

## This Week's Top Articles

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## Government bonds always have a role in diversified portfolios

Paul W. Chin

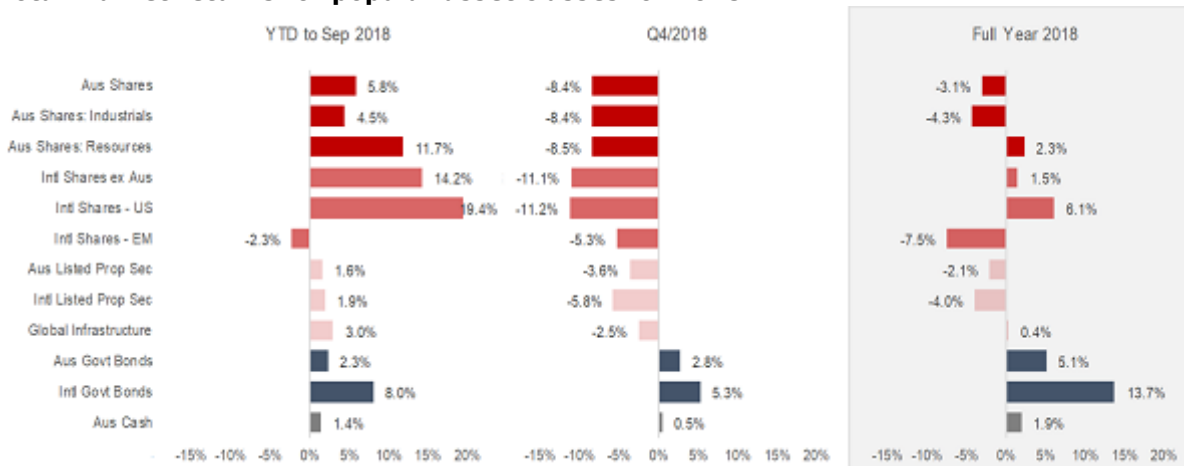
The December 2018 quarter reminded investors of the importance of considering risk when constructing portfolios. Questions remain on a possible global growth slowdown and how asset classes will perform. It is an opportune time to revisit portfolios and fortify them against this sobering outlook with government bonds such as highly rated and liquid sovereign bonds, state-based or agency debt (minimum rating AA) or supranational paper (e.g. World Bank issuing in A\$).

### The investment context

For much of the calendar year to September 2018, adding risk exposures such as shares and property which leveraged easy monetary conditions performed strongly, as shown below. Simultaneously, many questioned the merit of holding high-grade government bonds ('high grade') given apparently higher returning or higher yielding credit-based alternatives.

In fact, over 2018, Australian high grade topped the return charts but, more importantly, played their defensive role, cushioning against negative share markets, providing principal & income stability and delivering liquidity.

### Total market returns for popular asset classes for 2018



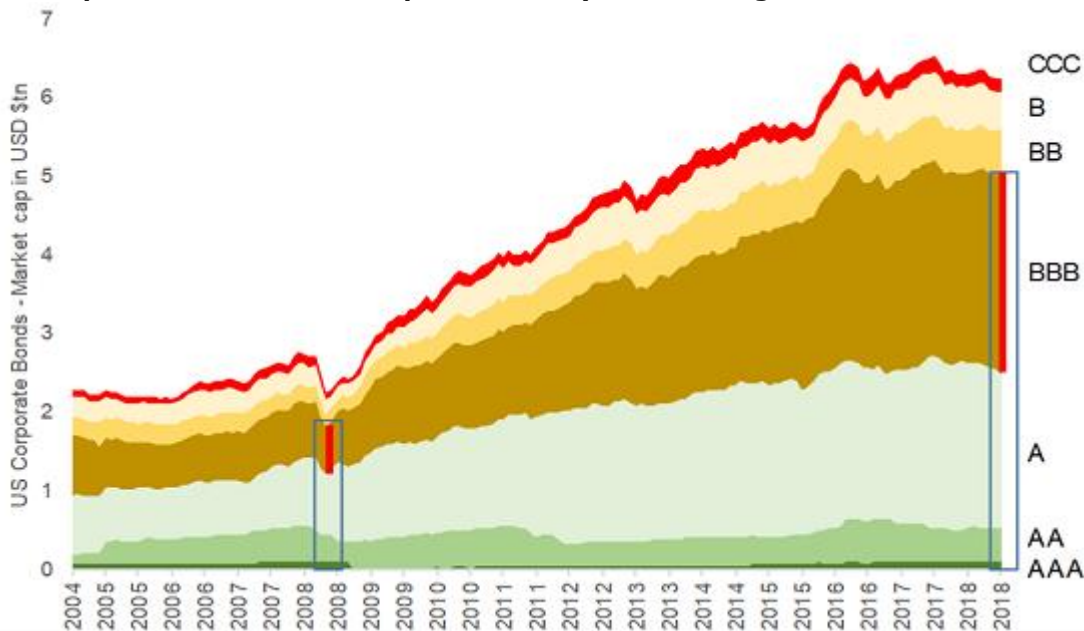
Source: JCB team analysis, Bloomberg to Dec 2018. [\[1\]](#)

