

### This Week's Top Articles

- **Do you know the fees you're paying?** *Sam Wylie*
- **When the \$1.6m cap is no longer relevant** *Noel Whittaker*
- **AFCA: A new era in financial services dispute resolution** *David Locke*
- **Royal Commission must remove aged care anomalies** *Rachel Lane*
- **Roboadvice's role in financial advice's future** *Harry Chemay*
- **Taxpayers with lowest tax rate are hardest hit** *Jon Kalkman*
- **Share outlook turns negative for first time** *Recep Peker*

### Do you know the fees you're paying?

Sam Wylie

Most investors don't have a clue how much they pay across all the different types of fees they are charged. There are fees for advice, administration, investment management, tax planning, and more. The examples below are intended to help you better understand these fees and roughly calculate how much you pay in total. Many investors who do this calculation are shocked at how much it comes to.

An example will demonstrate the importance of minimising investment fees. Imagine that over your 40 years in the work force, you put 10% of your annual income into superannuation each year. Let's assume that your income starts at \$50,000 per year and then grows at 4% per year above inflation of 2.5%, and your investments deliver an annual, after-tax return of 5% per year above inflation, but before fees.

If the total annual fees you paid were 2% (200 basis points) of your accumulated super, then after 40 years you have \$1.9 million in super. If instead, your fees were 1% (100 bps), then you have \$2.3 million. Cutting fees by 1% leads to a 21% increase in the amount of money retirement in this realistic example.

#### Calculating fees

The first step towards ensuring that you are not paying too much is to understand how much you are paying today. The following examples are intended to help you calculate the total percentage (and dollar) amounts you are currently paying.

#### Total fees for different types of investment and advice

	Type	Advice	Admin	Management	Structuring and tax	Total
Evi & Karl	Financial advisor Retail super fund	1.00%	0.65%	0.75%	0%	2.40%
Faiz & Mary	No advisor Industry fund	0%	0.12%	0.76%	0%	0.88%
Axil & Wei	Brokerage firm SMSF & Fam Trust	0.95%	0%	0.50%	\$6,800	1.61%

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### Example 1: Financial advisor and retail super fund

Evi and Karl's investible savings (other than the family home) are \$580,000 of super. The couple's financial advisor, Steve, has put their \$580,000 of combined super into one of the big retail super funds (MLC, CFS, BT and AMP are the largest).

They pay: 1.00% (for advice) + 0.65% (for administration) + 0.75% (for management) = 2.40% of \$580,000 = \$13,900 a year.

There are three levels here. Financial advice from their advisor. Administration from a retail super fund. Investment management from various fund managers.

**Advice:** Evi and Karl meet with their advisor once a year to discuss:

- their financial goals
- how much they need to save to meet those goals
- what they should invest in (asset allocation) and in which managed investment funds
- whether they should borrow to invest in property
- how much insurance they need
- how to minimise tax
- how they should structure their investments (do they need an accountant to set up an SMSF, a family trust, etc.)

Steve charges 1% (100 bps) of their super balance for this advice.

**Administration:** The retail super fund charges the couple 0.65% (65 basis points) for administration of the super fund, which involves:

- the creation and governance of the super fund
- access to a large number of different managed funds (for investing in Australian shares, global shares, fixed income, commercial real estate, infrastructure, etc.)
- buying power to access those managed funds at low cost
- calculation of the couple's share of value in the super fund (which has many thousands of members)
- preparation of reports for Steve, and some smaller things

**Management:** Steve chooses which retail super fund to put the couple's \$580,000 into. Then he looks at all the different managed funds that the retail super fund gives access to and chooses a managed fund for Australian shares, global shares, commercial real estate, etc. On average these funds are charging 0.75% (75 basis points) for the effort they put into researching and choosing the shares or properties that they invest in. The 75 bps would be more if not for the buying power of the retail super fund (which many billions are invested through).

**Tax and structuring:** Evi and Karl's taxes are simple. They file their taxes online using 'intelligent' online software that takes them through the process and costs a small amount (negligible compared with their advice, administration and investment fees).

### Example 2: No advisor and industry fund

Faiz and Mary's investible assets are \$620,000 in super plus a negatively geared investment property (for which they pay the rental agent 8.5% of the rent, which I will ignore here). They both have their super in the 'balanced' option of their industry super fund (the biggest industry funds are AustralianSuper, Hostplus, HESTA, REST, and Unisuper)

They pay 0% (for advice) + 0.12% (for administration) + 0.76% (for management) = 0.88% of \$620,000 = \$5,500.

**Advice:** Faiz and Mary have never spoken to a financial advisor. They wonder whether they might benefit from advice but have put that off until their situation becomes more complex.

**Administration:** Their industry super fund charges an administration fee of 0.12% which covers the costs of collecting members' super payments, calculating account balances, providing annual statements and answering members' inquiries.

**Management:** Faiz and Mary's industry fund manages some of its members' money in-house and pays external managers fees to manage the remainder. The 0.76% fee covers all of the costs of this investment management. The couple chose the 'balanced' investment option and the industry fund makes decisions on asset allocation and choice of investment managers on their behalf.

**Tax and structuring:** Faiz and Mary pay a tax agent about \$300 to complete their income taxes, but only because of the tax rules around their rental property, so I have ignored the tax expense above.

