Cuffelinks
Connecting investors with ideas

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Labor franking policy creates incentive to close SMSFs

Graham Hand

Introduction to email trail

The Labor Party misjudged the opposition to its new franking credits policy, forcing it to introduce hastily the 'Pensioner Guarantee', protecting those on a welfare pension from the loss of franking credit refunds. In this announcement, Labor singled out SMSFs as major beneficiaries of the franking refunds:

> *"Labor is cracking down on this tax loophole because it will soon cost the budget $8 billion a year.*
>
> *Much of this goes to high-wealth individuals, with 80% of the benefit accruing to the wealthiest 20% of retirees. The top 1% of self-managed superannuation funds received an average cash refund of more than $80,000 in 2014-15.*
>
> *Labor does not think it is fair to spend $8 billion a year on a tax loophole that mainly benefits millionaires who don't pay income tax."*

As part of its Pensioner Guarantee, Labor provided a grandfathered date for SMSFs, stating:

> *"Self-managed superannuation funds with at least one pensioner or allowance recipient before 28 March 2018 will also be exempt from the changes."*

Many people remain confused by the policy. The Labor proposal stops cash refunds of **excess** franking credits when taxable income reaches zero, not the use of all franking credits. A range of strategies will unfold which will make the cost savings nowhere near Labor's estimates, regardless of the merits of the policy proposal.

A clarifying exchange of 10 emails

This exchange between a reader (who we'll call Trustee X to keep personal details private) and Shadow Treasurer **Chris Bowen's** office clarifies Labor's position. The reader is distressed by the loss of a cash refund in his SMSF even when he receives an age pension in future, and he should be considering alternatives.

SMSFs are specifically targeted, but why should the type of investment vehicle used to hold superannuation money be penalised? A recipient of an age pension could move money out of an SMSF into a public super fund or 'member direct' structure and the proposed franking refund policy would have no impact.

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1. Email from Trustee X to me

Dear Graham,

Some time ago I contacted you regarding my interpretation of the ALP franking credit cash refund policy. My understanding from some media reports was that I would permanently lose the cash refunds in my SMSF even if at a later stage I became eligible for a pension.

I recently asked Bowen's office to clarify this issue, and I had promised to let you know the result. The following is a copy of emails between myself and Bowen's office. It appears that I had wrong information.

If in the future, I reduce my assets and become eligible for a pension I will be able to reclaim the cash refunds. Until then, I will lose $10,000–$14,000 income per year.

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2. Email from Trustee X to Chris Bowen

Dear Sir

Could you please give me a clear answer to the following question.

I was not in receipt of a Commonwealth Pension on the date that Bill Shorten announced the ALP policy proposal on Franking Credit cash refunds.

The question is: If, in few years' time, my assets fall to the amount where I can claim a Commonwealth Pension, will I ever be able to reclaim entitlement to my Franking Credits? ie they are lost to me forever?

There is a lot of confusion among SMSF Trustees over this area of the proposed policy.

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3. Email from Bowen's office to Trustee X

Hi Trustee X,

If you are in a position to claim the commonwealth pension, you will, from that point on, be able to claim franking credits. You won't be able to claim franking credits before that time.

Hope this helps,

Warm Regards,

Thomas McCrudden
Office of Chris Bowen MP
Federal Member for McMahon

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4. Email from Trustee X to Bowen's office

Thomas

Thank you for the very prompt reply, greatly appreciate it. However can you clarify that I will "be able to claim franking credits" **and also retain any cash refunds of these franking credits**.

I realised after I sent the original email that my actual question didn't refer to the cash refunds.

Sorry to be so pedantic but it is an important distinction.

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5. Email reply from Bowen's office

Hi Trustee X,

Yes, you will also be able to given the cash refunds as well after you are on the aged pension.

Warm Regards,

Thomas McCrudden
Office of Chris Bowen MP
Federal Member for McMahon

Trustee X sent me the emails above. He was excited that he would receive franking credit refunds in his SMSF when he started receiving a part age pension. I thought this was incorrect.

6. Email from me to Trustee X

Hi Trustee X

Are you asking as an SMSF trustee about your SMSF? It clearly says in the Labor announcement that the SMSF is only exempt from the changes if a trustee was a welfare pensioner on 28 March 2018.

So I suggest you write back to them and say: "Do you realise that I'm asking this question as a trustee of an SMSF about my SMSF."

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7. Email from Trustee X to me

Graham

Bugger, I thought I had this nailed and had some future hope. I wrote in the first email, "There is a lot of confusion among SMSF Trustees over this area of the proposed policy."

The last line was ignored in their reply. Below, in blue, is my final reply from Bowen's office. You were correct. Basically my wife and I are screwed and will lose $14,000 income.

I started this process because I was reading contradictory advice from experts who were advising asset reduction to obtain a pension as a way of SMSF trustees getting back their cash refunds. I think that many SMSF trustees are still not fully on top of the proposed policy.

Any how this final advice has renewed my determination to do what I can to prevent Bill from being PM.

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8. Email from Bowen's office to Trustee X

Hi Trustee X,

You are correct. If you are not a pensioner before 28 March 2018 the SMSF is not eligible.

Warm Regards,

Thomas McCrudden
Office of Chris Bowen MP
Federal Member for McMahon

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9. Email from me to Trustee X

Hi Trustee X

When your assets fall, perhaps at some point it will no longer be as useful to have an SMSF. Why not follow one of the options in this article?: https://cuffelinks.com.au/smsfs-member-directed-labors-franking/

10. Final email from Trustee X to me

Graham

My assets haven't yet fallen, share prices since the GFC have been kind. We still have about $920,000 in the super fund. That's the problem, if I hadn't been so frugal over the last 5 years I may have been able to take advantage of the grandfather clause.

I have read about the 'member direct' type of structure, probably in a Cuffelinks article, but unsure about the practical application of it. I will research this further in case Bill gets elected.

Thank you for your interest and support in what I find a very stressful situation.

