

This Week's Top Articles

- **Why a glide path makes sense, with equities for growth** *Don Ezra*
- **Retained profits a conspiracy against super and pension fund** *Graham Horrocks*
- **Sir Michael Hintze: why an investing edge needs imagination** *Graham Hand*
- **Impact on pensions and super from loss of excess franking** *Nicholas Stotz*
- **Impact on returns from loss of excess franking** *Ashley Owen*
- **A chat with Chris Cuffe at 'Women in Super'** *Susie Bell*
- **When death benefits include life insurance** *Mark Ellem*
- **Financial advisers not allowed to advise** *Graham Hand*

Reply to Peter: Why a glide path makes sense, with equities for growth

Don Ezra

My last article, [The glide from youth into life after work](#), prompted a response from Peter Thornhill (PT hereafter) who "noticed with sadness" the support for 'lifecycle' investing. When someone distinguished says that about a piece you've written, it takes you aback. On reading [his piece](#), I gather (this is a guess on my part) he thinks I'm endorsing volatility as the risk measure that leads to a glide path. I neither said nor implied it.

In keeping my article short, I focused on the human-interest aspect. Let me get to grips with risk in this piece. And you'll find I agree with PT in many ways, and yet I still advocate a glide path.

PT's approach is straightforward: over the long term, equities invariably outperform fixed income, so they are the obvious choice for accumulation. I agree with both parts of that statement, but there's more to it than that.

Here, I'll define risk and then apply that definition to investing. Then I'll show how it works in the accumulation and decumulation phases of retirement planning (quite differently, it turns out).

And you'll be glad to know that it takes no expertise to understand this stuff.

What is risk?

Risk is the chance of an adverse outcome. As simple as that.

What is adverse depends on the situation and on how the risk-taker defines the goal and the difference between acceptable and adverse outcomes. So, what's adverse to one person may be acceptable or even favorable to another. *Risk is necessarily subjective.*

What is investment risk?

This is the chance of an adverse outcome in an investment context. As simple as that.

I have never found a better framework for analysing risk than that of William Bernstein, in his little gem of a book called *Deep Risk*. He distinguishes between 'shallow risk' and 'deep risk'. Shallow risk is the risk that we're forced to interact with the market at a bad time. We're forced to buy right after the market has gone up, or to

sell right after it's gone down. It makes sense for volatility to be a good measure of shallow risk. Much of what's called Modern Portfolio Theory is based on this concept. In many circumstances, it's an avoidable and therefore irrelevant risk, as I'll show.

Deep risk is much more serious. It's the risk that the economy, and therefore the stock market, doesn't perform over the long term. This is what places us all in retirement jeopardy. And sadly, it's unavoidable.

I won't get into Bernstein's complete analysis, I'll just go with PT's flow, that equities give the average investor by far the best chance of achieving long-term growth.

The impact of shallow risk on an individual's retirement finances

How can you escape shallow risk?

In the accumulation phase, you don't really need to. It has little effect because you're investing regularly. Volatility just means that sometimes you'll buy high and sometimes low. This is often called 'dollar cost averaging'. As long as it's just volatility around a long-term upward path, in fact volatility is your friend, as a buyer.

Suppose, for example, you invest \$100 per period. Suppose the price at which you buy is a constant \$100. Then each period you buy 1 unit. After two periods you have bought 2 units. But suppose the price isn't a constant \$100. Suppose it alternates, sometimes \$90 and sometimes \$110. Then, in two periods, you buy 2.02 units. What if it alternates between \$80 and \$120? Then in two periods you buy 2.08 units. The more volatility, the more units you own. Far from being a risk, (pure) volatility in the accumulation phase is your friend.

In the decumulation phase, exactly the opposite holds true. Now you're selling, to generate the cash you need for spending. And to generate \$100 per period in those scenarios, you need to sell 2 units, or 2.02 units, or 2.08 units. The more (pure) volatility there is, the more units you sacrifice and the worse off you are. Now volatility becomes your enemy, and it becomes a form of risk, as the outcome is adverse for you, relative to the absence of volatility.

Can you avoid it? Yes, but at a cost.

If you need \$100 a period, you can arrange your assets to generate exactly \$100 when needed. This requires investments with explicit, certain outcomes. Typically, these investments have a low return, with no long-term growth potential, so you have a trade-off. The more you seek long-term growth, the smaller the portion of your portfolio available to generate exact amounts when you need them. The more predictability, the less available to seek long-term growth.

Fortunately, the need for predictability doesn't occur, in a retirement context, until decumulation.

The lifecycle rationale

What's the rationale for reducing exposure to growth-seeking assets over the accumulation lifetime?

The theory is simple. You have two kinds of assets. One is human capital: the ability to earn income through work, which in turn creates the ability to save for retirement. The other is financial capital: the value of what you've saved. At any time, your personal asset portfolio is the sum of the two. (Google "Bodie Merton Samuelson 1992" if you want details.)

An essential assumption in the theory is that your tolerance for (or aversion to) a large one-shot decline in your portfolio is constant over your lifetime (aka 'constant relative risk aversion' or CRRA).

Your human capital is (in this theory) viewed as a form of reasonably predictable inflation-linked fixed income, rather than a risky/growthy asset such as equities. The theory argues that growthy assets have far greater uncertainty than your human capital. In particular, as far as risk (in this context, a significant permanent decline in value) is concerned, growthy assets are far more susceptible than human capital.

Let's suppose you invest all your savings in growthy assets. Over time, your savings get bigger and your human capital declines. That means that your total personal portfolio has an increasing proportion in growthy assets. Your exposure to risk increases over time. The way to keep it constant (remember CRRA) is to replace growthy assets with assets that look more like human capital (essentially, inflation-linked fixed income with a time horizon that ends at retirement).

That's what a glide path is meant to do.

