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Four SMSF strategies if imputation credits rules change

Michael Hutton

Labor's proposal to change the way dividend franking credits are treated has both its advocates and its critics. Some argue that the proposed changes are an issue of fairness. In my view, what is not fair is that Labor's proposal is squarely aimed at SMSFs, and that industry funds and retail funds will mostly be unaffected.

Regardless of one's point of view, any plan that removes imputation credit refunds will negatively impact self-funded retirees, and those hoping to become self-funded retirees, and result in them rethinking their investment strategies.

While the current proposal could impact any share investments held personally – and potentially also investments held through a family trust or investment company – SMSF members feel particularly targeted. At a time when self-funded retirees should be applauded for not relying on government support, the landscape seems to be changing. Such retirees will be penalised for their independence.

It is surprising that a tax change has been suggested that applies solely to one section of the superannuation system, but not to others. This is new and unwelcome. In the past, changes such as to contribution limits or the imposition of \$1.6 million pension account balance caps have applied across the superannuation industry.

Possible strategy changes

If the changes come into effect, some SMSF members and self-funded retirees will make changes to their investment strategy to minimise their losses.

First, people will reduce their investment assets to receive both greater tax refunds and larger age pensions. The proposed change will have the greatest impact on self-funded retirees who fall just outside the assets test thresholds. A retiree who is receiving just \$1 of the age pension will be entitled to both a personal tax refund or excess imputation credits and also their super pension receiving a tax refund. They will be significantly advantaged over those who fall just outside the assets test limit, which is currently \$837,000 for a couple who are home owners or \$556,500 for a single person home owner. Assessable assets can be reduced, for example, by renovating the family home or taking overseas trips.

Second, SMSF members will reduce their investments in Australian shares. Full imputation credits add about 1.6% to the return, and where this benefit is lost, the relative attractiveness of Australian shares as an investment sector will be diminished. International shares, cash and property may become relatively more attractive, and allocations here may increase.

Third, people will circumvent the changes by transferring the Australian shares part of a portfolio to a 'super wrap' type retail fund that will refund the imputation credits due on their account. These 'member direct' offers usually allow members to hold managed funds and shares in the S&P/ASX300.

Fourth, with the Government's announcement to increase the maximum number of SMSF members from four to six, there will likely be more families that treat an SMSF as a true family investment vehicle. Younger family members who are accumulating super will be added to use the credits that their parents, in pension mode, may otherwise have lost.

Labor's proposed change is unlikely to boost government revenue to the amount forecast.

Perhaps the only tangible outcome will be to continue eroding confidence in our superannuation system. It is difficult to encourage people to put more into super when the money is locked away for a long period of time and the benefits continue to be taken away. It seems that for many people, they will be better off having a lower amount in super and receive increased age pension payments in retirement.

These latest proposed changes if Labor is in government come on top of the major rejig to retirees' investment situation resulting from the Coalition's changes that came into effect 1 July 2017, including limitations on super contributions, the \$1.6 million cap and changes to death benefit payouts, amongst other amendments.

If successive governments are looking for ways to turn people away from saving for their retirement and encouraging them to seek government assistance, they are certainly going the right way about it.

Michael Hutton is a Partner and Head of Wealth Management at [HLB Mann Judd](#). This article is general information and does not consider the circumstances of any individual.

A super new opportunity for EOFY 2018

Gemma Dale

In the excitement of the introduction of sweeping superannuation changes on 1 July 2017, a new superannuation contribution opportunity may have gone unnoticed by many people. From that date, anyone eligible to make personal super contributions can claim that contribution as a personal tax deduction, regardless of their work status. This change is a result of the removal of the '10% test' which generally meant you had to be self-employed or have no employment income in order to claim a deduction for your super contributions.

This is the first financial year that anyone – including people who work for an employer – can use this strategy, even if you are already making salary sacrifice contributions. It's an opportunity to make lump sum or regular contributions up to 30 June to maximise use of the \$25,000 concessional contribution cap and potentially reduce your personal tax liability.

There are a few things to consider:

- you can only contribute to superannuation if you are under age 65, or if you are between 65 and 75 years of age and meet the work test (which constitutes 40 hours of gainful employment during a 30-day period),
- any contributions for which you claim a personal deduction will count toward your \$25,000 concessional contribution cap (which also includes your Superannuation Guarantee and any other employer contributions you receive), and
- if you are earning over \$250,000 p.a, your contribution may be taxed at up to 30% due to the application of Division 293 tax (an extra 15% on top of the general 15% contributions tax).

