust brand in a low trust industry is ludicrously expensive. It's not a technology problem. It's not a cost problem. It's an asset management distribution problem.

GH: Does the advice model need face-to-face contact to build trust, the 'warmth' discussed at this conference.

MK: The most trusted brand in the US is Amazon. All computers, no human contact. Can't even get a human if you want one. We don't have any problem learning to trust technology companies, because they are doing it by default in a trusted industry. Robo advisors try to frame themselves as tech companies, but they are managed accounts in the asset management business. Good luck scaling that fight for the brand.

Graham Hand is Managing Editor of Cuffelinks. This is Part 1 of the interview with Michael Kitces, and Part 2 next week explores where financial advisers have gone wrong and how they should position for the future.

Currency risk deserves more than a coin toss

Joseph Bracken And Robert Chapman

More Australians are investing in offshore equity and bond markets, but they may underappreciate how currency fluctuations either cushion or exacerbate gains and losses in their portfolio.

For many investors, the decision to hedge the currency exposure on offshore investment portfolios is often seen as a binary choice akin to a coin toss – heads or tails, hedged or unhedged.

Investors spend much of their effort deciding which asset class to allocate to, but often devote less consideration to how decisions around currency exposure can dramatically improve the risk-adjusted returns of their portfolio.

The hedging decision and avoiding regret

When investors buy foreign assets, they obtain exposure not only to the underlying securities but also to foreign currency. Movements in exchange rates play a significant role in determining the performance of a foreign investment. A second-order decision is whether to hedge this foreign-currency exposure. Many investors implicitly weigh up their outlooks for the respective currency and their appetite for losses due to adverse currency movement (the so-called 'regret tolerance').

Regret theory assumes that investors are rational but base their decisions not only on expected payoffs ('value') but also on expected regret. Sebastien Michenaud and Bruno Solnik (2008) found that risk-averse investors dislike volatility, whereas regret-averse investors may prefer volatility to avoid regret for giving up on the large gains that may materialise.

They found that many investors, when considering both volatility and regret, tend to err towards regret avoidance, and under-hedge even when fully hedging is the optimal decision based on all available information and traditional risk-return optimisation.

It is little wonder then, according to their research, that approximately 39% of currency investors do not hedge, 34% adopt a 50% hedging strategy, 14% adopt of a 100% hedging strategy, and the remaining 13% adopt some other hedge ratio.

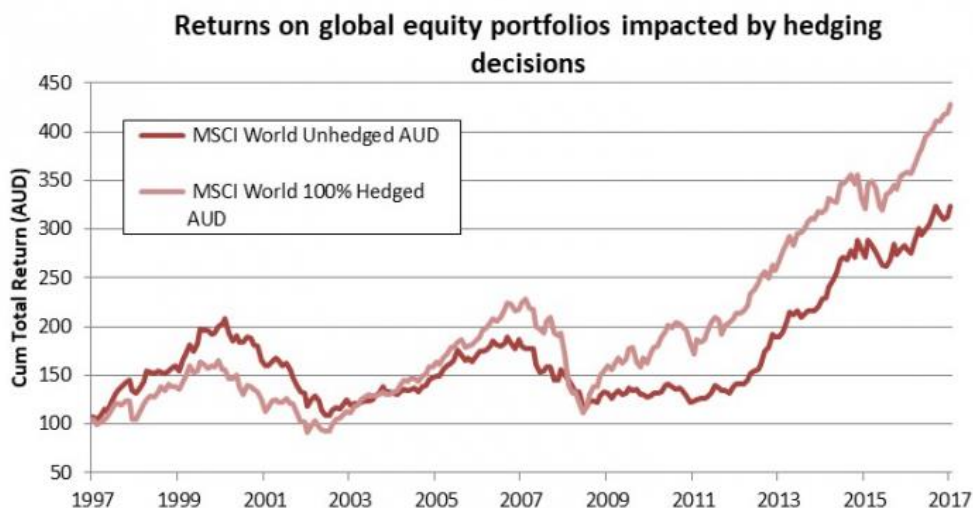
The impact of currency on global portfolios

Whilst many investors make a binary choice to hedge 100% or not, our own research indicates that the optimal hedging decision varies considerably over time.

For Australian investors:

- If the AUD is appreciating, a hedged global equity portfolio outperforms an unhedged one.
- If the AUD is depreciating, an unhedged global equity portfolio outperforms a hedged one.

This can be seen from the graphs and table below.



MSCI World Annual Return		
To Sept 2017	Unhedged	100% Hedged
1 Year	15.9%	19.6%
3 Years	12.3%	10.7%
5 Years	18.1%	15.0%
10 Years	6.1%	6.7%
20 Years	5.7%	7.3%