## Deep in a late-cycle environment, beware credit-based exposures

The world has continued to lurch even deeper into late-cycle, magnifying financial system risks. The easy conditions (record low policy rates, readily available credit, U.S. stimulatory one-off tax cuts and repatriation) are being reversed by tightening monetary policies worldwide. For investors, these changes have profound implications for defensive 'income' exposures in an anticipated lower forward-return environment:

- Asset class returns since 2009 have been inflated by the distortional policies. A return to properly-calibrated market risk means returns will likely revert to closer to (or lower than) trend partnered with bouts of volatility. In this late-cycle stage, investors should be mindful of being compensated for the risks they are taking.
- Corporates have enjoyed a strong run since the GFC driven by low rates and share buybacks. However, the debt levels they have assumed are enormous at ~US\$9 trillion (a +64% increase since 2009). Now they face the hurdle of rolling over debt into a hiking rate cycle. According to S&P Global Ratings (August 2018), investment-grade corporate credit will need to refinance about US\$600 billion in 2019, ballooning to over \$660 billion in 2020 and to \$700 billion in 2021.
- With around half of all U.S. investment-grade debt rated BBB (i.e. one notch above junk, see below), we question the quality of these assets and the risk of default. The financial system interconnectedness (such as the sources of wholesale funding needed by the large Australian financial institutions) has global implications.

### US corporate bonds market capitalisation by credit rating



Source: JCB team analysis, Bloomberg.

- Credit-based debt is in danger of suffering material and sustained underperformance in a time of tighter lending, less liquidity and ultimately growing corporate defaults. In stressful periods, credit-based exposures have behaved less defensively and more like equities as demonstrated during 2007-2009. The venerable Norwegian sovereign wealth fund, [Norges Bank IM](#), underlined that holding corporate credit amplifies portfolio risk when substantial equity positions are already held. With credit spreads having already tightened in this late-cycle stage, credit-based holdings are not compensating investors for the risks in holding this exposure. This is notable considering the clear dominance of equity holdings in many Australian portfolios.

### How do high grade bonds differ from other bonds?

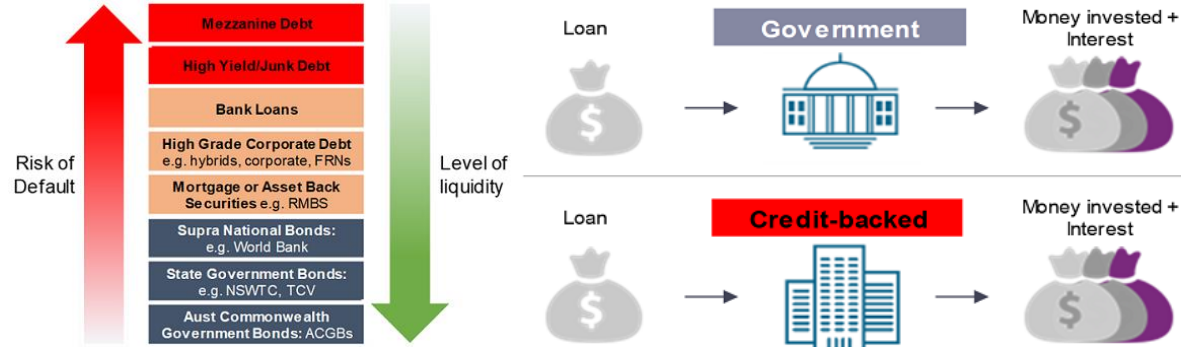
Australian investors are, on average, significantly underweight bonds and, in particular, high grade bonds. Willis Towers Watson's annual Global Pensions Asset Study in February 2018 reported that bond allocations for Australians are small in absolute terms (14%) and low in contrast to other major developed economies, including US (21%), Canada (31%), Japan (56%), Netherlands (50%), Switzerland (34%), U.K. (35%).

The bond allocations as shown below tend to be dominated by credit (corporate debt, hybrids, floating rate notes) and securitised (asset/mortgage-backed) debt which offer a higher yield but come with lower liquidity in times of stress and risks of default.

In contrast, high grade bonds are backed by AAA-rated (or at least AA) issuers such as governments (Commonwealth or state/territory) which is reflective of a relatively solid financial position and an outlook that remains strong versus other developed market countries. The willingness and ability to continue to meet their ongoing obligations should not be an issue.

Not all bond instruments are built or perform the same across different market conditions.

**The defensive instrument hierarchy**



Source: JCB team analysis.

