

This Week's Top Articles

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Corporate toads kissing, but no princes here

Roger Montgomery

Finally, the global wave of media mega-mergers has washed up on Australia's shores, following Malcolm Turnbull's removal of the 'two out of three' and '75% coverage' rules in October 2017. But will Nine's bid for Fairfax make any difference to either organisation or will it be a case of a princess vainly kissing a toad in the hope of finding a prince? Or is it more like two toads kissing?

Media's changing landscape

Overseas, the US-based Comcast bid US\$66 billion for the Fox Inc. entertainment assets which includes franchises like the X-Men and The Simpsons. That bid was pipped by Disney's US\$77 billion rival offer, leaving Fox and Comcast to fight it out for the 61% of European broadcaster Sky plc that Fox doesn't already own.

Meanwhile rumours of further mega-mergers and acquisitions circle media companies such as CBS and Viacom by the likes of Apple and Amazon.

Closer to home, Nine Entertainment executives appear to be equally enamored with their childhood reading of the Russian fairytale about the frog-kissing princess. They expect their corporate kiss will transform Fairfax. Nine is offering Fairfax shareholders 0.3627 Nine shares (equivalent to 82 cents currently) plus 2.5 cents cash for each Fairfax share. That's 84 cents per share for Fairfax, or about \$1.17 if the value of Domain's in-specie distribution is included.

With 2.3 billion shares on issue, Nine's offer values Fairfax at about \$2 billion, or more than two times its equity (which itself was written down aggressively in 2012 as a result of persistent returns on equity of less than 4%pa).

Fairfax has responded approvingly by stating:

"The structure of the proposed transaction provides an exciting opportunity for our shareholders to maintain their exposure to Fairfax's growing businesses whilst also participating in the combination benefits with Nine."

Takeovers often promise and are frequently justified on the basis of 'combination benefits', also known as synergies. But synergy benefits invariably fail to materialise, or if they do, they take much longer to arrive than expected, forcing the bidder to write down the goodwill in its offer. Recently, Japan Post was forced to write off \$4.7 billion, several years after buying Toll Holdings with the company's President, Masatsugu Nagato, stating:

"The price we paid for Toll was high ... the writedown is intended to wipe the slate clean." Wiping the slate clean is easy for CEOs when its billions of dollars of other people's money used as the mop.

Consumption of media has changed completely

Newspaper audiences have been gutted and diced by the emergence of digital media alternatives. The era of newspapers monetising their markets through advertising and classifieds is long gone.

Free-to-air television has likewise seen its audiences decimated not only by Facebook and Google taking eyeballs away from television, but by streaming alternatives such as Netflix, Apple TV and Amazon.

TV content has changed over the last decade. The age of binge-watching has been sparked by series such as Game of Thrones, Homeland, Ozark, Breaking Bad and House of Cards. Consumers will always be attracted to the next hit forcing media companies to keep increasing their spend on ever-higher production, casting quality and writing values.

How can Nine compete when it spends \$2 billion on Fairfax, while Netflix and Time Warner (which owns HBO) and CBS (which owns Showtime) spend US\$6 billion annually on developing their own content. Meanwhile, Disney and NBC Universal are spending around US\$12 billion annually on TV programming.

I once likened the Australian TV competitive landscape to four card players (four networks – Nine, Ten, Seven and the ABC) locked in a room with no windows or doors. The Australian viewing audience is represented by the pile of chips that each player tries to win. Each year one of the players secures a winning hand (the most popular TV drama or reality TV concept) but the next year its mantle is lost to another network. The pile of chips never grows, it is merely passed around. Today, thanks to the likes of Facebook, Google, Amazon, Netflix and others, that card-playing room has a drain in it and chips are constantly falling down the drain making the pile of chips smaller.

Merging with Fairfax will not change that dynamic for Nine. The Fairfax audience already knows Nine exists and the Nine viewers are all familiar with Fairfax's titles. At best, Nine will win a few chips this year or next, but lose them again the year after, or the year after that.

What motivates managers of public companies to make acquisitions?

The drivers of acquisitions include:

1. The desire to be bigger, which is the yardstick by which salaries are often measured
2. The pressure from institutional shareholders to 'grow' revenues and profits
3. The aspiration to increase the share price
4. The need to grow faster
5. The push from lenders and corporate advisers to take advantage of other factors such as low interest rates, a buoyant stock price or investors flush with cash and a rapidly closing window for deal-making
6. The belief the buyer can do a better job than the target.

Rarely do the above motivations result in better long-term returns to shareholders.

Would I give my money to Nine?

There is only one compelling reason to make an acquisition and that is to receive more than is being given away. Nine's shareholders will effectively pay two times equity for Fairfax ensuring that Fairfax's forecast 14% return on equity will be halved in the hands of Nine's shareholders. Why would I give my money to Nine to pay more for Fairfax than I could have paid for Fairfax myself on-market?

If a princess kissing a toad does not produce a prince, then two toads kissing each other certainly won't. The economics of newspapers and free-to-air TV are not improved by a change in ownership, and the market has already spoken. The Fairfax share price is cheering the news, while the Nine share price fell.