Source: Bloomberg, MSCI

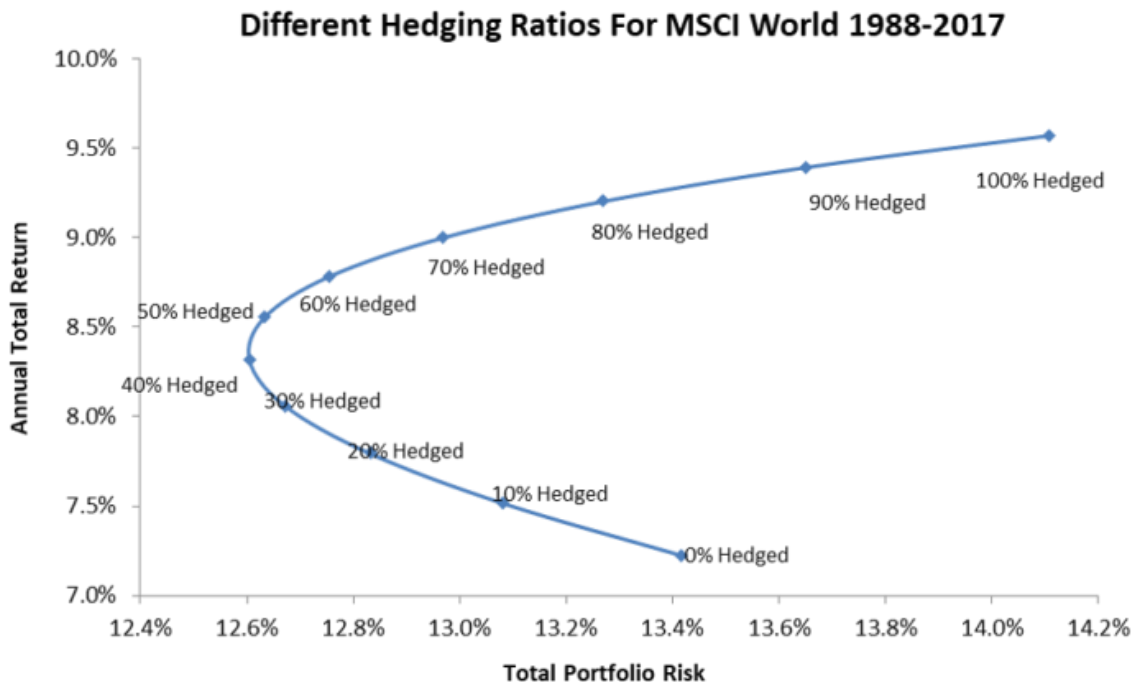
The outperformance can be substantial and persistent. In the table above, the unhedged global equity portfolio has outperformed the hedged by 3% annually for the last five years. That is, the AUD has strengthened and it was better to be hedged than exposed to the 'weaker' global currencies in an unhedged position.

So then, what is the 'best' hedging ratio that both captures good returns and prevents extremes of underperformance?

The optimal hedge ratio over the (very) long term

The AUD is often characterised as a commodity currency, meaning that its movements are correlated to commodity price cycles. This means that the AUD appreciates during economic booms when commodity prices are higher and depreciates when the cycle turns.

To figure out the optimal hedge ratio, a set of different portfolios were created using different hedging assumptions. Their returns vs. risk were then plotted over time, essentially creating an efficient frontier (series of possible return outcomes for a given level of risk) for different hedging solutions, as illustrated below.



MSCI World		
	Unhedged	100% Hedged to AUD
Annual Return	7.2%	9.6%
Annual Risk	13.4%	14.1%
Return/Risk	0.5	0.7

Source: Bloomberg, MSCI, Tempo AM

The graph above illustrates that, over this long run (about 30 years), the hedged equity portfolio generally outperforms the unhedged one. Unfortunately, while this analysis is interesting, it is not very useful for investors.

The difficulty in figuring out an optimal hedge ratio is that this ratio changes over time. Certain hedge ratios are 'optimal' for a certain time interval while others are 'optimal' for other time intervals.

For currencies, 'optimal' is a slippery concept

It is worth noting that while the 40% – 100% hedging ratio illustrated above is optimal over the very long term, during specific periods other hedging ratios may be better to avoid cash drawdowns required by hedging counterparties.

For example, during the GFC from 2006 to 2008, where the AUD/USD dropped from 0.98 down to 0.60, the best hedging strategy was to have no hedge at all (that is, exposure is left open to foreign currencies which increase in value as the AUD falls). Maintaining a 100% hedged strategy would have cost an extra -2.4% per year over these three years compared with not hedging.

However, extending the analysis an extra two years and including the period from 2009 to 2010 when the AUD/USD bounced back from 0.60 back to over 0.90 again, the optimal solution would have been to 100% hedge. It's exactly the opposite of the previous analysis!

In this second scenario, maintaining a 100% hedge ratio over the full timeframe would have benefited Australian clients by nearly 6% annually over an unhedged portfolio.

Conclusions

The complexity of investing requires that portfolio management is best done by asset class or sector specialists, and currency should be no different.

Currency management requires specialist portfolio management skills, systems, analytical frameworks, and sell-side broker relationships that are different from mainstream asset classes. Specialist currency managers are also well placed to ensure trading execution is done in the most cost- and timing-efficient manner.

Furthermore, using currency hedging specialists, as opposed to embedding currency management within investment products allows for portfolio managers and products to be adjusted independently of the currency overlay avoiding unnecessary tax consequences and trading.

*Joseph Bracken and Robert Chapman are principals of [Tempo Asset Management](#). Tempo is a global equity alliance partner of Fidante, a sponsor of Cuffelinks. This article is in the nature of general information and does not consider the circumstances of any investor. Reference: Michenaud, S & Solnik, B., 2008. Applying Regret Theory to Investment Choices: Currency Hedging Decisions, *Journal of International Money and Finance*, vol. 27, no. 5*

Commodities rebound still running

Ashley Owen

Mining has always played a major role in Australia's stock markets, from the first days of informal share markets in dusty mining towns in the early-mid 1800s and up to today. About every 30 years, there is an almighty mining boom when great fortunes are made quickly, followed by busts when fortunes are lost, and many long years waiting for the next boom.