### **Example 3: Brokerage firm and SMSF**

Axil and Wei have considerable investible assets: \$2.4 million in an SMSF and \$1.8 million in their family trust, which continue to grow quickly. This is in addition to the ownership of their family home and the business created and run by Wei. Their investible assets are managed by an advisor of a brokerage firm (some large brokerage firms are JBWere, Morgans, Ord Minnett and Evans).

They pay 0.95% on \$4.2 million (for advice, administration and management of their Australian shares) plus 0.50% extra (for management of global shares and some commercial property trust investments – see below) = 1.45% of \$4.2 million = \$60,900. Their accountant's fees (structuring and taxes) are \$6,800, which is 0.16% of their investible wealth. They have paid 0.95% since they started with the brokerage firm but are considering asking for a reduction to 0.85% now that their investible assets are larger.

**Advice:** Axil and Wei speak with their advisor three or four times a year. There is a scheduled annual meeting when their advisor takes them through the changes to their investments and performance of their portfolio over the year. But there are also ad hoc telephone conversations when their advisor is considering large changes to their investments or their advisor wants to offer them a particular investment opportunity. These include investments in property trusts, initial public offerings of shares and even investments in some start-up companies.

**Administration:** Advice, administration and management of the Australian share portfolio are bundled together in the 0.95% fee charged by the brokerage firm.

**Management:** The brokerage firm manages Axil and Wei's portfolio of Australian shares in a 'separately managed account' that is not pooled with the shares of their other clients. However, their investment in global shares is through a managed fund that charges 1.50% per annum, and their investment in private commercial property trusts has a fee of 1% per year. In total these extra fees are equivalent to 0.50% of their \$4.2 million of investible assets.

**Tax and structuring:** Axil and Wei's accountant provides tax advice and prepares their personal tax forms, as well as the financial reporting, taxes and audit of their SMSF and family trust. The same accountant is used by their business, but those fees are charged to the company.

### **Concluding remarks**

Fees, taxes and transaction costs are, in one sense, all the same thing for investors. They are all money out, and that needs to be minimised. But 'minimised' doesn't mean 'set to zero', because everyone needs some level of help, especially with tax planning and structuring (SMSFs, family trusts, etc.). The advice you receive might lead you to save more, take the right amount of risk, manage your taxes effectively, etc. which will lead to better outcomes. Minimising fees just means getting value for the fees that are paid.

How much do you pay annually in fees, with total fees broken down into advice / administration / management / structuring and tax? Try to work it out yourself. But if you have a financial advisor then ask them. If you don't get a clear and direct answer, then that is a problem. There is obviously a great deal more to discuss on this topic, but this can start your conversations.

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## When the \$1.6m cap is no longer relevant

Noel Whittaker

The year is rapidly drawing to a close, which means it's highly likely that you will now hold completed financial statements for your SMSF. If your balance is over \$1.6 million, the first thing you may notice is that your imputation credits refund is down from last year.

This is due to the change in rules made by the Turnbull Government, which restricted the amount that could be held in tax-free pension mode to \$1.6 million, leaving the rest of the fund's earnings to be taxed at 15%.

### When trustees no longer need to worry about the cap

The next thing you might discover is that the \$1.6 million that was your Transfer Balance Cap (TBC) at 30 June 2017 has now grown. It could easily be worth as much as \$1.7 million if your fund earned, say, 7%, while you drew the mandatory pension of 4%.

This situation has triggered a few emails asking what the trustees of the fund should do. Will the TBC now stay at \$1.7 million or will it go back to \$1.6 million if the amount in pension mode drops as a result of bad performance or increased pension drawings in the current year?

Superannuation guru Monica Rule has good news for you. She tells me that your TBC is no longer relevant, provided the documentation was done properly as at 30 June 2017. As long as your fund did the paperwork correctly on that date, the fund trustees no longer have to concern themselves with the \$1.6 million TBC.

Thus, there is no limit to what your super in pension mode could grow to if you had excellent returns, way in excess of the compulsory drawdowns. And there is no penalty if, for any number of reasons, the amount you hold in pension mode drops below \$1.6 million.

### Continue to draw minimum

But one factor is critical. If all or part of your fund is in pension mode, you are required to draw a set percentage of the balance of the fund that was in pension mode at 30 June. The factor is 4% for anybody under 65 and rises progressively to 14% at age 95 and above.

Age	Minimum pension drawdown factors
<b>55-64</b>	4%
<b>65-74</b>	5%
<b>75-79</b>	6%
<b>80-84</b>	7%
<b>85-89</b>	9%
<b>90-94</b>	11%
<b>95 or older</b>	14%

For example, if you are aged between 65 and 74 you should be withdrawing at least 5% of the previous June balance each year. Therefore, if your balance was \$1.6 million at 30 June 2017, you should have drawn \$80,000 in pension for the year ended 30 June 2018. However, if your financial statements now show that your TBC has become \$1.7 million, you will need to increase your drawdowns in the present year to \$85,000.

This is a further example of the complexity of our superannuation system, and the dangers for people running SMSFs who don't get it right. Despite the penalties, which can be heavy, I am still amazed by the number of questions I receive from people who obviously don't know what they're doing. Often, they simply don't know what they don't know. This is an area where expert advice is critical.