Trustee X

In conclusion, a person on a part age pension can address the loss of a refund by switching out of an SMSF into a public or 'member direct' structure, or use other solutions such retaining the SMSF and allocating to investments which do not produce franking credits. Here's a reminder what this article said about the 'member direct' alternative:

> *"The Fund uses its total franking credits to offset the total tax liabilities it pays. It achieves this because the assets supporting each investment option across the accumulation and pension phases are combined in the one entity. The franking credits are then allocated to the investment options that have exposure to Australian equities. For example, franking credits received in the Member Direct investment option are attributed to members in the option so they receive their respective benefit of the credits."*

Footnote

Looking at Chris Bowen's speeches, this is from the **National Press Club** on 17 May 2018:

Journalist*: "Your negative gearing changes are grandfathered meaning those who enjoy the benefits today enjoy the benefits forever; they're largely baby boomers who enjoyed the growing economy every step of the way from free education all the way through to negative gearing with you. How is that fair?"*

Bowen*: "It's fair because those people have made investment decisions based on the rules at the time. Big investment decisions and we respect that."*

What about the SMSF trustees who set up investments based on the franking rules at the time?

Graham Hand is Managing Editor of Cuffelinks. The information in this article does not consider the circumstances of any other person.

Tax on so-called 'super rich' could prove costly

Ian Henschke

In March 2018, the Labor Party announced a radical new policy. If elected, it would close a 'tax loophole' exploited by the rich. It would reap $59 billion over 10 years by disallowing tax credits from Australian shares to be paid to people who had little or no income. Labor leader Bill Shorten said: *"A small number of people will no longer receive a cash refund."*

Adverse member reaction

But the 'small number' was a large number. It included hundreds of thousands of pensioners, part pensioners, war widows, people on Centrelink payments and self-funded retirees. The Australian Stock Exchange says 58% of retirees own shares and Australia has more than three and a half million people over 65.

These people never saw the imputation credits they were being paid as a 'tax loophole'. Quite the opposite. Many saw themselves as investing in the future of the nation and getting a benefit in their retirement. They'd been encouraged to take up shares in initial public offerings like CSL, Telstra, Qantas and the Commonwealth Bank. It was also income they had relied on for almost 20 years.

So, would it be fair to change the policy? We did a poll of National Seniors members and found nearly 90% thought the removal of tax credits for retirees was unfair.

It was apparent the proposal to end the payment of tax credits had unintended consequences. Bill Shorten realised this after an extraordinary outcry. He announced he would modify his policy. National Seniors fought for and helped win that change for more than 300,000 pensioners who would have lost $3.3 billion over 10 years.

Labor said if elected it would exempt all full and part age pensioners from its policy. It was called the 'Pensioner Guarantee'. We think more needs to be done. The follow-up poll we did after the 'Pensioner Guarantee' was announced revealed two out of three members still thought the policy was unfair.

Middle-class retirees abandoned

The 'Guarantee' protects only a fraction of those affected. What about the rest who are self-funded retirees? The purpose of the policy, according to the ALP, is to stop the rich rorting the system. But what if you're not rich, not rorting and not a pensioner?

The policy means a 30% drop in income from shares. This is why the Coalition is calling the Labor Party proposal a Retirement Tax or tax on retirees.

One member, Joe, said he had worked and paid taxes for 49 years and is not 'rich'. He summed up the feelings of many self-funded retirees, saying: *"My generation was encouraged to plough more into superannuation and, if possible, invest in shares in Australian companies so we could be self-sufficient."*

Joe, like hundreds of thousands of others, made his investment decisions based on a policy that's been in place since July 2000.

Another member wrote: *"By any measure the Labor policy is unbalanced and unfair. It should be either amended to focus on the truly wealthy, or (the policy should be) abandoned."*

Australians want a reasonable level of certainty in financial planning and superannuation. What happened in March shows politicians can't afford to ignore people's concerns and it is possible to adjust a policy to make it fairer.

At the time, National Seniors said we hoped this would lead to a proper debate about how we can have a fair and sustainable retirement system in a rapidly ageing Australia. Former Minister and Labor power broker Graham Richardson wrote: "*Self-funded retirees have never really organised themselves into a powerful lobby group and that makes it much easier for governments to send out a raiding party."*

The organised response

This was a call to arms. Half a dozen organisations decided to band together to form the Alliance for a Fairer Retirement System. That has since grown to 10, including the Association of Independent Retirees. The Self-Managed Super Fund Association and National Seniors were founding members.

The Alliance chair is a highly-respected superannuation expert, Professor Deborah Ralston. Its website was formally launched last Friday by personal finance guru and author Noel Whittaker AM. Mr Whittaker gave a powerful example of how a couple who had saved $1 million in shares would be worse off than a pensioner couple who had saved $300,000 in shares. He said the policy was "ridiculous".

Last week, the Alliance took its case to Canberra. It met with politicians from both the government and opposition, and with officials from Treasury and Social Security. National Seniors was also part of an Alliance delegation that met with Shadow Treasurer Chris Bowen and his advisers.

It pointed out the new policy results in pensioners (who keep their credits) being better off than self-funded retirees who lose theirs. The Shadow Treasurer insisted the policy would not change between now and the next federal election. He also said he was open to an honest debate in good faith.

The Alliance stressed the whole retirement system needs to be fair, adequate, sustainable and have certainty. One in every two voters is now over 50. As Sir Humphrey says in Yes Minister, it would be a 'very brave' move to ignore them.

Ian Henschke is Chief Advocate of consumer lobby group, National Seniors Australia. The article is published with permission from National Seniors.

Three market scenarios, including a 30% fall

Hamish Douglass

We are cautious about global equity markets at present and running a defensive portfolio. This is because we face an extraordinary cocktail of circumstances that skews risks to the downside, including:

- Asset prices are at, or near, record levels

  Prices for sovereign, corporate and high-yield bonds and equities are at, or near, record levels thanks to the ultra-low policy interest rates and the massive quantitative-easing programs of the G3 central banks (the US Federal Reserve, the European Central Bank and the Bank of Japan) over the past decade.

- Central banks have commenced quantitative tightening

  In response to the strengthening economic environment, the Federal Reserve is raising the cash rate and has commenced a pre-set programme to shrink its balance sheet while the European Central Bank has announced that it will cease its asset buying program by 31 December 2018. The combined impact of announced balance sheet activities of the Federal Reserve and the European Central Bank will remove liquidity from global markets, resulting in a reduction in demand for bonds and other assets by these central banks of about US$1.5 trillion on an annualised basis from October 2017 to the end of December this year. We believe that a change in demand by the central banks of this magnitude is likely to have a meaningful impact on longer-term bond yields by early 2019.