**High grade bonds uniquely defend portfolios**

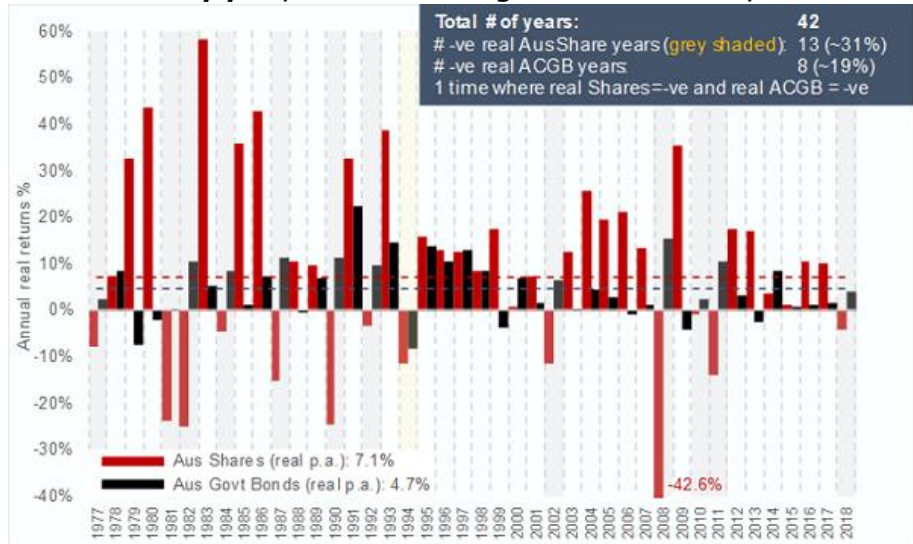
High grade bonds can dampen share market volatility in a diversified portfolio by:

**1. Providing principal and income stability**

The sheer strength of the issuer combines with the macro tools available, such as the ability to raise revenues through taxation, reduce spending and issue more currency. Principal and income stability is generally solid for highly-rated governments, delivering principal and income stability for this asset class. This design means that high grade bonds represent something different other than financial sector risk which is embedded in other assets so common in Australian’s portfolios.

It’s also a key reason why high-grade bonds have historically played an effective role in offsetting weak real (i.e. after inflation has been accounted for) share market performance, as shown below. This has been the case for extended periods, inclusive of varying inflationary and economic periods. Since 1977, there has only been one year where both real returns on shares and Australian Commonwealth Government Bonds (ACGB) have both been negative.

**Real returns by year, shares versus government bonds, 1977-2018**



Source: JCB team analysis, Bloomberg data.

## 2. Performing in a rising rate environment over time

Compared to shares, high grade bonds are self-rebalancing and are an asset class that derives the majority of its returns from income, and the income earned on its income. A hiking rate cycle (lower bond prices) leads to maturing bonds and coupons being re-invested at higher rates. Nearer-term returns may be modestly dampened but, over time, holders of this exposure greatly benefit from compounding.

Contrast this to the experience of corporate debt: a rising yield backdrop would increase the stress on the firm as a dramatically-falling bond price would tend to indicate financial woes. To make good on their coupon obligations, the firm would need to grow income (as they do not have access to the same macro tools governments have) while managing financial stress.

## 3. Delivering portfolio liquidity

The underlying securities attract major offshore investor interest (over 60% of investors in ACGB are from overseas given relatively attractive yields). Term deposits have the investor locked into terms and redeeming early generally results in penalties.

### Closing thoughts

Liquidity and asset quality in defensive assets play a key part in effectively mitigating portfolio risk. High grade provide stable principal and income returns and protecting against cyclical downturns. They should play a core role in partnership with other defensive assets across the spectrum such as credit and cash.

The challenge is to right-size the allocation so that investors can secure better portfolio control and be clear on sources of return between high grade bond and credit exposures. In the current late-cycle environment where Quantitative Easing is converting to Quantitative Tightening, returns previously enjoyed will become more modest. It is time to shore up defences with high quality and liquid assets.

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[i] Notes to return calculations: Aus Shares: S&P/ASX 300; Aus Shares Industrials: S&P/ASX Industrials; Aus Shares Resources: S&P/ASX 300 Resources; Intl Shares ex Aus: MSCI World ex Aus in A\$; Intl Shares – US: S&P 500; Intl Shares – EM: MSCI Emerging Markets in A\$; Aus Listed Property Securities: S&P/ASX 300 Listed Property Securities Index; Intl Listed Property Securities: FTSE EPRA NAREIT DM; Global Infrastructure: S&P Global Infrastructure; Aus Gov Bonds: Bloomberg Ausbond Treasury Bond Index; Intl Govt Bonds: Bloomberg Barclays G7 Index hedged to USD in A\$; Aus Cash: Bloomberg Ausbond Bank Bill Index. Past performance is not an indicator of future performance.

## Why bother investing in government bonds?

Jonathan Rochford

At this time of year, many investors look back on the returns achieved in various asset classes in the previous year and reconsider their asset allocations. In 2018, Australian government bonds (+5.2%) soundly beat the ASX Accumulation Index (-2.8%). The gains for government bonds were driven by yields falling, with the five-year Australian government bond yield now a miserly 1.84%. This is below the latest reading of consumer price inflation at 1.9%.

Experienced investors know that switching their sector allocation to [last year's winners is a recipe for underperformance](#), and a contrarian approach is much more likely to deliver outperformance. Given all this, is it now time to sell out of government bonds? What alternatives do investors have for the low risk allocation within their portfolio?

### Three common reasons for owning government bonds

The most common reason given for making an allocation to government bonds is the expectation of a negative correlation in returns when riskier asset classes fall. This expectation is based on good historical experience. In times when equities have materially fallen, government bonds have typically delivered solid gains. If an investor is running a 60/40 equities/bonds portfolio, the gains from bonds are expected to provide a decent offset if equities enter a bear market (>20% fall). Many Australian investors with superannuation balanced fund

allocations have less than 10% invested in government bonds. For these investors, the hoped-for bump from government bonds in a downturn will do little to offset the losses taken on the 80%+ of the portfolio invested in equity-like assets.