When viewing mergers and acquisitions, look through the lens of the industry's economics and the return on equity of the target. When I do that, I don't see anything to get excited about on behalf of long-term Nine shareholders or Fairfax shareholders, who may soon be Nine shareholders too.

Roger Montgomery is Chairman and Chief Investment Officer at [Montgomery Investment Management](#). This article is general information and does not consider the circumstances of any individual.

The SMSF gaps in the Productivity Commission’s Superannuation Report

Kevin Bungard

The Productivity Commission’s 571-page ‘Report into Superannuation’ provides some well-researched findings on institutional funds, but it fails to hit the mark on SMSF performance. This is not a reflection on the quality of the Commission’s work, but it is a stark reminder of the inherent differences between how the Australian Prudential Regulation Authority (APRA) and the Australian Tax Office (ATO) report fund performance. We need to highlight and fill in some critical ‘SMSF gaps’ identified in the Commission’s draft Report.

The disparities in performance reporting result from:

- The ATO includes contributions tax and insurance costs in net earnings while APRA does not.
- Given these extra costs, the ATO performance measure will always be worse than APRA’s.
- The smaller the SMSF balance, the higher the impact of those extra costs.

We have analysed publicly-available contribution tax and insurance data from the ATO to restate SMSF performance so it can be directly compared to institutional fund returns.

For the 10-year period the Commission’s Report covers, SMSFs outperformed APRA funds on a like-for-like basis.

- In a technical supplement to the Report, the Commission noted that if APRA fund performance is calculated using the ATO method, then SMSFs outperform institutional funds (SMSFs 5.59% compared to 4.98%)
- The Class submission shows that when SMSF performance is restated using the APRA approach, the amount by which SMSFs outperform institutional funds is even higher (SMSFs 6.71% compared to 5.58%).

The discrepancy around 10-year performance reporting

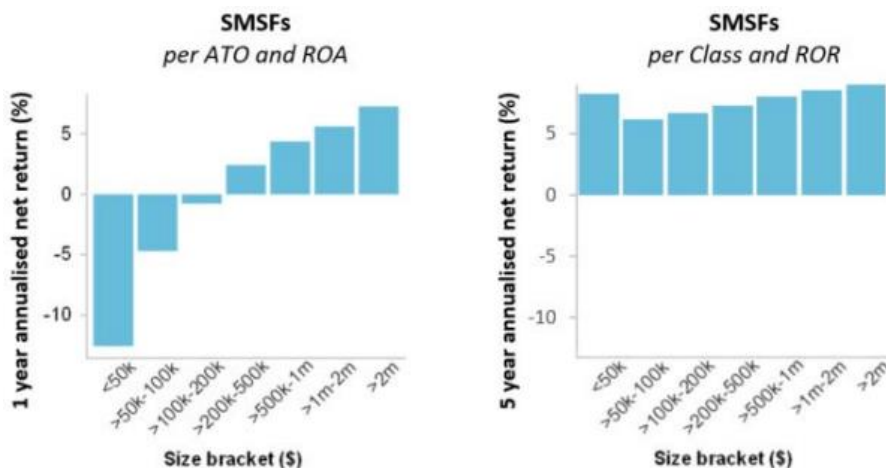
The Report highlights how institutional funds of different sizes performed over the 10 years from 2006 to 2015. In parallel, the Report should also show how SMSFs starting with different balances (e.g. \$1,000 – \$50,000 and \$51,000 – \$100,000) performed over the same period. Instead, they provide a mash-up of one-year performances across the 10 years.

The Commission noted in the Report:

“It is unclear to what extent the presence of small SMSFs in the system is necessarily a problem. It may be that many of these SMSFs will move into higher balance categories over time (or as the upfront capital costs are paid off), although this is difficult to discern given the lack of publicly-available panel data.”

This is highly concerning, given that super is all about saving over the long term, and the industry should be able to compare data on a like-for-like basis.

Class analysis of SMSF performance across five years shows that although funds with smaller balances do generate lower returns, the variance is considerably less than the exaggerated results provided in the draft Report.



Left-hand side: from Figure 2.10 in the Report. Right-hand side: from Class submission

The analysis in the right-hand chart used APRA’s rate of return (ROR) method (as against the ATO’s return on assets (ROA) method) and looked at SMSF performance over the five years from 2013 to 2017. Funds were grouped by their starting balance in 2013.

Long-term fund analysis published by the ATO in the infographic [SMSFs first lodged in 2012 FY: where are they five years on?](#) did not include performance data. The ATO should provide a 10-year version of this document and it should include performance for all SMSFs, grouped by their start of year balance in 2006.

A call for collaboration between APRA and the ATO

It appears that the advice the Commission received from the regulators was that it is ‘too hard’ to compare the performance of APRA funds against SMSFs. This is disappointing, given the dual regulators are responsible for an industry worth over \$2.5 trillion. The competing approaches deliver significant performance reporting differences.

It’s time that the two industry regulators collaborated to deliver accurate insights into like-for-like fund performance.

A full copy of the Class submission can be downloaded [here](#).

Kevin Bungard is CEO of [Class Limited](#), a provider of SMSF administration software.

