

This Week's Top Articles

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Sebastian Evans: hanging on until the market catches up

Graham Hand

Introduction: Sebastian Evans is Chief Investment Officer and Managing Director of NAOS Asset Management. NAOS manages three listed investment companies (LICs) with concentrated exposures to Australian listed industrial companies outside of the ASX-50. The LICs are in micro-cap stocks (ASX:NCC), small caps (ASX:NSC) and mid-caps (ASX:NAC).

GH: In the micro investing universe with more than 1,000 companies on the ASX, where do you even start to look?

SE: Sometimes we are criticised for having too few positions but we have strong company screens. We use ESG checks and we don't invest in resources, oil and gas companies, exploration companies and anything smaller than \$10 million in market cap. That rules out most companies.

Then by the time we meet credible managers who can deliver on expectations and run public companies under pressure and meet goals and objectives, we're quickly down to about 50.

GH: Do you meet the management of every company before you invest?

SE: Yes. In some of our investments, we might own 25% of a company, so we're intimate with them – board, directors, senior executives, unlisted competitors, ex-employees ... all the war stories. That's where I spend most of my time, with the investments. We're not traders, we've had some investments for seven years, which is essentially the length of our business.

GH: Given that management have continuous disclosure obligations, what sort of things do you get from them?

SE: The biggest is consistency of the message and that they deliver what they say they're going to do. In small businesses, as soon as something's not consistent or the messaging becomes loose, it tends to show there's something a little wrong. And then it can become seriously wrong quickly.

GH: Are you looking more at the person or the business or both?

SE: I learned the hard way that backing people in small business is almost everything. Good people are driven, they can manage teams, they have to run a listed company, and there are few people who can do all that well.

But if you invest in an industry that's struggling, you're not doing yourself any favours. You want to operate in an industry that has growth prospects today and for 30 or 40 years.

GH: After the success of growth stocks versus value in the last five years, do you feel the decision to restrict to industrial stocks has limited your performance?

SE: From an investment and performance point of view, it's definitely hurt. But from a company brand and business point of view, it hasn't hurt as we're consistent with our messaging. We're very transparent, people understand what we invest in.

Sometimes, the best managers in the world go through periods where they are in the lowest quartile of performance. And unfortunately, although I don't look at tables, I'm sure we're in the bottom quartile in the past 12 months. Would I change it? No, because it's what we feel comfortable with and the team has invested in. There's no point in me managing other people's money and trying to invest in businesses that I can't understand and don't feel comfortable with.

GH: Why have you chosen the LIC structure, given it's a double-edged sword? You raise committed capital but you have to manage problems such as trading at a discount.

SE: We used to run two small managed funds, but we'd spend a lot of time on ratings, getting on platforms, generating advice demand. You know, all the conflicted gatekeepers. The real growth was never going to happen. We were the first LIC to list after the success of MFF (Magellan) but of course the market has come a long way since then.

Using the LIC structure was the smartest thing we did in the Australian micro-cap sector. I heard a prominent fund manager interviewed last week about his unlisted fund and he said, "Never invest in illiquid stocks."

GH: Because of redemptions, which force you to sell.

SE: Yes, and you can't recover your losses. If something goes wrong, the fund can kill you. We take a very different view. We operate in a LIC format. We don't suffer from redemptions and we can invest in illiquid businesses that might be better than liquid businesses. Often it's illiquid because the founder has a large stake. The benefit of a LIC is you're not forced out of some of these businesses today. You can wait for them to become successful businesses.

GH: In the micro space, do you find sometimes you're the only professional analyst?

SE: Yes, sometimes we're the only fund manager on the register. If look at all the positions in our micro-cap fund, there might be two that are covered by brokers with one or two other fund managers there.

GH: And you see that as a comparative advantage?

SE: I do, but people will have their own views. I can get on my mobile phone now and I could call any managing director of stocks we own and they would pick up and talk for an hour and a half about the business. I could ask them for referrals from customers, old employees, whatever. We might not make money on them in the first six months, or even the first 12 months, but I feel we benefit from that level of understanding. A lot of bigger fund managers don't waste their time on a \$10 million investment.

For example, we have a big position in a company called MNF Group. It's a voice-over-internet telco capped at about \$300 million, where the founder owns 40%. Also, Lifestyle Communities, a retirement village operator capped at \$500 million. We understand these businesses, especially when some of them are unloved.

GH: We've talked about the upside of the LIC structure. What about managing the downside? Most LICs trade at a discount to NTA, and a couple of yours are at decent discounts.

SE: Yes, it's frustrating. The LIC that we acquired (*Ed, now ASX:NSC, formerly Contango Microcap Limited*) was a lot harder than I thought it was going to be, as it trades at a big discount. When a LIC doesn't perform, it can fall out of favour quickly, and that's had more sellers than buyers. But I believe if you pay a good dividend, it puts a floor under your share price as long as you've got the reserves for the dividend. Our dividends have gone up every year for seven years.

NAOS spends a lot of time and money on messaging and marketing, even though we're not a profitable business. Our biggest investors are in places like Rockhampton and Adelaide, not Sydney or Melbourne, so for us to find the people who actually invest in LICs is very time-consuming. It's about developing their relationship with us as their fund manager.

GH: It's difficult for anyone to corral SMSFs, with 1.1 million trustees who are hard to identify and pin down.

SE: Exactly. It's a borderline nightmare. You need to find advisers who are not aligned or pitch to individuals on why we can invest in a market better than someone else. While in our space, there's not a huge amount of competition but our performance has been poor. The key is consistency of message but it's definitely not a get-rich-quick scheme.

GH: Given the size of your dividends, are you surprised it hasn't led to more support? Many claim retirees are interested in income and not overly fussed about what's happening with the share price.

SE: I don't think there's a lot of new money coming into equity LICs at the moment due to the uncertainty about franked dividends. They're looking for debt funds and offshore funds. NSC is the one we acquired (*Ed, current discount to NTA 20%*) with 6,000 shareholders, and we added 900 new ones to that but we lost 1,900.

GH: Would you like to name a stock in each of your funds that you're most confident about?

SE: In NAC, our biggest holding is MNF Group, and a lot of products offered by companies like Google and Facebook are voice-over-internet. Uber and Carsales use MNF. In NSC, we like another telco called Over The Wire. It's a one-stop-shop for telecommunication services, cloud services, security services, things like that. And finally, a small one in NCC is a business called Wingarra. They export oaten hay and red meat to China and other places in Asia.

GH: Okay, to finish up, what skill are you most proud of that makes NAOS a better fund manager?

SE: Being able to stick to what we have always said we will do. I've been doing this for 11 years and it's getting harder. Look at all the fund managers that have closed recently, and the competition from ETFs and index funds. I appreciate you've got to understand when something's not going right and you need to adapt to the times. But I think you need to stick to your core philosophy and we've been able to do that. And hopefully, it'll bear fruit at some stage.

Graham Hand is Managing Editor of Cuffelinks. This article is general information and does not consider the circumstances of any investor. Disclosures: [NAOS Asset Management](#) is a sponsor of Cuffelinks, and Graham Hand's SMSF owns shares in ASX:NSC.

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

Do franking credits justify SMSF bias to Aussie shares?

Jonathan Whiteoak and Don Hamson

Many Australian investors have an overly-large allocation or home bias towards Australian shares in their investment portfolios relative to global shares, despite the purported benefits of diversifying more globally.

Australia accounts for less than 3% of the MSCI World index, yet the average large superannuation fund holds 22% in listed Australian shares versus 23% in global listed shares (as a percentage of total assets under management). Expressed another way, half their listed equity exposure is domestic.