Actually, it's more complicated than that, because right at the start you have no growthy assets at all, so you actually have too little risk exposure. What you need to do, at least in principle, is borrow against your human capital and invest the borrowed amount in growthy assets. In most countries you can't do this explicitly with your retirement savings, but you can achieve the right direction to some extent if you buy a property financed by a mortgage.

How does this relate to the discussion on risk?

It relates purely to deep risk, not shallow risk.

The glide path's rationale is based on a constant tolerance of exposure to risk of a significant one-shot decline. That's a form of deep risk. It has to be a decline that isn't recovered later; if it's recovered, that's just volatility, and remember, volatility is your friend in the accumulation phase.

What about later, during retirement decumulation? PT says that in retirement he's interested in the income from the equities, and volatility in value is a non-issue. Not so! If PT doesn't need to touch the capital, then financing retirement isn't his focus; he has ample wealth. Fair enough, in that case. But the average person doesn't have that luxury, and needs to sell regularly to generate spending money. And therefore volatility is indeed a potentially big issue after retirement, for the average person.

If we have to sell right after a big decline, those units have gone forever. They aren't there to claw back anything from mean reversion. This is the danger often called 'sequencing risk'.

I partially avoid shallow risk personally by having five years of spending in savings bonds or fixed-term deposit accounts. This is my 'spending ladder'. Each year, the ladder naturally shortens by one year. If markets have been good, I'll extend it by a year, back to five. If markets have fallen, I'll wait for a recovery. My risk, of course, is that there'll be five years without a recovery. Then I'll be in trouble, but so will we all, and that's my unavoidable exposure to deep risk. I wish I could afford a 15-year ladder. But holding that amount in fixed income wouldn't give me as much exposure to the long-term growth I still hope for. It's my trade-off.

Conclusion

I've tried to show that risk is subjective, that shallow risk is your friend in accumulation and your enemy in decumulation, and that even in decumulation it's potentially avoidable for some time, giving growthy assets a chance to work for you. Deep risk is always with us. The glide path is a sensible way to keep our exposure to deep risk relatively constant throughout the accumulation period.

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.

Retained profits a conspiracy against super and pension fund

Graham Horrocks

In [Part 1](#) of this series, we showed that the company tax rate has no impact on the amount of after-tax dividend received by an Australian shareholder.

This Part 2 examines whether a company should retain earnings or pay them as dividends to shareholders. Fund managers often advise that it is best for companies to retain profits and redeploy the capital to generate attractive returns. This advice ignores the tax implications for different types of investor.

Better for superannuation and pension funds to receive dividends

Retaining after-tax profits in a company in Australia means that from each \$100 in company profit before tax, \$70 is reinvested by the company (after the 30% tax). The cost to a shareholder of investing that \$70 in the company is the forgone after-tax dividend.

This is \$53 or \$65.50 for an individual after tax, depending on the personal tax rate. This might seem a good deal for these shareholders, but the deal becomes less than favourable when capital gains tax (CGT) is taken into account.

For a superannuation or other low tax-paying shareholder, however, the retention by the company is *singularly unattractive*. The cost to the shareholder of investing that \$70 is the foregone after-tax dividend of \$100 if the shareholder is a pension fund or \$85 if the shareholder is a superannuation fund. Neither of these represent an attractive means of adding \$70 to their investment in the company. Companies do need to retain capital in order to continue to operate and to expand but retaining some of their after-tax earnings is an easy and indeed lazy way for the directors to grow capital.

CGT implications make it even worse

Consideration of CGT does not improve the position. Retaining an after-tax profit of \$70 within the company rather than distributing it as an increased franked dividend only makes sense if it increases the value of the company by at least \$70. For CGT purposes, the retained after-tax profit does not change the cost base for future calculation of CGT.

If the shareholding is sold having held the shares for more than 12 months, the position becomes:

Shareholder	Individual	Individual	Super fund (accumulation)	Super fund (pension)
Shareholder tax rate	47%	34.5%	15%	0%
Retained after tax profit	\$70	\$70	\$70	\$70
Retained franking credits	\$30	\$30	\$30	\$30
Increase in sales price of company	\$70	\$70	\$70	\$70
Increase in CGT Cost base	-	-	-	-
Increase in Capital gain	\$70	\$70	\$70	\$70
CGT discount	50%	50%	33%	33%
Taxable capital gain	\$35	\$35	\$47	\$47
Increase in CGT payable	(\$16)	(\$12)	(\$7)	-
Capital gain after tax	\$54	\$58	\$63	\$70

Consider the 'dividend after tax' scenario modelled in the table last week, reproduced below.

Shareholder	Individual	Individual	Super fund (accumulation)	Super fund (pension)
Dividend after tax	\$53	\$65.50	\$85	\$100

The impact on a shareholder of investing \$70 into an Australian company because the company did not distribute a dividend and retained the \$70 will be:

- individual shareholder on a marginal tax rate of 47% – instead of receiving an after-tax dividend of \$53, the after-tax benefit if sold at that time would be \$54, or close to a line-ball.
- individual shareholder on a marginal tax rate of 34.5% – instead of receiving an after-tax dividend of **\$65.50**, the after-tax benefit if sold at that time would be **\$58**.
- superannuation fund shareholder on a tax rate of 15% – instead of receiving an after-tax dividend of **\$85** the after-tax benefit if sold at that time would be **\$63**.
- pension fund shareholder on a tax rate of zero – instead of receiving an after-tax dividend of **\$100** the after-tax benefit if sold at that time would be **\$70**.

Both the superannuation fund and pension funds would be significantly better off if the company distributed the profits rather than retained them in the company, and then raised new capital as required in other ways, including from the shareholders who received the dividends.

The case for dividend reinvestment rather than retaining earnings

Retained after-tax earnings is an easy and lazy way for company directors to increase or retain capital but it is a conspiracy against low tax-paying Australian shareholders. The alternatives would be for the directors to justify the need to raise capital by a share offer to shareholders and the market.

