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Back to basics shows franking credit refunds are fair

Warren Bird

Federal Opposition Leader Bill Shorten has proposed to change the dividend imputation system so that people or funds who have a zero tax rate do not receive franking credits. He has presented it as way to make the tax system fairer, by clawing back what is asserted to be an overly-generous provision. However, if implemented, it would make the tax system much less fair.

What is dividend imputation supposed to do?

Let's start by going back to the fundamental principle behind dividend imputation, which is to ensure that *income is taxed once* by those who are obliged to pay it.

If people who have a zero tax obligation do not received franking credit refunds, then they have paid tax on income when they should not have. This results in them paying more tax than someone who earns the same gross income.

To illustrate, consider the following three cases.

- Person A does a little bit of part-time work that earns them \$17,500 a year, just under the income tax threshold. They don't have to pay any tax.
- Person B is semi-retired but runs a small sole trader business that brings in a net of \$17,500 a year. They also don't have any tax obligation.
- Person C is retired and owns shares in a company that earns \$17,500 of profit on C's shares. Being a company with other shareholders, it pays 30% company tax and most of the rest is distributed to shareholders as dividends. Person C receives a dividend of \$12,250 (that is, 70% of \$17,500). They have effectively paid \$5,250 in tax on their income because of the veil that the company structure has created.

Under the current imputation system, Person C receives a franking credit for that amount and a payment of \$5,250 from the ATO. This recognises the fact that the full \$17,500 earned by the company should belong to Person C, just the same as Person B's business income or Person A's part-time salary.

It's similar to someone getting a tax refund at the end of the year because their PAYG taxes didn't take legitimate deductions into account. They overpaid tax and so are allowed to get it back. It is their money.

Why the current system is fair

The proposal by the Labor Party will take this away, leaving Person C with a lower income. That is not fair. Why should the presence of other income earners on the share register of the company force low income earner Person C to pay 30% tax?

There was a lengthy discussion of this in the Campbell Inquiry in 1981 ([see chapter 14](#)). When he introduced dividend imputation in 1987, Paul Keating moved our tax system in the right direction. However, his system had a flaw in it because Person C in my example was not afforded the same fairness as higher tax rate payers. John Howard (the Treasurer to whom the Campbell Inquiry Report was delivered) and Peter Costello fixed it, so that Person C could get that \$5,250 back. Thus, in two steps we ended up with a much better tax system.

I understand charities will be exempt from this change. That seems to recognise the very point I am making. Why stop there? All people who have a zero tax rate should be treated the same and people who have a zero tax obligation shouldn't be forced to pay tax. This is a matter of not discriminating against those who happen to earn their income through shareholdings.

Most of the arguments against zero tax rate individuals receiving franking credits are actually arguments against the whole dividend imputation system, or that SMSFs in pension mode should not have a zero tax rate. For if you accept that zero tax payers shouldn't get a credit, why stop there? Why should any tax payer get franking credits to offset other tax? The answer for all is that the pre-tax earnings of the companies they own, partly via being one shareholder among many, or wholly if it is their own business, belong to them.

The company, for all shareholders irrespective of their tax rate, is simply a pooling structure. It should not pay tax on earnings it pays to the members of the pool. The fact that it does is what creates the errors of perception about the incidence of taxation, about who should pay what, that are now clouding the discussion.

The current dividend imputation system is the second-best way of fixing the error that having a company tax system has created. The best way would be to have a zero company tax rate and apply withholding tax on retained earnings and foreign shareholder distributions.

From the Budget point of view, both systems would raise the same revenue.

The real issue is the zero rate paid by some taxpayers

Which brings us to the real issue behind Mr Shorten's proposal. It reflects a view that some tax payers shouldn't be in the zero tax bracket. In that case, he should just propose a change to their tax rate. Be explicit about who you are taxing and why. Don't hide behind erroneous thinking and bad policy, and don't muck up a good tax reform.

Understanding imputation in this way also changes the discussion about the company tax rate. The economic and public finance impact is the same as if the company tax rate was **already zero**. Domestic shareholders pay tax on the earnings that they receive from dividends at their own tax rate. All the tax paid by companies on behalf of local shareholders is effectively repaid via the franking credit system and the individual (or managed fund or SMSF or charity) is assessed for tax on the income. Foreign shareholders pay a rate of 30%, and there's a 30% tax on retained earnings.

If the company tax rate was zero and the government charged 30% withholding tax on all dividend payments to non-residents and on retained earnings, the budget would be in **exactly** the same position as it is now. There'd be no need for an imputation system. There'd be no franking credits for any income level and shareholders would include dividends (on which no tax had already been paid) in their income tax calculation.

The company is simply prepaying tax for its shareholders

Politically, the latter is unlikely to come in. My point is that the discussion about tax policy matters required us to recognise that the individual is always the ultimate payer of any tax and is where the incidence of tax lies. Behind the 'veil' of the legal structure, when a company pays tax it is, in effect, prepaying tax for its shareholders.

The point of the imputation system is to adjust how much tax has been collected on the shareholder's behalf and correct it back to the amount of tax that should have paid in the first place. If that was zero, then a fair and just system would pay a tax refund. We have that system now. It shouldn't change.

Warren Bird is Executive Director of [Uniting Financial Services](#), a division of the Uniting Church (NSW & ACT). He has 30 years' experience in fixed income investing. He also serves as an Independent Member of the GESB Investment Committee.

Warren would like to thank John Stroud, who worked on the Campbell Inquiry, for reminding him of the fundamental principle on which this article is based.

Women's super needs protection of reversionary benefits

David Bell and Estelle Liu

International Women's Day and the focus on equality in superannuation outcomes continues to gain momentum. Congratulations to all involved, notably Women in Super. The progress emphasises this is no time to take a step back on women's rights to retirement savings.

According to the [Women in Super website](#), women in Australia retire with 47% less superannuation than men. Reasons explaining such a large gap include:

- A gender pay gap of about 19%.
- Women's fragmented patterns of paid work associated with having children.
- Greater likelihood of women working in part-time and casual positions, and the associated lower level of pay.
- Women undertake the majority of unpaid housework, caring and parenting.