Reasons SMSFs allocate to Australian shares

There is no definitive data on SMSFs, but the average SMSF allocation is between 30% and 40% to Australian shares (including via funds) and only about 10% to global shares. ATO data on SMSFs is unreliable because it only shows direct holdings of global shares, not the majority of the allocation via managed funds and ETFs.

Part of this large home bias to Australian shares may be explained by domestic investors having liabilities in Australian dollars (AUD), and they are happy to receive AUD returns to fund AUD expenses. Other reasons include potentially higher costs associated with direct global investments as well as the tendency for investors to invest in companies they are familiar with.

In Australia, we have another reason to invest in domestic stocks: **franking credits**.

Australian companies that pay Australian company tax can distribute franking tax credits to Australian investors, and these can typically boost returns by approximately 1.5% p.a. for the S&P/ASX200.

With franking credits potentially under threat for SMSFs and low tax individuals under the current Labor proposal, it is timely to reassess the impact of franking credits on home bias to understand the impact of changes to taxation policy.

Optimal asset allocation with and without franking

First, even without franking credits, the Australian equity market has provided highly competitive long-term returns. Credit Suisse’s [Global Investment Returns Yearbook 2019](#) shows that the Australian market beat all other developed markets over the past 119 years (1900-2018). Real returns (returns in excess of inflation) in US dollar terms over that period show Australia just pipped the US equity market to take the top spot, realising a real return in USD of approximately 6.5% p.a. In real local currency (AUD) terms, the Australian market rose slightly more at around 6.7% p.a. over the same period. These returns are before franking credits.

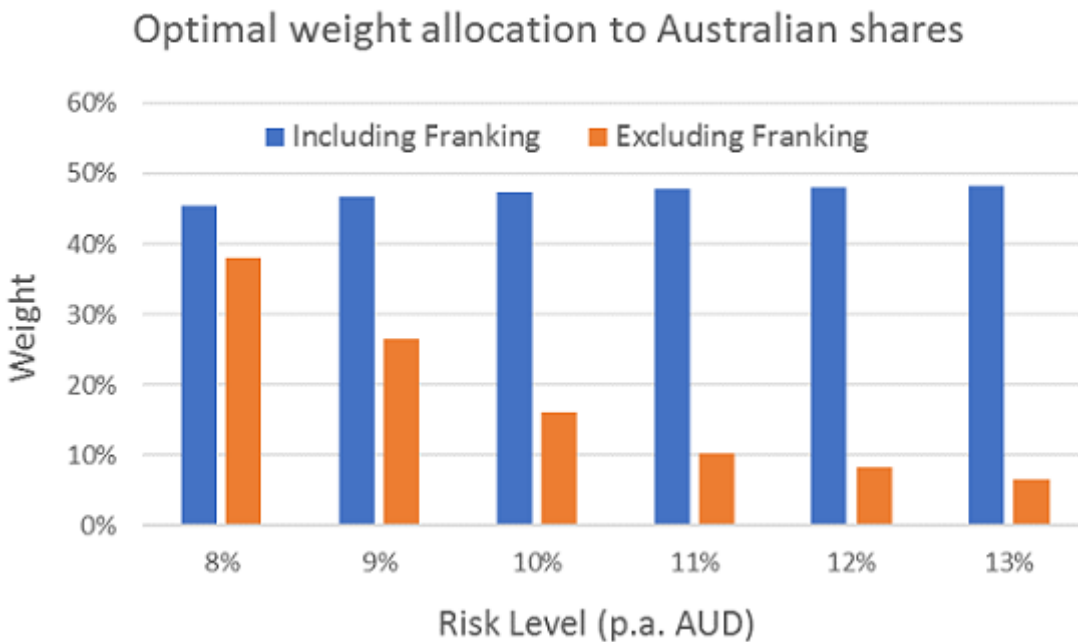
In order to estimate the impact of franking credits, we built an efficient portfolio (where efficiency is based on building the highest returning portfolio for a given level of portfolio risk) based on return expectations which both include and exclude the benefits of franking credits. Unlike most analyses, we build our portfolios bottom-up based on individual stock return expectations, rather than top down using country allocations.

Our portfolios are benchmark-unaware with currencies unhedged. Stock level return forecasts are based on Plato’s global alpha model, with franking credits added for with-franking portfolios. We built a range of optimal portfolios for a given level of total portfolio risk.

The impact of franking

Not surprisingly, Figure 1 shows that when we include franking credits, the optimal allocation to Australian shares goes up.

Figure 1. Optimal allocations to Australian shares within the equity allocation

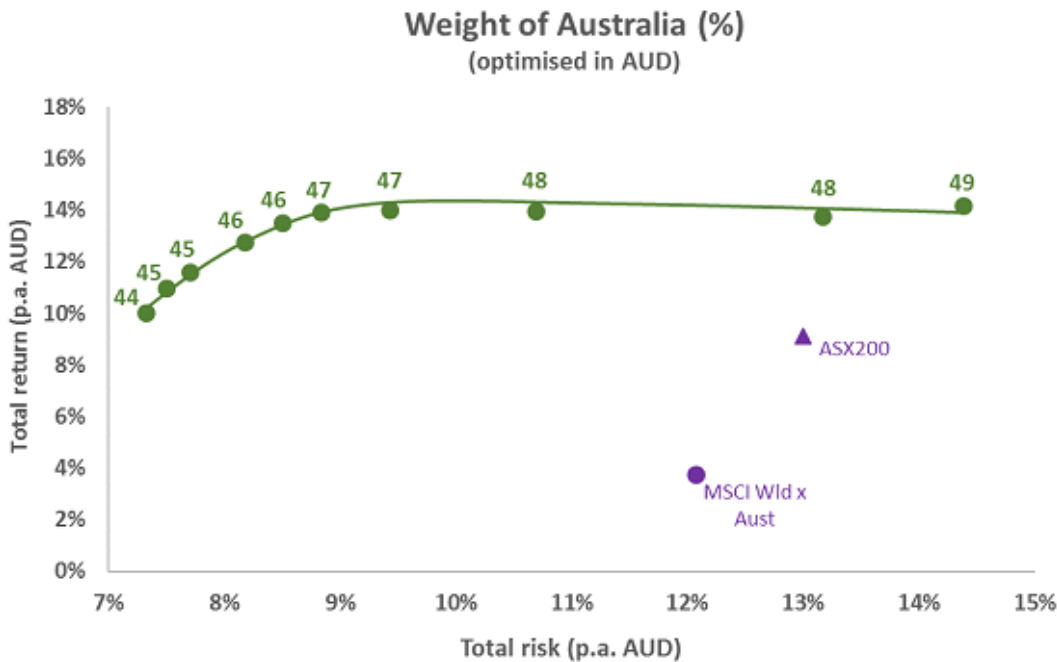


For reasonable ranges of risk, the optimal allocation to Australian shares (within the equity allocation component, not the entire portfolio) including franking is just under 50% which is consistent with the allocations of large superannuation funds. That is, a similar allocation to domestic and global equities.

If we exclude franking credits, efficient allocations to Australian shares fall significantly to just below 40% and as low as less than 10%, depending on the investor’s risk tolerance. That is, at high levels of risk tolerance, the optimal allocation to global equities rises significantly without franking.

Figure 2 plots the efficient frontier for franking credit-inclusive returns, and also highlights the percentage exposure allocated to Australian shares at different risk levels.

Figure 2. The efficient frontier for returns when including franking credits



It also highlights that a portfolio built from individual stocks is significantly more efficient than either an S&P/ASX200 portfolio or an MSCI World ex Australia portfolio. That is, we have built a portfolio with substantially higher returns and significantly less risk than an index investment in either the Australian or global equity markets.