- Late-cycle US fiscal stimulus

  In our view, the Federal Reserve's strategy to tighten monetary policy in a smooth and well-foreshadowed manner has been complicated by the large fiscal stimulus being implemented by the Trump administration at the tail end of an extended economic expansion. The tax cuts and additional spending will make a fiscal injection into the US economy of nearly 2% of GDP per annum for the next two years. The US unemployment rate at 4% is near an 18-year low and the US economy has added jobs over the past 93 months, which is the longest such consecutive stretch on record. While there appear to be powerful longer-term secular forces at work that are likely to result in low inflation over the longer term, there is a significant risk that the size and timing of the US fiscal stimulus could trigger a jump in US inflation, in particular from stronger wages growth, over the next year or two. This could be highly problematic for the Federal Reserve and complicate its efforts to engineer a gradual tightening with a soft landing. We cannot think of a similar combination of circumstances in modern history. The cocktail of circumstances could be explosive. The best hope for investors is that either the US tax cuts and extra spending have limited effects on growth and inflation in coming years or the secular forces that have kept inflation low accelerate to offset any inflationary pressures from the fiscal stimulus.

The possibilities of three scenarios

We assess that there are three possible scenarios for markets over the next 12 to 18 months:

- The first scenario is a continued US economic expansion without triggering a material increase in US wages growth or inflation. In these circumstances, we would expect the Federal Reserve to increase short-term interest rates and to shrink its balance sheet broadly in line with current expectations. In these circumstances, it would be reasonable to expect that over the next, say, 18 months the US cash rate would rise to 3% to 3.5% and the 10-year Treasury yield would increase to about 4%. In this scenario, defensive equity assets, longer-term bonds and emerging-market equities are likely to underperform growth assets

and economically cyclical assets, and some commodities are likely to outperform driven by the economic expansion. We would place slightly less than a 50% probability on this scenario.

- The second scenario is where the Federal Reserve is forced to act more swiftly and forcefully than expected to counter inflationary forces. It would be reasonable to assume that US longer-term bond yields could jump suddenly and meaningfully (above 4% compared with 2.86% for the US 10-year Treasury bond at the end of June), which could trigger the biggest slump on world share markets since the global financial crisis. In our view, a 20% to 30% global stock market correction in the next 12 to 18 months is conceivable. In these circumstances all equities are likely to be affected. We would put a similar probability on this scenario to the first or, in other words, we don't know which of these two scenarios is more likely.

- The third scenario is where an external event occurs that causes the Federal Reserve and the European Central Bank to reverse course and put on hold any further tightening of monetary policy. We believe that this is most likely to occur in circumstances of a significant event and, therefore, this scenario is likely to be negative for share markets. There is a remote possibility of a 'Goldilocks moment' where the central banks stop their plans to tighten money policy, longer-term bond yields fall and equity markets don't fall or even rise.

While global stocks have set record highs over the past 12 months, we are cautious on the outlook for equity markets and consider that risks are asymmetrical to the downside. Our caution is reflected in the defensive positioning of the Magellan Global Trust with cash at 30 June 2018 representing 21% of the portfolio.

Conservative investors sleep well

Some people might consider that having such a large cash holding exposes investors to underperformance if equity markets rise. We have no fear of missing the tail end of an extended bull market. Renowned investor Sir John Templeton was perhaps best known for saying:

> *"Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."*

In our view, only conservative investors sleep well. Implicit in conservative investing is the focus on the conservation of capital. As Warren Buffett has said, there are two rules in investing: 1. Don't lose money. 2. Don't forget the first rule.

Hamish Douglass is Chief Executive Officer and Chief Investment Officer at Magellan Asset Management, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor.

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How SMSFs should manage the Total Superannuation Balance

Monica Rule

All superannuation funds are preparing their financial statements for 30 June 2018, and it's important to keep in mind a member's Total Superannuation Balance (TSB) across all of their superannuation funds. It dictates whether:

- the member can make certain contributions
- how often their SMSF needs to report to the ATO on transfer balance account events, and
- whether the member might benefit from new and proposed superannuation changes.

Areas affected by the Total Superannuation Balance

A member's TSB is the sum of all their accumulation accounts and retirement accounts across all of their superannuation funds minus any personal injury (structured settlement) contributions that have been paid into any of the member's superannuation funds.

Some SMSF members are calculating their TSBs incorrectly by only counting their superannuation savings in their SMSF and not including balances in other superannuation funds.

Here, I outline areas of superannuation that are currently affected by a TSB and those areas that will be affected if the proposed superannuation changes become law.

Non-concessional contributions: For an SMSF member to be eligible to make non-concessional contributions into their SMSF, the TSB must be below $1.6 million immediately before the start of the financial year in which the contribution is made.

Catch-up concessional contributions: From 1 July 2018, if a member did not make any concessional contributions in one year, then provided their TSB is below $500,000 immediately before the start of the financial year in which the contribution is made, they can use any of the unused limit from 1 July 2018 in the following five consecutive years.

Spouse contributions: For a member to be able to make contributions for their spouse and claim a tax offset on the contribution, the spouse's TSB must be below $1.6 million immediately before the start of the financial year in which the contribution is made.

Government superannuation co-contributions: The government will contribute 50 cents for every $1 of non-concessional contributions of up to $1,000 made by a member into their SMSF (or any super fund). However, the member's TSB must be below $1.6 million immediately before the start of the financial year in which the non-concessional contribution is made.

Transfer balance account reporting: If any member of an SMSF has a TSB of $1 million or more, and the SMSF has a transfer balance event, then the SMSF must report the transfer balance account within 28 days after the end of the quarter in which the event occurs. Where all SMSF members have a TSB less than $1 million, then their SMSF can report the transfer balance event on an annual basis at the same time as when its tax return is due.

Tax exemption on pension income: If an SMSF has a member with a combined TSB in excess of $1.6 million across all of their superannuation funds (as at 30 June of the previous financial year), and the person is in receipt of a retirement pension, and the SMSF has at least one member in retirement phase, then the SMSF can only calculate the tax exemption on earnings generated from pension assets using the unsegregated or proportionate method. However, if an SMSF has a member in receipt of a retirement pension and all of members' TSB is less than $1.6 million across all of their superannuation funds (at 30 June of the previous financial year), then the SMSF can calculate the tax exemption using the relevant segregated and/or unsegregated method.