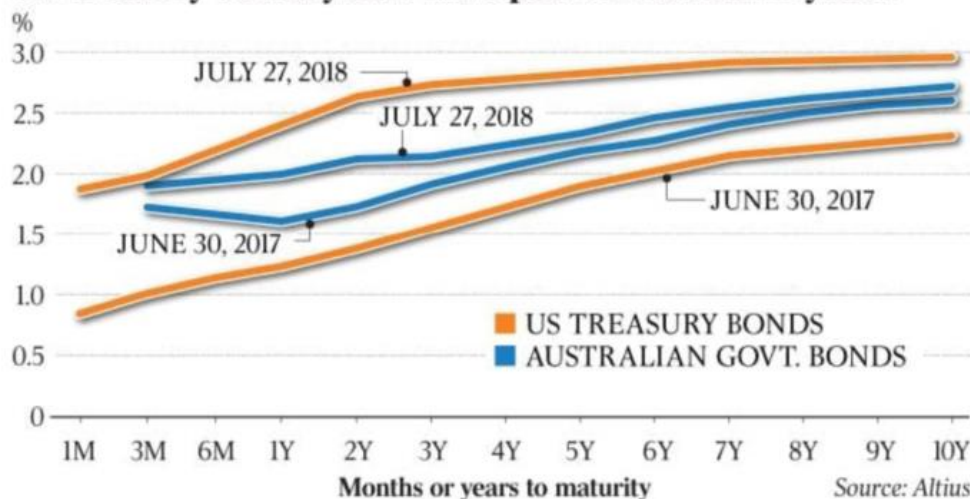
3 reasons the Aussie dollar has not collapsed

Don Stammer

A year or so ago, views formed that the US cash rate would likely rise above Australia’s during 2018. Many forecasters predicted the Aussie dollar would plunge when this happened.

The US cash rate is now a half percentage point above the cash rate here, with widespread expectations of the gap widening further. Moreover, and as the chart below shows, the whole of our yield curve is now below the US curve. Although the local dollar is lower than it was a year ago, it certainly has not crashed.

US Treasury bonds yields have passed Australian yields



Forecasting exchange rates is a fraught and challenging activity. A wide range of ‘fundamental’ influences has to be considered, and sometimes their pecking order changes at short notice. Also, exchange rates often tend to overshoot their new level. For example, in the late 1990s, the Australian dollar fell ‘too much’ on views we were an ‘old economy’ and in 2011 our currency soared ‘too high’ on our apparent ‘complementarity’ to the buoyant Chinese economy.

Often, exchange rates do unexpected things. Moreover, wide swings in sentiment towards the Australian dollar must be allowed for.

In the next year or so, we're likely to hear occasional but shrill forecasts for a sharp weakening in the Aussie dollar as US/Australia interest rate spreads widen. Nonetheless, as in 2016, the Aussie dollar may not trend down as much as suggested in the recurring gloom. Here's why.

Looking ahead for the Aussie dollar

1. Commodity prices

With commodities contributing three quarters of our exports of goods and services, our dollar is often seen as a 'commodity-based currency'. Thanks to the strengthening, and synchronised, economic growth across the global economy, the index of our commodity prices has increased by 10% in the past year, and helped support the Aussie dollar as interest rates in the US rose.

The pace of economic growth in China is the dominant influence on our commodity prices, especially the prices of the bulk commodities we export. Any marked weakening in Chinese growth – real or imagined – will likely drive the Aussie dollar lower.

In my view, economic growth in China is likely to slow, but to a still-respectable rate of 5%-5.5% over the next couple of years. Bad debts are hurting property developers, some regional governments and the shadow banks. But China is managing its restructuring away from heavy industry towards services and consumption reasonably well. And economic management is always easier in countries with big reserves of foreign exchange. Indeed, China seems to be beginning another round of policy easing.

At times, market sentiment towards the Australian dollar will over-play the negatives in China's economic prospects. In particular, further escalation in the trade war will also cause concerns, at times exaggerated, of both a global currency war and an early recession in China. Financial markets experience more fake crises than real crises.

Of course, the US economic cycle in the US also affects the global cycle in commodity prices. The US is now in the ninth year of its cyclical upswing, which has been running at an unusually slow pace, and is now receiving a late-cycle boost from tax changes and, soon, from the larger budget deficit, equivalent to 5% of US GDP.

2. Interest rates

A year ago, the US cash rate was 1.25% and our cash rate was 1.5%. Now, the US cash rate is 2% while ours has stayed at 1.5%.

Market expectations are that the US cash rate will be raised by three, four or five times over the coming 18 months, as inflation moves above the Fed's target of 2% and as the Fed moves further to 'normalise' its policy settings. In my view, expectations for the number of changes in the US cash rate are more likely to be scaled down over the coming year than be stepped up.

With our economy having more slack and our inflation more quiescent, Australia's cash rate is expected to stay where it is until mid-2019 and then move gradually higher.

Any widening of the gap in cash rates between the US and Australia will attract a lot of attention in financial markets and at times likely lead to widespread views the Australian dollar will move down sharply.

3. Other important influences

From time to time, two other big influences affect the Australian dollar.

The Aussie dollar generally weakens against the US dollar when the latter strengthens against the euro and the yen. And our currency usually gains against the greenback when the US dollar falls in value against the euro and the yen. Currently, the general expectation in the market is the US dollar will trend higher against the other major currencies over the next year or two, causing some further slippage in the A\$/US\$ rate.