To date, the focus has been on developing policies to reduce the large gender-based super gap. If successful in achieving policy change, it will then take decades for these changes to season and realise their full, intended impact.

In the meantime, it is important for the retirement outcome of women that any new regulatory rules are not further detrimental to the retirement outcomes of women. Unfortunately, we face such a situation right now.

Reversion of pension benefits might be lost

At present, Treasury's first cut of the CIPR (Comprehensive Income Product for Retirement, read more [here](#)) guidelines details highly-prescriptive product rules which emphasise income and place zero value on retirement features such as bequests including reversionary benefits. A reversionary benefit is where a pension 'reverts' to an eligible spouse or de facto partner when a member dies after retirement. Products with reversionary benefits are not precluded from CIPR, but these features cost money and hence reduce incomes. Our analysis suggests it is nearly impossible to meet the CIPR minimum requirements with a product which provides a reversionary benefit.

Currently, most pension assets sit in account-based pensions. When most people switch out of super, they roll into an account-based pension. As long as a beneficiary is nominated, a reversionary benefit feature will exist.

We know that about 65% of Australians retire with a partner. Currently, whether we like it or not, the benefits of superannuation largely flow to women through their male partners. This is at risk through the current framing of CIPR if they do not relax the stance on reversionary benefits. This is a massive issue for future retirement savings of women.

Establishing retirement preferences

The industry may be heading down the path of addressing the post-retirement challenge via prescriptive solutions, such as new products. We believe the better approach is to first establish preferences for retirement, and then use these to assess the best of a range of possible solutions.

Treasury has ventured down the prescriptive route with the first cut of CIPR. We undertook a significant amount of reverse engineering to discover the preferences that are implied by the CIPR design rules. We feel many superannuation trustees will be uncomfortable assuming these implied preferences on behalf of their members (for instance, the zero-value placed on reversionary benefits). This clearly creates a difficult situation of conflict for trustees of super funds between acting on behalf of their members' best interest while being required to follow law.

What can be done?

The Government has announced its desire for a covenant requiring superannuation fund trustees to design appropriate retirement income solutions to their members. Minister Kelly O'Dwyer has appointed an Advisory Group to assist with this and review the design characteristics of CIPR (read more [here](#)).

The potential loss of reversionary benefits in retirement and the impact on women in retirement is too important to dismiss. Treasury and the Advisory Group members must be made aware of this.

Estelle Liu is a Quantitative Analyst in the Retirement Outcome team at [Mine Super](#). David Bell is Chief Investment Officer at Mine Super, and a PhD candidate at UNSW. The views expressed in this article are their own and may differ from those at Mine Super.

Impact on hybrids of Labor's franking policy

Brad Newcombe

A Labor Party win at the next Federal election may change the dividend imputation system with potentially significant impacts on self-funded retirees. Fears that the abolition of excess franking credit refunds will cause a substantial disruption to the hybrid market are unlikely. However, as with any change there is always potential for winners and losers, and with that comes opportunity.

A long way to go in its current form

There are a number of events required prior to this policy becoming legislated, including:

- The Labor Party would have to win government at the next Federal election
- The policy would have to withstand changes to water down its impact
- The legislation would need to pass in both the House of Representatives and the Senate.

There are doubts about all three to varying degrees and the probability of all three occurring appears relatively low. The second and third points are somewhat related. The proposal as currently structured is unlikely to receive support in the Senate. Changes may be required to ensure low-income earners are protected, such as introducing a cap on claims. If the policy is watered down, the proposal may continue to struggle unless the Labor Party has a majority in the Senate.

Likely to lead to a buying opportunity

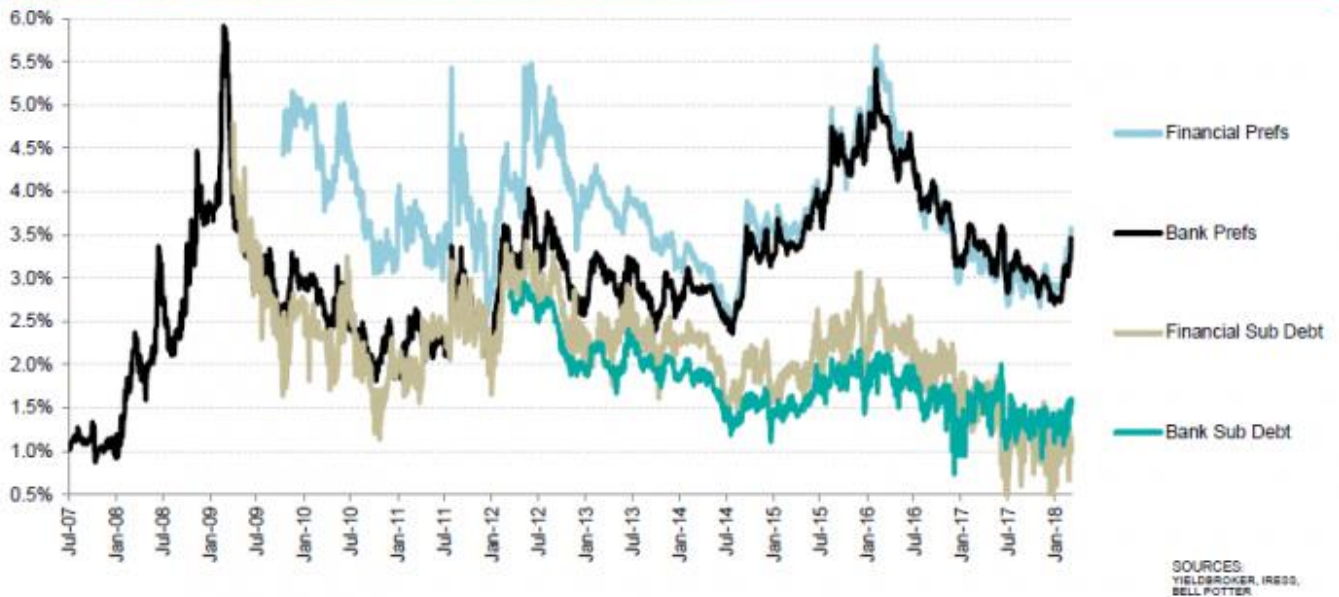
Even if legislation is enacted as initially communicated, it is unlikely to be a death knell for the hybrid market. While SMSFs and self-funded retirees account for a substantial part of the hybrid market, they aren't the only investors who can utilise the franking credits. In the retail space, for example, SMSFs in accumulation phase and self-funded retirees with other taxable income will continue to gain the full benefits of fully franked hybrids. The market also includes institutional buyers.