Areas affected by the 2018 Budget

Work test exemption for recent retirees: In the 2018 Federal Budget, the government proposed that from 1 July 2019, an individual aged 65 to 74 with a TSB of less than $300,000 (at the beginning of the financial year following the year that they last met the work test) will be permitted to make voluntary contributions for 12 months from the end of the financial year in which they last met the work test.

Opt-in requirements for life insurance: In the 2018 Federal Budget, the government proposed that from 1 July 2019, life insurance cover will move from a default framework to an opt-in basis for members with balance of less than $6,000, members under the age of 25 years, or members whose accounts have not received a contribution in 13 months and are inactive.

Capping passive fees: In the 2018 Federal Budget, the government proposed that from 1 July 2019, a 3% annual cap will be placed on passive fees (i.e. administration and investment fees) charged by superannuation funds on accounts with balances below $6,000.

It is important that SMSF members are aware of how their TSB affects their superannuation entitlements so that they can maintain their funds' compliance and even take advantage of the changes to superannuation law.

Monica Rule is an SMSF Specialist and author. See www.monicarule.com.au. This article is general information and does not consider the circumstances of any individual.

Redefining risk for income investors

Andy Sowerby

An equity-based investment fund that aims to deliver *dependable* income is likely to deviate significantly from the Australian share market index. It requires an active approach to manage a set of different risks.

For a typical return-seeking equity fund aiming to outperform the index, the main risk is 'relative risk' due to the portfolio deviating from the index and underperforming this benchmark. But what really matters for income investors is the risk that the fund does not deliver a sustainable and growing income stream.

A different set of risks requires a different approach.

Risks specific to the income investor

Income investors face several unique risks that are often not acknowledged in traditional investment literature:

Income level risk

Typically, income investors aim to generate an income stream that enables them to maintain their standard of living. This is a critical issue for retirees, and to achieve this goal they must tackle income level risk – the danger that income paid by an investment falls in response to interest rate changes and other factors.

For example, in 2010 one of Australia's leading banks offered its customers a five-year term deposit rate of 8% pa. Today, the market rate is below 3.5% pa and around 2% for a more popular 90-day term. For investors who have relied on short-term cash rates, the steady fall in interest rates over this decade has exposed them to heightened income risk. Of course, living costs continue to rise.

In today's lower interest rate world, term deposit investors need to invest larger sums of capital to achieve the same dollar return. Additionally, these lower rates impact the returns from other annuity-type products and create significant challenges.

Inflation risk

Inflation risk is the risk that the real value of an income stream declines as the cost of living rises. For investors to maintain their spending power and living standards, they must ensure their income stream grows at least in line with inflation. This is particularly important for people in retirement as they are likely to incur increased costs in areas such as health care and aged care services.

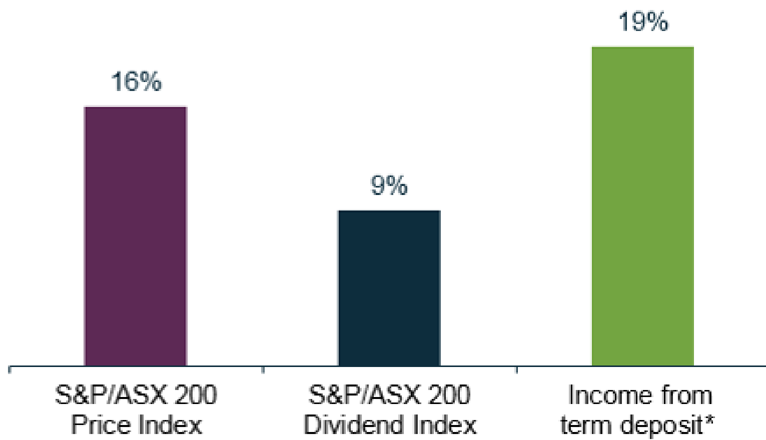
For example, investing in a term deposit at 2% pa when inflation is compounding at 2.5% annually leaves the investor with a real (inflation-adjusted) return of negative 0.5%.

Given retirees usually have a relatively fixed capital base, inflation protection is central to any medium- to long-term income-oriented financial plan.

Income volatility risk

Investors worry about movements in the capital value of their investments but for income investors, we believe it is more important to focus on the volatility of the income stream. What matters most for income investors is that their investments deliver a sustainable and growing income stream, and the main risk they face is that it does not. Reducing the volatility of the income stream in search of reliable income delivery should be a primary consideration.

Chart 1: Income volatility over the last 15 years – equities and cash



*Past performance is not a guide to future performance Source: Martin Currie Australia, Factset; as of 30 June 2018. *Average 'special' rate (all terms).*

The chart above compares the volatility of Australian shares (prices and dividends) and term deposit income over the last 15 years. The volatility of the income stream from term deposits is more than double the volatility of the dividend stream from Australian equities, and the income from dividends has been materially higher.

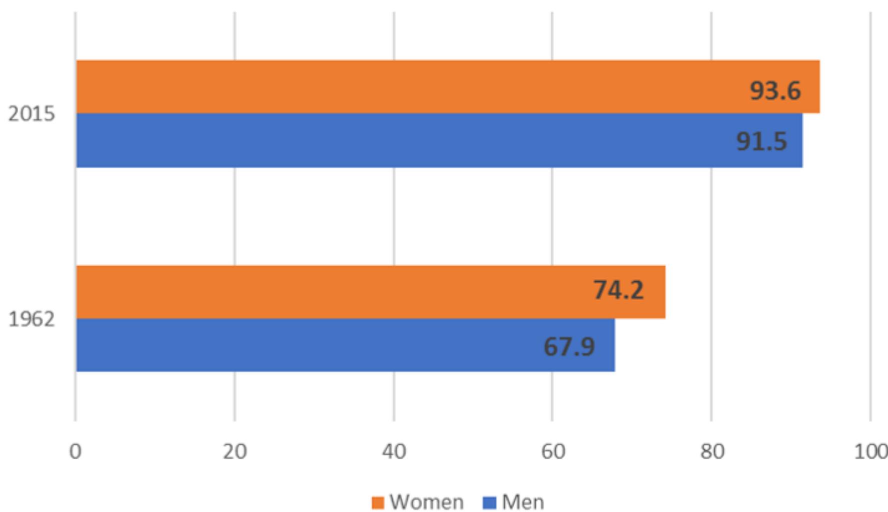
With this understanding, equity income investors are increasingly valuing the more dependable nature of dividend streams especially from higher quality companies and are worrying less about short-term capital volatility associated with share markets.