Process for making tax deductible contributions

Firstly, you will need to make your super contributions **before 30 June 2018** if you want to ensure they are counted towards the 2017/18 contribution cap. As a general guide, a super contribution is made when it is received by the super fund. For example, you are contributing electronically via BPAY, the contribution is deemed to have been made when the funds are credited to the super account, not the day you make the BPAY transaction. Individual super funds will also have specific requirements and deadlines towards the end of the financial year which they will usually publish on their websites. If you have an SMSF, you should consider timing your transfer to ensure it will be received in your account by 30 June (and note, 30 June 2018 is a Saturday).

Notice of Intent form

You will need to lodge a 'Notice of Intent' form with your super fund by the earlier of:

- the date your tax return is lodged for the year the contribution was made, or
- the end of the financial year following the financial year in which the contribution was made.

Your fund *cannot* accept a Notice of Intent if:

- you have exited the fund (e.g. rolled over your funds to another super fund, or withdrawn them), or
- the contribution(s) being claimed have been paid out as a lump sum or used to start a pension, or
- you have submitted a spouse contributions-splitting application (that hasn't been rejected by the fund).

This Notice of Intent is critical to ensuring you can claim a deduction for your contribution, so if you have any questions about how it operates, contact your super fund or your financial adviser.

Claiming a deduction for personal contributions to super may not be for everyone, and it's worth noting that salary sacrifice may still be a more attractive strategy. The good news is that you can make a contribution under these rules at any time up to 30 June but get it in on time.

Gemma Dale is Director, SMSF & Investor Behaviour at [nabtrade](#), a sponsor of Cuffelinks. This article has been prepared without taking into account your objectives, financial situation or needs. Before acting on any this information, we recommend that you consider whether it is appropriate for your circumstances.

The top seven EOFY superannuation tips

Bruce Brammall

It has never been more important for your superannuation for you to get ahead of the game and understand the rules before the end of financial year rush.

A raft of new thresholds for superannuation kicked in on 1 July 2017, and not updating your super settings could be ... catastrophic might be a little dramatic, but it wouldn't be far off.

Proper preparation is essential. The good news is you still have time to fine tune things. No-one likes the end of financial year (EOFY) panic, so here are some of the more important ways to get the most from your super.

1. Adjust salary sacrifice arrangements

This should have been done before now. But if you haven't made adjustments to the reduction in the concessional contribution (CC) limits from FY17 to \$25,000 from \$30,000 for the under-50s and \$35,000 for the over-50s, then it might not be too late.

Find out how much in CCs you have put into super to date, then make immediate adjustments.

Where would the problem lie? If you are earning \$110,000 a year and are receiving \$10,450 in SG contributions, you might have had a salary sacrifice set at \$1,625 a month (under 50s, \$30,000) or \$2,045 a month (over 50s, \$35,000). If you haven't made adjustments, you're on course to break your CC limit by \$5,000 or \$10,000. But you might be able to cancel your last few salary sacrifice contributions to keep you under your limit or reduce how much you blow your cap by.

2. Use the new rules for extra CCs

If you haven't salary sacrificed to this point, it's not too late. From 1 July 2017, the '10% rule' regarding employees was removed, allowing almost everyone to make contributions and get tax deductions (similarly to salary sacrifice arrangements) by putting money directly into your super fund in the lead up to 30 June, as a lump sum, or in parcels.

This is an important new way of equalising how people can get money into super, but don't leave it right until the last minute. Contributions to super funds count for the year that they are received. If you send it on 28 or 29 June (30 June is a Saturday this year), particularly by BPay, there's a chance it will not be received by the super fund until 3 July where it will count towards your FY19 contributions.

3. Make decisions on capital gains tax relief

If you had more than \$1.6 million in pension or transition-to-retirement pension on 30 June 2017, then you were able to potentially take advantage of the CGT relief provisions to soften the blow of the new transfer benefit cap (TBC) of \$1.6 million.

Those decisions need to be made soon, if they have not been made yet. It's not a blanket decision to say 'yes' for your whole portfolio. It can be made asset by asset. There will be assets in most portfolios where you want to apply for the CGT relief, while other assets where you're sitting on losses can be used for a future CGT loss to offset other gains.

It is a complex decision-making process, which might require evaluating each parcel of a particular share that you bought over an extended period. Don't leave this complex work until too close to the deadline. Sit down with your adviser or accountant to work through this process soon.

And understand that you need to make these elections, which are irrevocable, before you put in your SMSF's returns for FY17.

4. Make minimum pension payments before 30 June

An annual piece of advice: make sure that you make your minimum pension payment before 30 June. If you don't, the ATO deems your super fund to have NOT been in pension mode for the whole financial year, meaning you'll pay tax on income and gains for that period. And any payments will be considered super lump sums for both income tax and SIS Regulation purposes.

This would also mean starting a new pension the following financial year, which could have even broader implications, potentially also for pensions with benefits tied to social security.