That's not to say there won't be some dislocation. There is likely to be a sell-off of hybrids as investors who can't utilise the franking credits transfer them to those who can. Also, given the pool of potential fully franked hybrid investors will diminish, there may be an increase in margins attached to new hybrids. For those who can use the franking credits, that is good news. The increase in margins, however, is likely to be moderate creating a relatively minor impediment for hybrid issuers rather than a permanent roadblock.

The proposed changes have already impacted the hybrid market, with bank and insurance securities experiencing a sell-off and adding to the widening trend that commenced in February. The following chart from Bell Potter shows that trading margins on the most common major bank hybrids (the black line) have increased

from around +275bps to +350bps since early February 2018, a material move. We believe there may be some further weakness in the near term but ultimately this will be seen as a buying opportunity.

Figure 3: Trading margins on ASX listed debt and hybrid sectors



Source: Bell Potter Fixed Interest Weekly 16 March 2018

Notwithstanding that the impact on the more recent Basel III hybrids is likely to be less than the market is anticipating, our preferred hybrids remain the pre-GFC/legacy perpetual income style securities such as those listed on the ASX under codes NABHA (National Australia Bank) and MBLHB (Macquarie Bank). We believe that there is a high probability that there will be a buy-back and/or redemption of these securities in the next few years with either option resulting in substantial capital gains from current levels.

More detail on NABHA

The National Income Securities (ASX:NABHA) are a legacy Tier 1 hybrid that was issued in 1999. We believe NAB will look to replace the NABHAs with a Basel III compliant hybrid (i.e. Additional Tier 1 security such as the NABPDs) when the NABHA’s become inefficient capital between 2020 and 2022 and that investors will be able to exit at \$100.

Based on a current price of \$78.55 (at the time of writing), this equates to the following yields to call depending on the timing of the potential exit:

NABHA	Yield to call	Margin to call
15-February-2019	31.9%	29.9%
15-February-2020	16.9%	14.9%
15-February-2021	12.5%	10.3%
15-February-2022	10.4%	8.1%
15-February-2030	6.7%	3.9%

Our base case is that this will likely happen on the first coupon payment date in 2021 (i.e. 15 February 2021 – highlighted in blue) which would equate to yield to call of 12.5% (or a trading margin of +10.3% over swap). Further, NABHAs are set to benefit from any recycling out of traditional hybrids that may be impacted by the ALP’s proposed franking changes given that NABHAs do not have any franking credits attached but rather pay the entire coupon in cash.

We believe that although the documented maturity is 'perpetual', NAB will retire the NABHAs before 2022 for three key reasons:

1. Capital/regulatory treatment – these legacy securities will no longer count towards capital ratios from 1 January 2022
2. Replacement cost – NAB can replace the NABHAs with cheaper and/or more capital effective securities
3. Precedent – the recent buybacks of the NAB USD Libor+15bps (i.e. very cheap) legacy Upper Tier 2 capital security.

Of course, much can happen between now and 2022 and investors must make their own enquiries and judgement, and the Labor Party policy has added an element of uncertainty to the outlook for hybrids.

Brad Newcombe is a High Yield Analyst, Fixed Income at [Mint Partners Australia](#). Individuals should make investment decisions based on a comprehensive understanding of their own financial position and in consultation with their own financial advisors.

Title 4 Five reasons Australian rates unlikely to follow US

Anthony Kirkham

The US Federal Reserve is tightening monetary policy and US bond yields are rising. In the current environment, we believe there are significant differences between the US and Australia that suggest local monetary policy may continue somewhat independently.

Australia is different

While Australian bond yields often move in tandem with the US, particularly during periods of weakness, it is not unprecedented for the domestic market to outperform US moves or even 'do its own thing'. Market correlation is a strong force, but sometimes domestic fundamentals are stronger.

1. The extent of the easing cycle

The first major difference is the extent to which the US and Australian central banks eased monetary policy following the financial crisis in 2008. US rates went to zero, Australian rates did not. The US used extensive quantitative easing (QE) to stimulate the economy, Australia did not. This is significant as it suggests the early stage of the US tightening cycle – the part we are in right now – is actually policy rate *normalisation*, not really policy *tightening*. It's about the Federal Funds rate going back to a 'normal' level relative to history, now that the US economy has recovered.

In Australia, the mining boom initially supported the economy and when that ended in 2012, growth broadened to other sectors, preventing a recession. Monetary policy was eased but the cash rate settled at 1.5% and no QE was necessary. There is less need to normalise interest rates and the Reserve Bank of Australia (RBA) has now kept interest rates on hold for 18 consecutive months.

2. The structure of the housing market

The process of setting mortgage rates is different in each country. Australian mortgage rates are priced off the official cash rate, so a tightening of monetary policy, of say 0.25%, usually leads to a corresponding 0.25% lift in mortgage rates. This can slow the housing sector significantly and impact consumption.

By contrast, US mortgage rates are priced off the 30-year bond yield which doesn't move in line with the US Federal Funds rate. So US monetary policy tightening doesn't feed straight into higher US mortgage rates. To date, the 30-year bond has been relatively stable as shown in Chart 1 that compares the US yield curve in March 2016 and February 2018. The yield curve suggests growth is expected to be brought forward by tax cuts and fiscal stimulus, but this isn't anticipated to increase inflation materially, hence long-term bond yields have risen by less than the shorter end.

Chart 1: US yield curve



Source: Bloomberg, March 2018

Australian households currently have a *lot* of mortgage debt, with a household debt to GDP ratio of about 120%. High debt levels make the housing market more vulnerable to any monetary policy tightening and increase the risk of sharp slowdown in consumer demand. The RBA has stated many times that it is concerned about financial stability and this is keeping policy on hold despite US tightening. We expect this to remain the case through 2018.