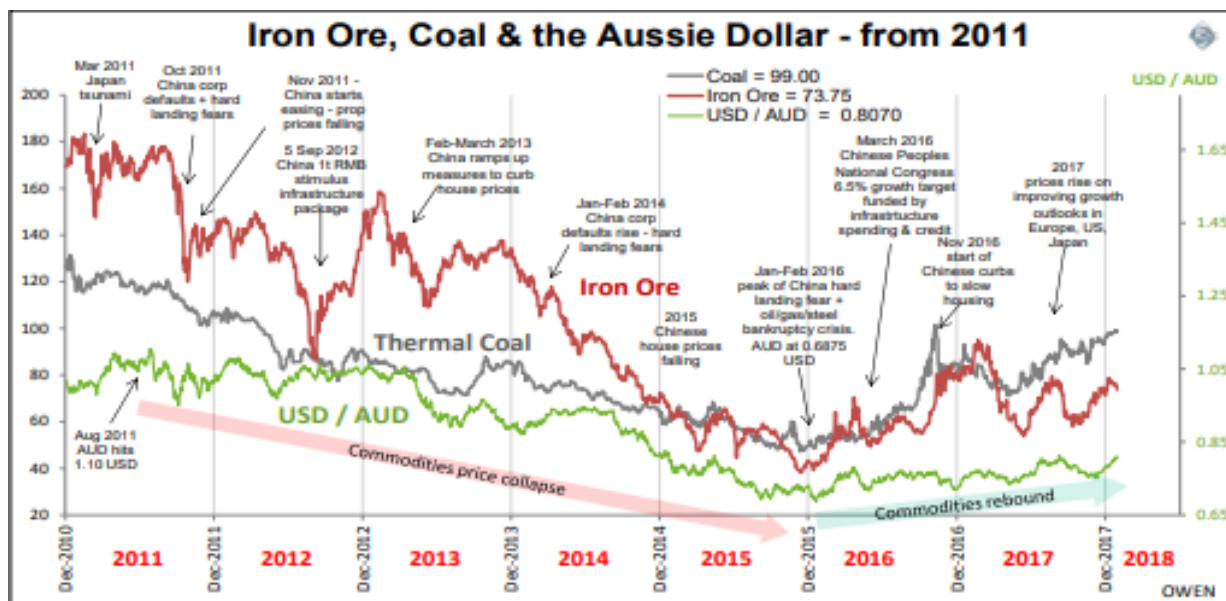
China dominates demand

The most recent mining boom was driven by China's surge in demand for the minerals it needed for its industrialisation, urbanisation and export manufacturing booms starting in the early 2000s. China quickly became the largest consumer in almost all industrial commodities in the world. Commodity prices soared as supply (exploration, development and bringing new mines into production) takes several years to catch up with surging demand.

The 2000s China-led mining boom was punctuated briefly by the GFC but thanks to China's massive stimulus spending programmes to boost activity when the GFC crunched global trade, the mining boom went on to peak in April 2011 after the Fukushima tsunami. The Aussie dollar hit US\$1.10 and BHP reached \$50. Mining companies went on a wild debt-funded spending spree buying over-priced mines at the top of the market assuming prices would rise forever. They don't.

Then supply caught up and overtook demand, as it always does. On the supply side, many of the mines developed early in the boom came into production. On the demand side, Chinese urbanisation reached 50% of the population and started to slow, and global demand for Chinese exports reduced in a lower spending post-GFC world. Chinese economic growth peaked at 14% in 2007 but by 2012 the growth rate had halved. Rising supply and slowing demand resulted in price falls and this is how all mining booms end.

Here is a price chart for Australia's two largest exports: iron ore and steel.



[Click to enlarge](#)

The commodities price collapse ... and rebound

Prices of all industrial commodities collapsed by up to 80% in the four years following the 2011 peak. The price falls triggered losses and bankruptcies in miners, oil, gas and steel producers all over the world. These losses caused a global 'earnings recession' in the main developed markets including the US, UK, Europe and Japan, and triggered deep recessions and political crises in commodities producing emerging markets. The losses also flowed through to their bankers. Meanwhile Europe and Japan relapsed into recessions, and the collapse of the 2014-15 Chinese stock market bubble and housing boom raised fears of 'hard landing' in China, sending commodities prices even lower. The Aussie dollar followed the same path down.

The crisis ended when the Chinese government finally announced a range of new stimulus measures at the Peoples' National Congress in March 2016, targeting 6.5% growth driven by deficit-funded infrastructure spending. This immediately turned around commodities prices, miners' share prices and flowed through to rises in company profits and dividends over the past year. The Aussie dollar (and Australian share prices) followed the same path. In 2017, demand was supported by long-awaited signs of recovery in Europe and Japan and continued steady growth in the US.

In 2018, the AUD is now running into expensive territory again, but we see commodities prices remaining relatively firm this year.

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.

The role of multi-asset funds in retirement

Matthew Merritt

In preparing for retirement, the investor journey used to be simple. Individuals would focus on growing their superannuation accounts, and as retirement approached, advisers encouraged them to switch systematically from risky assets to less risky assets, say, from equities to bonds. At retirement, they would focus more on capital preservation and often hold healthy levels of cash, term deposits or perhaps annuities.