Digging into the results, the weighting in banks tends to be underweight the MSCI index when franking is excluded. However, when franking is included, there is an increase in banking weight of 5-7% for much of the efficient frontier, and this reflects a steering of the portfolio away from global banks and into Australian banks. This is an interesting empirical result and is also an outcome we observe in many retail portfolios.

In summary, our analysis finds that franking credits help explain Australians’ home bias, justifying the average asset allocations of large super funds.

SMSFs still have a problem

Our analysis does not justify the much higher weighting that SMSFs have in Australian shares. Remember, we are looking at allocation within the equity component, not over all asset classes. SMSFs typically have 75% or more allocated to Australian equities within the equity component.

Our analysis would also suggest that for investors who may lose franking credit refund ability under the Labor proposal, **allocations to Australian shares could fall significantly**, by as much as 40% of total equity allocations depending on risk appetite, in favour of global shares.

However, we don’t expect individual investors will all significantly reduce their allocations to Australian shares. While losing franking might encourage many investors to reduce their Australian share exposure, home bias and capital gains tax for taxed investors will likely reduce the amount of money switched from Australian shares.

When we surveyed our clients, 81% of 1,414 respondents said they would reduce exposure but 7% said they would not, with the balance not knowing.

In terms of where investors would re-allocate their funds, for those who did say they would reduce exposure, almost half (46%) said they would increase exposure to global shares. Only 8% of respondents indicated they would increase their exposure to property.

Jonathan Whiteoak is Senior Quantitative Analyst and Dr Don Hamson is Managing Director at [Plato Investment Management](#). This article is general information and does not consider the circumstances of any investor.

Frank(ing) exchange with Bowen: "Is it fair?"

Graham Hand

Editor's introduction

Someone I have known for 30 years sent me this exchange with Shadow Treasurer, Chris Bowen (and we should acknowledge it was good that Bowen responded). The 'fairness' of the franking credits policy has become a major issue for Labor. It was a few days after the initial announcement that the 'pensioner guarantee' was introduced, requiring an arbitrary date of 28 March 2018 for a pensioner in an SMSF to qualify for franking credits.

The policy carries 'horizontal equity' problems, for example, where an investor in a public fund receives a full franking refund while an identical investor in an SMSF loses the refund. Regardless of how people feel about refunding credits, if a policy is based on an important basic principle, why are there so many exemptions or examples of no impact? Among other groups, the wealthiest will retain their franking.

NO LOSS OF FRANKING REFUND

- *Members of public funds (industry and retail) where the fund has enough taxpaying accumulation members to outweigh the pension members*
- *Large SMSFs in both accumulation and pension phases*
- *SMSFs where a member was a Centrelink pension recipient on 28 March 2018*
- *Personal shareholders with a marginal tax rate above 30%*
- *Foreign investors (who could never claim franking)*
- *Companies*
- *A range of special exemptions such as charities and the Future Fund*
- *Other welfare recipients who qualify under the 'pensioner guarantee'*

LOSS OF FRANKING REFUND

- *SMSFs in pension phase (except when qualify for the 'pensioner guarantee')*
- *Personal shareholders with a small portfolio of Australian shares who are not 'pensioners' but have limited sources of other taxable income (and may have a marginal tax rate of zero)*

Here is the reader's cover note, followed by the exchange with Chris Bowen. The sender's name has been blacked out.

"I enjoy your commentaries in Cuffelinks – keep up the good work.

I came to the conclusion long ago that use of the terms dividend imputation and franking credits would not resonate with people whom I needed to alert about the flaws in the ALP policy. It needed to be more simple and pick up on the misleading claims of fairness upon which the ALP bases its pitch.

So the loss of 30% of my SMSF pension is a concept people can grasp although the size of the claimed percentage loss makes them a bit sceptical.

But when I point out that retired politicians (and many others) on a similar pension are unaffected by the ALP policy they become very interested as it appears unfair. This is a very important issue that will have consequences for many vulnerable retirees apart from the ALP's stated target population.

Instead of just grumbling about it I decided to do some of my own politicking! To take my message further I spent some of the pension money that I clearly stand to lose in producing some banners and street signs – see photograph.



However, within 24 hours of installation, these advertisements are usually removed, presumably by people who disagree or who don't want the issue highlighted.

I wrote to Chris Bowen pointing out the problems with the policy and that there were alternative and fairer ways to raise \$8 billion in a budget of \$500 billion. I even suggested simplistic policy alternatives, if you have to go after retirees, like a regressive tax on pension income (however sourced) at a low rate (say 3%) on amounts in excess of \$80,000 as a means of raising revenue. At least this would be fair and consistent with income tax being calculated upon income amount rather than source of income.

People approaching retirement had every right to rely upon the prior arrangements in planning their retirement.

Even the Grattan Institute and the Parliamentary Budget Office acknowledge that the ALP policy, while targeting the wealthy, will also severely affect many people with modest assets and income. These are the less well-off people for whom the ALP used to stand – but now they are getting it in the neck when they are most vulnerable.

There was a time when I used to work at polling booths for the ALP in western Sydney. But Bowen has invited those who disagree with his flawed policy not to vote ALP. I will be taking him up on his proposal and suspect that thousands more who are feeling ALP hands in their pockets will do likewise.

Having got nowhere, I tried the 'fairness' test with him and copies of correspondence are attached for your information."

10 January 2019

Mr C Bowen MP
Member for McMahon
PO Box W210
FAIRFIELD NSW 2165

Dear Mr Bowen

POLICY FAIRNESS

I am a self-funded retiree and I have recently filed my audited returns for our SMSF for 2017-2018.

During 2017-2018 I received a total net pension from our SMSF of just over \$50,000 pa – 31.2% of which comprised tax credits arising from dividend imputation.

Under the retiree tax changes proposed by the ALP, I will lose 31.2% of my net retirement income from the SMSF.

Yet, retired politicians currently enjoying a similar pension rate will not be affected by this policy.

Once your proposed policy is effective the retired politician would continue to receive a \$50,000 pa pension while I will receive \$34,400 pa pension.

Could you kindly advise me why you think that this outcome is fair?

Yours sincerely,



THE HON CHRIS BOWEN MP
SHADOW TREASURER
SHADOW MINISTER FOR SMALL BUSINESS
MEMBER FOR McMAHON

21 January 2019



Dear 

Thank you for your letter of 10 January 2019 in relation to Labor's plans to reform dividend imputation.

Australia is the only country in the world with fully refundable imputation system. Under Labor's policy dividend imputation will remain, but cash payments will no longer be made to people who have managed to reduce their tax rate to zero or have paid no income tax. Tax on company profits will continue to be paid only once under Labor's plans. This is in keeping with the intent of the original dividend imputation system, which was brought in by Paul Keating, and with Labor's principles of a fairness and simplicity in tax policy.

Labor's reforms to excess dividend imputation credits will remove a fiscally unsustainable tax arrangement that is seeing billions of dollars in lost revenue, making it harder for the government to fund important services and return to surplus. Dividend imputation worked perfectly well between 1987 and 2000 when cash refunds weren't sent to people who didn't pay income tax. Labor will return to that system. When cash refunds were introduced, it was estimated to cost the budget around \$500 million a year. The annual cost has now blown out to \$6 billion. An ageing population is set to put even further pressure on the budget in the coming years making it harder for future governments to fund important health care services, which is why this is a growing cost the budget can no longer afford.

It is important to remember that our policy means that no one loses a cent of their share dividends, and no one pays more tax. The very generous tax concessions provided to superannuation which allows many retirees to draw an income which is tax-free will continue to apply.