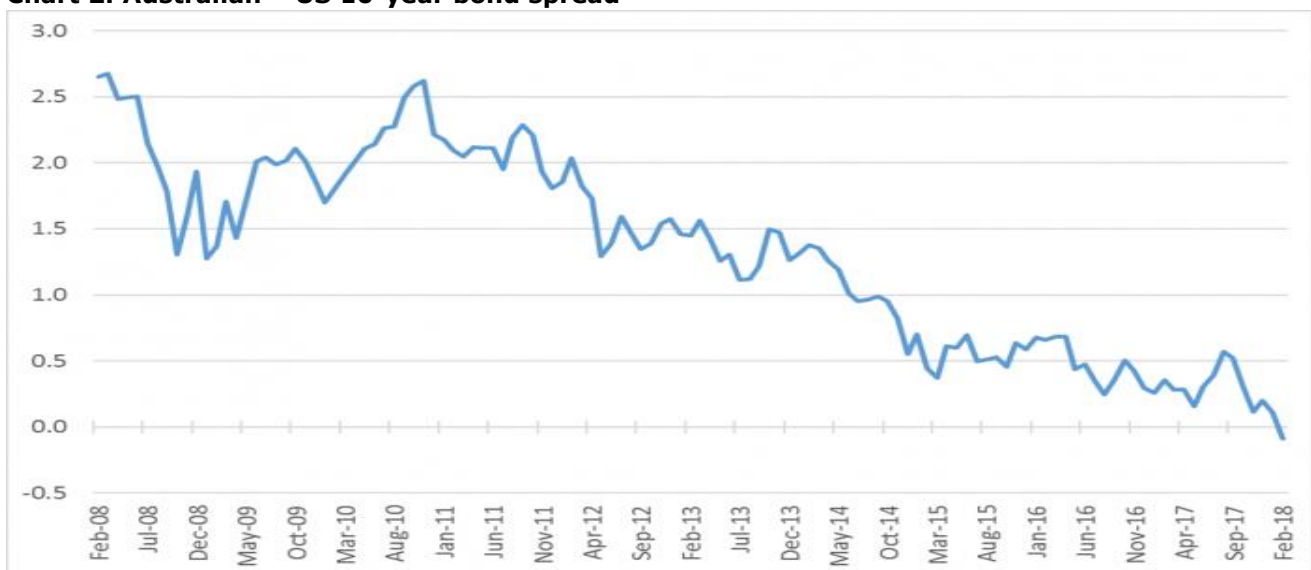
The key to higher rates in Australia is real growth in wages which remains at record lows. Until consumers experience higher wages, it is unlikely that growth and inflation will accelerate sufficiently for the RBA to tighten without risking a consumption slump.

3. US fiscal stimulus

Another driver of higher US interest rates is President Trump’s fiscal stimulus, including large corporate tax cuts. It is also increasing US sovereign debt, causing investors to shift their view on where US bond yields should trade.

Consequently, the spread between US and Australian 10-year bonds has narrowed and Australian rates are just below US rates, as shown in Chart 2. This is unusual but not unprecedented, but the US is embarking on debt-funded fiscal stimulus whilst Australia is not.

Chart 2: Australian – US 10-year bond spread



Source: Bloomberg, March 2018

4. Australian dollar is holding its level

When Australian interest rates fall below US rates, there is always a risk that the \$A may react negatively. This has happened in the past, but it assumes investors are only happy to invest in Australia as long as they are compensated via an interest rate premium. This is not always the case.

We believe the interest rate differential is less important as a driver of the \$A, partly because commodity prices are quite strong. As a capital importer, Australia still needs willing investors to provide funding, but with the global economy strong and possibly getting stronger, investors should be more comfortable with Australian yields below US yields since national income is underpinned by commodity demand.

It is also worth noting that European interest rates have been below US rates for quite some time and this has not led to weakness in the Euro.

5. Credit spreads and positive fundamentals should prevail

Australian credit spreads between government and non-government bonds remained firm in 2017 despite concerns about US tightening. Corporate profitability is improving, as shown in the February 2018 reporting season, economic growth is steady-to-improving, and domestic leverage has moved downwards in the past 12 months.

Technical factors also suggest ongoing support for the sector, with several recent deals being well oversubscribed. For example, AusNet issued a 10.5-year BBB security during the market volatility in February and it was oversubscribed. Australian investors are still seeking yield for both cyclical (historically-low term deposit rates) and structural (baby boomers retiring) reasons. We do not expect this to change in the near term.

The bottom line

Short-term Australian interest rate rises are unlikely until early 2019, and even then, we expect the pace of tightening to be slow, with the RBA mindful of debt levels and not wanting to inhibit growth. We expect credit spreads to do well and we remain overweight in the sector, albeit with a focus on the shorter maturities, in our bond portfolios.

Anthony Kirkham is the Head of Investments at [Western Asset Australia](#) and Portfolio Manager of the Legg Mason Western Asset Australian Bond Fund. This article is in the nature of general information only and does not consider the circumstances of individual investors.

Four checks for super downsizer contributions

Julie Steed

The downsizer contributions legislation will allow an individual aged 65 years or over to use the proceeds of the sale of one main residence to make contributions of up to \$300,000 to superannuation for themselves and/or their spouse. The legislation became law in December 2017 and is designed to reduce pressure on housing affordability. However, downsizer contributions can only be made if the contract for sale of the home is exchanged on or after 1 July 2018.

In this article, we outline the eligibility criteria and requirements that relate to:

1. the contributor
2. the downsizer contribution cap
3. the home
4. contributing to super

1. The contributor

The person making the contribution must be age 65 or over. There is no maximum age, no work test requirement, and no requirement for the contributor to be permanently retired.

2. Downsizer contribution cap

The downsizer contribution cap is the maximum amount that can be contributed to super. The cap is calculated as the lesser of:

- the proceeds of the sale
- \$300,000 per person

If a couple sell their home for \$1 million, they can contribute \$300,000 each. If a couple sell their home for \$400,000, the contribution made between the two of them may not exceed \$400,000. They could contribute \$200,000 each or some other combination totalling up to \$400,000 with no more than \$300,000 for one person.