Secondly, since the global financial crisis, some hedge funds have expected Australia to experience a severe slump in house prices and massive write-downs in banks' loan books, causing among other things, the Aussie dollar to crash.

In my view, these fears are exaggerated, particularly while the Australian government retains its AAA credit status and stays on course to return its budget to balance over the next couple of years.

Don Stammer has been involved with investing since 1962, variously as an academic, central banker, investment banker, fund manager, and company director. He writes a weekly column on investments for The Australian. This article is general information and does not consider the circumstances of any individual.

Why dividend yields in Australia are so high

Ashley Owen

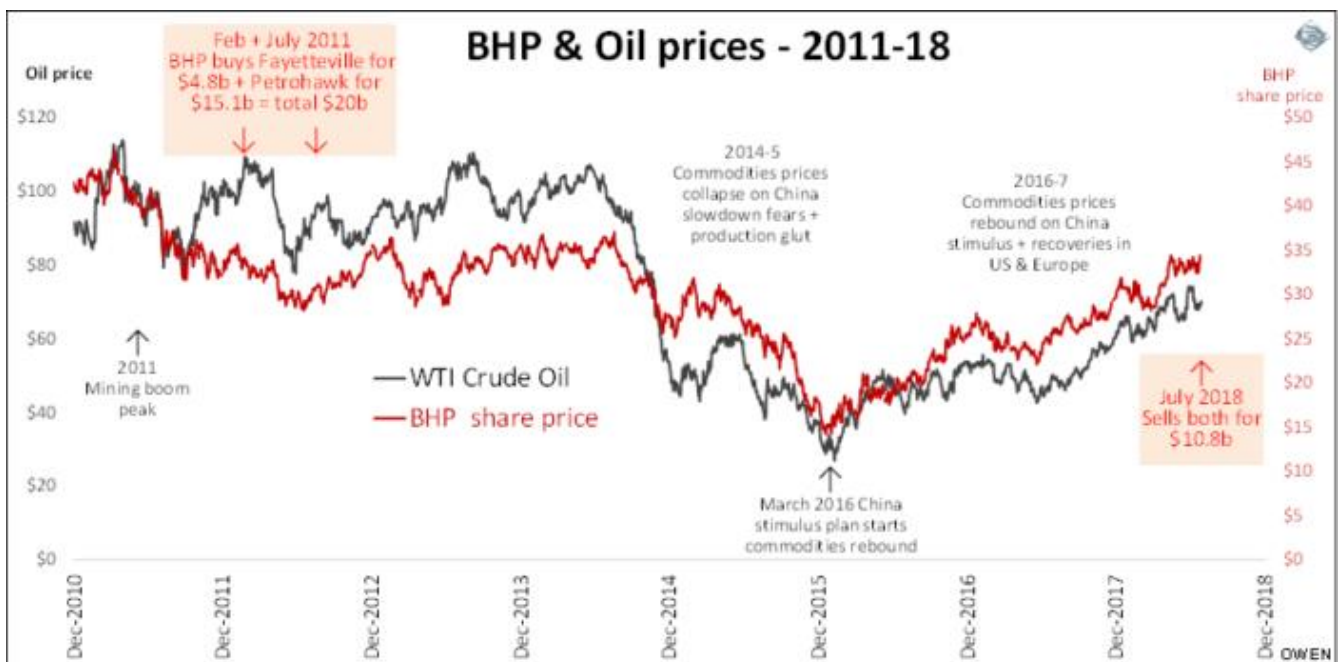
People often ask me why listed company dividend yields in Australia are so high. The average dividend yield across the Australian stock market is currently 4.1% or twice the world average. It is the highest in the world apart from Russia, Portugal, Turkey, UAE, Qatar and Nigeria.

There is a good reason for this. In the early stages of a country’s development, dividend yields start at high levels because investors are nervous about getting their money back if they have to wait too long. In the 1880s, dividend yields in Australia and the US both ran at 6% to 8%. As a country matures, investors develop trust in the corporate sector’s ability to invest wisely for future growth and so they let boards retain more of their profits to invest, and pay less back as dividends. In this sense, Australia is still like an early stage emerging market.

A history of reckless spending

Investors have a well-deserved distrust of Australian directors’ and CEOs’ ability to invest excess cash wisely, and so they demand profits be returned as dividends instead. Australian companies have a long history of wasting money on ego-boosting projects, usually in the form of reckless over-priced overseas ventures undertaken in booms. Then they are forced to sell, close or give the assets away after wasting billions of dollars. This trait has infected our big banks, miners, telcos, retailers, and hundreds of other companies. Success stories like Westfield, Macquarie, CSL, Seek, Cochlear, Sonic and Computershare are rare exceptions in a sea of red ink from failed expansions.

Australia is a small country in the middle of nowhere, and our directors find it hard to resist the temptation to chase the dream of free travel and adventure in pursuit of fame and fortune, all with shareholder money! Grand plans are usually hatched at the tops of booms, often with debt, with assumptions that prices will keep rising forever. They never do of course.