Labor is focused on creating a tax system that works for all Australians and that the burden of budget repair is evenly shared across the community. We also need to ensure that the budget can help support the delivery of world class health and education systems into the future. Whatever your income or wealth in Australia, I want to make sure that if people

Parliament House
CANBERRA ACT 2600

need to see a doctor or they want to give their children a good quality education, that they can afford it. This is why difficult decisions on the budget are necessary. Whether it be education, health care or dealing with climate change, Labor is really committed to making sure that we hand on a better deal to the next generation of Australians.

Unlike the Abbott-Turnbull-Morrison Government, Labor is prepared to be honest about its plans well in advance of an election. While I understand not everyone will agree with this policy, it is necessary. If this issue is not addressed it ultimately means that working Australians will have to shoulder a larger burden of budget repair. By being upfront with our plans, people will have time to seek advice and if desired, re-structure their financial affairs to reduce the impact of the policy.

Yours sincerely,



CHRIS BOWEN MP
SHADOW TREASURER
SHADOW MINISTER FOR SMALL BUSINESS
FEDERAL MEMBER FOR MCMAHON

30 January 2019

Mr C Bowen MP
Member for McMahan
PO Box W210
FAIRFIELD NSW 2165

Dear Mr Bowen

Dividend Imputation Credits

Thank you for your letter dated 21 January 2019.

In my letter dated 10 January 2019 I had taken the unusual step of disclosing my personal financial circumstances. I had thought that this gesture might have demonstrated my goodwill and elicited a reply to my straightforward question.

Instead I received a pro forma document which did not address my question.

For reference I have attached a copy of my original letter.

I look forward to hearing from you

Yours sincerely,

13 February 2019

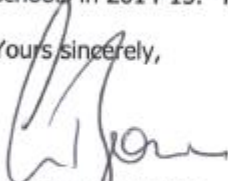


Dear 

Thank you for your letter of 30 January 2019 in response to my letter to you of 21 January 2019.

In your original letter, you spoke about fairness. In my letter to you, I outlined the reasons why Labor is proposing to reform dividend imputation. I won't repeat those reasons, apart from saying it is not sustainable to have a system that provides cash refunds to people who don't pay income tax, which resulted in more being spent on cash refunds than public schools in 2014-15. That outcome is not fair.

Yours sincerely,



CHRIS BOWEN MP
SHADOW TREASURER
SHADOW MINISTER FOR SMALL BUSINESS
FEDERAL MEMBER FOR MCMAHON

18 March 2019

Mr C Bowen MP
Member for McMahon
PO Box W210
FAIRFIELD NSW 2165

Dear Mr Bowen

Dividend Imputation Credits

Thank you for your letter dated 13 February 2019.

In your letter you again failed to answer my pretty specific question by answering a question that I did not ask.

You have already pointed out publicly that you expect to extract circa \$8 bill pa from the current entitlements of self-funded retirees. You estimate that this will exceed current outlays on Government Schools of \$7.7 bill which is a component of the overall federal education budget of \$34 bill.

You could equally have said that this measure will be equal to less than half of the current \$17.8 bill annual interest amount paid on government debt.

But perhaps the optics of that comparison would not be as attractive as the one you have chosen.

For clarity my question was:

Under the retiree tax changes proposed by the ALP, I will lose 31.2% of my net retirement income from my SMSF. Yet, retired politicians currently enjoying a similar pension rate will not be affected by this policy. Could you kindly advise me why you think that this outcome is fair?

I really would appreciate your considered response to what many would regard as a quite reasonable question.

I look forward to hearing from you

Yours sincerely,



~~04~~ April 2019

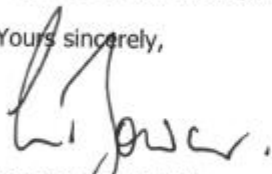


Dear 

Thank you for your letter of 18 March 2019 in response to my letter to you of 13 February 2019.

Politicians may be affected, depending on their individual circumstances. Post-2004 Federal Election politicians such as myself are on defined superannuation contribution schemes, like everyone else. Of course, other policies such as our proposed returning of the Budget Repair Levy will affect politicians.

Yours sincerely,



CHRIS BOWEN MP
SHADOW TREASURER
SHADOW MINISTER FOR SMALL BUSINESS
FEDERAL MEMBER FOR MCMAHON

18 April 2019

Mr C Bowen MP
Member for McMahon
PO Box W210
FAIRFIELD NSW 2165

Dear Mr Bowen

Dividend Imputation Credits

Thank you for your letter dated 4 April 2019 in response to mine of 18 March 2019.

In your letter you again failed to answer my quite specific question by answering a question that I did not ask. It is not clear to me why you choose to do that.

In response to my question reproduced below you observed that '[retired] politicians may be affected by your policy depending upon their individual circumstances'.

For clarity (and I have added some more definition to make my meaning clear) my question was:

*Under the retiree tax changes proposed by the ALP, I will lose 31.2% of my net retirement income from my SMSF. Yet, retired politicians (who are beneficiaries of a defined benefit superannuation scheme) currently enjoying a similar pension rate will not be affected by this policy. **Could you kindly advise me why you think that this outcome is fair?***

I really would appreciate your considered response to this quite reasonable question.

I look forward to hearing from you.

Yours sincerely,

Which political party is best for share prices?

Ashley Owen

It is election season in Australia and I have received the usual questions about which side is better for shareholders.

We have been blessed (or cursed) with 30 Prime Ministers in the 118 years since Federation in 1901, an average of 3.9 years each. If we exclude the temporary 'fill-in' periods of Watson, Page, Fadden, Forde and McEwen, this leaves 25 PMs in 118 years for an average of 4.7 years each. This is almost exactly the same as the US, which has had 45 Presidents (including one twice) in 230 years, an average of five years per President.

Left or right?

For this article, I have labelled each PM and their government as either 'left-leaning' or 'right-leaning' to enable comparisons, with 'right' for Liberal and Country/National parties, and 'left' for Labor.

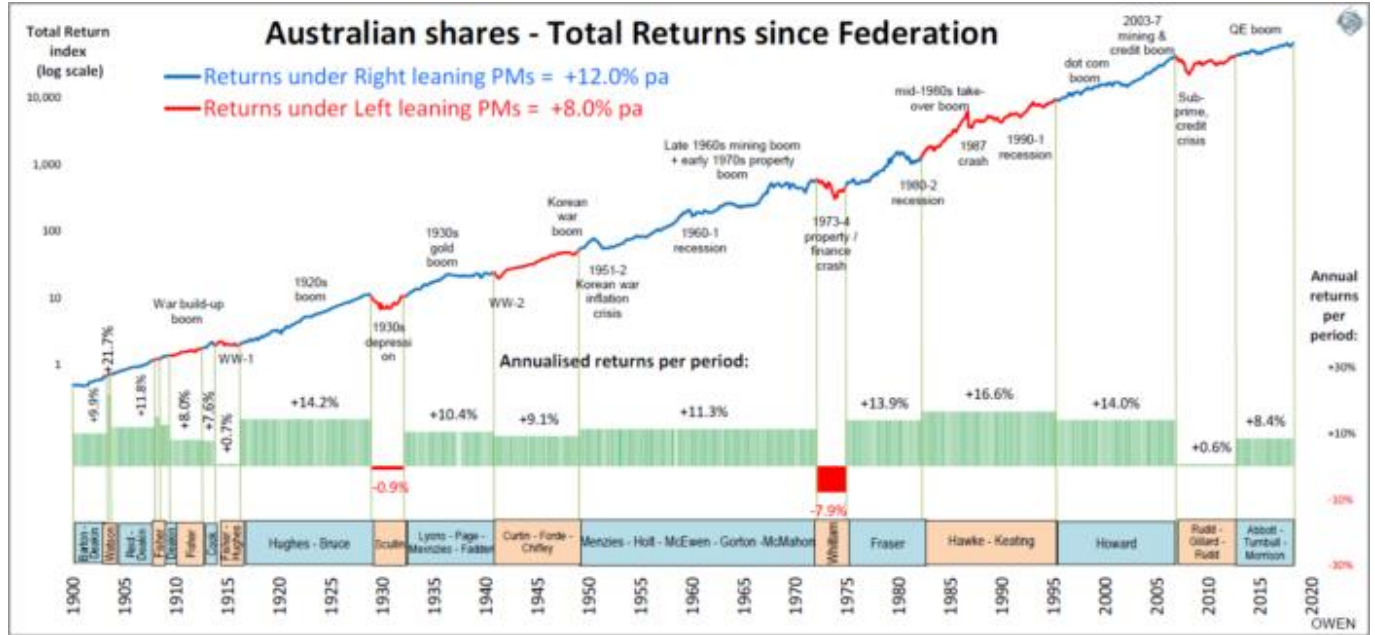
Traditionally, 'left' meant pro-workers, and 'right' meant pro-business but is not that straight-forward. For example, in many ways, the Hawke and Keating Labor governments were more right-leaning than the Fraser Liberal government. There is a degree of subjectivity involved here but it is a good starting point.