But the investor journey has changed. People are living longer and interest rates are low. People may need to generate growth in their superannuation for longer, not just in the period up to retirement. Multi-asset funds could play a role in helping investors grow their pension pots both before and after retirement. They can offer the potential for more consistent returns than single growth asset classes, such as equities. This is relevant whether an investor is following a traditional shift from risky to less risky assets or other ways to construct a portfolio that supports their specific needs in retirement.

Different types of multi-asset funds for post-retirement

Many different types of strategies might be labelled as multi-asset, with a wide range of risk/return objectives. Some are based on quantitative or systematic processes, while others will be more qualitative in nature.

Investors often want a more conservative post-retirement portfolio than pre-retirement. They want to generate returns to match or exceed their specific income needs. Depending on the individual investor's circumstances, multi-asset funds with a greater focus on managing volatility and downside risk – such as those with an absolute return target set against a specified time frame – could be taken into consideration. Some investors may prefer a multi-asset fund with a higher return target with a greater short-term volatility, but these higher risk funds may not be appropriate for all investors.

We believe an effective multi-asset portfolio should consider investing beyond mainstream equity and bond markets. By incorporating holdings that are less sensitive to overall market direction, a portfolio can access a broader range of risk premia, enabling a degree of diversification which traditional strategies cannot match.

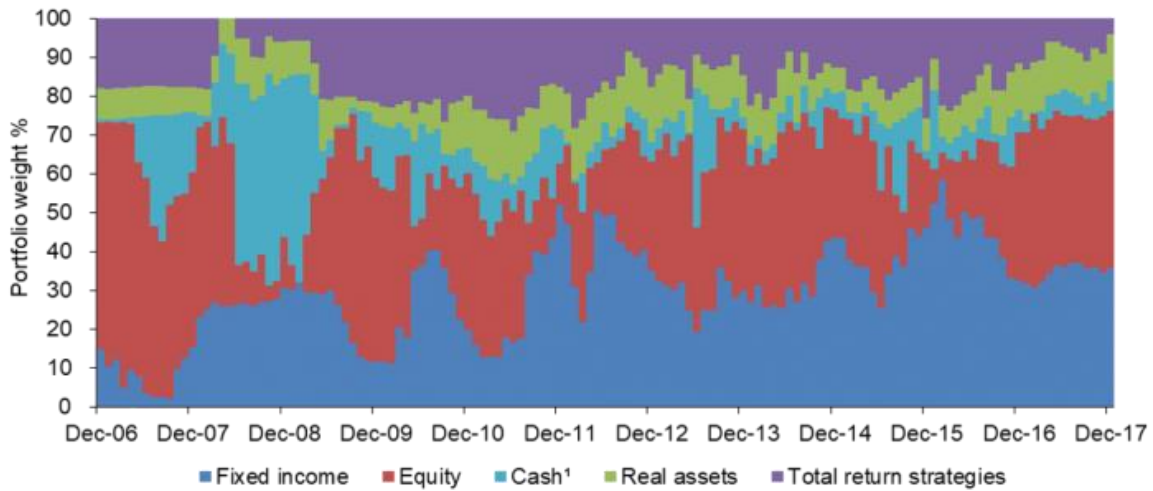
A multi-asset fund may be placed alongside other strategies or approaches in a wider portfolio that is tailored to meet the investor's specific needs and objectives.

Merits of actively-managed funds versus strategically-managed funds

In our opinion, multi-asset portfolios with a strategic asset allocation, where the target allocations are set for the long term, are deficient. Conventional approaches rely on a long-run assessment of return expectations, risk and cross-asset relationships to drive the allocation. We believe it is impossible to forecast the necessary critical inputs of returns, volatility and correlations with the degree of accuracy needed to have confidence in the outcome. The practical implications are large swings in performance, which is the last thing an investor wants when approaching, or after, retirement.

We advocate a more dynamic and flexible approach that places a greater emphasis on active asset allocation: understanding which environments are conducive for positive asset class performance (or associated with poor performance) is, in our view, more achievable than forecasting inputs with the degree of accuracy required by a strategic asset allocation approach.

The diagram below shows the frequency with which we change the asset allocation mix under this dynamic approach.



Source: Insight as at 31 December 2017. Positions are shown on a net basis. Cash: Includes cash at bank, FX forwards and money market instruments.

A strategic blend of passive funds will rely entirely on market-based returns across the underlying asset classes. A multi-asset fund with a wider opportunity set – including the flexibility to invest in strategies that rely less on rising markets – has the potential to generate more consistent returns over time.

Examples of such 'less directional' strategies include relative value positions, which generate a profit or loss based on the spread of performance between two segments of the same asset class or markets – for example, a position that favours US treasuries relative to German bunds, or the euro relative to the US dollar. Strategies with the potential to generate returns if markets trade sideways are another example. Some real assets, such as infrastructure, also offer the potential for attractive, steady returns over time.

Some investors are wary of allowing the use of derivatives. However, if used appropriately, they add value and help in managing risk. In particular, they can assist multi-asset managers to switch exposures more swiftly and cost-effectively than if they invest in physical assets. The use of derivatives also allows investors to access sources of return that would otherwise be unavailable.

Choosing the right mix of returns versus risk



Individual investors approaching retirement are typically more sensitive to large negative movements (drawdowns) in their superannuation account than earlier in their lives. This drawdown can undermine confidence in retirement plans and impact their ability to fund lifestyle choices.

The right multi-asset portfolio could give the potential for growth over the longer term but with lower volatility than a narrower set of growth assets alone. For example, the diagram below shows the performance and maximum drawdown of various global equities, bond and hedge fund strategies against Insight's multi-asset mix since inception in 2004 (included to illustrate how using alternatives and dynamic allocations can add value).