Of course, directors could encourage dividend reinvestment by making it more attractive. With dividend reinvestment, the company retains the after-tax amount of \$70 but the benefit of the franking credit is distributed to the shareholders.

Further, for tax purposes, the shareholder has invested \$70 in the company and this is reflected as an increase in the cost base for future CGT purposes whenever the shares are sold. The company's value has still increased by \$70 but so has the cost base so there is no immediate CGT liability if the shares are sold at this time.

Company directors should be asked why they do not seem concerned at the tax inefficiency of retaining after-tax profits.

(Note that no comment is made here on the proposed Labor Party policy to stop refunds of excess franking credit. Labor is not proposing an end to dividend imputation, and there is too much uncertainty about whether Labor will be elected, whether they will change their policy or whether they can pass it into legislation).

Graham Horrocks is an actuary specialising in financial planning and superannuation, and a former General Manager, Research & Quality Assurance, with Ord Minnett. Since 1999, he has been an independent financial adviser. The article was reviewed by Geoff Walker, former Chief Actuary at the State Bank of New South Wales and winner of the 1989 JASSA Prize for published research on the implications of the then relatively-new dividend imputation system.

Interview with Sir Michael Hintze: why an investing edge needs imagination

Graham Hand

Introduction: Sir Michael Hintze is the Founder, Chief Executive and Senior Investment Officer of CQS, a London-based credit-focused global multi-strategy asset manager with AUD20 billion in funds under management as at March 2018. Sir Michael considers himself an Australian having come here as a refugee from China and receiving his education at the University of Sydney and University of NSW. In the charitable sector, The Hintze Family Charitable Foundation has provided funding to over 200 charities mainly in the UK and Australia.

GH: You've made the point that to have an investment edge, knowledge is not enough, you need imagination. How important is it when you hire staff that they have backgrounds and interests outside of finance?

MH: Over the years, I've hired staff with broad backgrounds, but let me say, they do need to be numerate as well, good with numbers. I've hired people who are historians or work in English literature, for example, many different backgrounds.

Knowledge has become a commodity, and true alpha lies in insight and imagination. You construct an investment, trade it and then risk manage it. You get paid for the imagination.

GH: When you interview someone, how do you find out if they have imagination?

MH: It's difficult, that's why you need to have a conversation. We have a process to see whether they can absorb some facts and how they think about them in a creative way. We might ask if they've seen something in the news today, what they think of it and have a conversation around it. It's hard but you can pick up if someone is not aware.

GH: You also write about the need for context and deep analysis in investing. Do you find you need to encourage staff to switch off their first reaction to something (what Daniel Kahneman calls 'System 1 thinking') and delve deeper into a problem?

MH: That’s why you have processes. You want analysts who pull apart a problem, you want them to understand the fundamental issues around it with issues viewed through the lens of our models.

GH: Is that what you mean when you write, “Models are a great way to begin but a terrible place to end.”?

MH: We have models which simulate various scenarios, but the really interesting thing for me is thinking about the problem and using imagination and judgement. We like to look at what can go wrong. For example, looking at the sub-prime market meltdown, you need imagination to say whether it will matter or not, to try to think about the fatter tails, the opportunities.

GH: In 2008, despite delivering excellent performance in the previous few years, your funds under management fell corresponding with a negative performance. And then 2009 and 2010 performance was again good. The same in 2015, there was a negative followed by a really strong year in 2016, but funds flowed out in 2015. Is that frustration for you, that some investors take such a short-term perspective and exit at the wrong time?

MH: Operationally, we’re always watching liquidity, we’re watching what’s happening, and perhaps that makes us an ATM. Many of our investors who were getting cash calls in 2008 needed to take money out.

GH: I can understand why you felt like an ATM around the GFC, but what about 2015?

MH: I think what happened in 2015 was a general view that the credit cycle was going to turn and the strategies I manage had substantial exposure to that. It’s structured credit, and to some extent, still is. But we need to make sure our messages are put together in a more effective way.

GH: Your long-term track record is outstanding with only three small negative years since 2005. Do you look back on those years and ask what did we do then that was different?

MH: We always study where we make and lose our money, we pull it apart, I make sure we have liquidity and excess margin, we manage operational risk, and we take a longer-term view. The types of investments we make where the market falls often allows the next year to be much better.

In 2015 for example, there were a number of dislocations such as the end of QE, the end of the year concerns over China growth and systemic risk, a sharply-declining oil price, and that affected the high-yield bond market. That dislocation provided an opportunity to set up for a good 2016.

GH: It does look like many investors are exiting at the wrong time.

MH: I think they might but that’s the nature of the business. I’m just managing strategies for long-term opportunities and not worrying about if it falls a bit.

GH: You’ve had an office in Sydney since 2010, and CQS funds are not available to retail investors although they are available to sophisticated investors through some private advisers. We have a shortage of the types of funds you manage for retail investors. Are there better opportunities to open access to retail investors in Australia, perhaps with a listed vehicle?

MH: We’re uncomfortable with the potential volatility not only from the assets, but in a listed entity, the discount or premium relative to net asset value. It doubles up on the NAV volatility.

GH: In some of your presentations, the amount of detail on geopolitical issues is mind-boggling. How do you stay on top of it and lead to an investment decision?

MH: Again, we have a process, we have staff who do it and it’s been my passion in my thinking, it’s always been there. The market will also give a view, provided we’ve already done the background work. You start with noise, such as prices, news and events. You have to structure that noise into data sets to be able to create information and do more work on it to create knowledge. The problem is that because of education and data services, many can get to that knowledge, and there are lots of financial qualifications such as CFAs, CAIAs and MBAs.



Plus we're very well plugged in, we access think tanks. The key is to understand the transmission mechanism, not every interesting event will have a market impact. If you're in the Department of Defence or the Home Office or Foreign Affairs or wherever, you'll have a different take on it. Consider, say, the ebola virus versus SARS. Different cost and effect on GDP.

GH: Can you elaborate on your comments that social media undermines the battle for ideas?