On this basis, we have had right-leaning governments for two-thirds of the time and left-leaning governments for the remaining one-third.

The chart shows total returns from Australian shares since Federation, divided into 'right' periods (blue line) and 'left' periods (red line). The average annual total returns (including dividends reinvested) for each period are shown in the lower section.

Returns

Right-leaning governments win but due mainly to luck. Total returns from the local stock market have averaged 10.5% per year since Federation, with 12% p.a. on average under right-leaning governments beating 8% p.a. average returns under left-leaning governments.



Although the 'right' side has clearly won, we can draw no conclusions from this. There are two main problems: causation and luck.

Periods of poor returns

There were only four PMs who presided over periods of very poor or negative total returns from the share market, and they were all left-leaning – Fisher, Scullin, Whitlam and Rudd/Gillard/Rudd. They would all claim that this was not of their making of course. Each would argue that the losses or poor returns were due to the excesses of the prior government, or to global crises beyond their control. They would largely be correct.

First – Andrew Fisher can hardly be blamed for the world-wide stock market falls on the outbreak of the First World War.

Second – Jim Scullin took office just six days before Wall Street's Black Monday on 28 October 1929, after the long 1920s boom under Stanley Bruce. While he can hardly be blamed for the crash, Scullin made things considerably worse with his 'Scullin Tariff' and with the hard-line Niemeyer plan and Premier's Plan to cut spending savagely.

Third – Gough Whitlam came to power on a wave of euphoria after the long period of Liberal rule under Menzies, Holt, Gorton and McMahon. In the brief but volatile Whitlam years, the share market headed straight down with very little respite. The share market collapse in 1973-74 was made worse by Whitlam's credit squeeze and government financing scandals but the mid-1970s was a period of great turmoil across the world. Governments in many countries fell to military coups, insurrections and widespread civil unrest.

Fourth – Kevin Rudd came to power in November 2007 at the top of the 2003-07 boom that had been frothing along under Howard's rein. Despite the massive government stimulus programmes during the sub-prime crisis (the second largest in the world relative to GDP, after China), the local stock market collapsed by more than nearly every other country in the world. Prior to Rudd, we had not only a wild credit boom like they rest of the world, we also had a wild speculative mining boom at the same time, thanks to China's explosive growth. Our boom was bigger than the US and other countries, so our bust was also bound to be bigger.

Periods of high returns

Periods of high returns from shares can often be attributed to rebounds out of recessions, which coincided with the election of new governments. The returns under Joe Lyons from the bottom of the 1930s depression were more a case of recovering over-sold shares in the depression, and the general deflation (which increases real returns), plus the gold boom triggered by the Roosevelt's US devaluation.

The overall winner for high returns was the Hawke-Keating period, with annualised returns averaging 16.6%. These returns were not only a strong rebound from the early 1980s double-dip recessions under Fraser, but also were greatly assisted by the wide-ranging deregulation and economic reforms introduced by Hawke and Keating.

On the other hand, periods of strong economic growth and stable political regimes do not necessarily result in above-average share returns. For example, the great 'long boom' under Menzies in the 1950s and 1960s saw rapid rises in population, living standards, education levels, healthcare, consumer spending, building activity, industrial production and retail sales – but it produced below average returns to shareholders, apart from the brief speculative mining boom at the end of the 1960s which collapsed in the early 1970s.

Cause and effect

Although global events and trends dominate the direction of the local capital markets and economic conditions, global trends do not translate automatically to local impacts. Much depends on the actions of government within each country.

For example, Australia and Argentina had similar economies before the start of the 20th century, and both shared the highest living standards in the world at that time as commodities-exporting former European colonies. However, we have followed different paths since then due largely to the actions and effectiveness (or lack thereof) of governments within each country. Argentina suffered a string of political and economic disasters almost entirely due to internal decisions.

Many governments end in economic disaster, so we should give credit to our governments over the years for not falling into the many traps that have ensnared the majority of countries in the world. There are 240 countries in the world today, but Australia is one of the few that is an open democracy with stable, accountable government and strong public institutions. Only Australia, New Zealand, Canada and the US have delivered an unbroken run of high returns to shareholders since 1900 (aside from the inevitable ups and downs along the way).

The credit for this must go to the governments we elect, and to prior governments that established and developed these institutions. Once these big-picture political and institutional settings are in place, it is very difficult to attribute economic outcomes to particular governments or to claim that one side of politics delivered better returns than the other.

Ashley Owen is Chief Investment Officer at advisory firm [Stanford Brown](#) and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is for general information purposes only and does not consider the circumstances of any individual.