Source: Insight and Bloomberg as at 31 December 2017. Returns shown gross of fees in AUD. The long-term track record of the Insight broad opportunities strategy has a base currency of USD. This performance record has been adjusted by interest rate differentials to derive an AUD proxy. Static asset allocation is based on a 60% global equities and 40% global government bonds allocation. Global equities represents MSCI World Index, net, hedged into AUD. Global Gov bonds represents JP Morgan GBI index hedged into AUD. Drawdown is calculated as the largest peak-to-trough change in the period, based on monthly data.

Lower volatility in returns also means investors are less likely to need to pre-determine a trigger date for switching into lower-returning assets as they should reduce the substantial drawdowns evident when investing largely in growth assets such as equities.

Multi-asset funds in the post-retirement, decumulation phase

After retirement, investors need to withdraw income from superannuation to live on. This can have a significant effect on their portfolio’s long-term potential. ‘Dollar cost ravaging’ is a term used to describe the impact of regular withdrawals after a portfolio has lost value – more assets need to be sold to generate the same amount of income, thereby damaging their super’s potential for future growth. It may be possible to manage the timing of withdrawals to lessen their long-term impact, but investors will typically expect to make regular withdrawals and are unlikely to have the flexibility to leave their pots to recover losses before taking out income.

Investors should be aware of the factors that could lead them to draw down more than they expect. Significant risks include:

- longevity – that they live longer than they expect
- inflation – that the cost of living rises by more than forecast
- increase in spending needs – for example, to cover unexpected healthcare costs.

As their aim is to provide more consistent growth over time, multi-asset funds can sustain a liquidity buffer that can fund regular withdrawals and mitigate their impact on the portfolio’s longer-term growth potential. They can also provide some element of real returns which would help with the rising cost of living.



Source: Insight Investment as at 31 December 2017. The Insight broad opportunities strategy performance has been adjusted by interest rate differentials to derive an AUD proxy. These returns are gross of fees. Inception date 31 December 2004.

Matthew Merritt is Head of Multi-Asset Strategy Team at [Insight Investment](#). This article is general information and does not consider the circumstances of any individual. Insight Investment is a sponsor of Cuffelinks.

Ensure death benefit nominations are upheld

Julie Steed

When a superannuation fund member dies, the fund trustee pays the death benefit to their eligible dependants or to their estate. This is one area of super where there have not been incessant changes to the rules in recent years. However, super fund members are often not familiar with the requirements on death benefit nominations. The main issues relate to the types of nominees and the classes of nominations.

Types of nominees

Superannuation law provides that a super death benefit can only be paid to a *legal personal representative* or a *dependant*.

The *legal personal representative* (LPR) is the person responsible for ensuring that various tasks are carried out on behalf of the estate for a person who has died. A person may be appointed to the role by being named as the executor in the will or where there is no will, by being appointed as administrator of the estate by the Supreme Court.

A *dependant* includes a spouse, a child, a financial dependant or any person with whom the deceased had an interdependency relationship.

A spouse is the surviving partner of a legally married couple or a de-facto couple (either same sex or opposite sex).

A child may be:

- an adopted child, a stepchild, or an ex-nuptial child of a person
- a child of a person's spouse, or
- a child within the meaning of the Family Law Act (mainly covering artificial conception).

Whilst a stepchild is included in the definition of a child, note that the dissolution of the relationship between the parent and the stepparent severs the stepchild relationship. That is, if the natural parent dies or separates from the stepparent, the stepchild/parent relationship ceases at that time. The child may however still qualify as a financial dependant or under an interdependency relationship.

Two people have an interdependency relationship if:

- they have a close personal relationship, and
- they live together, and
- one or each of them provides the other with financial support, and
- one or each of them provides the other with domestic support and personal care.

Two people may still have an interdependency relationship if they have a close personal relationship but do not live together due to disability or temporary absence (for example if one person lives overseas for work). Otherwise, it is important to note that all four of the interdependency conditions must be met.

It is up to the trustee's discretion to determine the recipient of a member's death benefit. The two exceptions to this rule are member-directed nominations for small funds and binding death benefit nominations.

Classes of nominations

The nomination options include:

1. Member-directed nominations

SMSFs and small APRA funds (SAFs) are exempt from the provisions of superannuation law which prohibit a person who is not a trustee from exercising a discretion as to who will receive the death benefit.

Members of SMSFs and SAFs are able to incorporate certainty in the nomination of beneficiaries using a clause in the fund's trust deed. Such a clause would typically state that:

- if a member nominates a valid dependant, the benefit shall be paid to them.
- if there is no nomination, or the nomination is invalid, the benefit shall be paid to the LPR.

2. Reversionary pensions

Upon the death of the pensioner, payments from reversionary pensions revert to the reversionary beneficiary. If the reversionary beneficiary pre-deceases the pensioner, the benefit would ordinarily pass to the pensioner's estate. From 1 July 2017, the maximum amount that can revert to a spouse is generally \$1.6 million.

These types of nominations generally provide certainty and peace of mind for clients. In most situations, the surviving spouse simply needs to notify the trustee of the death and a new bank account number.

Since 1 July 2007, death benefits cannot be paid in the form of an income stream to children over the age of 25 unless they are disabled. Accordingly, adult children cannot generally be nominated as reversionary beneficiaries.