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## **AFCA: A new era in financial services dispute resolution**

David Locke

On 1 November 2018 we opened the doors of the Australian Financial Complaints Authority (AFCA), a significant milestone for the financial services industry. AFCA is the new ombudsman scheme replacing three predecessor organisations – the Financial Ombudsman Service (FOS), the Credit and Investments Ombudsman (CIO) and the work of the Superannuation Complaints Tribunal.

AFCA is a key recommendation of the 2016 Ramsay Review into external dispute resolution. The review recommended a simplification of the duplicative industry ombudsman schemes that consumers and small businesses previously had to navigate. AFCA is designed to make it easier to access the scheme as a one-stop shop, delivering services to Australians that are easy to use, free for complainants, efficient, timely and most importantly – fair.

AFCA is a membership-based ombudsman scheme, and all Australian Financial Services Licensees, Australian Credit Licensees, superannuation trustees and other financial firms that are required to become members of AFCA by law, contribute to its operation through membership levies and complaint-related charges.

### **Focus on efficiency**

AFCA's complaint resolution ensures ease of navigation and efficiency for consumers and small businesses. Whenever possible, there is one case handler and an ombudsman who deal with each complaint.

Their investigation process assesses the issue and gathers relevant information from the parties. Information is exchanged to ensure that each party can respond to the other's material and that there are no surprises.

AFCA resolves complaints using a variety of techniques including negotiation and conciliation, and will engage with the parties in question to determine the most effective method.

### **Increased jurisdiction**

AFCA has increased monetary limits and higher compensations caps, including a new superannuation jurisdiction. This increased scope means that more consumers and small businesses will now be able to access AFCA and obtain fair and effective solutions for financial disputes, rather than having to navigate multiple schemes or go to court.

For superannuation disputes there is no financial limit on claims or on compensation that can be awarded. For most non-superannuation disputes involving consumers, AFCA can consider disputes where the claim does not exceed \$1 million and can award compensation of up to \$500,000. Where the dispute relates to a guarantee given against a person's place of residence there is no monetary restriction or compensation limit.

Small businesses are now defined as any business employing less than 100 employees and AFCA can consider claims relating to credit facilities of up to \$5 million. Any charity registered with the ACNC can use the AFCA service, irrespective of the number of employees.

These new thresholds are a game changer and mean that the many disputes that couldn't be resolved by the predecessor organisations can now be handled by AFCA.

AFCA is now the largest external complaints resolution organisation in Australia, with over 550 expert staff, including 22 Ombudsmen, 14 Adjudicators and 28 Panel Members. We are well resourced and need to be in order to handle the 1,000 or so disputes a week coming our way.

### **The Royal Commission**

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry exposed significant failings across the financial services industry. It also highlighted the significant impact that financial firms' practices have had on consumers and small businesses.

We are acutely aware that there is an individual story behind every complaint that is raised. In many cases, it is a story of not just financial loss but also of the human toll of stress, anxiety and ill health, which has flow-on effects, beyond the people involved in disputes, to the community more generally.

Many people who engage with the financial services industry for both business and personal reasons have strong and successful relationships with their financial firm, be that their insurer, bank or financial adviser. The

vast majority of these interactions are based on the financial firm doing the right thing, and the relationship is built on mutual trust. But when things do go wrong, they can be catastrophic and enact a huge personal and business toll.

### **Rebuilding trust**

Financial firms that are AFCA members understand that regaining customer trust is important to the survival and health of their industry. And consumers and small businesses expect that, at a bare minimum, financial firms will do the right thing by them.

We cannot even start to rebuild trust in financial institutions unless consumers with complaints have somewhere to go to get fair consideration of their issues and proper redress where appropriate. This is where AFCA comes in.

Of course, it is always preferable for complaints to be resolved by the financial firms themselves. All financial firms need to have clear and easy to access internal dispute resolution (IDR) processes to rectify issues early when things go wrong. We proactively work with members to support them in delivering improved IDR that will result in improved relationships with consumers.

AFCA is a wholly new vision, part of a much bigger picture to restore trust in financial services. AFCA will have a strong voice and will use our data and experience from our disputes work to better inform the community.

### **Remediation**

Remediation programs established by financial firms provide a way for these firms to identify issues and compensate those affected, without the need for the consumer to make a complaint to us. They are a proactive mechanism for acknowledging and compensating for an error when it occurs.

AFCA will become aware of a remediation program through a variety of channels and will also independently assess remediation outcomes if consumers have any ongoing concerns.

As we have seen in the Royal Commission, delay in responding to issues has consequences for reputation and consumer outcomes. Well-run remediation programs can help restore trust between financial firms and their customers. When the programs are implemented properly, and in accordance with the principles that AFCA would apply, we would expect to see very few follow up complaints.

### **Compensation scheme of last resort**

Unfortunately, many consumers who obtained a determination from FOS and CIO have not had compensation paid to them after a favourable outcome through external dispute resolution (EDR). Over the last eight years approximately 270 people have found themselves in this situation.

This occurs typically when the financial firm has gone into liquidation or administration, or when adequate compensation arrangements of the licensee fail to respond.

To address this, AFCA supports the establishment of a compensation scheme of last resort. We see this as the missing piece of the puzzle to address the regulatory gap that currently exists in consumer protection arrangements.

What can often get lost in this discussion is the impact that losses and unpaid compensation awards have on the lives of individual consumers, their families and small businesses.

We acknowledge the need for a compensation scheme of last resort to provide access to justice for consumers who do not receive awarded compensation for financial loss.