3. The home

The sale contract for the home must be exchanged on or after 1 July 2018. The settlement date is not relevant. The home must be located in Australia and must be affixed to land. Caravans, houseboats, or other mobile homes are not eligible.

The home must have been owned for 10 years or more by the contributor, their spouse, or former spouse. Ownership can be held solely, jointly, or as tenants in common.

There is no need for the spouses to have been in a relationship for 10 years or more. For example, if a person has owned a home in their sole name for more than 10 years, their current spouse of only two years is still eligible to receive a downsizer contribution if the home is sold.

The home must qualify for the main residence capital gains tax (CGT) concession or would have qualified if it is a pre-CGT asset, acquired before 20 September 1985.

A home will be eligible if the main residence CGT concession applies in part or in full. This means that the property does not need to be a current home. It could be a former home that is now an investment property.

This is also relevant for the sale of a farm or business where only a partial main residence CGT exemption applies because the property is also used for income producing purposes.

Case studies

Sidney and Isabel are both in their 70s and are looking to retire from the farm. They have lived in the homestead on the farm for 45 years and they sell the farm in 2019 for \$3 million.

As they qualify for a partial main residence exemption they can each contribute \$300,000 to super. There is no need to apportion the proceeds from the sale between the part of the farm used as the main residence and the income-producing part of the farm.

Although the contributions are named downsizing contributions, there is no need to sell the home to buy a smaller home. In fact, there is no need to buy another home at all.

In addition, if a person was to 'upsized' their home and buy a more expensive one, they could still make a downsizer contribution (up to the sale proceeds of the home) if they have other cash that they can use to contribute to super.

Kim and Kanye sell their \$1 million home and buy a \$1.5 million home, using some of the \$2 million they have available in cash. As the sale proceeds are \$1 million, they can each contribute \$300,000 to super.

4. Contributing to super

A downsizer contribution does not count towards the non-concessional contributions cap and a person's total super balance is not relevant. Normally, non-concessional contributions cannot be made if a person has a total super balance of \$1.6 million or more at the previous 30 June. However, downsizer contributions can still be made even if a person has \$3 million in super.

The balance at 30 June after the contribution is, however, relevant if making other non-concessional contributions. There is no exemption from the total super balance for downsizer contributions.

The ability to make a downsizer contribution is a once-in-a-lifetime event: only one home sale ever is eligible for downsizer contributions. For example, if a person sells their only home and contributes \$100,000 to super and buys a new home, when they subsequently sell their new home, they are not able to 'top-up' their downsizer contributions.

Downsizer contributions cannot be used to claim a tax deduction or to receive a Government co-contribution.

The proceeds from the sale of the home must be paid to super within 90 days of receipt. Multiple contributions may be made from the sale of a single home, however, they must all be made within 90 days of receipt.

Further, individuals must elect to treat the contribution as a downsizer contribution by completing the ATO downsizer contribution form. The form must be received by the super fund at or before the time the contribution is made.

Whilst the downsizer contribution may increase a person's super retirement income, it may reduce any Centrelink age pension. Unlike the family home, there is no Centrelink means test exemption for the downsizer contributions. Any downsizer contribution to super for members over their qualifying age pension age counts towards the age pension assets test and is deemed under the income test.

Conclusion

The downsizer contribution could assist older Australians who would otherwise be precluded from contributing to super to upsize their super balances. However, people in receipt of Centrelink benefits should seek professional financial advice before making downsizer contributions to understand any reduction in age pension that may result.

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.

Why do most retirees spend less than the age pension?

Jeff Gebler

More than half of Australian retirees are spending less than the age pension each year, raising significant questions about current retirement policy and super fund strategies. The unexpected finding, which is also affected by age and location, was revealed in Milliman's latest Retirement Expectations and Spending Profiles ([ESP](#)) analysis of 300,000-plus retirees' real-world annual expenditure.

It suggests mandatory and voluntary measures to boost super may not be enough to produce improved retirement lifestyles without a deeper understanding of the motivations driving retiree behaviour. The findings come as a particular surprise given the commonly used '50% of median income' poverty line typically captures many retirees.

For example, the latest Australian Council of Social Service Poverty in Australia [report](#) estimated that 13.9% of age pension recipients were living below the poverty line. The OECD's Pensions at a Glance 2015 [report](#) found a more pronounced issue. It ranked Australia second lowest on social equity among 33 countries, with more than one-third of pensioners living below the poverty line.

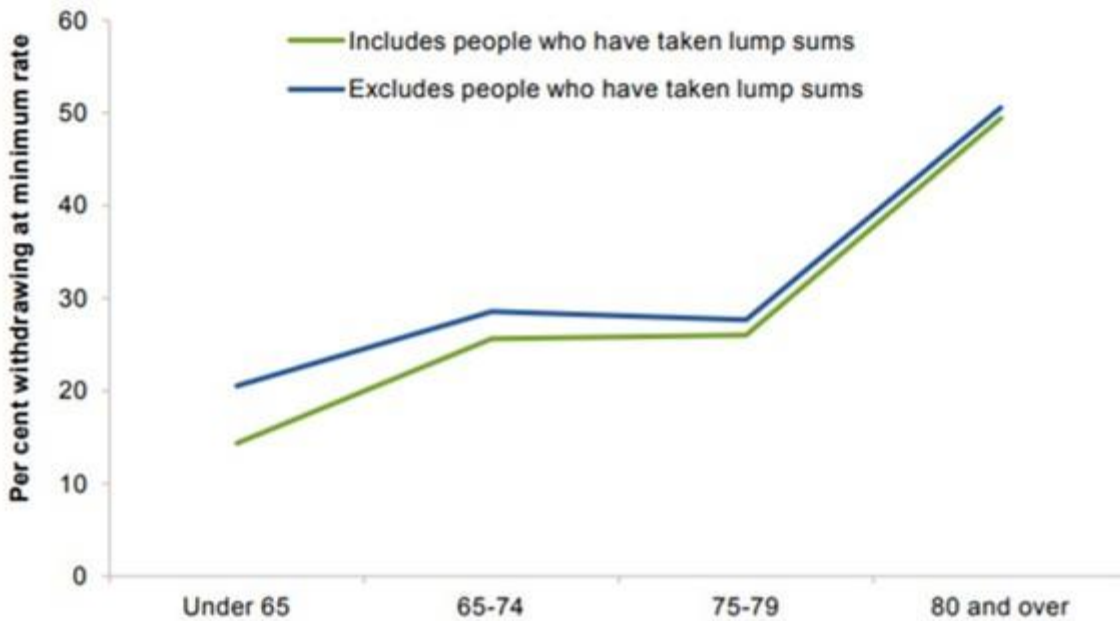
Common measures and targets for adequate retirement incomes (including the median income poverty line) provide a starting point for discussion, but the data suggests they can also mislead. Such measures fail to explain the motivations and experiences (given most surveys are statistically insignificant) of the majority of retirees who spend less than the age pension each year.