5. Protect capital gains with CCs

Making concessional super contributions to help reduce capital gains tax is nothing new, except it is easier as a result of point 2 above. If you have made a capital gain, you can reduce your CGT (or more precisely, how much tax you have to pay for the entire year) by making CCs.

For example, if you have made a capital gain of \$50,000 (reduced to \$25,000 for assets held longer than a year) then a concessional contribution will generally reduce your taxable income and might allow you to pay less tax on your capital gain, particularly if it impacts on your marginal tax rate.

In any case, a \$10,000 CC will save you tax of up \$4,700, while you'll pay a maximum of 23.5% on the capital gain itself.

6. Make the most of non-concessional contributions (NCC) rules

The annual limit for NCCs was dropped from \$180,000 a year to \$100,000 a year as of 1 July 2017. The other usual rules apply. You can make them up to age 65 with few restrictions, and you can use the pull forward rule to put in up to \$300,000 in one year. But this will limit how much you can put in for the subsequent two years.

Come this time of year, it's important to know the rules even more clearly. If you have enough money, you and your partner could get up to \$800,000 into super (combined) in the next three months.

The pull-forward rule is only triggered if you put in more than \$100,000 in a financial year. If you put in more than \$100,000 (say \$110,000) in the current financial year, then you are limited to putting in another \$190,000 over the following two financial years.

But if you put in no more than \$100,000 this financial year, then you can contribute, on 1 July 2018, \$300,000, which would trigger the pull forward rules and maximise your contributions for the FY19, FY20 and FY21 years.

There are extra restrictions this year on making NCCs. If you already have more than \$1.5 million in combined super, then you are limited to making \$100,000 in NCCs. If you have between \$1.4 million and \$1.5 million, you are limited to putting in one year's worth of NCCs, plus one year of pull forward. Only if you have less than \$1.4 million in super can you use the maximum pull forward rules to put in \$300,000 in one year.

7. Spouse super splitting

The imposition of the \$1.6 million TBC has bought back the 'spouse super split' as a critical part of many couples' financial planning. It didn't matter previously if one member of a couple had a \$10 million super balance and the other had diddly squat. Nothing was taxed, in anyone's hands. But with the \$1.6 million TBC, if you have more than \$3.2 million in super and it's unevenly split, you are literally donating extra to the ATO.

One way to even up super balances is 'spouse super splitting', or transferring your concessional contributions for one spouse to another (less the 15% contributions tax) after the end of a financial year.

How does that work? Let's say one spouse has a large super balance and received the full \$25,000 in CCs for the year. The partner has a small super balance and received nothing in CCs for the year. The partner with the higher contributions could use the spouse splitting rules to roll over \$21,250 (\$25,000 less 15% contributions tax) to the partner's account. If this is done every year, it can go a long way to evening up super balances.

You only have until the end of the following financial year to do the spouse split. That is, for FY17, you will need to give super funds the instruction to do the spouse split rollover before 30 June 2018.

There are many more super hints available, but for this year, the above are the major new opportunities or numbers and limits you need to check.

Bruce Brammall is Managing Director of [Bruce Brammall Financial Pty Ltd](#) and Bruce Brammall Lending Pty Ltd. Bruce's sixth book, [Mortgages Made Easy](#), is available now. The information contained in this article is general and does not consider anyone's specific circumstances. If you are considering strategies mentioned here, consult your adviser.

New investment suitability rules must flow from Royal Commission

Paul Resnik

Australians are ball-tampering convicts to many people in London, from where I've viewed the Royal Commission. Unfortunately, the evidence seems to support that opinion.

No-one is surprised by the details, because Australia's got Bradman-like form in bad financial advice. Previously, I've needed to explain how scandals like Storm Financial, Opes Prime, Westpoint, Trio, Fincorp and Bridgecorp happened under our regulators watchful eyes.

To be fair, I explain that it's not just a regulatory failure: the problem is the far deeper issue of 'unsuitable advice'. Even when all rules and regulations are 100% complied with, institutions are still capable of giving unsuitable advice that damages the financial lives of their clients.

You know unsuitable advice when you see it

It is a 75-year-old pensioner advised to mortgage her home to invest in high-risk leveraged funds. It is a 'low-risk' investor being sold high equity exposure. It is every client walking away with the same portfolios and products regardless of their circumstances. It is when the conflicted products are given precedence over the most suitable products.

We've known about the unsuitable advice problem for a long, long time. Consumer group Choice identified it in a shadow shopping programme in 1990 and again in 1995. And again in 1998. And again in 2003. The Storm Financial scandal laid bare a step-by-step guide on how to put the interests of the customer last. Low income, vulnerable investors lost \$880 million in 2009 while the Storm founders were, just last month, fined \$70,000 each and banned from running a business for seven years.

But the 'quality of advice' is a problem that this Royal Commission does not have time to explore.