A compensation scheme of last resort should provide a material degree of protection for financial services consumers and small businesses who have not been paid an eligible AFCA determination or award owed to them by a financial firm.

*David Locke is Chief Ombudsman and Chief Executive Officer at Australian Financial Complaints Authority. Complaints can be made online at [afca.org.au](http://afca.org.au), by emailing [info@afca.org.au](mailto:info@afca.org.au) or by phoning 1800 931 678.*

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## Royal Commission must remove aged care anomalies

Rachel Lane

The Royal Commission into Aged Care will resolve once and for all the debate about staffing ratios. It is imperative that the Commission identifies appropriate minimum standards of care. It is equally imperative to broaden their scope to identify who pays what for care now, and who should pay what in the future.

### Resident contributions system is broken

The current means testing arrangements use a complex formula combining an income and asset test to determine the resident's liability to contribute to the cost of their accommodation and care. While on the surface this seems fair, the reality is that the current means test protects the very poor and the very wealthy, leaving those in the middle to pay the most.

The formula used to calculate someone's liability to contribute towards their cost of accommodation and care involves a combination of an income test and an asset test:

- 50c per dollar of income above \$26,985 (single) \$26,465 (couple), plus
- 5% of assets between \$49,000 – \$166,707, plus
- 1% of assets between \$166,707 – \$402,122, plus
- 2% of assets above \$402,122

A few important aspects of the means test are:

- The former home is exempt if a protected person is living there.
- When the former home is assessed, it is assessed up to a capped value of \$166,707.
- Any amount the resident pays as a lump sum accommodation payment is included in the asset test.
- The resident cannot pay more than their cost of care.
- There is an indexed Annual Cap of \$27,232 and a Lifetime Cap of \$65,357 (which includes any amount paid as an Income Tested Care Fee in a Home Care Package).

### How the means test works

Every resident can pay the basic daily fee, set at 85% of the age pension, currently \$51/day. In addition to the cost of care, residents still have personal expenses including telephone, medications, clothing and travel, as well as any extra or additional services provided by the facility.

At the fully subsidised end is Tom, a full pensioner with \$40,000 of assets. Tom pays the Basic Daily Fee and the government pays the facility an accommodation supplement up to \$57/day to cover the cost of his care.

### Three examples of means testing

1. At the low means end, Shirley is a full pensioner with \$90,000 in the bank and \$5,000 of personal assets.

Based on Shirley's assets, her Daily Accommodation Contribution (DAC) is \$22.11/day. The lump sum equivalent (Refundable Accommodation Contribution or RAC) is \$135,067. The RAC is calculated at the government-set interest rate, currently 5.96%/year. With \$95,000 of assets, Shirley cannot afford to pay by RAC alone but she can pay by combination. If she pays \$40,000 towards her RAC, her DAC will reduce to \$15/day. After meeting her cost of care, she has less than \$2/day for personal expenses or will need to dip into her \$50,000 of remaining capital.

2. Don is a part pensioner. He has \$190,000 of investments and \$10,000 of personal assets. Because his assets exceed \$166,707, his accommodation payment is based on the market price set by the aged care facility. If Don lives in a capital city, the Refundable Accommodation Deposit (RAD) could easily be \$500,000 or more.

If Don moves to a facility with a RAD of \$500,000, paying \$100,000 towards his RAD, his daily accommodation payment (DAP) will be \$65.31/day. Combined with the basic daily fee, his cost of care will be over \$42,000/year. Don's income is just \$26,000/year so he will either dip into his remaining investments to meet his cash flow or deduct his DAP from his RAD (an option available to all residents). If Don chooses this option, which would ease the pressure on his cash flow, his DAP will increase each month as his RAD reduces and in less than 5 years his RAD will be exhausted.

3. At the other end of the spectrum is Dot, a self-funded retiree with a home worth \$1 million, \$1.5 million of investments and \$50,000 of personal assets. She is also moving to a facility where the RAD is \$500,000. She pays her RAD in full, from her investments.

If Dot keeps her home, it will be assessed at the capped value of \$166,707 and she will pay a means tested care fee of \$85/day. After 320 days, she will reach her annual cap and stop paying this fee for the remainder of the year and in 2.5 years she will reach her lifetime limit of \$65,000.

By keeping her home Dot's Means Tested Care Fee is around \$90/day less than if she sold it.

### **Inequitable outcomes**

If all three retirees live out their lives in aged care, Shirley, as a low means resident, will have just \$2/day to cover her living expenses or will need to dip into her limited capital. Dot will keep her \$1 million home, \$1 million of investments and \$50,000 of assets, and her \$500,000 RAD will be refunded after she leaves care. She will pay the lifetime limit of \$65,000 toward her cost of care. Don, meanwhile, will have lost the entire \$100,000 of his RAD within five years. He may still have some investments left, but like Shirley he has needed to draw on his assets to meet his cost of care.

The outcome of the Royal Commission will undoubtedly recommend changes to the cost of providing aged care. The next step will be to ensure that the means testing arrangements share that cost in a way that is equitable.

*Rachel Lane is the Principal of [Aged Care Gurus](#) and has co-authored a number of books including '[Aged Care, Who Cares?](#)' with Noel Whittaker. This article is for general information only.*

## **Roboadvice's role in financial advice's future**

Harry Chemay

A rebuttal to Graham Hand's [The 4Ps of roboadvice: persist, pivot, partner or pack up](#).