Based on current yields, this portfolio protection expectation comes at a substantial cost to long-term returns. Current yields provide limited room for bond yields to fall further, meaning the upside for bonds in a downturn is unlikely to be substantial. In effect, government bond investors are paying a high annual premium for insurance that is likely to have a limited payoff in a downturn.

A second reason for allocating to government bonds is their perceived low risk status. For countries like Australia and New Zealand, with relatively low debt to GDP ratios, this perception is reasonable. But for countries like Japan and Italy, there is material credit risk embedded in their government bonds. These countries have a long history of running deficits, rising debt to GDP ratios, poor demographics and no meaningful plan to ever reduce their debts.

When the next downturn occurs, there's a reasonable probability that investors bailout of these government bonds with debt defaults or restructurings required. Even the low risk perception of US government bonds is questionable after a decade of both major political parties supporting very high deficits. If the US government can't balance its budget now with a booming economy, will it ever be able to?

A third reason put forward for holding government bonds is their liquidity during times of crisis. However, this is an apples and oranges comparison. The proponents are arguing that government bonds are more liquid than shares, property and credit investments, all of which have much higher expected returns. A fairer comparison is to bank bills or term deposits. These have higher yields than a five-year Australian government bond and also have good liquidity from their short-dated investment terms. If the investment fees charged by a typical bond manager are included, the yield shortfall on government bonds is even higher.

### Alternatives to government bonds

The merit of various alternatives to government bonds will vary, depending on the investor classification and their liquidity requirements. For investors classified as non-institutional (retail, SMSFs, not-for-profits, family offices), blackboard special term deposit rates of up to 2.75% are available. Building a ladder of maturities allows for a regular return of capital, maintaining good liquidity. Some online savings accounts have even higher rates, but these are often limited to smaller balances.

Investment Type	Suitable For	Current Yield	Maturity	Liquidity
<b>Term Deposits</b>	Non-Institutional	2.00-2.75%	1-60 months	Build a ladder of maturities for portfolio liquidity
<b>Bank Bills/ Commercial Paper</b>	Institutional	2.00-2.80%	1 day-12 months	Very good daily liquidity
<b>AAA RMBS</b>	Institutional	3.40-4.00%	1.8-3.0 years	Currently good, will reduce in a downturn

For institutional investors that cannot access regular term deposit rates, the primary alternatives are overnight accounts, bank bills and commercial paper. One-month bank bills are currently paying 2.02%, with commercial paper paying a premium on top of this to account for the small amount of credit risk involved. Unlike term deposits, bank bills and commercial paper can be traded on a same day settlement basis. Short dated, AAA-rated, senior tranches of securitisation transactions yield around 2.80%. These typically have a weighted average life of 1-5 months.

Institutional investors looking for higher yields but with a similar credit risk and maturity profile to government bonds can also consider AAA-rated residential mortgage backed securities (RMBS). These typically come with a weighted average life of 1.8-3.0 years and yields of 3.4%-4.0%. Liquidity on these instruments is currently good, but this will reduce if there is a downturn. RMBS is a good alternative to government bonds for investors looking at medium- and long-term holding periods. They won't provide an offset to equity losses in a downturn, but they can come with a yield of more than double that of government bonds. Based on the current starting position, AAA-rated RMBS returns will easily beat government bonds in a solid majority of years and over the medium and long term, without adding credit risk.

*Jonathan Rochford, CFA, is Portfolio Manager for [Narrow Road Capital](#). This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice.*

## Know what you own in complex markets

Nicholas Paul

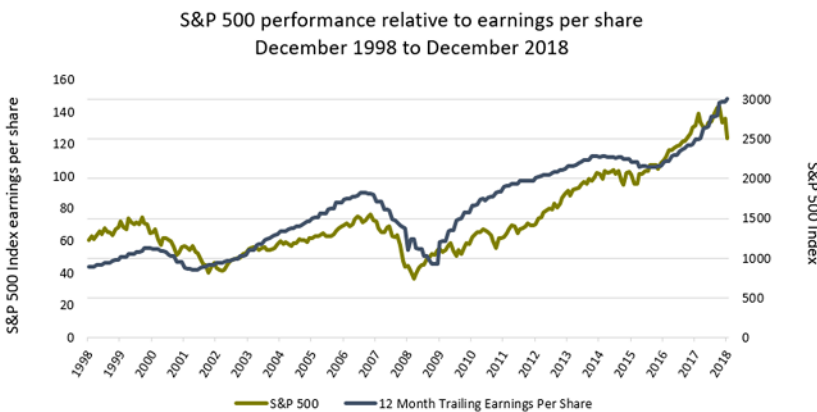
The world economy is experiencing massive shifts involving changes in consumer and business behavior. These shifts have largely been driven by technological advancements combined with where we are in the current business cycle. However, it may not be enough to own the companies behind this innovation and disruption, as these shifts are likely to create ongoing swings in profit pools over the next 10 years and beyond. It may be just as important to avoid companies adversely impacted.

