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Labor's franking policy is a ticking bomb for all super funds

Don Hamson

The Australian Labor Party (ALP) proposal to limit cash refunds of franking credits will clearly impact many pension phase SMSFs, but we believe it also has the potential to impact many other superannuation funds.

In this paper, we build a model of the key variables which determine whether a superannuation fund is likely to lose refunds of net franking credits under the ALP proposal. Our model is consistent with and helps explain an article in The Australian which reported that $309 million in franking credit refunds were paid to over 2000 APRA-regulated superannuation funds, including 50 (out of a total of 240) large APRA funds, in 2015-16, impacting 2.6 million member accounts.

The ALP proposal

On 13 March 2018, the ALP announced a proposal to abolish the net refunding of franking credits to Australian investors other than for charities and endowments. The initial proposal was expected to impact 1.17 million individuals and superannuation funds and generate $59 billion in government savings over 10 years.

On 26 March, the ALP revised their proposal in the light of significant public criticism. Direct investments by welfare pensioners (part and full on aged, disability and other Centrelink pensions) were also excluded, ensuring 306,000 pensioners will continue to receive cash refunds. SMSFs are also exempt if they had at least one welfare pensioner before 28 March 2018. We understand this exemption does not apply to other superannuation funds.

Which super funds are affected?

Note that franking credits themselves are not abolished. Australian investors can continue to use franking credits to offset income tax payable and for a superannuation fund, **contributions tax** payable.

The ALP believes the main superannuation funds impacted by this proposal will be pension phase SMSFs. However, ATO taxation data (as quoted in The Australian) and analysis of APRA statistics show that many APRA-regulated funds will likely also be affected. This implies the impact may be far broader than initially predicted.

We have built a superannuation tax model under which we undertake sensitivity analysis of the key drivers to losing franking credit refunds and their potential magnitude.

Franking credits will be lost if total tax payable by a superannuation fund is less than franking credits received. Tax payable is a function of tax on investment earnings on the accumulation portion of a fund, as well as contributions tax payable on normal contributions. The percentage of pension phase assets, the level of taxable earnings and the level of contributions will vary from fund to fund and may vary from year to year.

For example, taxable investment earnings will be largely determined by the state of investment markets. The level of franking credits can also vary between funds and over time. We base our estimate of the typical impact of imputation assuming an average SMSF exposure to Australian shares based on March 2018 ATO statistics of 31%, and the franking credit yield of the S&P/ASX200 Index which has averaged approximately 1.5% pa over the 10 years to December 2017.

Investors with higher allocations to Australian shares, or allocations to higher-yielding Australian shares could earn even higher levels of franking credits. They stand to lose more if franking credit refunds are denied. In our sensitivity analysis we double the level of franking credits in our high-franking scenario.

Loss of refunds depends on pension v accumulation and franking levels

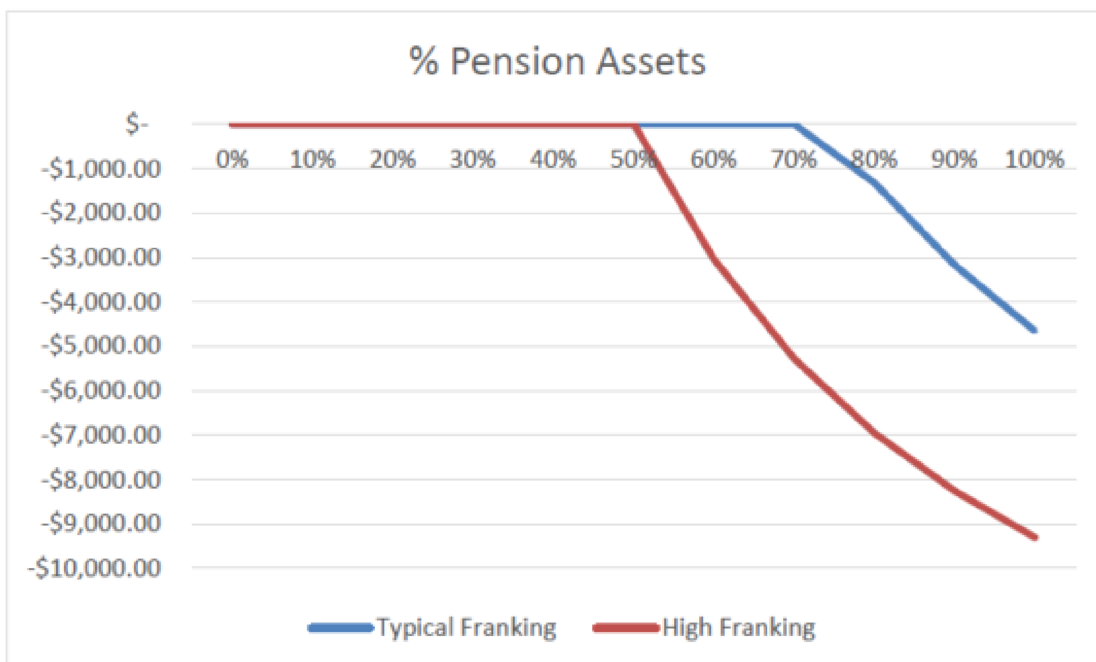
We then varied the proportion of a superannuation fund devoted to pension and accumulation as well as the levels of franking credits, contributions tax and taxable income [1].

Figure 1 illustrates the outcome of our sensitivity analysis varying the proportion of pension assets and the level of franking credits.

Clearly funds with 100% pension assets will lose all their franking credits. We estimate that for a typical level of franking credits, funds with **70% or less in pension assets** should not expect to lose franking credits. For funds with double the typical level of franking credits, **this number drops to 50%**.

If accumulation phase (or 15% taxed) members aren't paying contributions and therefore aren't paying contributions tax, funds are more likely to lose franking credits. Funds with higher levels of taxable income would be less likely to lose franking credits. Higher levels of taxable income are usually associated with strong markets or the realisation of capital gains.