Sometime in 2018, the Australian population reached 25 million. There are almost 20 million mobile phones in use in this country today, and smartphones comprise 88% of them. Australians are among the leading adopters of smartphone technologies and the apps that we increasingly use in our daily lives.

A recent Deloitte [survey](#) asked, "What did we ever do before smartphones?", noting that:

*"From the moment our fingertips touched the screen, Australians have enthusiastically embraced the smartphone and its myriad and multiplying uses. This disruptive innovation, which started out as the technological Swiss Army knife, has gone on to enable radical changes in not only the global communications landscape but across almost all facets of life and the economy."*

According to the Productivity Commission's [Inquiry Report into Competition in the Australian Financial System](#) (PC AFS), during 2007, about 3 million Australians received financial advice, or approximately 20% of the adult population at the time. The PC AFS report notes that during 2016, about 2.6 million Australians received financial advice, or only 14.5% of the adult population, nine years later.

Far from expanding and assisting more Australians in the important task of securing their financial futures, the financial planning industry (yes, I said industry) is failing to engage people with a value proposition that resonates. Investment Trends estimates that 48% of adult Australians, or some 9 million people, have unmet advice needs. What gives?

### **Costly, complicated and untrustworthy**

There are three hurdles that the advice industry has to overcome if it is to engage with, and genuinely provide, a value-added service to more Australians.

#### **1. Too costly**

From a global context, wealth management (as financial advice or planning is generally known) is a niche service for the wealthy. It's an industry that was conceived to serve the needs of 'High Net Worth' (HNW) clients who could afford the costs involved in the provision of advice.

In the post-FoFA era, the cost of providing advice simply does not square with the fee appetite of the majority of non-HNW clients. The PC AFS report noted that the cost of providing comprehensive advice averaged \$2,500, but people are only willing to pay \$780 on average to receive such advice.

In a post-[FASEA](#), post-Hayne Royal Commission world, the costs of providing advice will rise, precluding even more Australians from receiving the financial advice they desire and deserve.

## 2. Too complicated

Many Australians neither want nor need comprehensive ('holistic') financial advice. That 50-page Statement of Advice magnum opus incorporating debt, cashflow management, superannuation, retirement planning, insurances and estate planning is of interest to far fewer prospective clients than the advice industry cares to admit.

What people increasingly want is piece-by-piece advice on issues of concern at the point at which they occur. Rather than the all-encompassing comprehensive financial plan, the growing demand is for 'scaled advice'. It must be suitably qualified, efficiently provided and at a price that reflects the nature of the advice.

## 3. Too untrustworthy

A recent Investment Trends report indicates that trust in financial planners has fallen to an all-time low, with a survey of over 8,000 respondents revealing that on a scale of 0 – 10 (with 10 being the most trusted) financial planners now sit at 4.8, placing them in the 'distrusted' range.

There is little doubt that the revelations at the April 2018 hearings of the Hayne Royal Commission of systemic and persistent failings by some of Australia's largest advice providers have impacted the public's perception of the advice industry. Many of the issues raised involved contraventions of the FoFA obligations that [I've previously opined on](#). The advice industry has struggled to come to grips with the implementation of these changes years after they came into effect in 2013. These transgressions will likely now accelerate the removal of concessions, especially grandfathering of commission arrangements.

### Roboadvice to the rescue?

First, one small gripe. The term 'roboadvice' does a disservice to both providers and users of this technology. It's a pejorative phrase, coined in the US by those threatened by its arrival, thus labeling it with a term suggestive of killer droids from some dystopian future arriving to destroy advisers and take captive their HNW clientele. Nothing could be further from the truth.

In fact, the technology created by Clover.com.au and others like us who manage investments on behalf of clients can best be described as digitally-enabled advice. The technology facilitates user *engagement* in the advisory process, to produce the necessary disclosure documents in a compliant manner (for digital advisers that provide personal financial advice), to automate the on-boarding of a client (Know Your Client, AML/CTF, bank or broker account opening). Thereafter, it provides an ongoing service incorporating cashflow and market-based rebalancing and regular reporting, depending on the contractual nature of the on-going service.

Digital advice (the term preferred by ASIC) is as much about the automation of the **middle and back office functions** of a financial practice as it is about the front office interaction with the client. If digital advisers impact anyone in the financial advice industry, it's more likely to be paraplanners, customer service officers and compliance personnel who won't be required to the same degree in digitally-enabled offerings.

### Future-proofed from birth

So why is digital advice here to stay, and will in time become a key component of future-oriented financial advice dealer groups and practices?

The reasons are simple. Australian digital advice was created from inception for a post-FoFA world where transparency, compelling user engagement, simple investment strategies that are evidence-based and low-cost and [unapologetically favour the client's interests](#) over competing interests are defining features of the digital advice value proposition. As Commissioner Hayne noted in his Interim Report:

*"The interests of the client are to obtain the best financial advice reasonably available. More particularly, if the advice is for the client to acquire some financial product, it is in the client's interests to obtain the best product; best in the sense that it is fit for purpose but best in the sense also that it is the cheapest and (as far as can reasonably be determined) the best performing product available."*

Australians are increasingly turning to digital advisers. Investment Trends, in reporting that 27% of the Australian online investor population has heard of the term 'roboadvice', recently opined that *"roboadvice will take centre stage as more solutions become available, and as investors themselves begin to engage with these non-traditional advice models."*

**Why does CSC matter more than CAC in the long run?**

Graham Hand's piece, quoting the irrepressible US sage of all matters financial advice, Michael Kitces, noted that the Cost of Acquiring a Customer (CAC) is notoriously high in financial advice, and that this marketing cost would be difficult for digital advisers to overcome and lower over time, relative to the low fees charged by digital advisers.