3. Binding nominations

A binding nomination can provide certainty as to who receives the member's death benefit based on a nomination of the person(s) to whom the death benefit will be paid. This nomination is an exception to the rule that no one other than the trustee can exercise a discretion.

Before this exception is granted, the following conditions must be met:

- The trustee must give the member sufficient information to understand the nature of a binding nomination.
- The nomination must nominate a superannuation law dependant.
- The nomination must be in writing.
- The nomination must be signed and dated in the presence of two witnesses.
- The witnesses must be over 18 and not a nominated dependant or LPR.
- The nomination must be clear and unambiguous.
- If the nomination is not clear, the trustee must seek clarification as soon as practicable.
- The nomination expires after three years.
- The nomination may be amended or revoked.

The fund's trust deed must also permit binding nominations. If a trustee accepts a nomination that meets the criteria stipulated in superannuation law, the trustee is bound to make the payment in accordance with the nomination.

However, a binding nomination can never bind a trustee to make a payment to a person who does not meet the definition of a dependant.

4. Nominated beneficiaries

A beneficiary nomination is an expression of wishes which is not binding on trustees. As with all other types of nominations, a nominated beneficiary must meet the superannuation law definition of a dependant.

With the exception of SMSFs and SAFs, once discretion has been exercised as to the intended recipients of the death benefit, the trustee is required to undertake a claim staking process to identify potential beneficiaries and inform them of their intentions as to how the benefit will be distributed.

Potential beneficiaries include anyone who meets the superannuation law definition of dependant. The potential beneficiaries have 28 days to object to the trustee's intention. If a potential beneficiary objects to the intended distribution, the trustee must obtain further information about the potential beneficiaries' level of dependency, reassess their decision, and re-commence the claim staking process.

If potential beneficiaries are dissatisfied with the trustee's decision, they may lodge a formal complaint through the fund's internal complaints process. If they remain dissatisfied, they can refer their complaint to the Superannuation Complaints Tribunal.

Obtaining certainty

Issues continue to arise when people are nominated who do not meet the definition of a dependant, such as where a member wishes to nominate their parents to be the recipients of their death benefit, but they are not living with their parents nor are they providing them with financial support. In this instance, the member would need to prepare a will and direct the superannuation to the LPR. The trustee would not be able to make the payment to the member's parents.

In retail, corporate, or industry super funds, certainty is obtained by completing binding nominations or reversionary pensions. The most certain outcome for SMSFs and SAFs is to include the requirement to pay a nominated dependant in the fund's trust deed.

Members should review their death benefit nominations to ensure no issues arise later.

Julie Steed is Senior Technical Services Manager at [Australian Executor Trustees](#). This article is in the nature of general information and does not consider the circumstances of any individual.

Choosing the date of your retirement

Neil Rogan

Most people would love to choose when they retire, preferably before they are too old to enjoy it. At the same time, because people are living longer, they need to be realistic about how long they are likely to be in retirement and how much money they will need. Superannuation is a great long-term investment vehicle, with significant tax advantages for most Australians, but recent changes and a lack of flexibility mean super isn't necessarily the only long-term option.

Investors who want greater flexibility of access to their super, or who are facing limits to their super contributions, should consider alternative ways to save in order to have enough money to retire at a time of their choosing.

Most individuals do not have enough super

Despite recent improvements in super balances and gender imbalances, the table below reveals that individual super amounts are frequently insufficient to fund retirement at the usual desired age of 60-64, let alone allowing the option of early retirement. Super balances at retirement age (60-64) stand at \$270,710 for men and \$157,050 for women.

Putting aside the problem of the large gap between men and women, these balances are a far cry from the \$545,000 that ASFA estimates a single person needs for a comfortable retirement. Furthermore, there are restrictions on when most people can access their super, such as the age of 60 if born after 1960.

Superannuation by gender and age ([from ASFA superannuation statistics](#))

Mean balance and coverage (2015-2016)

Characteristics	Age	\$	% with super
Males	15+	111,853	73
Females	15+	68,499	67
Males	30-34	43,580	89
Females	30-34	33,750	83
Males	60-64	270,710	79
Females	60-64	157,050	66

Source: ABS.

Around 14.8 million Australians currently have a super account.

For most people, making additional super contributions will be the most tax-effective way to build retirement funds. However, recent changes mean that some Australians will be unable to contribute more to super in a tax-effective way. Here's a brief reminder of the recent changes:

- Concessional (pre-tax) contributions are limited to \$25,000 per annum. If a person's adjusted taxable income exceeds \$250,000 a year, concessional super contributions are taxed at 30% instead of the usual 15%.
- Once a threshold of \$1.6 million in super is reached, no additional non-concessional (post-tax) contributions are permitted.
- Balances in tax-free pension phase accounts are limited to \$1.6 million. Once this is reached, the excess must be transferred back into an accumulation phase account, or out of super.
- Non-concessional (after-tax) contributions to super are limited to \$100,000 per annum (or nil if more than \$1.6 million is already held in super).

What are the alternatives to super?

Alternative savings strategies such as investing in property, contributing to a managed fund, building a share portfolio or perhaps using term deposits or bonds are all valid investments that will not lock money away in the same way as superannuation, but they have few reliable tax advantages. Negative gearing on property relies on making a loss to be used to offset other income. On other investments, most people will pay their marginal tax rate on returns from investments outside of super.