Figure 1. Sensitivity analysis of the impact of non-refund of franking credits for superannuation funds expressed as $ annual cost on $1m pension balance.



Source: Plato

The number of funds impacted will vary from year to year in response to the level of investment returns. When investment returns are very low or negative, tax on investment earnings will also be low, increasing the chance that the value of franking credits received by a fund exceeds tax payable.

Accordingly, when investment returns are low, a higher percentage of superannuation funds may miss out on some or all of their franking credits, exacerbating the low investment returns.

The winners and the losers

We find that the loss of franking credits is likely to be positively related to:

1) The percentage of assets in pension, with maximum loss at 100% pension assets, but losses starting to occur from 50% to 70% pension assets

2) The level of franking credits generated by the underlying assets (the more franking credits generated the more likely you are to lose some).

The loss will be negatively related to:

3) The level of taxable income generated from the underlying assets (with losses in franking credits more likely in periods of weak investment markets meaning investors may receive a double hit to returns)

4) The level of contributions and contributions tax payable by accumulation members (the less contributions tax payable the more likely a fund loses franking credits).

Our model explains why The Australian reported that 50 large APRA-regulated superannuation funds (out of 240) received net refunds of franking credits in the 2015/16 tax year.

Mature funds may suffer most from loss of refund

Our model finds that any relatively mature superannuation fund, where maturity is defined by the percentage of member balances in pension mode, may be in a net franking credit refund position.

While many SMSF members have been vocal critics of this proposal, we believe members of other superannuation funds probably don't even know they receive franking credit refunds (they are not reported on investment summaries) and probably won't know whether they might miss out on franking credits should this proposal be enacted.

We suggest these members or their advisers should ask: **Will my superannuation fund lose net franking credit refunds?**

Finally, we believe that as the superannuation industry matures as a whole, as more members migrate to pension status, the loss of franking credit refunds will impact a growing number of people, be they members of government, industry, retail or SMSFs.

As such we believe this proposal may represent a ticking time bomb for the whole superannuation industry.

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[1] We vary pension proportions in rests of 10% from 0% to 100%. For franking credits we used a normal level of franking credits as discussed above and then we doubled the level of franking credits to reflect a higher exposure to Australian shares and/or a higher franking yield from the Australian portfolios. We use two levels of contributions – none (reflecting for instance pension phase SMSF with greater than $1.6 million balances per member) and 7% of the accumulation balance which attract contributions tax of 15%. Similarly, we varied the taxable income level which can be caused by (for instance) realisation of capital gains. Full details of our assumptions are available on request.

Check 6 key 'moats' around small stocks

Richard Ivers

When we lift our vision from directly in front and look towards the horizon, we see much more. It's similar with investing. Taking a long-term view forces us to think more broadly about the risks likely to confront a company and its ability to withstand them. This inevitably leads to assessing a company's moat or barriers to entry.

'Understanding the moats' is relevant to any company but is particularly important for small cap stocks. The strengths of these moats may decide which small cap companies are destined to grow and which are consumed by the competition.

Are small cap valuations terminal?

It is little appreciated that approximately half a small cap company's valuation is attributable to its terminal value when using the discounted cashflow method. Terminal value is a multiple of earnings roughly 10 years in the future, further underlining the importance of the long term.

So how do we assess a small cap company's barriers to entry, and more importantly the direction of those barriers (rising or falling) given they often compete against larger companies?

The following six elements can determine the moats around small cap stocks:

1. The company's industry: Ideally, investors are looking for a niche that requires specialist skill or an unusual product that caters for a market segment and is difficult to replicate. Larger companies typically focus on big markets, particularly during the growth phase, leaving space for smaller companies in niches to improve their barriers.

In the finance sector, for example, large banks leave gaps for smaller, specialist providers in areas like SME funding and debtor financing.

2. The product or service offered: Investors must consider the level of specialisation and the ability of others to replicate, especially a similar or better product or service at a lower price. Judgement, experience and the benefit of industry expert opinion is required for this assessment, and it must be constantly monitored due to changes through time.

Large players have more capital, so competing on cost does not create a convincing barrier for a small company, particularly when an industry matures and large companies look for new areas to grow. However, customer loyalty based on rational economic benefit is a barrier. Software often has high barriers particularly when delivered in an efficient, scalable model such as SAAS. Customer switching costs can be high when including training, human inertia and execution risk.

Some other areas to consider include benefits of scale, customer fragmentation, legal barriers (e.g. patents, ACCC restrictions), brand and reputation, contractual commitments and network effects.

At its core, investors must determine how sticky the customer is in the face of competitive threats and what price the customer would be willing to pay for the offering.

Healthcare companies often have sticky customers. Given conservative approaches to patient health, an established product can be difficult to replace when it becomes widely used and trusted. For example, Cogstate (ASX:CGS) benefits from over 10 years of data accepted by the FDA in the use of drug trials. Large pharmaceutical customers have a low tolerance for procedural error making this history a high barrier to new entrants. Nanosonics (ASX:NAN) has a large and growing installed base of Trophon machines within hospitals for which it sells highly profitable consumables. Note, investors must be aware valuations can at times be exuberant in this space.

3. Rising or falling barriers: A frequently overlooked yet exceedingly important element is the direction of barriers to increased competition i.e. are they rising or falling? This is probably the most important element of value creation as price and revenue will typically follow.

For example, Bravura Solutions (ASX:BVS) is enjoying rising barriers as it signs new customers with high switching costs, and Bravura's greater scale enables increased product development.

The process of assessing a company's barriers to entry never stops, and it is becoming harder to assess as technology causes rapid change.

4. The company's management: Management's ability to build and adjust the organisation to ever-changing circumstances will determine the success of the offering and thereby the stock price. Management with a long-term view will often reinvest in growth. This can be a very powerful earnings driver as scale enables greater investment.