Are retirees attempting to self-insure against longevity risk?

Running out of retirement savings is a key concern for many people given that a 60-year-old man is now expected to live for a further 26.4 years and a 60-year-old woman for 29.1 years, according to the government's [2015 Intergenerational Report](#).

This concern may be a driver for the substantial proportion of retirees with account-based pensions who draw down the [minimum](#) legislated annual amount.

Figure 1: Percentage of retirees drawing down their superannuation at the age-specific minimum rate, 2011-12^{a, b}



^a The percentage of people who draw down the minimum (excluding lump sums) is calculated by dividing annualised income from superannuation by an individual’s superannuation balance at the beginning of the period. The drawdown rate, which includes lump sums, is calculated by summing annualised income from superannuation and the total value of lump sums (total superannuation benefits) and dividing this by the value of superannuation balances before superannuation benefits were taken. ^b SIH does not separate out ages above 80 years. The Commission has taken an average of the proportion of people who draw down between 7 and 14 per cent — the minimum drawdown rates for those aged 80-84 years to those aged over 95 years.

Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

However, the age pension, which can be viewed as a sovereign-backed perpetual lifetime annuity indexed to inflation, is traditionally viewed as a safety net rather than a discretionary income source for savings.

Are older retirees more prone to frugality given their experience of multiple recessions compared to younger generations? While the Australian economy has suffered several slowdowns in recent decades, its last technical recession occurred in the early 1990s. Before that, the economy went through regular booms and busts. Many retirees today entered the workforce during the 1970s, a period when the Australian economy suffered four recessions in a decade. Have these experiences made some retirees more cautious now that they are no longer in the workforce?

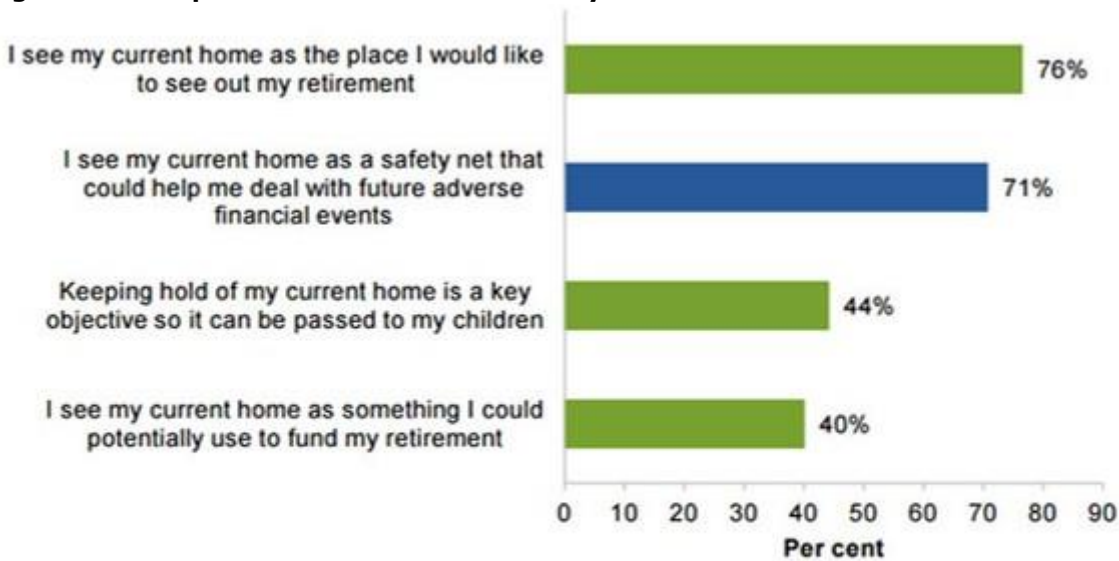
Untapped equity in the family home

Is the desire to leave a bequest to adult children stronger than assumed? Does this include the family home, leaving significant housing equity untapped that could help fund retirement?

The family home has become a significant source of wealth for many older Australians as east coast residential property prices have soared in recent years. However, few retirees use this wealth to fund their retirement with reverse mortgages remaining deeply unpopular.

The majority of retirees want to ‘age in place’, viewing their home as another safety net if required to potentially pay for an aged-care bond or some other unexpected event, but plan to leave the home to their adult children.

Figure 2: Perceptions of the role of the family home in retirement^a



^a Percentage of respondents agreeing with the statement.

Source: Commission survey.

Government policies, such as excluding the family home from the age pension assets test and state-imposed stamp duties on property transactions, have also encouraged retirees to hold on to their home. However, the 2017-2018 budget proposed allowing people over 65 to sell their primary residence and roll up to \$300,000 per person into super.

Are retirees diverting savings to help their adult children enter the property market at the cost of their own retirement lifestyle?

Home ownership rates have plummeted in recent years as record low interest rates have spurred an investor-led housing boom. According to the Household, Income and Labour Dynamics in Australia (HILDA) [survey](#), couples (aged between 20 and 29) with kids aged younger than 14, have seen a 13% fall in house ownership, and single people in this age bracket, also with kids younger than 14, have seen a 40% drop. Married couples, aged between 60 and 69, with no dependent kids, have seen a 1% increase, while single 50- to 59-year-olds, with kids, have seen a 7% increase.