The Commission has hit the areas tantamount to street-crime, where the Corporations Act was flagrantly breached, or a fee was charged for a service that was never delivered. This is deserving work that has provoked outrage from the public.

Royal Commission is missing the main problem

The Commission is not going deep enough to see the main game. The real money-for-jam is made by pushing customers through advice systems that ignore who they are, so that the sale of a standardised product can be closed quickly and cheaply. No thought is attached to what impact that product might have on the client's life.

So what does 'suitable' advice look like? To be suitable, the advice must properly take into account their goals, current financial situation and financial risk tolerance. Investors need financial advice and products that suit their circumstances, needs and personalities.

Put another way, the question is this: *'Where are you now, where do you want to get to and how do you feel about the financial risk you'll need to take on to possibly get you there?'* These are tough questions that can take time to answer. Unfortunately, to institutions, that time is a cost to their bottom line, so these critical questions are frequently dealt with superficially, or not at all.

I've spent almost five decades in financial services, with the past 25 years helping advisers and institutions to give better financial advice, based around suitability, particularly the risk tolerance part. I have clients in more than 20 countries, with our tools used in over one million financial plans.

But, in Australia, when I would say, *'I can help you give advice that is tailored to the client sitting in front of you'* the responses would often range from blank stares through to explanations that *'clients wouldn't want that and it would take too long'*. For most, the passion was around quickly closing more sales, rather than giving good advice that would suit the customer's needs, situation and personality.

I want to believe that the Royal Commission will change things, but I'm far from convinced.

It is worth recalling that almost everything that came out in evidence was self-reported by the institutions. But can we really have confidence that they would own up to giving unsuitable advice, when they are so reluctant to even cop to blatant breaches of the law?

The pushback against the Royal Commission has already begun. Submissions are arguing over the semantics of their breaches. For example, AMP admits it lied to ASIC seven times, but takes offence that it is alleged to have lied 20 times. Westpac admits that one of its advisers engaged in misconduct when he advised a couple to sell their family home to establish an SMSF, accepting he may have breached the Corporations Act. But the bank submits to the Commission that:

"While the advice was plainly inadequate, there is no basis to conclude that it involved either deliberate misconduct or dishonest conduct."

That, in a nutshell, is the problem. The advice was inadequate so, by definition, the client has suffered. To the public whether that suffering stems from incompetence, dishonesty or failure to follow process is irrelevant. A bank did someone harm and seems tone-deaf to that harm.

Regulation not only inevitable but necessary

It's not surprising that people don't trust the industry because it is unworthy of being trusted. It gives bad advice. It refuses to accept responsibility for its actions. Left alone it will sacrifice clients to its own self-interests.

So the answer is not to leave it alone. Tie up its hands in regulations that force it to act responsibly. Give the job of oversight and prosecution to a regulator who is not afraid to do it. And impose harsh financial penalties at both the corporate and personal levels.

That's what the UK did. For decades the Brits were doing just as bad as us, or even worse. When these mis-selling scandals finally blew up, justice was delivered to customers who got tens of billions of pounds in compensation. Some industry players did not survive to endure tough new rules that mandate that only 'suitable' financial products can be sold. The suitability criteria are specific and strict. Non-compliance can see a UK business fined 10% of its turnover, while individuals can be fined up to 5 million euros.

It's not just advisers who are on the hook. Fund managers and financial product providers are to be held equally culpable for mis-selling. Product providers must now design products for specific market segments, know who is buying the product and have methods to ensure it is, indeed, suitable for that specific buyer. This can't be done by proxy through an adviser. The product issuer and customer must now have direct, independent relationships.

And this could all soon be coming to Australia!

The Australian Treasury circulated a draft of regulations similar to the UK's, which are modelled from the European Union rules. If the political will was there (always a questionable assumption) these new rules could be in place quickly, hopefully enforced by an inspired regulator.

Paul Resnik is the founder of a number of financial services business, and has created tools to help give better financial advice in more than 20 countries and to one million financial advice clients. Find out more on [risk profiling here](#).

Budget's focus on retirement's next challenge

Patricia Pascuzzo

Changes announced in the 2018 Federal Budget take us a step forward in ensuring the superannuation system achieves what it was set up to do: provide greater security of income for people in retirement while reducing the burden on taxpayers of supporting retirees.

The Budget promised a new retirement income framework which aims to boost living standards for retirees and expand the options available to them by requiring super fund trustees to offer new comprehensive income products.

A framework is needed because our defined contribution system asks individuals to manage financial risks beyond their capability. Despite the complexity involved, Australians have proved reluctant to pay for advice, a prospect that only looks unlikely to diminish given revelations at the Royal Commission.

Help needed when employment income ceases

The irony is retirees have never needed more help managing the heightened risks they face without the security of employment income. These include unfavourable investment returns close to or in retirement (sequencing risk), outliving their savings (longevity risk), loss of purchasing power (inflation risk) and unexpected health and aged care needs (event risk).