We view EQT Holdings (ASX:EQT) as a good example of management taking a long-term view and balancing short and long term growth. Each additional dollar of revenue requires little additional cost meaning that profits could easily be boosted short term. But by re-investing in operating efficiencies and sales and marketing, the business reduces its cost to serve and increases customer awareness.

5. Company meetings: Meeting management is important, but the greatest insights are often gleaned by meeting other companies in an industry, particularly competitors. They are often more forthcoming with the weaknesses in a competitor's moat and how it can be breached.

It's also worthwhile talking to suppliers, customers and employees (past and present) to get a fuller picture of the business.

6. A measured approach: At times, meeting a new company CEO can appear an exciting opportunity, but by their nature, CEOs are typically good salespeople. Always take a measured approach to a stock's weighting in the portfolio. Investors may like a company, but the prudent approach may be to start with a relatively small position and increase it over time as understanding increases. This is particularly the case with initial public offerings (IPOs) with time restrictions.

The process of assessing a company's barriers to entry never stops. Barriers are rising and falling constantly and it is one of the most important aspects of small cap investing.

Stocks mentioned

Company	Code	Price	FY19 PE	FY20 PE	FY19 EV/EBIT	FY20 EV/EBIT
EQT Holdings	EQT	22.50	19	17	14	12
Cogstate	CGS	0.59	15	13	11	10
Nanosonics	NAN	3.40	100	40	85	35
Bravura	BVS	4.35	29	25	20	16

Source: company data, analyst estimates, PVAM

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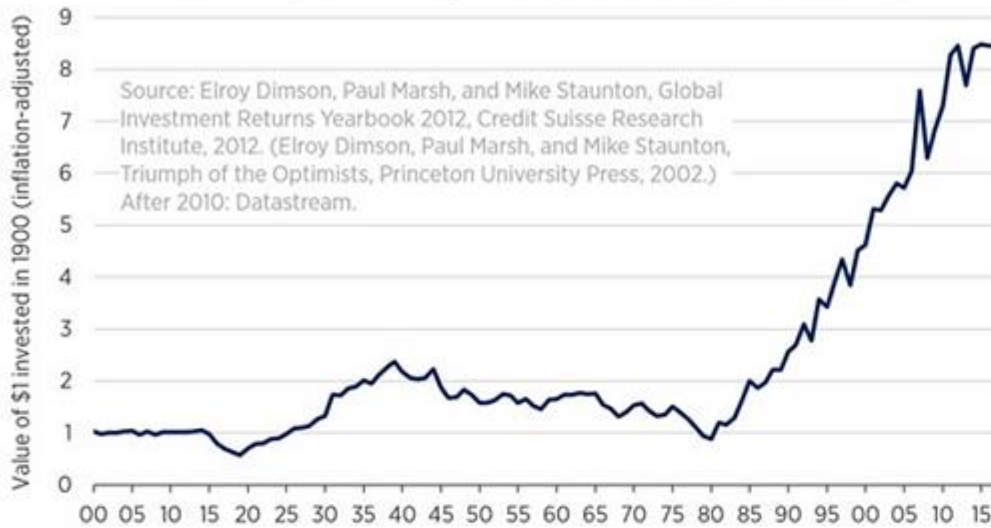
Is 'shaken and stirred' coming? The risky business of bonds

Graeme Forster

Bonds have been an exceptionally rewarding asset class for nearly four decades. They have also proven to be a reliable diversification tool, particularly when deployed with stocks in a so-called '60/40' portfolio. But expecting a repeat performance in the decades to come reminds us of the late financial historian Peter L. Bernstein's comment that: "*There is a difference between an optimist and a believer in the tooth fairy.*"

As can be seen in the chart below, this extraordinary period of performance has been unusual in the context of longer-term history. Bonds have benefitted from a favourable tailwind that stretches back to the early 1980s. Recently, the tailwind has been reinforced by the unprecedented actions of central banks following the GFC. To avoid a deflationary debt spiral, the Federal Reserve and other major central banks intentionally drove bond yields to historic lows and even into negative territory in some instances, sending bond prices to new highs.



Prospective returns for many bonds now appear limited

In addition to nosebleed prices and rock-bottom yields, the risks embedded in the bond market would appear to be well above average when we observe cuts in taxes and a ramp up in fiscal spending at a time when government debt is already at or near all-time highs. Governments and central banks are desperate to inflate away these debt burdens. Sustained negative real yields imply sustained negative real returns to holders of these nominal assets.

We also ask ourselves: "*Who is the marginal buyer of bonds at these yields if central banks are stepping back?*" Historically it might have been large governments recycling their enormous current account surpluses. If a country exports more than it imports, it needs to do something with the difference, and exporter countries have often been major buyers of importers' bonds. But the reduction of international trade imbalances is now top of the political agenda.

In addition to political will, there are forces at work that should lead to a more natural reduction of the global gross trade surplus. Examples include the seismic shifts in China, where supply-side reforms have the potential to substantially boost imports, and in the US, where the shale oil and gas revolution is beginning to impact the export picture.

The bond sell-off that spooked investors in February this year was driven by greater-than-expected wage growth in the US. It could be a sign of more volatility to come. Negative returns are likely if interest rates continue to rise as quantitative easing begins to unwind. When yields are low, bond prices become extra sensitive to any change in yield, adding a layer of risk.

Rise in correlation reduces diversification benefits

Worse, there are signs that stocks and bonds are now moving together, negating the diversification benefit bonds are expected to provide. Taking a longer-term view of history, the following chart shows that the strong anti-correlation between US stocks and bonds (the negative numbers) since the late 1990s is quite unusual. History suggests that investors should expect bonds and stocks to be more correlated in the future with the possibility of high correlations in a rising interest rate environment. It also suggests that investors might question the traditional diversification role played by long-dated government bonds in a balanced portfolio.