Asset managers have helped with this process through educating investors on the opportunities and risks of equity-based strategies and by developing specialist funds to enable them to benefit from these attractive income streams.

Longevity risk

Australians are living longer. As the chart below shows, the average life expectancy of Australian men and women is now over 90 years, having increased by around 20 years since 1960. So the probability (risk) of outliving savings is growing, and this is known as longevity risk.

Chart 2: Australian life expectancy (at birth)



Source: Australian Institute of Health and Welfare, Australian Treasury Intergenerational Report, ABS, March 2018

Over the next 40 years, Australia's population will experience a major shift. A far greater proportion of the population will be older, and the dominant baby boomer generation will move into retirement. This combination will significantly increase the nation's pension expenses and upset the balance between retirees and the working age people who are funding the pension system. Currently, for every person aged 65 and over there

are 4.5 people of workforce age (15 to 64 years) but this is forecast to decrease to around 2.7 people per retiree by 2055, putting an increased strain on the entire system (see the 2015 Intergenerational Report, Chapter 1, Australian Department of Treasury).

This all points towards continued growth in demand for income-generating investment solutions, particularly given the prevailing 'lower for longer' view of interest rates. In this world, equities can carry much of the burden, especially funds that utilise proven active management focused on uncovering the highest quality, most sustainable, dividend streams.

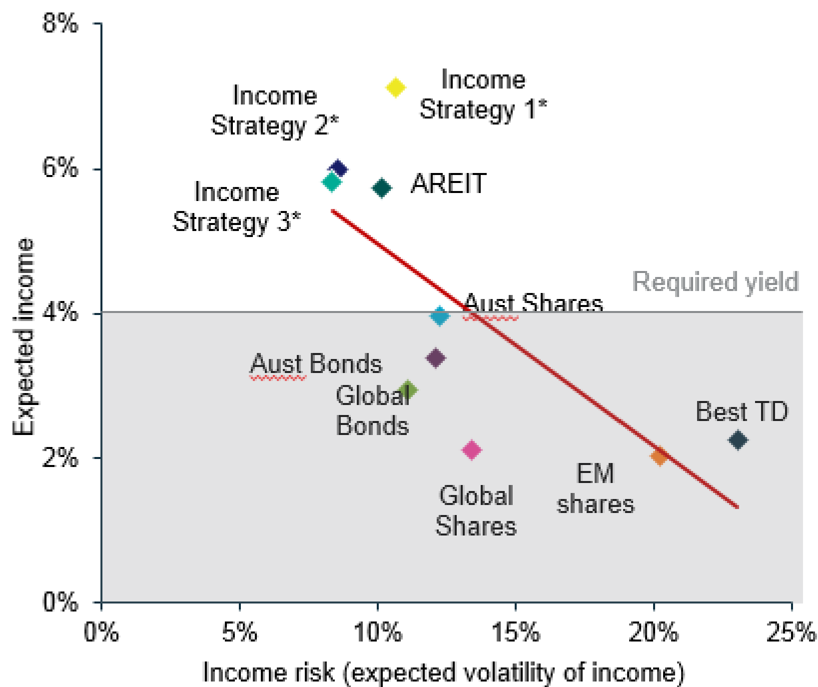
The real risk/return trade-off for income investors

Investors seeking income need solutions that can generate a yield high enough to meet their requirements today, that is sustainable over the long term, that can be expected to grow at least in line with inflation, whilst also protecting their hard-earned capital base. This requires a change in investor behaviour and the need to challenge some traditional investment approaches.

Given these specific risks, what is the true risk/return trade-off that applies to income-focused portfolios?

The traditional approach to investing looks at the potential total return (capital plus income) of an investment and compares it to the expected risk. The aim is to create a portfolio that can deliver the best possible return for a given amount of expected risk. But this only makes sense if your investment objective is focused on total return. If you are an *income investor*, your objective is to generate a sustainable and growing income stream. Hence a different approach to investing and portfolio construction is required as *low risk* in this context is defined as *income sustainability*.

Chart 3: Expected income versus income risk



*Source: Martin Currie Australia, ASFA, Factset; as of 30 June 2018. Income is calculated using manager assumptions for each asset class – because of this, the returns quoted are estimated figures and are therefore not guaranteed. *Data calculated for representative Legg Mason Martin Currie Australia Equity Income (1), Real Income (2) and Diversified Income (3) accounts in A$ gross of management fee; gross performance data is presented without deducting investment advisory fees, broker commissions, or other expenses that reduce the return to investors. Assumes zero percent tax rate and full franking benefits realised in tax return.*

The risk/return chart above examines how the major asset classes fare when the portfolio construction trade-off is redefined as expected income versus income risk (also known as the expected volatility of the income stream). Term deposits have deeply disappointed as the dramatic drop in interest rates over the past decade means that the volatility of the income offered is high and actually worse than the income volatility from emerging market shares. Australian shares and A-REITs do much better and these can be improved further by

dedicated equity income strategies that target the companies that matter most to income investors – those with high dividends that are both sustainable in difficult economic conditions and are expected to increase in value over time.

Andy Sowerby is Managing Director at Legg Mason Australia, a sponsor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. The opinions and views expressed herein are not intended to be relied upon as a prediction or forecast of actual future events or performance, guarantee of future results, recommendations or advice.

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Shifting asset allocations by Sovereign Wealth Funds

Adrian Harrington

Sovereign wealth funds (SWFs), the 100-pound gorillas of the investment world, are pulling away from real estate and infrastructure and deploying more capital into listed deals and technology.