At the top of the 2011 mining boom when oil prices were above \$100 per barrel, BHP spent \$20 billion buying two shale oil operations in south eastern USA – Fayetteville for \$4.8 billion and Petrohawk for \$15 billion. BHP’s CEO was South African former management consultant Marius Kloppers, and Chairman was former Ford CEO Jac Nasser. Nasser had spent his career at Ford begging Canberra for handouts for Ford Australia, and begging Washington for handouts for Ford US. Neither knew much about mining or running profitable businesses without taxpayer support. BHP then spent the next six years throwing even more money at the troublesome projects while progressively writing off billions.

In theory, shareholders appoint the custodians of their companies

Finally last week, BHP announced the sale of both projects – Fayetteville for just \$300 million and Petrohawk for \$10.8 billion. At the same time, it wrote off another \$3 billion, bringing losses to around \$20 billion. That’s US dollars, not Australian dollars!

In the meantime, CEO Kloppers was fired and replaced by Scotsman Andrew Mackenzie, a real miner, and Chairman Nasser was replaced by former Amcor CEO Ken MacKenzie, with real experience running a very profitable business.

It is good to see BHP back in good, or at least better, hands once again. But we still don’t trust them. Thankfully, they are handing back all of the cash proceeds of the Petrohawk and Fayetteville sales to shareholders. They are also paying out record dividends from the windfall recovery in commodities prices over the past two years. The BHP share price is drifting up again, mainly because commodities prices are rising, not because of good management.

The scary thing is that it could have been much worse. Kloppers and Nasser tried to use BHP to take over rival miner Rio Tinto for \$150 billion in early 2008 when the iron ore price was at its all-time peak of \$200 per tonne. It is now just \$65 per tonne, and Rio was rescued by the Chinese government.

The problem is we can’t blame the CEOs, directors and chairpersons for bad decisions even if they had no relevant experience when there were appointed. In theory, they are put there by shareholders, so that’s where the blame lies. In reality, it is a cozy club because the big shareholders – which is mainly the big institutional super funds – stand by idly and let it happen. For small shareholders, it is easier to just watch from a safe distance and get out when we see trouble brewing.

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Three key attributes of great companies

Kurt Winrich

Investors need to consider more than the hard numbers of target investments. They need to identify ‘softer’ aspects of companies to gain an advantage. Recent revelations of misconduct from the Financial Services Royal Commission also emphasise the need for investors to garner greater insights into the corporate culture of companies in which they invest.

We’ve identified three key attributes in great growth companies. They are:

1. A tailwind or growth path ahead

Is the company in an industry set for secular growth or secular decline?

If the global demand for a company’s products is shrinking, or worse, if the product has been made irrelevant by a change in consumer preferences, it can be severely detrimental to value. A recent example is any small- or mid-sized newspaper company.

This attribute is a ‘price of admission’ characteristic. Making sure it is present won’t set you apart much, but if you forget to think about it, you are asking for trouble.

2. An expanding 'moat'

Warren Buffett used the 'moat' metaphor to describe an enduring competitive advantage. He likened a business to a castle and suggested that the company's edge, the thing that keeps competitors from simply copying the business and destroying the company's high profits, was the moat around the castle. A wide moat business can earn higher profits for a longer time. With Buffett's success, this concept caught on. Today, for example, Morningstar publishes moat ratings for thousands of companies.

One financial metric that gives a good sense of the size of the moat is return on invested capital, or ROIC. High profitability attracts competitors, so an ROIC that has stayed high is a decent indication that there is some kind of valuable moat. But note the past tense. ROIC is a rearview mirror metric, in that it tells you where you have been, but really tells you nothing about where you are going.

The critical thing is not the *size* of the moat or the rearview mirror look at competitive advantage, but rather how the competitive advantage is *changing* – is it getting stronger, or weaker?

We call this dynamic aspect the 'moat trajectory', and our approach to identifying moat trajectories, as early as possible, has been to:

1. Analyse dozens of historical examples of moat lifecycles (essentially business case studies) and:

- A. Look for common patterns.
- B. Not expect those patterns to repeat exactly but check for where they tend to rhyme.
- C. In those places where they rhyme, identify and catalogue the indicators of improving or deteriorating moats, and then construct a rough framework of what to look for.

2. Evaluate a prospective investment using that framework of indicators and:

- A. If the markers are present, have confidence the moat is expanding.
- B. If absent, conclude the moat is flat or deteriorating.

Deteriorating moats can be serious capital destroyers. And they are deceptive, because they usually start out as a great company that starts to look really cheap. Just ask the shareholders of Nokia or Blackberry or Yahoo, or others like them.

So, a "wide-moat company selling at a discount to intrinsic value" (an all-too common phrase in our industry) is not the answer. In particular, don't let cheapness deceive you into believing you have a 'safe' investment.

The question to ask is, "Where is the company's competitive edge in the future?" This is more important than the share price and value. For instance, some people will invest in the biggest company, or in market leaders, believing that this will provide safety for their investment. But if the organisation is losing its edge, either by declining market share or some other symptom of its shrinking moat, then that organisation will experience challenges and ultimately its share price will suffer.

3. An aligned corporate culture

An aligned corporate culture makes intuitive sense. If your employees hate working at a company, they will not put in their best efforts or ideas, and that will make it nearly impossible to have a good company (or investment). In contrast, if people enjoy working there, they will do more for it and their colleagues, and for the customers.