Managing these risks involves complicated trade-offs that are highly specific to each member's circumstances and preferences. Yet most are ill-equipped to do this. And the system is focussed on the accumulation of assets with little support during the drawdown phase.

Compulsory super and default funds were designed to overcome behavioural and other barriers that prevented people from saving. But those biases do not suddenly self-correct when people reach retirement age. After all, having been in default vehicles throughout their working lives, why would people suddenly be able to switch on and navigate even more complex variables?

The answer is to develop our contributions-based system so that it delivers outcomes akin to a defined benefits framework designed around individual needs. At a minimum, a mass-customised solution will take account of each member's age, gender, health status and debt, while providing couples the option of a reversionary benefit. To ensure income stability over retirement, the solution also should take into account pension entitlements.

Given limited access to financial advice, trustees will need improved products and a scalable process to guide or nudge members towards better retirement outcomes. To ensure members' interests are served, super funds will have to make major investments in governance, people, systems and technology, including decision support systems.

It's arguable that our intensely regulated industry, conceived via government mandate, lacks the required level of innovation, entrepreneurialism and vision to meet the needs of the bulge of baby boomers now entering retirement. So, again, there is a role for the government to facilitate market development by setting the rules of the game.

The Budget is a step in this direction

The Budget means superannuation fund trustees will be required to consider the retirement income needs of their members and develop a strategy to help members achieve their retirement income objectives.

Alongside the requirement to offer comprehensive income products, the government also announced new means testing rules that remove important impediments to development of new income stream products to better manage longevity and sequencing risk. Not only are such solutions needed for disengaged super fund members, they may also provide an escape route for SMSF trustees looking for a set-and-forget secure income stream that kicks in during their advanced years.

For the nation, these changes represent a substantial, long-term investment in making our market work more effectively, making our retirement income system more sustainable and making the lives of millions of Australians better.

The CSRI Leadership Forum on 31 May 2018 will bring together leaders in public policy, industry and academia for detailed discussions about what these changes mean and how to take them forward.

Patricia Pascuzzo is Founder and Executive Director of the Committee for Sustainable Retirement Incomes (CSRI), an independent, non-partisan and non-profit think tank which is holding its leadership forum in Canberra on 30-31 May 2018 <https://csri.org.au/events/2018-leadership-forum/>

Bank reporting season scorecard: May 2018

Hugh Dive

The last few months have been tough for shareholders in the major Australian financial services companies, who have seen their share prices drift lower through March to May 2018. Evidence of misconduct presented at the Royal Commission has fed market fears that bank profitability will diminish. However, the major banks have recently reported their profit results for the past six months, showing the market how their underlying businesses are performing and how the management teams plan to address the issues raised at the Royal Commission.

In this article, we look at the common themes emerging from the May reporting season. We differentiate between the banks and hand out our reporting season awards to the financial intermediaries that grease the wheels of Australian capitalism.

Reporting season scorecard May 2018

Code	Share Price	Cash earnings growth	Dividend growth	Net interest margin (reported)	Impairment charge as % of loans	Capital Ratio	Return on Equity	Forward PE Ratio	Forward dividend yield	2018 total return	Summary of 2018 result
WBC	\$ 29.75	6.00% ★	0.0%	2.17% ★	0.11% ★	10.5%	14.0%	12.2	6.8% ★	-4.4%	Pros: Best result of the season, very low bad debts, expanding margin Cons: Minimal internal capital generation
ANZ	\$ 27.95	4.0%	0.0%	1.93%	0.14%	11.0% ★	11.9%	12.0 ★	5.8%	-2.4%	Pros: Capital stronger and bad debts falling Cons: Markets income down and a big fall in bad debts was a key driver of profit growth
NAB	\$ 28.72	-2.0%	0.0%	1.87%	0.13%	10.2%	13.6%	12.2	6.0%	-2.8%	Pros: Bad debts low, mar Cons: weaker revenue growth, costs to grow in second half with transformation project
CBA (Feb 2018)	\$ 71.41	4.7%	0.5%	2.16%	0.16%	10.4%	14.5% ★	12.9	6.3%	-8.0%	Pros: All round solid set of results Cons: Compliance costs rising, slight increase in the bad debt charge

Source: Company reports, IRESS, Atlas Funds Management

Overall, the simplification theme

The main new theme to emerge from this reporting season is that banks will reduce their footprint on the financial services landscape by divesting businesses that are deemed to be non-core. This results season showed the complexity arising from either announcements of new significant moves or by sales made in 2017.