Yields for long-term government bonds can be broken into a few components: inflation expectations, the expected path of real interest rates and the term premium. This latter component can be thought of as the compensation offered to investors for taking on a long-dated risk. It should always be positive, but today, term premiums in most developed markets are near zero, and some, astonishingly, are negative. A negative term premium implies that investors are paying for the privilege of taking on term risk. This is highly unusual, if not nonsensical. Yields can be low for good reasons, but it's hard to imagine a good reason for the term premium to be negative. This looks like a real inefficiency — a mispricing.

One culprit is quantitative easing (QE), the process where central banks buy bonds and other assets using newly-printed money. Large price-insensitive buyers of government bonds are bound to create price distortions. In this environment it makes sense for governments and companies to borrow long term, and this is what we have seen. Ireland and Austria have issued bonds that mature in 100 years.

Today's prices force a rethink

One definition of risk is that "more things can happen than will happen", and purchasers of these bonds have 100 years' worth of potential surprises to look forward to. For taking on this enormously long-dated risk, investors receive a paltry 2% per annum. Relying solely on long-term government bonds to manage risk at today's prices strikes us as imprudent at best.

Graeme Forster is Portfolio Manager at Orbis Investments, a sponsor of Cuffelinks. Commentary is adapted from Orbis quarterly reports and reflects recent views. The information provided in this article in general in nature and does not take into account your personal objectives, financial situation or needs.

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Building portfolios: diversification without the heartburn

Jim Masturzo and Jonathan Treussard

Just as enhancing a meal with spices can cause indigestion and heartburn, adding asset classes to an investment portfolio beyond traditional core stocks and bonds can induce an uncomfortable reaction. To the degree our individual risk tolerance allows, however, the addition of diversifying asset classes can offer more rewarding long-term investment outcomes when compared to less-diversified portfolios.

Of equal importance, and of equal cause for heartburn, is holding on to those less familiar asset classes through periods of volatility. Yet, being able to stomach both potential causes of discomfort – adding the diversifying assets in the first place and then holding onto them – offers investors the potential to reap the benefits of diversification over the long run. The crucial ingredient to a diversifying strategy's success is to find the diversifying mix an investor is comfortable with over the long term.

How much diversification is enough?

The most common objective of individual investors' portfolios is to maximise after-tax net-of-inflation (or real) returns, so that those returns provide money for expenditures when needed. The most crucial aspects of diversification are that:

- diversification is **long-term**. Over shorter horizons, particularly in volatile markets, we must remember the long-term value proposition of diversification.
- diversification is **not** an all-or-nothing choice. We can put diversifying asset classes into the current portfolio mix to the extent we are capable of tolerating the inevitable short-term discomfort.
- finding the **right allocation** to diversifying asset classes helps avoid the costly but common practice of rotating into and out of diversifying strategies at the wrong times.

The asset mixes of a diversified portfolio

The Asset Allocation Interactive (AAI) tool on the Research Affiliates website can assist advisers and their clients in visualising the benefits of greater diversification in their current portfolio mix. AAI uses a common risk-and-return framework to identify efficient (from a return per unit of risk perspective) portfolios, which are well diversified for a range of target volatilities.

The following scatter plot from AAI shows the long-term real risk and return expectations in AUD (based on data as at 31 August 2018) for 27 global asset classes and four portfolios along the efficient frontier (shown below in the four black dots).

Portfolio and asset class expected 10 year returns as of 8/31/2018

Note: The term 'Linkers' refers to inflation protected bonds. Source: Research Affiliates, LLC, Asset Allocation Interactive Tool. Please see disclosure.

For illustration, look more closely at the 8% volatility portfolio. Over 72% of the portfolio consists of asset classes outside of developed-market equities and bonds. The equity allocation of 54% is invested 31% in

emerging market equities. This outcome is driven by today's valuation levels (as of August 31, 2018), which call for an efficiently diversified portfolio to step even further out of the mainstream than would otherwise be the case, given the better bargains that exist elsewhere in the capital markets. Note that the Credit category includes investment grade, high yield and Emerging Market bonds.

The 8% volatility efficient portfolio asset allocation as of 31 August 2018

Asset Weight	
AUD Cash	0.0%
Equities	54.1%
Core Bonds	1.0%
Credit	29.2%
Linkers	0.9%
Cash	6.4%
Commodities	3.2%
Hedge Funds	0.0%
Private Equity	5.3%
Model	0.0%

Note: The term 'Linkers' refers to inflation protected bonds. Source: Research Affiliates, LLC, Asset Allocation Interactive Tool. Please see disclosure at end of article.

Diversification is not an all-or-nothing choice

To some, the 8%-volatility efficient portfolio may seem too alien and uncomfortable. We get it. Even though the rational side of our brain knows we should hold diversified portfolios, the discomfort of unfamiliar assets can lead us to gravitate toward a more familiar mix, such as a 60/40 allocation. The behavioural finance literature (e.g. French, Kenneth, and James Poterba. 1991. "Investor Diversification and International Equity Markets." American Economic Review, vol. 81, no. 2: 222–226) shows that investors are naturally predisposed to tilt their portfolios toward the stocks and bonds of their own country. Referred to as home bias, this tendency is often fueled by a preference for the familiar and an aversion to the unknown.

Our behavioural biases go even further. Investors can easily feel more regret when losing money in foreign markets than they do when underperforming in their home markets. For this reason, diversification is unfortunately sometimes referred to as 'regret maximisation'. So it's no surprise the predominant risk in most investors' portfolios is mainstream equity risk, and that the average asset allocations of financial advisers, wealth managers, and public plans are heavily weighted to mainstream stocks and bonds.

Yes, the urge to invest within the friendly confines of home is both strong and natural. But this doesn't mean we should sacrifice global diversification altogether. We can still harness the potential of diversifiers if we first accept that building and holding a diversified portfolio is not an all-or-nothing choice. We can successfully engage in the pursuit of diversification by building asset mixes that marry individual preferences or tolerances with forays into an expanded opportunity set. Even if diversifying assets compose a small portion of our overall portfolio, any nudge in this direction puts us on a path toward better long-term outcomes gained by achieving the potential benefits of diversification.