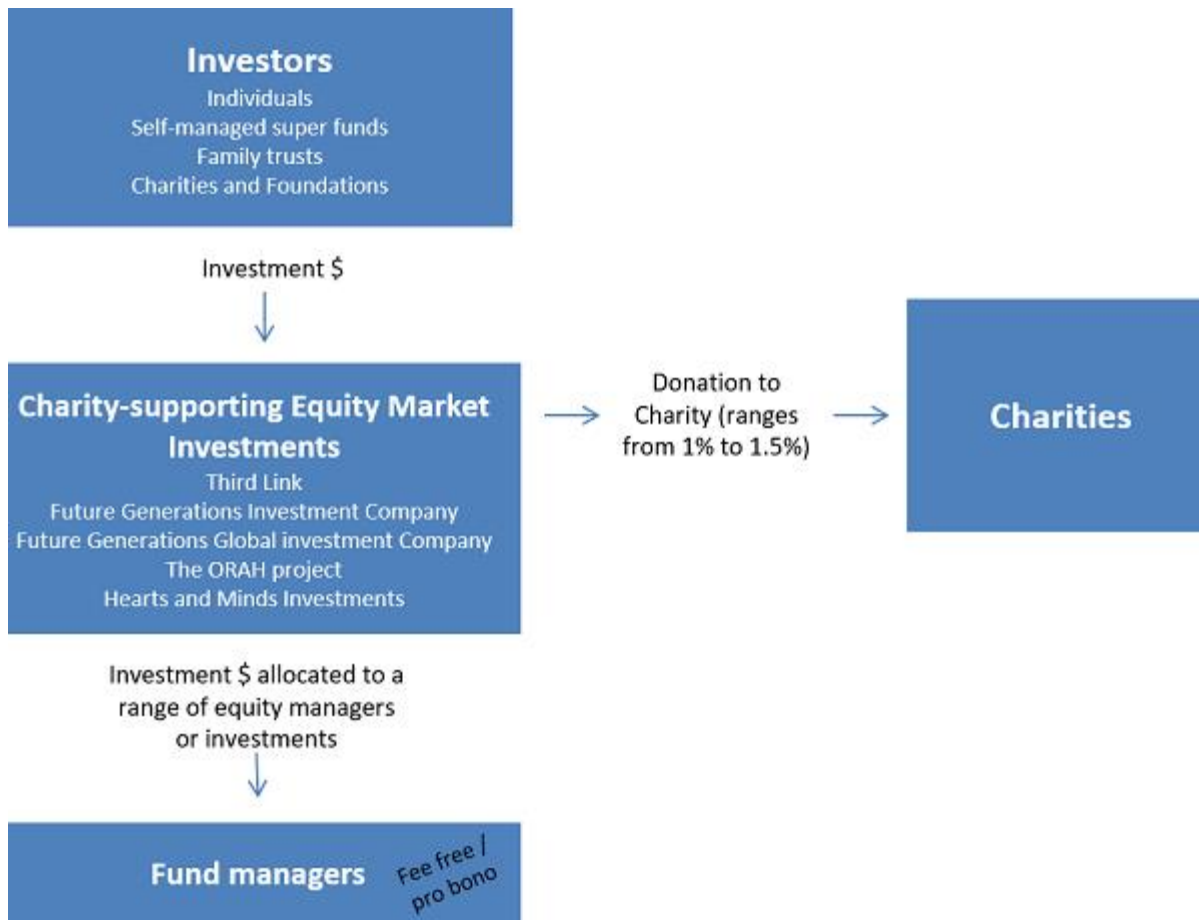
Five charity-supporting investment vehicles

Bernie Connolly

In 2019, charities and not-for-profits will benefit from around \$20 million in donations as charity-supporting investment vehicles come of age. The beauty of it? No investor has to write a cheque while the money is effectively and efficiently managed to the benefit of a wide range of stakeholders.

What is a charity-supporting investment vehicle?

Rather than the fund managers receiving a management fee, it is redistributed directly to charities, providing them with a sustainable and growing income source. This year more than \$1.6 billion worth of investments have gone through the five existing vehicles in Australia, serving the dual purpose of delivering investments returns as well as social returns via charitable donations.



Consider the three main stakeholders in the structure.

1. From the fund manager's point of view

The costs to a single fund manager of investing additional funds or sharing intellectual property is negligible, although the access and knowledge are valuable. To date more than 30 fund managers have embraced the opportunity to support one of the charity-supporting equity investments in Australia. They 'give back' to the charitable sector through a mechanism other than writing a cheque.

2. From the investor's point of view

In our role as advisers, we stress that first and foremost an investment product needs to be considered on its merits and be appropriate in the context of a client's overall portfolio and investment objectives.

The charitable donation tail does not wag the investment dog. That said, the investment managers who sit behind these vehicles are generally good quality and, in some cases, include managers who have otherwise reached capacity and are no longer taking new money from investors.

When this type of investment fits with a portfolio, the investment serves two purposes: it is part of an investment portfolio and it is effectively 'passive giving'. This is beneficial for investors who have a portfolio of assets serving charitable purposes such as Private Ancillary funds, other Foundation or purpose-driven organisations, but only when it fits with their existing investment strategy.

3. From the charity's point of view

The income stream from this type of donor can be a reliable source of income with a growth prospect in line with the investment. Furthermore, the charity is tapping into a new world of passive donors who may have invested on the merits of investment product alone and who would not otherwise be an active or engaged donor.

History of charity-supporting investment vehicles in Australia

Cuffelinks co-founder Chris Cuffe AO was at the forefront of this innovation. He was the key driver in the creation and ongoing success of the first investment vehicle that generated donations to charities, [Third Link](#), in 2008. By 31 December 2018, Third Link had donated over \$10 million to Australian charities.

The structure of Third Link is an unlisted unit trust investing in domestic markets. It has an investment track record of market outperformance and supports children's charities recommended by Australian Philanthropic Services. Although initially an open-ended unit trust, it is now closed for new investments having reached its target size. Fund managers also waive performance fees, which can otherwise be high, and many of the managers are not easy to access directly.

Wilson Asset Management Chairman Geoff Wilson AO created Future Generation Investment Company (ASX:FGX) and its sibling the Future Generation Global Investment Company (ASX:FGG) both under the Listed Investment Company (LIC) structure.

The fund of funds model sees FGX and FGG invest with leading Australian and global fund managers respectively. The management and performance fees waived by the fund managers exceed the companies' annual investment in charities representing 1% of assets, to the benefit of investors. The two companies have donated \$21 million since 2014 to youth at risk and mental health causes respectively.

Investments in FGX and FGG are diversified across Australian and global equity managers respectively, with managers each covering three broad types of strategy – long equities, absolute bias and market neutral. At times it will take cash positions to minimise volatility.

FGX and FGG differ to other charity-supporting investments available today in one key area. Where investors hold more than 1 million shares in either company, that investor can decide which charity the donation goes to. In the case of a charity investing their corpus, the 'fee' can be returned to the charity in the form of a donation – effectively giving fee-free investment management.

The ORAH fund (an unlisted managed investment scheme) is specifically aimed at supporting Jewish causes. As a relatively small fund of funds, it has been able to invest with specialist equity managers including some that are otherwise capacity-constrained.

The most recent innovation is the LIC, Heart and Minds Investments (ASX:HM1). This offering is unique because instead of offering a diversified mix of managers and funds, it holds a more concentrated portfolio of around 25 high conviction securities selected by leading fund managers in Australia and overseas. Donations from Hearts and Minds Investments are directed to Australian medical research institutes. At its current size of about \$600 million, it will give away about \$8 million a year. Chris Cuffe is the Chair and Geoff Wilson is also on the Board.

A potential win-win for all

The generosity of the funds management community combined with the innovation and drive of committed individuals in the financial sector has been the key to the success of these investment products.

For all investors, the potential returns from the investment and an understanding of the risks are paramount but having made the investment decision the ability to generate both an investment return and a social return is compelling.

Bernie Connolly is Executive Director and Financial Adviser at [Morgan Stanley Wealth Management](#). This article is general information and does not consider the circumstances of any individual.

Lifetime income tackles retirement timebomb

David Orford

A typical household has two or three sources of income in retirement including the age pension, income from superannuation and income from non-super investments. Running out of savings means living solely on the age pension which is \$24,081 per annum for singles or \$36,301 per annum for couples.

For those wanting a lifestyle that's higher than the age pension, a complex balance needs to be met between how much we want to spend now and how we preserve some assets for spending later in life.