Creating a company structure to hold investments is one way to reduce tax. Most companies pay a corporate tax rate of 30% rather than the investor's personal tax rate, which could be as high as 49% including the Medicare levy.

There are two downsides to this strategy. The first is that setting up and maintaining a company (including preparing financial statements every year as well as on-going legal compliance requirements) can be expensive. In addition, the tax advantage is only a way of deferring tax. As soon as dividends are paid from the company to an individual, the individual will pay the difference between the company tax rate and the personal marginal rate.

An investment bond can mean you pay less tax

In operation, investment bonds seem like tax-paid managed funds, whereas in structure, they are in fact insurance policies, each with a life insured and a beneficiary. Like managed funds, they offer investors a range of underlying investment portfolios, from defensive assets like cash and fixed interest, to higher-growth options such as share portfolios, as well as portfolios with a mixture of both.

There is no upper limit to how much can be placed in an investment bond, and it is possible to continue to contribute each year up to 125% of the previous year's contribution.

The tax advantage works like this: returns from the underlying investment portfolio are taxed at the company rate of 30%, and are then reinvested. The investor does not receive a distribution, and therefore does not need to declare returns on their personal income tax return.

In addition, if the underlying portfolio in the bond contains equities with franking credits, the effective tax-rate paid may be less than 30%.

If the investor holds the bond for 10 years, all accumulated returns and principal are distributed free from further taxes.

Investment bonds are flexible as it is possible to access funds before the 10-year period is up. However, depending on timing, some of the tax advantage may be lost.

An investment bond can also be an effective estate planning tool. Investment bonds do not form part of an investor's estate and can be left to a nominated beneficiary who will receive all proceeds tax-free on the death of the life insured, regardless of when that occurs.

Case study

For example, Anthony has contributed as much as he is legally able to super, both in terms of his concessional (pre-tax) and non-concessional (post-tax) contributions.

At the same time, he has recently sold a property investment, making a profit of \$200,000, and he wants to invest the proceeds as tax-effectively as possible rather than pay 49% tax on any returns. He earns a good income and does not need investment distributions to live on, and would prefer returns re-invested to benefit

from compounding over the longer term. He is also not ready to lock up savings in superannuation in case he needs money before he retires.

Anthony first considers a portfolio of Australian and international shares via a managed fund, but he knows that any distributions will be taxed at the highest rate.

Instead, Anthony invests in an investment bond, with an underlying portfolio of equities, which means he receives a tax advantage at two levels:

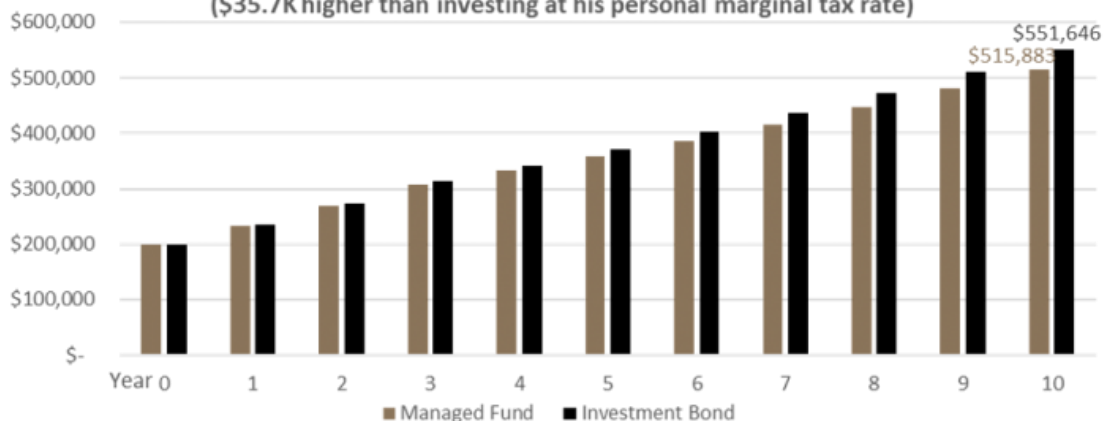
- Returns from the portfolio of an investment bond are taxed at the company rate of 30%, and are re-invested in the bond. Anthony does not need to declare returns in personal tax.
- Some of the equities in his portfolio pay fully-franked dividends, and the actual rate of tax paid in the bond is less than 30%.

In addition, because Anthony is unable to contribute more to his super fund, he contributes \$20,000 per annum to his investment bond instead. And after three years, he reduces his annual contribution to his bond to \$5,000. After 10 years from the start of his bond, Anthony redeems his bond to pay off his home loan. Assuming total returns of 8.5% pa (4.5% pa income (80% franked), 4% pa capital growth, 100% annual turnover of the portfolio, 50% CGT discount applies for managed funds), the proceeds are around \$551,646 and, because he has held the bond for 10 years, they are tax-free in the investment bond. If Anthony had invested in a managed fund with the same portfolio and rate of return, he would have \$35,763 less, due to the tax paid on returns.

Comparison of Managed funds and Investment bonds performance over 10 years

	Managed Fund	Investment Bond
Start	\$200,000	\$200,000
Year 1	\$233,778	\$235,466
Year 2	\$269,671	\$273,425
Year 3	\$307,813	\$314,053
Year 4	\$332,403	\$341,482
Year 5	\$358,534	\$370,840
Year 6	\$386,301	\$402,262
Year 7	\$415,807	\$435,892
Year 8	\$447,161	\$471,887
Year 9	\$480,478	\$510,412
Year 10	\$515,883	\$551,646

Portfolio balance (after tax) over 10 years (\$35.7K higher than investing at his personal marginal tax rate)



Flexibility and choosing the date of retirement

Anthony now has more flexibility about choosing when he will retire, because he no longer has a home loan and he followed a disciplined saving regime. Even if he had already paid off his loan, he would have a significant boost to his retirement savings while retaining access flexibility over the previous 10 years.