Tracking error, or the volatility of relative returns between a portfolio and its benchmark, represents the risk taken by an investor who strays from the benchmark. Most investors don't think of their portfolio relative to an investment benchmark per se, but often benchmark their returns against their friends, family, or the market index. By keeping tolerance to discomfort in check, we can increase the likelihood of willingly holding the portfolio over a longer horizon.

Conclusion

A consistent diet of spicy food has been linked to health benefits, including a longer life span. For those who want these benefits, but are especially averse to the painful flames, do not despair. Simple remedies abound for those who want to ramp up their tolerance for spicy food. Ultimately, how much heat to ingest is a personal choice, the same is true when it comes to investing.

There are benefits for our investment health of finding the right level of asset class diversification. Beyond the obvious practical implications for customising client portfolios, the AAI tool can illustrate the trade-offs of

greater portfolio diversification. This visual means of communication may be helpful in *extending the baseline tolerance level*, especially in times of short-term underperformance which is likely be beneficial in the long run.

Extending the adviser-client dialogue by illustrating the likely risk and return trajectories of a spectrum of diversified portfolios is a simple yet crucial method. The opportunity to encourage trust through greater understanding, while reiterating a few enduring principles such as the long-term value proposition of diversification, can help us steer investors to better long-term outcomes.

Jim Masturzo, CFA, is Senior Vice President, Head of Asset Allocation and Jonathan Treussard, PhD, is Director, Head of Product Management at Research Affiliates LLC. Research Affiliates will be hosting symposiums in Australia on 13 (Melbourne) and 14 (Sydney) November 2018. Financial professionals can learn more details, and request an invitation here.

Disclosure

The figures are from the Research Affiliates Asset Allocation Interactive tool. All data presented herein are estimates and are based on simulated portfolios and do not reflect the performance of any product or strategy. Past performance is not indicative of future results. Please reference the important legal disclosures found at www.researchaffiliates.com which are fully incorporated herein.

Active or passive ETFs: how do you decide?

Justin Arzadon

Working for an Exchange Traded Fund (ETF) manager, investors might presume that I'll always favour a simple passive index-tracking ETF. Whilst I may think that indexing is the way to go most of the time because of the instant diversification, lower costs, and the historical inability of the majority of active managers to outperform their benchmarks, active strategies have their role in portfolios.

However, as an investor, how do you decide which approach to use?

The evolution of ETFs

Exchange traded products have gone through an evolution over the years like products in other industries:

1. At first there were passive index-tracking ETFs which seek to mirror the performance of a specific investment index, and which often utilise a simple market-cap weighted methodology or aim to track a specific commodity or currency, or group of commodities and currencies.
2. Then came smart beta or rules-based exchange traded products, typically using a systematic investment approach. Some of these approaches can still be index tracking. However, such indices typically go beyond market-cap weighted methodologies and may consider factors like size, value and volatility as an alternative weighting methodology. Other products may not track an index but still use a prescriptive set of rules as part of their investment objectives (for example, yield-oriented buy-write strategies or funds that aim to provide short exposure to share markets).
3. More recently, active ETFs have portfolio managers making decisions on the underlying portfolio composition and do not try to mirror the performance of any underlying index. Instead, typically the manager's main goal is to outperform a benchmark index by actively trading or changing sector allocations.

What should an investor take into consideration when deciding whether to select active or passive investment strategies? Here are three considerations:

1. How efficient is the underlying market?

There are segments of the market that are inefficient, giving an opportunity to exploit mis-pricing and potentially deliver outperformance, or 'alpha'. Active management or smart beta, rules-based strategies may do better. Two examples are hybrids and small cap markets.

In hybrids, an active manager can potentially add value over an index-tracking approach by accessing deeper liquidity and improved trading costs, with specialist knowledge to assess the complex and varied issuance terms of securities, and the ability to sell securities when they become overvalued.

In small caps, we believe that most of the outperformance in the sector can be achieved over market cycles, by identifying and avoiding companies with undesirable investment characteristics. This can be achieved with some sensible screens, delivered in a cost-effective way via an exchange traded product.

2. Where are we in the market cycle?

When a momentum-driven market is generally moving higher, there may be no need to look at active or smart beta strategies. “A rising tide lifts all boats” is the saying, and just having exposure to the right sector may be all that is needed.

However, as a market peaks and corrects, market pull backs and risks may be mitigated by using a strategy that is active or rules-based, which will hopefully have exposure to higher quality securities that will be less affected by the fall.

High volatility or trendless markets present another opportunity for active and smart beta strategies to take advantage of specific securities or sectors. Or alternative strategies that are defensive, or not as correlated to rest of the market, can also shine.

Yield strategies have always been popular with Australian investors. A few years ago, most yield stocks performed well. The market environment is different today. Banks may struggle to grow their earnings and therefore their share prices in the years ahead. There is some prospect that interest rates could rise again, which would impact interest rate sensitive investments, and many market observers feel the top 20 stocks on the ASX will have a more difficult time.

For funds with a specific income objective, active management can add value above a passive strategy by navigating the markets in changed market conditions. Specific strategies aim to deliver an attractive, tax-effective and low volatility income stream that can increase with inflation, targeted at retirees and low-tax paying investors.

3. Is the added cost for active or rules-based strategies worth the money?

Shopping for any product is about value. A top quality shirt may cost more but with longer wear, it might cost less in the long run. The same goes for investing. Will there be enough outperformance in the long term to justify the added cost? Management fees eat into returns and, although an active manager may outperform their benchmark, after considering their fees may underperform.

The cheapest Aussie equities exposure in the world is currently the BetaShares Australia 200 ETF (ASX:A200), with a management fee of 0.07% per annum. However, this is a market cap-weighted index and potential outperformance may come from a smart beta approach such as Fundamental Indexing. It is also available via an ETF and has outperformed the market cap-weighted index over the long term by about 2% per annum*, but with higher fees.