In May, CBA announced plans to spin off the wealth management business, Colonial First State, which followed the sale of the life insurance business in 2017. ANZ's result was complicated by the sale of both their wealth management and life insurance businesses in 2017. NAB also announced plans to sell MLC by 2019, while Westpac reduced its stake in BT Investment Management (now renamed as the Pandal Group). These moves acknowledge the costly exercise of creating vertically integrated financial supermarkets was a mistake. Whilst some of these moves to sell carefully constructed divisions may be attributed to the events of the Royal Commission, some of these sales were consummated well before the force of the harsh light on the witness stand.

Profit growth

Across the sector, profit growth was roughly in-line with the credit growth in the overall Australian economy. Westpac reported the strongest cash earnings increase courtesy of cost control, very low bad debts and the sound performance of their core domestic businesses. NAB brought up the rear due to the combination of weaker revenue and elevated costs even when the restructuring charges are excluded.


Bad debts

One of the biggest drivers of earnings growth over the last few years has been the ongoing decline in bad debts. Falling bad debts boost bank profitability, as loans are priced assuming that a certain percentage of borrowers will be unable to repay and that the outstanding loan amount is greater than the collateral eventually recovered. Bad debts fell further in 2018, as some previously stressed or non-performing loans were paid off or returned to making interest payments. This resulted primarily from a buoyant East Coast property market and higher commodity prices. Further, at the big end of town there were no major corporate collapses over the past six months which kept corporate bad debts low.

Westpac gets the gold star with a very small impairment charge courtesy of their higher weight to housing loans in their loan book. Historically home loans attract the lowest level of defaults.


Shareholder returns

Across the sector, dividend growth has essentially stopped, with CBA providing the only increase of 1 cent over 2017. With relatively benign profit growth, a bank can either increase dividends to shareholders or retain profits to build capital (thereby protecting banks against financial shocks), but not both. In the recent set of results, the banks have held dividends steady to boost their Tier 1 capital ratios to closer to the APRA mandate of a core tier 1 ratio of 10.5%.

Looking ahead, there may be some capacity to increase dividends as the rebuild of bank capital to APRA's standards is largely complete. ANZ shareholders can expect capital returns in the form of further on-market share buy-backs as the proceeds from the sale of their wealth management and insurance businesses are received. The major Australian banks in aggregate are currently sitting on a grossed-up yield (including franking credits) of 8.9%.



Interest margins

The banks' net interest margins [(Interest Received – Interest Paid) divided by Average Invested Assets] in aggregate increased slightly in 2018, despite the imposition of the major bank levy. This was attributed to lower funding costs and repricing of existing loans onto higher rates. In response to regulator concerns about an overheated residential property market – and in particular the growth in interest-only loans to property investors – the banks have repriced these loans higher than those repaying both principal and interest. For example, Westpac currently charges 6.3% on an interest-only loan to an investor, which contrasts to the 4.44% being charged to owner-occupiers paying both principal and interest. This has had the impact of boosting banks' net interest margins, though these gains will tail off as borrowers switch to principal and interest loans.



One of the key things we looked at closely during this results season was the impact of the May 2017 Major Bank Levy on the various banks' margins. It's apparent that this levy was passed on both to borrowers in the form of higher rates and to depositors by offering lower rates on term deposits.



Total returns

In 2018, all the banks have delivered negative absolute returns due to falling share prices while also trailing the S&P/ASX200 which has gained 2%. The uncertainty around the outcomes from the Royal Commission, rising compliance costs and slowing credit growth have weighed on their share prices. CBA has been the worst performing bank as it has seen its CEO ushered to the door (as well as many direct reports and the resignation of the CFO), incurred fines for not complying with anti-money laundering laws and has faced uncertainty around the potential impact of changes implemented based on recommendations from the Royal Commission.

– No stars given –

Our take on investing in banks at the moment

How to approach investing in the Australian banks is one of the major questions facing both institutional and retail investors alike. We expect the banks to deliver around 3-5% earnings growth as they face low credit growth, increased regulatory scrutiny, and the sale of some of their insurance and wealth management divisions. However, if investors examine the wider Australian market the banks look relatively cheap, are well capitalised, and unlike other income stocks such as Telstra, should have little difficulty in maintaining their high fully franked dividends.

Additionally, their share prices are likely to see support over the next 12 months from share buybacks, as the proceeds from the sales of non-core assets come through. The key bank overweight positions in the Maxim Atlas Core Equity Portfolio are Westpac, ANZ and Macquarie Bank.

Hugh Dive is Chief Investment Officer of [Atlas Funds Management](#). This article is general information and does not consider the circumstances of any investor.

Trump's tariff proposals benefit global infrastructure

Nick Langley

During the 2016 US presidential campaign, a familiar rhetoric used by Donald Trump was the need for the US to re-evaluate trade deals such as the North American Free Trade Agreement (NAFTA) as well as several bilateral trade agreements with the intention to improve domestic employment and industries.