Yet, there is some evidence that a rising proportion of parents are helping their adult children get a foot on the property ladder by guaranteeing home loans or providing a partial deposit.

What is the subjective experience of Australians in retirement?

Has the financial services industry overestimated the cost of living in retirement or will spending pick up as the super system matures and people have higher balances? This is a confronting issue for many people that tests our assumptions about work, lifestyle, and the nature of retirement.

The HILDA survey has [previously suggested](#) that increases in age strongly correlate with reduced odds of financial stress, beyond what can be accounted for by differences in education, marital status, labour market experiences, wealth, or household income.

Financial stress classifies any individual who struggles to pay their utility bills, mortgage, or rent on time, and has foregone necessities, pawned or sold something, or has sought financial assistance from friends, family, or a welfare organisation. Financial stress is more common among young people (20- to 29-year-olds), with 56% experiencing financial stress in 2015, down from 61% from 2006. For individuals aged between 40 and 49, half experienced financial stress, compared to only 39% in 2006. Finally, for those aged over 70, only 13% experienced financial stress, compared to 10% in 2006.

A separate [analysis](#) of HILDA data, examining individuals' self-reported changes in standard of living, financial security, and overall happiness over the transition to retirement, found subjective well-being either improved or remained constant for the majority of people.

However, the research also found that people who were forced to retire early after losing their job or due to poor health, and then suffered lower-than-expected retirement incomes, reported significant declines in their well-being.

It is difficult to draw a direct line between this research and the knowledge that half of all retirees are spending less than the age pension.

More information is needed, which superannuation funds can obtain directly from their members. In this way, super funds' general advice can be better aligned with the actual experience and needs of members. It is also part of an important, and broader, conversation about the adequacy of older Australians' living standards after a lifetime in the workforce.

Jeff Gebler is a senior consultant at actuarial firm, [Milliman](#). Read more about the Milliman Retirement ESP [here](#).

How to stay focused in volatile markets

James Freeman

Investing in markets means accepting volatility, but investors are paid to take risk. Why do sharp drops in the market have such a visceral impact on us? This article explores why we feel and react the way we do, and how to develop a sound strategy to deal with volatile markets.

The most recent fall that attracted media headlines, in February 2018, was far from unusual. Since 1979, there have been 182 five-day periods worse than the February decline. It happens, on average, every three months. It's about as frequent as a 29-degree day in Sydney. Warm, yes, but barely worth a comment.

Chart: The 200 worst 5-day periods since 1979.



Chart: The 183 times the market dropped 4.6% or more in 5 days.



Source: Macquarie, Factset, Australian Government Bureau of Meteorology. Data as at: 7/2/2018.

With central banks commencing or stepping up their interest rate hiking cycles and unwinding quantitative easing (QE) stimulus, together with a divergence in monetary and fiscal policies, the result should be greater volatility, and more movements such as the above.

Preparing for the inevitable

So the market fell, and you're reading headlines claiming billions of dollars of value have been wiped off the stock market in a matter of hours or days. You check into your account and see that your investments have also been affected. What will you do?

What most people do is act. They sell in fear. This is natural, however, it is likely to be the wrong strategy. What should you do? To paraphrase a recent [Wall Street Journal headline](#), 'The Share Market Isn't Being Tested, You Are'.

We need to feel in control

Nothing undermines a sense of control over your investments like a sharp and unexpected stock market fall. The immediate priority for many is to re-establish that sense of control. One of the most tempting actions is to do something, anything. This is linked to a deep-seated part of human nature and manifests in a desire to maintain the illusion of control.

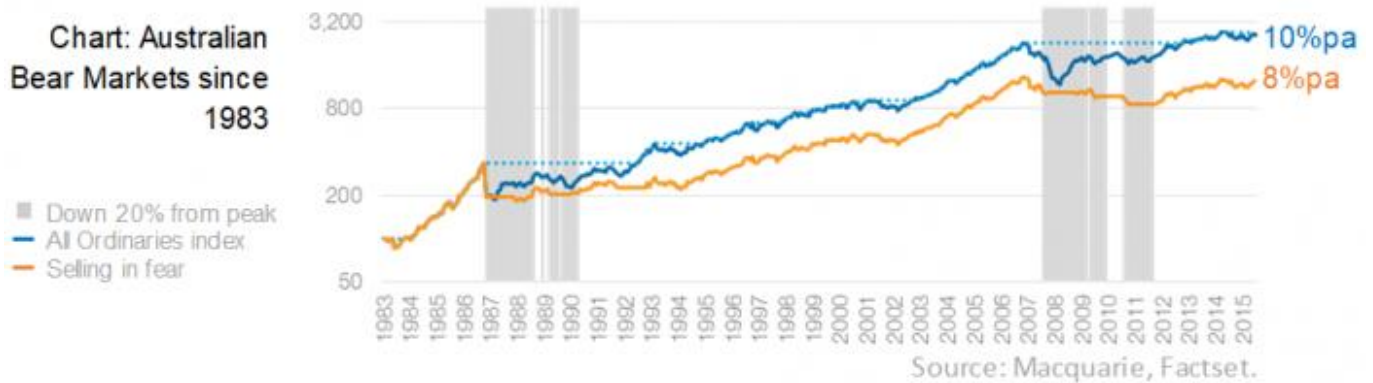
In our daily lives, in order to act, we need to be confident in our ability to make an impact. In most cases this confidence can be classified as overconfidence, but without it we might not act at all. Being paralysed by indecision can be as bad as acting with overconfidence.

The tendency for people to overestimate their ability to control outcomes that they demonstrably do not influence has been academically studied and replicated in many [different contexts](#). In the investing context, [a study by Barber and Odean](#) found a correlation between overconfidence and active trading and that the active traders in the study underperformed the market.

You will probably have a strong need to know why the market movement happened. It is more than mere interest. Needing to know is linked to the desire to act. Because jumping blind into a strategy feels wrong, we need an insight to give us enough confidence to act. Hence, the pressing need to find out why.