Typical use of a retirement account

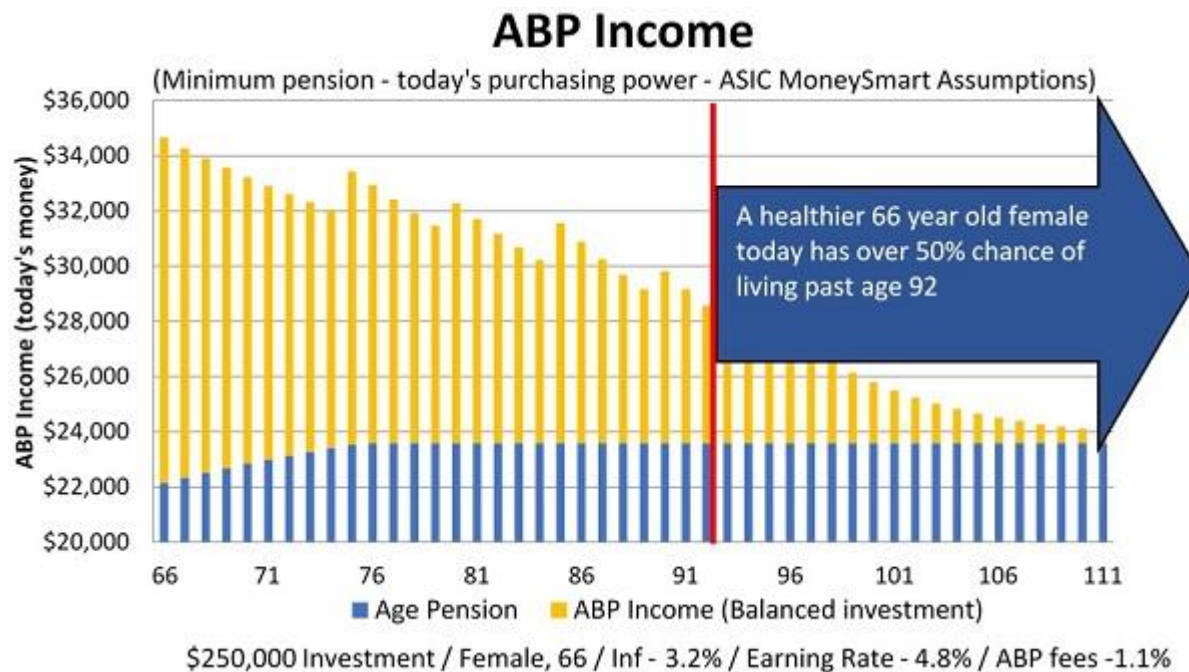
The superannuation product we typically use today to manage the balance between spending and capital preservation is the Account Based Pension (ABP).

ABPs, and their predecessor the 'allocated pension', were designed around 1992, with the purpose of providing an income that is similar to a CPI-linked lifetime pension up to life expectation around age 80. After this they have a declining real income, when greater amounts of the age pension will likely be payable by the Australian Government.

However, it is not usually sufficient to provide a total (ABP plus age pension) income that keeps pace with inflation. Therefore, for many of us, depending on rates of investment return and inflation, an ABP plus age pension may not deliver anything like a CPI-linked income for the whole of our lifetime.

The market risk of an Account Based Pension

As we saw in the GFC in 2008, investment returns above inflation can be very uncertain. The following chart shows the projected income (in today's purchasing power) from an ABP invested in a balanced portfolio using the recommended assumptions in ASIC's MoneySmart retirement calculator. This assumes a rate of return of just 4.8% per annum, less fees of 1.1% per annum and a 3.2% allowance for cost of living increases throughout retirement. Presumably ASIC is being conservative to allow for the fact that ABPs carry significant investment market risks.



You can see from the blue line that in the earlier years of this person's retirement only a part pension is received (due to means testing). The retiree relies more on consuming their own savings for their income until the full age pension applies from their mid-70's onward.

By age 95, the spending power of the income from the ABP under this scenario has dropped to around one-third of what it was at age 66. This is a far cry from the product's objective when it was designed in 1992 - to provide a CPI-linked pension - even if only to life expectation.

Longevity risk is increasing

Longevity is increasing, which is a benefit to each of us, but creates two financing problems:

1. Have we each saved enough to avoid poverty in retirement?
2. How can we spread our savings over longer periods in retirement?

More of us are living well into our 80's and 90's now and are often running low on savings. As an indication, a healthier 65-year-old female today has a 50% chance of dying between age 92 and 110. Taking into account that most retired households have a female member, it's a fair question to ask: has Australia outlived the ABP?

Making sure your retirement income lasts for life

The options we have for retirement income now include:

1. **Account Based Pension (ABP)**
2. **Traditional Lifetime Annuity**
3. **Real Lifetime Pension**

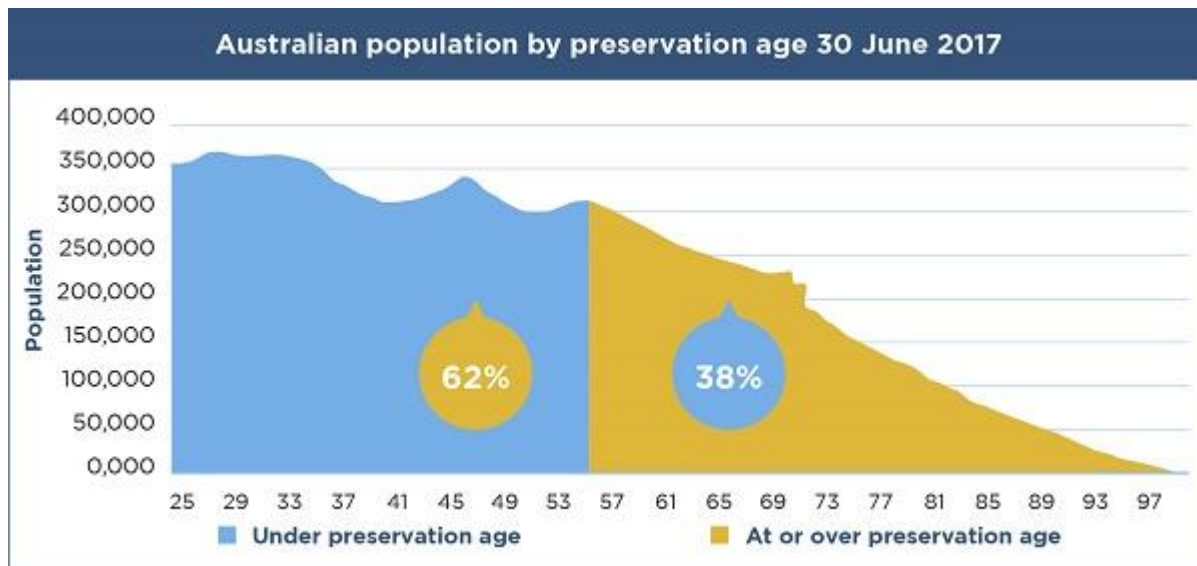
A Real Lifetime Pension is an investment-linked lifetime income stream that's guaranteed to last for life but where the payment level is linked to the performance of the professionally-managed investment option selected. It means when you reach age 65, you can secure an income in retirement that, depending on how long you live, is 20% – 30% in aggregate higher than the aggregate account-based pension minimums (with the same investment choice). It removes the worry of running out of savings if markets perform poorly or if you live well beyond your life expectancy, and who doesn't want to do that?

The Real Lifetime Pension lets superannuation funds insure mortality risk whilst still offering members investment choice, providing the retiree with an income no matter how long they live. It gives the ability to switch between different investment options and can be offered as both an immediate or deferred pension. In our product, the longevity risk is underwritten by the world's third-largest reinsurer, Hannover Re.

For those impacted by Centrelink means testing, options (2) and (3) will also result in a higher age pension than option (1) from 1 July 2019.

Trustees must tackle the retirement time bomb

We are able to access our super once we have reached preservation age. Our individual preservation age is between 55 and 60 depending upon our date of birth. The following chart shows how many of us are increasingly approaching preservation age.