In terms of engaging more people, and particularly people with lower investible assets earlier in life, Kitces is right when he [says that](#) ...

*"... the problem is not the lack of a business model to serve the masses effectively; the problem is a marketing model to convey the value of financial planning to the masses effectively, and doing so at a cost-effective price point that doesn't bury the business model in too-high client acquisition costs."*

True, but we need to acknowledge that CAC is high in financial advice in large part **because** of the trust deficit that exists. A legislative environment has developed to protect investors from industry participants who seek to put personal financial interest above those of their clients. The lower the trust factor and higher the financial stakes, the higher CAC invariably will be.

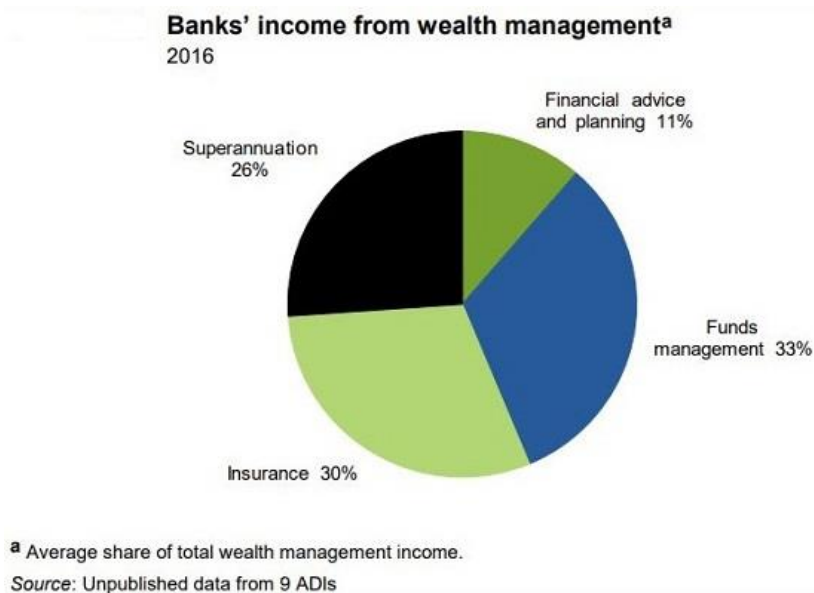
In an Australian context, however, it is becoming increasingly apparent that in the future, it is not CAC that will determine the long-term winners in financial advice but the Cost of Servicing a Client (CSC).

The Royal Commission laid bare an inconvenient truth: the financial advice industry that emerged in the 1980s adopted the modus operandi of the insurance industry from which it evolved. It was a transaction-based, sales-oriented business model fueled by an opaque compensation structure in commission payments between product provider and advice giver.

The business model was never designed for the provision of ongoing services, and so CSC was never factored into the equation. Now it is front and centre.

In a post-FoFA world, the CSC will almost certainly rise, and reduce the viability of advice for even more Australians. The risks to the current 14.5% market penetration of traditional financial advice are more to the downside.

In fact, as the following chart from the PC AFS shows, for nine deposit-taking institutions dominated by the Big Four banks, financial advice is primarily a distribution strategy for asset management and platforms, and makes little money in its own right. Except for Westpac, the three others are exiting advice as it's simply not worth the problems.



## A hybrid model will prevail for most people

It need not be so. The real future of financial advice may be neither purely digital or purely human, but a hybrid of advisers doing what they do best: engaging in honest conversations, determining financial needs, goals and objectives. Then they will use digital advice technologies to deliver investment solutions, investor education, client on-boarding, portfolio implementation and ongoing monitoring, reporting and compliance requirements.

As ASIC opined in its submission to the PC AFS report:

*"An effective advice market should accommodate the diverse needs and different financial circumstances of consumers, deliver advice in a cost-efficient manner and be accessible through a variety of channels."*

Digitally-enabled advice offers the best hope for such a future to emerge, to the advantage of all Australians, not the shrinking minority who will be able to engage financial advice in a post-FoFA, post-FASEA, post-Royal Commission world.

Harry Chemay is a Co-Founder of the digital advice provider [Clover.com.au](http://Clover.com.au).

## Taxpayers with lowest tax rate are hardest hit

Jon Kalkman

In all the talk about refundable franking credits, it is easy to overlook the fact that a franking credit is additional income as well as a tax credit. The purpose of Australia's franking system is to transfer all of the company profit to the shareholders as additional income where it is then taxed at shareholders' marginal tax rates. But the shareholders only receive the dividends as money in the bank, which are paid out of the company's after-tax income. Therefore, the shareholder also needs to include the company tax portion, withheld by the Tax Office, as well as the dividend in their taxable income. The portion withheld by the ATO then becomes a tax credit that can be set against the taxpayer's own tax liability.