It is critical to 'know what you own' in terms of profitability and earnings growth in such a complex market environment.

### Earnings drive equity returns

Why do we spend so much of our time evaluating the potential earnings and profitability of companies? It's because, over time, earnings generally drive equity returns, as shown below for 20 years between 1998 and 2018. Despite short-term dislocation, which is typically the result of substantive macro risks, stock prices usually reflect the earnings growth of companies. Show me a chart of a company's earnings growth and I'll show you a chart of a company's stock price.

### The strong correlation of earnings and equity returns



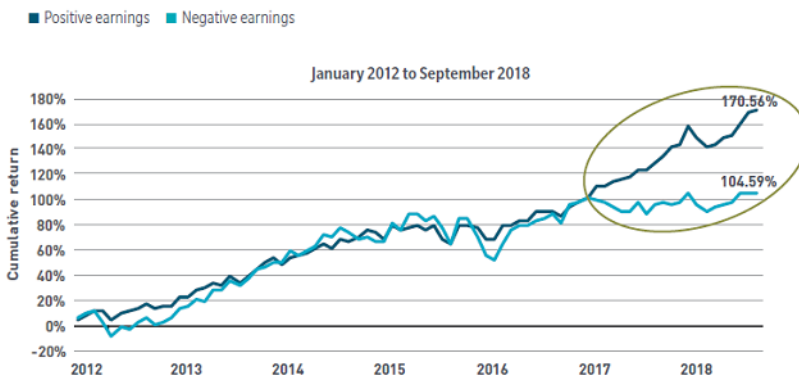
Source: Bloomberg, 31 December 2018

For example, US market earnings growth has been significantly higher than that of non-US markets in the wake of the global financial crisis, and thus we see the greater comparative advance of the US stock market.

### The historical trend favouring quality

Another way to look at the dynamic between profitability and stock prices is through a quality lens that shows companies with positive earnings generally outperform companies with negative earnings by a significant margin, as shown below.

### Quality has performed again after taking a breather



Source: Compustat earnings per share (EPS) data, January 2017–September 2018, for the S&P 500 Index. Each portfolio of positive and negative earnings companies is rebalanced monthly and market-cap weighted. Data labels are cumulative returns, as of 30 September 2018.

However, there are exceptions to this trend. From 2012 to the end of 2016, you couldn't tell the difference between the stock prices of positive and negative earners. There were many reasons for this, including the global central banks accommodative policy creating massive amounts of liquidity, as well as the proliferation of passive investing. It was akin to an episode of *Shark Tank* in which the investors give money to entrepreneurs whether their ideas have merit or not. However, since 2016, the symbiotic dynamic of profitability and stock prices has been restored, which has led to the significant outperformance of the positive versus negative earners.

### **Differentiation and the alpha generation connection**

We have witnessed this scenario play out in our own portfolios. From 2010 to 2015, company financial quality showed less differentiation, as the lower-quality companies we chose not to own generally outperformed. It's no coincidence that this dynamic changed recently, when the Federal Reserve started raising interest rates in a consistent fashion, which also aligns with the charts above. We believe in overweighting companies that we value highly, as well as underweighting (or avoiding all together) stocks in the benchmark where we question the underlying fundamentals and future earnings potential.

In addition to higher rates, it's becoming increasingly difficult for businesses to maintain a sustainable competitive advantage, or barrier to entry, to drive future earnings growth. This is largely due to the massive disintermediation in more traditional sectors and industries (an example is Amazon's impact on bricks-and-mortar retailing) combined with peak profit margins for many companies at this stage in the cycle.

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## **Trading trends feature global moves**

Gemma Dale

A review of nabtrade's annual trading data shows some key trends among retail investors. New accounts – which includes those new to the sharemarket in addition to those switching trading accounts – increased by 13%, while total domestic turnover grew by 2%. All generations were net sellers of domestic equities, as cash holdings reached record highs. On the other hand, international turnover grew by 30% and all investor groups were net buyers throughout the year.

### **Growth driven by younger investors**

While Baby Boomers continue to hold the greatest share of wealth among nabtrade investors, it was the Gen Z (those born after 1995) and Gen Y investors (those born between 1980 and 1995) who recorded the biggest gains, up 73% and 20% respectively in the 12 months to 31 December 2018.

Younger investors remain interested in the blue-chip shares favoured by older generations, such as financials, but also pursued growth stocks such as Afterpay and A2 Milk.

A feature of the top 10 domestic buys among younger investors was the presence of diversified solutions such as ASX200 ETFs. As many younger investors are new to the market and are slowly building their expertise and confidence in investing, diversified products give them broad exposure while minimising stock-specific risk.

Interestingly, younger investors showed similar contrarian tendencies as their older peers when investing in AMP during a tough year for the stock.

These trends reflect easier access to share investing for young investors than would have been available to their parents and grandparents, whose early forays into equity markets would likely have included finding a stockbroker in the White Pages and checking daily prices in the newspaper. Investors can now open an account

online in minutes, free of charge, access high quality research and insights, set up watchlists and invest small sums for brokerage that costs about the same as a smashed avocado breakfast.

### Sector rotations for older investors

For those investors with established portfolios, there was a shift away from financials, consumer discretionary and telecommunications stocks, and an increase in holdings in healthcare and consumer staples.