An organisation can have the greatest products, a robust brand and reputation, effective policies and processes and a long history of trading, but if the culture is poor, it is much less likely to succeed when compared with a business that has a healthy culture. Despite those good products, customer might complain about slow delivery, poor service or rude employees. These are all indicators of a company's culture.

In contrast, companies with great service and employees that go the extra mile rarely have complaints made against them. If they are not making complaints, then customers will return to the better businesses, leading of course to better business results. It's that simple.

Even when you have nearly identical businesses in the same industry, there can be big differences in business performance. Corporate culture is generally the explanation. For example, consider how Costco is so much more successful than Sam's Club (a division of Walmart).

But how do you analyse corporate cultures? It's not easy, and that's why most investors skip it. We have an analyst dedicated to probe the cultures of companies in which we invest, and we have developed a proprietary methodology for assessing this subjective element. Assessment techniques we use to determine this include meeting with company management, and interviewing former employees, vendors, customers, and competitors. We also consider employee turnover rates, net promoter scores, online reviews, surveys, and many more inputs.

Visiting a business's operations, for example, enables us to gather small yet highly informative details to evaluate its culture. Similarly, industry surveys and net promoter scores reveal hard-to-quantify appraisals of cultural reputations or overall customer satisfaction. The latter, for businesses with a significant proportion of customer-facing staff, is often reflective of its culture. Happy employees make happy customers, which make for happy shareholders.

The magic combination is a culture which encourages the behaviours that enhance the company's competitive advantage. This can keep a business ahead of its competitors for years.

Accordingly, good investment research today is not just about getting hard financial numbers, it's also about gaining a better understanding of the 'softer' aspects of businesses.

Kurt Winrich is Co-CEO and Portfolio Manager of [WCM Investment Management](#), a California-based investment management firm.

Winner-takes-all is turning conventional wisdom on its head

Erik Weisman

The Wilshire 5000 Index was introduced in the mid-70s, and at that time, shouldn't be too terribly shocking, there were about 5,000 publicly traded companies in the United States. Over the course of the next 20 years, that number rose to about 7,500. Interestingly, over the last 20 years, that number has declined and it's now at about 3,500. There are a lot fewer publicly traded companies in the United States.

In fact, these large companies are taking a larger and larger part of the playing field for each particular sector. This is a little bit strange. It's not happening that much in other countries. We basically have a publicly traded company deficit in the United States. The bottom line is, there are fewer and fewer companies that are taking the playing field, and therefore, these companies tend to be larger companies. They're older companies. They're companies that we know. It becomes more and more difficult for small and new companies to enter the playing field.

Historically, those small and new companies tend to be the ones that are innovative. They're the ones that push the envelope. They're the ones that force the incumbents to have to be more innovative, more creative, more competitive. When we take those smaller and newer companies off the field, it should be a bad thing for the economy. It should mean less innovation. It should mean less job growth. We should be a little bit worried about that.

The other thing that's really interesting about this dynamic is the textbooks would tell us, as there are fewer and fewer companies in any given sector, and you get sort of an oligopolistic outcome, few companies that control their space, prices should go higher and consumer welfare should fall. But what we're actually seeing, and especially in some of the digital spaces, is that these companies are competing on price. So, prices are actually falling and consumers are better off because prices are lower.

So, why should we care? Why is this a problem? Well, it could be a problem, again, because we're not seeing the kind of competition that we would want to see. We're not getting the innovation. We're not seeing the new job growth from smaller companies, but let's abstract from that for a minute and ask, what does it mean in terms of markets? What does it mean in terms of finance?

Well, about 25 years ago there was a really important paper that came out from Fama and French that told us that you could extract rents over the course of a business cycle by buying value companies over growth companies and buying small cap companies over large cap companies. That's worked out pretty well over the course of the last 25 years through the business cycle.

In a world, though, where winner takes all, it's the incumbent companies that tend to do better. We might want to reinspect this notion that you can extract rents from value companies and small companies over the course of long periods of time. In a world where winners take all, it might be the case that these growth companies and these large companies, the ones that we know so well, are the winners and you might want to place your bets there rather than what the conventional wisdom would tell us.

Erik Weisman is Chief Economist and Portfolio Manager at [MFS](#), a sponsor of Cuffelinks. The views expressed are those of the speaker and are subject to change at any time. These views are for informational purposes only and should not be relied upon as a recommendation to purchase any security or as a solicitation or investment advice from the Advisor.

For more articles and papers from MFS Investment Management, please [click here](#).

Latest SMSF updates from the ATO

Graham Hand

The new financial year brings a major update from the Australian Taxation Office for SMSF trustees. Below are some of the ATO's recently-published [SMSF news and alerts](#).

Illegal early release of super

The ATO recently issued a media release warning the public about promoters encouraging people to illegally access their super early.

Illegal schemes will cost members a lot more than the super they access and may get them into trouble.

As an SMSF trustee, you must ensure that the member has met a condition of release before you release any funds. There are severe consequences for you and your fund if you access your super before you are legally entitled to do so.