MH: If somebody says something that is mildly controversial, the trolling can get quite aggressive. It doesn't even need to be controversial if you put your head above the parapet. It's not just the individual, it's their family. An example is my view on the environment. I care deeply about our planet and our environment is complex and fragile. For the record, I do think there is anthropogenic climate change and the whole global warming issue is important, but the almost-exclusive focus on CO2 is too simplistic. When I write that, I've had most horrific hate mail. The point I make is it's all very well to get the Government to focus on CO2, but what about deforestation, use of antibiotics, what about plastic pollution and poisoning the oceans, biodiversity, what about all those critical issues. Some people think all we should legislate about is CO2 and we'll be fine. We need a holistic view and strong global leadership to tackle the environmental challenges our planet faces. It's like the sugar debate ... people should know not to eat too much and exercise more, why should the government legislate against sugar?

GH: Do you mean it's a personal responsibility, not the government's?

MH: Any market needs to have rules and guidelines but governments cannot simply legislate things away. We are living through a time of unprecedented challenge and change and the old world order is under threat. The institutions and governments and economic models we've grown up with are struggling and less effective. Politically-inspired regulation can be stifling. But given proper rules, markets, which are a voting system, can solve problems.

GH: Last question, it's important to mention your charity work, worsening income inequality, the plight of refugees, you say it's our job to protect the most fragile in society.

MH: Society cannot rely solely on the public purse. Prior to the 20th Century, it seldom did. I believe private philanthropy is better placed to motivate and partner with charities. We must take individual responsibility to look after others, it's our obligation to give back.

I often quote from the bible. It says, 'To those to whom much has been given, much is expected.' Charity is important. There are three principles that shape my philanthropy and career. The first is protection for the most fragile in society; the second is fostering aspiration; and the third is respect for institutions.

Graham Hand is Managing Editor of [Cuffelinks](#) and this exclusive interview with Michael Hintze took place on 8 March 2018.

Impact on pensions and super from loss of excess franking

Nicholas Stotz

The drums of class warfare seem to be beating loud and clear after Bill Shorten's announcement that a Labor Government would stop refunding excess franking credits received from Australian company dividends. This announcement comes on the heels of Labor's proposal to reform negative gearing, reduce the CGT discount and tax family trusts at a minimum of 30%.

Dividend imputation prevents investors being double taxed, once at the company level and again at the individual level. The franking credits allow individuals to reduce their taxable income by the amount they paid in corporate tax as a shareholder. The Keating Government introduced this policy, however the Howard Government extended the policy by refunding any franking credits not used to reduce taxable income. Labor is not ending dividend imputation, but is rather returning to the imputation system envisaged by Paul Keating.

The new (or is it old?) policy will have no impact on investors paying a higher tax rate than the company tax rate, since they don't receive franking credit refunds (see Table 3 below). However, for investors who pay a

lower tax rate, the removal of the refund policy renders some or all of their franking credits worthless, lowering their after-tax income (Tables 1 and 2).

Political posturing begins

Unsurprisingly, the Liberal Party is crying murder, with Treasurer Scott Morrison describing the policy as “a brutal and cruel blow for retirees, for pensioners”. This is the Treasurer who introduced balance limits on superannuation accounts and capped non-concessional contributions leading to higher taxes for wealthier investors. Each side of the aisle is employing a healthy amount of spin after the announcement. Labor is claiming their policy is not a tax increase, but it’s not a stretch to say that removing a measure to prevent double taxation is effectively a tax increase. The Liberals are calling it a \$59 billion tax grab, which is the expected value of the foregone refunds over 10 years. Why stop at a decade? It’s a half trillion-dollar tax grab if we extrapolate over a century.

An interesting development will be that if Labor removes refundable franking credits, changes in the corporate tax rate will affect the after-tax returns of investors with a lower tax rate than the corporate tax. As detailed in Graham Horrocks’ [article](#) in last week’s edition of Cuffelinks, the corporate tax rate currently has no impact on the after-tax income because higher rates render higher franking credits and vice-versa. However, if investors paying little tax aren’t able to realise their franking credits via a refund, they will benefit from lower tax rates that increase dividends and thus reduce franking credits (i.e lower corporate tax rates = higher returns for low tax investors) (Table 4).

SMSFs may change asset allocations

The Labor announcement has caused some to warn that the policy will drive SMSF investors from listed shares to income-paying assets such as REITs and direct property, driving property prices further up. In an interview on the Today Show on 14 March 2018, Bill Shorten acknowledged this possibility, adding that Labor would make “improvements in property investment to make it more attractive to invest in new housing”. This statement may come as a surprise to many, since Labor is promising negative gearing reform to promote housing affordability. All things being equal, an asset reallocation may occur, but all things are rarely equal, and a Labor budget is almost certain to target property investors despite Shorten’s comments.

A key consideration for all investors is how the policy will affect dividend payout ratios in corporate Australia. Classical financial theory suggests that lower payout ratios would result in higher share valuations, since companies keep more capital to re-invest into growth opportunities. However, this relies on the assumption that Australian management can invest additional capital wisely. This week’s hearings from the Royal Commission suggest this may be a somewhat heroic assumption.