In line with this protectionist view of international trade, on 1 March 2018, President Trump announced his plan to enforce a 25% tariff on steel imports and a 10% tariff on aluminium imports. Immediately post-announcement, the US and global equity markets pulled back sharply over global trade concerns.

Since this initial statement, several trade negotiations have taken place, and on 22 March, the Trump Administration announced that it would suspend the steel tariffs on select countries until 1 May 2018, including Australia.

However, on the same day, President Trump also issued a memorandum directing his Administration to take action under section 301 of the US Trade Act of 1974, related to China's acts, policies, and practices related to technology transfer, intellectual property and innovation. The actions include:

- Restrictions on Chinese investment in the United States.
- Imposition of higher customs duties on imports from China.

This announcement sparked global concerns over a potential trade war between the US and China which resulted in another sharp drop in global equity markets. As trade negotiations continue, the outcome of the tariff proposals and the Administration's broader trade policy remain unclear. Many market participants believe that a 'watered down' version of the initial proposals may be implemented.

Impact on infrastructure and flow of trade

Theoretically, the enactment of tariffs changes the trading dynamics between economies, which in turn, changes the flow of trade. For the importing nation, the local consumer must seek domestic alternatives or pay a premium for imported goods. For the exporting economy, on the assumption that the volume of goods produced remains unchanged, these goods can be redirected to other countries. This redirection of trade flow has a net positive impact on infrastructure. Let's explore why.

From a global perspective, user-pay infrastructure, specifically port, road, and rail operators, move goods throughout the global economy as well as domestically. Given tariffs impact trade flows, these companies are set to be most exposed to the impact of a US tariff on Chinese imports.

We believe that in the event the proposed tariff on Chinese imports is imposed, it will likely change the direction of trade flowing out of China rather than the volume. In other words, it's likely that the goods will be shipped to other countries instead of the US.

For port operators outside the US, this could mean that shipping volume could remain neutral, or, in fact, could stimulate the need for greater shipping which positively affects the infrastructure needed to support the redirected trade. For instance, the frequency of the China to US route might be replaced by increased China to Europe shipments. As an extension of this, where the goods land will require a recalibration of that economy's infrastructure to account for the increased goods coming in and then the movement of these goods around that economy. Domestic freight rail operators, and warehousing and storage providers, may have to increase their capacity to account for the increased trade.

From the perspective of the US, fewer goods being imported from China may see long-haul rail companies experience a reduction in freight volumes, however, domestic intermodal operators might see increased activity domestically as US consumers switch to alternative products. This will result in a need to re-calibrate US infrastructure. Trump's infrastructure proposal, if passed by Congress, will help make capital available for this recalibration.

Caveats on identifying consequences

However, we do see some cautionary elements to consider:

- 1) The actions of the Trump Administration, including high-level personnel changes, since taking office have heightened US political risk. Some market participants believe that the recent share price movements signal that the equity markets are factoring in this heightened risk, that is, it's less about trade, and more about general policy uncertainty.
- 2) Investors like infrastructure assets because they are typically characterised by long useful lives and a stable cash flow profile. Tariffs, in contrast, are often short lived and thus have a limited impact. For instance, in early 2002, the Bush Administration imposed steel tariffs of up to 30% on the import of steel. Similar to Trump's tariffs, this tariff was highly controversial, with many market pundits fearing a global trade war. In November

2003, the World Trade Organisation (WTO) ruled against the steel tariffs citing that they had not been imposed during a period of import surge and thus the tariff violated the US WTO tariff-rate commitments. Given a looming \$2 billion penalty in sanctions coupled with trade retaliation from the European Union, the US withdrew this tariff in December 2003. This tariff was only enforced for an 18-month period.

3) The enactment of a tariff may not completely remove the comparative advantage some economies have in the production of certain goods. For instance, relative to the US, Australia has a comparative advantage in the production and export of steel (predominately in the cost of transportation from the point of origin in East Coast Australia to the final market in the US West Coast). The implementation of a steel tariff, for instance, is highly unlikely to completely erode this and thus may not result in the intended redirection of steel trade flows.

Nick Langley is Chief Investment Officer of [RARE Infrastructure](#), an affiliate of Legg Mason, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any individual.

How much industry knowledge does a board member need?

Graham Hand

Here is an exchange between me and a Cuffelinks reader on the subject of board expertise. In response to revelations at the Royal Commission and the subsequent resignation of four directors from the AMP Board, I wrote this editorial comment:

"In fact, the structure of wealth management is a complex and intriguing web. There are so many gatekeepers, with dealer groups, asset consultants, rating agencies, fund managers, regulators, industry associations, media groups, platforms and financial advisers, each with a power base and clients. The Royal Commission is only unraveling parts of it.