These could include:

- the disqualification of trustees
- the fund being made non-complying
- an imposition of administrative penalties

If any of your SMSF members have been involved in a scheme, contact the ATO immediately.

Is establishing an SMSF right for you?

Practical tips for individuals considering starting up an SMSF, based on the recently published Australian Securities and Investments Commission (ASIC) report – Improving the quality of advice and member experiences.

The Australian Securities and Investments Commission (ASIC) have completed their review into the quality of advice in setting up and running a self-managed superannuation fund (SMSF). The [report](#) identifies a number of practical tips that advice providers can use to improve the quality of SMSF advice provided to individuals.

The report also identified that a small proportion of newly established SMSF trustees do not properly understand what it means to set up and run an SMSF, and that an SMSF is not for everyone.

Running an SMSF comes with many obligations and responsibilities and requires you to have the both the time and skills to manage the SMSF in order to have a financially successful outcome. As a trustee of the SMSF, you'll be responsible for operating your fund within the law. If you don't manage your SMSF within the law, you may face penalties and your fund may suffer tax consequences. While mistakes can happen, and the ATO will

work with trustees to get their SMSF back on track, they do take regulation of the SMSF sector seriously and will take appropriate compliance action where warranted.

You'll be responsible for the investment decisions of the SMSF, including formulating an investment strategy that should be reviewed regularly. You'll need to understand the restrictions on the investments an SMSF can make, for example, that your SMSF cannot purchase a property for you or a member of your family to live in.

There are set-up and ongoing costs when running an SMSF. For every year that the SMSF is operating you will need to pay for an independent audit and the supervisory levy.

You are also likely to have costs associated with:

- preparing the SMSF annual return
- valuations of the SMSF's assets
- for some SMSFs, actuarial certificates for paying superannuation income streams (pensions)
- financial advice
- legal fees, for example, if the trust deed needs to be amended
- assistance with fund administration
- insurance for members.

When considering whether to set up an SMSF you should also consider:

- compensation is not available to trustees where the SMSF make a loss due to fraud or theft
- SMSFs members cannot take complaints to the Superannuation Complaints Tribunal
- running an SMSF can be time consuming and requires a number of different skills
- how your SMSF will be managed in respect of major life events such as marriage, divorce, and death.

The ATO's web content and online education courses can provide assistance to individuals thinking of setting up an SMSF. They will also work with you, as a trustee, to help you with your situation whether you want to wind up your SMSF or want to make a [voluntary disclosure](#) if you have contravened the superannuation laws.

SMSFs are a great way to take control of your superannuation, but you should consider whether they suit your needs and skills first and will meet your retirement goals. You should strongly consider consulting an independent qualified, licensed professional before you make the decision to establish an SMSF.

SMSFs and one-stop property shops

Individuals and current trustees are strongly encouraged to seek independent professional advice from a licensed adviser before establishing an SMSF and before undertaking any new investments.

ASIC has completed their review into the quality of advice in setting up and running a self-managed superannuation fund (SMSF). A key concern of ASIC's [report](#) was in relation to the establishment of SMSFs for property investments using 'one-stop shop' models.

One-stop shop models tend to promote the purchase of geared residential property through an SMSF, arranged by groups of related real estate agents, developers, mortgage brokers, accountants and financial advisers.

The one-stop shop model creates inherent conflicts of interest that may affect the advice given to a client to set up an SMSF. For example, some of these businesses take advantage of customers with limited or no knowledge of SMSFs or super and have the potential to cause major financial detriment to an individual's financial savings, including:

- being given inappropriate or misleading advice to set up an SMSF which may result in members being financially worse off
- the advice provider may not adequately consider or explain the obligations of being an SMSF trustee
- members may be encouraged into a property purchase at an inflated value, or unaware of undisclosed high commissions.

The ATO strongly encourages individuals to seek independent professional advice from a licensed adviser before establishing an SMSF and before undertaking any new investment in an SMSF.

Where a mistake occurs, SMSF trustees are also encouraged to consider making a voluntary disclosure using the [SMSF early engagement and voluntary disclosure service](#). In these instances The ATO will work with trustees to help get their SMSF or super back on track where possible.

SMSF checklists

Make sure you haven't missed anything – here is a range of [checklists](#) for each stage that your fund moves through.

Superannuation: the journey continues

With the end of financial year and the due date for new reporting obligations nearing, it's important for trustees and SMSF professionals to know what they need to report, and what they should look out for.

ATO Deputy Commissioner James O'Halloran chats to John Maroney, CEO of the SMSF Association ahead of the new financial year.

Listen to the [latest episode](#) for more.

Please note this content is extracted from ATO publications to share their views and has not been edited or written by Cuffelinks.

Strangers to themselves in retirement

Jeff Gebler

Behavioural economics has revealed the vast gulf between what people say they want and how they behave. It makes life challenging for financial planners, superannuation funds and financial institutions attempting to deliver the right products and services.

However, new approaches built on data, analysis and algorithms can help solve the paradox of advising people who are effectively strangers to themselves.

The difference between stated and revealed preferences

Financial planning questionnaires typically ask clients for stated preferences such as how they believe they will react in different circumstances, but decision theory and behavioural economics explain why people's actions regularly deviate from their intentions.