Superannuation is often the best retirement option, but for Australians looking to build financial freedom with more choices – including when and how they retire – other tax-effective options such as investment bonds are worth considering.

Neil Rogan is Head of Investment Bonds for [Centuria](#). Centuria is a sponsor of Cuffelinks. Suitability of an investment bond will depend on a person's circumstances, financial objectives and needs, none of which have been taken into consideration in preparing this article.

The glide from youth into life after work

Don Ezra

Let me tell the story of how the GFC and market crash of 2008 affected different members of a family in different ways. This will enable me to draw lessons for how the competing goals of growth and safety typically change as we age.

What is a glide path?

Americans introduced a simple but powerful concept for all of us who invest for retirement. They called it a [glide path](#). It concerns your exposure to equities. Like a plane, your exposure should start high and glide gradually down over time as you approach retirement. It considers:

- How high it should start
- How low it should reach at retirement

Those decisions should be customised to your goals, your other sources of retirement income, and your risk tolerance. But the notion of gliding down as you age is common to all such paths.

I could explain the rationale the way economists do, by referring to financial capital and human capital. But it's much more compelling to tell a story.

Once upon a time ...

There was a family where Dad was an investment geek, and the family endured his stories and lessons over the dinner table. He was fond of waving his arms and proclaiming that young people could invest 100% in equities without worrying. And the family was fond of Dad, tolerated him with affection, and generally ignored his well-meaning advice, whether on investments or anything else.

Son grew up, left home, got a job, and started investing in his company's compulsory superannuation scheme. He chose a fund that invested 100% in global equities, as he had remembered about global diversification.

Along came the GFC, and early in 2009, Son took his annual statement to Dad and, with a reproachful look, showed it to him.

Dad was ashamed that his first instinct was a feeling of pleasure that Son had actually listened to him about something. This was not par for the course. But he suppressed that feeling, since Son's look didn't just imply "Look what's happened to my assets." It was worse than that. It was more like "Look what *you've* done to me." Son was upset at the big loss, and at least needed empathy.

So, Dad also suppressed the geeky responses that came to mind. He didn't say: "Did I ever tell you about mean reversion?" This is the notion that, over time, returns tend to revert to some sort of long-term average, and don't stay extreme for long. No, Son's money had depreciated permanently. Suggesting that the market would restore the loss wasn't credible.

He also didn't say: "Gosh, your fund only lost 30%. The global equity index lost 40%. You did 10% better than the index. People would kill for that sort of outperformance!" As another saying goes, you can't eat relative performance; losing less than others is no consolation.

So Dad said, "Yes, we've all lost money. This has been the worst market in two generations. The loss is beyond anything we ever seriously considered. The thing is, let's see how much of an impact it has on your goal, which is income security in retirement."

When is the best time for exposure to equities?

Dad did some rough calculations about how much income Son could reasonably expect at retirement at age 70. (After those dinner conversations, Son knew he wasn't likely to be able to retire earlier than 70. But that would still probably give him a generation of active enjoyment.) First Dad projected the income that might have accrued if the index hadn't gone down at all. Then he reduced the current assets by 30% and repeated the projection. And lo and behold, the projected income only decreased by 3%. Just a nuisance, rather than a tragedy.

How was that? No, not sleight of hand. The explanation was that 90% of the projected 401(k) income was due to come from Son's *future* savings. (Son was about 30 at the time, and hadn't been saving long.) That portion didn't suffer the market decline because it had not yet been saved. Only 10% of the projected retirement income was affected. A 30% loss there meant a 3% loss overall.

(Economists would say that Son's retirement assets consisted, at that point, of 10% financial capital, invested in equities, and 90% in human capital – essentially future earning and saving power – and therefore not yet exposed to the market.)

Son absorbed this new perspective, this new framing of the issue, and was reassured by it. Then he asked: "How about you and Mum?" "Well," said Dad, "our retirement assets were only 50% in equities. But it has cost us 9% of our projected income."

Need to include future earning potential

In other words, even though Mum and Dad had only half of Son's equity exposure (50% compared with Son's 100%), they had actually taken three times as much risk. Why? Because the parents had much more in financial assets, and little human capital left.

And essentially that's the rationale for a glide path. Most of us must necessarily take some long-term risk (in the expectation of long-term reward) in order to achieve our retirement income goals, because the amount we need to save, if we focused just on risk-free assets, is typically beyond us. The glide path approach tells us something very important: that we shouldn't spread that long-term risk equally over our working lifetime. Instead, we should take much more at the start, when our financial capital is low, and reduce it as our financial capital increases.

How about after we retire? That's much more complex, and there's no broad agreement on the best approach. I'll deal with it in a later post.

We should take investment risk when we're young and have little financial capital at stake, and less when we mature and have much more at stake. The shape of our risk-taking during our years of saving should follow a sort of glide path, from higher risk to lower risk.

Don Ezra has an extensive background in investing and consulting and is also a widely-published author. His current writing project, blog posts at www.donezra.com, is focused on helping people prepare for a happy, financially secure life after they finish full-time work.

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