Actions have consequences

Adjusting your market exposure to suit evolving risk and return opportunities can be valuable. However, selling in fear is a powerful behavioural bias that costs investors dearly. Looking at Australian equities since 1983, if you were to sell in fear once a bear market starts (20% down from its peak) and return to the market 12 months later, or when a recovery was underway (rolling 1 year returns reached 10% pa), then instead of a compound annual growth rate of 10% pa, you'd have achieved only 8% pa. This is a costly bias.



One of many costly biases

There is a panoply of behavioural biases which help us get through the day. They are valuable mental shortcuts that help us act fast, handle information overload and find meaning. Occasionally these mental shortcuts do not serve us well. If everyone is running out of a building, our instinct is to join them, no questions asked. This is a good example of the 'herding' bias, and the building could be on fire. However, this same bias in the investing context can be costly. Many studies have measured the costs of these 'behaviour gap' biases and estimates range from 1% pa to as much as 6% pa.

What to do

- Recognise that markets are complex. For example, it took the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission five months to [report their findings on the cause of the 2010 flash crash](#).
- Seek advice and consider the impact. Ask why you are making this decision? Is this investment part of an overall plan? What might go wrong? What does the evidence say?
- Record your decision and why you made it. By tracking your decisions, you can reflect on the evidence and adjust or confirm your approach.

Keep your eyes on the prize, whether that prize is growth, income, capital preservation or a mix. Bouts of short term volatility don't mean allocations have to change. Remember, this has happened before and will happen again. Selling in fear costs real returns in the long term. Financial advice is the best insulation from these and other biases waiting to erode our returns.

James Freeman is an Associate Director at [Macquarie Wealth Management](#), a sponsor of Cuffelinks. This information is general in nature and does not take into account your objectives, financial situation or needs.

Investors profit from demand for luxury goods

Jason Orthman and Mark Arnold

Australians may be busy paying for groceries rather than a new Ferrari, if last month's Bureau of Statistics figures showing a strong rise in the cost of living is anything to go by, but local investors can benefit from demand for luxury goods, even if it's not to park a Ferrari in the driveway, yet.

Some luxury goods companies have the brand equity to keep their prices high, and the business strategy to benefit from structural growth in global economies. This is aligned with Hyperion's investment philosophy to take a bottom-up approach to invest in extreme quality companies with solid fundamentals and structural growth opportunities, and why global equities should be front of mind for Australian investors.

Why quality luxury goods stand out

Where do we see value at the moment?

One sector we particularly like is luxury goods, which continues to benefit significantly from the growth of economies like China and India, and the rise of the middle class.

However, not all luxury goods are created equal. It's important to focus on high-quality businesses with strong growth prospects, large and growing addressable markets, low levels of gearing, and predictable medium to long-term earnings streams. Two such companies are French high-fashion house Hermes and Italian car manufacturer, Ferrari.

Both companies have been around for some time, Hermes since 1837, and Ferrari since 1947. Unlike some of their competitors, both have eschewed offshore manufacturing for home factories where they can control the quality their brands rely on.

Both companies have strong brand equity which gives more pricing power than any of their competitors. Both produce items which are considered significant status symbols, and their strategy of strictly limiting supply has seen demand for their products hold up strongly. After the GFC, Ferrari sales fell a tiny 4%, compared with other ultra-luxury cars (except Lamborghini), which fell 40% over the same period. The typical wait for a Ferrari is between 18 to 24 months, and, even after three years, a Ferrari typically retains 93% of its value and will actually increase in value after 20 years.

The power of the Ferrari brand means that its competitive position in its market is secure, its pricing power will not diminish, and its capacity to profit from a growth in demand is second to none. And, in our view, these markets remain underpenetrated, giving a lot of capacity for growth.

Hermes has a similar story and a similar business model. When President Xi Jinping began implementing anti-corruption reform in China in 2012, the crackdown on gift-giving saw a significant drop in retail sales generally, and in sales of luxury goods in particular. As a result, 2013 was a difficult year for many luxury retailers in China. Growth in sales fell from 7% in 2012 to 2% in 2013, according to a report by Bain & Co, and average spending of China's high-net-worth individuals also decreased significantly. Yet, against this backdrop of difficult retail conditions and falling sales in luxury goods, Hermes was one of the few not affected, and was in fact able to grow sales by 16%.

The importance of looking beyond our own borders

Australian investors have long had a strong domestic bias when it comes to equity investment, and historically, quality Australian businesses have had the ability to produce growing and sustainable earnings. However, overseas markets offer a much larger universe of stocks and a greater diversity in industries to choose from. The economies in which these companies operate have higher growth potential. This means addressable markets are typically larger than those on offer in Australia (often significantly larger). In many cases, internationally-based companies offer superior economics and scale and better long-term growth pathways.

As the world economies are growing, they are also becoming more accessible to investors. Before the digital revolution and advances in technology, Australian investors were at a significant disadvantage when it came to accessing in-depth information and on-the-ground intelligence about international companies. The time difference and our physical location at the end of the world meant investors on the spot had a real advantage.

The evolution of technology changed all that. Australia's physical location is not the barrier to investment it once was, and Australian investors now have the ability to trade and access information 24 hours a day. This doesn't mean it's no longer important to travel to overseas markets, and to talk to company management face-to-face, but it does mean that the ability to identify quality growth businesses both here and overseas has been enhanced.

The numerous quality-investment opportunities on offer globally are often better from a relative value perspective. With a few exceptions, global companies are of a higher quality than their Australian counterparts,

and current five-year earnings forecasts are also higher – all of which, translates into stronger returns for investors with relatively lower levels of risk.

The bias towards the home market has served many well, but the opportunities on offer in the larger, more diverse economies overseas should improve the risk/return profile of any portfolio if the right stocks are chosen. International companies with large addressable markets, market dominance and consistent earnings, like luxury goods providers Hermes and Ferrari, are exceptional businesses, that can produce strong, sustainable returns to investors over the medium to long term. And it's those fundamentals, regardless of domicile geography, that will drive investors' wealth.

Mark Arnold and Jason Orthman are the Chief and Deputy Chief Investment Officers respectively at high-conviction equities manager, [Hyperion Asset Management](#). This article does not consider the circumstances of any investor.

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