Tables showing impact on removing refunds at different shareholder tax rates

Table 1. Impact of different franking credit refund rates on after-tax income in Pension phase

Franking credit refund policy	Current policy - 100% refund	Compromise - 50% refund	Proposed Policy - 0% refund
Company profit	\$1,000	\$1,000	\$1,000
Corporate tax rate	30%	30%	30%
Company tax paid	-\$300	-\$300	-\$300
Net profit after tax	\$700	\$700	\$700
Cash dividend (franked)	\$700	\$700	\$700
Franking credit	\$300	\$300	\$300
Taxable income	\$1,000	\$1,000	\$1,000
Shareholder tax rate	0%	0%	0%
Tax payable	\$0	\$0	\$0
Plus franking credits	\$300	\$300	\$300
Tax paid (positive = refund)	\$300	\$300	\$300
Refund paid out	\$300	\$150	\$0
After-tax income received	\$1,000	\$850	\$700

Table 2. Impact of different franking credit refunds rates on after-tax income in Super phase

Franking credit refund policy	Current policy - 100% refund	Compromise - 50% refund	Proposed Policy - 0% refund
Company profit	\$1,000	\$1,000	\$1,000
Company tax rate	30%	30%	30%
Company tax paid	-\$300	-\$300	-\$300
Net profit after tax	\$700	\$700	\$700
Cash dividend (franked)	\$700	\$700	\$700
Franking credit	\$300	\$300	\$300
Taxable income	\$1,000	\$1,000	\$1,000
Shareholder tax rate	15%	15%	15%
Tax payable	-\$150	-\$150	-\$150
Plus franking credits	\$150	\$150	\$150
Tax paid (positive = refund)	\$150	\$150	\$150
Refund paid out	\$150	\$75	\$0
After-tax income received	\$850	\$775	\$700

Table 3. Impact of different franking credit refunds rates on after-tax income in highest tax bracket

Franking credit refund policy	Current policy - 100% refund	Compromise - 50% refund	Proposed Policy - 0% refund
Company profit	\$1,000	\$1,000	\$1,000
Company tax rate	30%	30%	30%
Company tax paid	-\$300	-\$300	-\$300
Net profit after tax	\$700	\$700	\$700
Cash dividend (franked)	\$700	\$700	\$700
Franking credit	\$300	\$300	\$300
Taxable income	\$1,000	\$1,000	\$1,000
Shareholder tax rate	47%	47%	47%
Tax payable	-\$470	-\$470	-\$470
Plus franking credits	-\$170	-\$170	-\$170
Tax paid (positive = refund)	-\$170	-\$170	-\$170
Refund paid out	\$0	\$0	\$0
After-tax income received	\$530	\$530	\$530

Table 4. Impact of change in corporate tax rate + removal of franking credit refunds in pension phase

Hypothetical corporate tax rate	15%	30%	45%
Company profit	\$1,000	\$1,000	\$1,000
Company tax rate	15%	30%	45%
Company tax paid	-\$150	-\$300	-\$450
Net profit after tax	\$850	\$700	\$550
Cash dividend (franked)	\$850	\$700	\$550
Franking credit	\$150	\$300	\$450
Taxable income	\$1,000	\$1,000	\$1,000
Shareholder tax rate	0%	0%	0%
Tax payable	\$0	\$0	\$0
Plus franking credits	\$150	\$300	\$450
Tax paid (positive = refund)	\$150	\$300	\$450
Refund paid out	\$0	\$0	\$0
After-tax income received	\$850	\$700	\$550

Source: Stanford Brown calculations

The tables assume Australian shares paying fully franked dividends are the only investments held by the relevant shareholder, so for example, there is no other taxable income to reduce using the franking credit. It's worth repeating that Labor is not proposing to abolish dividend imputation, but rather the refunding of excess franking credits.

The examples show the material impact of the proposed policy on after-tax income of a pension or super fund holding only shares paying fully-franked dividends.

Nicholas Stotz is Investment Research Analyst at advisory firm, [Stanford Brown](#). This article is general information and does not consider the circumstances of any individual investor.

Impact on returns from loss of excess franking

Ashley Owen

The Labor Party has announced that if elected, it will end cash refunds of imputation credits on dividends paid by Australian companies. It would reduce *cash* returns to Australian shareholders by about 25%, and it would reduce *total* returns (including capital gains and income) by about 1% per year. The change would have significant impact on taxpayers paying little or no tax, especially retirees in pension phase.

Cash returns from the overall Australian stock market are currently running at around 5.7% including 1.5% in franking credits. Without the franking credits, the cash income from a broad portfolio would be reduced to the unfranked 4.2% dividend yield, which is a drop of around 25% in the cash yield on the portfolio.

There would be no direct impact on foreign shareholders as they are not entitled to franking credits or cash refunds unless they have other Australian tax payable.