### It's not only a high-income impact

At present if that tax credit exceeds their tax liability, taxpayers are entitled to a cash refund, just like a PAYG taxpayer who finds their employer has paid too much tax on their behalf. Under Labor's proposal, franking credits will not be abolished, but excess tax credits will be withheld. The effect is that taxpayers with the lowest income tax rates are hardest hit. It's not "excessive tax concessions for high income superannuation accounts" as [Labor claims](#).

Company tax is a constant 30% regardless of the amount of profit being taxed. When that company profit is transferred to the shareholder for tax purposes, it is **both additional income and a tax credit to account for the company tax already paid**. The franking credit therefore represents 30% of the total income that a taxpayer derives from Australian shares.

Income taxes are progressive. This generates excess franking credits (and therefore tax refunds) on **all** low and middle incomes:

<i>Taxable income</i>	<i>Tax on this income</i>
<b>0 – \$18,200</b>	Nil
<b>\$18,201 – \$37,000</b>	19c for \$1 over \$18,200
<b>\$37,001 – \$90,000</b>	\$3,572 plus 32.5c for each \$1 over \$37,000
<b>\$90,001 – \$180,000</b>	\$20,797 plus 37c for each \$1 over \$90,000
<b>\$180,000 and over</b>	\$54,097 plus 45c for each \$1 over \$180,000

As income rises, not only do taxpayers pay more tax, but they pay an increasing proportion of their income in tax. For example, from the above table the tax on an income of \$37,000 is \$3,572. The marginal tax rate on each additional dollar is 19%, but as a proportion of the total, the tax is only 9.65%. This is the average tax rate. The tax on \$90,000 is \$20,797. The marginal tax rate on each additional dollar is 32.5%, but as a proportion of the total, the tax is 22.1%. A taxpayer earning \$90,000 pays *proportionally* more tax than someone earning \$37,000.

If we were to revert to the situation that existed before 1987 when there were no franking credits, and there were no tax refunds, tax on dividends would then be identical to the tax on bank interest.

Taxpayer >	A	B	C	D	E
<b>Dividend</b>	21,000	35,000	49,000	70,000	140,000
<b>Tax payable</b>	532	3,192	7,472	14,297	39,297
<b>After-tax income</b>	20,468	31,808	41,528	55,703	100,703
<b>Average tax rate</b>	2.53%	9.12%	15.25%	20.42%	28.07%

If we fast-forward to today and assume that all of our example taxpayers' income is derived from franked dividends, the following table illustrates how the constant rate of company tax interacts with the rising proportion of tax as incomes rise. For simplicity, the tax payable has ignored the Medicare levy, which increases the tax, and tax offsets which reduce it.

Taxpayer >	A	B	C	D	E
<b>Dividend</b>	21,000	35,000	49,000	70,000	140,000
<b>Franking credit</b>	9,000	15,000	21,000	30,000	60,000
<b>Taxable income</b>	<b>30,000</b>	<b>50,000</b>	<b>70,000</b>	<b>100,000</b>	<b>200,000</b>
<b>Tax payable</b>	2,242	7,797	14,297	24,497	63,097
<b>Tax credit</b>	9,000	15,000	21,000	30,000	60,000
<b>Refund</b>	6,758	7,203	6,703	5,503	-3,097
<b>After-tax income</b>	<b>27,758</b>	<b>42,203</b>	<b>55,703</b>	<b>75,503</b>	<b>136,903</b>
<b>Average tax rate</b>	7.47%	15.59%	20.42%	24.50%	31.55%
<b>LABOR PROPOSAL</b>					
<b>After-tax income</b>	<b>21,000</b>	<b>35,000</b>	<b>49,000</b>	<b>70,000</b>	<b>136,903</b>
<b>Proposal effect</b>	-32.18%	-20.58%	-13.68%	-7.86%	0%

In the table above, it is clear that the franking credit is a constant 30% of the taxable income. It also shows that the franking credit exceeds the tax liability on all incomes where the 30% company tax rate exceeds the average income tax rate. That excess tax credit is presently refunded as cash.

If the franking credit is additional income for one taxpayer, it must be additional income for all taxpayers. If it is not additional income, we would be using Table 1 and everyone would be much worse off, precisely because it would be a return to double taxation.

### Effective minimum tax rate becomes 30%

The franking credit is income that is additional to the dividend. Taxpayer 'A' has a taxable income of \$30,000 and pays \$2,242 in tax. With the tax credit of \$9,000, they are entitled to a cash refund of \$6,758. Under Labor's proposal, that excess tax credit will be withheld. Without the refund of the excess tax credit, Taxpayer 'A' has a taxable income of \$30,000 and an after-tax income of \$21,000. They have paid \$9,000 tax on that taxable income compared to a PAYG taxpayer who pays \$2,242 on the same taxable income. Without the cash refund, the effective minimum tax on those dividends is 30%, regardless of the marginal tax rate.

Clearly the cash refund does not depend on whether or not you pay tax, as Mr Shorten claims, but on the difference between the franking credit and your own tax liability. Without the cash refund, the after-tax incomes of many low and middle taxpayers are reduced. For low incomes that reduction in after-tax income is proportionally very large because the difference between their average tax rate and the constant company rate is also large. For higher incomes the reduction in after-tax income from this proposal becomes proportionally smaller because the difference between the constant franking credit rate and the average tax rate also becomes smaller.