This reflects a shift toward more defensive sectors in the face of economic and sector specific headwinds, but also concerns about the overweight sector positions many investors have held over the last five years.

While financials dominated the top 10 buys as they have in previous years, they also dominated the sells as investors reduced their overall exposure. Gen Y was the only group to buck this trend, increasing exposure to financials slightly.

### Continuing demand for international equities

nabtrade offers investors the opportunity to invest directly in the US, United Kingdom, Germany and Hong Kong. Appetite for stocks on these markets grew by 30% in 2018, driven by an increase of 38% among Gen Z investors, 32% for Gen X and 31% for Gen Y. Over 90% of these trades were in the US, although demand for Asian, particularly Chinese, stocks continues to increase (these may be listed in the US or Hong Kong). The total number of new customers investing in international shares rose 32%.

Australian investors, particularly younger investors, appear to appreciate that while the Australian sharemarket offers some great opportunities, many critical, fast-growing sectors are not well represented on the local exchanges.

These investors are generally pursuing two key themes – technology and the rise of the Asian consumer. They are often choosing to create exposure directly into the US or Asian markets. For young investors who are checking their Facebook, Instagram or trading accounts on an Apple or Samsung phone, this desire to invest in the products and services they access on a daily basis is entirely logical. The emergence of the Asian tech giants in the top 10 reflects a shift away from the FAANG dominance of recent years and a more global approach to investing offshore.

As with previous years, the only non-technology-based stock to appear consistently in the top 10 International buys is Berkshire Hathaway, Warren Buffett's investment company. These are primarily Class B shares, which are currently priced around US\$200, rather than the better-known Class A shares, which are valued at over US\$300,000.

### Top 10 domestic BUYs by value during 12 months to 31/12/18

Baby Boomers	Gen X	Gen Y	Gen Z
NAB	NAB	NAB	NAB
CBA	CBA	A2 Milk	Afterpay
BHP	Westpac	AMP	Telstra
Westpac	BHP	Telstra	Resolute Mining
Telstra	Telstra	Afterpay	CBA
ANZ	CSL	CBA	AMP
CSL	A2 Milk	Vanguard Aust Share Index ETF	Vanguard Aust Share Index ETF
Fortescue	Fortescue	Westpac	Bellamy's
Macquarie	Rio Tinto	Lynas	Lynas
AMP	Macquarie	Bellamy's	A2 Milk

## Top 10 international BUYs by value during 12 months to 31/12/18

Baby Boomers	Gen X	Gen Y	Gen Z
Apple	Apple	Facebook	Facebook
Amazon	Amazon	Apple	Amazon
Tencent	Facebook	Tesla	Tesla
Facebook	Tesla	Amazon	Apple
NVIDIA	Tencent	Alibaba	Microsoft
Berkshire Hathaway B	Alibaba	NVIDIA	Alibaba
Microsoft	Microsoft	Microsoft	Plus500
JD.com	NVIDIA	Berkshire Hathaway B	NVIDIA
Alibaba	Berkshire Hathaway B	Tencent	Visa
Alphabet Class C	Netflix	Netflix	Netflix

### What about international ETFs

Data on Exchange Traded Funds in 2018 shows international equities attracted the largest flows, so why are none of them in the Top 10 in the nabtrade data?

It might be explained by the specific characteristics of nabtrade investors. They can access global stock exchanges directly in the US, UK, Germany and Hong Kong. We also offer the ASX's mFund range so there is a dilution of investments in any single product or strategy. Global flows are spread between S&P500, followed by NASDAQ, followed by a MSCI-type investments outside the US. Plus many investors are keen to ride the Asian consumer and Asian tech stories, such as Tencent, Alibaba and Baidu. Investors appear to prefer to go direct for specific themes rather than into the indexes represented by the ETF flows. Most nabtrade clients are self-directed, whereas financial advisers are greater users of funds.

*Gemma Dale is Director of SMSF and Investor Behaviour at [nabtrade](#), a sponsor of Cuffelinks. Any information in this publication is of a general nature only. It is not intended to be a substitute for specialised advice and nabtrade is not a registered tax agent.*

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## Great investment expectations are deluded

### Miles Staude

Sadly, investors lost one of their greatest advocates recently, when Jack Bogle, the founder of Vanguard and a pioneer of the index investing movement, passed away. Jack's legacy is that he created a practical real-world application for a well-established academic idea. The efficient market hypothesis holds that the current price of an asset should already fully reflect all available information. Given this, it should be impossible to outperform the market by actively picking stocks or bonds.

### Unrealistic expectations for stable returns

While in the real world, the idea of efficient markets is more a useful framework than an established investing law, over the long run, market returns dominate the outcomes of most traditional buy-and-hold investment strategies. For a typical long-only stock portfolio, market returns will usually explain at least 80% of total portfolio return over time. Mr Bogle identified that the investment returns in the traditional mutual funds could be replicated for a fraction of the cost than was being charged.

The 'Vanguard effect' forced a dramatic re-pricing of fees across the investment management industry. It also established a fair hurdle that all active managers must beat to justify their existence. Perhaps more important,

Mr Bogle's crusade brought home to ordinary investors one of the most important underpinnings of investing: the fallacy that it is easy to consistently and predictably outperform the market.