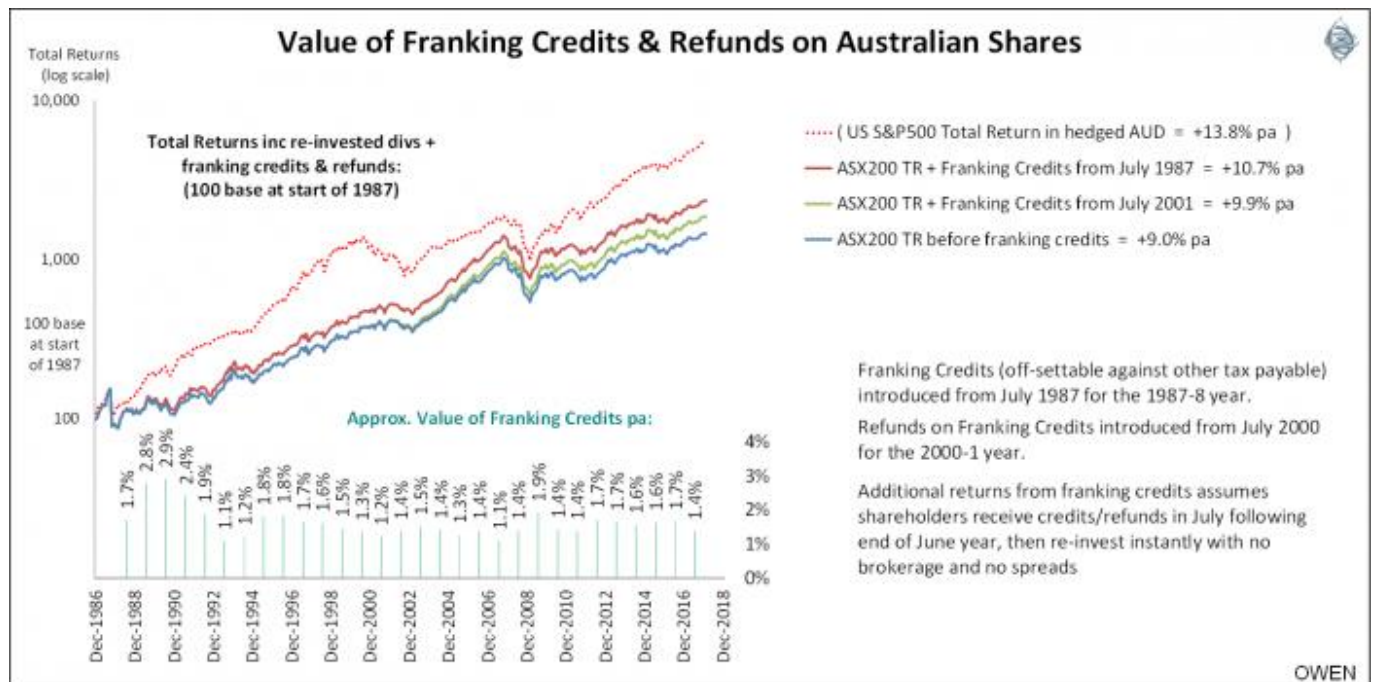
Background

Dividend imputation was introduced by the Hawke/Keating Government from July 1987 starting from the 1987-1988 tax year. Before 1987 company profits in Australia were taxed twice – first as company tax on the profits in the hands of the company, and then if the company paid out its profits as dividends to Australian shareholders, it was taxed again in the hands of shareholders.

Dividend imputation ('franking') credits meant tax already paid as company tax were available to Australian shareholders to offset other tax payable on other income. Cash refunds of excess franking credits were introduced by the Howard/Costello Government from the 2000-2001 year.

Impact of franking on returns to Australian shareholders

The net impact on investment returns experienced by Australian shareholders in Australian listed companies has been significant. For taxpayers who had enough other income to use the franking credits fully from 1988, the franking credits have added an average of **1.7%** per year to their total returns from the broad Australian stock market (S&P/ASX200 index).



The net benefit of franking credits has remained more or less constant over the period. The company tax rate has reduced from 39% to 30%, but the dividend payout rates across the market have risen from 60% to near 80%. On the chart I have added the total returns from the broad US market (S&P500 index) in hedged Australian dollars to remind investors that even including full re-investment of franking credits since 1988, the Australian market still lags the US market (in Australian dollar terms) by more than 3% per year.

If franking credit refunds are removed, it may lessen the myopic 'home bias' that many Australians suffer from and encourage them to increase their interest in other opportunities in global markets.

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A chat with Chris Cuffe at 'Women in Super'

Susie Bell

"Everyone wants to fix the system, that to me, isn't broken." This was Chris Cuffe's assessment of the default superannuation system at a recent Women in Super lunch held at Sydney's Doltone House.

At the packed event, the former Chairman of UniSuper and one-time head of Colonial First State shared his views on superannuation and the wider financial services sector in a Q&A style session.

Topics covered included:

Default super system: I'm a convert

Cuffe admitted that if you'd asked him a decade ago, he would have said he was philosophically opposed to the default system, where those who don't deliberately choose where their super funds will go have them deposited in a predetermined fund. But having been a director of an industry fund for over 10 years, he is now a convert.

"The default system has created monoliths (like UniSuper) which have achieved great economies of scale which have brought costs down significantly, provided very good service to their members, and achieved solid performance."

Unwinding of vertical integration: the merit of 'banks just being banks'

When discussing how a number of banks and large financial institutions had acquired an array of different companies, from funds management to financial advice to insurance, Cuffe said he wasn't surprised to see some of these unwind. According to Cuffe, the customer experience from these services varies significantly and not always in a positive way. The customer experience can depend on returns from investment markets, or the 'fine print' of a policy document or underwriting conditions, or the experience of the staff member servicing the customer. Banks have big, delicate brands that need to be carefully protected to maintain trust.

These varying activities do not sit well together, and the profit contributions of non-bank financial services are relatively low compared to banking. Cuffe said that banks slimming down their operations was logical so they can focus on 'just being banks'.

Internalisation of funds management: consistency is key

Another hot topic was the decision of a growing number of industry funds to internalise funds management in an attempt to deliver further value for members. Cuffe believes this can work for those with the right scale.

"Once you are large enough there is no reason why you cannot employ your own people with the same skill set as external fund managers. It's about turning a variable cost into a fixed cost ... leading to lower costs as the funds continue to grow."

Past performance is in fact a good indicator of future success

Cuffe holds a common-sense point of view of past performance over long term cycles as an indicator for future success. Many people, particularly regulators, say you should not rely on past performance when making an investment, but it is an important indicator of the skill level of a fund manager.

Should industry funds be compelled to have independent directors?

Cuffe said the issue has never been about independent directors, but more about the skill set. Many industry funds are very large, with billions of dollars under management, thousands of members, complex administration systems, insurance and financial planning services and extensive superannuation laws to comply with. They are some of the largest organisations in Australia. The board of directors should comprise individuals who are experienced in those fields. Such experience is unlikely to be found within the employers/employee representatives of most funds.

Does A.I have a place in financial services?

When thrown a curve-ball question around artificial intelligence, a philosophical Cuffe responded: "*We have to ask ourselves – where is the end-game and who will hold the power?*"

Susie Bell is a Partner and General Manager at [Honner](#).

When death benefits include life insurance

Mark Ellem

Death benefits that include life insurance proceeds require an understanding of how to manage the tax consequences. The amount of tax levied on such a payment from a superannuation fund depends on whether a member has any 'tax dependants', their 'eligible service date' (ESD) and whether the member died before reaching age 65. Trustees should have these details available if a death or disability benefit becomes payable.