(An accepted definition of an SWF is a special-purpose investment fund owned by the general government for macroeconomic purposes. They manage assets to achieve financial objectives using a set of investment strategies. The definition excludes foreign currency reserves held by central banks and state-owned enterprises, government-employee pension funds and assets managed for the benefit of individuals).

Changes in SWF asset allocation

Using a three-year database of investments by more than 60 SWFs, the International Forum of Sovereign Wealth Funds and Bocconi University recently released a report ('Dealing with Disruption', issued 16 July 2018) that found that the number of private deals dropped from 196 in 2016 to 184 in 2017, while the number of listed investments rose from 94 to 119.

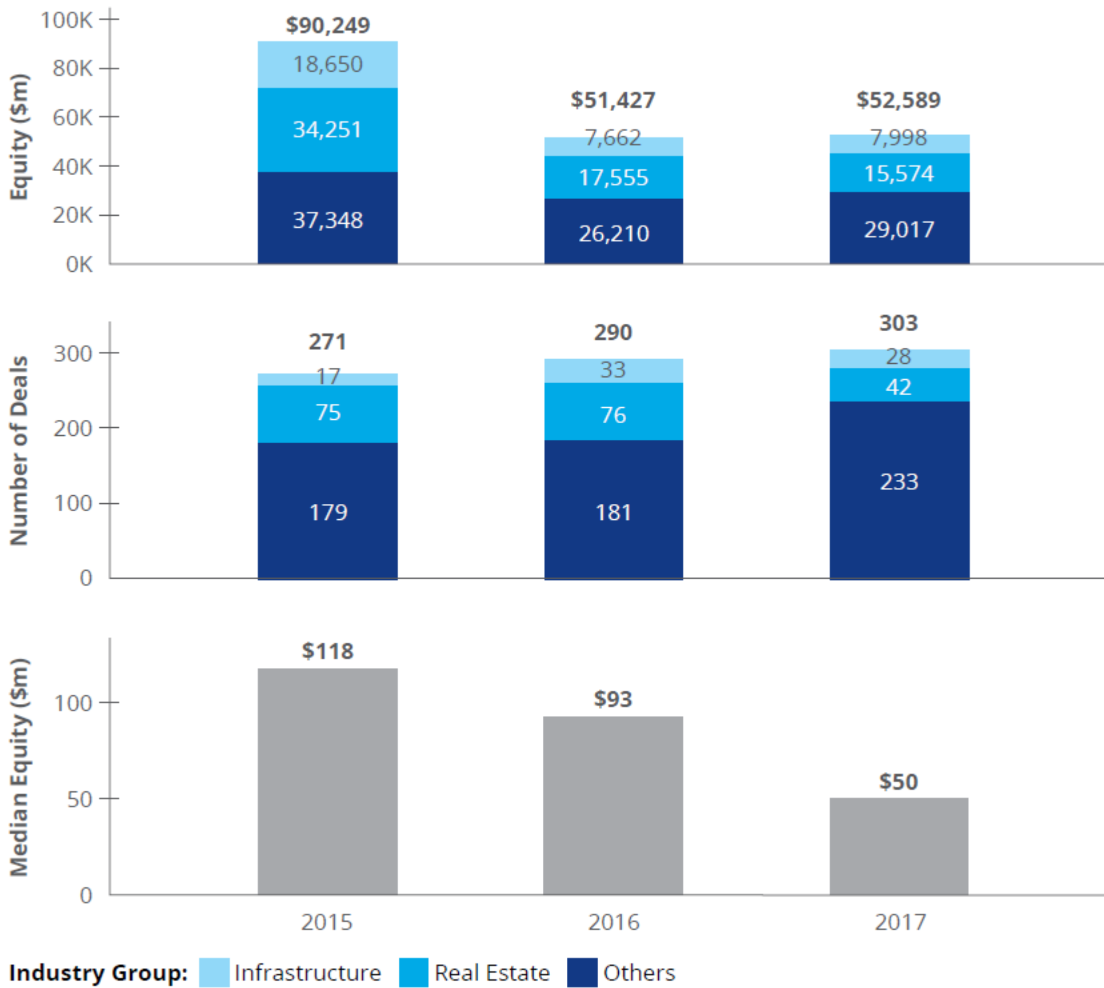
SWFs have long been active participants in private markets. Their scale, long-term investment horizon and little need for liquidity was seen as a good match to private market investments such as real estate and infrastructure.

But as the Report points out, SWFs appear to be facing challenges deploying capital. Abundant liquidity and strong competition for high quality assets from a growing array of institutional investors looking for real estate and infrastructure assets is pushing valuations higher.

In 2017, the number of direct real estate and infrastructure investments made by SWF's declined from a total $25.2 billion in 2016, split between 76 deals in real estate, and 33 in infrastructure, to $23.6 billion, comprising only 42 deals in real estate and 28 in infrastructure (Figure 1).

In the real estate sector, there was almost a 40% decrease in the number of SWF investments in private markets between 2016 and 2017, while in infrastructure, the number of deals fell by 15%.

Figure 1: SWF Direct Investments in Real Estate and Infrastructure vs Total



Source: IFSWF Database

Global protectionism encourages investment in other places

In infrastructure, rising global protectionism also threatens to stymie foreign direct investment by SWFs in strategic sectors. The Report acknowledges SWFs:

> *"… are encountering greater resistance from regulators, preventing them from investing in major infrastructure assets. Regulatory regimes in the US and Europe are installing more stringent screening processes for foreign direct investments in strategic infrastructure assets."*

Asia and Latin America are now on the radar for SWFs looking for established infrastructure companies with predictable cash flows. In 2017, SWFs completed 17 direct investments in emerging-market infrastructure, of which 10 were cross-border, for a total value of $3.8 billion versus 11 deals in developed markets totalling $4.2 billion.

The Report noted that:

> *"… while it might, on the face of it, appear to be a higher-risk strategy, emerging markets can carry lower potential political risks as there are fewer concerns about foreign investment in infrastructure and SWFs can pair with a domestic promotor. Deals are often less complex, with fewer parties involved, and lower costs reducing third-party operating risk."*

Across their direct investment platform, the median equity investment by SWFs was $50 million, just over half the $90 million recorded in 2016. Excluding real assets, such as real estate and infrastructure projects, this trend was even more marked. The median equity investment was $27 million, plummeting from that of previous years: $60 million in 2016 and $58 million in 2015.