The idea that beating the market should be thought of as hard and unpredictable is a vitally important concept with a number of significant implications.

Consider how many investors set their own investment expectations. Surveys typically show that investors are wildly optimistic when it comes to their own investment goals. For example, a [2017 global investor survey by Schroders](#) found that 41% of Australian investors expected annualised returns of over 10% from their whole portfolio over the following five years. Similarly, the most recent [ASX Australian Investor Survey](#) (prepared by Deloitte Access Economics) showed that the average return expectation for an Australian investor was 9%. Even more revealing are the acceptable risk tolerances. Fully 67% of Australian investors surveyed by the ASX held a risk appetite that accepted only 'guaranteed' or 'stable' returns. Indeed, the most prevalent investment held was cash, with 56% of those surveyed putting their savings in the bank, compared to only 51% who owned some shares.

### **An inconvenient truth on investment returns**

Humans are emotional actors. When investing, we are prone to behavioural biases such as over-confidence and trend-chasing. The highly-ambitious double digit return expectations could only apply to investors willing to bear the risks in a portfolio solely invested in higher-risk assets, like shares or private equity. There is of course nothing guaranteed, and very little that is stable, about investment into these sorts of asset classes.

Determining reasonable 'long run' return assumptions for an asset class is an inherently problematic exercise. Most academics and industry experts would hold that long run share market return expectations should be somewhere between 5% to 8% a year. While global share market returns have annualised at 9.7% in A\$ terms over the last 10 years, over the last 20 and 30 years (horizons picking up both bear and bull markets) these returns have been 3.7% and 7.1% respectively.

It is a particularly optimistic investor who uses a long-run return expectation of greater than 10%, even for a portfolio consisting only of shares. With cash rates for retail investors at only 2%, such returns are herculean for investors with a low risk tolerance (ie guaranteed or stable returns). Under the efficient market paradigm, it is impossible to outperform the 'market' while taking significantly less risk than the market.

We live in a world of low nominal growth and ultra-low interest rates that looks very different to the past. Over the 10 years leading up to the GFC, the average Australian cash deposit rate was 5.5% and real economic growth averaged 3.6%. Today, growth is running at 2.8% and cash returns are 2%. Economic theory tells us that, short of significant technological change (a possibility), future returns for investors should be a function of current interest rates and expected economic growth.

In the real world, markets are not efficient. There are managers and investment strategies that have shown that they can, to some degree, bend the risk-versus-return equation in favour of investors. Indeed, many of these strategies and managers can now be accessed by retail investors via the ever-expanding breed of new LICs and ETFs arriving onto the ASX. There is a limit however to what investors should let themselves expect as no manager or strategy will perform as hoped all the time.

### **Hope is not a strategy**

For the first time in years, many investors will have suffered losses over the calendar year of 2018, particularly over the final six months. While painful, times like this can serve as a great test to see if your risk profile matches your risk tolerance in both the good years and the bad. If your losses were greater than what you willingly accept from time to time, ask yourself some questions about what you should realistically expect and the risks you are willing to take to get there.

Judging by the survey findings, the average investor today expects high returns from a low growth, low interest rate world. Over the long run, those are not safe assumptions to make when planning for important savings goals like retirement. Happily, there is one sure-fire way to bridge the gap between unrealistic expectations and needing to provide for your retirement. It's not very glamorous and we've all heard it before. Save more.

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## Marks and the tax system explained in beer

Graham Hand

The following explanation of the tax system has been popular for many years, and in his [latest memo](#), Oaktree's Howard Marks uses it and says,

*"I've been waiting a long time for a chance to use this. The numbers may not be exactly right but the idea is. The unarguable bottom line is that everyone's view of the fairness of the tax system – like most such matters – depends largely on the angle from which you look at it."*

Here is an example of the beer explanation:

Suppose that once a week, ten men go out for beer and the bill for all ten comes to **£100**. If they paid their bill the way we pay our taxes, it would go something like this...

The first four men (the poorest) would pay nothing.  
The fifth would pay £1.  
The sixth would pay £3.  
The seventh would pay £7.  
The eighth would pay £12.  
The ninth would pay £18.  
And the tenth man (the richest) would pay £59.  
So, that's what they decided to do.

The ten men drank in the bar every week and seemed quite happy with the arrangement until, one day, the owner caused them a little problem. *"Since you are all such good customers,"* he said, *"I'm going to reduce the cost of your weekly beer by £20."* Drinks for the ten men would now cost just **£80**.

The group still wanted to pay their bill the way we pay our taxes. So the first four men were unaffected. They would still drink for free but what about the other six men? The paying customers? How could they divide the **£20** windfall so that everyone would get his fair share? They realized that £20 divided by six is **£3.33** but if they subtracted that from everybody's share then not only would the first four men still be drinking for free but the fifth and sixth man would each end up being paid to drink his beer.

So, the bar owner suggested that it would be fairer to reduce each man's bill by a higher percentage. They decided to follow the principle of the tax system they had been using and he proceeded to work out the amounts he suggested that each should now pay.