In summary, active, rules-based and passive strategies can be used in conjunction with one another and should be considered as part of a diversified portfolio.

**Source: Bloomberg. FTSE RAFI Australia 200 Index v S&P/ASX 200 Index, 1992 to June 2018. Does not take into account ETF fees and expenses. You can’t invest directly in an index. Past performance is not indicative of future returns.*

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Don’t allow a BoMaD to ruin your retirement

Kaye Fallick

This article is the third in a series written for Cuffelinks by leading retirement website YourLifeChoices. It reports on the financial impact on parents who are assisting adult children with loans to buy property or are allowing them to live rent-free at home.

What is a BoMaD and why should you care?

The BoMaD – or Bank of Mum and Dad – is the 10th largest lending institution in Australia, ahead of ING, Suncorp and Bendigo Bank. It is estimated to be lending $65 billion per annum, according to a Mozo survey in September 2017. That’s right, $65 billion a year is being transferred from the pockets of Australian mums and dads to their adult children to assist them in buying a house.

Children staying at home is more difficult to measure

While children are no doubt lovable, they can also be very expensive, particularly when it comes to reducing your retirement income. It’s not just in the headline fact of parents lending grown-up children money to buy property. There is a quieter, more insidious erosion of retirement savings and income, and that occurs when adult children live at home for extended periods without contributing to household expenses. This is a less spectacular, difficult-to-measure version of the BoMaD. And it’s not a loan, but a gift!

YourLifeChoices runs frequent in-depth surveys on all things to do with retirement. In the recent 2018 *Retirement Matters* survey, we asked our 230,000 **55–75**-year-old members whether assisting younger family members was eroding their retirement savings.

Here is what we learnt:

- 17% of respondents still have adult children living at home
- Of these, only 58% are receiving contributions to the household expenses
- Of those respondents with adult children at home, 32% believe their retirement income is reduced by this arrangement
- The median amount respondents projected they were losing per annum was $10,000, within a range of $5000 to $50,000.

So, what does this mean for you and your retirement? This is tricky emotional territory.

As reported above, most parents are relaxed about long-term cohabitation with their adult kids. The extended family is a traditional source of strength, support, love and fun. There’s a lot to like about this way of living, and it really is the very basis of community.

But financially, it can be an extremely lopsided arrangement. The great ‘risk shift’ of retirement income, as identified by American academic Jacob Hacker in 2006, suggests that we are all basically on our own when it comes to creating a retirement nest egg and managing it successfully.

Consider the money foregone

What is often overlooked is money foregone, and this is where a BoMaD can kill your future prospects. Retirement is fast becoming a user-pays system, exacerbated by the increasing need for personal income to cover both health and aged care.

So, what can you do if you love having your adult children living at home, but fear this is having a negative impact on your finances?

You could start by recognising that family comes first, and if you are happy to have them at home, then that is where they belong. But make sure everyone is paying their way.

Think back to your early days of share houses and flatmates. There are mutual costs which include:

- mortgage repayments
- energy bills

- communication: internet, movie streaming, subscriptions, etc
- maintenance
- cleaning
- gardening
- insurances
- food and groceries.

When you stop and itemise the expenses, you realise that it costs a lot to run a home, even one which is fully owned. So create a spreadsheet with all household expenses listed, total it and divide it equally by all adults aged 21 and over. Set up a new bank account to be managed by the home owner, or whoever's name is on the lease if you are renting.

Request all 'guests' organise an automatic payment from their own bank account into the household expenses account, equalling their share of these expenses, on the first of the month, every month.

When sufficient money is collected, organise for automatic payments of all household bills on their due date, and a payment covering 'general monies' (i.e., money for consumables, such as food and other supermarket items) to be made monthly into the homeowner's account to cover these extra, often unnoticed, expenses.

This will hopefully remove potential arguments and ensure that a fair share of the expenses is paid by all, as painlessly as possible.

It may sound like an overly formal system, but rent-free kids eating you out of house and home is hardly the answer, either. Yes, you love them dearly, but you also have to plan for your next 20 or 30 years of paying bills, perhaps when your health is far less robust than theirs.

YourLifeChoices' June *Retirement Affordability Index™* reports that it costs a couple on a full or part age pension, living in their own home, about $42,830 per annum to cover all expenses. If these costs are higher because you are accommodating your grown-up kids, it's up to you to ensure you are not digging into your savings to support them forever.

At the very least, it is worth thinking about.

Kaye Fallick is publisher of YourLifeChoices, Australia's leading retirement website for over-55s. It delivers independent information and resources to 250,000 members across Australia.

Opportunities in tech sectors in Asia

Aleksey Mironenko

Investors are increasingly concerned about global growth and how to adjust portfolios going forward. Most agree that the US and Asia are bright spots today and that exposure to technological innovation is needed to capture the transformation occurring in nearly every industry.

Why focus on Asian innovation?

Asia is home to 60% of the world's population, creating immense opportunities for adoption and scaling of new technologies. Countries without strong bank penetration are skipping branches and going straight to mobile. A newly-formed middle class shops online, not in malls. Hands-on governments are sponsoring domestic innovation. The list goes on.