Increasing sophistication of SWFs

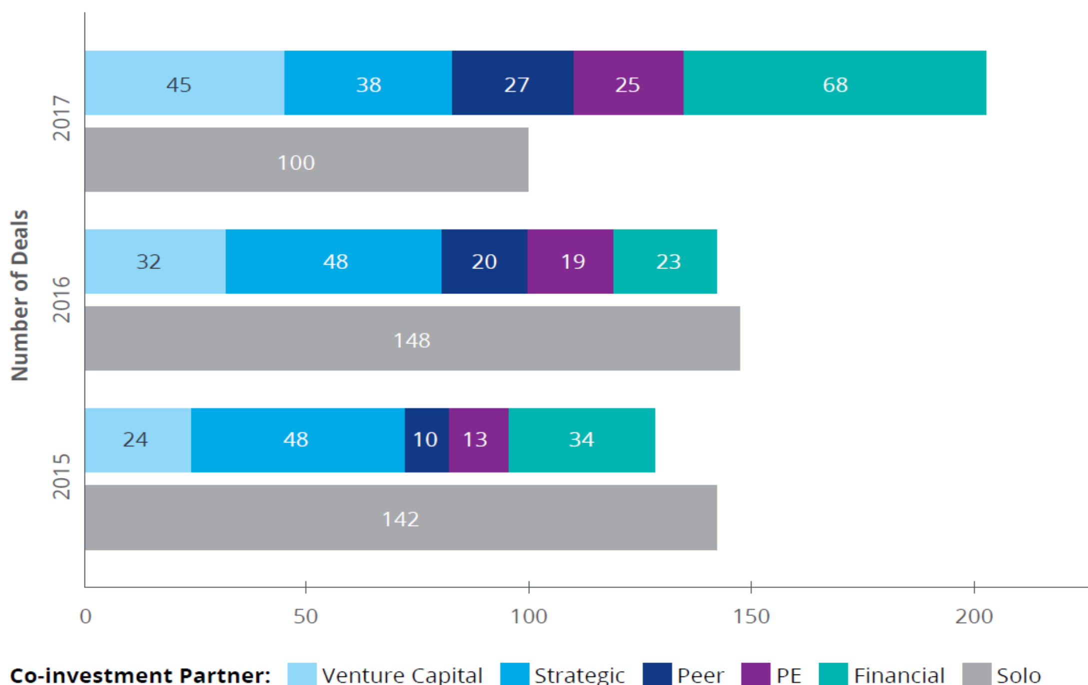
While there are certainly headwinds in private markets, SWFs have been taking advantage of the weak US dollar, strong global growth, and expectations that tax reform in the US would push stock markets to record highs, and increasing their direct investments into listed companies. In 2017, SWFs bought publicly listed shares in 119 transactions – 39% of the total – up from 94 deals in 2016, which represented 32% of the total.

With the growing size and sophistication of SWFs, they are now less likely to be simple investors in funds. They are increasingly collaborating with other investors, including their peers and private equity firms on investments, enabling them to harness external expertise across sectors. In an era where generating above-market returns requires a much more active management of investments,

> *"SWFs are now genuinely participating in, and setting the strategic agenda of, their portfolio companies, using their global influence to drive investment performance and working actively with (and learning from) more experienced joint-sponsors and partners in a deal."*

In 2017, the trend reached a new high as SWFs completed 203 investments in a consortium or partnership, more than double the number of solo deals (Figure 2).

Figure 2: SWF Direct Investments – Partnerships and Consortia



Source: IFSWF Database

SWFs are also investing more in technology and particularly earlier stages of the private equity cycle. There was a material uplift in investments in innovative sectors in 2017, with 29 deals in technology and 16 in healthcare, up from 15 and 6 respectively in 2016. The breadth of disruptive technology stretches from augmented reality and artificial intelligence to new materials, biotechnology, innovative pharmaceuticals and new medical devices.

SWFs continue to grow their asset base, up 13% in the year to March 2018 to US$7.45 trillion, as reported in the 2018 Preqin Sovereign Wealth Fund Review. With that amount of firepower, any changes in how and where they deploy their capital will have implications for global financial markets and all investors.

Adrian Harrington is Head of Funds Management at Folkestone, a sponsor of Cuffelinks. This article is in the nature of general information and does not consider the circumstances of any investor.

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Some trustees should self-manage out of SMSFs

Robin Bowerman

One of the great misnomers in the Australian investment scene is that self-managed super funds are actually self-managed.

The simple reality is that there is an entire advice industry built around SMSFs, be they traditional accountants, financial advisers, lawyers or one of many SMSF administration platforms.

This makes the provision of quality advice to those Australians who have an SMSF – or those considering setting one up – absolutely critical, if the more than one million SMSF trustees are to achieve the best outcome when they retire.

Concern about quality of SMSF advice

Last month, ASIC released a comprehensive report on the quality of advice and member experiences in the SMSF sector.

The 120-page report is uncomfortable reading for many in the industry because it calls out a high level of non-compliance with the best interests duty. In a review of 250 client files by an independent expert, 10% of the files risked clients being significantly worse off as a result of the advice they received to set up an SMSF.

A healthy and vibrant SMSF sector is a vital part of our compulsory superannuation system. It provides a competitive alternative to the institutional APRA funds and gives super fund members an effective choice and alternative.

ASIC says that in the right hands:

> *"SMSFs can be very effective retirement savings vehicles. In the wrong hands, however, SMSFs can be a high-risk option."*

ASIC's focus was on funds set up in the past five years – so the research sample is skewed to relative newcomers to the sector – and there are some strong messages for the advice industry on where it needs to lift standards. There are also some red flags that both existing SMSF trustees and those thinking about establishing an SMSF should pay attention to.

Common problems with SMSFs and trustee expertise

ASIC found common issues centred on the disclosure of costs and risks about the set up and running of an SMSF, advisers not properly considering the client's circumstances or existing super fund and not prioritising the needs of the client.

The ASIC report also holds up a mirror to trustees, or would-be trustees, with a challenging reality check around the personal responsibility that comes with the decision to set up an SMSF. In some of the case studies, financial literacy among trustees is clearly an issue with some trustees not aware of how their fund is performing, what it costs to operate or even if it has an investment strategy.