Australian population by preservation age, 30 June 2017

Many super funds find it challenging to retain us as members when we retire. Failure to provide effective solutions that are in our best interests as we age may potentially result in a range of challenges for super funds:

- **loss of members to other institutions and SMSFs** which promise better retirement services and products. This includes pooled lifetime income products which are scheduled to receive preferential Centrelink means testing from 1 July 2019 that will result in higher age pensions for many retirees
- **trustees potentially failing to act** in the best interests of their retired members. Medical advancements will continue to increase life expectancies. One in three retired households will see at least one spouse live

into their late 90s. It could be argued that trustees are negligent if the only retirement product they offer fails to meet its desired outcome for at least one-third of its members

- **funds failing to retain adequate amounts** of their retirees' money to remain sustainable and maintain economies of scale
- **increased demand on cashflow** that causes more assets to be invested in liquid assets that could skew the available investment strategies, potentially reducing returns for all members.

This potential demographic time bomb can severely affect the long-term viability of super funds – and our retirement – and it is already ticking.

For each of us, including SMSF members, the investment linked-lifetime pension option (including a deferred version) can reduce or eliminate longevity risk and still allow the use of professional investment managers and switching between investment options.

David Orford is the Founder and Managing Director of [Optimum Pensions](#). Optimum Pensions was launched in late 2017 with the objective of providing innovative sustainable retirement income solutions.

Labor's \$3,000 cap on managing tax affairs

Bob Deutsch

On a long list of measures being proposed by Labor to close tax loopholes used by multinationals and 'the top end of town' is a proposal to cap the allowable tax deduction for managing tax affairs to \$3000. The full policy, *Plan for making multinationals pay their fair share*, is [linked here](#).

A deeper analysis

Labor's proposal to disallow any amount above \$3,000 spent on managing one's tax affairs as a tax deduction is a misguided and inappropriate policy response.

I say that for a number of reasons including:

- It appears to have been generated as a result of some 48 deduction claims which appear one way or another to have given rise to excessive amounts of foregone revenue. I know nothing about those 48 claims but no matter how egregious they are, it is hardly appropriate to respond by subjecting the whole taxpaying community to this broad-brush draconian response.
- The well-heeled will continue to pay for these tax management services irrespective of the tax deductibility as they have the funds to do so. The people who will suffer the consequences are especially those who are experiencing change requiring careful tax advice which currently could depending on the circumstances be fully deductible but will now be restricted to a \$3,000 deduction. This could include either partner in a divorce situation, either partner left after the death of a spouse or partner, and people in small business restructure arrangements.

All these can require complex and involved tax advice which will be far more expensive as a result of this proposal.

Tax agents as front-line auditors

Since the introduction of self-assessment, the Australian Tax Office has effectively been using tax agents as quasi front-line auditors to weed out bogus or inflated claims.

While the majority of agents have done a good job in playing that role, there is no doubt that some aspects of that work have not been done to the standard required. With that in mind there is now a clear and unambiguous process being undertaken to remove the worst elements through regulation and education. As a result, I am confident, and the latest figures do bear this out, that overall standards are improving.

That process however will not be helped by a heavy-handed approach that will make competent, entirely legal tax advice more expensive especially when provided by tax advisors who are doing their best to ensure their clients comply with the law.

This proposal is deeply flawed and should be abandoned at the earliest opportunity.

The Tax Institute has written to the Leader of the Opposition, the Hon Bill Shorten MP, expressing the Institute's concerns over the comments recently made in the media by the Leader of the Opposition that the availability of a tax deduction for fees incurred for tax services provided by accountants are a 'rort' and should be capped at \$3,000. The Institute opposes such a measure. A copy of the letter is reproduced below, or can be accessed as a pdf [here](#).

Bob Deutsch is Senior Tax Counsel at [The Tax Institute](#).

From Tim Neilson, President of The Tax Institute, to Bill Shorten

Dear Mr Shorten,

Re comments attributed in the media to you concerning tax advisers

It has been reported in the [media recently](#) that you described the long standing, express statutory availability of a tax deduction for assistance from a lawfully authorised tax practitioner as a "rort", and propose that a Labor government would cap that deduction at \$3,000.

The purpose of this letter is to present The Tax Institute's view on that deduction in the context of Australia's tax system and the role played in it by tax practitioners. (The Tax Institute is the leading forum for the tax community in Australia. For further information, please refer to the Appendix.)

Australia's tax laws now run to many thousands of pages. Ordinary Australians did not ask for that. It has been inflicted on them by successive governments.

Over 30 years ago, the Commonwealth government decided to abdicate primary responsibility for administering its own tax laws and to impose that responsibility, via the so-called "self-assessment" system, on ordinary Australians, and to subject ordinary Australians to the threat of severe penalties if they failed to achieve perfection in carrying out that newly imposed obligation.

The apparent intention of that measure was to reduce the administrative costs incurred directly by government. The correlative effect was to increase drastically the costs incurred by many Australians in seeking to meet their new obligations.

Not surprisingly, today most Australians employ a registered tax agent to assist them with the task of complying with the "self-assessment" regime. They pay the agent, and in accordance with the letter of the law claim a deduction for that payment.

Many such Australians have comparatively simple financial affairs and would pay less than \$3,000 for such assistance. But many don't. If they are to obey the laws government has chosen to impose on them they need help. In many cases they will need more than \$3,000 of assistance. For example:

- someone considering making the leap of faith to create a new business, which may in time provide employment and prosperity to many other Australians, will need extensive advice on the tax consequences of all aspects of that decision;*
- many people with foreign income or assets e.g. migrants need to address aspects of tax law that are complex even by the standards of the tax regime in general;*
- people facing difficult circumstances such as a family that has suffered bereavement often need specialist assistance to sort out unwelcome problems.*

It has been reported that one purported "justification" of the proposed measure is that some proportion of the tax compliance expenses is paid by some taxpayers for advice on complying with the law in a way that carries a reduced tax cost.

Firstly, as noted above, there can be many other reasons why an ordinary Australian would pay more than \$3,000 for tax assistance. It is a matter of public record that Labor appears to have announced this policy on the basis of deficient information, considerably overestimating the amount of money actually spent on

such tax assistance. Once that total amount is correctly identified, there remains the question of how much of that total is spent on advice on reducing tax and how much is necessarily spent merely on calculating and reporting taxpayers' liabilities. The Institute strongly believes that many taxpayers spend considerably more than \$3,000 solely on the latter.

Secondly, so what if taxpayers do pay for such advice? Australians pay architects to design the best possible living space in accordance with planning laws. They use buyers' advocates to get the cheapest house price, insurance brokers to get the cheapest insurance and travel advisers to get the cheapest holidays. What's wrong with them saying to their tax advisers "these are my circumstances – how do I comply with the tax laws at the least cost?" Does Labor believe that Australians should be practically compelled to pay more tax than the law requires, by the costs of tax assistance being made considerably more expensive through the de facto tax increase of denied deductibility?

The Tax Institute is proud of the fact that vast numbers of its members provide essential help to vast numbers of ordinary Australian taxpayers in complying with the often bewildering and onerous demands that the tax law imposes on them. The work of qualified tax professionals is an essential part of Australia's tax system, as has been recognized for many years, especially since the advent of the self-assessment regime. Tax deductibility of advice in complying with tax laws is a legitimate expense of business, investment or other income earning activities. We utterly reject the notion that an open, express and long standing right to a tax deduction for costs in complying with laws imposed by government is a rort, and strongly oppose a de facto tax increase by restriction of that right.

Whatever motivated the remarks which this letter addresses, many of the Institute's members have interpreted them as insulting to them and their clients. The Tax Institute urges Labor to acknowledge publicly the importance of taxpayers getting the assistance they need to comply with the tax system and that that advice often legitimately costs well over \$3,000 and to reconsider this ill-informed and counterproductive proposal.

If you would like to discuss any of the above, please contact me on 02 8223 0003.

Yours faithfully,

Tim Neilson
President

CC The Hon Chris Bowen MP
CC The Hon Dr Andrew Leigh MP

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