Let's see how tax is impacted by these factors by focusing on life insurance which can be worthwhile to have inside an SMSF for two main reasons:

1. The premium can be tax deductible to the fund (provided the fund complies with the relevant requirements) but not when paid by individuals.
2. The insurance premium is not funded from personal cash flow but from deductible contributions or the fund's investment income.

The rules governing premiums and proceeds

Outside super

Life insurance premiums paid on policies held outside superannuation are not eligible for income tax deductions. However, the proceeds from life policies attract no income tax upon death or many other insured events.

Inside super

Likewise, insurance proceeds paid by the insurer to an SMSF are not taxed in the fund. However, any resulting benefits paid by the fund because of the death of a member are tax free if paid to a 'tax dependant' as a lump sum.

If the lump sum is paid to a 'non-tax dependant' the 'taxable component' of the lump sum is taxed. The most common case study of a 'non-tax dependant' is an adult child of the deceased. However, an adult child may qualify as a 'tax dependant' if they are disabled, in an interdependency relationship, or financially dependent on the deceased for support at the time of the member's death.

Where the proceeds of a life insurance policy are allocated to the deceased member's superannuation accumulation interest, it forms part of the taxable component of that interest. This occurs by default as the insurance proceeds form part of the member's taxable component and not included in the tax-free component.

Where a deceased member's interest is then paid as a lump sum death benefit to a 'tax dependant', such as a spouse or a child under 18, the whole of the amount of the payment (including the insurance component) is tax-free. A trustee will generally not be required to calculate the tax components or withhold any tax from the payment.

Where a fund pays a death benefit as a lump sum from the member's accumulation interest to a 'non-tax dependant', the trustee will need to withhold tax from the benefit payment as follows:

- Tax-free component – Nil withholding (non-assessable, non-exempt income).
- Taxable component (taxed element) – 15% withholding.
- Taxable component (untaxed element) – 30% withholding.

Medicare levy/NDIS levy will also be added to the withholding, except where the death benefit is paid to the deceased member's estate.

Where the death benefit includes insurance proceeds and the trustee has never claimed a deduction for the cost of the insurance premiums, the taxable component will include a 'taxed element' and an 'untaxed element'.

The tax laws provide specific steps to calculate the taxed and untaxed elements of a death benefit lump sum. Generally, the rule of thumb is that the 'untaxed element' will approximate the amount of the insurance proceeds, but this is not always the case. This is best illustrated in the following case study.

Case study on treatment of life insurance

Will, aged 41, is divorced with no spouse and has one child aged 22 who is not considered a tax dependant. Will has an SMSF and is the sole member and sole director of the trustee company. The current balance of his member account is \$700,000 (including a \$200,000 tax free amount – personal contributions he has made and not claimed as a tax deduction) and he also has life insurance of \$600,000 under the SMSF (the fund has claimed the cost of insurance premiums as a tax deduction).

Will has been a member of his SMSF since 17 October 1997 and he died on 12 October 2017 which covers a period of 7,300 days. The number of days to Will's 65th birthday from the time of his death is 8,395 days. Using Will's current accumulation balance of \$700,000, together with insurance proceeds of \$600,000, there is a total benefit payment of \$1.3 million to his adult child (Will had in place a valid binding nomination to direct the SMSF trustee to pay his adult child the whole of his death benefit).

As the SMSF has claimed a tax deduction for the cost of insurance premiums, the taxable component will be required to be split between the 'taxed element' and the 'untaxed element'. Applying the relevant rules, the components of the lump sum death benefit payment and applicable tax is:

Benefit component	Benefit Amount	Tax Rate	Tax Levied
Tax free amount	\$200,000	0%	\$0
Taxable component – taxed element	\$404,651	17%	\$68,791
Taxable component – untaxed element	\$695,349	32%	\$222,512
	\$1,300,000		\$291,303

While the insurance proceeds total \$600,000 you will notice that the untaxed element is higher, being \$695,349. Using the general rule of thumb that the 'untaxed element' approximates the insurance proceeds in this case would have underestimated the amount of tax levied on the lump sum death benefit paid to Will's adult son.

Let's look at the effect on the calculation of the untaxed element assuming Will has a current service period of just five years more, i.e. assuming he dies on 11 October 2022 and has a future service period of five years less.

The components of the death benefit payment and applicable tax is now:

Benefit component	Benefit Amount	Tax Rate	Tax Levied
Tax free amount	\$200,000	0%	\$0
Taxable component – taxed element	\$555,814	17%	\$94,488
Taxable component – untaxed element	\$544,186	32%	\$174,140
	\$1,300,000		\$268,628

The additional five-year service period reduces the tax liability to a 'non-tax dependent' by \$22,675. Again, you can see that the untaxed element does not equate to the insured amount.

The importance of the eligible service date

In this case study, Will's service period could have been extended where it was discovered that he had an eligible service date (ESD) five years earlier. This could occur where Will had rolled over superannuation from another fund to his SMSF and that other superannuation fund had an earlier ESD.

A member can effectively transfer an earlier ESD from one superannuation fund to another simply by transferring just \$1 of the amount accumulated in that superannuation fund. SMSF trustees (and the fund's accountant/administrator) should record the earliest ESD, particularly with a member with no tax dependents and insurance held within the SMSF. A member with a large service period will have relatively less 'untaxed element' than another member of the same age with a shorter service period. A worthwhile task would be to review for any rollovers into the fund to ascertain if any had an earlier ESD.

Once a member turns 65, they cannot have an 'untaxed element' in a death benefit lump sum paid to a 'non-tax dependent'. This is due to the formulae used including future service days only up until what would have been the deceased's 65th birthday.

So, would it have been better (for Will's adult child) for Will's insurance to have been held outside of his SMSF or in another superannuation fund due to the ESD?

It would be worthwhile to enquire whether members with life insurance cover have 'tax dependants'. Where they do not, do they understand the personal income tax consequences (for the intended beneficiary) of a lump sum death benefit payment to a 'non-tax dependant'? By checking this, the SMSF trustee would also meet the obligation under the super law to regularly review the fund's investment strategy including insurance.