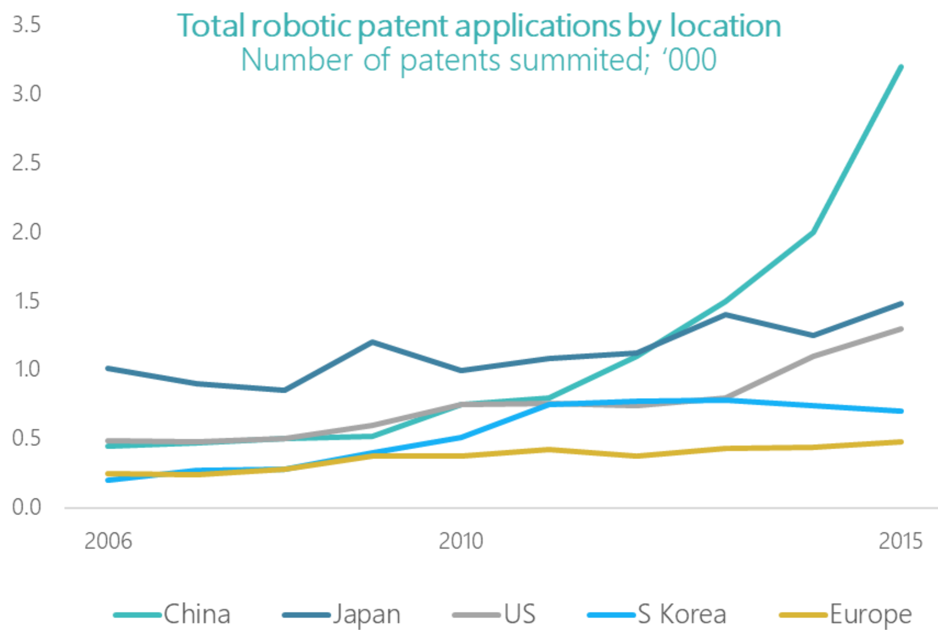
In our view, innovation in Asia consists of three big picture themes:

1. Digital Transformation: According to Microsoft, 60% of Asia's GDP will be driven by digital products or services in 2021. Asia is the most digital region in the world: 2 billion internet users, 1.8 billion active social media users and 4.3 billion mobile connections. Digitizing business activity is a no-brainer given the scale of adoption possible. As an example, Indonesia has more Facebook users than the US. WeChat, WhatsApp, Line, KakaoTalk and Viber are widely used and build local solutions for digitization of business not possible at smaller scales elsewhere.

2. Health and Life Sciences: Asia will be home to 60% of the world's elderly population (age 65 and above) by 2030, resulting in massive implications for healthcare. Pharmaceutical models will shift from volume to value through upgraded research and development (R&D) laboratories. Medical records will be digitized, initial diagnoses automated. Wearable health applications and data gathering will become the norm.

Working age population as a percentage of total population

3. Robotics and Automation: Asia is the world's factory, but labour costs are rising due to an aging population, education increases and service industry growth. The only solution is aggressive automation. Japan has been at the forefront of automation for quite some time and China is ramping up its robotics R&D aggressively. Use cases range from automated fulfilment centres, farm irrigation and maintenance, assembly line automation, autonomous transport for the elderly, etc.



Defining technology and innovation in investment strategies

Some questions faced by investors looking for investment solutions on Asian innovations are:

- **Thematic focus**: whether to focus on only one theme requiring strong views or maintain a portfolio of strategies. Neither is ideal given the sizing and overlap concerns.
- **Global versus Asian**: both are valid, but Asia makes sense because of faster adoption and national policies for local champions.
- **Beyond tech**: technology's benefits have spread well beyond the technology sector. Robotics manufacturers are industrial stocks and electric car companies are consumer stocks. A sector-agnostic approach is needed.
- **Valuations and size**: market cap weighting dilutes exposure and leads to concentration risk. In Asia, Alibaba and Tencent would make the rest of the portfolio irrelevant.
- **Transparency**: thematic exposures require certainty in team, process and methodology to avoid drift from desired themes.
- **China as a proxy**: Asian innovation goes beyond the top Chinese internet stocks. For a strategy to add value, it must go beyond a 5-stock portfolio that can be replicated with ease.

Among the above, industry classification 'beyond tech' is often considered as the biggest challenge as technology-driven innovations are not only influencing all kinds of industries but also disrupting the traditional investment paradigm, especially when screening for new industries beyond traditional classifications.

FactSet is an example of pioneering index providers redefining industry classifications. For instance, below is a sample of relevant RBICS® sub-industries for a Robotics and Automation theme:

- 3D Modelling/Rapid Prototyping Automation Providers
- Autonomous Drone Manufacturers
- Global Positioning System Manufacturing
- Industrial Robots and Robotic Assembly Line Makers
- Machine Vision and Quality Control
- Motion Control and Precision

Implementation for Asia

The recently launched Premia FactSet Asia Innovative Technology index aims to capture leading Asia-based companies engaged in emerging and disruptive solutions across technology-enabled sectors of digital transformation, healthcare & life sciences, and robotics & automation. These companies are selected for their significant revenue from the FactSet RBICS innovative technology sub-sectors, their growth characteristics, and their consistent investment in R&D. The exposure is currently largely North Asia – China is the biggest exporter of goods & services in the region and Japan is driving the automation revolution globally. About 64% of that is technology, but healthcare, industrials and even consumer stocks are all innovating their way to future growth. Most importantly, innovative industries are 75% of the index revenue, the growth forecast is 18%, yet forward PE is only 22x. It's a high-quality tilt as well – R&D, margins and ROE are all above average.

Unlike cap-weighted indexes, this equal-weighted strategy provides investors with more diversified exposure to the high growth names across the three selected themes, such as: Tencent, Alibaba, Samsung (digital transformation); BeiGene, Otsuka, Daiichi (health & life sciences); Fanuc, Keyence, Nidec (Robotics & Automation). Since inception from 13 June 2014, the index has generated an annualized return of about 13% to date, outperforming the MSCI AC Asia Technology Index and most of the other broad China and Asia indices.

Aleksey Mironenko is Partner and Chief Distribution Officer at Premia Partners. This article is for general information and does not consider the circumstances of any investor. Past performance is no guarantee of future results. 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.

Good policy maintains pension age at 67

Adam Shultz

One of Scott Morrison's first decisions as Prime Minister was to abolish the plans to increase the eligibility requirements for the age pension (**pension**) to age 70, announced originally as part of the unpopular 2014 budget. At the time, then Treasurer Joe Hockey (Abbott Government) planned to lift the pension age from 67 to 70. The move back to 67 is good public policy. It reduces the pressure on vulnerable people who, through no fault of their own, do not have the physical capacity to continue to work up to the age of 70.