### High income earners pay enough tax to use the franking credit

That difference between the two rates disappears completely when the average income tax rate is equal to the company tax rate of 30%. But the average income tax rate does not reach 30% until incomes are very high.

The above table shows that only taxpayer 'E', with the highest income, will not experience any reduction in after-tax income as a result of Labor's proposal and will continue to be able to fully utilise their franking credits to pay their tax liability.

All taxpayers with dividend incomes below \$140,000 will lose some of that tax credit refund, and those on the lowest incomes lose the most proportionally. This proposal has the effect of hitting taxpayers on the lowest tax rates the hardest, unless they belong to one of the exempt groups.

The ignorance around the fact that taxes on company profits are **both additional taxable income and a tax credit for shareholders** allows Labor to pretend that company profits are somehow separated from the shareholders who are responsible for the tax payable on that profit. Labor's proposal focuses only on the tax credit, which may or may not be refunded, while ignoring the fact that shareholders also have a higher taxable income (and tax liability) due to those dividends and company taxes. To complete the fiction, Labor likes to pretend that franking credits are a gift from the ATO through a loophole unavailable to less sophisticated investors.

Under Labor's proposal, the effective **minimum** tax rate on dividends (and only dividends) will be 30% **regardless** of a taxpayer's marginal tax rate for all 'non-exempt' Australian shareholders. Although retirees tend to have lower marginal tax rates, the impact of this proposal is certainly not limited to retirees.

*Jon Kalkman is a former Director and Vice President of the [Australian Investors Association](#). This article is for general information only and does not consider the circumstances of any investor.*

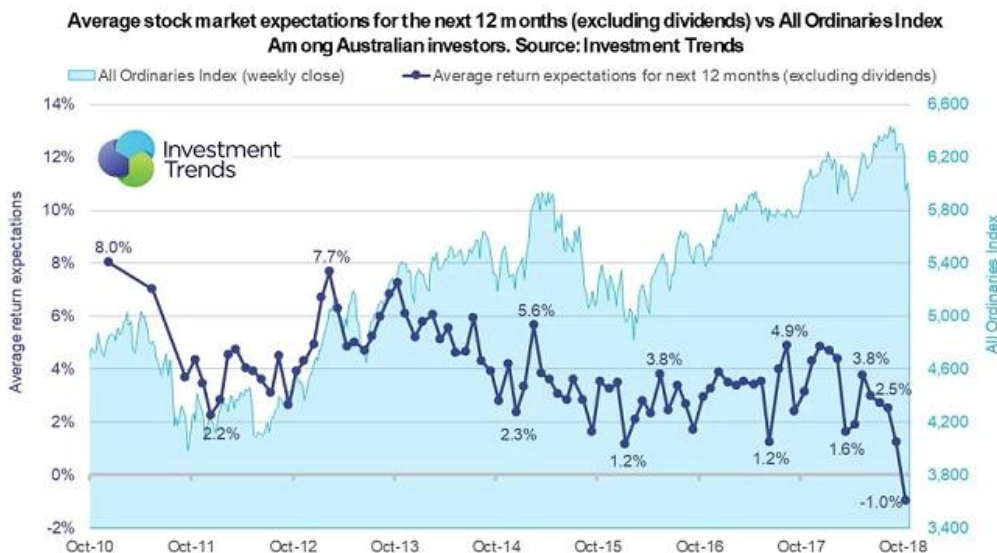
*See also: Data analysis by SuperConcepts, [Poorer retirees to be hardest hit by ALP franking credit changes](#). It argues: "A 20-year projection of different income levels confirms that lower earning retirees will be hit hardest by the ALP's proposed removal of franking credit refunds. Data analysis by SuperConcepts confirms that retirees with an account-based pension receiving a minimum pension amount of \$45,000 per annum at age 65, will find themselves 15% worse off in retirement savings after 20 years."*

## Share outlook turns negative for first time

Recep Peker

According to the Investment Trends October 2018 Investor Intentions Index, Australian retail investors' stock market return expectations have slipped into negative territory for the first time since tracking began in 2009.

Each month, Investment Trends asks investors what return they expect from the Australian stock market, excluding dividends, over the coming 12 months. In October 2018, the average capital gain expectation of investors fell to -1%, down from +1.2% in September and +4.7% in January this year. For the first time, on average, investors expect domestic markets will be lower in 12 months' time than where they are today.



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## Investors believe we're in a bear market

By way of comparison, when asked to rate their level of concern with global financial markets, in February 2018 the average investor was the least concerned since the GFC. In fact, throughout 2017 investors became increasingly desensitised to both market volatility and global events.

Fast forward to October 2018 and the picture is very different with concern levels reaching a 22-month high. While recent volatility has played a hand in driving this pessimism, investors are now more concerned about major global issues.

## Geopolitical events cast a darker shadow over investors' outlook

When asked what they are most worried about, investors cite:

- the current White House administration (46%)
- tension between the world's major economies (40%)
- global debt levels (33%)
- China slowdown (32%), and
- recent share market volatility (27%)

Whether directly or indirectly, Australians are concerned about the economic outcomes of the current White House administration and the trade policies being implemented both by the US and in response to them.

With capital gain expectations for the Australian stock market turning negative at the same time that the local property market has cooled, for financial services there's a big job to be done to convince Australians to stay invested through the current cycle.

*Recep Peker is Research Director at [Investment Trends](#).*

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