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Financial advisers not allowed to advise

Graham Hand

In [the recent article](#) by author and lecturer, Peter Thornhill, he made the case for a long-term asset allocation of all Australian shares. His main argument was the long-term superior income backed by capital growth, but it requires investor tolerance of the inevitable short-term fluctuations in the market value of their portfolio. Peter argued investors should focus on income, and dividends are less volatile than market prices.

The article was a response to a piece on [life-cycle investing](#) by an equally well-credentialed expert of long-standing, Don Ezra. We have also published Don's [further contribution](#) this week.

Some comments on Peter's article highlight another serious issue. Financial advice as a profession has taken a beating over recent years, most notably in CBA-aligned licencees, with millions of dollars of compensation paid to clients. There is no doubt that some poor advice was given including cases of fraudulent activity, leading to ASIC investigations, the Future of Financial Advice (FoFA) legislation and the current Royal Commission. Clients argued they did not understand the risks in their portfolios when entering the GFC, and cases such as the elderly lady invested in a geared listed property fund are high profile examples of advice failure.

What is rarely acknowledged, however, is that many people took advantage of the media and regulatory focus on financial advice and made ambit claims, even when they knew the risks they were taking. The Australian share market ran strongly in the five years to 2007, and investors wanted a piece of the action and enjoyed the hefty gains. When it went bad, many saw an opportunity to claim innocence. I was working at Colonial First State at the time, and amid the obvious problems, a lot of appropriate advice was also targetted by clients simply because exposure to shares had resulted in losses. It was a chance to recover some money, what some called a 'put option' back to the bank. As the media hype became hysterical, CBA virtually waved the white flag and made payments in cases where internally, it was strongly felt clients knew exactly what was in their portfolios, and had knowingly signed their Statements of Advice.

Advisers started ducking for cover and banks such as ANZ have stepped back from the advice business. In fact, CBA and Colonial First State have lost confidence in defending their rights and the merits of financial advice given, and would rather write \$100 million in cheques than face further slamming of their reputations.

Many advisers do not give the advice they believe in, faced by a potential legal liability and the worry that clients will panic amid the media whipping up fear.

Comment by Andrew Rowan

"As an adviser for 25 years, my career commenced in 1993, and shortly after that, I came face to face with the Bond Crash of 1994, when even 'safe' investments fell in value (collapsed), and obviously every 'crash' since that time.

When I was younger, I compiled possibly too many spreadsheets to prove theories such as yours (ie Peter Thornhill's) for myself using actual client situations; nowadays I am happy just to know the truth.

My observation over time is that volatility has never really mattered in client portfolios provided that they have had sufficient cash to meet their income and 'emergency' needs.

In theory, I would like all clients to say hold near 100% in equities in their portfolio. However in the real world as advisers, we have to contend with the media setting expectations and trying to scare the daylights out of the public whenever the sharemarket undergoes repricing from time to time (what they call Australians losing 'billions').

Coupled with this, is the concept of 'Risk Aversion' where some people simply do not have the appetite for any volatility, such is their fear that they will lose their hard earned.

In such cases, and as advisers we are under an obligation to 'know' thy client and invest their funds accordingly. I know that when I invest a client's money in a 'conservative portfolio', I am setting up the client to earn less over time.

If on the other hand, I were to do the right thing by the client and invest in a way that we know the client will be better off (i.e. shares), then when next the market falls, my conservative client will in all likelihood complain. This could then cause them to sell their investments of their own volition and crystallise the 'loss'.

This scenario would likely end up with me meeting the lawyers.

In my experience volatility for our clients is a concept until it becomes real, and the portfolio report shows a 'loss'. That is when the real test is applied, and then when they listen to the media, they panic.

My question then is how in the face of knowing what is right, how then do we deal with the reality of fear, risk aversion, misinformation and prejudice in clients."

Comment by Phil Brady

"Excellent summary of the problem Andrew and sums up the dilemma of managing multiple clients, not just your own portfolio, or Peter's in this case, on which you can manage your own emotions or not. Much more difficult to manage other's emotions. Part of the answer is education, but in my experience as well, the education may not actually sink in, or it is abandoned when fear becomes real, hence we revert to the 'safe' approach. **The no win no fee lawyers would have a field day with portfolios 80% in Australian equities**, no matter the theory. That's why some choose to be educators and theorists I guess, and not personal advisers!"

Comment by Rob

"I once considered very seriously becoming a financial adviser (I was already involved in the finance industry in another capacity) however I was unable to reconcile my own firm views on high ASX asset allocation and the importance of income above all else, to the 'standard' approach of the 'balanced' portfolio and the much lower outcomes that must occur as a result.

So I just stayed where I was and in the end was able to personally retire some 10 years ahead of most, if not all, of my colleagues and peers. This is not to 'brag', I actually state this with a sense of disappointment for the missed opportunities of the majority caught up in the mire of the bog standard asset allocation world.

Concluding note

The increasing amount of compliance and legal obligations faced by advisers is one reason many are leaving the large advice groups and becoming Independent Financial Advisers or setting up themselves. Every adviser faces significant paperwork obligations each time they hand out personal financial advice, including the 70 page Statement of Advice, the Approved Product Lists, the Professional Indemnity Insurance, the administrative platform and the model portfolios. It limits the scope for individual advisers to follow their instincts and accumulated knowledge as they fear the backlash from advice that goes wrong. [Michael Kitces](#) argued that the future of financial advice is specialisation, not these generic responses and institutionally-based rules. In the meantime, financial advisers will give the advice they've been told to give.

Leaving the last words for Peter Thornhill:

"I have always felt for advisers. Know your client? What a joke. You know many of them only until things don't go their way and then it is your fault. The GFC was a great opportunity for many 'clients' who signed off on their plans to activate a 'put' option."

Graham Hand is Managing Editor of Cuffelinks.

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