The working age problem and increases in life expectancy

A quarter of the total population in all advanced economies is expected to be aged over 65 by 2050. Australia is no different, with the number of people aged 65 to 84 expected to double, and the number of people aged 85 and older expected to quadruple, over the same period. At present, the cost of the pension is approximately 2.6% of Australia's annual Gross Domestic Product (GDP), or $44 billion. It is predicted to remain relatively stable and is comparatively affordable when compared to an average of 3.9% of GDP among advanced economies.

To provide context, the age pension commenced in 1909 when eligibility was set at 65 for males and 60 for females. At the time, life expectancy at birth was 55.2 years for males and 58.8 years for females. Today, life expectancy for males is 80.4 years and for females 84.6 years.

To negate some of these impacts, Australian Governments (the former Labor and current Coalition) have attempted to gradually extend the working age. At present, the former Labor Government's policy changes include the steady rise in eligibility age from 65 through to 67 by 2023. The Coalition's scuppered plan was a gradual rise to 70 by 2035.

The question for future policy makers

If a future Government increases the pension age, will retirees look for alternative forms of Government assistance to maintain their expected income at the retirement date they had anticipated?

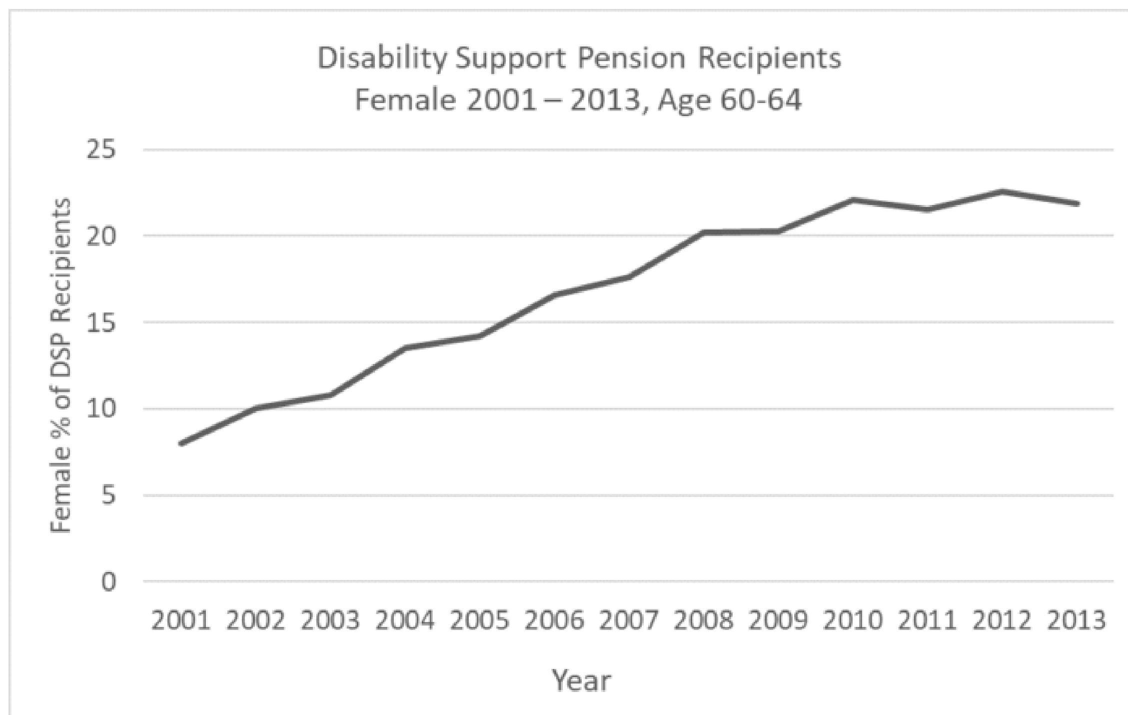
To extrapolate and make reasonable inferences about the future, it is important to consider the past. There could be a relationship between increasing the age requirements of the pension and people accessing the Disability Support Pension (DSP).

From 1995 until 2013, the pension qualifying age for women gradually increased from 60 to 65 years, while the requirement for men remained fixed at 65 years. Over this 18-year period, the overall percentage increase in women accessing the DSP increased 174%, compared to a 36% increase for men.

The monetary value of the Government assistance for the pension and DSP (including supplements) is identical for both genders, at $908 per fortnight for singles. It could be reasonably inferred that if the pension eligibility requirements are increased, some Australians may seek to apply for the DSP to maintain their expected retirement income and retire at the date they had originally anticipated.

Between 2001 to 2013, the percentage of female DSP recipients aged between 60 and 64 increased from 8% to 21.9%. This is a substantial increase and requires more analysis to accurately determine all the factors underpinning this outcome.

Nevertheless, in 2012, the then Labor Government overhauled the DSP eligibility requirements due to the exponential growth in DSP recipients. This policy change resulted in a comprehensive assessment of all new DSP applications, including a determination as to whether the applicant could undertake any form of work, as opposed to relying on a medical diagnosis. The Coalition Government has since made it even more difficult to qualify, with an individual now required to prove that their permanent disability prevents them from working more than 15 hours per week.



Source: Department of Social Service

Protection of vulnerable people

Australians who rely solely on the pension in retirement are among the most vulnerable members of our society. They are subject to regular variation of asset and income testing requirements from Governments of all persuasions.

Unfortunately, these Australians have not been able to accumulate substantial superannuation savings through the compulsory superannuation system. As the system was made mandatory in 1992, part way through their working lives and through an initial contribution rate of only 3%, many have not become financially independent in retirement. It is unfair to expect these Australians to work for longer periods of time, often in physically-demanding roles that their bodies are no longer strong enough to carry out.

Two-thirds of females who receive the DSP do not own a home, and 72% of females receiving the DSP are single, separated, divorced or widowed. Australia has a responsibility to support its vulnerable. The abandonment of the plan to increase pension age to 70 is not only good politics, but good public policy.

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