And so, the fifth man, like the first four, now paid nothing (a 100% saving).  
The sixth man now paid £2 instead of £3 (a 33% saving).  
The seventh man now paid £5 instead of £7 (a 28% saving).  
The eighth man now paid £9 instead of £12 (a 25% saving).  
The ninth man now paid £14 instead of £18 (a 22% saving).  
And the tenth man now paid £49 instead of £59 (a 16% saving).  
Each of the last six was better off than before with the first four continuing to drink for free.

But, once outside the bar, the men began to compare their savings. *"I only got £1 out of the £20 saving,"* declared the sixth man. He pointed to the tenth man, *"but he got £10!"*

*"Yeah, that's right,"* exclaimed the fifth man. *"I only saved a £1 too. It's unfair that he got ten times more benefit than me!"*

*"That's true!"* shouted the seventh man. *"Why should he get £10 back, when I only got £2? The wealthy get all the breaks!"*

**"Wait a minute," yelled the first four men in unison, "we didn't get anything at all. This new tax system exploits the poor!"** The nine men surrounded the tenth and beat him up.

The next week the tenth man didn't show up for drinks, so the nine sat down and had their beers without him. But when it came time to pay the bill, they discovered something important – they didn't have enough money between all of them to pay for even half of the bill!

And that, boys and girls, journalists and government ministers, is how our tax system works. The people who already pay the highest taxes will naturally get the most benefit from a tax reduction. Tax them too much, attack them for being wealthy and they just might not show up anymore. In fact, they might start drinking overseas, where the atmosphere is somewhat friendlier.

## Is a Division 293 tax notice coming your way?

Julie Steed

From 1 July 2017, the income threshold above which individuals pay an additional 15% tax on certain superannuation contributions reduced from \$300,000 to \$250,000. In December 2018, the ATO began issuing over 90,000 Division 293 notices for the 2017/18 income year. It is estimated that approximately 44,000 individuals will receive their first Division 293 notice early in 2019.

Importantly, there are no strategies that can be used to reduce an individual's liability for Division 293 tax. However, understanding the options that are available and how the Division 293 notice process works will assist individuals who receive a notice.

### Overview to the lower income tax threshold

People with Division 293 income greater than \$250,000 will pay 15% additional tax on certain superannuation contributions. The tax is a personal tax rather than a tax deducted from super contributions by a fund. However, individuals may elect to release funds from super to pay the tax (see the Choices section below).

Division 293 income includes taxable income, reportable fringe benefits and total net investment losses.

Individuals who are not generally high-income earners may still be liable for Division 293 tax if they receive certain one-off payments during a year. Such payments include eligible termination payments, the taxable component of a superannuation death benefit and capital gains.

However, the taxable component of a super lump sum benefit (other than a death benefit) is not included where it is received by individuals from preservation age to age 59, and it is up to the current low-rate cap of \$205,000.

### Division 293 contribution definitions

Division 293 contributions include:

- employer contributions
- personal deductible contributions
- contributions for a defined benefit interest (valued by an actuary)
- employer contributions (including salary sacrifice) to a constitutionally protected fund

The additional tax does not apply to:

- excess concessional contributions
- non-concessional contributions
- contributions to certain Government funds for senior personnel, unless they are salary sacrifice contributions
- contributions for certain Judges to defined benefit funds

Division 293 tax is 15% of the lesser of the amount of the Division 293 contributions and the amount of Division 293 income and Division 293 contributions above the \$250,000 threshold.

### Case study

Bill has Division 293 income of \$240,000 and Division 293 contributions of \$20,000, totalling \$260,000. Division 293 tax is therefore payable on \$10,000, being the lesser of \$20,000 or  $\$260,000 - \$250,000 = \$10,000$ . The Division 293 tax amount is 15% of \$10,000 or \$1,500.

## Division 293 notice and choices

The ATO issues an [Additional tax on concessional contributions \(Division 293\) notice](#) to individuals which specifies the additional amount of tax that is payable and the due date for payment. The ATO has recently redesigned the Division 293 notice to provide information clearly and concisely. This includes providing the full assessment calculation to make it easier for people to understand how their tax has been calculated. This will also make it easier to identify any erroneous assessments due to incorrect reporting of information.

When an individual receives a Division 293 assessment, they can choose to pay the tax from their personal resources. Alternatively, they can elect to have the amount released from their super fund to pay the tax. The timeframe for making the election is 60 days. However, this may be a greater time frame than the date upon which payment of the tax is due.

The election can be made to release the tax amount from any super fund (other than some defined benefit funds). There is no requirement for the release to be made from the fund that received the contributions.

If an election to have the amount released from super is made, the ATO will send the super fund a release authority and the fund will make the payment to the ATO. Funds are required to make the payment within 10 business days from the date the release authority is issued by the ATO.

Importantly a fund must not release an amount until they have received the ATO release authority. This requirement is sometimes misunderstood by SMSF trustees.

## Conclusion

Understanding the choices available and the process involved in paying Division 293 tax can assist in ensuring that any tax payable is completed in a manner most appropriate to an individual's circumstances.

*Julie Steed is Senior Technical Services Manager at [Australian Executor Trustees](#). This article is in the nature of general information and does not consider the circumstances of any individual.*

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