The bottom line is that an SMSF is not for everyone. Even someone who has good levels of financial literacy and resources may not be suited to an SMSF. ASIC cites the example of an investor with more than $2 million in super but no time or interest in running their own fund.

It raises the question of whether some base level of financial literacy needs to be demonstrated before the keys to an SMSF are handed over. The stark example in the ASIC research is that 55% of the SMSFs in the research sample had more than half their money invested in one asset type. That level of portfolio concentration risk, ASIC says, means those members may face greater risk in reaching their retirement goals.

SMSF marriage of convenience with property

Nowhere is the issue of financial literacy more pointed in the SMSF world than on the issue of borrowing to buy property. What ASIC's online and face to face interviews showed is that for some, an SMSF has become a happy marriage of convenience between those wanting to access the residential property market and using their super savings to do it.

Now Australian investors' love affair with property is beyond dispute. The property market has generally been kind, to the point that ASIC found that the surge in prices in recent years particularly in Sydney and Melbourne markets had "created a sense of urgency driven by a fear of missing out". But perhaps this is a case of where love of the property market is making investors blind to risks and costs.

The fear of being locked out of the market is clearly playing into the hands of so-called 'one-stop property shops'. ASIC's research showed that trustees who had used a property one-stop shop had quite different experiences to those using a financial adviser or accountant. ASIC reports:

> *"After members had made a decision to set up an SMSF with a property one-stop shop they were introduced to related parties such as mortgage brokers, lawyers, insurance brokers, property management companies and property developers."*

What was surprising was not how the one-stop shops were operating but rather that the members seemed unconcerned about the potential conflicts of interest, and some even saw that as an advantage. Some members didn't know if commissions or kickbacks had been paid to related parties, indeed they were vague about what the total cost of setting up the SMSF and the loan facility had been.

A Sydney case study, Luke, provided a hard-earned lesson. He set up an SMSF to buy a property in Queensland after a cold call from an adviser and a related accountant. He found costs of buying the property and running the SMSF higher than expected. He is now attempting to sell the Queensland townhouse for $22,000 less than he paid for it and his overall loss will be around $70,000. Luke admitted he should have done a lot more research, but he is not alone.

SMSF trustee responsibility

And while the financial advice industry has much to do to improve its level of professionalism, the trustees of SMSFs have to also take personal responsibility for both the decision to set up the fund, and for its investment decisions.

You certainly do not have to manage everything to do with an SMSF yourself, but if you are not prepared to spend the time understanding the costs of running an SMSF, setting an investment strategy and monitoring its performance, then you should seriously question whether an SMSF is the right retirement savings vehicle for you.

Robin Bowerman is Principal and Head of Corporate Affairs at Vanguard Australia, a sponsor of Cuffelinks. This article is in the nature of general information and does not consider the circumstances of any investor.

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10 steps to protect your SMSF from loss of mental capacity

Brian Hor

If you have an SMSF, you need to plan ahead to ensure that it can keep going if you lose mental capacity due to dementia or other reasons such as suffering a stroke. Otherwise, the fund's assets and operations could be frozen. This may result in losses from being unable to buy or sell investments at the right time, control of the fund falling into the wrong hands (including total strangers), and even the loss of complying fund status with catastrophic tax consequences.

Before the unthinkable happens, here are 10 ways to protect your SMSF from your incapacity:

1. Talk to your financial adviser about what you want with your fund if you lose mental capacity. This should include:

- Who should be in control
- What should happen to the investment strategy and ongoing management of the fund
- Whether the fund should be wound up and your member benefits rolled into an APRA fund
- What should happen to your death benefits, and so forth.

Your adviser should counsel you and co-ordinate further assistance from an accountant or a lawyer where necessary.

2. Put into place a corporate trustee rather than individual trustees. This is easier as there will be no need to change the ownership of the fund assets (which can be a costly and time-consuming exercise) as they will be in the name of the corporate trustee, and all that needs to happen is that you will be replaced as a director.

Enduring Power of Attorney

3. Put into place an Enduring Power of Attorney to appoint someone who you trust to handle your financial affairs and to be appointed in your place as a director of the corporate trustee (or a trustee of the fund if you are not using a company as trustee) if the need arises.

4. Check the SMSF's trust deed to ensure it allows an Enduring Attorney to be appointed in your place as a trustee of the fund or as a director of the corporate trustee. If it doesn't, then have it updated accordingly.

5. Provide written instructions to your Enduring Attorney and the other trustees or directors of the corporate trustee. Let them know that you want your Enduring Attorney to be appointed in your place. Advise their roles and responsibilities and specific instructions regarding issues such as dealing with particular fund investments.

6. Appoint one or more substitute or 'back up' Enduring Attorneys, especially if you appoint your spouse as first choice, as they may be the same age as you and therefore at risk of developing dementia at the same time as you do. In this case, the substitute attorneys should be younger than you (such as one or more of you trusted children).

Investment and governance strategy

7. The investment strategy should set out what should happen both before and after a member loses capacity, and ensure that the strategy binds all the fund trustees.

8. If you are a director and shareholder in a corporate trustee of the fund, check the constitution of the company to make sure that your Enduring Attorney can exercise the voting power on your shares so that they can be appointed as director in your place.

9. Put into place a Non-lapsing Binding Death Benefit Nomination (and if necessary update the trust deed for your SMSF to allow you to do this). Otherwise, if you lose capacity and your nomination lapses, you will not be able to renew it and the trustee of the fund will have the discretion to pay your death benefit, perhaps to someone you did not intend as a receiver.

10. Make sure your will is properly updated, because once you lose capacity, you can no longer make or change your will. This can be critical in the context of your SMSF, as the only way you can give your super to persons who are not eligible to receive benefits directly from your SMSF is via your will. For instance, unless you were in an interdependency relationship with them or they were your financial dependants, you cannot nominate grandchildren to receive a death benefit directly from your fund. Instead, you have to direct the death benefit to your deceased estate and then make a gift of the death benefit to your grandchildren under your will.

Brian Hor is Special Counsel, Superannuation & Estate Planning at SUPERCentral. This article is general information and does not consider the circumstances of any individual.

The ATO provides guidelines on winding up an SMSF, and it's more complicated than most people expect.

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