For example, the second-highest financial priority cited by seniors in a recent [ASIC survey](#) was 'having enough money to enjoy life and do what they want to do' (69%). Yet a significant proportion of retirees spend less than the age pension according to the Milliman Retirement Expectations and Spending Profiles (Retirement ESP).

Meanwhile, the industry has long known that stated preference for reliable retirement income doesn't translate into sales of products such as annuities.

These inconsistencies suggest retirees are prone to stronger opposing forces that change their behaviour in ways they don't realise. It makes setting personal goals a complex task because people don't know themselves, let alone how to balance competing desires.

Comprehensive data helps. The Retirement ESP has revealed several surprises about the [behaviour of retirees](#) which differs from industry assumptions.

Shachar Kariv, Professor of Economics at UC Berkeley, recently pointed to gamification, or the process of melding game-like actions with everyday tasks, as a more accurate methodology than questionnaires. It can show how clients will actually behave (their revealed preferences) rather than how they think they will behave (their stated preferences).

"People will enjoy it because it will be a game," Kariv said at a recent Milliman breakfast event. "It's going to be fun and fast. You can do it from your phone or tablet and in different periods of time."

For example, a coin flipping gambling game can reveal players’ risk-return trade-offs and preferences in a mathematically-sound approach. Various [studies](#) are now showing, with statistical certainty, just how certain segments of the population behave by using these techniques.

The problem with risk

Understanding the risk that hides behind investment returns is complex.

Individuals may think of risk in terms of the possibility of investment losses or in terms of not achieving their financial goals. The asset management industry on the other hand typically defines risk in terms of the distribution of returns (volatility). This disconnect between everyday Australians and investment professionals can lead to poor outcomes.

The problem is exacerbated by the fact that individuals make poor predictions (stated preferences) about their level of risk tolerance. Many investors withdraw or switch their portfolios to cash when equity markets decline. The following chart is now dated but fund managers confirm similar patterns of flows recently as their performance varies against a benchmark.

S&P 500 Index performance vs. 12-month equity mutual fund flows



Sources: BlackRock; Informa Investment Solutions; DB US Equity Strategy; Investment Company Institute (US mutual funds and ETFs). The S&P 500 Index is an unmanaged index that consists of the common stock of 500 large-capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. Returns assume reinvestment of dividends. It is not possible to invest directly in an index. Past performance is no guarantee of future results. The information provided is for illustrative purposes only and is not meant to represent the performance of any particular investment.

A secondary issue is the way the industry gauges investors’ risk tolerance with standard risk and return questionnaires. As Kariv, who is also Chief Risk Scientist at risk profiling firm Capital Preferences, said:

"I would claim there is no scientific basis whatsoever for this method. A survey is like designing a bridge without writing any mathematical equations. You will not drive on a bridge that the engineer has designed without writing any mathematical equations."

Accurately measuring risk capacity, not just risk tolerance, is essential if investors want to achieve their goals. Risk capacity is the level of risk an investor can withstand while still meeting their objectives with a reasonable level of certainty.

For example, many older investors have higher levels of loss aversion, which leads to lower risk tolerance levels. However, wealthier investors with high levels of cash to fund their day-to-day lifestyle can have higher levels of risk capacity.

Risk capacity is also relevant for younger investors. The [ASX Australian Investor Study 2017](#), which surveyed 4,000 Australian residents, suggests that young investors may be more risk averse than previously thought. It found that 81% of investors aged under 35 were seeking guaranteed or stable investment returns.

However, young investors have a higher risk capacity when it comes to their retirement savings, given that they will have decades in the workforce and can withstand market gyrations.

Analysis can discern the difference between risk preferences and risk capacity and help advisers balance the tension to find a solution that works for their clients.

Most people do not know their spending or lifestyle habits

People are bad at estimating how much they spend, which makes it difficult to choose the optimal investment strategy to lift retirees' standards of living.

The evidence is the Household Income and Labour Dynamics in Australia (HILDA) data, which surveys more than 9,500 households. It provides information and insight into everyday Australians. However, spending surveys of this nature have shortcomings when applied to the context of financial planning.

For example, an industry [analysis](#) estimated that the median expenditure for households aged 65-69 was \$24,640 a year while the average was \$33,944. The Retirement ESP, which uses bank transaction data from more than 300,000 retirees, shows that the median couple aged 65-69 spends \$34,858 while the average expenditure was \$43,675. This is a significant difference even when accounting for the different time periods of the underlying data (2015 versus 2017).

Other differences are also revealed when people qualitatively assess their own lifestyle compared to a quantitative assessment of data. For example, 2,527 people surveyed in the 2015 HILDA survey said they smoke at least one cigarette a week. However, 38% of these respondents reported spending no money each week on cigarettes.

These discrepancies in spending survey data are not material when taken in the appropriate context. However, they do highlight the potential risks of relying on spending survey data to form views about the spending needs of future retirees.

Financial advisers, and increasingly, super funds, develop an understanding of clients' and members' qualitative information and life experiences because they spend time with them. However, a mix of tools powered by data, analysis, and algorithms can help them bridge the gap between the things people say they want and how they actually behave.

This type of quantitative information is a key component of this approach and can provide a clearer view of retirement expectations and what people need to do to achieve their goals.

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

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