Which is why the calls for 'clean brooms' from outside wealth management to sweep through the industry are misplaced. Every time I see a person from another industry appointed to a board position in wealth management, I wonder what they know about the value chain and who pays the piper. The AMP head of advice told the Royal Commission he had not "turned his mind" to commission structures. How could the former Chair of AMP, previously a middle-level executive at investment bank ABN Amro, have understood thoroughly what was happening in the advice payment structure?"

Response from a reader

Someone who is not known to me, Carlo Bongarzoni, sent this email with another perspective:

"As a relative newcomer to Cuffelinks Newsletter I count myself lucky to receive such a wide and penetrating set of thought and opinion frameworks so regularly. However in this issue 253 I would like to take issue with the negative views expressed about "non financial industry" people being appointed to positions aimed at cleaning up various facets of the industry.

Firstly many non-financially qualified people have proven ability in the investment side and other avenues within the FS industry. Secondly in my own experience within a broadish industry career range I think I can modestly claim that entering an executive role with no previous experience in that industry has in fact been an advantage to changing the culture and the results. Thirdly I would advance that ASIC's failure to be a pre-emptive and prosecuting "supervisor" has seriously something to do with its staff mostly being drawn from industry insiders.

Becoming knowledgeable about a product or an industry or for that matter any subject does not necessarily require prior ancillary or mainstream background – only the keen desire or need to do so. It's the qualities/abilities of the candidate that are paramount. As well – I found that listening first to those who could warts and all explain processes, history and the fundamentals prepared an initial framework of understanding. From then on it became first a process of thorough exploration within the 'entity' asking dumb questions where necessary but always aiming for complete comprehension of the organisation, its business, its culture and its directions. Second – engaging with customers and suppliers sufficiently to learn the strengths/must dos/improvement areas and explore opportunities. Thirdly – as far as possible engaging with competitors and relevant community groups. Diving down through the organisation to the "shop floor" also vital. On this last –

usually it's the people within an organisation who can tell you what needs doing! Something that outside consultants milk and then claim it as their own insight.

That above process equips one with the ability to fulfil the CEO/Chair role or lesser executive function. I have managed that in a leading financial service organisation; the superannuation industry; the logistics industry of port management; the chemical industry and in general consulting. I raise all of this not as a boast but as a relatively striving rather than intellectual person who successfully showed that one can lead achievement in an industry without previous background.

ASIC needs a head from outside the industry who is zealous about changing the Corporation with will and the unfettered energy to prosecute its duties and clean up the industry. The banks have long portrayed little desire to fulfil their obligations under their charter – having consulted within and engaged as a B2B customer. My contact with advisor groups and investment managers indicates likewise. There are exceptions but few to the maxim that "experience within an industry" is often the best way to achieve needed change, recant the operation to fulfil its socially as well as business obligations and forecasts.

Sorry about the length but I get so frustrated with the expectancy that inside knowledge/experience is the vital pre-requisite in such matters. That's why using past politicians to head up enquiries or to change situations invariably fail too. The head of the Royal Commission has little financial industry experience I would guess?
Regards carlo"

Then I wrote back

"Hi Carlo

Thanks for your extensive comments. We would like to post them to our website if that is ok.

I accept the need for a diversity of backgrounds on a board, as skills from other industries can be shared. However, it is also important for many on the Board, I think a majority including the Chair, to have deep experience in the company's industry, so they can provide the appropriate due diligence and governance. In any large company, the Chair needs to guide and advise the CEO, and we saw the consequences at CBA of the former Chair being too distant from the business.

It was especially important in AMP's case to have industry knowledge because it seemed the Head of Advice was 'hands off' himself. If he wasn't watching the business closely enough, did the board know what was happening? The fact that 70% of AMP's advice commission was subject to grandfathering which now may be overturned is a massive issue the company should have discussed at board level. How much did the board know about the value chain in the advice business?

So this is what I meant when I wrote:

"Every time I see a person from another industry appointed to a board position in wealth management, I wonder what they know about the value chain and who pays the piper. The AMP head of advice told the Royal Commission he had not "turned his mind" to commission structures. How could the former Chair of AMP, previously a middle-level executive at investment bank ABN Amro, have understood thoroughly what was happening in the advice payment structure?"

I was not saying boards should not have people from other industries."

And then he responded:

"Yes of course Graham but I wasn't seeking any wider audience. I do agree that some if not most Board members should have industry experience but that's only as good as it should be if they're prepared to question wisely and penetratingly. I'm not sure that the Chair needs industry experience though – just broad scope of background and a persona that isn't easily side-tracked. One of the problems with having industry knowledge sometimes is that it offers a tendency to sometimes make assumptions about a matter that more properly should be questioned more deeply. But thank you for your response. Regards carlo"

Your comments are welcome.

Graham Hand is Managing Editor of Cuffelinks

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